

MVE220 Financial Risk

Reading Project – WorldCom

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Abstract

To write this report both members of the group have contributed equally. Conclusions were made through discussion within the group.

Introduction

The story of WorldCom started with a plan on how to create a long distance telephone service provider, sketched on a napkin in a coffee shop back in 1983. The company started out as Long Distance Discount Service (LDDS) the following year, and grew through acquisitions and mergers into United State's second largest long distance telephone company by the end of the 20th century. With a worldwide presence it seemed poised to become one of the world largest telecommunications corporations. Instead, it filed the largest bankruptcy, of some \$79.5bn, in the U.S. history at the time. The question is then how could this happen - and why did it happen? There are of course several key factors leading up to the huge amount of money filed in the bankruptcy, and these will be discussed here.

From Nothing to Everything

It all started back in 1984 when the LDDS was founded, in the following year, the CEO up to the bankruptcy, Mr Bernhard Ebbers was appointed. [1] Described as likable and colorful by supporters and greedy and incompetent by others [2], he will play part of the upcoming ruin of WorldCom. But at the time he helped LDDS grow into a huge worldwide renowned company, renamed to WorldCom in the early 1990's. He managed this by pursuing an aggressive policy of mergers and acquisitions.

The 1990's were a time of growth and immense expansion in many areas, but especially the telephone and internet traffic, which were the main areas of focus for WorldCom. A capacity planner at WorldCom, Tom Stluka, created a model to predict the growth of the traffic handled by WorldCom. However, his model was a best-case scenario, which suggested that the total internet traffic would double every 100 days. For reasons unknown, this model ended up at top of the company, and they chose to believe in the model. Therefore WorldCom went through with not less than 65 acquisitions and mergers during a seven year period from 1991 to 1997. These deals cost WorldCom almost \$60 billion, and at the same time, accumulating a debt of \$41 billion. [3] These sums are huge, and in order to live through these kinds of investments there has to be a good coordination and integration between new parts and old parts of the company – this was not the case at WorldCom. Instead of actually integrating the assets, so expensively purchased, profit was created through sketchy bookkeeping and accounting fraud. This will be covered more extensively shortly, but first a short digression about the relation between Mr. Ebbers and a telecommunication analyst at the brokerage Solomon Smith Barney, Mr. Grubman.

Friends, and Nods between Friends

Citigroup, the result of a merger between Citibank and Travelers Insurance Company, which owned the brokerage Solomon Smith Barney, had a big deal with Mr. Ebbers; a loan of \$134 million to a timber company which he was heavily invested in. These contacts allowed WorldCom to choose Grubman to be the lead underwriter of \$5 billion of its bond issue in the early 1990s. Citigroup had reason to push up the WorldCom stock as the loan to Mr. Ebbers was collateralized by his equity holdings. Shortly after the appointment, Grubman started to hype WorldCom by claiming he possessed “insider information”. In the beginning investors were handsomely rewarded as WorldCom's stock continued to rise, and the personal relationship between Grubman and Mr. Ebbers was deemed as something good and legitimate. [4] However as soon as predictions and recommendations turn sour, this kind of relationship usually is thought of as corruption instead. This was the case with WorldCom. Grubman kept his rating of the WorldCom stock high, at the later time of crisis, and it was not until it had fallen by almost 90 percent he finally changed its risk rating.

Accounting fraud

WorldCom managed to get people to buy stocks even when the company and the telecom industry weren't doing well. To do this they had to adjust numbers in their accounting records to make it look as if everything was fine. The adjustment meant that WorldCom booked expenses as capital expenditures. [9] Capital expenditures are booked over a long period of time, while expenses must be subtracted from the monthly revenue immediately. WorldCom took these expenses to a balance sheet and they were expensed over a period of seven to ten years. The result of this action was that the expense in a given period of time was smaller and the income greater, which gave WorldCom a healthier image.

