

Accounting fraud at worldcomm flashcard



By June 2002, it had become evident to the SEC that WorldCom had engaged in a significant corporate accounting fraud scheme which had overstated pretax income by about \$7 billion since 1999. At the time, this was the largest deliberate misstatement in US corporate history. Although there are many interesting elements and players involved with this incident, for the purpose of this case study I will focus on the role played by Betty Vinson, the Director of Management Reporting and a key figure in enabling the type of illegal behavior WorldCom was involved in.

Betty Vinson is a native of Jackson, Mississippi, and joined WorldCom in 1996 when she was 40 years old. WorldCom's corporate headquarters, as well as finance department, were located in Jackson as well at the time, which was a large benefit to Vinson and her family. Although she had only been at WorldCom for a few years, Vinson had developed a solid reputation as a hardworking, loyal employee who enjoyed the ability to live and work in her hometown. By the time WorldCom declared bankruptcy, she had been promoted to Director and was making around \$80, 000 per year.

This salary made her the family's main breadwinner and when considering the additional insurance benefits, as well as the lack of employment opportunities in Jackson, Vinson felt very fortunate to have such a position at WorldCom. Aside from Betty Vinson, the two other main players in the case are Bernard Ebbers, CEO, and Scott Sullivan, CFO. Ebbers lacked technological expertise or experience and, admittedly, stated his only real qualification was " being the meanest SOB they could find" (Kaplan and Kiron, 2007).

However, Ebbers was the right man for the job during the companies' infancy, since his aggressive M&A strategy took less than a year to make WorldCom profitable. However, in 1999 when the WorldCom – Sprint merger failed to materialize, it appeared a new growth strategy would be required. Unfortunately, likely due to his own personal limitations and inability to relinquish power, Ebbers appeared to lose direction. As for Sullivan, although he was viewed as a “ financial whiz kid” (Kaplan and Kiron, 2007), he also seemed to possess some of the negative traits exhibited by Ebbers, specifically related to his own personal morals and ethics.

Hiring someone like Sullivan was likely intentional, as Ebbers was in complete control and preferred to keep managements function informal and powerful. For example, Ebbers and Sullivan did not like written policies, the legal department in general, and also preferred to grant bonuses based on their own perceptions versus actual approved bonus salary guidelines. Overall, Ebbers fostered an unhealthy and unethical corporate environment, in turn creating a culture which employees felt compelled to not question orders and simply do as they were told.

When you consider this environment with Ebbers stated goal “ to be the #1 stock on Wall Street” (Kaplan and Kiron, 2007), as well as his aggressive grow-at-all-costs strategy, the potential for disaster was extremely prevalent. It is in this sense that Vinson, with her personal tendencies to be loyal and not question authority, was most likely taken advantage of. Although it cannot be entirely proven that Vinson was not a driving force behind this plan, logic dictates that an employee only making \$80, 000 per year, who is

also well aware of the illegality of their actions, would not voluntarily engage in such behavior.

Still, for reasons and rationalizations that will be discussed, Vinson went ahead and performed the fraudulent entries based on her manager's direction. This case study will examine the circumstances and rationalizations that led to her decisions, as well as propose potential strategies that would have resulted in a more positive fate for Betty Vinson.

Situation Analysis As previously stated, WorldCom grew rapidly during the 1990's through an aggressive M&A strategy. Ebbers stated in 1997 that "Our goal is not to capture market share or be global. Our goal is to be the #1 stock on Wall Street" (Kaplan and Kiron, 2007).

Among the financial markets and analysts, the Expense-to-Revenue Ratio was a key indicator of performance and was very closely monitored each quarter. Ebbers was fully aware and somewhat blinded by this fact, as he was likely not being entirely strategic when he chose to focus so intently on short-term growth and stock performance, versus long-term sustainable growth which may have been more appropriate for a company which is providing a utility-like (near) essential service. Anyways, this focus on the E/R ratio resulted in some risky revenue growth strategies, namely entering into long-term fixed rate leases for network capacity on the assumption of anticipated future increases in customer demand. These leases also contained severe financial penalties for opting out early or unused capacity. Unfortunately, WorldCom failed to anticipate the dot-com bubble and the onset of recession in the late 1990's, early 2000's. These deteriorating economic conditions put severe pressure on WorldCom's financial

performance indicators, specifically their ability to maintain the 42% E/R rating they so coveted.

