WorldCom: A Simple Recipe for Cooking the Books

by Rebekah A. Sheely, Ph.D., CPA

Enron, Tyco, Global Crossing, Adelphia, WorldCom, and HealthSouth - the list continues to grow. While Enron is perhaps the most complicated fraud in the recent string of business failures, WorldCom was the most simple to perpetrate. Before new accountants and the average investor can even begin to understand the chicanery that took place at Enron, they would need to receive instruction on Special Purpose Entities (SPEs) and their associated accounting rules. However, to understand the fraud that occurred at WorldCom, the student need only understand the difference between operating and capital expenditures - a topic introduced fairly early in the first accounting course.

Most introductory accounting textbooks introduce the notion of operating versus capital expenditures in the chapter dealing with long-term assets. See if the following illustration jogs your memory. A company spends $500 to perform annual maintenance on a cutting machine. This expenditure is an operating expenditure and, as such, it would be posted to the Repairs & Maintenance Expense account. Current net income would decrease as a result. However, if the company spends $500 to replace the motor in the machine, this expenditure would be posted to the asset account “Property, Plant, and Equipment”. Such an expenditure is a capital expenditure because the life of the equipment has been extended and/or its operating efficiency increased. There would be no effect on net income except as a result of increased depreciation expense for the current and subsequent years. The cost is spread over many years as opposed to being expensed in the current year only. You now know enough to “cook the books” using

WorldCom's recipe for fraud.

<u>The Fraud:</u>

WorldCom, the number two long-distance telephone provider, announced $3.8 billion in improperly booked expenses for 2001 and 2002. And in August 2002, the company disclosed an additional $3.3 billion in accounting errors. As a result, the company will be forced to restate earnings for 2000 as well.[1] The sheer size of the fraud is difficult to comprehend. How did it happen and why did no one catch it sooner?

The fraud perpetrated at WorldCom did not take place at the lower levels of the organization. When invoices were paid, they were properly coded to an operating expense account. The Arthur Andersen staff auditor tracing an invoice through the accounts payable system would not find this fraud. Instead, huge amounts were reclassified by upper management as capital expenditures. For example, $500 million in undocumented computer expenses were logged as a capital expenditure. In addition, line costs were not expensed as required by Generally Accepted Accounting Principles (GAAP). The following paragraph taken from an Oct. 30, 2002, *Wall Street Journal* article elaborates:

> By 2000, WorldCom had started to rely on aggressive accounting to blur the true picture of its badly sagging business. A vicious price war in the long-distance market had ravaged profit margins in the consumer and business divisions. Mr. Sullivan [WorldCom's former chief financial officer] had tried to respond by moving around reserves [for bad debt], according to his indictment. But by 2001 it wasn't enough to keep the company afloat.
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> And so Mr. Sullivan began instructing Mr. Myers [senior vice president and controller] to take line costs, fees paid to lease portions of other companies' telephone networks, out of operating expense accounts where they belonged and tuck them into capital accounts, according to Mr. Sullivan's indictment.[2]

<u>Where were the auditors?</u>

Audit authorities say that WorldCom's fraud was so rudimentary it should have been obvious to the firm's external auditors, Arthur Andersen. Expenses disguised as capital expenditures are one of the first things a skeptical auditor would examine.[3] Evidence was produced in the recent court case against the public accounting firm that Andersen did not verify WorldCom's treatment of line costs. Rather, it relied on management's representations. The U.S. District Court held that Andersen would have uncovered the fraud if it had conducted the required review before issuing its audit opinion. The Court held that the Andersen audit opinions included in WorldCom's year-end financial statements materially misrepresented the company's financial condition.[4]

It would take three internal auditors to uncover the fraud - Cynthia Cooper, head of the internal audit department; Gene Morse, whose technology skills were useful in ferreting information out of WorldCom's information system; and Glyn Smith, a senior manager. Ms. Cooper's department primarily performed operational audits and, as such, was unlikely to discover the fraud. The majority of the financial auditing was left to Arthur Andersen. However, concerns over the treatment of a $400 million bad debt reserve and questions from the Securities and Exchange Commission (SEC) caused Ms. Cooper to start performing financial audits, looking at the reliability and integrity of the financial information the company was reporting publicly. [5]

