A Social-Psychology Perspective of WorldCom Failure: 
Appraising Accounting Manipulation in the Lens of Fraud Triangle

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Abstract

The headline-grabbing corporate failures in the early 2000s attracted immediate attention of the politicians, regulators, academic researchers and public. As the impact of the corporate failures, such as Enron and WorldCom was severe and far-reaching, the inquiry committees and many researchers explained the causes and ways of accounting manipulation. The purpose of this paper is not to simply explain accounting manipulation, but to specifically focus on a framework for explaining the interrelationships of the factors contributing to accounting manipulation. WorldCom as the biggest case of corporate failure in the history of corporate America was selected as a case for in-depth analysis. A social—psychology perspective was taken for this purpose. As a consequence, a theory of 'fraud triangle' was chosen from the sociological criminology literature. The facts suggest that the three factors— incentives, opportunities and rationalisation—worked in conjunction to explain the accounting manipulation in WorldCom. The findings of this paper will be useful for other studies to explain the social—psychological relationships of the factors of accounting manipulation.

Keywords: manipulation, fraud triangle, incentives, pressures, opportunities, rationalization.

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A Social-Psychology Perspective of WorldCom Failure: 
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1. Introduction

WorldCom is known as the biggest corporate failure ever in the history of the United States of America (USA). After Enron failure, the collapse of WorldCom drew massive attention of the politicians, regulators and media. The independent directors of WorldCom and the Bankruptcy Examiner Dick Thornburg investigated the causes of this failure. They embarked on the accounting malfeasances that happened in the presence of adverse industry and entity conditions, weak internal governance, lax oversights, analysts' expectations about company performance, and self-interests as well as dominant role of the senior executives. Although academic literature on WorldCom is not as rich as that on Enron, a number of studies (Unerman and O'Dwyer, 2004; Kaplan and Kiron, 2005; Reber and Gower, 2006; Knechel, 2007) saw WorldCom from diverse perspectives. I intend to see accounting manipulation in WorldCom from a social-psychology perspective. As the accounting numbers are not manipulated in the vacuum and the accounting research is becoming day by day interdisciplinary in orientation, the rationale of using a social-psychology approach is that the behaviour (attitude) of the preparers of financial reports along with the incentives for and ways of manipulation can be seen in holistic perspective. Hopwood (1973, 2007) continues to suggest adopting the social-psychology framework in conducting accounting research. As noted by Hopwood:

'New fields of inquiry often are in both the sciences and social sciences. Fama’s research on efficient markets emerged at the interface of finance, economics, and statistics. Similarly for the endeavour of Ball and Brown, and my own research (Hopwood 1973) utilized the insights and approaches of social psychology and organizational sociology as well as accounting.' (Hopwood, 2007: 1366).
Although the insights and approaches of social psychology and organizational sociology began to be used in accounting in the late 1960s and 1970s, a comprehensible framework for interpreting accounting manipulation in the lens of social-psychology was not present in the contemporary periods. The earnings management and income smoothing studies progressively published in the 1960s, 1970s, 1980s and onward used to take agency theory and positive accounting theory viewpoints that became more apparent with the groundbreaking work of Jensen and Meckling (1976) and Watts and Zimmerman (1986, 1990). The main argument of the positive theory of agency is that the managers may behave opportunistically to maximize their own welfare (Arrow, 1984; Strong and Waterson, 1987). As managers have different objective functions from the shareholders, in a world of bounded rationality and asymmetric information, they may be strategic to have the opportunity and incentive in order to pursue their own goals at a cost to the shareholders (Merrett and Houghton, 1999: 224). However, the limitation of the positive view of agency is that the process of rationalisation, that is, how people demonstrate their attitude or language to support self-directed or self-committed manipulation has not yet been clearly addressed. People live in the society with inherent human characteristics and “no one is perfect” (Roberts, 2009). Therefore, in the view of the sociologists (Sutherland, 1949; Cressey, 1953), the persons in the high positions can take opportunities of manipulation in their own interests (incentives and pressures) and show dominant (or deviant) attitude to rationalise their actions. This social-psychological interpretation of the executive fraud is commonly known as ‘fraud triangle’. The specific purpose of this paper is to examine the causes, ways and justification of accounting manipulation in WorldCom using the social-psychological notion of “fraud triangle”. Section 2 explains ‘fraud triangle’ as a theory. Section 3 introduces WorldCom as a case. Section 4 appraises the case against the theory.
2. Theoretical Framework

