

How Three Unlikely Sleuths Exposed Fraud at WorldCom

Firm's Own Employees Sniffed Out Cryptic Clues and Followed Hunches

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Oct. 30, 2002 at 4:58 pm ET

CLINTON, Miss. -- Sitting in his cubicle at WorldCom Inc. headquarters one afternoon in May, Gene Morse stared at an accounting entry for \$500 million in computer expenses. He couldn't find any invoices or documentation to back up the stunning number.

"Oh my God," he muttered to himself. The auditor immediately took his discovery to his boss, Cynthia Cooper, the company's vice president of internal audit. "Keep going," Mr. Morse says she told him.



Cynthia Cooper

A series of obscure tips last spring had led Ms. Cooper and Mr. Morse to suspect that their employer was cooking its books. Armed with accounting skills and determination, Ms. Cooper and her team set off on their own to figure out whether their hunch was correct. Often working late at night to avoid detection by their bosses, they combed through hundreds of thousands of accounting entries, crashing the company's computers in the

process.

By June 23, they had unearthed \$3.8 billion in misallocated expenses and phony accounting entries. It all added up to an accounting fraud, acknowledged by the company, that turned out to be the largest in corporate history. Their discoveries sent WorldCom into bankruptcy, left thousands of their colleagues without jobs and roiled the stock market.

At a time when dishonesty at the top of U.S. companies is dominating public attention, Ms. Cooper and her team are a case of middle managers who took their commitment to financial reporting to extraordinary lengths. As she pursued the trail of fraud, Ms. Cooper time and again was obstructed by fellow employees, some of whom disapproved of WorldCom's accounting methods but were unwilling to contradict their bosses or thwart the company's goals.

WorldCom is under investigation by the Justice Department and the Securities and Exchange Commission. Scott Sullivan, WorldCom's former chief financial officer and Ms. Cooper's boss, has been indicted. He has denied any wrongdoing. Four other officers have pleaded guilty and are cooperating with prosecutors. Federal investigators are still probing whether Bernard J. Ebbers, the company's former chief executive, knew about the accounting improprieties. Since the initial discoveries, WorldCom's accounting misdeeds have grown to \$7 billion.

Behind the tale of accounting chicanery lies the untold detective story of three young internal auditors, who temperamentally didn't fit into WorldCom's well-known cowboy culture. Ms. Cooper, 38 years old, headed a department of 24 auditors and support staffers, many of whom viewed her as quiet but strongwilled. She grew up in a modest neighborhood near WorldCom's headquarters and had spent nearly a decade working at the company, rising through its ranks. She declined to be interviewed for this story. Mr. Morse, 41, was known for his ability to use technology to ferret out information. The third member of the team was Glyn Smith, 34, a senior manager under Ms. Cooper. In his spare time he taught Sunday school, took photographs and bicycled. His mom had taught him and Ms. Cooper accounting at Clinton High School.

Frightened that they would be fired if their superiors found out what they were up to, the gumshoes worked in secret. Even so, their initial discrete inquiries were stonewalled. Arthur Andersen, WorldCom's outside auditor, refused to respond to some of Ms. Cooper's questions and told her that the firm had approved some of the accounting methods she questioned. At another critical juncture in the trio's investigation, Mr. Sullivan, then the company's CFO, asked Ms. Cooper to delay her investigation until the following quarter. She refused.

Ms. Cooper's first inkling that something big was amiss at WorldCom came in March 2002. John Stupka, the head of WorldCom's wireless business, paid her a visit. He was angry because he was about to lose \$400 million he had specifically set aside in the third quarter of 2001, according to two people familiar with the meeting. His plan had been to use the money to make up for shortfalls if customers didn't pay their bills, a common occurrence in the wireless business. It was a well-accepted accounting device.

But Mr. Sullivan decided instead to take the \$400 million away from Mr. Stupka's division and use it to boost WorldCom's income. Mr. Stupka was unhappy because without the money, his unit would likely have to report a large loss in the next quarter.

Mr. Stupka's group already had complained to two Arthur Andersen auditors, Melvin Dick and Kenny Avery. They had sided with Mr. Sullivan, according to federal investigators.

But Mr. Stupka and Ms. Cooper thought the decision smelled funny, although not obviously improper. Under accounting rules, if a company knows it is not going to collect on a debt, it has to set up a reserve to cover it in order to avoid reflecting on its books too high a value for that business. That was exactly what Mr. Stupka had done. Mr. Stupka declined to comment.

