

WorldCom's Bankruptcy Crisis

INTRODUCTION

The story of WorldCom began in 1983 when businessmen Murray Waldron and William Rector sketched out a plan to create a long-distance telephone service provider on a napkin in a coffee shop in Hattiesburg, Miss. Their new company, Long Distance Discount Service (LDDS), began operating as a long distance reseller in 1984. Early investor Bernard Ebbers was named CEO the following year. Through acquisitions and mergers, LDDS grew quickly over the next 15 years. The company changed its name to WorldCom, achieved a worldwide presence, acquired telecommunications giant MCI, and eventually expanded beyond long distance service to offer the whole range of telecommunications services. WorldCom became the second-largest long-distance telephone company in America, and the firm seemed poised to become one of the largest telecommunications corporations in the world. Instead, it became the largest bankruptcy filing in U.S. history at the time and another name on a long list of those disgraced by the accounting scandals of the early 21st century.

ACCOUNTING FRAUD AND ITS CONSEQUENCES

Unfortunately for thousands of employees and shareholders, WorldCom used questionable accounting practices and improperly recorded \$3.8 billion in capital expenditures, which boosted cash flows and profit over all four quarters in 2001 as well as the first quarter of 2002. This disguised the firm's actual net losses for the five quarters because capital expenditures can be deducted over a longer period of time, whereas expenses must be subtracted from revenue immediately. WorldCom also spread out expenses by reducing the book value of assets from acquired companies and simultaneously increasing the value of goodwill. The company also ignored or undervalued accounts receivable owed to the acquired companies.

These accounting practices made it appear as if WorldCom's financial situation was improving every quarter. As long as WorldCom continued to acquire new companies, accountants could adjust the values of assets and expenses. Internal investigations uncovered questionable accounting practices stretching as far back as 1999. Investors, unaware of the alleged fraud, continued to purchase the company's stock, which pushed the stock's price to \$64 per share.

Even before the improper accounting practices were disclosed, however, WorldCom was already in financial turmoil. Declining rates and revenues and an ambitious acquisition spree had pushed the company deeper in debt. The company also used the rising value of their stock to finance the purchase of other companies. However, it was the acquisition of these companies, especially MCI Communications, that made WorldCom stock so desirable to investors.

In addition, WorldCom's CEO Bernard Ebbers received a controversial \$408 million loan from the company's board of directors to cover margin calls on loans that were secured by company stock. The board loaned Ebbers the money at a rate below the national average and below their rate of

return. In July 2001, WorldCom signed a credit agreement with multiple banks to borrow up to \$2.65 billion and repay it within a year. According to the banks, WorldCom tapped the entire

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amount six weeks before the accounting irregularities were disclosed. The banks contend that if they had known WorldCom's true financial picture, they would not have extended the financing without demanding additional collateral.

On June 28, 2002, the Securities and Exchange Commission (SEC) directed WorldCom to disclose the facts underlying the events described in a June 25 press release regarding the company's intention to restate its 2001 and first quarter 2002 financial statements. The resulting document explained that CFO Scott Sullivan had prepared the financial statements for 2001 and the first quarter of 2002. WorldCom's audit committee and Arthur Andersen, the firm's outside auditor, had held a meeting on February 6, 2002, to discuss the audit for the year ending in December 31, 2001. Arthur Andersen had assessed WorldCom's accounting practices to determine whether there were adequate controls to prevent material errors in the financial statements. Andersen attested that WorldCom's processes for line cost accruals and for capitalization of assets in property and equipment accounts were effective. In response to specific questions by the committee, Andersen had also indicated that its auditors had no disagreements with management and that it was comfortable with the accounting positions taken by WorldCom.

PRESSURE TO COMMIT FRAUD

The trouble leading to the fraud had actually begun two years prior. In 2000, a downturn in the telecommunications industry was impacting WorldCom's bottom line. Its line costs—fees paid for leasing parts of other companies' telephone networks—were increasing compared to revenue. A few of WorldCom's clients went bankrupt, meaning they could not pay their bills valued at \$685 billion.

In response, pressure was placed on company accountants Betty Vinson and Troy Normand to reduce expenses so the firm could meet Wall Street's expectations. However, the two accountants were not able to cut enough expenses to make up for the shortfall. Their boss Buford Yates claimed that CFO Scott Sullivan and company controller David Myers had asked them to take \$828 million from a reserve account set aside for line costs and use it to pay expenses. This would violate accounting rules because reserves are supposed to be developed only if top managers believe there will be losses in that unit. Additionally, reserves should be developed for the unit in which the loss occurs, and there must be valid reasoning behind reducing the reserve account.

