

# Worldcom accounting failure

[Business](#), [Accounting](#)



This research paper will seek to discuss accounting failure at WorldCom by trying to understand the nature of fraud committed, the perpetrators who caused the failure, the lacking controls that may have caused all these problems and the intentions of the perpetrators as would be revealed by the extent and frequency of manipulation done in the financial reports of the company. This paper hopes to find the lesson of the story for the guidance of people who may be involved the same way or the other. . Analysis and Discussion 2. 1 Brief background of the company. WorldCom was part the Telecommunication Company before its name it was eventually named to MCI in 2003, Inc after several events including its merger with LDDS and later with MCI Communications as part of its strategy to get out from bankruptcy caused by the scandals that the company went through. MCI, Inc was purchased by Verizon Communication and now part of Verizon Division.

What happened at WorldCom, what caused them to commit fraud?

WorldCom's stocks were used as means to enrich its chief executive officer (CEO) Ebbers and other officers basically from finance and accounting departments at the expense of many investors by making the company's to look more profitable than what is real. The fake profitability has caused the price of the company's stock to rise significantly but only to be used by certain people to take advantage with malice against the investors.

As to what caused them to commit fraud may be clearly blamed on the apparent greed of these people for more wealth with the involvement of many of officers or from another point of view, by the laxity of the system of control that allowed things to happen so easily. As to which is more believable would be subject to analysis in the following sections and

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subsections. 2. 1. b. What kind of fraudulent accounting practices were used to manage earnings, describe the specifics of how it was accomplished?

The two fraudulent practices could be classified into two. The first one the underreporting of “ line costs” by capitalizing them rather than recording as expenses for the period and the second one is inflating or overstating the revenues. In accounting profitability is measured by the excess of revenues over expenses every period. The company in effect deferred the recognition of the expenses so that company appeared more profitable than what is real when expenses are recognized properly.

The other fraudulent practice is therefore logical and would have the same effect as the first since inflating or increasing the revenues would cause the company’s profitability to look better. Each of the fraudulent practice is described in detail below. The overall objective of efforts was to keep reported line costs to approximately 42% of revenues which is far from having actually reached levels in excess of 50%, and to maintain in its report to investors double-digit revenue growth when the truth is that actual growth rates were so much lower substantially.

People became rich because of the frauds including the company’s CEO Bernard as derived from the increasing price of his shareholdings with the company. The start of the fraudulent accounting was found to be 1999 when the company wanted to paint a good financial condition contrary to what the company was actually in after the downturn in the telecommunication industry shortly after WorldCom has acquired MCI in 1998. By painting a different picture investors were plainly deceived into investing. 2. 1. b. 1)

Underreporting 'line costs' (interconnection expenses with other telecommunication companies) by capitalizing these costs on the balance sheet rather than properly expensing them. The first fraud committed is the reduction of reported line costs, which represents the company's largest category of expenses. It is a good thing its internal audit personnel were the ones which alerted about improper transfer of \$3.852 billion from line cost expenses to capitalized accounts during 2001 and the first quarter of 2002.

It was later announced by the company about the additional line cost accounting fraud which when combined with the first \$3.8 billion would total at \$6.412 billion in improper reductions to line costs. These and other manipulations of line cost caused fraudulent jumping up of pre-tax income by over \$7 billion. The fraud actually started as line cost adjustments in the form of accruals in 1999 and 2000 but when it was not possible to make more large accruals, the next scheme was to capitalize or defer 2001 and 2003 operating line cost as assets.

Capitalizing will cause the assets to be bigger than actual and would also make the financial structure of the company which would make it attractive to investors while improving its profitability position because of understatement of expenses that would bloat the income. Line costs could be defined as charges for carrying a voice call or data transmission from one point to another point which represents the company's largest single expense from 1999 to 2001. Being the largest, it was in reality approximately more than 50% of total expenses.

This was taken particular focus by company management and other parties particularly outside analysts to find out the trends by the use of ratio of line cost expense to revenue (E/R ratio) as a way to measure the trend of behaviour of the cost to revenues . The company's manipulation in accrual could be found in releasing the same with the required analysis even it was in excess of the amount required. Even in case of excess accruals, the company did not cause them to be effected at the time of identification.

What happened rather was for certain line cost accruals to have been kept as rainy day funds and managers caused only their release when needed. It appears that everything was really in the control of the perpetrators which included key accounting and finance officers since the accounting information was almost being manipulated to serve their selfish purpose as when there is a felt need to improve results. There could only be malice for this kind of behavior since accounting information as supposed to be reported because standards require them to be such.