The origin of ‘fraud triangle’ is grounded in the seminal work of the sociological criminologists. Depending on the concept of ‘white-collar crime’ developed between 1939 and 1949 by the eminent sociologist T. E. Sutherland, his research fellow as well as academic colleague Donald R. Cressey theorised and tested the concept of ‘fraud triangle” to explain the causes, ways and rationalisation of embezzlement (of fund) leading to violation of trust. Cressey’s (1953) ideas about the relationship between the three components of fraud triangle are commonly known now-a-days as “incentives-opportunities-rationalisation”. Incentives are broadly defined as the self-interests of the persons (e.g., senior management) charged with governance and the internal or external pressures motivating to commit manipulation. Opportunities derive from the weak governance (control and oversight) and the subjective judgements in the application of accounting principles. Rationalisation is demonstrated through the attitude, behaviour or verbalisations of the preparers justifying a manipulation. A manipulation or fraud does not occur in the absence any of these three elements. The concept of fraud triangle was first introduced in accounting literature by Albrecht, Howe and Romney (1984). Accounting professions including the American Institute of Certified Public Accountants AICPA), the International Federation of Accountants (IFAC) and the Auditing and Assurance Standards Board (AUASB) in Australia have considered the underlying notion of fraud triangle in developing or adopting the auditing standards (such as, AICPA: SAS 82 and SAS 99; AUSAB: ASA 240). Very recent studies (Albrecht et al., 2004, 2008; Rezaee, 2005; Choo and Tan, 2007; Aguilera and Vadera, 2007) have used “fraud triangle” to explain accounting manipulation in general. There is still a dearth of research to appraise in-depth the components of fraud triangle and holistically view the single cases of manipulation (entity) in the lens of this framework.
### Table 1: Index of the key components of fraud triangle

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<th>Framework</th>
<th>Key points / symptoms of manipulation</th>
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<td>Incentives and pressures</td>
<td>Entity/industry/economic conditions - threats to financial stability or profitability:</td>
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<td>- market competition and market saturation</td>
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<td>- product obsolescence and declining customer demands</td>
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<td>- declining margins or increasing operating losses</td>
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<td>- unusual profit growth as compared to other companies</td>
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<td>- inability to generate positive cash flows</td>
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<td>- Huge debt and vulnerability to interest rates</td>
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<td>- imminent hostile takeovers</td>
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<td>- rapid changes in technology</td>
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<td>- new accounting, statutory or regulatory requirements</td>
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<td>Self-interests: earnings expectations (Levitt, 1998):</td>
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<td></td>
<td>- analysts’ expectations for earnings impacting on stock prices</td>
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<td>- management’s expectations for earnings impacting on stock options and bonus</td>
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<td>- auditors’ conflicts of interest (fees) also the reasons for weak external oversight</td>
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<td>Opportunities</td>
<td>Accounting and related environment for fraudulent financial reporting:</td>
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<td>- Unusual and unaudited related-party transactions</td>
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<td>- Non-arm’s length (inappropriate) transactions resulted from strong financial presence or dominating</td>
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<td>position in the industrial sector that allows to dictate suppliers or customers</td>
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<td>- Subjective judgements relating to accounting estimates and uncertainties</td>
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<td>- Highly complex (unusual) transactions</td>
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<td>- Cross border transactions in diverse cultural settings &amp; business environment</td>
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<td>- Use of business intermediaries, bank accounts, subsidiaries or branch operations for which there</td>
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<td>appears to be no clear business justification</td>
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<td>Complex organisational structure and ineffective internal oversight:</td>
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<td>- One person (e.g., CEO) dominance and lack of board independence</td>
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<td>- Deficient internal control - inexpert and ineffective audit committee, ineffective accounting</td>
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<td>information systems, and high turnover of senior accounting, internal audit or information technology</td>
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<td>staff</td>
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<td>- Complex organisational structure - unusual lines of management authority,</td>
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<td>difficulty to understand who have controlling interest in the entity, and high turnover of senior</td>
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<td>management, lawyers and persons charged with governance</td>
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<td>Weak external oversight:</td>
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<td>- absence of auditor independence, and negligible auditing</td>
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<td>- negligible oversight by securities regulators, financial regulators and government</td>
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<td>Rationalisation</td>
<td>- Communication of inappropriate values or ethical standards by management</td>
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<td>(attitude to justify</td>
<td>- Non-financial management’s excessive involvements in selecting accounting policies or determining</td>
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<td>unethical behaviour)</td>
<td>significant accounting estimates</td>
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<td>- Known history of violations of laws and regulations by senior management</td>
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<td>- Excessive interest by management in maintaining or increasing entity’s stock price or earnings trend</td>
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<td>- A practice to commit to analysts and creditors to achieve unrealistic forecasts</td>
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<td>- Management failing to correct material weaknesses in internal control timely basis</td>
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<td>- Low morale among senior management</td>
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<td>- Recurring attempts by managements to justify inappropriate accounting choice</td>
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<td>- Strained relationship of management with current (also predecessor) auditors for unreasonable time</td>
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<td>constraints to complete audit or issue audit report, restrictions to communicate people, influence on</td>
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<td>audit engagement and other disputes</td>
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3. The Case in Brief