Ms. Cooper decided to raise the issue again with Andersen. But when she called the firm, Mr. Avery brushed her off and made it clear that he took orders only from Mr. Sullivan, according to the investigators. Mr. Avery and Mr. Dick declined to comment. Patrick Dorton, a spokesman for Andersen, said his firm thought that the \$400 million wireless reserve was not necessary.

"That was like putting a red flag in front of a bull," says Mr. Morse. "She came back to me and said, 'Go dig.' "

Some internal auditors would have left it at that and moved on. After all, both the company's chief financial officer and its outside accountants had signed off on the decision. But that was not Ms. Cooper's style. One favorite pastime among the auditors who reported to her was applying the labels of the Myers-Briggs & Keirsey personality test to their fellow staffers. Ms. Cooper was categorized as an INTJ -- introspective, intuitive, a thinker and judgmental. "INTJs," according to the test criteria, are "natural leaders" and "strong-willed," representing less than 1% of the population.

And so Ms. Cooper decided to appeal the decision. As head of auditing, it was her responsibility to bring sensitive issues to the audit committee of WorldCom's board. She brought the reserves question to the attention of the committee's head, Max Bobbitt. At a committee meeting at the company's Washington offices on March 6, she and Mr. Sullivan presented their cases, according to minutes from the meeting. Mr. Sullivan backed down, according to people familiar with his decision.

The next day he tracked down Ms. Cooper. Unable to reach her immediately, Mr. Sullivan called her husband, a stay-at-home dad to their two daughters, to get her cellphone number. He finally caught up with her at the hair salon. In the future, she was not to interfere in Mr. Stupka's business, Mr. Sullivan warned, according to people familiar with the reserves question.

The confrontations put Ms. Cooper in a sticky position. Mr. Sullivan was her immediate supervisor. Plus, her vague discomfort with the way WorldCom was handling its accounting led her into areas that were not normally her bailiwick. Although her department did a small amount of financial auditing, it primarily performed operational audits, consisting of measuring the performance of WorldCom's units and making sure the proper spending controls were in place. The bulk of the company's financial auditing was left to Arthur Andersen. But neither of those things dissuaded Ms. Cooper from following her nose to the root of the ill-defined problem.

A Surprise Request

On March 7, a day after Ms. Cooper had visited with the audit committee, the SEC surprised the company with a "Request for Information." While WorldCom's closest competitors, including AT&T Corp., were suffering from a telecom rout and losing money throughout 2001, WorldCom continued to report a profit. That had attracted the attention of regulators at the SEC, who thought WorldCom's numbers looked suspicious.

But investigators had grown frustrated as they combed through public filings looking for evidence of wrongdoing, according to people familiar with the inquiry. So they asked to see data on everything from sales commissions to communications with analysts.

Concerned about why the SEC was sniffing around, Ms. Cooper directed her group to start collecting information in order to comply with the request.

She also was growing concerned about another looming problem. Andersen was under fire for its role in the Enron case, which soon would lead to the accounting firm's indictment. It was clear that WorldCom would have to retain new outside auditors.



Scott Sullivan

Ms. Cooper set off on an unusual course. Her own department would simply take on a role that no one at WorldCom had assigned it. The troubles at Enron and Andersen were enough to warrant a second look at the company's financials, she explained to Mr. Morse one evening as they walked out to WorldCom's parking lot. Her plan: her department would start doing financial audits, looking at the reliability and integrity of the financial

information the company was reporting publicly.

It was a major decision, which would necessitate a lot more work for Ms. Cooper and her staffers. Still, Ms. Cooper took on financial auditing without asking permission from Mr. Sullivan, her boss, according to investigators and a person familiar with Ms. Cooper's decision.

"We could see a strain in her face," recalls her mother, Patsy Ferrell, about that time period. "She didn't look happy. We knew she was working late and some of the other people were working late. We would call and say, 'Can we bring some sandwiches?' and her father would bring them sandwiches."

A Curious E-Mail from Afar

Several weeks later, Mr. Smith, a manager under Ms. Cooper, received a curious e-mail from Mark Abide, based in Richardson, Texas, who was in charge of keeping the books for the company's property, plants and equipment.

Mr. Abide had attached to his May 21 e-mail a local newspaper article about a former employee in WorldCom's Texas office who had been fired after he raised questions about a minor accounting matter involving capital expenditures. "This is worth looking into from an audit perspective," Mr. Abide wrote. Mr. Smith, who declined to be interviewed, forwarded the e-mail to Ms. Cooper, according to investigators and a lawyer involved in the case.

The e-mail piqued Ms. Cooper's interest. As part of their initial foray into financial auditing, Ms. Cooper and her team had already stumbled on to the issue of capital expenditures, a subject that would prove to be crucial to their quest.

