The accounting fraud at WorldCom the causes, the characteristics, the consequences, and the lessons learned

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THE ACCOUNTING FRAUD @ WORLDCOM:

THE CAUSES, THE CHARACTERISTICS, THE CONSEQUENCES, AND THE LESSONS LEARNED

by

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Abstract

The economic prosperity of the late 1990s was characterized by a perceived expansive growth that increased the expectations of a company's performance. WorldCom, a telecommunications company, was a victim of these expectations that led to the evolution of a fraud designed to deceive the public until the economic outlook improved. Through understanding what led to the fraud, how the fraud grew, and what its effects were, lessons can be derived to gain a better understanding of the reasons behind a fraud and to prevent future frauds from occurring or growing as big as the WorldCom fraud did.

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Dedications

For my family, who fed me, clothed me, and distracted me, all to make sure I stay sane during this knowledge gaining experience.

For the numerous cups of tea that made me fall asleep and saved me from information overload.

For my grandfathers: the businessmen.

Contents

Introduction

WorldCom was a provider of long distance phone services to businesses and residents. It started as a small company known as Long Distance Discount Services (“LDDS”) that grew to become the third largest telecommunications company in the United States due to the management of Chief Executive Officer (“CEO”) Bernie Ebbers. It consisted of an employee base of 85,000 workers at its peak with a presence in more than 65 countries. LDDS started in 1983. In 1985, Ebbers was recruited as an early investor of the company and became its CEO. It went public four years later. Ebbers helped grow the small investment into a $30 billion revenue producing company characterized by sixty acquisitions of other telecomm businesses in less than a decade. In 1999, Ebbers was one of the richest Americans with a $1.4 billion net worth.

From the outside, WorldCom appeared to be a strong leader of growth. In reality, the appearance was nothing more than a perception. On June 25, 2002, the company revealed that it had been involved in fraudulent reporting of its numbers by stating a $3 billion profit when in fact it was a half-a-billion dollar loss. After an investigation was conducted, a total of $11 billion in misstatements was revealed.

To understand fraud, why it happened, and what it constitutes, it is important to understand not only the details of the accounting methods, as is summarized in The Report of Investigation conducted on WorldCom, but also what was happening in the environment of the company while the fraud was occurring.

Therefore, the objective of this paper is to analyze the events that occurred before (causes) and after (consequences) the fraud, the accounting tactics utilized to accomplish this fraud (characteristics), and the lessons learned from each of the problems.

Causes

Internal Environment

<u>Strategy (or lack thereof)</u>

The executive and strategic decisions at WorldCom were characterized by rapid growth through acquisitions (In re WorldCom, inc., 2003). "Growth, growth, growth…" (G. Morse personal communication, October 22, 2010). By 1998, WorldCom had been involved in mergers with sixty companies. Together, these transactions were valued at more than $70 billion, the largest of which, MCI Communications Corporation ("MCI"), was completed on September 14, 1998, and was valued at $40 billion (In re WorldCom, 2003).

According to Smith & Walter (2006), WorldCom was motivated by the low interest rates and rising stock prices during the 1990s. From the beginning it committed itself to the high-growth strategies that relied on aggressive corporate actions that often involved "creative" accounting practices.

Dick Thornburgh's investigation of WorldCom (2003) revealed a lack of strategic planning, often depicted by nonexistent "proper corporate governance protocols." While documents called "strategic plans" were found, they only consisted of an overview of the company's financial outlook in the event that WorldCom stopped the aggressive acquisitions. They did not contain any realistic strategic plans (Thornburgh, 2003). There was no strategic committee and the decision makers mainly consisted of Ebbers, Chief Financial Officer ("CFO") Scott Sullivan ("Sullivan"), and Chief Operations Officer ("COO") John Sidgmore ("Sidgmore") (Thornburgh, 2003).

Once WorldCom acquired the new companies, it failed to properly integrate the systems and policies that not only led to very high levels of overhead in proportion to the revenues but also to an extremely weak internal control environment (Breeden, 2003). Due to the fast pace of the acquisitions as well as management's neglect, the accounting systems at WorldCom were unable to keep up with integration and efficiency. The lack of internal controls allowed manual adjustments to be made in the system without the emergence of any red flags, thereby minimizing any chance of detection (Breeden, 2003).

To further this acquisition problem, the MCI merger caused WorldCom to take on a huge debt load. In addition, MCI had a residential customer base with slower growth rates while WorldCom had historically served business customers, a customer base consisting of high margins and less turnover. (Katz & Homer, 2008).

The beginning of WorldCom's fall came with its attempt to merge with the second largest telecommunication company at the time: Sprint (WorldCom being the third largest). The plan was terminated by the U.S. Department of Justice due to the lack of anti-competitiveness it would create within the telecommunications industry. With no other companies to merge with, WorldCom's growth through acquisitions strategy came to a screeching halt (Clikeman, 2009).

According to Porter (1985), a competitive strategy searches for a favorable competitive position in a company's industry, aiming to establish a position in which the company is profitable and sustainable against its competitors. The management at WorldCom was so determined to grow that it not only failed to create a competitive strategy, but also did not see that with growth comes "the need to maintain" to prosper. In the end, that lack of strategy prevented it from effectively planning and determining a position to acquire that prosperity.

Company Culture

Top Management's Managing Style

According to Albrecht & Albrecht (2004), to prevent fraud, the opportunity to commit fraud should be minimal or nonexistent. Creating a work culture of "honesty, openness, and assistance" is key to fraud prevention (Albrecht & Albrecht, 2004, p. 61). First, it is important to hire honest people and train them in fraud awareness, and to present a code of conduct or ethics that is not only stated on a piece of paper, but is truly respected and followed by other employees including top management. Second, a positive work environment must be created. Third, employees must be provided with assistance programs (Albrecht & Albrecht, 2004).

The growth through acquisitions "strategy" at WorldCom was enforced and reinforced by top management. The consistent pressures from top management created an aggressive and competitive culture (in re WorldCom, inc., 2003) that did not contain any communication of the need for honesty or truthfulness or ethics within the company (Breeden, 2003). In fact, one former executive reports that the pressure became "unbearable-greater than he had ever experienced in his fourteen years with the Company" (Zekany, Braun, & Warder, 2004). One employee stated that WorldCom was never a happy place to work, even when the company was doing well, the employees were forced to work 10, 12, or even 15 hour days but it balanced out with the higher compensation. However, when the stock dropped, the employees were still required to work the long hours even when compensation was all but gone (L. Jeter, personal communication, October 17, 2010).

There was a large focus on revenues, rather than on profit margins and the lack of integration of accounting systems allowed WorldCom employees to move existing customer accounts from one accounting system to another. This allowed the reporting of higher revenues for WorldCom through which employees pocketed extra commissions that amounted to almost $1 million (in Re WorldCom, inc., 2003). According to the Beresford, Katzenbach, & Rogers (2003), efforts made to establish a corporate Code of Conduct received Ebbers's disapproval. He often described the Code as a "colossal waste of time." Implementing a code of ethics and having employees read and sign it periodically can reinforce ethical conduct as well emphasize that it is important to the company (Albrecht & Albrecht, 2004). The lack of a code of ethics at WorldCom shows that no training on awareness of fraud or ethics was conducted. Therefore, it is very possible that when the employees reported existing customers as new ones, they were not aware of the obdurate consequences that may occur.

The employees at WorldCom did not have an outlet to express concerns about company policy and behavior either. Special rewards were given to those employees who showed loyalty to top management while those who did not feel comfortable in the work environment were faced with obstacles in their need to express their concerns (Panday & Verma, 2004). Due to the multiple acquisitions, WorldCom's business units were spread across the eastern United States (see Figure 1). Hence, if an employee working at headquarters in Clinton, Mississippi was facing a problem, he/she would have to contact the Human Resources department in either New York, N.Y. or Boca Raton, Florida. This autonomous structure complicated matters further and discouraged most employees from saying anything at all (Beresford, Katzenbach, & Rogers, 2003). The lack of an outlet to express concerns was not only problematic for regular employees, but also for the upper level employees who were asked to participate in the fraud. Betty Vinson and Troy Normand, managers in Clinton's Accounting Department, were told to make journal entries on the instructions of the Director of General Accounting Buddy Yates (Beresford, Katzenbach, & Rogers, 2003). They followed his orders. However, they both wrote a letter of resignation after they felt uncomfortable with the falsified journal entries they made. The two never submitted their resignation letter due to their dependence on their jobs to support their families (Cooper, 2008).

