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Accounting Fraud at WorldCom

WorldCom could not have failed as a result of the actions of a limited number of individuals. Rather, there was a broad breakdown of the system of internal controls, corporate governance and individual responsibility, all of which worked together to create a culture in which few persons took responsibility until it was too late.

—Richard Thornburgh, former U.S. attorney general[1]

On July 21, 2002, WorldCom Group, a telecommunications company with more than $30 billion in revenues, $104 billion in assets, and 60,000 employees, filed for bankruptcy protection under Chapter 11 of the U.S. Bankruptcy Code. Between 1999 and 2002, WorldCom had overstated its pre-tax income by at least $7 billion, a deliberate miscalculation that was, at the time, the largest in history. The company subsequently wrote down about $82 billion (more than 75%) of its reported assets.[2] WorldCom's stock, once valued at $180 billion, became nearly worthless. Seventeen thousand employees lost their jobs; many left the company with worthless retirement accounts. The company's bankruptcy also jeopardized service to WorldCom's 20 million retail customers and on government contracts affecting 80 million Social Security beneficiaries, air traffic control for the Federal Aviation Association, network management for the Department of Defense, and long-distance services for both houses of Congress and the General Accounting Office.

Background

WorldCom's origins can be traced to the 1983 breakup of AT&T. Small, regional companies could now gain access to AT&T's long-distance phone lines at deeply discounted rates.[3] LDDS (an acronym for Long Distance Discount Services) began operations in 1984, offering services to local retail and commercial customers in southern states where well-established long-distance companies, such as MCI and Sprint, had little presence. LDDS, like other of these small regional companies, paid to use or lease facilities belonging to third parties. For example, a call from an LDDS customer in New Orleans to Dallas might initiate on a local phone company's line, flow to LDDS's leased network, and then transfer to a Dallas local phone company to be completed. LDDS paid both the

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[1] Matthew Bakarak, "Reports Detail WorldCom Execs' Domination," *AP Online*, June 9, 2003.

[2] WorldCom's writedown was, at the time, the second largest in U.S. history, surpassed only by the $101 billion writedown taken by AOL Time Warner in 2002.

[3] Lynne W. Jeter, *Disconnected: deceit and betrayal at WorldCom* (Hoboken, NJ: John Wiley & Sons, 2003), pp. 17–18.

Professor Robert S. Kaplan and Senior Researcher David Kiron, Global Research Group, prepared this case. The case was developed from published sources and draws heavily from Dennis R. Beresford, Nicholas deB. Katzenbach, and C.B. Rogers, Jr., "Report of Investigation," Special Investigative Committee of the Board of Directors of WorldCom, Inc., March 31, 2003. References to this report are identified by alphabetic letters which refer to information in the endnotes. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

New Orleans and Dallas phone company providers for using their local networks, and the telecommunications company whose long-distance network it leased to connect New Orleans to Dallas. These line-cost expenses were a significant cost for all long-distance carriers.

LDDS started with about $650,000 in capital but soon accumulated $1.5 million in debt since it lacked the technical expertise to handle the accounts of large companies that had complex switching systems. The company turned to Bernard J. (Bernie) Ebbers, one of its original nine investors, to run things. Ebbers had previously been employed as a milkman, bartender, bar bouncer, car salesman, truck driver, garment factory foreman, high school basketball coach, and hotelier. While he lacked technology experience, Ebbers later joked that his most useful qualification was being "the meanest SOB they could find."[4] Ebbers took less than a year to make the company profitable.

Ebbers focused the young firm on internal growth, acquiring small long-distance companies with limited geographic service areas and consolidating third-tier long-distance carriers with larger market shares. This strategy delivered economies of scale that were critical in the crowded long-distance reselling market. "Because the volume of bandwidth determined the costs, more money could be made by acquiring larger pipes, which lowered per unit costs," one observer remarked.[5] LDDS grew rapidly through acquisitions across the American South and West and expanded internationally through acquisitions in Europe and Latin America. (See **Exhibit 1** for a selection of mergers between 1991 and 2002.) In 1989, LDDS became a public company through a merger with Advantage Companies, a company that was already trading on Nasdaq. By the end of 1993, LDDS was the fourth-largest long-distance carrier in the United States. After a shareholder vote in May 1995, the company officially became known as WorldCom.

The telecommunications industry evolved rapidly in the 1990s. The industry's basic market expanded beyond fixed-line transmission of voice and data to include the transport of data packets over fiber-optic cables that could carry voice, data, and video. The Telecommunications Act of 1996 permitted long-distance carriers to compete for local service, transforming the industry's competitive landscape. Companies scrambled to obtain the capability to provide their customers a single source for all telecommunications services.

In 1996, WorldCom entered the local service market by purchasing MFS Communications Company, Inc., for $12.4 billion. MFS's subsidiary, UUNET, gave WorldCom a substantial international presence and a large ownership stake in the world's Internet backbone. In 1997, WorldCom used its highly valued stock to outbid British Telephone and GTE (then the nation's second-largest local phone company) to acquire MCI, the nation's second-largest long-distance company. The $42 billion price represented, at the time, the largest takeover in U.S. history. By 1998, WorldCom had become a full-service telecommunications company, able to supply virtually any size business with a full complement of telecom services. WorldCom's integrated service packages and its Internet strengths gave it an advantage over its major competitors, AT&T and Sprint. Analysts hailed Ebbers and Scott Sullivan, the CFO who engineered the MCI merger, as industry leaders.[6]

In 1999, WorldCom attempted to acquire Sprint, but the U.S. Justice Department, in July 2000, refused to allow the merger on terms that were acceptable to the two companies. The termination of this merger was a significant event in WorldCom's history. WorldCom executives realized that large-scale mergers were no longer a viable means of expanding the business.[a] WorldCom employees

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4 Jeter, p. 27.