WorldCom got started suddenly as a private company in 1983 in Mississippi when three business partners and Bernard J. Ebbers (popularly known as Bernie Ebbers) met in a Hattiesburg, Mississippi coffee shop to discuss starting a long-distance telephone company (Stonham, 1998; Reber and Gower, 2006). A Long Distance Discount Service (LDDS) was born as a result of this meeting (Thornburgh, 2002). The CEO Bernie (Bernard) Ebbers came into the picture because of his success in raising money for a small chain of hotels he had acquired after a brief career as a high school basketball coach in Mississippi (Skeel, 2005: 148). The founders of LDDS adopted a strategy of “selling long-distance phone service by buying network access wholesale from AT&T and other long-distance giants and then reselling it to consumers at a discount, cheaper than the large carriers’ retail rates, but enough to make money for LDDS” (Jennings, 2003:441). There were five phases of the growth and transmission WorldCom (Thornburgh, 2002):

i. The Emergence of LDDS (1983-1989): expansion as a reseller network and becoming a public company;

ii. From LDDS to WorldCom (1990-1995): expansion to a national and international long distance provider and acquisition of a significant transmission facilities;

iii. WorldCom (1996): expansion into local markets and internet service;

iv. WorldCom (1997-1998): consolidation of its leadership position in local and long distance telecommunications services;

WorldCom went public on NASDAQ in 1989 (Beresford et al, 2003), and (b) formally changed its name to “WorldCom” after its acquisition of IDB WorldCom in 1994, which launched it into the overseas market, (Skeel, 2005). CEO Bernie Ebbers adopted “acquisition spree” as a simple but crazy strategy to expand and run the business (Skeel, 2005: 149). The MCI acquisition was the largest merger transaction in history with reported value of approximately $40 billion (Thornburgh, 2002: 17). Altogether, WorldCom was the largest phone carrier in the US; 65-70 % of the World’s internet traffic ran across its carrier (Thornburgh, 2002: 34). The problems in WorldCom were first intensified with the failure of $115 million Sprint merger during 1999-2002. Restrictions were imposed by the US and the European antitrust regulators to abandon the merger of WorldCom and Sprinter. As a consequence, WorldCom had to change its accounting practice from this point of time. The year 2002 was an upsetting year for WorldCom for significant reduction of workforce, resignation of CEO Bernie Ebbers, change of auditors, draw down on line of credit, lower credit rating, discovery of major accounting malpractices relating to capitalisation of line costs, restatement of earnings, SEC enforcement actions against the company, and appointment of the corporate monitor (see Thornburgh, 2002). Over a press release on June 25, 2002, WorldCom announced its intention to restate its financial statements for 2001 and the first quarter of 2002. The company filed for bankruptcy (chapter 11) protection in July 2002. With this filing, WorldCom appeared to be the biggest bankruptcy in the US history (Rezaee, 2005: 278) and also in the world (Lee et al, 2008: 699). At the time of collapse, WorldCom had $11 billion accounting misstatements (Lee et al, 2008: 699) and $107 billion assets including $63.4 billion in the USA (CNN, 2002: July 22). As of 31 December 2001, its reported total revenues and debt were over $35.2 billion and $30.2 billion respectively (Thornburgh, 2002). It worked with more than 60000 employees.
WorldCom in the Framework of Fraud Triangle

4.1. Incentives and pressures

4.1.1. Industry and economic conditions

WorldCom worked in an environment where there were major changes in the local and global markets of telecommunications and information technology with severe competition to occupy market share. Particularly, the following conditions had impact on WorldCom’s growth, performance and sustainability (Thornburgh, 2002 and Beresford et al, 2003):

- WorldCom commenced business in 1983 as DDLS when AT&T divestiture in 1982 had opened the gate for entering of many telecom carriers in the market

- The Telecommunications Act signed by President Clinton in 1996 brought regulatory changes in the telecom market. Stonham (1998) noted that it was the first major overhaul of telecommunications law in the US in 62 years.

- The 1990s showed diversity in the telecom industry both for large carriers and variety of services including computing internet, intranet and voicemail or wireless services.

The different phases of phenomena as indicated above make us understand that WorldCom worked in a complex business world where there was a severe competition. As argued by Akhigbe et al (2005: 49), long before WorldCom’s accounting irregularities came to light, WorldCom and most of its competitors in the telecommunications industry
were being hurt by negative market forces including overcapacity in their networks, the slowing economy, which had reduced business demand for telecommunications services, and the ongoing price wars that had reduced consumer long-distance rates considerably. The average price of a US long distance call dropped by 70 percent between 1984 and 1997 (Stonham, 1998). The ultimate results of these factors were the failures of Global Crossing, Northpoint and Qwest before WorldCom collapse (see Thornburgh, 2002; Beresford et al 2003). Importantly, in its last year, WorldCom was working in an era when Enron demise had already saturated the market and economy. Unprecedented investor awareness, anxiety and uncertainty were created because of Enron demise (Akhigbe et al., 2005: 49).

Prior to the spate of corporate collapses in the first years of 2000s, academic literature (Lang and Stulz, 1995; Ferris, Jayaraman and Makhija, 1997) had uncovered that bankruptcy announcements generate a dominant industry contagion effect; particularly, the stock prices of competitors decline because the bankruptcy reveals adverse information about industry asset values and future prospects.

