

## ETHICS IN ACCOUNTING: THE WORLDCOM INC. SCANDAL

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### ABSTRACT

What is ethics? What do ethics have to do with accounting? How does a scandal affect the business environment and the society? This article will explain just those questions by analyzing a “famous” fraud scandal: WorldCom Inc. The article discusses the chronology of events that lead to the WorldCom Inc. collapse and explains how the figures were manipulated for the owners’ interest and what the accounting scam was. The article ends with the consequences of the scandal and what the effects were on the society and business environment in general.

Key words: ethics, accounting, bankruptcy, WorldCom Inc., expenses.

### What is ethics? Why ethics in accounting?

Ethical values are the foundations on which a civilized society is based on. Without them, the civilization collapses. In business, the purpose of ethics is to direct business men and women to abide by a code of conduct that facilitates public confidence in their product and services. In the accounting field, professional accounting organizations recognize the accounting profession’s responsibility to provide ethical guidelines to its members.

Ethics must and should be taught. People are not born with the desire to be ethical or be concerned with the welfare of others. And contrary to all beliefs, one person can make a difference. One of my favorite quotes says:

I am only one.

But still I am one.

I cannot do everything,

But still I can do something;

And because I cannot do everything

I will not refuse to do the something that I can do.

(Edward Everett Hale)

Accounting ethics is both a normative and descriptive discipline. Interest in business ethics and accounting ethics accelerated dramatically during the 1980s and 1990s, both within major corporations and within academia. When we talk about accounting ethics, we always link the term with creative accounting, earnings management, misleading financial statements, securities fraud, insider transactions, bribery, executive compensation and many more. If you occupy a position of leadership, then your actions will profoundly influence those who follow your example. And the well known cases of fraud, WorldCom and Enron included, prove just that.

### The WorldCom Inc. Scandal – Bankruptcy Information

On July 21, 2002, WorldCom Inc. filed for Chapter 11 bankruptcy protection, according

to John Sidgmore, the company's chief executive. The bankruptcy is the largest in US history, being twice as large as Enron's record-setting filing in December 2001. WorldCom Inc. admitted on June 25, 2002, that it had falsely booked \$3.85 billion in expenses to make the company appear more profitable. Arthur Anderson, the company's auditor, accused Scott Sullivan, WorldCom Inc.'s financial officer, of withholding crucial information about the company's bookkeeping. Sullivan was fired the same day.

But what is WorldCom Inc. and what's its history? During 1983, Murray Waldron and William Rector, both from USA, drafted a business plan to start a business offering long distance services at a discount. The company was created and was named "Long Distance Discount Services" (LDDS). Bernie Ebbers became the CEO for LDDS in 1985. He grew the company through a series of acquisitions – Advantage Companies Inc., Advanced Telecommunications Corp., Resurgens Communications Group Inc., Metromedia Communications Corp., IDSB Communication Group Inc. and Williams Telecommunications Group Inc. – and changed its name to WorldCom in 1995. The acquisitions continued and the new named WorldCom took over MFS Communications Inc. in 1996, UUNet Technologies Inc. in the same year, MCI Communications Corp. in 1998 for \$40 billion, Brooks Fiber Properties Inc. and CompuServe Comp., also in 1998. The largest merger was in 2001 when WorldCom took over Intermedia

Communication Inc., a provider of Internet and data services to businesses.



Figure 1 WorldCom hits all-time high for market value

Source: Jake Ullick, 2002, WorldCom's financial bomb, at CNN Money , <http://money.cnn.com/2002/06/25/news/worldcom/>, visited Friday, June 15, 2007

At the peak of the telecom boom, WorldCom Inc. was valued at \$180 billion. But from this stage onwards, WorldCom started facing job cuts, credit ranking down grades and enquires. The stock price fell from \$64 (all-time high for market value) to \$2.65. As a result, Ebbers resigned on April 30, 2002, right after the fall of stock price. Within 10 day from Ebbers' resignation, WorldCom's long-term debt ranking was reduced to junk status. Ebbers started selling stocks to repay his personal loans and in order to stop him from selling the stock WorldCom gave him the loan to repay his bets. It wasn't clear why that happened but the fact is with the ransom earned, Ebbers has built a nice mansion in Florida.