A low fraud environment could have been created if WorldCom's culture consisted of positive work environment elements such as employee assistance programs that make it easier for the employees to not only report fraud, but decrease their own likelihood of committing it. Open door policies, positive personnel, and operating procedures could have been implemented to diminish the barrier between employees and upper management (Albrecht & Albrecht, 2004). Unfortunately, in the case of WorldCom, the personnel themselves were involved in the fraud. Yet, if the personnel were the ones to implement the positive work environment, they might not have been involved in the fraud in the first place.

On top of the lack of an ethical code and an outlet for concerns was the concept of employee compensation with stock options. Employees at WorldCom received a lower salary than their counterparts at competitors such as AT&T and Sprint (J. Chalmers personal communication, October 21, 2010). According to Chalmers, a lawyer who dealt with many WorldCom employee cases after the fraud, the gap between the competitors' compensation and WorldCom employee compensation was filled through stock options which further enforced management's ideology of focus on revenues. The higher the revenues, the better the company appeared to Wall Street which in turn led to a higher stock price and higher compensation for both employees and management. However, when WorldCom fell, so did the stock price, leaving its employees with worthless stock options. Gene Morse (personal communication, October 22, 2010), one of the internal auditors who helped discover the accounting fraud, had been given the senior level director's stock options package. If the stock had returned to its high and WorldCom had not fallen, his options would have been worth over $900,000. Morse stated that he never sold the options because he too, like the majority of other employees and stakeholders, believed in Ebbers's optimism about WorldCom.

Ebbers played a huge part in turning LDDS into a "global telecom giant," WorldCom, with the goal of acquiring the position as the "number one stock on Wall Street" (Panday & Verma, 2004). Ebbers had started out by managing hotels in 1974 (Clikeman, 2009). He continued his "hands on" managerial style throughout his involvement in WorldCom even when the company had revenues amounting to billions of dollars (in re). He was known for taking risks (Katz & Homer, 2008) no matter how aggressive, towards making WorldCom's stock a highly demandable one. According to Panday & Verma (2004), Ebbers created an individualistic culture where loyalty to a person was more important than loyalty to the company. This created an environment where the boss was not to be questioned. Therefore Ebbers's plan was the company's plan.

Sullivan was Ebbers's right hand man. He and Ebbers had the same managing style. Sullivan was known as a "whiz kid" who enjoyed the reputation of "impeccable integrity." He was a leader that, like Ebbers, was not to be questioned. The loyalty that existed at WorldCom was very important to keep the fraudulent activities that occurred bottled up. Most of the information was not fully available to employees, furthering this secrecy. Even some who had the need to know the information (Zekany, Braun, & Warder, 2004), such as the internal auditors, were able to view only some of the journal entries in the income statement and the balance sheet but never the entire documents (G. Morse Personal Communication, October 22, 2010).

The combined management allowed the creation of a culture that was more suitable for a sole proprietorship than for a billion dollar corporation. The aggressive nature of the managing style such as the plethora of acquisitions as well as the failure to integrate them properly created an environment where employees were pressured to report high growths quarter by the quarter. There was no emphasis or encouragement of honesty and integrity with those demands. According to Romney & Steinbart (2008), a work environment that emphasizes "integrity and commitment to both ethical values and competence" depicts good business, yet it all has to start at the top. Management that required and rewarded integrity and honest behavior (Romney & Steinbart, 2008) may have prevented what occurred at WorldCom. Furthermore, if management had envisioned a more stable and long term outlook for the company, the quick paced acquisitions may not have occurred. Unfortunately, they did. The approval for these acquisitions was given by the Board of the Directors.

Corporate Governance

Board of Directors

According to Romney & Steinbart (2008), a Board of Directors that is active and involved within an organization is an important internal control for the organization. The directors at WorldCom were from different backgrounds. While some had widespread knowledge and experience of business and legal issues, others were appointed due to their connections with Ebbers (Breeden, 2003). The mix of the Board and the close ties to Ebbers led to the Board's lack of awareness on WorldCom's issues. The Board was inactive and met only about four times a year, not enough for a company growing at the rate that it was. In addition, the directors were only given a small cash fee as compensation, thus an appreciation of stock was the only form of compensation available. The directors also depended on company growth and stock appreciation for compensation, as did the employees and management. They had a large amount of influence on the approval or disapproval of company decisions. Their approvals of the acquisitions allowed WorldCom's growth to an increase that led to a higher stock price and a large amount of compensation. Directors dependent on this type of "large issuances of equity" not only conveyed an unhealthy practice, but also created a conflict of interest where their goal became more focused on the growth of the stock than on what was in the best interests of the company (Breeden, 2003). Another conflict of interest arose for those board members that had strong ties to Ebbers. Their closeness to Ebbers hurt their duty to be independent from the company and its management.

Due to the Board's lack of active participation, there was a lack of awareness about WorldCom's matters. According to Thornburgh (2003), management aided that lack of awareness by presenting the directors with very limited information about the company and its acquisitions. Thornburgh (2003) states multibillion dollar transactions were approved by Board of Directors with the limited information. At times they were approved with discussions that lasted less than half an hour. Sometimes these discussions did not involve the Board at all and at other times no documents were even presented concerning the terms of the transactions. In addition, no risk assessment was performed on these acquisitions (Breeden, 2003).

Romney & Steinbart (2008) recommend that the Board of Directors of a company should be responsible for overseeing management and inspect its "plans, performance, and activities" (p. 208).The directors should also approve the company's strategy, review its financial statements, and evaluate security policy. They should also always interact with the auditors, both external and internal.

Loans to Ebbers

"We stand by our accounting." Ebbers made this statement during an earnings conference call with analysts in February of 2002 (in Re WorldCom, inc., 2003). However, what was unknown at the time was Ebbers's personal financial situation. Ebbers had made several purchases for which he had acquired loans and used his WorldCom stock as collateral. The purchases were quite extravagant and included the largest ranch in Canada, a yacht construction firm and yard, a marina, motels, a hockey team, and even a yacht Ebbers named "Acquasition." Once the price of WorldCom stock fell, Ebbers was required by the banks to fill in the margins between the value of his loans and the fallen value of his stocks (Panday & Verma, 2003). Instead of selling his stock, which he thought would further cause a decline in stock price on Wall Street, Ebbers requested the Board to approve personal loans to fill in the margins (Breeden, 2003). To ease the process, Ebbers took advantage of the lack of independence of the board members who were loyal to him such as Stiles Kellett, chairman of the Compensation Committee, and Max Bobbitt, chairman of the audit committee. Not only did the two allow the loans to grow to more than $400 million, but also when the Board found out about these loans, they failed to take any action and allowed the loans to carry on (Breeden, 2003). A strong Board, that included directors who were more focused on the shareholders rather than on what 'Bernie' recommended, could have avoided the multimillion dollars in loans that further deteriorated WorldCom's financial situation. This shows that it is important to inform the directors about company policies, mission, and ethics since they are not a part of the company's daily life and culture.

The Compensation Committee

One main reason Ebbers's loans were approved was the Compensation Committee. The Committee's authority was stated in a charter from 1993 that listed a vague description of its power to supervise the compensation of the officers (Beresford, Katzenbach, & Rogers, 2003). However, in the company's proxy statements, the committee had the power to determine the "salaries, bonuses, and benefits" of the officers (p. 270). The Committee approved the loans to Ebbers without confirming with the Board and asked for the Board's approval after the loans had already been paid out (Beresford, Katzenbach, & Rogers, 2003). The Committee was the only one at WorldCom that met regularly: seven to seventeen times per year during the fraud period of 1999-2001. Similar to the Board of Directors, the Compensation Committee failed to properly conduct its role in placing appropriate pay programs that not only supported the company's mission and strategy but were also in the best interests of the company. The approval of Ebbers's loans does not qualify as an action in the company's best interests, but only in the best interests of Ebbers and the board members who were loyal to him.