4.1.2. Entity conditions

WorldCom grew rapidly nationally and internationally, in large part through the acquisition of diverse and increasingly large companies during the 1990s (Beresford et al, 2003: 44-48). On a stand-alone basis, WorldCom was forecast to triple in size between mid 1997 and the year 2000 (Stonham, 1998: 323). However, WorldCom’s growth and profitability slowed and risk escalated between 2000 and 2002. The following discussion shows entity conditions contributed to WorldCom’s growth and fall.
**Acquisition failure:** Acquisition was a major technique to achieve growth and profitability by WorldCom. WorldCom got stunned when its 1999 attempt for Sprint acquisition failed in July 2000, because the Antitrust Division of the US Department of Justice refused to approve this merger on terms acceptable to WorldCom and Sprint (Thornburgh, 2002; Beresford et al, 2003). According to the Special Investigative Committee of the WorldCom board of directors, the termination of the October 1999 Sprint acquisition initiative for $115 billion was a significant event in WorldCom history (Beresford et al, 2003: 49). The proposed combination with Sprint had generated considerable regulatory scrutiny in the United States and Europe (Thornburgh, 2002: 19-20). If the deal was not vetoed by the Department of Justice and the European Union on concerns of it creating a monopoly, the company would have been the largest communications company in the US and the merger would have put AT&T number two for the first time in history (Clarke, 2007: 333). Subsequent discussion shows how this failure had impact on WorldCom’s earnings, stock price and sustainability.

**Unusual earnings:** The earnings growth of WorldCom during most of the periods in the 1990s was explosive rather than usual. In 1989 when WorldCom became public, its revenue base was $109 million and in 1992, $800.8 million after the takeover of Advanced Telecommunications Corporation (ATEL) of Atlanta (Stonham, 1998: 323). Then its revenues went to $4.5 billion by 1996, operating income rose 132% from 1997 to 1998, and net income increased 217% by 1999 (Jennings, 2003: 430-431). Although WorldCom was able to highlight a double-digit revenue growth until the third quarter of 2001, after the failure of the Sprint merger and for increased competition and worsening industry conditions, it was becoming hard for the company to tout its revenue in 2002 (Thornburgh, 2002). WorldCom CEO Bernie Ebbers was happy to show earnings growth
in his annual report letter, however, he had no numbers in his annual report letter to the shareholders when the bubble burst (Jennings, 2003:431).

**Unstable stock prices:** WorldCom’s share prices showed spectacular changes before and after 2000. When share prices of the telecom sector rose sharply in the last half of the 1990s demonstrating impressive performance of the sector, WorldCom’s share price rose from the low $20s in January 1995 to over $90 per share by mid-1999 (Thornburgh, 2002: 21). However, the industry as a whole, and WorldCom in particular, experienced sharp as well as continuous declines in share prices from early 2000 to 2002 (Thornburgh, 2002: 21). More specific declines of WorldCom share prices are documented as follows:

WorldCom common stock fell from a high on June 30, 1999 of $96.766 per share to a low of $46 per share by 30 June 2000. As of December 29, 2000, the stock’s high was $18.656. For the next year it generally fluctuated between $24 and $12 per share. It fell precipitously in 2002 and was delisted from the NASDAQ stock market as of July 30, 2002 (Thornburg, 2002: 21).

There were a number of causes of share price fall during 2000 and onward. Beresford et al (2003: 55) in their Special Investigative report explained that the competitive environment hurt WorldCom with losing at least 75% of its share price value between January 2000 and June 2002. Other reasons, as stated earlier, were that worsening industry conditions along with the existing embargo on WorldCom to go for large scale acquisitions. With the Sprint merger failure, when the acquisition engine did not run at a very high speed, WorldCom’s capability to pump up profits significantly reduced and its stock price became under severe pressure (Thornburgh, 2002). WorldCom shareholders
who watched their stocks fall from $6.97 on February 5, 2002, the day before the first
negative news event regarding the firm came to light, to $0.83 on July 19, 2002 when the
firm ultimately filled for bankruptcy (Akhigbe et al, 2005: 50).

**Debt:** From 1997 throughout 2001, WorldCom showed a long term debt growth at least
of 285% (Grant and Visconti, 2006: 374). The bid to buy Sprint in 1999 was blocked by
the government for the possibility of strategic debt arising out of widespread acquisitions.
As of 31 December 2001, WorldCom had a total debt over $30.2 billion (Thornburg,
2002: 22). Eventually, the company was crushed by its $41 billion debt (Beltran, 2002;
Lee et al, 2008). That is, debt had placed tremendous pressure on WorldCom executives
not only to have high earnings to offset high interest costs but also to report high earnings
to meet debt and other covenants (Albrecht et al, 2004: 122).

The accumulated impact of the declining earnings, stock prices and debt condition was
that credit ratings for WorldCom’s debt securities were downgraded several times in the
first half of 2002, including on April 22-23, again on May 9-10, and on June 17-20; the
downgrade reduced WorldCom’s credit ratings from investment grade to “junk” status
(Lavey, 2006: 623).