As it became clear to Ebbers and Sullivan that their growth strategy may have been too aggressive, they decided to manipulate the accounting entries in order to, hopefully, ride out the less favorable economic period. At this point, Betty Vinson becomes heavily involved. Ebbers and Sullivan, with their high-level view of the drastic current state of their company's financial position, seem to have almost entirely resigned to committing fraud. In their eyes, it appears that this is the only way out of their current mess.

Failure, otherwise known as declaring bankruptcy due to mismanagement, is not an option for them. However, Ebbers and Sullivan will need the cooperation of several key members of the accounting group if they are going to be able to implement their plan. In October 2000, Betty Vinson and Troy Normand (another Director in General Accounting) are called into Buddy Yates' office. Yates is the Head Director of General Accounting, who is the manager of both Vinson and Normand at the time. Yates occupies the rung below David Myers, Corporate Controller, who is the second-hand man to Sullivan.

Anyways, this is the first time Vinson is asked to engage in illegal activity. Yates tells Vinson and Normand that Myers and Sullivan have directed the group to release \$828 million of line accruals, which will then flow positively into the income statement, artificially lowering operational expense and pumping up revenue. Like any good accountant or financial professional,

Vinson immediately recognizes this as bad accounting and likely is fully cognoscente of the overall purpose of this release.

Amazingly, when Vinson and Normand state their concerns over the directive, Yates agrees that he is also not happy about the transfer either! However, Yates assures the two accounting directors that Sullivan has stated this will be the one and only time for such activity and that he had agreed to go along, so they should do the same. This is a key point in the case and Betty's life in general. Ever since starting at WorldCom she has never questioned authority and has built the reputation of being a solid team player.

Furthermore, WorldCom's corporate culture was one in which employees did not question superiors, which definitely enabled Vinson to rationalize this inappropriate strategy. For instance, let's examine her 3 main rationalizations; being the family's main breadwinner, the lack of alternative employment opportunities in the community, and that Sullivan likely knew what he was doing. An argument can be made that Vinson used all four classic rationalizations when she decided to keep quiet and go along with the plan.

She definitely was concerned with being absolutely loyal, told herself Sullivan probably knew what he was doing (this is standard, not my responsibility), and tried to convince herself it wasn't a big deal (Gentile, 2009). What she failed to realize, however, that it was that her duty, as a CPA, to challenge these types of decisions (Paine, 2007). It is certain Vinson likely realized this, since after making the transfer and releasing the

fraudulent 3rd quarter results she is overcome with guilt and strongly considers resigning.

I am fairly certain that, due to her stress level at this point, Vinson is aware that she has crossed a boundary between being a loyal team player into the area of criminal behavior and / or being an accessory to corporate fraud. Although her original intuition was likely correct, which was to resign, Ebbers and Sullivan catch wind of the accountants intentions and are able to talk them out of their decision. In a meeting with Normand and Vinson regarding their resignation plans, Sullivan gives the analogy of being an aircraft carrier with planes in the air.

Although this analogy may seem weak when read in the form of a case study 10 year later, any senior executives opinion is tough to discount when placed in a face-to-face meeting situation. As we have learned, many senior executives (and, ironically, psychopaths) are extremely charismatic storytellers, capable of exerting significant influence over others (Alster, 2006). Furthermore, when we consider Vinson's personality and desire to remain in Jackson, it is no surprise that Sullivan is able to talk her and Normand out of quitting.

No less than two quarters later, Vinson and Normand were again asked to help Sullivan manipulate WorldCom's financial performance. However, this time the transfer was even less defensible than the previous accrual release plan. Due to deteriorating external conditions, revenues were once again less than the forecast required. Anyways, since there were not enough funds left in accrual accounts to release in order to achieve the 42% E/R ratio,

Sullivan's new directive was to capitalize the line costs which had always been treated as an operational expenditure.

This makes almost no sense, since to capitalize a cost it must be both tangible and benefit more than one operating cycle (Investopedia). In terms of line usage, it is neither tangible nor useful over time (i. e. only useful in the instant to respond to increased demand capacity). Obviously, this put Vinson in an extremely difficult position as she mentions feeling overwhelmed and trapped. Although she had already made one illegal entry, this was truly the crossroads for Vinson, in my opinion.