Lessons in Corporate Governance

Corporate governance involves the protection of shareholders by the Board of Directors (P. Roush, personal communication, 2011). The approval of Ebbers's personal loans was not in the best interests of the stakeholders. Breeden (2003) mentions that there are no "checklists" of achieving "good" governance. There is, however, a need of a Board that contains individuals who not only possess business knowledge and skills but also have "healthy sensitivity to norms of proper behavior" (p. 23). The focus then turns to the creation of value for the company rather than to simply avoid wrongdoing and to have a good code of ethics (Breeden, 2003).

Breeden further emphasizes "doing the right thing," stating that every Board whether at a national, business, or university level will at some point be faced with tough decisions and challenges. The key to the success of the Board is to take action and resolve any problems with competency (Breeden, 2003). Unfortunately, with WorldCom, when the Board was presented with the challenge of approving Ebbers's loans, among other large acquisition decisions, it failed to take action and limit Ebbers's power on the Board. Perhaps the Board did not realize the consequences that could occur as a result of those actions committed against their long time friend nor did it have the competency to take control of the board and take a strong position against the decisions.

Auditing: to detect or to neglect

Audit Committee

A director's independence from management is a key factor in a successful company. At WorldCom, an Audit Committee was established to conduct relations with Arthur Andersen, the external auditor. An Audit Committee consists of a selected number of Board members who are to meet from time to time with the company's auditing firm and discuss the progress of the audit, the findings, and resolve any conflicts that may occur between management and the firm (Louwers, Ramsay, Sinason, & Strawser, 2008). However, in WorldCom's case, the lack of independence and awareness of the Board as a whole trickled down to the audit committee. The committee's chairman, Max Bobbitt, was very loyal to Ebbers. Hence, the members of the committee, including Bobbitt, were either unaware or had known about the fraudulent misstatements for the years 1999, 2000, and 2001 and choose to ignore it. According to Breeden (2003), the Committee oversaw the $30 billion revenue company when it met for about three to six hours once a year.

While the Committee was represented positively, the accounting controls within were "virtually non-existent" (in Re WorldCom, inc., 2003). It appears the lack of activity was more of a "going through the motions" as opposed to the Committee sitting down and understanding the policies, the internal controls, and the audit programs that were a necessity to the company's core structure (Breeden, 2003). Even though Arthur Andersen acknowledged WorldCom as a “maximum risk” client and mentioned to the Committee that WorldCom had “misapplied GAAP (Generally Accepted Accounting Principles) with respect to certain investments,” the committee chose to ignore it and in the end Arthur Andersen gave WorldCom a clean, unqualified opinion (Zekany, Braun, & Warder, 2004).

The audit committee’s negligence depicts another weakness in WorldCom’s internal controls. Therefore, it is very important to have members in the committee that fulfill their duties by overseeing the corporation’s internal control structure as well as making sure that the company complies with “laws, regulations, and standards” (Romney & Steinbart, 2008). The members should also periodically meet with the firm’s internal and external auditors to ensure the audit process is efficient and be aware of the company’s operations. The fulfillment of these duties is now a requirement due to Section 301 of the Sarbanes-Oxley Act discussed later.

Internal Audit

WorldCom’s Audit Committee failed to meet with the Internal Auditors of the company, who had the duty to provide the Audit Committee with an independent and objective view on how to improve and add value to WorldCom’s operations (Louwers, Ramsay, Sinason, & Strawser, 2008). Not only were the personnel in the internal audit department not enough for a large company, but they also lacked the proper training and experience to conduct the testing of the company’s controls.

According to Thornburgh (2003), Ebbers or Sullivan would have the department work on “special projects” that were very time consuming and would normally not be part of the audit function. Thornburgh states that there were times when the auditors would work on the projects during the day and then stay late at night to complete the audits that were often delayed. Cynthia Cooper, the Vice President of the Internal Audit function and the individual whose department discovered and reported the fraud, stood by the intense work in the hopes that top management would see her department as important and add the personnel and resources needed to efficiently maintain the internal audit function (Thornburgh, 2003). Gene Morse (personal communication, October 22, 2010) adds that the internal auditors were provided with limited access to the income statements and balance sheets with only a partial picture of the company's financial situation that prohibited them from properly assessing the finances of the company.

The Internal Audit department is intended to be independent and report directly to the Audit Committee to avoid the influence of top management (Louwers, Ramsay, Sinason, & Strawser, 2008). This form of relationship was lacking at WorldCom. Furthermore, Ebbers wrongly associated the duties of an internal auditor with those of an external one. In reality, an internal auditor does little work on the financial statements and focuses more on "improving the organization's operations" (Louwers, 2008, p. 629), rather than conducting the actual operations. The department must try to reduce or eliminate risks that could create losses and also improve the efficiency of operations. Lastly, the department should help ensure compliance with management, laws and regulations as this would add value to the company (Louwers, 2008).

External Auditors

At WorldCom, it appears there were no checks and balances in auditing. The internal auditors were not sufficiently staffed to work on the internal controls and the audits of the company which prevented them from correctly reporting to the Audit Committee about the operational and financial situation of WorldCom. The Committee itself did not meet on a regular basis either and was unable to properly take actions to fix the situation. Yet, the external auditor, Arthur Andersen, was the one responsible for providing an independent opinion of the financial situation at WorldCom for investors and creditors. The auditing firm also failed to carry out its duties properly.

According to Beresford, Katzenbach, & Rogers (2003), Arthur Andersen's failure to detect the fraud was due in part to negligence and in part to the tight control top management kept over information. A flaw in Andersen's approach was that it limited its testing of account balances, relying on WorldCom's perceived strong internal control environment (Beresford, Katzenbach, & Rogers, 2003). Unfortunately, WorldCom's internal control environment was inefficient in many ways, and therefore allowed Andersen to overlook "serious deficiencies" that existed in the internal environment (p. 223). If the external auditors had performed their work properly, the fraud could have been discovered long before 2002. Moreover, even though the top management's control over the information was suspicious, Andersen failed to bring this problem to the attention of the Audit Committee (Beresford, Katzenbach, & Rogers, 2003).

Speaking at an event at Baylor University, David Myers, former comptroller at WorldCom, stated that the WorldCom audit was Arthur Andersen's largest audit in the region, and that Arthur Andersen wanted to keep WorldCom as a client (*Acc guest* 2009). Unfortunately, the retaining of WorldCom as a client was due to the consulting revenue that it brought in to Arthur Andersen. The auditors spent more time selling those consulting services and less time conducting analytical reviews and testing controls. According to Roush (personal communication, 2011), this situation created a conflict of interest because the auditors would first consult a company about how to increase performance or efficiency and then go back to the same company and independently audit it. Top management at WorldCom was aware of this and made the journal entries in the way they would be tested by Arthur Andersen. In addition, Myers notes that Arthur Andersen may not have overlooked the details purposely but rather the auditors were pressured to have the job completed as soon as they could. It appears that the relationship with WorldCom was more valued than performing appropriate audit work. Andersen's close relationship with Ebbers, in the end, resulted in a lack of professional skepticism: the questioning attitude an auditor must have when in the field.

External Environment

The external environment during the fraud period also served as a basis for WorldCom's growth during the Internet bubble**.** When the bubble burst in early 2000, WorldCom's share price plummeted along with most of the volatile Internet and telecommunications companies.