With this method WorldCom managed to record \$3.8 billion in capital expenditures. The result of this was that every quarter in 2001 and the first quarter in 2002 showed great profit and cash flow when there were losses actually. Accountants at WorldCom could adjust the records as long as the company acquired new companies. Investors, unaware of the fraud, kept purchasing WorldCom stock which made the price rise to \$64 per share, compared to a few pennies when they became a stock company. Internal investigations recognized questionable accounting methods as far back as 1999. [7]

Arthur Andersen was auditing WorldCom during this time and they had trust in WorldCom's senior financial management. Whenever Arthur Andersen asked the management if there were any significant top-side entries the response from the management was negative. Top-side entries are made manually and occur when a corporate entity makes financial entries on its subsidiaries journals. These entries can be used to make fraudulent transactions appear legitimate. The WorldCom management is responsible of the financial reporting and statements, not the auditors from Arthur Andersen. Arthur Andersen trusted WorldCom, because as with any audit they rely on the honesty and integrity of the management. Arthur Andersen had no disagreement with WorldCom and attested that the accounting was effective. Due to the fraud WorldCom admitted to violating generally accepted accounting practices (GAAP), and adjusted their earnings by \$11 billion from 1999 to 2002. After the investigation of that period, the total accounting fraud is estimated at \$79.5 billion. [7]

Loans to board members

WorldCom and Bernard Ebbers had been taking loans during the period of the fraud. Ebbers was granted a loan of \$408 million from JP Morgan and Citigroup. He secured the loan with his stocks and at that time WorldCom was still a company that had been predicted a great future. Ebbers was a penny pincher at WorldCom, but outside of the company he was a spender. He had bought a hockey team, yacht building company, the largest private ranch in Canada etc. [9]

When WorldCom was being accused of fraud the banks realized Ebbers couldn't afford to pay back the loan. To pay back his loan he was forced to sell all of his stocks, but since the board wanted to avoid a big sale of WorldCom stocks they granted him a loan from the company of \$408 million to cover margin calls. At the same time he was fired as CEO. The money was loaned at a rate below national average and below their rate of return. [12]

WorldCom was forced to loan money and in July 21 2001 they signed an agreement with several banks to borrow \$2.65 billion and to repay within a year. The loan was granted six weeks before the accounting fraud was disclosed. Had the banks known the true financial state of WorldCom, they wouldn't have extended the financing without demanding additional security/collateral.

When filing for bankruptcy WorldCom revealed that they didn't have the money to pay the debt of \$7.7 billion. In its filing for bankruptcy WorldCom listed assets worth \$107 billion and a debt of \$41 billion.

The exposé in WorldCom

Cynthia Cooper worked for WorldCom as the Vice President of Internal Audit. She is a native of Clinton, Mississippi, where WorldCom had its headquarters. She is the person who led the uncovering of the accounting fraud at the company she was working for. For the work Cynthia did at WorldCom she received several awards. Two of the awards are Time Magazine's Persons of the Year and 2003 Accounting Exemplar Award. The last award is given to a person who has made notable contributions to professionalism and ethics in accounting practice.[5]

Cynthia and her audit team worked during nights and collected data to figure out what was going on in the company's accounting record. They found all the expenses which had been written as capital expenditures and at that point knew what was going on. CFO Scott Sullivan asked her to stop her work, but she refused and kept on studying the accounting records. Eventually her team uncovered everything, even though the board tried to stop them from doing so. From that point on the board members were being prosecuted for fraud while she was receiving awards and national recognition for the work she did. [6]

Bankruptcy

With the unraveling of the accounting frauds and the rigged figures, coming up one after another, WorldCom finally declared bankruptcy in July 2002. After the filing, the post-bankruptcy audit found another two pieces of information that only served to increase the amount of fraud at WorldCom. First Mr. Ebbers had claimed a pretax profit of \$7.6 billion for the year 2000, when in reality WorldCom had net loss of \$48.9 billion. Additionally, WorldCom had overvalued several assets by a total of \$5.8 billion. These additional revelations pushed the total amount of fraud at WorldCom to a staggering \$79.5 billion. [10]

Who is to Blame?