5 Jeter, p. 30.

6 *CFO Magazine* awarded Sullivan its CFO Excellence award in 1998; *Fortune* listed Ebbers as one of its "People to Watch 2001."

noted that after the turndown of the Sprint merger, "Ebbers appeared to lack a strategic sense of direction, and the Company began drifting."[b]

Corporate Culture

WorldCom's growth through acquisitions led to a hodgepodge of people and cultures. One accountant recalled, "We had offices in places we never knew about. We'd get calls from people we didn't even know existed." WorldCom's finance department at the Mississippi corporate headquarters maintained the corporate general ledger, which consolidated information from the incompatible legacy accounting systems of more than 60 acquired companies. WorldCom's headquarters for its network operations, which managed one of the largest Internet carrier businesses in the world, was based in Texas. The human resources department was in Florida, and the legal department in Washington, D.C.

> None of the company's senior lawyers was located in Jackson. [Ebbers] did not include the Company's lawyers in his inner circle and appears to have dealt with them only when he felt it necessary. He let them know his displeasure with them personally when they gave advice—however justified—that he did not like. In sum, Ebbers created a culture in which the legal function was less influential and less welcome than in a healthy corporate environment.[c]

A former manager added, "Each department had its own rules and management style. Nobody was on the same page. In fact, when I started in 1995, there were no written policies."[7] When Ebbers was told about an internal effort to create a corporate code of conduct, he called the project a "colossal waste of time."[d]

WorldCom encouraged "a systemic attitude conveyed from the top down that employees should not question their superiors, but simply do what they were told."[e] Challenges to more senior managers were often met with denigrating personal criticism or threats. In 1999, for example, Buddy Yates, director of WorldCom General Accounting, warned Gene Morse, then a senior manager at WorldCom's Internet division, UUNET, "If you show those damn numbers to the f****ing auditors, I'll throw you out the window."[8]

Ebbers and Sullivan frequently granted compensation beyond the company's approved salary and bonus guidelines for an employee's position to reward selected, and presumably loyal, employees, especially those in the financial, accounting, and investor relations departments. The company's human resources department virtually never objected to such special awards.[9]

Employees felt that they did not have an independent outlet for expressing concerns about company policies or behavior. Several were unaware of the existence of an internal audit department, and others, knowing that Internal Audit reported directly to Sullivan, did not believe it was a productive outlet for questioning financial transactions.[f]

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[7] Jeter, p. 55.

[8] Personal correspondence, Gene Morse.

[9] Kay E. Zekany, Lucas W. Braun, and Zachary T. Warder, "Behind Closed Doors at WorldCom: 2001," *Issues in Accounting Education* (February 2004): 103.

Expense-to-Revenue (E/R) Ratio

In the rapid expansion of the 1990s, WorldCom focused on building revenues and acquiring capacity sufficient to handle expected growth. According to Ebbers, in 1997, "Our goal is not to capture market share or be global. Our goal is to be the No. 1 stock on Wall Street."[10] Revenue growth was a key to increasing the company's market value.[11] The demand for revenue growth was "in every brick in every building," said one manager.[g] "The push for revenue encouraged managers to spend whatever was necessary to bring revenue in the door, even if it meant that the long-term costs of a project outweighed short-term gains. . . . As a result, WorldCom entered into long-term fixed rate leases for network capacity in order to meet the anticipated increase in customer demand."[h]

The leases contained punitive termination provisions. Even if capacity were underutilized, WorldCom could avoid lease payments only by paying hefty termination fees. Thus, if customer traffic failed to meet expectations, WorldCom would pay for line capacity that it was not using.

Industry conditions began to deteriorate in 2000 due to heightened competition, overcapacity, and the reduced demand for telecommunications services at the onset of the economic recession and the aftermath of the dot-com bubble collapse. Failing telecommunications companies and new entrants were drastically reducing their prices, and WorldCom was forced to match. The competitive situation put severe pressure on WorldCom's most important performance indicator, the E/R ratio (line-cost expenditures to revenues), closely monitored by analysts and industry observers.

WorldCom's E/R ratio was about 42% in the first quarter of 2000, and the company struggled to maintain this percentage in subsequent quarters while facing revenue and pricing pressures and its high committed line costs. Ebbers made a personal, emotional speech to senior staff about how he and other directors would lose everything if the company did not improve its performance.[i]

As business operations continued to decline, however, CFO Sullivan decided to use accounting entries to achieve targeted performance. Sullivan and his staff used two main accounting tactics: accrual releases in 1999 and 2000, and capitalization of line costs in 2001 and 2002.[12]

Accrual Releases

WorldCom estimated its line costs monthly. Although bills for line costs were often not received or paid until several months after the costs were incurred, generally accepted accounting principles required the company to estimate these expected payments and match this expense with revenues in its income statement. Since the cash for this expense had not yet been paid, the offsetting entry was an accounting accrual to a liability account for the future payment owed to the line owner. When WorldCom paid the bills to the line owner, it reduced the liability accrual by the amount of the cash payment. If bills came in lower than estimated, the company could reverse (or release) some of the accruals, with the excess flowing into the income statement as a reduction in line expenses.

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[10] R. Charan, J. Useen, and A. Harrington, "Why Companies Fail," *Fortune* (Asia), May 27, 2002, pp. 36–45.

[11] Zekany et al., p. 103.

[12] The company also used aggressive revenue-recognition methods at the end of each reporting quarter to "close the gap" with Ebbers's aggressive revenue forecasts; see Zekany et al., pp. 112–114, and Beresford, Katzenbach, and Rogers, Jr., pp. 13–16.

Throughout 1999 and 2000, Sullivan told staff to release accruals that he claimed were too high relative to future cash payments. Sullivan apparently told several business unit managers that the MCI merger had created a substantial amount of such overaccruals. Sullivan directed David Myers (controller) to deal with any resistance from senior managers to the accrual releases.

In one instance, Myers asked David Schneeman, acting CFO of UUNET, to release line accruals for his business unit. When Schneeman asked for an explanation, Myers responded: "No, you need to book the entry." When Schneeman refused, Myers told him in another e-mail, "I guess the only way I am going to get this booked is to fly to D.C. and book it myself. Book it right now, I can't wait another minute."[j] Schneeman still refused. Ultimately, staff in the general accounting department made Myers's desired changes to the general ledger. (See **Exhibit 2** for a partial organizational chart.)