**4.1.3. Self-interests and earnings expectations**

Meeting or beating the expectations of the self-interested groups appeared to be one of
the vital causes of WorldCom accounting manipulation. As documented by Thornburgh:

> WorldCom put extraordinary pressure on itself to meet the expectation of securities
analysts. The pressure created an environment in which reporting numbers that met
these expectations, no matter how these numbers were derived, apparently became more important than accurate financial reporting (Thornburgh, 2002: 7).

The unhealthy relationships between WorldCom and financial analysts came to light in the months following WorldCom’s bankruptcy, (Beresford et al, 2003: 81-104). Public officials and financial media alleged that investment bank Salmon Smith and Barney (SSB) promised for lucrative IPO allocations and flattering analyst reports to entice corporate executives (e.g., Bernie Ebbers) to reward with highly profitable investment banking assignments (see Beresford et al, 2003: 82). Jack Grubman, the chief telecommunications analyst of SSB, inflated WorldCom’s stock ratings without merit from June 2000 until the company was on the verge of bankruptcy in April 2002, and these inflated ratings enabled Mr. Bernie Ebbers (CEO) to make at least $23 million by selling his WorldCom shares (State of New York v. Phillip F. Anschutz, et al). Some of the examples of Grubman’s ratings were as follows (Beresford et al: 2003):

- In 1997, Grubman recommended a strong buy and declared that “no telecom company of WorldCom’s market cap can come close to matching WorldCom’s top-line growth, margin expansion potential or strategic position, much less having all of these attributes which is why WorldCom remains our favourite stock”.

- Grubman gave the highest ratings on WorldCom stock during 1989-1999 setting target prices from 17% to 60%. During this period, Grubman urged investors to “load up the truck” with WorldCom stock.
What CEO Bernie Ebbers did for the analysts in exchange was that he had used his influence to assure that SSB was awarded much of WorldCom's valuable investment banking business. Therefore, the analysts' interest and the CEO's interest had coincided in expediting revenue growth and increasing stock value. Analysts marvelled at WorldCom's ability to outgrow an industry that was outgrowing the overall economy and Bernie Ebbers reportedly trumpeted the company's impressive growth during his conference calls with analysts (Beresford et al., 2003: 132). Higher stock price was extremely critical for CEO Bernie Ebbers for two reasons (see Thornburgh, 2002: 99):

(a) the CEO Bernie Ebbers often used WorldCom stock as currency for acquisition;

(b) he had purchased large amounts of WorldCom stock on margin or had pledged as collateral for non-WorldCom related business ventures.

Interests of the CFO and other directors were also related to stock price. The reason is that their overall compensation heavily weighted toward stock options (Beresford, 2003: 266, 132; Thornburgh, 2002: 40). During 2001, each non-employee director received a grant of options to purchase 10,000 shares of WorldCom Group stock at $15.6265 per share (Thornburgh, 2002: 39).

The proxy statement for the company's 2002 annual shareholder meeting disclosed that the beneficial ownership of WorldCom Group Stock and MCI Group stock by directors and executive officers including CEO and CFO (in total for 12 persons) were $40,374,564 for WorldCom Group and $947,678 for MCI (Thornburgh, 2002: 40). Since top compensation and bonuses were dependent on achieving a double-digit rate of revenue growth, corporate performance just had to meet expectations, and miraculously, even as...throughout the telecommunications industry (Zekany, 2004: 103).
4.2. Opportunities of manipulation

4.2.1. Accounting techniques

The story of massive accounting fraud in WorldCom was opened for public when WorldCom in its press release on June 25, 2002 intended to restate its financial statements for 2001 and the first quarter of 2002. It became a hot issue when this press release was followed by the dramatic events published in the media in 2002. For example, (a) President George W. Bush severely criticised WorldCom accounting on June 26, 2002 when he was at a global economic conference in Canada; (b) WorldCom’s open letter (dated June 27, 2002) to President W. Bush was published on June 27, 2002; (c) WorldCom filed for bankruptcy on 21 July 2002; and (d) WorldCom again (for the second time) announced on 8 August 2002 that it had an additional $3.3 billion in improperly reported earnings.

A common understanding derived from the investigations reports on WorldCom is that acquisitions and accounting techniques were the major devices used in WorldCom to demonstrate better performance. From strategic viewpoint, the benefit of aggressive acquisitions was that “WorldCom’s growth was impressive – outperforming its peers in revenue and earnings growth and operating profitability” (Stonham, 1998: 323). Particularly, there was a complementarity. For example, MCI, the biggest acquisition, was stronger in long distance while WorldCom had a stronger local presence created by buying MFS/UUNet in December 1996, Compuserve and America Online in September 1997, and Brooks Fiber Properties in October 1997 (Stonham, 1998: 323).
A single item called “line costs” was used to commit major accounting manipulations. “Line costs” also known as “access charges” were the payments by WorldCom to other carriers for using their lines or services for originating and transforming calls (Thornburgh, 2002; Beresford et al, 2003; Lavey, 2006). The main mechanisms for using line costs for manipulations were as follows:

**Transfer of line cost to reserve (phase-1):** By at least 1999, WorldCom was relieving some of the pressure of its spiralling line costs on its bottom line by releasing line cost reserves into income, which resulted in a corresponding reduction in line cost expenses reported the company’s income statement. The manipulation of line cost reserves was achieved through a number of means, including: (i) the failure to release reserves in accordance with (generally accepted accounting procedures) at the point when there were no longer necessary; (ii) the release of some reserves without any analysis to support that they were access and should be released; and the use of reserves recorded for other purposes to offset line cost expenses (Thornburgh, 2004: January 26).