The team had run into an inexplicable \$2 billion that the company said in public disclosures had been spent on capital expenditures during the first three quarters of 2001. But they found that the money had never been authorized for capital spending.

Capital costs, such as equipment, property and other major purchases, can be depreciated

over long periods of time. In many cases, companies spread those costs over years. Operating costs such as salaries, benefits and rent are subtracted from income on a quarterly basis, and so they have an immediate impact on profits.

Ms. Cooper and her team were beginning to suspect what was up with the mysterious \$2 billion entry: It might actually represent operating costs shifted to capital expenditure accounts -- a stealthy maneuver that would make the company look vastly more profitable.

When Ms. Cooper and Mr. Smith asked Sanjeev Sethi, a director of financial planning, about the curious adjustment, he told them it was "prepaid capacity," a term they had never heard before. Further inquiries led them to understand that prepaid capacity was a capital expenditure. But when they asked what it meant, Mr. Sethi told them to ask David Myers, the company's controller, according to Mr. Morse and a person familiar with Ms. Cooper's situation. Mr. Sethi did not return phone calls.

Ms. Cooper and Mr. Smith opted instead to call Mr. Abide, who had pointed out a capital expenditures problem in his e-mail. When they asked him about "prepaid capacity," he too answered very cryptically, explaining that those entries had come from Buford Yates, WorldCom's director of general accounting.



Gene Morse

While perusing records looking for accounting irregularities later that same day, May 28, Mr. Morse made the big discovery of the \$500 million in undocumented computer expenses. They also were logged as a capital expenditure. "This stinks," Mr. Morse recalls thinking to himself. He immediately went to Ms. Cooper to tell her what he'd found. She called a meeting of her department. "I knew it was a horrific thing and she did too, right off

the bat," says Mr. Morse.

Several days later, Ms. Cooper and Mr. Smith met to try to make sense of their growing list of clues. Particularly puzzling were the cryptic comments made by Mr. Sethi and Mr. Abide. Finally the two auditors came up with a plan of action to test their sense that when it came to the booking of capital expenditures, something was very wrong at WorldCom. Ms. Cooper would send Mr. Smith an e-mail saying she wanted to know more about prepaid capacity as soon as possible, and asking how much harder they should press Mr. Sethi. They would copy Mr. Myers on the e-mail.

Mr. Myers shot back an e-mail. Mr. Sethi should be working for him and did not have time to devote to Ms. Cooper's inquiries, he wrote. Ms. Cooper had been stonewalled yet again.

A Secret Plan

Ms. Cooper and Mr. Smith didn't know it, but they had stumbled onto evidence that some executives were keeping two sets of numbers for the then-\$36 billion company, one of them fraudulent.

By 2000, WorldCom had started to rely on aggressive accounting to blur the true picture of its badly sagging business. A vicious price war in the long-distance market had ravaged profit margins in the consumer and business divisions. Mr. Sullivan had tried to respond by moving around reserves, according to his indictment. But by 2001 it wasn't enough to keep the company afloat.

And so Mr. Sullivan began instructing Mr. Myers to take line costs, fees paid to lease portions of other companies' telephone networks, out of operating-expense accounts where they belonged and tuck them into capital accounts, according to Mr. Sullivan's indictment.

It was a definite accounting no-no, but it meant that the costs did not hit the company's bottom line -- at least in the version of the books that were publicly scrutinized. Although some staffers objected, the scheme progressed for the next five quarters.

Ms. Cooper, Mr. Smith and Mr. Morse didn't know this. They only knew that accounting entries had been hopscotching inexplicably around WorldCom's balance sheets and that nobody wanted to talk about it. To put all the pieces together, they would need to plumb the depths of WorldCom's computerized accounting systems.

Full access to the computer system was a privilege that normally had to be granted by Mr. Sullivan. But Mr. Morse, a bit of a techie, had recently figured out a way around that problem.

Without explaining what he was up to, Mr. Morse had asked Jerry Lilly, a senior manager in WorldCom's information technology department, for better access to the company's accounting journal entries. Mr. Lilly was testing a new software program and gave Mr. Morse permission to road test the system, too.

The beauty of the new system, from Mr. Morse's perspective, was that it enabled him to scrutinize the debit and credit sides of transactions. By clicking on a number for an expense on a spreadsheet, he could follow it back to the original journal entry -- such as an invoice for a purchase or expense report submitted by an employee, to see how it had been justified.