In another instance, Myers asked Timothy Schneberger, director of international fixed costs, to release $370 million in accruals. "Here's your number," Myers reportedly told Schneberger, asking him to book the $370 million adjustment. Yates, director of General Accounting, told Schneberger the request was from "the Lord Emperor, God himself, Scott [Sullivan]." When Schneberger refused to make the entry and also refused to provide the account number to enable Myers to make the entry, Betty Vinson, a senior manager in General Accounting, obtained the account number from a low-level analyst in Schneberger's group and had one of her subordinates make the entry.[k] Employees in the general accounting department also made accrual releases from some departments without consulting the departments' senior management. In 2000, General Accounting released $281 million against line costs from accruals in the tax department's accounts, an entry that the tax group did not learn about until 2001.

Over a seven-quarter period between 1999 and 2000, WorldCom released $3.3 billion worth of accruals, most at the direct request of Sullivan or Myers. Several business units were left with accruals for future cash payments that were well below the actual amounts they would have to pay when bills arrived in the next period.

Expense Capitalization

By the first quarter of 2001, so few accruals were left to release that this tactic was no longer available to achieve the targeted E/R ratio.[l] Revenues, however, continued to decline, and Sullivan, through his lieutenants Myers and Yates, urged senior managers to maintain the 42% E/R ratio. Senior staff described this target as "wildly optimistic," "pure fantasy," and "impossible." One senior executive described the pressure as "unbearable—greater than he had ever experienced in his fourteen years with the company."[m]

Sullivan devised a creative solution. He had his staff identify the costs of excess network capacity. He reasoned that these costs could be treated as a capital expenditure, rather than as an operating cost, since the contracted excess capacity gave the company an opportunity to enter the market quickly at some future time when demand was stronger than current levels. An accounting manager in 2000 had raised this possibility of treating periodic line costs as a capital expenditure but had been rebuffed by Yates: "David [Myers] and I have reviewed and discussed your logic of capitalizing excess capacity and can find no support within the current accounting guidelines that would allow for this accounting treatment."[n]

In April 2001, however, Sullivan decided to stop recognizing expenses for unused network capacity.[13] He directed Myers and Yates to order managers in the company's general accounting department to capitalize $771 million of non-revenue-generating line expenses into an asset account, "construction in progress." The accounting managers were subsequently told to reverse $227 million of the capitalized amount and to make a $227 million accrual release from ocean-cable liability.

WorldCom's April 26, 2001 press release and subsequent 10-Q quarterly report filed with the U.S. Securities and Exchange Commission (SEC) reported $4.1 billion of line costs and capital expenditures that included $544 million of capitalized line costs. With $9.8 billion in reported revenues, WorldCom's line-cost E/R ratio was announced at 42% rather than the 50% it would have been without the reclassification and accrual release.[o] (**Exhibit 3** shows a selection of WorldCom false statements in filings to the SEC.)

General Accounting Department

Betty Vinson, a native of Jackson, Mississippi, joined WorldCom in 1996, when she was 40 years old, as a manager in the international accounting division. She soon developed a reputation as a hardworking, loyal employee who would do "anything you told her" and often voluntarily worked extra hours at night, while at home, and on vacation.[14] Her good work soon led to a promotion to senior manager in General Accounting. In October 2000, Vinson and her colleague Troy Normand (another manager in General Accounting) were called into their boss's office. Their boss, Yates, told them that Myers and Sullivan wanted them to release $828 million of line accruals into the income statement. Vinson and Normand were "shocked" by their bosses' proposal and told Yates that the proposal was "not good accounting."[15] Yates replied that he was not happy about the transfer either, but after Myers had assured him that it would not happen again, he had agreed to go along. After some debate, Vinson and Normand agreed to make the transfer. When the company publicly reported its third-quarter results, however, Vinson and Normand reconsidered their decision and told Yates that they were planning to resign.

Ebbers heard about the accountants' concerns and (according to another WorldCom employee) told Myers that the accountants would not be placed in such a difficult position again. A few days later, Sullivan talked to Vinson and Normand about their resignation plans: "Think of us as an aircraft carrier. We have planes in the air. Let's get the planes landed. Once they are landed, if you still want to leave, then leave. But not while the planes are in the air."[16]

Sullivan assured them that they were doing nothing illegal and that he would take full responsibility for their actions. Vinson decided against quitting. She earned more than her husband, and her WorldCom position paid for the family's insurance benefits. She knew that it would be difficult to find alternative work in the community with comparable compensation. Moreover, while she and Normand had doubts about the accounting transfers, they believed that Sullivan, with his "whiz kid" CFO reputation, probably knew what he was doing.

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[13] Sullivan's rationale, formally described in a two-page white paper, was rejected by the SEC, independent auditors, and WorldCom's own senior managers.

[14] Susan Pulliman, "WorldCom Whistleblowing," *The Wall Street Journal*, June 23, 2003.

[15] Ibid.

[16] Ibid., p. 1.

In April 2001, Vinson and Normand were again placed in a difficult position, except this time the position was, from Vinson's perspective, even less defensible. Revenues in the quarter were worse than expected, and Sullivan wanted them to transfer $771 million of line costs into capital expenditures.[17] Vinson was again shocked at the request but was reluctant to quit without another job. She knew Myers and Yates had already acquiesced to Sullivan's request. It was her job to distribute the amount across five capital accounts. She felt trapped but eventually made the entries and backdated them to February 2001.

Vinson continued to make similar entries throughout 2001 but began losing sleep, withdrawing from workers, and losing weight. Each time she hoped it would be the last, yet the pressure continued. In early 2002, she received a raise (to roughly $80,000) and a promotion to director. In April 2002, Yates, Normand, and Vinson reviewed the first-quarter report, which included $818 million in capitalized line costs. They also learned that achieving Ebbers's projections would require making similar entries for the remainder of the year. They made a pact to stop making such entries.