At this point, based on Sullivan's risky plan it should have been obvious that the company was in deep trouble. One transfer would not be enough to solve WorldCom's issues and likely no amount of creative accounting would make up for deteriorating market conditions, stronger competition, and financial mismanagement. Although Vinson agrees to the transfer yet again, complete with a backdated entry to the previous year, this was a key decision in her career at WorldCom and as an CPA in general.

Predictably, Ebbers and Sullivan reward Vinson's behavior with a promotion, however, this comes at a high cost. Vinson is required to continually capitalize such line costs throughout 2001, which comes at the detriment to her physical health and mental state. Alternative Solutions When discussing alternative solutions I am going to start by focusing on the original directive to release the accruals, which is turning point #1 for Vinson, and then discuss what she could have done at turning point #2, which was the directive to capitalize line costs.

Furthermore, I will discuss Vinson's subsequent realization that this behavior would likely need to continue indefinitely into the future, as well as other possible actions which could have been undertaken all along. When Vinson and Normand were called into Yates' office in October 2000, they should have pushed to get the accrual release directive in writing. This does not necessarily mean they should demand or even ask for it to be emailed. Instead, Vinson could have leveraged her newbie status within the corporate accounting group to send an email related to the accrual release (Gentile, 2009).

For instance, she could qualify her statement as "thinking out loud as a new member of the team", or something along those lines. Anyways, the key question to raise here would be the fact that even though these accruals are to be released, what is the justification for our anticipated lower future billing? If Sullivan responds once again with his MCI merger explanation, Vinson should declare the need for physical, quantitative backup, as it is her role within the organization as a CPA and Director of Accounting to verify such transfers.

Otherwise, accruals should only be released upon reception of the actual bills (at a lower cost than anticipated), or based on actual data presented regarding the MCI merger. By taking this position, she is leveraging her newbie status, removing the personal emotion from her position (it is just part of my job), and attempting to poke holes in Sullivan's MCI merger rationalization (Gentile, 2009). Furthermore, it would be wise to start keeping an external journal of actual directives from her managers, in case (or when) WorldCom is scrutinized for such questionable accounting practices.

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Even if Vinson takes this position, I have the feeling that Ebbers and / or Sullivan will find a way to satisfactorily explain to Vinson that the accrual release is either acceptable as a one-time strategy, or that she will rationalize this transfer as acceptable, so long as it does not become common practice. Either way, it is clear in the case that Vinson realizes that this is either illegal or very unethical accounting. Therefore, along with recording whatever emails related to these transfers she can, it would likely be a good idea to also retain the services of a lawyer.

By retaining legal counsel, Vinson may be afforded greater piece of mind throughout this trying period of her career, as well as support her argument that although she did knowingly perform such illegal transfers, she did so due to family reasons and was planning on blowing the whistle at some point when she had collected sufficient evidence. Moving forward to April 2001 (turning point #2), Vinson and Normand are once again asked to bailout WorldCom, however, this time Sullivan's plan is even more flagrant.

He proposes re-classifying line usage costs, which have historically been an operational expense, into a capital expense. Besides the fact that line usage costs are neither tangible nor useful in some future period, this will obviously significantly decrease WorldCom's overall expenses, since these costs will now be moved over to the balance sheet and slowly depreciated over time (Investopedia). The problem, however, is that line usage contracts do not qualify as a capital asset. This is a fact well-understood by Vinson and Normand, not to mention likely anyone who works in the industry and has a basic understanding US GAAP (Generally Accepted Accounting Principles).

Obviously, Vinson and Normand should be extremely shocked at the request and it should now be clear what type of distress WorldCom is in. This is a key moment for Vinson, as she needs to really consider the direction her company is headed, as well as what is being asked of her. At this point, there seems to be no basis or logic behind Vinson's decision to continually misclassify these operational expenses for her employer's benefit, especially without getting some sort of agreement in writing or at least documenting the extreme levels of corruption she was faced with.

Although the case mentions the high level of stress and anxiety she experienced, which undoubtedly results in thinking less clearly than usual, Vinson really failed herself by not taking any action with the exception of following orders. If she had refused to go along with any further fraud, documented some of the emails or directives, or at least retained a lawyer, her punishment would have likely been much less severe.