Sifting through the data for answers to still-vague questions about capital expenditures amounted to a frustrating task, Mr. Morse says. He combed through an account labeled "intercompany accounts receivables," which contained 350,000 transactions per month. But when he downloaded the giant set of data, he slowed down the servers that held the company's accounting data. That prompted the IT staff to begin deleting his requests because they were clogging and crashing the system.

Mr. Morse began working at night, when there was less demand on the servers, to avoid having his work shut down by the IT department. During the day, he retreated to the audit library -- a windowless, 12-by-12 room piled with files from previous projects and tucked away in the audit department -- to avoid arousing suspicion.

By the first week of June, Mr. Morse had turned up a total of \$2 billion in questionable

accounting entries, he says.

The Sleuths Get Nervous

Having found the evidence they were looking for, the sleuths were suddenly faced with how serious the implications of their endeavor really were.

Mr. Morse grew increasingly concerned that others in the company would discover what he had learned and try to destroy the evidence, he says. With his own money, he went out and bought a CD burner and copied all the incriminating data onto a CD-Rom. He told no one outside of internal audit what he had found.

Mr. Morse even kept his wife, Lynda, in the dark. Each night, he'd bring home documents he was studying. He instructed his wife not to touch his briefcase. His wife thought the usually gregarious father of three looked drained.

Ms. Cooper had begun confiding in her parents, with whom she was especially close. Without going into detail, she told her mother that she was worried about what her team was finding, and that it was definitely a very big deal, according to a person close to Ms. Cooper.

Meanwhile, Mr. Sullivan began to ask questions about what Ms. Cooper's team was up to. One day the finance chief approached Mr. Morse in the company cafeteria. When Mr. Morse saw him coming, he froze. The auditor had only spoken to Mr. Sullivan twice during his five-year tenure at WorldCom.

"What are you working on?" Mr. Morse later recalled Mr. Sullivan demanding. Mr. Morse looked at his shoes. "International capital expenditures," he says he replied, referring to a separate, and less-threatening auditing project. He quickly walked away.

Days later, on June 11, Ms. Cooper got an unexpected phone call from Mr. Sullivan. He told her that he would have some time later in the day, and invited her to come by and tell him what her department was up to, according to a person familiar with Ms. Cooper's situation.

That afternoon, Ms. Cooper, Mr. Smith and another auditor arrived at Mr. Sullivan's office. They talked about pending promotions and other administrative matters, according to lawyers involved in the case.

As the meeting was breaking up, Ms. Cooper turned to Mr. Smith and suggested that he tell Mr. Sullivan what he was working on. It was meant to seem like a casual comment. In fact,

the two auditors had planned it out beforehand, so that they could gauge Mr. Sullivan's reaction, according to a person familiar with Ms. Cooper's situation.

Mr. Smith briefly described the audit, without going into the explosive material they already had found.

Mr. Sullivan urged them to delay the audit until after the third quarter, saying there were problems he planned to take care of with a write-down, according to several people familiar with the meeting.

Ms. Cooper replied that no, the audit would continue. Mr. Sullivan didn't respond, and the meeting ended in a stalemate.

Concerned now that Mr. Sullivan might try to cover up the accounting improprieties, Ms. Cooper and Mr. Smith appealed to Mr. Bobbitt, the head of WorldCom's audit committee. Mr. Bobbitt had to travel to Mississippi from his home in Florida for a board meeting scheduled for June 14, so the day before he met with Ms. Cooper and Mr. Smith at a Hampton Inn in Clinton.

The two auditors told Mr. Bobbitt what they had found. He asked Ms. Cooper to contact KPMG, the company's new outside auditors, and brief them on what was happening. Mr. Bobbitt did not raise Ms. Cooper's suspicions at the board meeting the next day, according to a document WorldCom later submitted to the SEC. James Sharpe, Mr. Bobbitt's lawyer, declined to comment.

Farrell Malone, the KPMG partner in charge of the WorldCom account, urged Ms. Cooper to make sure she was right.

On June 17, Ms. Cooper's team began a series of informal confrontations meant to convince themselves that there was no legal explanation for the accounting entries.

That morning, Ms. Cooper and Mr. Smith went to the office of Betty Vinson, director of management reporting, and asked her for documentation to support the capital-expense-accounting entries. Ms. Vinson told the two that she had made many of the entries but did

not have any support for them, according to an internal memo prepared by Ms. Cooper and Mr. Smith. Ms. Vinson's lawyer did not return phone calls.

Next they walked a few feet to Mr. Yates's office. He said he was not familiar with the entries and referred Ms. Cooper and Mr. Smith to Mr. Myers.