The court that followed the bankruptcy is heavily criticized for being set up to frame Mr. Ebbers for all of WorldCom's problems and actions. On March 15, 2005, Ebbers was found guilty on all charges and sentenced to not less than 25 years in prison, possibly a life sentence for the then 63 year old man. However, his lawyers still argue that his trial was unfair, as many high level WorldCom executives were barred from testifying on Mr. Ebbers behalf. Indeed, only Sullivan, the former CFO at WorldCom was allowed to speak to the court. But he had cut a deal to push over as much blame as possible onto

Mr. Ebbers, the highest scapegoat. Compared to Mr. Ebbers' 25 years, Sullivan only received a five year prison sentence. [11]

Impact

According to the CEO at AT&T “WorldCom's expansion and [faked] economic profit wrecked the telecommunications industry.” [8] Because of WorldCom's profits, all the other companies in the telecommunications industry, especially the giants AT&T and Sprint, had to try to cut their costs in order to compete. [16] Sprint is said to have laid off 10'000s of people during the late 1990's in an attempt to achieve the cost efficiency of WorldCom. Several smaller companies went bankrupt as WorldCom could offer their customers the same services for cheaper prices. AT&T together with Sprint diverted huge efforts to analyze, and understand the figures reported by WorldCom, but the only result was the question: “How can they do it?” [8]

Conclusions

The aggressive expansion through mergers and acquisitions, which were meant to grow WorldCom into a worldwide competitive company in the telecommunications industry, instead became its downfall. Instead of consolidating and integrating its assets, the company only used them as a screen, behind which to build up the greatest accounting fraud in US history. Had this screen not been allowed to stay up for several years, the magnitude of the fraud and its implications could have been avoided. Therefore, much of the blame should be put on the chain of communication from the accountants performing the fraud, through the senior officers at WorldCom, to the auditor Arthur Anderson. Had anyone in this chain, either investigated its information a little bit further, or stopped telling a lie, the fraud would have been uncovered in an instant. Earlier uncovering, could have helped the company to change its policies and actually integrate its assets, and survived the scandal without a bankruptcy. However, in the end there was only one team, with the leader Cynthia Cooper, which was strong enough to blow the whistle and uncover the fraud.

Several sources put a lot of blame on Mr. Ebbers as an incompetent leader of such a large company WorldCom had become in the end. It is said that he would grow upset and angry by bad news, criticizing any who came to him with results or figures not meeting his wishes. This led to the creation of a “bubble” around the most senior manager of the company, in which no bad news was allowed to enter. Further, many decisions had to come directly from Mr Ebbers, as it had been in the small

company LDDS “back in the days”. Maybe a bad leader, this alone should not be enough to interrupt the workings of such a large company, but it did.

The ethics about performing accounting fraud is easy when viewed from the naïve point of just looking at the actual act of changing the numbers to lie. It basically shouldn't be done, it is wrong. However, taking in the whole picture: you are helping your company, perhaps keeping it alive. If you stop or uncover it you might lose your job and your income – the very thing that keeps you alive in a world like ours

Companies could minimize the risk of fraud happening if the auditors look through the whole accounting record and minimize the reliance of trust and honesty from the company's management. This way a company and its auditors can discover errors early on and change the error before it becomes illegal. It's important to have early whistleblowers, employees who discover these errors in order to avoid scandals. This means that both the internal audit team, external audit team and everybody else involved have to pay attention to what's being done in these records.

Reading Guide

Because of the magnitude of the amount of fraud in the WorldCom scandal, there exists a lot of information about the case. To start off both [3, 4] and [12] provide a brief basic coverage of the case. For the person interested in a brief introduction without effort is directed to [8] which offers an interesting documentary on the case. For the thorough researcher, all the information used in the bankruptcy filings can be found at [10]. For a more personal approach, there are several articles [13, 14, 15] about Bernhard Ebbers, his personality and his part in the bankruptcy. For the aftermath of the bankruptcy please consult any of [am, am1].

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