After the damage has been done by SEC<sup>1</sup> and the credit ranking companies, on June 26, 2002 WorldCom made a statement

<sup>1</sup> Securities and Exchange Commission

saying that improper accounting has shed light on \$3.8 billion in expenses which will wipe away the profits declared in 2001 and for the first semester of 2002. As a result, within a day the stock price has fallen to \$0.09.

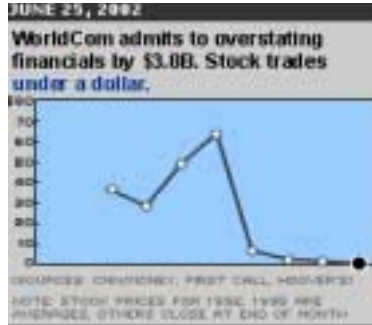


Figure 2 WorldCom hits all-time low stock price  
 Source: Jake Ulick, 2002, WorldCom's financial bomb, at CNN Money ,  
<http://money.cnn.com/2002/06/25/news/worldcom/>,  
 visited Friday, June 15, 2007

WorldCom then started its own internal investigation. As a result, WorldCom fired Scott D. Sullivan –the chief financial officer – and accepted the resignation submitted by David Myers. The CEO, John Sidgmore apologized to the investors for the accounting mistakes, while Scott D. Sullivan told that he informed Ebbers about the book-keeping maneuvers that made the company look better than it really was.

On July 21, 2002, WorldCom have filed for bankruptcy which was the largest bankruptcy in US history. Based on the investigation committee appointed by WorldCom and on an investigation conducted by the Auditors, few more facts have come to light. The Auditors have discovered some questionable accounting

practices since 1999 in WorldCom. The internal auditors have uncovered an additional \$3.831 billion in improper accounting, making the amount of WorldCom known accounting errors to more than \$7.683 billion over the past 3-4 years, which makes WorldCom the ultimate corporate accounting fraud in the world. Andersen, WorldCom's auditor, declared that the internal audit report could not be relied on in the view of the accounting manipulations.

It is relatively easily for an auditor to detect error but earnings management can involve sophisticated fraud that is covert. The requirement for management to assert that the accounts have been prepared properly offers no protection where those managers have already entered into conscious deceit and fraud. Auditors need to distinguish fraud from error by identifying the presence of intention. Part of the difficulty lies in the accepted recognition that there is no such thing as a single "right" earnings figure and that it is possible for legitimate business practices to develop into unacceptable financial reporting.

#### Who paid for the frauds?

In the first instance, the employees who rapidly discovered that immediately after the bankruptcy announcement, 17,000 WorldCom workers got the push. Next in line were the investors as the shares dropped from over \$60 to less than a dollar. But the scandal also blasted a huge hole through confidence in the telecom and technology sector and also hit the share

prices in several other sectors. And of course, anyone with a pension would pay the price as well.

The White House saw the plunging stock prices as one of the most important threats for the economy. Right after the bankruptcy announcement, the stock plummeted in early trading reaction, followed by crawling back up and closing mixed. The Dow Jones industrial closed at 9,120.11, while the Standard & Poor's 500 Index closed at 973.53, after falling 6.71 and 2.61, respectively.

#### WorldCom Inc. –Chronology of Events

On February 8, 2002, WorldCom Inc. reduces the revenue and earnings projections for 2002 and announced second quarter expenses of \$15-20 billion to write down some acquired operations. At the same time, the company's CEO, Bernard Ebbers, owes WorldCom \$366 million to cover the loans he took to buy his own shares. A week later, WorldCom suspends three star employees and stops commissions of 15 salespeople over a booking scandal in three of the branch offices.

On March 12, 2002, SEC launches enquiry into the WorldCom Inc.'s accounting practices. Three weeks later, the company planned to layoff 7500 employees. At the end of April, WorldCom reduced at least \$1 billion for its 2002 revenue projections and on April 30, 2002, Bernard Ebbers resigned. On May 9, 2002 a rating company reduced WorldCom's debt to "junk" status and the company's shares plunged to a new low.

