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WorldCom: The Accounting Scandal

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Summary

On June 25, 2002, WorldCom, the Nation's second largest long distance telecommunications company, announced that it had overstated earnings in 2001 and the first quarter of 2002 by more than $3.8 billion. The announcement stunned financial analysts and, coming on top of accounting problems at other corporations, had a noticeable effect on the financial markets. The accounting maneuver responsible for the overstatement – classifying payments for using other companies' communications networks as capital expenditures – was characterized by the press as scandalous, and it was immediately asked why Arthur Andersen, the company's outside auditor at the time, had not detected it. WorldCom filed for bankruptcy protection on July 21st. On August 8th, the company announced that it had also manipulated its reserve accounts in recent years, affecting an additional $3.8 billion.

Response in Washington was swift. On June 26th, the U.S. Securities and Exchange Commission (SEC) charged the company with massive accounting fraud and quickly obtained court order barring the company from destroying financial records, limiting its payments to past and current executives, and requiring an independent monitor. Hearings were held by the House Committee on Financial Services on July 8th and by the Senate Committee on Commerce, Science, and Transportation on July 30th. Several company officials have been indicted.

The fundamental economic problem confronting WorldCom is the vast oversupply in the Nation's telecommunications capacity, a byproduct of overly optimistic projections of Internet growth. WorldCom and other telecommunications firms faced reduced demand as the dot–com boom ended and the economy entered recession. Their revenues have fallen short of expectations, while the debt they took on to finance expansion remains high. As the stock market value of these firms has plunged, corporate management has had a powerful incentive to engage in accounting practices that conceal bad news.

Background. WorldCom Inc. began as a small Mississippi provider of long distance telephone service. During the 1990s, the firm made a series of acquisitions of other telecommunications firms that boosted its reported revenues from $154 million in 1990 to $39.2 billion in 2001, placing it 42nd among Fortune 500 companies. Noteworthy acquisitions included the 1998 takeover of MCI, which made it the second largest U.S. long distance carrier, and the purchases of UUNet, CompuServe, and America Online's data network, which put WorldCom among the leading operators of Internet infrastructure.

The fundamental economic problem confronting WorldCom is the vast oversupply in telecommunications capacity that emerged in the 1990s, as the industry rushed to build fiber optic networks and other infrastructure based on overly optimistic projections of Internet growth. WorldCom and other telecommunications firms have faced reduced demand as the dot–com boom ended and the economy entered recession. Their revenues have fallen short of expectations, while debt taken on to finance mergers and infrastructure investment remains.

WorldCom is not the only telecommunications firm in financial trouble. The difficulties of Qwest Communications, Global Crossing, Adelphia, Lucent Technologies, and Enron (which had major investments in internet ventures) have been widely reported.[1] As in these other firms, investors in WorldCom have suffered major losses: the market value of the company's common stock plunged from about $150 billion in January 2000 to less than $150 million as of July 1, 2002. Depending on the outcome of the bankruptcy proceedings, the stock may soon be worthless. The desire to avoid or postpone stock market losses of this magnitude creates a powerful incentive for corporate management to engage in accounting practices that conceal bad news.

The Accounting Maneuver. In its June 25th statement, WorldCom admitted that the company had classified over $3.8 billion in payments for line costs as capital expenditures rather than current expenses. Line costs are what WorldCom pays other companies for using their communications networks; they consist principally of access fees and transport charges for messages for WorldCom customers. Reportedly, $3.055 billion was misclassified in 2001 and $797 million in the first quarter of 2002. According to the company, another $14.7 billion in 2001 line costs was treated as a current expense.[2]

By transferring part of a current expense to a capital account, WorldCom increased both its net income (since expenses were understated) and its assets (since capitalized costs are treated as an investment). Had it not been detected, the maneuver would have resulted in lower net income in subsequent years as the capitalized asset was depreciated (depreciation is an expense that reduces net income). Essentially, capitalizing line costs

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[1] Qwest Communications announced on July 28th that it had erroneously accounted for telecommunications capacity swaps with other companies and will restate its previous earnings.

[2] According to the July 4th *The New York Times*, a June 24th memo prepared by Scott D. Sullivan, the chief financial officer at the time, attempted to justify the capitalization by arguing that WorldCom was paying for excess capacity that it would need in the future, i.e., that the line costs in question were a cost of obtaining customers. (In some instances, accounting rules do allow for costs of obtaining customers to be capitalized.)

would have enabled the company to spread its current expenses into the future, perhaps for 10 years or even longer.