**Capitalisation of line cost (phase-2):** Beginning in the first quarter of 2001, WorldCom’s chief financial officer directed that hundreds of millions of the line cost expenses be capitalised, subtracting them from what otherwise would have been expenses against the company’s earnings for the successive quarters, and disguising most of these reductions by transferring them as additions to the company’s fixed assets (Thornburgh, 2004: January 26).

The first type of accounting technique is usually known as “cookie jar” approach (Thornburgh, 2002: 104; Jennings, 203:420). WorldCom did it by drawing down excess
or other reserves into earnings. WorldCom was doing it through consecutive acquisitions. Thornburgh (2002) provides a logical explanation of WorldCom's move from the first type to the second type manipulation as under:

When the government ultimately refused to approve the Sprint merger in July 2000, and signalled that it would not be sanctioning other large mergers, WorldCom did not have adequate excess reserves to draw down as a vehicle to increase earnings forward. Shortly after this time, the Company took the brazen and radical step of converting substantial portions of its line cost expenses into capital items. These conversions ultimately added approximately $3.8 billion improperly to income. The disclosure of these improprieties was the subject of the June 25, 2002 restatement announcement (Thornburgh, 2002: 8).

As explained in Special Investigative Report of the Board of Directors, WorldCom consistently emphasised throughout 2001 that its line cost to revenue ratio (E/R) stayed the same - 42 percent each quarter. That representation was false, because had it not capitalised, this ratio would have been much higher, typically exceeding 50 percent (Beresford et al, 2003: 12).

**Other accusations of manipulation:** Among other measures, (a) there were examples of questionable billing (i.e., some bills were made for the second time showing non-payment of the first bill), (b) revenues were booked twice by the sales persons to pump up sales commissions (and hence profit), (c) WorldCom collectables were eventually converted into cash, (d) bad debts were not written off (see Jennings, 2003). All of these measures had impact on WorldCom profits.

As of December 31, 2001 balance sheet, WorldCom Goodwill was 49.8 billion which was approximately 48 percent of the total assets and 86 percent of shareholders' investments.
Goodwill was written off over a period of 5 to 40 years and without showing impairment loss (Thornburg, 2002: 113). A long period to amortize and non-calculation of impairment loss both allow increasing earnings.

Beresford et al (2003: 16) identified different types of accounting adjustments that were improper, but had smaller effects on reported earnings. For example, (a) WorldCom personnel improperly reduced three types of expenses: selling, general and administrative (SG&A) costs; depreciation; and income taxes; (b) the company used general accrual accounts to accumulate excess accruals from other accounts, so they could later be released to offset expenses for which they may have not been established originally, to replenish under-funded accruals, and to write down asset accounts; and (c) there was evidence raising concerns about the manner in which costs were allocated when WorldCom realigned and formed two tracking stocks, WorldCom and MCI.

4.2.2. Governance and oversight functions

WorldCom came under attack of the academic research owing to its weak governance and the lax internal and external oversights over financial reporting (see Reber and Gower, 2006; Lee, Clarke and Dean 2008; Cullinan, 2004). The investigation reports of the Bankruptcy Examiner Dick Thornburgh and the Special Investigative Committee of the WorldCom Board Directors have identified these problems more rigorously.

In WorldCom, there was no CEO duality. However, the most crucial aspect of WorldCom governance was that the role of CEO Bernie Ebbers was uncontrollable and unchallengeable in devising and implementing company goal, agenda and fortunes. (see...
Thornburgh, 2002; Beresford et al, 2003). Within the knowledge of Bernie Ebbers, CFO Scott Sullivan was following improper accounting (Beresford, 2003: 6-7). However, “the board was so passive and reliant on Ebbers and Sullivan that it had little opportunity to learn of the fraud” (Beresford, 2003: 7). In other words, in the 10 member board of directors, 8 were independent, and despite this sort of independence, the board did not have courage for critical questioning about the activities of the senior executives (see Thornburgh, 2002: 37-43). Virtually, the board was removed from the WorldCom operations to the extent that its members had little sense of what was really going on within the company (Beresford et al, 2003: 31). This is because (a) outside board members were not visible to the employees other than their presence in the company during presentations they heard at meetings, and (b) there were no systems in place that could have encouraged employees to contact them with concerns about either the accounting entries or operational matters (Beresford et al, 2003: 31).