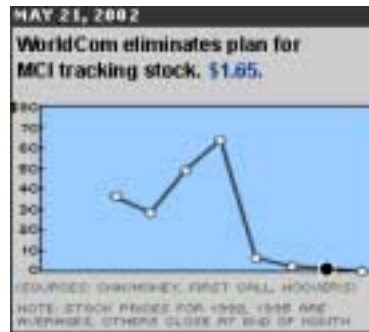


Figure 3 WorldCom Inc. hits a new low in May 2002

Source: Jake Ulick, 2002, WorldCom's financial bomb, at CNN Money , <http://money.cnn.com/2002/06/25/news/worldcom/>, visited Friday, June 15, 2007

At the end of the month, the company eliminated its MCI Group tracking stock, in hope of saving some money that would have gone to the dividends. At the beginning of June 2002, WorldCom announced its intension to cut further 15000 employees while restructuring and planning to sell its wireless unit. On June 24, 2002, analyst Jack Grubman wrote a negative report on the finances at WorldCom Inc. and the shares fell below \$1 (see Figure 2).

At the end of June 2002, WorldCom Inc. announced that during the entire 2001 and first quarter of 2002, company's revenue expenditure had been treated as capital expenditure and, as a result, there has been an overstatement of profits by \$3.852 billion in the financial results. Another declaration was made on August 9, 2002 which doubles the fraud figure declared earlier to more than \$7.6 billion, which makes WorldCom the company with the highest figure fraud in history!

WorldCom's first announcement worked like a bombshell. Obviously investors were irritated, which resulted immediately in hitting down the Dow Industrials more than 140 points and NASDAQ Composite Index by more than 3%. The investors sold the WorldCom shares at any price realizable. While in June 1999, the WorldCom shares were traded at \$62/share, they collapsed to \$0.09 in August 2002. Not surprisingly, on August 9, 2002 another \$3.8 billion fraud was unearthed at WorldCom by the same auditors. The company also announced that since an internal investigation was going on, they might find more accounting problems. WorldCom declared they would restate their financial reports from 1999 onwards, as a result of the new findings.

With the experience of Enron, another "resounding" accounting scandal in Corporate America, SEC has immediately approached the court seeking orders prohibiting WorldCom and its affiliates from destroying, hiding or altering relevant documents and prohibiting the company to make any extraordinary payments.

#### How was the fraud carried out?

Let us take a look at some selected financial data, from 1997 to 2001. In the Appendix, we also listed the "Consolidated statements of operations" and the "Consolidated Balance Sheets" of WorldCom Inc., for 1998 and 1999.

During 1990s, when WorldCom Inc. was marching forward with endless takeovers and merges sprints, the market conditions for

their services slowly started to deteriorate. The data shown above was before restatement figures. The point is to show how the accounting manipulations changed the data. The operating margin –which indicates the company's profitability – was not satisfactory even in 1998. Since the mergers didn't improve the margin either, the company realized during 1999 and 2000 that using accounting manipulations could lead to stable earnings. However, the planning was inadequate for maintaining the earnings by 2001. As a result, in 2001 the profit margin fell down to less than half when compared to the previous year's earnings.

During 2001, WorldCom Inc. split into two tracking stocks: MCI WorldCom Inc, the long-distance consumer carrier and WorldCom Inc, which sells voice and data services to corporations. During January and February 2002 there were rumors about WorldCom's stability. In the wake of the Enron scandal, followed by Global Crossing, which also declared bankruptcy, there were ongoing questions about WorldCom. Investors started believing the rumors that WorldCom might have off-balance-sheet finances and its investment-grade debt might be downgraded to "junk" status. Looking back, all the rumors were indeed correct.

WorldCom's new CEO explained that "the entire industry was experiencing severe problems which were unprecedented!" and "while many competitors were experiencing difficulties and surviving, many have gone

out of business". Indeed the economy went into recession during 2001, which led to a fall in revenues and earnings for all companies, more so for the telecom industry. The rise of mobile phone culture during the end of 1990s also led to the fall of WorldCom's revenues. The company was at this point suffering from the ego of being a large organization combined with a quality of non-learning attitude for the changes of consumer's styles and the neglect to go into mobile phones. Here is a table containing a summary of the consolidation financial statements from 1999 to 2001. Notice that the cumulative loss appears to be \$539 million for all three years.