WorldCom's accounting had been questioned before its June 25 admission. In March 2002, the SEC requested data from the firm about a range of financial reporting topics, including (1) disputed bills and sales commissions, (2) a 2000 charge against earnings related to wholesale customers, (3) accounting policies for mergers, (4) loans to the CEO, (5) integration of WorldCom's computer systems with those of MCI, and (6) WorldCom's tracking of Wall Street analysts' earnings expectations.

On July 1, 2002, WorldCom announced that it was also investigating possible irregularities in its reserve accounts. Companies establish these accounts to provide a cushion for predictable events, such as future tax liabilities, but they are not supposed to manipulate them to change reported earnings. On August 8th, WorldCom admitted that it had improperly used its reserves in recent years. The indictments issued August 28th charged that reserve accounts were reduced in order to provide credits against line expenses.

Auditing Questions. According to initial accounts, the treatment of line costs as capital expenditures was discovered by WorldCom's internal auditor, Cynthia Cooper, in May, 2002. The auditor discussed the misclassification with the chief financial officer at the time, Scott D. Sullivan, and the company's controller at the time, David F. Myers. Ms. Cooper reported the matter to the head of the audit committee of WorldCom's board of directors, Max Bobbitt, on or about June 12th, who in turn asked the company's current outside auditor, KPMG, to investigate. (WorldCom had replaced Arthur Andersen, which had served as its outside auditor since 1989, with KPMG on May 16, 2002.) The chief financial officer, Scott D. Sullivan, was asked to justify the treatment and, after further discussions, he was dismissed on the day WorldCom made its public announcement, June 25th. Mr. Myers resigned that day as well. Reportedly, Mr. Sullivan had not consulted with Arthur Andersen about classifying some line costs as capital expenditures, and Andersen has maintained it was not notified of them.

On July 15th, however, Representative Tauzin, Chairman of the House Energy and Commerce Committee, said that internal WorldCom documents and e-mail messages indicated that the Company's executives knew as early as the summer of 2000 that the accounting treatment was improper.

Internal auditors are an early line of defense against accounting errors (e.g., mistaken classifications with no intention to deceive) and accounting fraud (e.g., knowingly false classifications with intention to deceive). One question regarding WorldCom is why it took more than a year for the company's internal auditors to discover the misclassification; arguably, considering the amount of costs being capitalized (roughly, $750 million each quarter) and the impact on net income and assets, this might have been caught earlier.

Tougher questions might be asked of Arthur Andersen. To some observers, the fact that Andersen was not notified that line costs were being capitalized is irrelevant; they argue that Andersen should have designed its audit to detect misclassifications of this magnitude. Some observers also note that Andersen should have taken into account the

increasingly precarious financial condition of WorldCom and paid more attention to the possibility of aggressive accounting practices.

Some Consequences. Prior to the June 25th announcement about accounting problems, WorldCom stock had fallen from a high of $64.50 a share in mid-1999 to less than $2 a share. The price fell below $1 a share immediately after the announcement and then to pennies a share upon news that there might be further accounting irregularities. While much and perhaps most of this decline might be attributed to the firm's changing economic prospects, the accounting maneuver described above is likely to have hurt investors who continued to hold the shares or even bought more in anticipation of a rebound.

WorldCom employees who hold the company's stock in their retirement plans have also suffered losses. At the end of 2000, about 32%, or $642.3 million, of WorldCom retirement funds were in company stock; those investment have fallen to less than 4%, or less than $18.7 million, of the funds. WorldCom does not require employees to own company stock in their retirement plans, and they are permitted to sell the shares they do have.

WorldCom filed for Chapter 11 bankruptcy protection on July 21st. (The goal of a Chapter 11 bankruptcy is to keep the firm in business under a court-supervised rehabilitation plan.) While the company reported $103.8 billion in assets as of the end of March 2002, it also has $41 billion in debt on which it must make payments. The WorldCom bankruptcy is the largest in U.S. history; in comparison, Enron listed assets of $63.4 billion when it filed for bankruptcy in December, 2001.

One factor affecting WorldCom's future is whether its customers switch to other telecommunications carriers. On July 1st, the Bush Administration announced that it was considering disqualifying WorldCom from further federal government contracts. (The Federal Aviation Administration has rejected WorldCom's bid to modernize its communications systems.) How bankruptcy would affect service to customers retaining WorldCom contracts is an issue the Federal Communications Commission is monitoring.