Vinson at first refused to make the changes. However, under increased pressure from management and concerns over how they were going to support their families, the accountants eventually caved in to the pressure with the promise that this accounting manipulation would only occur one time. Normand and Vinson later felt guilty about their actions and planned to resign. However, CFO Scott Sullivan convinced them that the company needed them to get them through this crisis. He claimed the transfer was not illegal and he would accept full responsibility for it. Vinson began to rationalize her involvement and decided against quitting.

Contrary to what they were initially told, the accountants were asked again and again to make accounting manipulations. Specifically, they were asked to make improper accounting transfers that involved shifting line costs from operating expense accounts into capital expenditure accounts. Because capital expenditures are subtracted from income over longer periods of time, the line expenses would not immediately detract from the bottom line when placed in capital expenditures. Vinson knew this was even worse than the \$828 million transfer over which she had felt such guilt.

However, she went along with the maneuver while she simultaneously looked for another job. The same issues occurred in the second, third, and fourth quarters of 2001, and the accountants continued to feel pressure to make the improper transfers to hide WorldCom's growing losses.

When the group realized that they would have to continue making these improper accounting entries to keep the company afloat throughout 2002, they finally refused and told the controller that they would no longer make the transfers. However, by this time the Securities and Exchange Commission was suspicious that WorldCom seemed to be doing so well when other telecommunications firms were struggling. The activities had also caught the attention of the internal audit division at WorldCom.

THE WHISTLEBLOWERS

In March 2002 the head of WorldCom's wireless business visited Cynthia Cooper, the 38-year-old vice president of internal audit at WorldCom. He reported that he had placed \$400 million aside to make up for customers who did not pay their bills. However, CFO Scott Sullivan had made the decision to take the \$400 million and use it to boost WorldCom's income. While this did not necessarily violate accounting rules, Cooper thought it was strange because accounting rules dictated that when companies do not collect on debts, they are supposed to set up reserves to cover the debt and keep from making it look like the firm has more value than it really does. When Cooper approached Arthur Andersen about the issue, her concerns were ignored.

Cooper, who felt it was her responsibility to inform the audit committee of what had occurred, took information about the reserves to the board. Sullivan would later phone her while she was at a hair salon and tell her not to discuss the matter with Andersen auditors, signaling a major red flag that something was amiss. Cooper decided she and her department would undertake a financial audit of the firm, which was beyond the scope of what her department usually did.

In May 2002, manager Glyn Smith, who also worked under Cooper, was sent an email from WorldCom's Texas office. The email described how an employee at the Texas office had been fired for asking too many questions about the firm's capital expenditures. Smith forwarded the email to Cooper. The group began to suspect that money had been shifted from operating accounts into capital expenditure accounts to make WorldCom appear more profitable.

After asking the director of financial planning about the issue, Cooper was told that the adjustment involved "prepaid capacity," a term Cooper and her team were not familiar with. Attempts to ask different managers what the term meant were evaded. That same month, auditor Gene Morse discovered an accounting entry for \$500 million in computer expenses logged as a capital expenditure, without any documentation to substantiate it.

Morse combed through WorldCom's computerized accounting systems. He discovered \$2 billion that was supposedly spent on capital expenditures the year before but that had never been authorized for this type of spending. In June Cooper and Smith informed Sullivan that they planned to conduct an audit. Sullivan asked them to delay the audit until after the third quarter, another red flag that fraud was occurring. Cooper refused and approached the head of WorldCom's audit committee, who urged them to contact WorldCom's new external auditor KPMG (who had replaced Andersen after the Enron debacle). They also contacted Betty Vinson, who admitted she had had no

support to justify making the capital-expense-accounting entries. The controller Mr. Myers also could not justify the entries.

Reluctantly, Cooper and her team made the difficult decision to report the fraud. They reported the issue to the audit committee of the board. CFO Sullivan was told that he had a week to justify that the accounting activities in question were proper. When he failed to convince them, he was fired. WorldCom officially announced to the public that it had inflated profits by \$3.8 billion over the last five quarters. The SEC responded by filing a civil suit against WorldCom.