WorldCom has commenced its manipulations right from 1999, as the company's CEO declared, with the single purpose to obtain desired earnings to boost up stock market price. Before declaration of their intention to restate the earnings, Andersen, the Auditor, warned investors and others not to rely on the audit reports given by them earlier because the company was announcing accounting manipulations of transferring line costs to capital accounts. As per June 25, 2002 report, the quantum of such transfers were \$797 million in 1Q 2002 and \$3.055 billion during 2001.

As per the company's "game", it called certain revenue expenditure known as "line costs" as capital expenditure. Line costs are the amounts paid to a third party service provider whose telecommunication network will be used by WorldCom for getting a right to use the network for their activity. These

payments are revenue expenses and NOT assets to capitalize. Every year, the company's major expense was the "line costs" which accounted for 40-45% from the revenue earned. But the company developed a strategy to capitalize the expenses. Post manipulation, the quantum of the "line costs" paid during 2001 were \$14.739 billion. During the same year, the reported profit was \$1.407 billion while the line costs capitalized ALONE were \$3.055 billion. Therefore, the company had a loss of \$1648 millions but by using the account fraud they kept the top showing a profit of \$1407 million.

On the other hand, capital expenditure generally includes investments in assets like machinery and other long-term asset purchases. In other words, it's an investment in an asset from which the company benefits for more than one year. The cost of the assets will be gradually deducted from earnings by depreciation<sup>2</sup>.

In other words, WorldCom capitalized line costs instead of expressing immediately and hence avoided a loss of about \$7.6 billion in the financial statements. For several years, in such a way, billions of dollars worth of operating expenses started to appear in WorldCom's accounting books as assets. The company violated the Generally Accepted Accounting Principles (GAAP) by treating the operating costs as capital assets and created worthless assets.

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<sup>2</sup> N.A. Depreciation = The reduction in the balance sheet value of a company asset to reflect its loss of value through age and wear and tear. From [www.scottish-newcastle.com/sn/investor/services/glossary/](http://www.scottish-newcastle.com/sn/investor/services/glossary/), visited on Wednesday, July 18, 2007

### Instead of a conclusion...

It is astonishing to note how Arthur Andersen could miss such an elementary fraud. It was maybe the simplest fraud that could have been detected easily by anyone who cared to look carefully at the accounts. WorldCom hired Andersen to perform a standard audit, BUT not a fraud audit. Although WorldCom fraud was a straightforward lie that would not have been possible without the involvement of the entire group, the fraud could have been missed. To save their skin, Andersen blamed Sullivan for withholding information during the audit. However, when they discovered that certain expenses have been reported as investment, Andersen immediately announced that their reports on WorldCom's financial statements for 2001 should not be relied upon.

Ultimately, WorldCom Inc. had to go for bankruptcy, which was the biggest bankruptcy in the world. Immediately after bankruptcy, 17,000 employees were laid off – almost 20% of the company's workforce. Sullivan was fired and ultimately arrested for the accounting manipulations. Controller David Myers was also arrested on the same issue.

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## Appendix

WorldCom Inc. and Subsidiaries<sup>3</sup>  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
For the three months ended March 31, 1998 and 1999  
**UNAUDITED**, in \$ millions, except per share data  
Excluding Embratel  
**BEFORE CHANGES**