Internal Audit

Cynthia Cooper, a strong-willed, 38-year-old, nine-year WorldCom veteran, headed WorldCom's 24-member internal audit department. Cooper had grown up in Clinton, Mississippi, WorldCom's headquarters since 1998. Her high school teacher of accounting was the mother of one of her senior auditors. Gene Morse also was working in Internal Audit, as a senior manager; he had transferred after Yates threatened him, in October 1999, about speaking to external auditors. Internal Audit reported directly to CFO Sullivan for most purposes. It conducted primarily operational audits to measure business unit performance and enforce spending controls. Arthur Andersen, WorldCom's independent auditors, performed the financial audits to assess the reliability and integrity of the publicly reported financial information. Andersen reported to the audit committee of the company's board of directors.[18]

In August 2001, Cooper began a routine operational audit of WorldCom's capital expenditures. Sullivan instructed Myers to restrict the scope of Cooper's inquiry: "We are not looking for a comprehensive Capex audit but rather very in depth in certain areas and spending." Cooper's audit revealed that Corporate had capital expenditures of $2.3 billion. By way of comparison, WorldCom's operations and technology group, which ran the company's entire telecommunications network, had capital expenditures of $2.9 billion. Internal Audit requested an explanation of Corporate's $2.3 billion worth of projects. Cooper's team received a revised chart indicating that Corporate had only $174 million in expenditures. A footnote reference in this chart indicated that the remainder of the $2.3 billion included a metro lease buyout, line costs, and some corporate-level accruals.

In March 2002, the head of the wireless business unit complained to Cooper about a $400 million accrual in his business for expected future cash payments and bad-debt expenses that had been transferred away to pump up company earnings. Both Sullivan and the Arthur Andersen team had supported the transfer. Cooper asked one of the Andersen auditors to explain the transfer, but he

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[17] This figure was subsequently reduced to $544 million when Sullivan and Myers found $227 million worth of accruals that could be released for the quarter.

[18] This audit was described as operational in nature, with an emphasis on actual spending in the field, capitalization of labor costs, and cash management. Internal Audit focused on operational and not financial statement audits at this time in order to avoid duplicating the work Andersen was doing; one employee told us that Internal Audit also wanted to avoid being seen as digging in Scott Sullivan's " backyard" when the group reported to him. (Beresford, Katzenbach, and Rogers, Jr., p. 119.)

refused, telling her that he took orders only from Sullivan. Morse recalled: "That was like putting a red flag in front of a bull. She came back to me and said, 'Go dig.'"[19]

Cooper brought the issue to WorldCom's audit committee but was told by Sullivan, after the audit committee meeting, to stay away from the wireless business unit. Cooper recalled Sullivan screaming at her in a way she had never been talked to before, by anyone.[p]

Also in March 2002, SEC investigators sent WorldCom a surprise "request for information." The SEC wanted to examine company data to learn how WorldCom could be profitable while other telecom companies were reporting large losses.

Cooper decided, unilaterally and without informing Sullivan, to expand Internal Audit's scope by conducting a financial audit. Cooper asked Morse, who had good computer expertise, to access the company's computerized journal entries. Such access was granted only with Sullivan's permission, which they definitely did not have. But Morse, anticipating a need for unlimited access to the company's financial systems, had previously persuaded a senior manager in WorldCom's IT department to allow him to use the systems to test new software programs.

The software enabled Morse to find the original journal entry for virtually any expense. Morse worked at night, when his activities were less likely to clog the network.[20] By day, Morse examined his downloaded materials in the audit library, a small windowless room. He copied incriminating data onto a CD-ROM so that the company could not subsequently destroy the evidence. Morse, a gregarious father of three, was so concerned with secrecy that he did not tell his wife what he was doing and instructed her not to touch his briefcase.

The Outside Auditor: Arthur Andersen

WorldCom's independent external auditor from 1990 to 2002 was Arthur Andersen. Andersen considered WorldCom to be its "flagship" and most "highly coveted" client, the firm's "Crown Jewel."[q] Andersen viewed its relationship with WorldCom as long term and wanted to be considered as a committed member of WorldCom's team. One indicator of its commitment came after the company merged with MCI. Andersen, which had a Mississippi-based team of 10–12 people working full time on WorldCom's audits, underbilled the company and justified the lower charges as a continuing investment in its WorldCom relationship.

Originally, Andersen did its audit "the old-fashioned way," testing thousands of details of individual transactions and reviewing and confirming account balances in WorldCom's general ledger. As WorldCom's operations expanded through mergers and increased scope of services, Andersen adopted more efficient and sophisticated audit procedures, based on analytic reviews and risk assessments. The auditors focused on identifying risks and assessing whether the client company had adequate controls in place to mitigate those risks, for example, for mistakenly or deliberately misrepresenting financial data. In practice, Andersen reviewed processes, tested systems, and assessed whether business unit groups received correct information from the field. Its auditors assumed that the information recorded by General Accounting was valid. It typically requested the same 20 to 30 schedules of high-level summaries to review each quarter, including a schedule of

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[19] Susan Pulliman and Deborah Solomon, "Uncooking the Books," *The Wall Street Journal*, October 30, 2002.

[20] In an early effort, Morse attempted to download a large number of transactions from one account and crashed the system, which drew attention to his efforts.

topside entries made by General Accounting directly to the corporate general ledger after the close of a quarter.[r]

Andersen also assessed the risk that expenditures for payroll, spare parts, movable parts, and capital projects were being properly recorded and classified as expenses or assets by reviewing the relevant approval process. For line costs, Andersen assessed the risk that line-cost liabilities might be understated or overstated by testing whether the domestic telco accounting group received accurate information from the field. It did not perform comparable tests for the international line-cost group even after WorldCom employees told Andersen's U.K. audit team about a corporate reversal of $34 million in line-cost accruals after the first quarter of 2000.[s] Andersen focused primarily on the risk that WorldCom revenues would be misstated because of errors or inaccurate records, not by deliberate misrepresentation.