The duo then paid a call on Mr. Myers. When confronted, he admitted that he knew the accounting treatment was wrong, according to the memo. Mr. Myers said that he could go back and construct support for the entries but that he wasn't going to do that. Ms. Cooper then asked if there were any accounting standards to support the way the expenses were treated, according to the memo, which was later made public by a Congressional committee.

Mr. Myers answered that there were none. He said that the entries should not have been made, but that once it had started, it was hard to stop.

Mr. Smith asked how Mr. Myers planned to explain it all to the SEC. Mr. Myers replied that he hoped it wouldn't come to that, according to the memo.

An hour or so later, Ms. Cooper returned to her department to brief Mr. Morse and her other auditors. "They have no support," she told them, according to Mr. Morse.

It was clear to Ms. Cooper's team that their findings would be devastating for the company, and the prospect of going before the board with their evidence was sobering. They worried about whether their revelations would result in layoffs and obsessed about whether they were jumping to unwarranted conclusions that their colleagues at WorldCom were committing fraud. Plus, they feared that they would somehow end up being blamed for the mess.

Ms. Cooper's staffers began to notice that she was losing weight. Mr. Morse's wife noticed he was preoccupied and short tempered.

During the third week in June, Mr. Smith called his mother, who was vacationing in Albuquerque, according to a person familiar with the conversation. Without providing

specifics, he told her that he was about to take actions at WorldCom that were not going to make people happy. He asked his mother, Ms. Cooper's former high school accounting teacher, to remember him in her prayers and to pray for him to be strong.

Ms. Cooper prepared for several meetings with the audit committee. At one, on June 20, Mr. Sullivan was scheduled to defend himself.

One evening, as Ms. Cooper worked late with accountants from KPMG, she suddenly dropped her head into her arms on the conference-room table. Mr. Malone of KPMG led her onto a balcony, put his arm around her and showed her the sunset, according to a person familiar with the meeting.

Ms. Cooper, Mr. Smith and Mr. Malone headed to Washington to brief the board's audit committee. At the meeting on Thursday, June 20, Mr. Malone described the transfer of line costs to capital accounts and told the audit committee that, in his view, the transfers didn't comply with generally accepted accounting principles, according to a document WorldCom later submitted to the SEC.

Mr. Sullivan tried to give an explanation for the accounting adjustments but asked for more time to support the line-cost transfers. The committee gave Mr. Sullivan the weekend to explain himself. He got to work constructing what he called a white paper that argued that the accounting treatments he used were proper, according to the document.

It didn't work. On June 24, the audit committee told Mr. Sullivan and Mr. Myers they would be terminated if they didn't resign before the board meeting the next day. Mr. Sullivan refused and was fired. Mr. Myers resigned.

The next evening, WorldCom stunned Wall Street with an announcement that it had inflated profits by \$3.8 billion over the previous five quarters.

Afterward, Ms. Cooper drove to her parents' house, which was near WorldCom's headquarters. She sat down at the dining-room table without saying anything, says Ms. Ferrell, her mother. "She was deeply, deeply pained. She was grief stricken that it was true and that all these people would feel the consequences of having gone astray," Ms. Ferrell

says. "We were all so proud of WorldCom and it's just been the saddest, most tragic thing."

Mr. Morse worked late that night, and his wife phoned after she watched the news. The anchors were calling the company World-Con, she reported. Did he know anything about it?

The SEC on June 26 slapped the company with a civil fraud suit, and trading of WorldCom's stock was halted. Ultimately the company was delisted by the Nasdaq Stock Market.

Mr. Sullivan is preparing to go to trial. "We will demonstrate at the appropriate time that a number of the negative points that WorldCom's internal auditors have recently suggested about Mr. Sullivan are not accurate," says Irvin Nathan, a lawyer for Mr. Sullivan. "The fact is that he was always supportive of internal audit and was instrumental in the promotion of Cynthia Cooper and securing resources for her staff."

Mr. Myers, Mr. Yates, Ms. Vinson and Troy Normand, the director of legal entity accounting, have all pleaded guilty to securities fraud and a variety of other charges. David Schertler, an attorney for Mr. Yates, says that while his client pleaded guilty, "all the evidence would suggest he was acting under the orders of supervisors."

Ms. Cooper and her team have continued to work at WorldCom's Clinton headquarters and are responding to requests related to the various investigations of the company. Ms. Cooper, Mr. Smith and Mr. Morse have been interviewed by FBI agents in connection with the Justice Department's investigation.

Some WorldCom employees have told the auditors that they wish they had left the accounting issues alone.

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