	Reported 1Q 1998	Pro Forma 1Q 1998	Reported 1Q 1999
<b>Revenues:</b>			
Voice	1,162	4,754	5,095
Data	496	1,304	1,702
Internet	392	474	758
International	230	230	357
Communication Services	2,280	6,762	1,912
Information technology and other	40	490	403
<b>Total</b>	<b>2,320</b>	<b>7,252</b>	<b>8,315</b>
<b>Operating expenses:</b>			
Line costs	1,117	3,607	3,767
Selling, general and administrative	478	2,011	2,137
Depreciation and amortization	299	1,029	960
<b>Total</b>	<b>1,894</b>	<b>6,647</b>	<b>6,864</b>
Operating income:	426	605	1,451
<b>Other income (expense):</b>			
Interest expense	(102)	(276)	(260)
Miscellaneous	12	32	105
Income before income taxes	336	361	1,296
Provision for income taxes	143	170	551
Net income	193	191	745
Distributions on subsidiary trust mandatorily redeemable preferred securities	-	15	16
Preferred dividend requirement	7	7	-
Net income applicable to common shareholders	186	169	729
Earnings per commons share -Net income applicable to common shareholders:			
Basic	0.18	0.10	0.39
Diluted	0.18	0.10	0.38
Shares utilized in calculations:			
Basic	1,012	1,744	1,848
Diluted	1,074	1,829	1,922

<sup>3</sup> Source: Financial: MCI WorldCom Q1 1999 Results, Earnings Per Share of \$0.37, Compared with \$0.10, Operating Margins Improve on Revenue Mix and Merger Synergies - Company Financial Information, (1999), at [http://findarticles.com/p/articles/mi\\_m0UNZ/is\\_1999\\_May\\_3/ai\\_54528477](http://findarticles.com/p/articles/mi_m0UNZ/is_1999_May_3/ai_54528477), visited on Wednesday, July 18, 2007

WorldCom Inc. and Subsidiaries<sup>4</sup>  
**CONSOLIDATED BALANCE SHEETS**  
 UNAUDITED, in \$ millions  
 Reported, Excluding Embratel

	March 31, 1999	December 31, 1998
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	287	999
Accounts receivable, net	5,166	4,810
Other current assets	3,484	3,031
Total current assets	8,937	8,840
Property and equipment, net	19,852	19,259
Goodwill and other intangibles, net	45,815	45,468
Other assets	7,160	6,626
	81,764	80,193
<b>LIABILITIES AND SHAREHOLDERS' INVESTMENT</b>		
Current liabilities:		
Short-term debt and current maturities of long-term debt	6,507	4,628
Other current liabilities	10,095	9,886
Total current liabilities	16,602	14,514
Long-term liabilities, less current portion:		
Long-term debt	12,186	14,345
Note payable -Embratel	927	1,315
Other liabilities	4,108	4,226
Total long-term liabilities	17,221	19,886
Mandatorily redeemable preferred securities	798	798
Total shareholders' investment	47,143	44,995
	81,764	80,193

- \$ in millions-

	1997	1998	1999	2000	2001
Revenue	7384	17678	35908	39090	35179
Operating Income	1018	(975)	7888	8153	3514
Total Assets	23596	86401	91072	98903	103914
Operating Margin (%)	13.78	(5.51)	21.96	20.85	9.98

WorldCom inc. financial data

Adapted from: V.R.K. Chary, 2004, Ethics in Accounting, Global Cases and Experiences, WorldCom Inc., The ICFAI University Press, India, pg. 47

- \$ in millions-

	1999	2000	2001
Revenue	35,908	39,090	35,179
Net income	2,294	2,608	1,407
Net income-RESTATED	2,085	(649)	(1,975)
Total assets	91,072	98,903	103,914
Long-term Debt	17,209	17,696	30,038
Shareholders' funds	51,238	55,409	57,930
Intangible assets to total assets	48%	47%	52%

WorldCom's Consolidated Financial Statements

Adapted from: V.R.K. Chary, 2004, Ethics in Accounting, Global Cases and Experiences, WorldCom Inc., The ICFAI University Press, India, pg. 50

<sup>4</sup> Source: Financial: MCI WorldCom Q1 1999 Results, Earnings Per Share of \$0.37, Compared with \$0.10, Operating Margins Improve on Revenue Mix and Merger Synergies - Company Financial Information, (1999), at [http://findarticles.com/p/articles/mi\\_m0UNZ/is\\_1999\\_May\\_3/ai\\_54528477](http://findarticles.com/p/articles/mi_m0UNZ/is_1999_May_3/ai_54528477), visited on Wednesday, July 18, 2007