Immediately after the June 25th announcement, WorldCom stated that it would cut 17,000 of its 85,000 employees. The extent to which these dismissals would have occurred in the absence of the firm's accounting problems is not clear.

Most Recent Developments. Listed below are some recent developments regarding the WorldCom accounting scandal.

July 1, 2002: WorldCom submitted a statement about its accounting to the SEC. After criticism, it submitted a revised statement on July 8th. The latter is available through the SEC website at [http://www.sec.gov/news/extra/wcresponserev.htm].

July 2nd: The House Committee on Energy and Commerce asked the SEC to provide the Committee with information on its oversight of WorldCom and some other companies for which there are allegations of questionable accounting practices.

July 3rd: a federal district court judge in New York City appointed a former SEC Chairman, Richard C. Breedon, to review payments to WorldCom officers and see that the company does not destroy documents.

July 8th: the House Committee on Financial Services held a hearing about WorldCom's accounting problems. Two executives at the time of the misclassification, Scott D. Sullivan (the former chief financial officer) and Bernard J. Ebbers (the former chief executive) declined to testify, citing their Fifth Amendment rights. Testimony was given by John. W. Sidgmore (the current chief executive), Bert C. Roberts (the company's chairman), Jack Grubman (a telecommunications analyst at Salomon Smith Barney) and Melvin Dick (Arthur Andersen's former lead auditor for WorldCom).

July 11th: WorldCom announced that it was cancelling plans to pay a 60-cents a share dividend to shareholders of the long-distance MCI unit that it had acquired. The dividends would have cost WorldCom about $72 million.

July 15th: WorldCom did not pay $79 million in interest charges that were due this day.

July 21st: WorldCom filed for Chapter 11 bankruptcy protection.

July 22nd: U.S. Bankruptcy Judge Arthur Gonzalez granted a Justice Department request that an independent prosecutor be appointed to investigate WorldCom for fraud and mismanagement. The Judge also approved $750 million in interim financing, which may tide it over until a September 4th court hearing when further financing might be approved.

July 29th: WorldCom named a new chief financial officer (John S. Dubel) and a chief restructuring officer (Gregory F. Rayburn). A committee was named to represent the company's creditors. The Nasdaq stock market announced that it would delist WorldCom stock.

August 1st: Federal prosecutors charged Scott D. Sullivan (the former chief financial officer) and David F. Myers (the former controller) with securities fraud, conspiracy, and filing false statements with the SEC.

August 8th: WorldCom admitted that it had manipulated its reserve accounts in order to inflate earnings for years 1999, 2000, and 2001. The amounts at issue totaled $3.8 billion, thus doubling the total reported accounting irregularities. In addition, WorldCom indicated that it may write off $50.6 billion in goodwill and other intangible assets when it restates its financial results for previous years. Were this to occur, this write off would cut the book value of company assets in half.

August 9th: The House Committee on Financial Services said that it will subpoena additional documents from Citicorp as part of its investigations into how WorldCom was financed. The subpoena was issued on August 14th.

August 26th: (1) The House Committee on Financial Services released e-mails written by David F. Myers in January, 2002, in which he ordered a WorldCom financial executive based in Britain not to have any further meetings with Arthur Andersen;

reportedly, the executive had been questioning the way WorldCom was accounting for asset impairments. (2) Documents submitted to the House Committee on Financial Services (pursuant to the August 14th subpoena) indicated that Bernard J. Ebbers, the former chairman of WorldCom, had received almost a million shares of stock in initial public offerings (IPOs) from the investment banking firm Salomon Smith Barney (now a division of Citigroup) during the years 1996 through 2000.[3] Six other WorldCom executives also were given the opportunity to buy such stock. At issue is whether the IPO allocations were used to ensure that WorldCom continued to give the firm investment banking business.

August 27th: The federal district court judge who appointed the outside monitor for WorldCom's finances (see the July 3rd entry, above) raised concerns that the company was not keeping the monitor informed about millions of dollars in fees it was paying Wall Street investment firms.

August 28th: A federal grand jury indicted Scott Sullivan for securities fraud, conspiracy to commit securities fraud, and making false filings with the SEC. The indictment replaces the criminal complaint filed on August 1st. Also indicted was Buford Yates, WorldCom's former director of general accounting. Betty Vinson (former director of management reporting) and Troy Normand (former director of legal entity reporting) were named as unindicted co-conspirators..

[3] The documents can be accessed at the Committee's website, available through the congressional Legislative Information System (LIS). Larger IPO allocations were made by Salomon Brothers prior to its merger with Smith Barney in 1997.