**Case 2-1**

**WorldCom**

The WorldCom fraud was the largest in U.S. history, surpassing even that of Enron. Beginning modestly during mid-year1999 and continuing at an accelerated pace through May 2002, the company, under the direction of Bernie Ebbers, the CEO, Scott Sullivan, the CFO, David Myers, the controller, and Buford Yates, the director of accounting, “cooked the books” to the tune of about $11 billion of misstated earnings. Investors collectively lost $30 billion as a result of the fraud.

The fraud was accomplished primarily in two ways:

1. Booking “line costs” for interconnectivity with other telecommunications companies as capital expenditures rather than operating expenses;

2. Inflating revenues with bogus accounting entries from “corporate unallocated revenue accounts.”

During 2002, Cynthia Cooper, the vice president of internal auditing, responded to a tip about improper accounting by having her team do an exhaustive hunt for the improperly recorded line costs that were also known as “prepaid capacity.” That name was designed to mask the true nature of the costs and treat them as capitalizable costs rather than as operating expenses. The team worked tirelessly, often at night and secretly, to investigate and reveal $3.8 billion worth of fraud.

Soon thereafter, Cooper notified the company’s audit committee and board of directors of the fraud. The initial response was not to take action, but to look for explanations from Sullivan. Over time, Cooper realized that she needed to be persistent and not give in to pressure that Sullivan was putting on her to back off. Cooper even approached KPMG, the auditors that had replaced Arthur Andersen, to support her in the matter. Ultimately, Sullivan was dismissed, Myers resigned, Andersen withdrew its audit opinion for 2001, and the Securities and Exchange Commission (SEC) began an investigation into the fraud on June 26, 2002.

In an interview with David Katz and Julia Homer for *CFO Magazine* on February 1, 2008, Cynthia Cooper was asked about her whistleblower role in the WorldCom fraud. When asked when she first suspected something was amiss, Cooper said: “It was a process. My feelings changed from curiosity to discomfort to suspicion based on some of the accounting entries my team and I had identified, and also on the odd reactions I was getting from some of the finance executives.”

Cooper did exactly what is expected of a good auditor. She approached the investigation of line-cost accounting with a healthy dose of skepticism and maintained her integrity throughout, even as Sullivan was trying to bully her into dropping the investigation.

When asked whether there was anything about the culture of WorldCom that contributed to the scandal, Cooper laid blame on Bernie Ebbers for his risk-taking approach that led to loading up the company with $40 billion in debt to fund one acquisition after another. He followed the same reckless strategy with his own investments, taking out loans and using his WorldCom stock as collateral. Cooper believed that Ebbers’s personal decisions then affected his business decisions; he ultimately saw his net worth disappear, and he left owing WorldCom some $400 million for loans approved by the board. Ebbers was sentenced to 25 years in jail for his offenses.

Betty Vinson, the company’s former director of corporate reporting, was one of five former WorldCom executives who pleaded guilty to fraud. At the trial of Ebbers, Vinson said she was told to make improper accounting entries because Ebbers did not want to disappoint Wall Street. “I felt like if I didn’t make the entries, I wouldn’t be working there,” Vinson testified. She said that she even drafted a resignation letter in 2000, but ultimately she stayed with the company.

Vinson said that she took her concerns to Sullivan, who told her that Ebbers did not want to lower Wall Street expectations. Asked how she chose which accounts to alter, Vinson testified: “I just really pulled some out of the air. I used some spreadsheets.”

Her lawyer had urged the judge to sentence Vinson to probation, citing the pressure placed on her by Ebbers and Sullivan. “She expressed her concern about what she was being directed to do to upper management, and to Sullivan and Ebbers, who assured her and lulled her into believing that all was well,” he said. In the end, Vinson was sentenced to five months in prison and five months of house arrest.

**Questions**

1. **What is the difference between accrual earnings and cash earnings? In addition to the effect on accrual earnings of capitalizing the line costs, how might the treatment mask the true nature of operating cash flows?**

Cash earnings account for revenue with cash inflows and for expense with cash outflows. Cash earnings then are a recording of true cash flows. This method has timing differences between cash for revenue is received and when it is earned. There are also timing differences between cash disbursed for expenses and when the expenses are incurred. Accrual earnings are an attempt to match earned revenues with incurred expenses. Accrual earnings account for the timing differences found in cash earnings by recording a receivable or payable to record the matched revenue and expenses in the same time period.

For example, consider accounting for leases. Accounting rules on leases proscribe which leases qualify as an operating lease (a current expense), and which qualify as a capitalizing lease (capitalized and depreciated over the life of the asset). By capitalizing and depreciating the cost over the life of the asset, the expense amount is smaller each year and matches the expense of the asset with the revenues earned by the asset over its lifetime.

In WorldCom scandal, Scott Sullivan explained that the prepaid capacity was fiber optic lines leases that were being capitalized, instead of expensed. The revenues on the leased fiber lines had declined, so the leases were being capitalized to better match the expense with the revenues. (He later admitted that he was trying to use the matching principle to justify the capitalization of the lease costs and avoid additional expensing thereby reducing earnings.) Cooper realized that capitalization of leases is based upon the lease being a financing lease to purchase the asset, not matching of the costs of the fiber lines with the revenues from the lines.

1. **Identify the stakeholders in the WorldCom case and how their interests were affected by the financial fraud.**

The stakeholders in the WorldCom case are top management (i.e., Ebbers and Sullivan), Cooper, Vinson, the owners, employees, investors, creditors, the accounting firm (Andersen), the audit committee of the board of directors and the public. The owners, investors, and creditors lost their investment. Employees lost their jobs. Accountants like Vinson who gave in to the pressure to falsify the numbers suffered great harm. Andersen suffered a further blow to its already fragile reputation given the Enron fiasco. The public lost faith in public accounting and CPAs.

1. **Use ethical reasoning to compare the actions of Cynthia Cooper in the WorldCom case to those of Sherron Watkins in the Enron case, discussed earlier in this chapter.**

Cooper and the internal auditors used objectivity and skepticism in looking at the prepaid capacity costs. They did not accept glib answers after being stonewalled on questions and requests for support and documentation. Their actions relate to the Rest’s four-component model of morality: moral sensitivity, moral judgment, moral motivation, and moral character. The auditors realized the dilemma; knew that the accounting entries were not following generally accepted accounting principles; were motivated to find answers and not accept glib answers and stonewalling; and were determined to have the situation resolved and reviewed by the audit committee.

Watkins knew the company falsified its financial information and did not go beyond Ken Lay, who was partly to blame, in taking her concerns further in the organization. She knew it was wrong but only took limited action to correct the matter. She also seemed motivated by her own self-interests more than the interests of others. Watkins’ situation did not directly affect her position because she was not in the accounting or auditing group. Still, she had the knowledge to stop the fraud but didn’t act on it once it was clear nothing would be done within the company to stop the bleeding.