Double Bubble

Dot-Com Bubble

In 1996, UUNet, the technology and Internet sector of WorldCom, announced that Internet traffic was doubling every 100 days. According to Odlyzko (2003), while the statement may have been true from 1996-1997, when Internet was indeed growing, the growth failed to be carried on towards the later years when it was most often cited. This statement was not only made by Internet and telecommunications companies to boost investment in their companies, but also, by scientists trying to demonstrate the need for research within this new technology

(Odlyzko, 2003). Hence, people believing in the evolving myth started to invest rapidly into the volatile stocks of Internet and telecommunication companies. A majority of these companies were not even making a profit. Odlyzko emphasizes that people did not stop to think about how something could grow so fast and that the myth was repeated enough times that it became a reality. He states that in order for the traffic to keep on increasing, within a year every person would have had to be using the Internet twenty four hours per day, a scenario that was not plausible at the time. In his most recent paper, Odlyzko (2010) mentions the cause of bubbles like the Internet and telecommunications one is gullibility. This “beautiful illusion” of enormous profits and a better lifestyle block one’s ability to think objectively. In the end, the growth is empowered by this gullibility. Essentially people end up “drinking their own Kool-Aid” (Odlyzko, 2010). These actions later turn into anger and disbelief once the bubble is gone and reality becomes apparent.

Telecomm in Trouble

During the false growth of the Internet, the Telecommunications Act of 1996 was passed. The act allowed long distance companies such as WorldCom to compete in the local market and allowed the local phone companies to compete in the long distance market. Therefore it opened the different parts of the telecommunications industry to fierce competition and lowered the price of telecomm services (Economides, 1998).

As more and more Internet companies came into the market, an increased demand in broadband services appeared. Consequently, WorldCom started leasing fiber optic cables to support the demand (Gene Morse, personal communication, February 8, 2011). According to

Morse, when the hype of the internet stocks diminished, the Internet companies went out of business and canceled their services with WorldCom. Unfortunately for WorldCom, the leases it had made were two to five year agreements that could not be canceled. To make matters worse, companies like Cisco introduced switches that at first doubled the capacity the cable could carry, then soon gained the ability to carry thirty two-times capacity.

WorldCom had bought and invested a vast amount of capital into a transatlantic cable that when leased to other companies had only 4% utilization. The switches allowed the companies to lease only a small amount of the cables and acquire more capacity (Morse, personal communication, February 8, 2011). Morse refers to the idea of a restaurant with a hundred tables, but that only four of the tables are used on any given day. The problem here is that there was no return on the investment, yet WorldCom still had to incur the expenses for purchasing the cables. The timing of the situation was characterized by optimism, expansion, and opportunity so it was hard for anyone to predict anything other than growth. Jack Grubman, an analyst on Wall Street, stated "build it and they will come" when referring to the fiber optic cable expansion (The wall street fix, 2005).

Greed at Wall Street

The perceived unlimited growth the Internet and telecommunication bubbles were creating led to a significant flow of capital to WorldCom and other telecommunications companies (Thornburgh, 2002). The capital flow allowed the share prices of the telecomm industry as a whole to increase vastly. WorldCom's share price was in the $20 range in early 1995 and rose to more than $90 during 1999. WorldCom stock during the 90s was characterized by six different stock splits. On the other hand, when the new millennium started, WorldCom's stock faced a continuous decline until it became worthless. It was also delisted from the Nasdaq market once the misstatements were made public (Thornburgh, 2002).

The scenario was reminiscent of other telecommunications companies who also saw a large downfall in their stock prices. What differentiated WorldCom stock was that WorldCom was deceiving the public through the misstated financial statements and through Jack Grubman's repetitive "buy" ratings of the stock (in re WorldCom, inc., 2003).

Jack Grubman was an analyst for Salomon Smith Barney ("SSB"), an investment firm that was often involved in underwriting WorldCom's acquisitions. He was one of the most powerful men on Wall Street. What he said about a stock significantly affected its status on Wall Street. He was so close to Ebbers that when he was invited to his wedding, SSB's investment banking department covered all his expenses (in re WorldCom, inc., 2003). After the fraud was revealed, it was discovered that from June 1996 through August 2000, Ebbers received IPO allocations through Grubman that allowed him to make profits totaling $11.5 million (Exchange hearing 03-72, 2003). The question that arises is why was this loyalty so important to Grubman?

The economic environment at the time permitted investment banks to have their analysts rate companies that were a part of their own clientele base, due to the repeal of the Glass-Steagall Act during the 1990s (Katz & Homer, 2008). This created a conflict of interest similar to how the accounting firms were offering their clients both consulting and auditing services. In essence, when Grubman gave WorldCom's stock a "buy" rating, the public trusted him and bought more stock, thereby increasing its price. When the price went up, top management at WorldCom was able to use the appreciation to engage in more acquisitions which required underwriters such as SSB. Thereby, SSB was able to charge large fees for performing the underwriting services. From 1996 until 2000, SSB acquired a total of almost $76 million in fees from WorldCom (Exchange hearing 03-72, 2003).

Perhaps unknowingly or even knowingly, Grubman fulfilled the desire of top management at WorldCom, who found that the stock appreciation allowed WorldCom to keep the fraudulent activities a secret for that much longer. Grubman was pressured by his own management to maintain positive ratings for the clients of his company and prevent any form of action that would make those clients take their multi-million dollar fees elsewhere (Exchange hearing 03-75, 2003). When then New York State District Attorney General, Eliot Spitzer, launched an investigation into SSB, Grubman left SSB. The agreement he signed with SSB included compensation of about $19.5 million, plus $13 million in deferred compensation from previous years, which unfortunately did not serve as a lesson to analysts. Rather, it showed them that the worst that can happen to them as an analyst is that they retire earlier with a lower net worth than they would have otherwise. There is a dire need for standards and punishments for wrongdoing in the financial markets. Some efforts have been made to create a more stable economic environment such as the Dodd-Frank Wall Street Reform and Consumer Protection Act that was passed on July 21, 2010 (FDIC Law, 2010). The act included the Volcker Rule, proposed by former Federal Reserve Chairman, Paul Volcker, and restricts US banks from making certain investments if they are not on behalf of the banks' customers. Yet, continuous efforts are needed to ensure future stability.

Causes Conclusion

What lessons can we learn from the causes of the WorldCom fraud?

WorldCom's internal environment was a mess waiting to happen. It appears that even without the fraud, the company would have collapsed anyways, yet perhaps sooner than it really did. The fraud was similar to a piece of gum patching a hole in a dam. The external environment was the storm that caused the gum to lose its stickiness. Lastly, the lack of proper personnel to detect and fix the hole was the auditing failure.

The internal problems at WorldCom were its lack of a competitive strategy, weak internal controls, an aggressive culture that demanded high returns, and the failure to look out for what was best for the stock holder as well as the stake holder of the company.

While the growth of a company is necessary for its sustainability, it is also important for the company to focus on the long term rather than only on the next quarterly report. By doing so, the company emphasizes that it creates value not only for Wall Street, but also for its customers that are the drivers of the company.

Employees of a company are also drivers for its growth and success. However, the competitive culture at WorldCom was characterized by loyalty to management with no regards to ethics, honesty, or integrity ("doing the right thing").

The Board of Directors served as an internal control that was a failure on its own part. The duty of the Board was to correct the weakness of the company that management was unable to see due to its lack of the independence from the company. However, the Board appeared to be barely independent as most of the members were Ebbers's friends. Due to this friendship, the Board started to look out for pleasing management rather than fulfill its duty to protect the stake holders.

Within the Board was the Audit Committee that had the obligation to communicate with the internal and external auditors. Since it only met three to six hours a year, it did not fully communicate with either of the auditors. Although, Arthur Andersen did inform the Committee that WorldCom had misapplied GAAP, the committee members chose to ignore it.

The external environment was a storm moving into an already deteriorated structure. The collapse of the Internet and Telecomm bubbles led to a continuous decline in the company's stock price. This decline was only slowed due to Jack Grubman's continuous "buy" ratings for WorldCom.

In the end, the lessons learned from these causes is that when a company appears to be doing well within an external environment that is very bleak, it is the internal auditor's duty to investigate. In addition, the external auditor is the one that must come in with an objective, unbiased mind set and audit the company with integrity, honesty, and independence.