Times magazine would later award Cynthia Cooper the status of “Person of the Year” for 2002 and feature her on their cover issue, along with whistleblowers Sherron Watkins (Enron) and Coleen Rowley (FBI). However, she admits in her book *Extraordinary Circumstances: The Journey of a Corporate Whistle-Blower* that the decision to report the fraud was devastating and caused her severe anxiety and depression.

WorldCom admitted to violating generally accepted accounting practices (GAAP). It had been keeping two sets of books to hide its debt. Under Sullivan’s direction, WorldCom was taking line costs and diverting them to capital accounts. This kept the costs from impacting the company’s profitability—and also directly violated accounting principles. After the scandal broke, WorldCom adjusted their earnings by \$11 billion dollars for 1999-2002. Looking at all of WorldCom’s financial activities for the period, experts estimate the total value of the accounting fraud at \$79.5 billion.

WORLD.COM FILES FOR BANKRUPTCY

WorldCom did not have the cash needed to pay \$7.7 billion in debt, and therefore, filed for Chapter 11 bankruptcy protection on July 21, 2002. In its bankruptcy filing, the firm listed \$107 billion in assets and \$41 billion in debt. WorldCom’s bankruptcy filing allowed it to pay current employees, continue service to customers, retain possession of assets, and gain a little breathing room to reorganize. However, the telecom giant lost credibility along with the business of many large corporate and government clients, organizations that typically do not do business with companies in Chapter 11 proceedings.

In 2001 WorldCom created a separate “tracking” stock for its declining MCI consumer long-distance business in the hopes of isolating MCI from WorldCom’s Internet and international operations, which were seemingly stronger. WorldCom announced the elimination of the MCI tracking stock and suspended its dividend in May 2002 in the hopes of saving \$284 million a year. The actual savings were just \$71 million. The S&P 500 reduced WorldCom’s long-term and short-term corporate credit rating to “junk” status on May 10, 2002, and NASDAQ de-listed WorldCom’s stock on June 28, 2002, when the price dropped to \$0.09.

In March 2003, WorldCom announced that it would write down close to \$80 billion in goodwill, write off \$45 billion of goodwill as impaired, and adjust \$39.2 billion of plant, property, and equipment accounts and \$5.6 billion of other intangible assets to a value of about \$10 billion. These figures joined a growing list of similar write-offs and write-downs as companies in the telecommunications, Internet, and high-tech industries admitted they overpaid for acquisitions during the tech boom of the 1990s.

A detailed timeline of the events surrounding WorldCom’s bankruptcy is contained in the appendix to this case.

WHO IS TO BLAME?

Naturally, no one stepped forward to shoulder the blame for WorldCom's accounting scandal, not its auditors, executives, board of directors, or analysts. As the primary outside auditor, Arthur Andersen (also under fire for alleged mismanagement of many other large scandal-plagued audits) was accused of failing to uncover the accounting irregularities. In its defense, Andersen claimed it could not have known about the improper accounting because former CFO Scott Sullivan never informed Andersen's auditors about the firm's questionable accounting practices. However, in WorldCom's statement to the SEC, the company claimed that Andersen did know about the accounting practices, had no disagreement with management, and that WorldCom had taken no accounting positions with which Andersen was not comfortable.

Most people, including John Sidgmore, who replaced Bernard Ebbers as CEO for a time, blamed WorldCom's management for the company's woes. An initial observation by the independent investigator appointed by the bankruptcy court raised a "cause for substantial concern" regarding the board of directors and the independent auditors of WorldCom. The board has been accused of lax oversight. In particular, the board's compensation committee has been attacked for approving Bernard Ebber's generous compensation package.

Several former finance and accounting executives pleaded guilty to securities-fraud charges, claiming they were directed by top managers to cover up WorldCom's worsening financial situation. In 2004, former WorldCom CEO Scott Sullivan, who worked above many of these employees, pleaded guilty to criminal charges. Because of a plea bargain, Sullivan was sentenced to only five years in prison in exchange for testifying against Bernard Ebbers. For her part in the fraud, Betty Vinson was sentenced to five months in prison and five months of house arrest.

