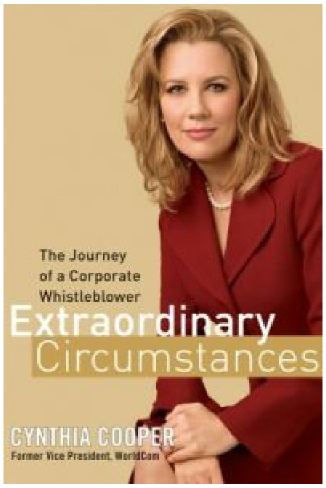

Book Extraordinary Circumstances

The Journey of a Corporate Whistleblower

Cynthia Cooper
Wiley, 2008
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Recommendation

Cynthia Cooper, ex-WorldCom VP and former head of its internal auditing department, is a genuine hero. Despite her supervisors' pressure, browbeating and subterfuge, Cooper uncovered and exposed the massive WorldCom corporate fraud. When her information became public, it set off a cataclysmic chain of events: WorldCom exploded like dynamite. It filed for bankruptcy. Investors lost billions on the suddenly worthless stock. CEO Bernie Ebbers went to jail for 25 years. Other executives received prison sentences. Being a whistleblower is painfully difficult, but Cooper stuck to her guns, as she relates in this personal and sometimes even chatty saga. BooksInShort recommends her instructive, inspiring book as a gripping corporate story and a cautionary tale.

Take-Aways

- Telecom giant WorldCom started out as LDDS, a small long-distance company.
- CEO Bernie Ebbers made it a major industry player by using aggressive acquisitions.
- In 1996, The Wall Street Journal reported that of all companies, WorldCom provided the best returns for investors over a 10-year period.
- Ebbers borrowed hundreds of millions from WorldCom to cover margin calls on $900 million in personal bank loans. He used his WorldCom stock as collateral.
- He had to keep WorldCom's stock value up to avoid deep financial trouble, but despite his fraudulent efforts to make the company look profitable, the stock fell.
- WorldCom's senior financial executives fraudulently disguised expense entries as assets to show a false increase in earnings.
- Cynthia Cooper, WorldCom's internal auditing VP, found and reported the fraud.
- When the fraud became public in 2002, WorldCom underwent the largest Chapter 11 bankruptcy filing in U.S. history.
- The Securities and Exchange Commission filed civil suits against WorldCom, its leaders and its accounting firm Arthur Andersen.
- Ebbers and other executives went to jail, leaving corporate destruction in their wake.

Summary

WorldCom Blows Up

In June 2002, WorldCom announced that it was in serious financial trouble. The enormous telecommunications company had $38 billion in annual revenues, operations in 65 countries and 100,000 employees, but it was imploding due to the largest corporate fraud in history. The announcement stated, "As a result of an internal audit of the company's capital expenditure accounting, it was determined that certain transfers...were not made in accordance with generally accepted accounting principles." That news flash was the PR understatement of the year. At the time of the release, WorldCom told the U.S. Securities and Exchange Commission (SEC) that it had to "restate its financials by $3.8 billion."

"Neither the fraud not the discovery of the fraud caused the downfall of WorldCom. The fraud simply masked the true state of the business. WorldCom should have gone into bankruptcy long before it did."

The SEC quickly brought a civil suit against WorldCom, although its stock had long been a Wall Street favorite. Scant years earlier, it had ranked first in shareholder return. Prior to its demise, only four companies had more stockholders. But after its first 17,000 layoffs and the SEC suit, WorldCom's stock value dropped from its all-time high of $64 to $0.09 before NASDAQ suspended its trading. WorldCom investors lost everything and its sudden fall shocked the global business community. One day WorldCom was the leading performer in the once super-hot telecommunications industry. The next day, the company had blown itself to smithereens.

"Our goal is to be the Number One stock on Wall Street." [– Bernie Ebbers]

WorldCom applied for Chapter 11 bankruptcy protection, the largest such filing in history. Soon after, a federal jury found deposed CEO Bernie Ebbers, 63, guilty on nine counts of corporate fraud and sentenced him to 25 years in federal prison. The court sentenced CFO Scott Sullivan to five years in jail, and gave lesser sentences to comptroller David Myers and other executives. How did WorldCom rise so quickly and fall so fast?

Murray Waldron Finds an Investor

In 1983, businessman Murray Waldron decided the time was right to get into the telecommunications business. The government recently had ordered the breakup of telecommunications giant AT&T, which had to spread its local telephone business among seven regional spinoffs. Waldron planned to buy long-distance minutes wholesale from AT&T and sell them. He and a partner set up the Long Distance Discount Company (LDDC), soon renamed LDDS (for "Services"), in Hattiesburg, Mississippi. But the company needed some $650,000 in capital. Waldron and his partner found an investor, Mississippi motel owner Bernie Ebbers, who was worth nearly $3 million in the early '80s. He became the owner of 14.5% of the new company.

"Bernie Ebbers...was larger than life, a local folk hero who lived the rags-to-riches American dream."

By 1985, LDDS had nearly $1.5 million in debt and was losing some $25,000 monthly. Ebbers became CEO to protect his investment. He knew the company couldn't turn around without reducing its long-distance costs, and that required securing more customers. Ebbers, who had made his motel fortune through acquisitions, pursued the same economies-of-scale strategy at LDDS. It quickly became an aggressive "reseller consolidator," buying other telecom firms to get their customers. Ebbers' strategy worked. Once it had a large local customer base, the company could get lower prices for the long-distance minutes it resold. It quickly began to make a profit. Acquiring a publicly traded company, Advantage Companies of Tennessee, enabled LDDS to go public without the hurdles of an IPO. By 1991, its annual revenues exceeded $700 million.