In an organization, when carrying out an objective, one must plan, design, implement, and evaluate. Throughout the research process, the information collected suggests that there are very useful guidelines that exist that provide a detailed outline of running and maintaining an organization. Unfortunately, while the planning and designing of a good ethical work culture, for example, already exists in these guidelines, their implementation is what companies fail to do.

Characteristics

Definition of Fraud

Gaining an unfair advantage over another person is considered fraud (Romney & Steinbart 2008). To be considered a fraud, the deception must be characterized by “a false statement, representation, or disclosure”; “a material fact,” that causes the fraudster to initiate the fraud; the “intention to deceive”; a “justifiable reliance” of the fraudster on the misstatements; and an injured party (Romney & Steinbart, p. 145).

While there are different types of fraud, the most common type of fraud is the misstatement of financial statements (Albrecht & Albrecht, 2004). The fraud is committed on behalf of the organization, usually through the acts of top management, as in the case of WorldCom. In management fraud, management is the perpetrator and the company’s stockholders, lenders, and other users of financial information are the victims (Albrecht & Albrecht 2004).The reason behind these manipulations is usually to “increase the company’s stock price, meet cash flow needs, or hide company losses and problems” (Romney & Steinbart, 2008, p.146).

In order to reduce and prevent fraud, it is important to understand what happened so that the case may be of use as a precedent for someone auditing a similar company in the same industry. At WorldCom, the fraud was characterized mainly by the improper reduction of line costs and false adjustments to report revenue growth.

The Misstatement of Line Costs

According to Beresford, Katzenbach, & Rogers (2003), line costs are the costs associated with carrying a voice phone call or data transmission from the call's origin to its destination. If a WorldCom customer made a call from New York City to London, the call would first go through the local phone company's line in New York City, then through WorldCom's long distance, and finally through the local phone company in London. WorldCom would have to pay both the local companies in New York City and London for use of the phone lines; these costs are considered line costs. Not only were line costs WorldCom's biggest expense but were also approximately half of WorldCom's total expenses. Especially after the collapse of the dot com bubble in early 2000, cost savings became extremely important, so important that line cost meetings were the only meetings with regular attendance by top management. WorldCom's top management strived to achieve a low line cost to revenue ratio ("line cost E/R ratio"), because a lower ratio meant better performance whereas a higher ratio meant poorer performance. To report better performance and growth, Sullivan implemented two improper accounting methods to reduce the amount of line costs: release of accruals from 1999-2000 followed by the capitalization of line costs in 2001 through early 2002 (Beresford, Katzenbach, & Rogers, 2003).

<u>Releasing Accruals</u>

According to Breeden (2003), the end of each month, during the fraud period at WorldCom, was characterized by the estimation of costs that were associated with using the phone lines of other companies. The actual bill for the services was usually not received for several months (Breeden, 2003). This meant that some entries made to the payables could be overestimated or underestimated. In the case that the liability was overestimated, when the actual bill was received there would be a surplus of liabilities that when "released" would result in a reduction of the line costs:

Accounts Payable	1,000,000	
Cash Paid to Suppliers		900,000
Line Cost Expense "release"		100,000

WorldCom adjusted its accrual in three ways. Some accruals were released without even confirming if any accruals existed in the first place. Second, if WorldCom had accruals on its balance sheet it would not release them for the proper period and instead keep them as "rainy day" funds for future uses. Lastly, some of the accruals released were not even established for line costs, thereby violating GAAP by using one expense type to offset another (Beresford, Katzenbach, & Rogers, 2003).

Line costs were very significant to WorldCom's bottom line. Ebbers made public promises to stockholders and Wall Street that WorldCom would keep those costs low. Therefore, the managers at WorldCom were continuously under pressure to find ways to reduce those costs (Breeden, 2003). With the burst of the Internet and telecomm bubbles, the pressure increased and more ways had to be discovered to keep on reporting the false numbers. According to Morse (personal communication, October 22, 2010), WorldCom's competitors such as Sprint and AT&T had line costs that were 52% of revenues. WorldCom reported line costs of about 42% of revenues, in reality these costs were 50%-52% of revenues. Although WorldCom's line cost ratio was in line with the telecomm companies in the industry, it chose to report lower line costs because that is what the analysts expected. By meeting analyst expectations, WorldCom would make Wall Street happy**.** Wall Street's contentment with WorldCom would result in an increase in investments and thereby a higher stock price for WorldCom. **T**he higher the stock price, the cheaper it would become for WorldCom to acquire other companies.

The pressure worsened by early 2001 as Sullivan tried to find different ways to reduce expenses. He directed General Accounting to reduce the line cost expense for the Wireless division by $150 million. The Wireless division saw this and told Sullivan that there was no support to the entry and he was forced to reverse it. He then ordered the managers of the General Accounting department to make large "round-dollar" journal entries that weren't related to the Wireless division without any documentation. They did not hesitate the first time because they believed in Sullivan's integrity and thought that he had most likely discovered an accounting loophole. Two years later, as the fraudulent reporting continued, the managers were very uncomfortable with what they were doing and the only reason they did not report the fraud was because they feared the loss of their well paying jobs (Breeden 2003).

Over the two year period, WorldCom had made inappropriate accrual releases both in the domestic and international divisions that amounted to about $3.3 billion (Beresford, Katzenbach, & Rogers, 2003). As the accruals started to run out, Sullivan came up with another strategy: capitalization of line costs.

Capitalizing Line Costs

The 4% utilization of the fiber optic cables meant that WorldCom was still paying for the leases on the cables even though it was generating no revenue on them. According to Morse (personal communication, February 8, 2011), WorldCom had leased the lines in a 2-5 year agreement that could not be canceled. However, the costs associated with the lines were causing the line cost E/R ratio to increase. Thus, when no more accruals could be released, Sullivan turned to capitalize these costs, another violation of GAAP.

By capitalizing the costs from the cables, the 2-5 year leases now had 20-30 year lives which would slowly depreciate over the next two or three decades (Morse, personal communication, February 8, 2011). GAAP requires these costs to be recognized immediately. A Line Cost to Revenue report was generated for top management to which round number adjustments were made a week or so before the numbers were announced to the public (Zekany, Braun, & Warder, 2004).

By the time the fraud was discovered, Sullivan had managed to improperly reduce the line costs by approximately $3.883 billion (Beresford, Katzenbach, & Rogers 2003). Capitalizing the expenses resulted in shifting the items from the income statement onto the balance sheet, allowing the overstatement of income as well as the overstatement of assets.

Revenue

Ebbers portrayed WorldCom as a high growth company. In April 2000, even after market conditions had started to deteriorate, he stated that he was still comfortable with a revenue growth of 13.5%-15.5% (Beresford, Katzenbach, & Rogers (2003). The increasing growth allowed an increasing stock price that resulted in higher compensation and currency for the numerous acquisitions WorldCom made. Unfortunately, the downturn due to the dotcom bubble resulted in the failure to achieve its highly marketed double digit growth.

A process called "closing the gap" was utilized to achieve the falsified growth. First, Ebbers and other top management received the "MonRev" report that provided a picture of the company's revenue for a given period (Breeden, 2003). The report was available exclusively to top management and its access was closely guarded. At the end of each quarter, top management would meet to close the gap that existed between the actual revenue number and the expected number. Usually the journal entries involved large round numbers, in millions or even tens of millions of dollars, and were booked to an account called Corporate Unallocated revenue account. In reality, this account had no relation to the operating revenues of WorldCom (Zekany, Braun, & Warder, 2004). A total of approximately $958 million in revenue was improperly recorded by WorldCom during Q1 1999 – Q1 2002 (Beresford, Katzenbach, & Rogers (2003).

What is interesting about the inflated earnings is that WorldCom was able to acquire a lower cost of capital in terms of borrowing because the banks assumed WorldCom could cover its loans. The reduction in cost of capital was one of the reasons WorldCom was able to make the multiple acquisitions, paying for the acquisitions with its own inflated stock. From December 1996 to July 2001, WorldCom spent a total of $65 billion in acquisitions. If the Sprint acquisition had been approved, it would have spent a total of $195 billion (Sidak, 2003).