Bernard Ebbers stated that he did nothing fraudulent and had nothing to hide. WorldCom's lawyers have indicated that Ebbers did not know of the money shifted into the capital expenditure accounts. However, the *Wall Street Journal* reported that an internal WorldCom report identified an email and a voice mail that suggested otherwise. According to Scott Sullivan's testimony, Ebbers had intimidated him into overseeing the accounting fraud. In 2004, Ebbers was charged with one count of conspiracy to commit securities fraud, one count of securities fraud, and seven counts of fraud related to false filings with the SEC. Ebbers was found guilty of all charges and sentenced to 25 years in prison. He is currently serving his sentence in Louisiana and cannot be considered for parole until 2028 (when he will be 85 years old).

Additionally, Jack Grubman, a Wall Street analyst specializing in the telecommunications industry and who rated WorldCom stock highly, admitted he did so for too long. Grubman knew WorldCom CEO Bernard Ebbers socially and even provided WorldCom executives with special opportunities on investments. However, he insisted that he was unaware of the company's true financial condition. Grubman was later fired by Salomon Smith Barney because of accusations that he hyped telecommunications stocks, including Global Crossing and WorldCom, even after it became public that the stocks were poor investments. He was also fined \$15 million by the SEC and banned from participating in securities exchanges in the future because of his conflicts of interest.

Investors also won several class action lawsuits against the financial industry for activities related to the fall of WorldCom. These settlements included \$1.64 billion from Citigroup for purchasers of WorldCom securities and \$2 billion from JPMorgan Chase for selling \$5 billion in WorldCom bonds.

Arthur Andersen paid \$65 million to investors to cover its liability in the collapse of WorldCom. Several executives including Sullivan and Ebbers also agreed to turn over substantial portions of their personal funds to employees and investors.

REORGANIZATION AND ACQUISITION

WorldCom took many steps toward reorganization, including securing \$1.1 billion in loans and appointing Michael Capellas as chairman and CEO. WorldCom also tried to restore confidence in the company, including replacing the board members who failed to prevent the accounting scandal, firing many managers, reorganizing its finance and accounting functions, and making other changes designed to help correct past problems and prevent them from reoccurring. Additionally, the audit department staff was increased and reported directly to the audit committee of the company's new board. "We are working to create a new WorldCom," John Sidgmore said. "We have developed and implemented new systems, policies, and procedures." In 2003, the company renamed itself MCI and emerged from bankruptcy proceedings in 2004. However, this reorganization was not enough to restore consumer and investor confidence, and Verizon Communications acquired MCI in December 2005.

The WorldCom accounting fraud changed the entire telecommunications industry. As part of their overvaluing strategy, WorldCom had also overestimated the rate of growth in Internet usage, and these estimates became the basis for many decisions made throughout the industry. AT&T, WorldCom/MCI's largest competitor, was also acquired. Over 300,000 telecommunications workers lost their jobs as the telecommunications industry struggled to stabilize. Many people have blamed the rising number of telecommunication company failures and scandals on neophytes who had no experience in the telecommunications industry. They tried to transform their startups into gigantic full-service providers like AT&T, but in an increasingly competitive industry, it was difficult for so many large companies to survive.

QUESTIONS

1. What are some things that could have been done by WorldCom executives to prevent the accounting scandal?
2. How could corporate ethics have played a part in this failure?
3. What penalties have WorldCom executives paid for their part in the fiasco? Do you think these penalties are sufficient?

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APPENDIX: WORLDCOM BANKRUPTCY TIMELINE

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|---------------|---|
| Early 2001 | WorldCom shows signs of financial troubles: rates and revenues decline and debt rises. |
| July 2001 | WorldCom receives \$2.65 billion in loans from 26 banks to be repaid by the end of 2001. |
| Feb. 6, 2002 | Arthur Andersen, LLP, and WorldCom's audit team meet to discuss the 2001 audit. Everything is deemed correct and Andersen gives its approval. |
| Mar. 11, 2002 | The U.S. Securities Exchange Commission (SEC) requests more information concerning accounting procedures and loans to officers. |