Between 1999 and 2001, Andersen's risk management software program rated WorldCom as a "high-risk" client for committing fraud, a conclusion that its auditors upgraded to "maximum risk" because of volatility in the telecommunications industry, the company's active merger and acquisition plans, and its reliance on a high stock price for acquisitions. The Andersen concurring partner said at the time of the 1999 risk upgrade, "If this job is not maximum, none are."[t] The engagement manager stated that there were "probably few other engagements where [Andersen] ha[d] a higher risk."

But the Andersen audit team for WorldCom did not modify its analytic audit approach and continued to audit WorldCom as a "moderate-risk" client. Andersen could have identified the fraudulent topside entries (accrual reversals and capitalized line costs) from a review of the company's general ledger, its primary transactional accounting record.[u] WorldCom, however, repeatedly refused Andersen's request to access the computerized general ledger. Also, Andersen's analytic review procedures, properly performed, should have triggered a search for accounting irregularities when WorldCom's quarterly financial statements reported stable financial ratios during a period of severe decline in the telecommunications industry: "[M]anagement's ability to continue to meet aggressive revenue growth targets, and maintain a 42% line cost expense-to-revenue ratio, should have raised questions. Instead of wondering how this could be, Andersen appeared to have been comforted by the absence of variances. Indeed, this absence led Andersen to conclude that no follow-up work was required."[v]

Myers, Stephanie Scott, and Mark Willson instructed WorldCom staff about what information could and could not be shared with Andersen. When Andersen auditors asked to speak with Ronald Lomenzo, senior vice president of financial operations, who oversaw international line-cost accruals, the request was refused. One employee commented: "Myers or Stephanie Scott would never permit it to happen."[w] In 1998, WorldCom's treasurer told the person in charge of security for WorldCom's computerized consolidation and financial reporting system never to give Andersen access. One employee said that she was specifically instructed not to tell Andersen that senior management orchestrated adjustments to domestic line-cost accruals. Myers told one employee who had continued to talk with Andersen's U.K. auditors, "Do not have any more meetings with Andersen for any reason. . . . Mark Willson has already told you this once. Don't make me ask you again."[x]

WorldCom also withheld information, altered documents, omitted information from requested materials, and transferred millions of dollars in account balances to mislead Andersen. In fact, special monthly revenue reports were prepared for Andersen:

> WorldCom provided Andersen with altered MonRevs [monthly revenue reports] that removed several of the more transparently problematic revenue items from the Corporate Unallocated schedule, and buried the revenue for these items elsewhere in the report. . . . After

> the third quarter of 2001, Stephanie Scott became concerned about how Andersen would react to the size of Corporate Unallocated revenue. . . . In the version prepared for Andersen, the Corporate Unallocated revenue items could no longer be identified by name and amount. . . . These items were removed from the Corporate Unallocated schedule and subsumed within a sales region's total revenue number.[y]

Andersen rated WorldCom's compliance with requests for information as "fair," never informing the audit committee about any restrictions on its access to information or personnel.

The Board of Directors

Between 1999 and 2002, nonexecutive members made up more than 50% of WorldCom's Board of Directors. The board members, most of whom were former owners, officers, or directors of companies acquired by WorldCom, included experts in law, finance, and the telecommunications industry (see **Exhibit 4**). Bert Roberts, Jr., former CEO of MCI, was chairman from 1998 until 2002. His actual role, however, was honorary. CEO Ebbers presided over board meetings and determined their agendas.

The board's primary interaction with WorldCom matters occurred at regularly scheduled meetings that took place about four to six times a year. With the occasional exception of Bobbitt (Audit) and Kellett (Compensation), none of the outside directors had regular communications with Ebbers, Sullivan, or any other WorldCom employee outside of board or committee meetings. Prior to April 2002, the outside directors never met by themselves.

A week prior to board meetings directors received a packet of information that contained an agenda, financial information from the previous quarter, draft minutes of the previous meeting, investor relations information such as analyst call summaries, and resolutions to consider at the upcoming meeting. The meetings consisted of a series of short presentations from the chairman of the compensation and stock option committee about officer loans and senior level compensation; the chairman of the audit committee;[21] the general counsel, who discussed legal and regulatory issues; CFO Sullivan, who discussed financial issues at a high level of generality for 30 minutes to an hour; and, on occasion, COO Ron Beaumont. This format did not change, even when the board considered large multibillion-dollar deals.[22]

Sullivan manipulated the information related to capital expenditures and line costs presented to the board. His presentation of total capital spending for the quarter included a breakdown on spending for local, data/long haul, Internet, and international operations and major projects. The board, which was expecting cuts in capital expenditures, received information that reflected a steady decrease. However, the spending cuts were far greater than they were led to believe. The hundreds of millions of dollars of capitalized line costs inflated the capital expenditures reported to the board (see **Table A**).

[21] A nominating committee, responsible for filling vacancies on the board, met only when vacancies occurred.

[22] Committees met separately in hour-long sessions. Special executive sessions discussed mergers and acquisitions.

Table A Report of Capital Expenditures to Board vs. Actual Capital Expenditures (in millions)

	3Q00	4Q00	1Q01	2Q01	3Q01	4Q01	1Q02
As reported to board	2,648	2,418	2,235	2,033	1,786	1,785	1,250
Actual spend, not shown to board			1,691	1,473	1,044	944	462

Source: Beresford, Katzenbach, and Rogers, Jr., p. 282.