Discovery

<u>The Internal Auditors</u>

The misstated numbers were not detected until suspicions arose in May 2002 when a 2001 capital expenditures audit resulted in a large variance due to entries to an account called "prepaid capacity." When Cooper, the Vice President of the Internal Audit, questioned other personnel about it, no one appeared to give a straightforward answer. When she asked Sullivan about it, he explained they were line costs that had been capitalized and told her to delay the audit until the third quarter of 2002 (Beresford, Katzenbach, & Rogers (2003). Cooper did not consider his request and continued with the audit. She asked Gene Morse, a Manager in the Internal Audit department to look into the entries. Morse (personal communication, October 22, 2010) states it did not take him long to find the journal entries, especially because they were large round-dollar entries even though his access to the full view of both the balance sheet and income statement was limited.

On June 17, 2002, Cooper and Glyn Smith, another internal auditor in the department, went to Betty Vinson in the General Accounting department to further inquire about the prepaid capacity entries. She informed them that she had indeed made those journal entries but only upon the request of top management. They next went to Buddy Yates, Director of General Accounting, who directed them to Controller David Myers who confessed to the fact that he indeed did not have any support for the journal entries and that once top management had started making those entries it was difficult to stop making them (Beresford, Katzenbach, & Rogers (2003). June 25, 2002 marked the public release of the fraud.

Sullivan's White Paper

The question arises: when the fraud was finally discovered, what did Sullivan do to defend himself? According to Beresford, Katzenbach, & Rogers (2003), before Sullivan was fired, he argued with the Board his reasoning of capitalizing the line costs. He stated that he capitalized the expenses because the excess capacity was not in use and should not be expensed until the usage occurred. He also mentioned that the billions of dollars were spent to expand the now unneeded network due to the predictions that demand was rising, which is why WorldCom entered into the long term leases.

In the end, his reasoning was not considered. Beresford, Katzenbach, & Rogers (2003) note the lack of numerical analysis, documentation or any support for the entries. In essence, Sullivan failed to provide independent evidence to the Board. If the external auditor had discovered the entries, the lack of proper and independent support would have raised the red flag that would have aided the auditors in discovering this fraud.

Fraud Triangle

According to Romney & Steinbart (2008), three conditions exist in the occurrence of fraud: pressure, opportunity, and rationalization. Albrecht & Albrecht (2004) state that auditors focus more on the elimination of opportunity by ensuring strong internal controls, however, they often fail to focus on the motivation or rationalization of the perpetrators. See Figure 2.

Pressure

Pressure is a person's motivation to commit fraud. Financial, Emotional, and Lifestyle pressures are common types of pressure that exist for perpetrators (Romney & Steinbart, 2008). In WorldCom's case, financial pressure existed for top management to meet the expectations of analysts at Wall Street. With the downturn in the economic environment, the pressure was intensified. During the month of September 2000, after reviewing the MonRev and other reports, Sullivan advised Ebbers that WorldCom's operating and financial results had worsened and that analysts' expectations for the quarter would not be met (Indictment, 2003). He further advised

Ebbers to issue an “earnings warning” to alert the public about the troubling situation at WorldCom. When Ebbers firmly refused, they both agreed to take steps to conceal the true nature of WorldCom’s financial statements (Indictment, 2003). If the culture at WorldCom had encouraged ethical decisions and integrity, Sullivan could have been the hero by directly informing the Board about the situation and saving billions in shareholder investments that were eventually lost. Sullivan’s loyalty to Ebbers contributed as a pressure to initiate the fraudulent activity.

Ebbers was upheld in society as a honest man who was relied on by the general public, analysts, and investors to provide “guidance” about investment decisions in WorldCom’s performance. Hence, he felt the pressure to continue to contribute as the figure everyone looked upon. Ebbers’s ostentatious lifestyle created pressure as he made large purchases with the help of loans that used WorldCom stock as collateral. If Ebbers had listened to Sullivan and announced the “earnings warning”, the stock price would have collapsed and he would have been fully responsible for his loans. Some form of emotional pressure existed such as greed that contributed to that extravagant lifestyle for both Ebbers and Sullivan. Sullivan was building a mansion in Boca Raton, Florida at the time (Beresford, Katzenbach, & Rogers, 2003). Lynne Jeter (personal communication, October 19, 2010), author of *Disconnected: Deceit and Betrayal at WorldCom*, states that it is very important to know when to step aside. Ebbers was a “master dealmaker” never afraid to walk away from a deal, but when he found himself in a multinational and multicultural environment of business, he lacked the expertise to make the deal and he failed to relinquish some of his control to allow someone else to make the deals.

Opportunity

Opportunity is the condition or situation that allows a person or an organization to: "commit the fraud, conceal the fraud, and convert the theft or misrepresentation to personal gain" (Romney & Steinbart, 2008, p. 150-1). The situation at WorldCom that created the opportunity to commit the fraud was the company's control structure: the control environment, the accounting system, and the control procedures (Albrecht & Albrecht, 2004). The control environment is the work atmosphere or company culture that exists in an organization for its employees. Unfortunately, WorldCom's top management failed to accept the responsibility to create a proper work environment. If top management had taken the action to create a clear culture that encouraged ethical behavior and properly modeled it to the employees, perhaps Sullivan would have given Ebbers a straight 'no' upon the idea of making up the numbers and the fraud would not have occurred. A proper and effective accounting system would provide an audit trail (Albrecht & Albrecht, 2004), essentially a paper trail that would make it easier to detect the fraud. According to Morse (personal communication, October 22, 2010), when WorldCom was in the process of obtaining multiple acquisitions at a fairly quick rate, there was little time to integrate the systems properly and the manipulation of numbers could go undetected thereby, increasing Sullivan's opportunity to commit the fraud and conceal it for longer than it would take an effective accounting system to detect it. Lastly, the control activities or procedures at WorldCom were not good as there was no system of authorizations at headquarters. Sullivan was able to get managers in the General Accounting department to make the journal entries for him without any documentation, even though the entries were valued at millions.

In addition to commit and conceal a fraud, opportunity allows the perpetrator to convert the misrepresentation into personal gain (Romney & Steinbart, 2008). In the case of WorldCom, the personal gain was limited. However, during the fraud period top management did receive large bonuses and Ebbers was able to keep the stock price up enough to satisfy his extravagant purchases and Sullivan was able to fund his Boca Raton mansion (Beresford, Katzenbach, & Rogers, 2003). In the end, all personal fortunes were lost.

The internal audit department did not have full access to the financial statements. Morse (personal communication, October 22, 2010) mentions that he requested Cooper to ask Sullivan for full access. When Sullivan failed to do so, Cooper became suspicious and asked Morse to look into it. He looked through the partial statements and was able to discover the fraudulent entries.

Hence, to decrease the opportunity for an employee or upper management to commit fraud, Albrecht & Albrecht (2004) recommend some important controls in Figure 3**.**

Rationalization

The final element of the fraud triangle is rationalization: a form of justification in the mind of the perpetrators of their illegal behavior (Romney & Steinbart, 2008). Most perpetrators, as in the case of WorldCom, are first-time offenders with no criminal background that allows them to use rationalization to hide their dishonesty (Albrecht & Albrecht, 2004). Due to the economic conditions that existed at the time of the fraud, the managers who made the journal entries presumed the misstatement to be a one-time act (Beresford, Katzenbach, & Rogers, 2003). It is possible that Sullivan also felt that the economy would turn around and all the fraudulent misrepresentation would be equalized by the profits of the next quarter. The choice for Sullivan and Ebbers alike was either their integrity or their personal reputations. Unfortunate for them, they both chose their personal reputations.