Another manipulation in the accrual as found by investigators was the release of accruals that are applicable for other purposes thus further again understating the expenses to attain the targeted level of profitability as promised to the investors by the manipulators. The inappropriate releases of had commonality in features since they appear directed Chief Finance Officer Sullivan, Controller Myers, and Accounting Yates who are incidentally part of the finance organization in the company.

Another is the fact that released occurred not during ordinary or normal day to day operations but during adjustment periods after the end of each

quarter and documentation are lacking and employees involved have raised concerns at time because they knew what was indeed happening to the company. The company has fundamentally worn out available accruals at the most possible means to address the needed manipulation of line costs as reported in its financial report by the end of 2000, The following quarter of 2001 and one year after in 2002, the reduction was reached \$3. 8 billion from the capitalized \$3. billion as directed by its Chief finance officer. It was a clear violation of company's capitalization policy and the generally accepted accounting standards. Sullivan when asked about the violation commented that there is the plan to ultimately reduce these apparently bloated assets accounts with a hefty restructuring charge to be effected in 2002.

The practice of capitalizing operating expense would produce the effect of shifting these costs to balance sheet from income statement and the effect was to bloat income and assets at the same time. Without the capitalization, there would have been losses instead of pre-tax gain as reported.

Capitalization by reduction of line cost allowed the company to have E/R ratio of about 42% in every quarter while in reality the company has exceeded 50% E/R ratio. The message that it was bringing to the stock market was that the company's have been able to sustain profitability despite the problem in the telecommunication industry. A capitalization strategy is in fact part of the internal control but was twisted by manipulators to serve their ends, and for this reason Chief Finance Officer Sullivan needed consent from a number of people from financial and accounting departments of WorldCom.

The company had its General Accounting group that is based in Clinton, Mississippi, which made actual journal entries, but the system of the company allows the creation of a swell effect from the books by adjusting databases and reports from several finance-related groups. These groups include Property Accounting group which had its base from Texas which and which as tasked to tracked company's capital assets. Due to non-passing through the ordinary capital expenditure process, the group was called to effect the capitalizations physically in its database and on its reports.

Another group from Texas, called capital reporting group had also participated responsible since it was tasked to approve capital expenditures and to track the same capital spending. It was normal to have the employees within the General Accounting group since the problems on manipulation are basically done by journal entries and their adjustments that these people became concerned about the propriety of the practice causing them to express concern to each others and some even talked of looking for outside that given the risks that they were exposed to.

Fortunately, something happened and the tilt of what is good eventually came to the rescue when the Internal Audit discovered the capitalization sometime in June 2002. 2. 1. b. (2) Inflating revenues with bogus accounting entries from ' corporate unallocated revenue accounts'). WorldCom painted itself in the market as high-growth Company, and how its revenues is going to grow is a thing that should speak for a successful company. Company's main business is to provide goods and service which are measurable by revenues.

Since revenues increase was clearly critical factor of its success, WorldCom was able to convince investors what the company was above water even if market conditions throughout the telecommunications industry were not that good in 2000 and 2001. Since investors would like to makemoney, it would it was very easy to dupe them into believing that the company could sustain growth. Claiming to have successfully managed industry trends which on contrary were already hurting all of its competitors, the company was wonderfully deceiving people with the promises of double-digit growth rates.

It would be asserted in addition to what was stated earlier, the higher the revenues, the higher also would be the profitability if all other things like the expenses are assumed equal. But the company has already bloated revenues and deliberated understated the expenses, so that the growth in profitability was indeed tremendous to attract people to invest in the company's stocks. The manipulators behind the schemes were therefore focus on revenue enhancement.

Ebbers was found by investigators intensely to have put much efforts on revenue performance, by his receiving and closely examining revenue reports which are given to him on a monthly basis by the company's Reporting and Accounting Group. It was starting in 1999 that the company people made efforts to bloat revenues after the end of every reporting quarter to show to users of information that it was achieving high revenue growth targets that CEO Ebbers and Chief Finance Officer Sullivan had made or wanted to happen.



The bloating of revenues was basically done by making adjustments between the differences of actual and “targeted revenues” and level the same as corporate unallocated revenue accounts. In simple means the company’ management announced a target in revenues to be attained and such must be attained and presented when reporting period comes that the same will require adjusting entries and level the same as unallocated.