Prior to the meetings, board members received line-cost information from a one-page statement of operations within a 15- to 35-page financial section. On this page, line costs were listed among roughly 10 other line items. In his hour-long PowerPoint presentations, Sullivan had a single slide that made quarterly comparisons of several budget items, including line costs. The investigative committee concluded:

> The Board and the Audit Committee were given information that was both *false and plausible*[z] [emphasis added]. . . . [Audit Committee] members do not appear to have been sufficiently familiar and involved with the Company's internal financial workings, with weaknesses in the Company's internal control structure, or with its culture. . . . To gain the knowledge necessary to function effectively . . . would have required a very substantial amount of energy, expertise by at least some of its members, and time—certainly more than the three to five hours a year the Audit Committee met.[aa]

Ebbers, in addition to his full-time job as WorldCom CEO, for which he was generously compensated,[23] had acquired and was managing several unrelated businesses, including hotels, real estate ventures, a Canadian cattle ranch, timberlands, a rice farm, a luxury-yacht-building company, an operating marina, a lumber mill, a country club, a trucking company, and a minor league hockey team.[bb] Ebbers financed the acquisitions of many of these businesses by commercial bank loans secured by his personal WorldCom stock. When WorldCom stock began to decline in 2000, Ebbers received margin calls from his bankers. In September 2000, the compensation committee began, at Ebbers's request, to approve loans and guarantees from WorldCom so that Ebbers would not have to sell his stock to meet the margin calls. The full board learned about the loans to Ebbers in November 2000, since the loans needed to be disclosed in the company's third-quarter 10-Q report. The board ratified and approved the compensation committee's actions. WorldCom did not receive any collateral from Ebbers or his business interests to secure these loans. Nor did the compensation committee oversee Ebbers's use of the funds, some of which were used to pay his companies' operating expenses. By April 29, 2002, the loans and guarantees to Ebbers exceeded $400 million.

According to the investigative committee, WorldCom's board was "distant and detached from the workings of the Company."[cc] It did not establish processes to encourage employees to contact outside directors about any concerns they might have about accounting entries or operational matters.[dd]

> The Board played far too small a role in the life, direction and culture of the company. The Audit Committee did not engage to the extent necessary to understand and address the financial issues presented by this large and extremely complex business: its members were not in a position to exercise critical judgment on accounting and reporting issues, or on the non-traditional audit strategy of their outside auditor. The Compensation Committee dispensed extraordinarily generous rewards without adequate attention to the incentives they created,

[23] Ebbers was ranked, for several years in a row, as among the highest paid CEOs in the United States.

and presided over enormous loans to Ebbers that we believe were antithetical to shareholder interests and unjustifiable on any basis.[ee]

On April 26, 2002, the nonexecutive directors met by themselves, for the first time, to discuss Ebbers's delay in providing collateral for his loans from the company. The directors, dissatisfied with Ebbers's lack of strategic vision and his diminished reputation on Wall Street, voted unanimously to ask Ebbers for his resignation. Within three days, the board signed a separation agreement with Ebbers that included a restructuring of his loans into a five-year note and a promise of a $1.5 million annual payment for life.[ff, 24]

The Endgame

Cooper's internal audit team, by the beginning of June 2002, had discovered $3 billion in questionable expenses, including $500 million in undocumented computer expenses. On June 11, Cooper met with Sullivan, who asked her to delay the capital expenditure audit until after the third quarter. Cooper refused. On June 17, Cooper and Glyn Smith, a manager on her team, went to Vinson's office and asked her to explain several questionable capital expense accounting entries that Internal Audit had found. Vinson admitted that she had made many of the entries but did not have any support for them. Cooper immediately went to Yates's office, several feet away, and asked him for an explanation. Yates denied knowledge of the entries and referred Cooper to Myers, who acknowledged the entries and admitted that no accounting standards existed to support them. Myers allegedly said the entries should not have been made, but that once it had started, it was hard to stop.[25]

On June 20, Cooper and her internal audit team met in Washington, D.C. with the audit committee and disclosed their findings of inappropriate capitalized expenses. When Sullivan could not provide an adequate explanation of these transactions, the board told Sullivan and Myers to resign immediately or they would be fired. Myers resigned. Sullivan did not and was promptly fired. On June 25, 2002, WorldCom announced that its profits had been inflated by $3.8 billion over the previous five quarters. Nasdaq immediately halted trading of WorldCom's stock. Standard & Poor's lowered its long-term corporate credit rating on WorldCom bonds from B+ to CCC-.

On June 26, the SEC initiated a civil suit of fraud against WorldCom. Attorneys in the U.S. Justice Department launched criminal investigations into the actions of Bernie Ebbers, Scott Sullivan, David Myers, Buford Yates, Betty Vinson, and Troy Normand.

[24] Subsequently, the corporate monitor and WorldCom's new management cancelled the $1.5 million annual payment and took control of some of Ebbers's personal business assets.

[25] Pulliman and Solomon.

Epilogue

Arthur Andersen was never held to account for its WorldCom audits. On June 13, 2002, after a six-week trial and 10 days of deliberations, jurors convicted Arthur Andersen for obstructing justice for its destruction of Enron documents while on notice of a federal investigation. After the verdict, the Securities and Exchange Commission announced that the accounting firm would cease practicing before the commission by August 31, 2002.

On August 28, 2002, David Myers pleaded guilty to three felony charges: securities fraud, conspiracy to commit fraud, and making false filings with the Securities and Exchange Commission. At the same time, the U.S. attorney brought criminal indictments against Sullivan and Yates, with Vinson and Normand named as unindicted co-conspirators. In October 2002, Yates, Vinson, and Normand each pleaded guilty to one count of securities fraud and one count of conspiracy to commit securities fraud, charges that carried a maximum sentence of 15 years in prison. Vinson was released on a bond secured by $25,000 of equity in her home. She was now working as an accountant for a large Kentucky Fried Chicken franchise.[26] Myers, Yates, Vinson, and Normand agreed to help prosecutors build cases against Sullivan and Ebbers while they awaited sentencing.

On March 2, 2004, Sullivan pleaded guilty to federal fraud and conspiracy charges that he deceived the public, the SEC, securities analysts, and others about WorldCom's true financial condition. Sullivan admitted: "I took these actions, knowing they were wrong, in a misguided effort to preserve the company to allow it to withstand what I believed were temporary financial difficulties. . . . I deeply regret my actions and sincerely apologize for the harm they have caused."[27]

U.S. Attorney General John Ashcroft announced, "Scott Sullivan faces a maximum sentence of 25 years in prison" and that Sullivan was cooperating with the government in its case against Ebbers.[28] Sullivan agreed to use the proceeds from the sale of his Florida home, on the market for $13 million, for restitution to WorldCom investors. The SEC, after filing a fraud action against Sullivan, reported that he had agreed to an order permanently barring him from serving as an officer or director of a public company.