An important note here is that because the crimes committed were not violent, the perpetrators did not understand the consequences of their crimes. If one commits murder, it is easier for the murderer to see he has done wrong by taking the life of another human being. However, by committing a fraudulent act, the perpetrator believes he is not hurting anyone even though most investors will later have their life savings and college funds evaporate. Research shows that those "who commit fraud usually mirror the public in education, age, religion, marriage, the length of employment, and psychological makeup" (Romney & Steinbart, 2008, p.148); Furthermore, they enjoy more "optimism, self-esteem, self-sufficiency, achievement, motivation, and family harmony than other property offenders (Albrecht & Albrecht, 2004, p. 19). Therefore, it is sometimes harder to point the finger on a well respected and trustworthy figure of society.

Perhaps if during fraud education training at a company the employees are told and shown that the consequences of fraud can be as devastating as or even worse than that of a violent crime, the perpetrators would be more hesitant of committing fraud and consider themselves different and apart from the regular population as opposed to being a part of it.

Characteristics Conclusion

Fraud occurs when one takes an unfair advantage over another. In WorldCom's case, Ebbers demanded Sullivan to produce the results Wall Street expected through any means.

Sullivan did this by wrongly releasing accruals to lower line costs and later capitalizing them once the accruals ran out. In addition, he "closed the gap" between expected and actual revenues by physically making a round number adjusting journal entry in the system. To prevent the internal auditors from discovering his schemes, Sullivan limited their access to the financial statements. This action created suspicions among the internal auditors that in the end led to the discovery of the fraud.

It is important to understand the details of the case to find out the reason of why the fraud occurred. Using the case as the example, a fraud triangle was created. This triangle has the answers to what led to the initiation of the fraud, how it was implemented without instant discovery, and why it continued for as long as it did.

First, the pressure from Wall Street and from Ebbers led Sullivan to initiate the process. Second, the weak internal control environment of the company was an opportunity that allowed the fraud to go undetected for as long as it did. Third, Sullivan most likely thought he was not causing anyone any physical harm and he expected that once the economy would get better, the extra revenues and growth would make up for the fraudulent misstatement. He did not see he was committing any wrong doing.

Preventing fraud in the first place is the most important control, because once it starts to grow, the damage is already done. The pressures are always going to be there, yet companies can create cultures that emphasize honesty, openness, and integrity so that an employee is less likely to be pressured to do anything unethical. Also, establishing strong internal controls with checks and balances can diminish the easiness of initiating the fraud in the first place and may prevent it from occurring altogether.

Consequences

An important aspect of understanding fraud is comprehending the consequences that occur as a result. If there is an extra emphasis on what happens to the people who put in their life savings and their children's college savings and see them evaporate as a result of someone's greed, the perpetrator may be more hesitant when initiating the fraud.

The events at WorldCom had the "magnitude they did as the result of a combination of forces and a series of weaknesses that came together and, to a degree, fed on each other" (Breeden, 2003, p 13).

Effects on Internal Environment

After the fraud was announced to the public on June 25, 2002, new measures were taken quickly to reform WorldCom and restore the public's confidence in the company. The first big step was the removal of top management. Ebbers resigned earlier in the year due to the extravagant loans he had taken from the company, Sullivan was fired, and Myers resigned. A new president was recruited. The new COO, CFO, general counsel, and director of internal control had no previous relations to WorldCom. The entire Board of Directors was replaced with a new Board to guarantee independence and objectivity about management's decision. The finance and accounting department in Clinton, Mississippi, where the fraudulent activities occurred, was shut down (Breeden, 2003). Hence, any hint that a fraud had occurred at the company was removed.

While more than four hundred new finance and accounting personnel were hired, 17,000 of the existing 85,000 employees at WorldCom were let go. A new independent auditor was brought in to re-audit the financial statements for the fraudulent period. The overstated assets were evaluated for impairment and the goodwill from the previous acquisitions was written down. The use of stock options was also abolished and restricted stock with full expensing value of equity grants was implemented (Breeden, 2003). The stock price itself, which was at a high of $64.50 at its peak in 1999, fell to $0.83 by July 21, 2002, when the firm filed for Chapter 11 bankruptcy. A thorough review of the internal controls was initiated to strengthen the company's internal controls. Lastly, a new ethics program was implemented with training programs for employees to educate them on the manner of their responsibility at the company and on the accounting issues that may signal an irregularity (Breeden, 2003).

While the new implementation of controls depicts a firm action by WorldCom to reinvent itself, it is unfortunate that these changes were exactly what WorldCom needed to prevent the fraud in the first place. If in the pre-discovery period the internal audit department in had been allowed to do its duties properly, it would have discovered the irregularities. While Cooper's department did present many of the deficiencies in the system to the Board, none were considered a priority due to Ebbers's lack of interest in the department.

WorldCom reorganized itself by filing for a Chapter 11 bankruptcy instead of Chapter 7 to show that it wanted to keep its business going and was not giving up on providing its customers what they expected. It also changed its name to its biggest acquisition, MCI, to differentiate itself from the fraudulent WorldCom. In essence, the bankruptcy was characterized by the restructuring of WorldCom's $41 billion in debt. Yet, the Chapter 11 reorganization allowed WorldCom to lower its costs, giving it an unfair advantage over its law abiding competitors. The bankruptcy did lower new WorldCom's market share, which allowed its competitors to survive, even though an artificial decline in prices occurred (Sidak, 2003).

In the end, the new WorldCom was bought by Verizon in 2006 for $8 billion. According to Morse (personal communication, October 22, 2010), Verizon was able to acquire it for a very good price when compared to WorldCom's large infrastructure and a market cap that was at $220 billion at its peak.

Effects on External Environment

The largest effect on the external environment was on the investors of WorldCom. The New York State Common Retirement Fund is the second largest public pension fund in the U.S. It invested the assets of the New York state and local employees' retirement system and of the New York State and Local Police and Fire retirement system. The pension fund lost over $300 million of its investments in WorldCom. The HGK Asset Management, a registered investment advisor, also purchased about $130 million of the debt securities offered by WorldCom on behalf of union sponsored pension and benefit plan and lost it all (in re WorldCom, inc., 2003).

Institutional investors and creditors were perhaps the few that were for the most part unaffected by the debacle due to the diversification of their investments. Hence, even the world's largest bankruptcy of the time was unable to shake their investments.

In terms of the banks, brokers, and accountants that knowingly or unknowingly aided the growth of the fraud, they were punished in five different ways: from the losses they incurred due to loans extended to WorldCom, by the financial penalties and settlements they had to agree to, by the class-action litigations, by losing market value of their own stocks as a result of association with WorldCom, and by the extensive additional costs that had to be incurred to meet the additional legal and compliance measures imposed on them (Smith & Walter, 2006).

Wall Street's settlements with the SEC and, then Attorney General, Eliot Spitzer amounted to $1.5 billion, including annual compliance costs of about $1 billion for five years. Due to the settlements, research budgets fell by 40%, causing many companies to be dropped from Wall Street's coverage, which was necessary to "support investment by institutional investors" (Smith & Walter, 2006).

While it may appear that WorldCom's competitors benefited from its downfall, the effect of the fraud on them was truly the opposite. Since WorldCom's competitors, such as AT&T and Sprint, liked many others, believed that the financial statements were true, the companies had to restructure themselves significantly to match WorldCom's position. Former AT&T CEO, Mike Armstrong, stated that AT&T made "bad investment decisions" such as firing 20,000 employees and utilizing other cost cutting actions to meet WorldCom's numbers. These draconian actions led many to credit Armstrong as the one who broke the company (Sadka, 2006). Former Sprint CEO, William Esrey, also stated that the pressure to compete in the market and to meet WorldCom's false numbers led to an unreasonable expansion of companies in addition to the "foolish investments" and unsustainable low prices (Sidak, 2006). He noted that employees at Sprint had a hard time understanding how it was that WorldCom was able to beat them and they were not able to compete successfully. Sidak adds that while general learning from competitors is healthy and can be socially beneficial, in the case of WorldCom, its competitors were relying on false statements that caused them to become "socially destructive."