Integrity in the financial reporting depends on the role of internal audit and audit committee. A team of Internal Audit Department headed by Cynthia Cooper got credit for their bold and uncompromising step to uncover for the first time in 2002 the irregularities about capitalisation of line costs (see Thornburgh, 2002; Beresford et al, 2003). Other than this courageous step, they identified exclusively operational inefficiencies and not financial reporting matters (Thornburgh, 2002: 7). Also, it was not a productive avenue for pursuing claims of wrongdoing by CFO Scott Sullivan by putting the job of the claimant employee in jeopardy (Beresford et al, 2003: 23-24). At the direction of CEO, the company’s lawyers were in fragmented groups and they were not located geographically near senior management or involved in its inner workings, and they had inadequate support from senior management (Beresford et al, 2003: 31).
The Audit Committee was ineffective (Thornburgh, 2002: 7). They did not even understand the non-traditional audit approach of Arthur Andersen (Beresford, 2003: 30-31). “To gain the knowledge necessary to function effectively as an Audit Committee would have required a very substantial amount of energy, expertise by at least some of its members, and a greater commitment of time” (Beresford et al, 2003: 31). Andersen was independent, but in many cases its access to information was controlled by management personnel (Beresford, 2003: 246). Its audit process was also flawed and hence, it missed many opportunities to identify accounting irregularities (Beresford, 2003). From 1999 to 2001, Andersen’s audit work papers demonstrated WorldCom as a “maximum risk” client owing to red signs (earnings targets, significant financial reporting risk and aggressive revenue growth) (Thornburgh, 2002: 50-51). However, Andersen did not pass any information to audit committee about “maximum risk” and problems relating to access to information (Beresfords et al, 2003).

The public anger continued to embark on the weaknesses in the control and oversight functions of WorldCom. Media articles are the useful resources to demonstrate such anger. As reported by John Shovelan in a media article entitled “Markets reeling from WorldCom crash” (ABC News Online, 2002, June 27), people from diverse background passed opinions their opinions. For example, according to Thomas Caldwell, the chairman of Caldwell Asset Management:

‘The board was either incompetent or complicit’ (ABC News Online, 2002, June 27).
‘Frankly, when the board of directors of a company advance loans to the CEO of $370 million, you knew that the board of directors was either made up of a pack of morons or crooks.’ (ABC News Online, 2002, June 27).
Blaming WorldCom as a corrupt business, the US Senator John McCain said, “until some one goes on gaol I’m not sure that these people are going to get a message” (ABC News Online 2002, June 27).

The Securities and Exchange Commission (SEC) is the body charged with oversight of corporate America. The monitoring, oversight and enforcement functions of the SEC and its chairman Harvey Pitt were not beyond criticism. In response to a question asked by the reporter as to whether or not there were adequate numbers of the accountants working in the SEC, Senator John Corzine argued that there were only “thirty five accountants in the accounting division in the SEC against a ten trillion economy” (ABC News Online 2002, June 27), when “the old firm that I worked with probably had 150 accountants. You know, it’s a peashooter” (ABC News Online 2002, June 27). Senate leader Tom Daschle, a Democrat, questioned about independence of the SEC chairman in contemporary period. Assuming the SEC chairman Harvey Pitt’s past corporate ties, Tom Daschle argued that:

‘His cosy relationship with the industry is one that has been raised on many, many occasions and whether or not he has the credibility to be independent regulator he needs to be is up to him. .. He needs to show his independence and his aggressiveness and to date he has not done so.’ (ABC News Online, 2002, June 27).

On the basis of the above discussion about opportunities of manipulation, it is evident that many of the elements of the fraud triangle were present in WorldCom. Cookie jar reserve, capitalisation of expenses and other accounting methods were used to inflate earnings. Senior executives were all in all. Audit committee was ineffective. Auditors were unable to inform the audit committee about maximum risk involved with business.
4.5.3. Rationalization (attitude)

Table 4.2 provides ideas about the symptoms of rationalisation. The goal, behaviour, and verbalisations of the senior executives indicate how they rationalised their activities to justify the ways and means of achieving their interests. WorldCom’s CEO Bernie Ebbers was at the centre of success and fall of the company. He had a strong determination from the very beginning of his involvement in the business. “As the company flounder, he stepped forward. ‘Look’, he told his partners, “if we’re going to go under, I at least want to pilot the ship” (see Skeel, 2005: 148).

The greatest dream of Bernie Ebbers was seen in 1997 when he explained his strategy, “Our goal is not to capture market share or be global. Our goal is to be No. 1 on Wall Street” (see Jennings, 2003). He had created a setting and a value system to pursue this goal. He did not have business education and financial expertise. Company’s CFO Scott Sullivan as a blind follower was violating accounting rules to make CEO’s dream a reality. CFO was in the good book of CEO. In Bernie Ebbers’ view, “he (CFO) has no peer in his ability to earn the trust and confidence of the investment community” (see Jennings, 2003, note 121: 414).