The team of internal auditors soon stumbled onto the issue of capital expenditures. They discovered that $2 billion that the company said in public disclosures had been spent on capital expenditures during the first three quarters of 2001 had never been authorized for capital spending. Concerned that CFO Sullivan might try to cover up the fraud, Ms. Cooper and Mr. Smith met with Mr. Bobbitt, the head of WorldCom's audit committee. The audit committee then took steps to remove both Sullivan and Myers. Mr. Sullivan was fired and Mr. Myers resigned. And the next evening, WorldCom announced that it had inflated profits by $3.8 billion over the previous five quarters. WorldCom has since filed for bankruptcy. With $107 billion in assets, WorldCom's bankruptcy is the largest in U.S. history, larger than even that of Enron Corporation.[6]

The Consequences:

In an attempt to remain a viable organization, WorldCom is doubling its internal audit department staff, creating two new operational CFO positions, and hiring a new corporate controller. In addition, a settlement with the Securities and Exchange Commission (SEC) also calls for WorldCom executives to attend ethics training while submitting future business decisions to extensive review by a court-appointed "watchdog". "WorldCom's management and board are determined to ensure that what happened here in the past cannot recur," said John Sidgmore WorldCom's current president and chief executive.[7]

However, WorldCom is not the only company facing reform. The SEC said WorldCom had committed "accounting improprieties of unprecedented magnitude" and that these improprieties were proof of the need for reform in the regulation of corporate accounting. And reform has come in the form of the Sarbanes-Oxley Act (SOX) of 2002. This act adds significant fines and longer jail time for a corporate executive who improperly signs-off on the appropriateness of the company's financial statements when that executive is aware of misstatements.

A September 2003 study by Proviti indicates that SOX is presenting chief financial offices with significant challenges beyond the well-publicized executive certification of financial statements. The executives revealed other concerns such as aligning audit committee activities with legal and regulatory requirements. An audit committee is a selected number of members of a company's board of directors whose responsibilities include helping auditors remain independent of management. It meets periodically with the public accounting firm to discuss audit progress and findings and helps to resolve conflicts between the accounting firm and management. Sixty percent of CFOs polled by Proviti said that since the passage of the Sarbanes-Oxley Act, their boards have expanded their oversight of the external audit process as well as internal audit activities. In addition, forty-six percent of respondents with large companies report that their directors or board committee are conducting self-assessments in which they are rating their own performance and reporting the results to the full board.[8]

There is one major difference between the situation at WorldCom and those at Enron, Tyco, and Global Crossing. While the board of directors of the other firms were in agreement with the fraudulent accounting treatments or -at the very least- grossly negligent in their duties, the board of directors of WorldCom, upon learning of the fraud, acted quickly. "As disastrous as this is, there really is a ray of light here because the company's own board of directors blew the whistle," said Stuart Gilman, president of the Ethics Resource Center in Washington. "They caught sight of the problem, took responsibility and stepped forward."[9] The investing community can only hope that more boards model their behavior.

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1. WorldCom finds more faulty accounting". *Network World* 6 19, no. 32 (Aug. 12, 2002).

2. Pulliam, S. and D. Solomon. "Uncooking the Books: How Three Unlikely Sleuths Discovered Fraud at WorldCom". *Wall Street Journal* A1 (Oct. 30, 2002).

3. "Authorities Say WorldCom Accounting Ruse Should Have Been Obvious to Andersen" in the *Chicago Tribune*, July 2, 2002; available at http://accounting.smartpros.com/x34540.xml.

4. Hecht, C. “SEC Central: Who is Responsible?” Aug. 2002; available at http://accounting.smartpros.com/x34948.xml.

5. Pulliam, S. and D. Solomon. “Uncooking the Books: How Three Unlikely Sleuths Discovered Fraud at WorldCom”. *Wall Street Journal* A1 (Oct. 30, 2002).

6. Beltran, L. “WorldCom files largest bankruptcy ever”, July 19, 2002; available at http://money.cnn.com

7. Ulick, J. “SEC hits WorldCom with charges”. Jun. 25, 2002; available at http://money.cnn.com/2002/06/25/news/worldcom.

8. “CFOs Identify Top SOX Challenges”. Sept. 15, 2003; available at http://accounting.smartpros.com/x40568.xml

9. “WorldCom finds more faulty accounting”. *Network World* 6 19, no. 32 (Aug. 12, 2002).