According to investigators, the questionable revenue entries found under the Corporate Unallocated accounts reached millions or tens of millions of dollars which appeared generally only in the quarter-ending month which were recorded weeks after the quarter has ended. Between Ebbers and Sullivan, it was the second one who became concerned since revenues recorded were already masking the result of the company’s operation. 2. 1. c. Who in the company perpetrated the fraud? Discuss also the fact that the corporations CEO, Bernard Ebbers, took millions of dollars in personal loans from the corporation’s funds.

Very briefly discuss the outcome of the fraud and the whole WorldCom scandal, how it was discovered, what happened to the perpetrators. Ebbers persuaded the company’s board of directors to provide him loans amounting to over than \$400 millions to cover his margin calls that he failed and was ousted as CEO in April 2002 by John Sidgmore. He and other perpetrators were eventually prosecuted and convicted of crimes in relation to corporate scandals. It was discovered by the internal audit group an announcement was made for the hefty understatement of line cost in the amount of more than \$3 billion.

This kind of fraud in additions other understatement of lines cost by capitalization and inflation of revenues caused their perpetrators caused their freedom and they are now serving the prison sentences. The fraud was the on the damaged caused to investors who lost their money because of the fake profitability and financial condition of the business. 2. 2) Discuss in detail what controls/ internal controls were missing and/or subverted in order for this fraud/accounting failure to occur.

The needed controls/internal controls that were missing and/or subverted in order for this fraud/accounting failure to occur is the independence of the auditors and integrity of the officers of the corporation. The need for independent auditors to ensure reliability of the financial statements is paramount since management not independent in many instances of their engagements and the most probable thing to happen is for management to make self-serving representation in the preparation of financial statements.

The practice of accounting profession where the independent auditors will have to attest to the reliability of the financial statements requires the auditor must indeed be independent, competent and with integrity. Lacking one of these requirements would really make a big difference. It appears that the auditor of WorldCom was Arthur Andersen which had involvement with Enron which also collapsed and Waste Management Company. In fact the Security and Exchange Commission had Mr Arthur Anderson convicted at lower court but said conviction was overturned by the Supreme Court sometime in May of 2005.

Although he was acquitted of the charge eventually, the fact that he was already charged and convicted is a question of character which does not have a place in the accounting profession. The role of auditors between their client and the public is one vested with public interest so that auditors must have good moral character. Since the auditor should be independent the engagement must be purely auditing or attestation service.

It was possible that Andersen was maintaining secretly a special relationship with the management of WorldCom thus Ebbers and company was courageous enough to do the fraudulent act as the very nose of the regulators and the investing public. Dependable information is essential to the very existence of our society. The investor making a decision to buy or sell securities, the banker deciding whether to approve a loan, the government is obtaining revenue based on income tax returns, all are relying upon information provided by others.

In many of these situations, the goals of the providers of information run directly counter to those of the users of the information. The purpose of having an auditor is for attestation function or to provide assurance as to reliability of the financial statements. Arguing to have the external auditors to protect the company assets from fraud would be sounding too simple since more than the auditors the stockholders or owners of the corporation must have also the protective or preventive attitude.

In addition therefore for the need to have independent, honest and competent external auditors, the company must have also the same independent and honest officers, particularly those who are members of the

audit committee and those performing money related functions. The function of company officers are part of a good internal control that any normal or good company must have so that functions would be defined and duties would be segregated or separated in such way that would provide checks and balances. This system of checks and balances are part therefore of good internal control that a company must put into effect.

A good internal control must also ensuring compliance with the GAAP is by having since the two are complementary. The GAAP is an external requirement to provide the needed characteristic of information to be reliable for decision making. It is faulty to argue that a company has an efficient and effective internal control over financial reporting if it not consistent with the requirements of GAAP. The underreporting of expenses and inflating of revenues are clear violations of the GAAP since GAAP works for fair presentation offinancial statementwhich are governed by revenue recognition principles and expense recognition principles.

Under the revenue recognition principles, revenues must be properly recognized when earned. The practice of inflating revenues by adjusting entries in creating corporate unallocated revenue accounts could easily be detected if there is an effort to do so since the name of unallocated accounts is very revealing but since the perpetrators are from the very people who are to ensure the reliability of the financial statements, the standard appeared to have no power over their criminal minds.

But as found in the investigation, it was the internal audit which first calls for the alarm when there was a transfer of line costs amounting to more than \$

3 billion. This means that the system of internal control of the company still allows the working of revenue recognition principle to be noticed since they found that the ratio of expenses to revenue was already too low despite the transfer of big amount of expenses to assets. The revenue recognition principle could have guided them the simple minds of auditor that it was utterly impossible to have produced those ratios.