Also on March 2, 2004, the U.S. Justice Department indicted Bernie Ebbers, who was then teaching Sunday school in Jackson, Mississippi, on the same federal fraud and conspiracy charges admitted to by Sullivan. Ebbers pleaded not guilty to the government's charges and asserted his innocence. On March 15, 2005, after a six week trial, Ebbers was found guilty of fraud, conspiracy, and filing false documents with regulators. These convictions could result in a prison term of up to 85 years. Mr. Ebbers had argued during the six-week trial that he was a salesman rather than a numbers man, but the jury did not accept that a fraud of such magnitude could have happened without his knowledge.

Cynthia Cooper remained as WorldCom's vice president of Internal Audit and was named by *Time* magazine, in December 2002, as one of its "Persons of the Year." She was not promoted, and no senior company executive had ever personally thanked her. Several employees resented Cooper, believing that her revelation of accounting irregularities had led to WorldCom's bankruptcy.

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[26] Susan Pulliman, "Over the Line," *The Wall Street Journal*, June 23, 2003.

27 Larry Neumeister, "Former WorldCom chief Ebbers charged, CFO Sullivan agrees to plea deal," *Associated Press*, March 2, 2004, http://www.boston.com/business/articles/2004/03/02/former_WorldCom_chief_ebbers_charged_cfo_sullivan_agrees_to_plea_deal/, accessed March 26, 2004.

[28] http://www.forbes.com/2004/03/02/cx_al_0302ebbers.html.

Exhibit 1 A Sample of WorldCom Mergers and Acquisitions, 1991–2001, with Acquisition Price for the Major Transactions

1991
- Mid-American Communications Corporation
- AmeriCall
- FirstPhone
- Advanced Telecommunications Corporation—Acquired for stock value of $850 million.
- World Communications, Inc.
- Dial-Net, Inc.
- TRT Communications, Inc.

1993
- Metromedia Communications Corporation and Resurgens Communications Group, Inc.—Acquired for $1.25 billion in stock and cash.

1994
- IDB Communications Group

1995
- Williams Telecommunications Group, Inc. (WilTel)—Acquired for $2.5 billion.

1996
- MFS Communications Company, Inc.—Acquired for $12.4 billion.
- TCL Telecom

1997
- BLT Technologies, Inc.
- NLnet

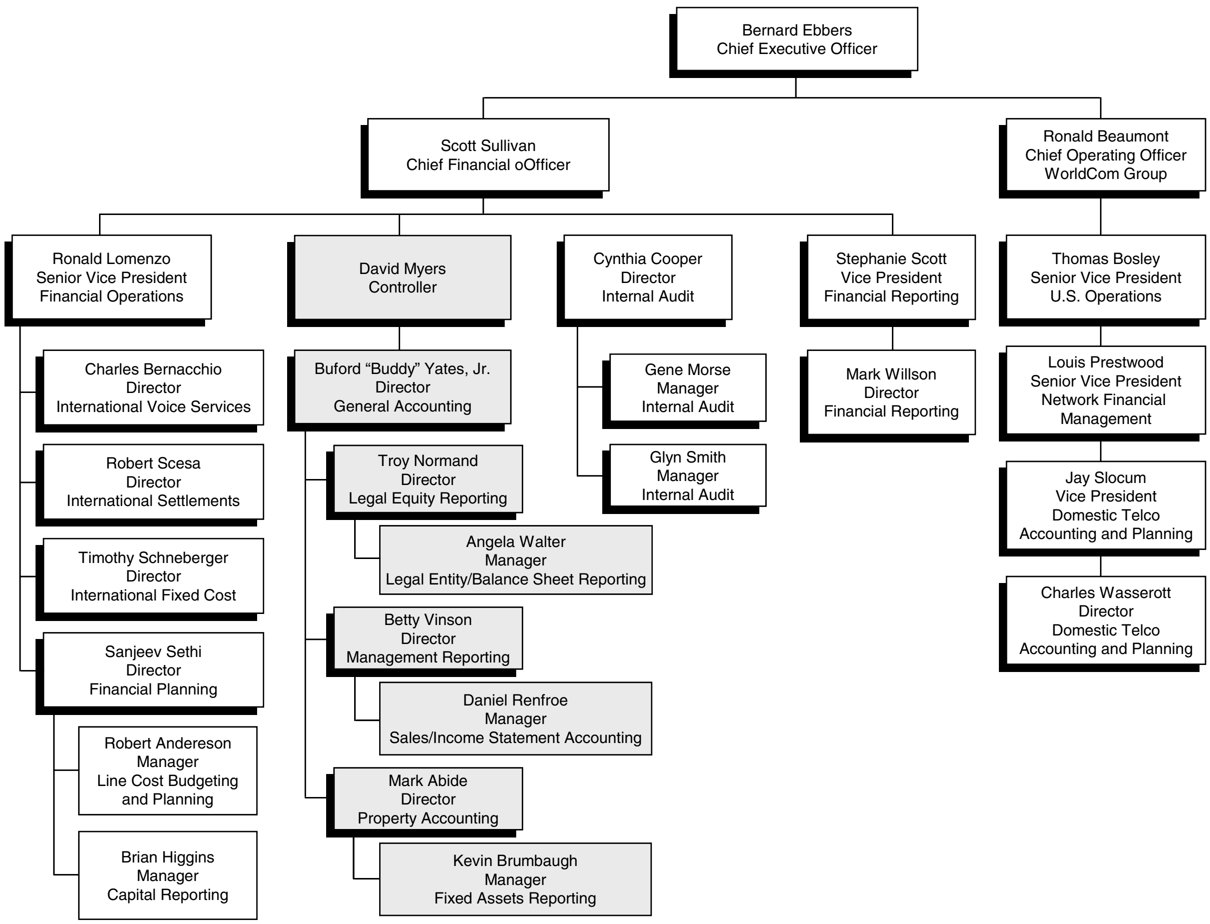
1998
- Brooks Fiber Properties, Inc.—Acquired for $2.0 billion.
- CompuServe Corporation and ANS Communications, Inc.— The WorldCom merger with CompuServe was valued at approximately $1.4 billion.
- MCI—Acquired for $40.0 billion.