Regulations

After the collapse of Enron, the public demanded regulators to take action, yet by early 2002, the rage had died down and no action was taken. However, with WorldCom's failure in June 2002, Congress quickly passed the Sarbanes & Oxley Act ("SOX") about a month later on July 30, 2002 (Smith & Walter, 2006). According to Li, Pincus, & Rego (2008), the purpose of the act is to protect the investors by improving the accuracy and reliability of the disclosures made by the publicly traded companies. It is probable that the act was passed as a political response, but it was also something that was needed in the economic environment much earlier.

If the act was passed before the WorldCom debacle, the fraud itself may not have occurred. Sections 302-306 of the act require management to certify that the financial statements are fairly presented. Hence if any misstatement occurs, management is responsible (The Laws). At his trial Ebbers said that he was unaware of the fraudulent activities and relied on the accounting department for all financial matters because he did not understand the financial statements (Beresford, Katzenbach, & Rogers, 2003). SOX does not allow that to be an excuse anymore. Moreover, SOX requires that when a restatement due to a fraudulent activity is discovered in the company, all bonuses and other incentive-based compensation have to be forfeited. Therefore, the millions in compensation acquired by both Ebbers and Sullivan would have to be returned if the act existed previously. Lastly, SOX forbids top management to obtain loans from the company. Consider how different the outcome might have been if WorldCom's board of directors had denied Ebbers's $400 million in loans. Lack of easy money may have prevented his extravagant lifestyle that pressured him to commit the fraud. On that September of 2000 when Sullivan advised him to report an "earnings warning" to the public, he might have followed the advice and prevented the collapse of the company he helped build for the previous twenty years.

The next important aspect of SOX is Section 301 that gives Audit Committees more responsibility to strengthen the committee’s role. Not only does the act advise the committee to oversee the auditor’s work, but also requires the members of the committee to be independent to ensure conflicts of interest do not arise. Additionally, the external auditors are required to report directly to the Audit Committee and not top management to ensure independence and objectivity (The Laws).

Lastly, Section 404 of the Act requires the SEC to assess the internal controls of financial reporting giving the company responsibility to strengthen the controls and exclude the requirement of having the external auditors assess management’s process of assessing the internal control system (The Laws). According to Cooper (Katz & Homer, 2008), the section established the need for an effective ethics office and a fraud hotline that would have made it easier for her to report the fraud and perhaps another employee would have reported the misstatements sooner than her team’s discovery of it.

In order to protect the interests of investors and the public, the Act also created the Public Company Accounting Oversight Board (“PCAOB”) “to oversee the audit of the public companies that are subject to the securities laws.” The PCAOB is independent, overseen by the SEC, and is funded through the fees paid by publicly held companies who wish to obtain an auditor’s opinion (Carmichael, 2004).

The role of government is an important one to note since the consequences of a debacle usually involve some form of governmental interference. SOX and other measures were used to clean up the existing mishaps that were occurring in the economic environment at the time. According to Smith & Walter (2006), while the new regulation may have satisfied the public outcry at the time, the costs associated with its implementation were quite high, including the large fees publicly held companies have to pay to the PCAOB to retain public status. A question arises: where was the government and the SEC when the fraudulent activities were in progress? It appears that while the government implements the measures, their impact is only on a large group of market participants and usually has limited success in the prevention of a future problem that will not be in the best interest of shareholders (Four years).

Jeter (personal communication, October 19, 2010), mentions some lessons learned from corporate America through the WorldCom downfall. She states that corporate America needs to "clean up" its act. Even with the regulations in place, there is still more work to be done. She adds that "overleveraging is poisonous" because there is simply too much debt in the U.S. corporate environment. The pressure that rises from the unrealistic stockholder demands creates a short-term focus of quarter-to-quarter earnings, when the focus should be on long term profitability as to how the company will perform in the next five.

Consequences Conclusion

Learning the consequences of a horrific event and teaching it to the employees can aid in their understanding of what fraud is and what harsh consequences can occur if one is involved in it. When Sullivan was committing the fraud, he did not see the lost pensions and retirements of many evaporating in the air. He also failed to see the effect the fraud would have on him such as going to jail and letting down the thousands of employees who looked up to him as a role model. Perhaps if employees were given a training session on fraud and saw the outcomes of it, they would think twice before committing it or not commit it altogether.

WorldCom's competitors were also hurt by the fraud. During the fraud period, competitors such as AT&T and Sprint were involved in laying off employees and making poor decisions to stay competitive with WorldCom, only to later find out that what was stated on WorldCom's financial statements was not true. They fired workers and tried aggressively to cut costs wherever they could. Also, when WorldCom received aid from the government with its filing for Chapter 11 bankruptcy, the prices in the telecomm industry declined, further hurting the companies.

The reason a government steps in is to respond to public unrest. In WorldCom's case, which very closely followed the Enron debacle, SOX was put into effect. While the government did take action, most of the regulations listed in SOX were needed to prevent the WorldCom fraud. While this ensures that another fraud very similar to WorldCom may not occur in the future, it does not guarantee that a massive fraud in general will not occur. There is always a loophole. Also, the external environment and the industry may be vulnerable enough to initiate some kind of fraud. Therefore, there should be an entity, such as the PCAOB, that has the role to detect these loopholes before any type of fraud is initiated through them. This will help prevent the fraud and increase the public's trust in the financial markets.

Conclusion

The causes, the characteristics, the consequences tell a story with a lesson.

The causes serve as red flags that the stakeholders and auditors of a company should look for to prevent a fraud. If the circumstances within the company and in its external environment suggest a situation different than what is represented in the financial statements, suspicions should be raised. Especially, the external auditor must increase the amount of persuasive evidence needed as well as increase the tests performed required to give an objective opinion.

The characteristics serve as red flags for auditing the financial statements. If a fraud has occurred in the company's industry previously, the auditor should gather as much information as possible about the previous fraud in terms of its journal entries and other accounting tactics utilized and observe closely the fraud triangle to see if similar pressures persist presently as they did in the previous fraud.

The consequences serve as red flags for the auditor as reminders that the objective of the auditor is to provide an independent opinion on the company and retain the public's trust in him/her. If the auditor fails to do so, the consequences can be disastrous and can lead to grueling circumstances for the company, its stake holders, and the economic state of the country.

The lessons learned serve as reminders to not commit the same mistakes as were previously committed.

Do not with hold from people what is rightly theirs and do not spread corruption. This is all for the better well being of society.

Appendix: Figures

Appendix: Figures

Figure 1: Locations of WorldCom offices

Figure 2: Fraud Triangle

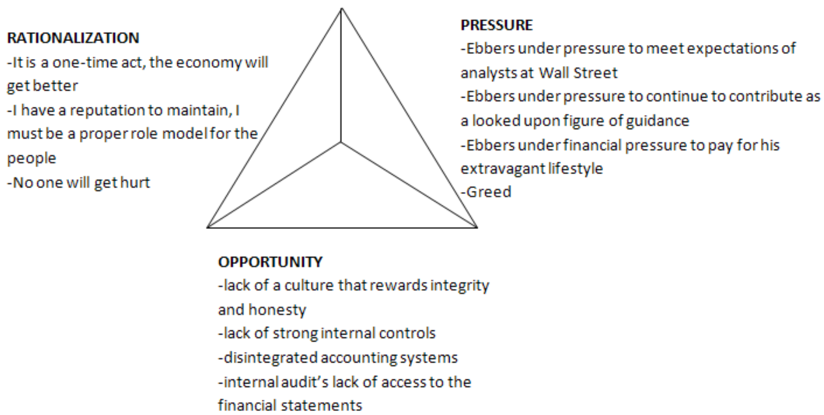

Figure 3: Internal Control Structure

Control Environment	**Accounting System**	**Control Activities or Procedures**
1. Management philosophy and operating style, modeling 2. Effective hiring procedures 3. Clear organizational structure of proper modeling and labeling 4. Effective internal audit department	1. Valid transactions 2. Properly authorized 3. Completeness 4. Proper Classification 5. Proper timing 6. Proper Valuation 7. Correct summarization	1. Segregation of duties 2. Proper procedures for authorization 3. Adequate documents and records 4. Physical Control over assets and records 5. Independent checks on performance

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