To go back to internal control, it is management's responsibility to have it in place but the people who were governed by the procedures did not all work together to protect the company assets since some are just evil while others are perhaps touched by their conscience especially the internal audit personnel who called the alarm on the transfer of more \$3 billion line costs to assets. It appears that internal control must also have the characteristic of integrity as a system since if others are honest but others are dishonest, it will still malfunction because the company appeared to have two sets of values.

Every practicing accountant and auditors will agree that the purpose of the internal control is to provide assurance that its financial statements are reliable and its preparation are in accordance with the accounting standards as issued by Financial Accounting Standards Board (FASB). Since internal control policies and procedures for the maintenance of record in reasonable detail and reflecting the same in accurate and fair manner, first and foremost, the objective must be desired by management as a goal.

In the case of WorldCom it is believable to assert that the company did have internal control but its implementation was clouded by the intention of the

few who wanted to enrich themselves at the expense of investors. If the company has indeed proper values that are adopted and desired by its members, the company could have surmounted the internal control's inherent limitations for its not to have prevented or detected the misstatement of revenues and expenses. 2. 3 Discuss in detail what a forensic accounting consultant (you) would have recommended or instilled to have prevented this fraud/accounting failure. pages As a forensic accounting consultant, what was needed was independence of the auditor from management. Auditors are to maintain their independence from the client as called for by their ethical standards but the moment that there is connivance, it goes pretty sure that fraud could easily happen. The work of an external auditor is separate from that of the company accountant or even an internal auditor. Companies must reliable financial reporting system so that information should accurate and in accordance with generally accepted accounting principles (GAAP).

One way of ensuring compliance with the GAAP is by having an efficient and effective internal control over financial reporting. Since it is management's responsibility to do the same, the company must do the same with a sense of integrity as part of its defining values. . Since the purpose of the internal control is to provide assurance that its financial statements are reliable and its preparation are in accordance with the US GAAP must be become a necessity for the company to make it good.

Internal control is policies and procedures for the maintenance of record in reasonable detail of information and should the reflection of the same in

accurate and fair manner. This set of policies and procedure would provide assurance at reasonable level so that unauthorized acquisition or disposition of company's asset that could materially affect financial statements are detected timely and prevented accordingly.

Every company's internal control has its own inherent limitations that may not prevent or detect the misstatement that must be watched. It is thus accepted by experts in accounting that projections of any effective evaluation to future periods could still have risk thus making the controls inadequate to respond to the needs for more reliable financial statements because of changing conditions as a necessary part of business and degree of compliance with establish procedures may decline as well.

It is for this reason that the managements desiring to have the internal in effect must conduct its own evaluation of its existing internal control on its financial reporting. It cans use as framework the Internal Control – Integrated Framework as issued by the Committee of Organizations of the Treadway Commission (COSO). 3. Conclusion The story of WorldCom is a story of how greed would cause damage to people and how the accounting profession could be used as an instrument to perpetrate fraud.

Theoretically, accounting is considered as the language of business and that it should provide information to help users for decision making. The basic requirement of valid accounting information is that it must be accurate or truthful. This characteristic was absent in the case of WorldCom as the accounting information was twisted to serve the interest of few people.

No wonder Ebberts and company have to go to jail to suffer for the accounting fraud they have committed against the investors and for other crimes which are connected to the act of fraud. The analysis revealed to have to good internal control as requirement for providing reasonable assurance of providing information that is reliable for decision making. Said purpose must be consistent in the company's being subjecting itself to compliance with US GAAP for the preparation of its financial statements that are reliable.

The company must put and serious stand on this since the standards are meant to reconcile conflicting interest of users to prevent one user from taking advantage at the expense of the other. The set of policies and procedures from the efficient and effective internal control would provide reasonable that unauthorized acquisition or disposition of company's assets that could materially affect financial statements are detected one time and preventive efforts could be applied accordingly.

In the final analysis however, between the good internal control and the people who would implement, more weight should be given in the need for integrity and honesty of people who will implement the internal control. The maker should control what it has made. By the same principle the good internal control will mean nothing if people do not have integrity and are only seeking their selfish interest at the expense of all other stakeholders.

There is no cure for greed there is a way to discourage or minimize the same by threat of strict implementation of the law. The case of Anderson who became an auditor of WorldCom appears to have not resulted to his



prosecution of any crime but the auditor' case with Enron was different. However he got himself acquitted in the higher court. Government therefore has also a role to play. It has imprisoned the perpetrators of WorldCom hence it should be a warning for many who plans to cheat investors.