1999
- ActiveNet
- CAI Wireless Systems, Inc.
- SkyTel

2001
- Intermedia Communications, Inc. (thereby gaining control of Digex, a leading provider of managed Web and application hosting services)—Acquired for approximately $6 billion ($3 billion in equity and $3 billion in debt and preferred stock).

Sources: WorldCom Web site press releases and Dennis R. Beresford, Nicholas de B. Katzenbach, and C.B. Rogers, Jr., "Report of Investigators," Special Investigative Committee of the Board of Directors of WorldCom, Inc., March 31, 2003.

Exhibit 2 Partial WorldCom Organizational Chart, 2002



Source: Adapted from Beresford, Katzenbach, and Rogers, "Report of Investigation," 2003.

Exhibit 3 Selected WorldCom False Statements to the Securities and Exchange Commission

Form Filed with the SEC	Reported Line-Cost Expenses ($ millions)	Actual Line-Cost Expenses ($ millions)	Reported Income before Taxes and Minority Interests ($ millions)	Actual Income (Loss) before Taxes and Minority Interests ($ millions)
10-Q, 3rd Qtr 2000	3,867	4,695	1,736	908
10-K, 2000	15,462	16,697	7,568	6,333
10-Q, 1st Qtr 2001	4,108	4,879	988	217
10-Q, 2nd Qtr 2001	3,730	4,290	159	(401)
10-Q, 3rd Qtr 2001	3,745	4,488	845	102
10-K, 2001	14,739	17,754	2,393	(622)
10-Q, 1st Qtr 2002	3,479	4,297	240	(578)

Source: U.S. District Court for the Southern District of New York 02 CV 8083 (JSR), COMPLAINT (Securities Fraud) Securities and Exchange Commission, Plaintiff, v. BETTY L. VINSON, and TROY M. NORMAND, defendants, http://www.sec.gov/litigation/complaints/comp17783.htm, accessed April 17, 2004.

Exhibit 4 WorldCom Board of Directors, as of 2001

Clifford L. Alexander Jr., 67, joined the board after the merger with MCI in 1998. He was previously a member of the MCI Board.

James C. Allen, 54, became a director in 1998 through the acquisition of Brooks Fiber Properties where he served as the vice chairman and CEO since 1983.

Judith Areen, 56, joined the board after the merger with MCI in 1998. She had previously been a member of the MCI Board. Areen was appointed executive vice president for Law Center Affairs and dean of the Law Center at Georgetown University in 1989.

Carl J. Aycock, 52, was an initial investor in LDDS and a director since 1983. He served as secretary of WorldCom from 1987 until 1995.

Ronald R. Beaumont, 52, was COO of WorldCom beginning in 2000 and had previously served both as the president and CEO of WorldCom's operations and technology unit and as the president of WorldCom Network Services, a subsidiary of WorldCom, Inc. Prior to 1996, Beaumont was president and CEO of a subsidiary of MFS Communications.

Max E. Bobbitt, 56, became a director in 1992 and served as chairman of the Audit Committee. He was president and CEO of Metromedia China Corporation from 1996 to 1997 and president and CEO of Asian American Telecommunications Corporation, which was acquired by Metromedia China Corporation in 1997.

Bernard J. Ebbers, 59, was the CEO of WorldCom since 1985 and a board member since 1983.

Francesco Galesi, 70, became a director in 1992. He was the chairman and CEO of the Galesi Group of companies, involved in telecommunications and oil and gas exploration and production.

Stiles A. Kellett Jr., 57, became a director in 1981 and served as chairman of the compensation and stock option committee.

Gordon S. Macklin, 72, became a director in 1998 after having served as chairman of White River Corporation, an information services company. He sat on several other boards and had formerly been chairman of Hambrecht and Quist Group and the president of the National Association of Securities Dealers, Inc.

Bert C. Roberts Jr., 58, was the CEO of MCI from 1991 to 1996 and served as chairman of the MCI Board beginning in 1992. He stayed on in this capacity after the WorldCom merger with MCI in 1998.

John W. Sidgmore, 50, was the vice chairman of the board and a director at WorldCom beginning in 1996. From 1996 until the MCI merger, he served as COO of WorldCom. He had previously been president and COO of MFS Communications Company, Inc. and an officer of UUNET Technologies, Inc.

Scott D. Sullivan, 39, became a director in 1996 after he was named CFO, treasurer, and secretary in 1994.

Source: "Annual Report for the Fiscal Year Ended December 31, 2000," WorldCom, Inc., March 31, 2001.

Endnotes

[a] Dennis R. Beresford, Nicholas de B. Katzenbach, and C.B. Rogers, Jr., "Report of Investigation," Special Investigative Committee of the Board of Directors of WorldCom, Inc., March 31, 2003, p. 49.

[b] Ibid.

[c] Ibid., p. 277.

[d] Ibid., p. 19.

[e] Ibid., p. 18.

[f] Ibid., p. 124.

[g] Ibid., p. 13.

[h] Ibid., p. 94.

[i] Ibid., pp. 94–95.

[j] Ibid., p. 83.

[k] Ibid., p. 71.

[l] Ibid., p. 16.

[m] Ibid., p. 94.

[n] Ibid., p. 99.

[o] Ibid., pp. 105–108.

[p] Ibid., p. 123.

[q] Ibid., p. 225.

[r] Ibid., p. 228.

[s] Ibid., p. 242.

[t] Ibid., p. 233.

[u] Ibid., p. 235.

[v] Ibid., p. 236.

[w] Ibid., p. 240.

[x] Ibid., p. 251.

[y] Ibid., p. 252.

[z] Ibid., p. 277.

[aa] Ibid., p. 286.

[bb] Ibid., pp. 294–295.

[cc] Ibid., p. 283.

[dd] Ibid., p. 290.

[ee] Ibid., p. 264.

[ff] Ibid., pp. 309–310.