- Apr. 30, 2002 Bernard Ebbers resigns as CEO of WorldCom and is replaced by vice chairman John Sidgmore.
- May 28, 2002 Auditor Gene Morse discovers \$500 million in fraudulent computer expenses.
- June 20, 2002 Cynthia Cooper reports the findings of her internal financial audit to the board.
- Jun. 25, 2002 CFO Scott Sullivan is fired after improper accounting of \$3.8 billion in expenses covering up a net loss for 2001 and the first quarter of 2002 is discovered.
- Jun. 28, 2002 WorldCom fires 17,000 employees to cut costs.
- Jul. 8, 2002 John Sidgmore testifies before a Congressional Committee to explain how internal investigations uncovered the accounting problems.
- Jul. 21, 2002 WorldCom files for reorganization under Chapter 11 Bankruptcy, an action that affects only the firm's U.S. operations, not its overseas subsidiaries.
- Aug. 9, 2002 Continued internal investigations uncover an additional \$3.8 billion in improperly reported earnings for 1999, 2000, 2001, and the first quarter of 2002, bringing the total amount of accounting errors to more than \$7.6 billion.
- Aug. 13, 2002 WorldCom names Greg Rayburn as chief restructuring officer and John Dubel as chief financial officer to lead the company through the reorganization process.
- Sep. 10, 2002 WorldCom formally announces it is seeking a permanent chief executive officer.
- Oct. 1, 2002 The U.S. Bankruptcy Court approves WorldCom's request to pay full severance and benefits to former employees, which had been limited under the company's Chapter 11 filing.
- Oct. 15, 2002 The U.S. Bankruptcy Court approves up to \$1.1 billion in debtor-in-possession (DIP) financing for WorldCom while it undergoes reorganization.
- Nov. 8, 2002 WorldCom files additional bankruptcy petitions for 43 of its subsidiaries.
- Nov. 15, 2002 Michael D. Capellas, former president of Hewlett-Packard Company, is named chairman and CEO.
- Mar. 14, 2003 WorldCom announces that it will take one-time \$79.8 billion write-off.
- Apr. 15, 2003 WorldCom unveils reorganization plan that would eliminate most of its debt, rename the company MCI, and relocate its headquarters from Clinton, Miss., to Ashburn, Va.
- Apr. 22, 2003 Former CFO, Scott D. Sullivan, pleads not guilty today to securities and bank fraud.
- May 19, 2003 WorldCom agrees to pay investors \$500 million to settle civil fraud charges.
- Jul. 7, 2003 A federal judge approves a \$750 million settlement between WorldCom and federal regulators.

- Jul. 31, 2003 The General Services Administration notifies WorldCom that it is ineligible to win new federal contracts until it improves accounting controls.
- Aug. 6, 2003 A bankruptcy judge approves a \$750 million settlement of civil fraud charges made by the Securities and Exchange Commission on WorldCom investors' behalf.
- Aug. 12, 2003 WorldCom appoints former AT&T Corp. executive Richard R. Roscitt as its new president and chief operating officer.
- Aug. 27, 2003 Oklahoma Attorney General W.A. Drew Edmondson files criminal charges against WorldCom Inc. and six former executives, including Ebbers.
- Sep. 3, 2003 Ebbers pleads not guilty.
- Sep. 9, 2003 Two groups of creditors abandon their legal challenge to the WorldCom's reorganization plan in return for a combined payout of more than \$400 million.
- Sep. 15, 2003 WorldCom's auditors testify in U.S. Bankruptcy Court that the company's books remain a tangled mess.
- Oct. 31, 2003 U.S. Bankruptcy Judge Arthur J. Gonzalez approves WorldCom's reorganization plan.
- Dec. 22, 2003 Federal prosecutors say they intend to show that former CFO Scott Sullivan was involved in 13 kinds of accounting fraud in addition to financial wrongdoing
- Jan. 7, 2004 The government lifts the suspension that prevented WorldCom from receiving new federal contracts.
- Apr. 20, 2004 MCI officially emerges from bankruptcy, 21 months after filing the largest Chapter 11 case in history.
- May 10, 2004 MCI says it will eliminate 7,500 jobs (15 percent of its workforce).
- Jan. 8, 2005 The lead plaintiff in the WorldCom class-action suit announces a \$54 million settlement covering 10 former WorldCom directors (part of the settlement is later rejected by a federal judge).
- Jan. 25, 2005 Bernard Ebbers' trial begins.
- Feb. 14, 2005 Verizon Communications Inc. announces a \$6.75 billion deal to buy MCI Inc.
- Mar. 15, 2005 Former WorldCom CEO Bernard J. Ebbers is found guilty of conspiracy, securities fraud, and making false filings with regulators. He is sentenced to 25 years in prison.
- Aug. 11, 2005 Former CFO Scott Sullivan is sentenced to five years in prison.