Another possible alternative solution would be to involve WorldCom's Internal Audit Department, however, as the case pointed out, many WorldCom employees felt skeptical of the department's purpose and objectivity since they reported directly to Sullivan. Vinson may have believed that this was not the place to question financial transactions and thought this would only draw negative attention to her information gathering efforts. With that being said, the internal audit department was aware of some level of fraud, or at least strongly expected it, as early as August 2001.

Although Vinson would have likely found solace and support by involving the internal team (especially post-August 2001), there was no way for her to

know who to trust, especially when considering the poisonous culture fostered by Ebbers. Therefore, I cannot fault Vinson for not choosing to trust the Internal Audit Department with such sensitive information at this time. Solution & Implementation Plan For the purpose of my solution, I am going to, in my opinion, be realistic and have Vinson release the accruals during October 2000. However, how she goes about this process and her subsequent decisions afterwards will be different.

Furthermore, I have decided to combine the solution and implementation plan sections since this is not a corporate initiative, rather, an individual plan to avoid legal prosecution. Starting with the October 2000 meeting with Yates and Normand, I would have Vinson act less shocked and more quizzical regarding the directive. Although Vinson and Normand recognize the potential illegal activity almost immediately, it does not do them any favors by expressing this concern. Instead, I would argue it immediately tips off Ebbers and Sullivan as to the thinking and knowledge level of their accounting directors.

This allows Ebbers and Sullivan to take more precautions when dealing with Vinson and other accountants required to implement their scheme. For instance, Sullivan would likely be more inclined to give written orders and not cover his tracks in the ERP system (Electronic Resource Planning system, where the General Ledger is typically maintained) if he assumed Vinson and Normand were completely oblivious to his intentions. If Vinson was able to give the impression of being unaware to the level of fraud they are committing, she may be able to coerce a greater level of evidence from him and WorldCom's books.

For example, shortly after the October 2000 meeting, I would have Vinson send an email raising the accrual release as an issue she would require further explanation on before executing the transfer, but in a positive or non-concerning tone. The key here would be to encourage (or frustrate through inaction) Sullivan enough to disclose his directive and / or intentions in writing, which should then be immediately saved on a personal external drive by Vinson. Finally, I would also at this time have Vinson retain a lawyer, to which she should also share / store whatever evidence and information she can gather with.

Moving on to April 2001, this is when Vinson definitely should realize the wheels are falling off WorldCom. As I have previously mentioned, there is basically no defense for the transfer of \$771 million in line usage operating expense into a capital account. At this point, the plan to be oblivious and leverage Vinson's newbie status will need to be revised. Instead, I feel that at this time Vinson should not hold back her assessment of the directive. She should state clearly that, as a CPA and Director of Accounting at WorldCom, it is her duty to make sure instances like this do not occur (Paine, 2007).

Furthermore, she should state that by asking her to perform this transfer, management has taken advantage of their position in order to exert unfair pressure related to performing an obviously illegal activity. Although Vinson is acting professionally and taking an appropriate stance, her actions are likely to be ill-received. I would assume she will be verbally accosted, possibly by both Sullivan and Ebbers, and fully risks losing her job. However, due to the actions she has already taken, I feel that Vinson can be more confident in her legal position.

Since she has retained a lawyer and documented some of the questionable directive from her superiors, she has multiple paths for recourse against WorldCom, whether that is a lawsuit for wrongful termination or going directly to the SEC. Although either path is likely quite stressful and potentially risky, we now know that in hindsight the cost of inaction, or going along with management's plan, was much more severe. Conclusion This case is a great example of the type of dilemma's even the most loyal and hardworking employee can experience, albeit extreme in terms of scale and punishment.

Still, after examining Betty Vinson's actions throughout the WorldCom fraud case, it is clear that the need for a strong ethical composition is adamant when managing large companies and budgets. Even after reading this case multiple times I am not sure whether or not Vinson knew what type of trouble she was getting herself into. Personally, I feel that she wanted to believe she was protected since she was, after all, just following orders. However, based on her level of education and position, Betty Vinson was obviously an intelligent woman.

If you consider her level of guilt, which got to the point of exhibiting physical symptoms, it is clear she had some idea of the risks being taken.

Unfortunately, Vinson failed to acknowledge that with advanced positions comes a greater level of responsibility, not just to the company but to society and its laws in general. It is sad to see bad things happen to good people, which I truly believe Vinson is, however, it is hard to say that she did not fail somewhat by choosing to neglect her ethics, morals, and basically overall sense of right and wrong throughout this ordeal.

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