Inevitably, to achieve the goal, CEO Bernie Ebbers had commitments and continuous contacts with the analysts. The analyst Grubman of Salmon and Smith Barney continuously provided favourable rating to WorldCom in their vested interests. By 2001, Grubman and Ebbers were so close that Grubman felt comfortable offering advice to Ebbers on how to handle analysts prior to a potentially contentious WorldCom conference call (Thornburgh, 2002; Skeel, 2005:149). One analyst explained about
CEO’s meeting with analysts as “prayer meetings” in which no one asked any questions or challenged any numbers” (New York Times, 2002: May 1).

Although CEO Bernie Ebbers had charismatic quality to maintain good relationships with outside interested parties and with CFO, there was a panic inside the company which helped stop the voice of others against senior management’s activities. Employees in the finance and accounting groups knew or suspected that senior management was involved in improper accounting, but no one was able to raise questions about the activities of the chief executives for the risk of losing jobs (Beresford et al, 2003). The arrogance and uncompromising attitude of CFO Scott Sullivan was demonstrated through his dealings with internal auditor Cynthia Cooper. When Scott Sullivan was asked to provide logical explanations about capitalisation of expenses, Scott Sullivan did not respond, rather asked Cynthia to stop internal audit. Since Scott Sullivan was hostile and showed disregard to Cynthia, she (Cynthia) declared, “when someone is hostile, my instinct is to find out” (see Jennings, 2003:414).

Personal gains of CEO were not only limited to his remuneration, but also to huge loan taken by him from the company. He was pledging company shares to the creditors for his personal gain which was highly unethical. His influence in the company was so deep that the board of directors approved lucrative retirement package. His luxurious life is a well-known fact. His second marriage to a pretty young staff who was almost half in age indicates his level of moral. After forced retirement of Bernie Ebbers and Scott Sullivan, the new CEO John Sidgmore publicly shifted blames to the prior executives and speculated bright prospect of the company making similar verbalisations as ex-CEO had made to present WorldCom’s dream (see WorldCom Press Release, 2002, June 28).
5. Summary and Conclusion

When Enron just hit the market and drew attention of the regulators and the legislators, WorldCom appeared to be the biggest corporate failures in the US history. Different investigation reports identified accounting manipulations at the backdrop of certain internal and external circumstances. Aggressive acquisitions, debt crisis, earnings volatility, unstable stock prices, and earnings expectations of the self-interested parties (e., analysts) were identified as principal pressure or motivating factors for accounting manipulation in WorldCom. Acquisitions had an important role on using accounting policies. Through consecutive acquisitions, management was transferring operating expenses (line costs) to reserves. This method resulted in increases in profit and decreases in retained earnings until the failure of Sprint acquisition in 2000. With the failure of Sprint acquisition, restrictions were imposed by the regulators on the large acquisitions. Then WorldCom CFO followed another approach which was called capitalisation of operating expenses (line costs). The later method had been used until it was uncovered by Internal Auditors Cynthia Cooper that capitalisation is a gross violation of GAAP. There were many other accounting techniques used in WorldCom to smooth profit. Examples include (a) billing second time showing non-payment of the first bill, (b) booking revenues twice by the sales persons to pump up sales commissions, and (c) without writing off bad debts. WorldCom collectables were eventually converted into cash. As of December 31, 2001 balance sheet, goodwill (approximately 48 % of the total assets and 86 % of shareholders’ equity) being a single component of intangibles appeared to be biggest asset. As usually, goodwill was written off over long period (5 to 40 years) and without showing impairment loss. The subjective judgements on amortisation and impairment facilitated profit-smoothing.
Beresford et al (2003:16) identified examples of accounting adjustments that were improper, but had smaller effects on reported earnings. For example, (a) WorldCom personnel improperly reduced three types of expenses: selling, general and administrative (SG&A) costs; depreciation; and income taxes; (b) the company used general accrual accounts to accumulate excess accruals from other accounts, so they could later be released to offset expenses for which they may have not been established originally, to replenish under-funded accruals, and to write down asset accounts; and (c) there was evidence raising concerns about the manner in which costs were allocated when WorldCom realigned and formed two tracking stocks, WorldCom and MCI.

The management used these techniques not only to increase their own interests (remuneration-bonus, stock options), but also to meet and beat unrealistic expectations of the analysts (such as, Grubman of Salmon Smith and Barney). There was unhealthy relationship between analysts and CEO Barnie Ebbers whose gluttony of success along with the goal to make WorldCom No. 1 stock on Wall Street was feed by CFO Scott Sullivan. Nobody was there either in the board or among the employees to charge CEO and CFO and raise questions about their unhealthy relationships with the analyst Grubman. The board by numbers of the outside directors was independent, but not by dint of independent judgement. Although there was no CEO duality, the board was highly ineffective in the presence of inactive chairman, passive directors and dominant CEO. By setting unrealistic goal, arrogance, panics in the entity, unhealthy relationship with the analysts, CEO rationalised his activities. His personal life was full of unethical stories. Integrity of financial reporting was reduced owing to lack of energy and expertise of the audit committee. The external auditor Arthur Andersen was independent, but not rigorous about its responsibility for financial reporting integrity.
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