Cynthia Cooper

LDDS became the U.S.'s fourth-largest long-distance firm (after AT&T, MCI and Sprint) when it purchased reseller ATC. In 1993, Cynthia Cooper became head of its internal auditing department. She insisted that her internal auditing unit should report functionally to the board of directors' audit committee, which would give internal auditing, "some independence from company management" since it approved their budget and "annual audit plan." Cooper and her auditors also had to report administratively to the CFO, soon to be Scott Sullivan. LDDS had grown so fast and absorbed so many firms, that internal controls were shaky and many operations were redundant. Cooper's first audit recommended large changes, including creating a department to calculate sales commissions, splitting sales and operations at the executive level, and consolidating call and service centers. Ebbers was furious that she wanted to install internal controls, a suggestion he interpreted as a personal attack. He told her not to use the term "internal controls" in the future.

"Bernie...cobbled together a national customer base, but unlike...the three largest telecom companies, LDDS owns only a small piece of its telecommunications network."

In 1995, LDDS changed its name to WorldCom. Soon after, President Bill Clinton approved the Telecom Act of 1996, making telecom a go-to industry for investors overnight. Ebbers quickly took advantage of this new environment, and signed partnerships with GTE and Ameritech, two giant telephone firms. WorldCom joined the S&P 500 and *Forbes* included Ebbers on its list of the most powerful U.S. corporate leaders. But the heady climb of Ebbers, WorldCom and the telecom industry was about to crash.

"Irrational Exuberance"

On December 5, 1996, Alan Greenspan, then chairman of the U.S. Federal Reserve, used the phrase "irrational exuberance" during a dinner speech about the economy. He referred to the almost insanely bullish stock market, led by Internet and telecom stocks. His words quickly reverberated globally, sparking fear that the Fed would raise interest rates to cool things down. The global stock market immediately went into the tank, though WorldCom continued to surge ahead. In 1997, thanks to Ebbers' almost mystical business adroitness, WorldCom acquired MCI, a firm three times its size. Wall Street saw Ebbers as a Messiah. In 1999, almost as if to say, "You ain't seen nothing yet," Ebbers and WorldCom attempted to buy Sprint for $127 billion. The U.S. government and the European Union nixed the deal. Ebbers ultimately completed 65 acquisitions. He and WorldCom were at the top of the pyramid with nowhere to go but down.

Margin Calls

By 2000, Ebbers was worth $1.3 billion, primarily in WorldCom stock. Nearing 60 and considering retirement, he bought $700 million worth of assets to manage in his planned post-WorldCom life: a yacht builder, a giant rice farm and 548,000 acres of timberland. Refusing to sell his WorldCom stock, he borrowed money on margin to make these purchases, using his stock for collateral. That strategy was risky because stock prices can drop – which they did. By May, NASDAQ stocks, including WorldCom, took steep reductions. Ebbers' net worth dropped nearly 50%. One of Ebbers' lenders issued a margin call. Ebbers asked WorldCom's compensation committee for a $50 million loan and got the money. To cover additional margin calls from his lenders, Ebbers sold $70 million of his WorldCom stock, further deflating the stock's overall value. As more margin calls followed, he borrowed another $25 million from WorldCom. A continued drop in WorldCom's stock value would cause him huge trouble – nevertheless, the stock continued to decline, with the other freefalling telecoms. All the while, Ebbers borrowed more money from WorldCom to cover additional margin calls on his loans.

> "As long as WorldCom stock stays high, Bernie's OK. But if it falls below a certain level, he could be in serious trouble."

By April 2002, WorldCom had lent Ebbers more than $400 million, but he owed the banks more than $900 million. The board asked him to sell some of his new assets to pay his loans, he refused and the board ordered him to resign. Shortly before he left, Cooper's team found a commission fraud scheme at WorldCom. *The Wall Street Journal*'s coverage spurred an SEC investigation.

> "Asking internal auditors not to use the words 'internal controls' is like asking a physician not to use the word 'prescription'."

Cooper's auditors then found an accounting problem with wireless resale customers' billings. CFO Sullivan told Cooper to downplay this serious "customer subscription fraud" in her audit report. "I want to take these sentences out," he said. Cooper replied that she was not comfortable doing so. "I feel an obligation to report this to the Audit Committee," she said. "You feel an ob-li-ga-tion, you feel an ob-li-ga-tion," Sullivan responded sarcastically. Shortly after, he told Cooper that the firm planned to cut her staff. Later, he upbraided her for discussing her auditors' findings of problems with Arthur Andersen, the company's external auditor. Cooper worried that Sullivan might try to block her access to Andersen, and wondered if it was doing a proper job auditing WorldCom's financial statements. When she asked an Andersen rep for some financial work papers, he refused, saying that he reported only to Sullivan and WorldCom controller David Myers, and adding, "These work papers belong to them." Cooper was flabbergasted.

> "If you're an auditor, and someone is acting hostile and out of character, you want to find out why."

When Cooper's team audited WorldCom's capital expenditures, they found confusing entries labeled "prepaid capacity." No one knew what the term meant, though the entries eventually covered hundreds of millions (and, later, billions) of dollars. When Cooper asked WorldCom's accountants to clarify the entries, they responded with doubletalk. Her auditors combed the records to pin down these listings, which made no sense. They found, "prepaid capacity amounts...jumping all over the place from account to account." The auditors determined that these sums had inexplicably been moved to the balance sheet, increasing apparent profits.

> "I find it difficult to believe that an accounting director could make an entry for hundreds of millions of dollars without understanding its merits or seeing support."

Myers tried to close Cooper's audits, but she and her team persisted. She had one auditor conduct his computer investigations at night to allay executives' suspicions. The team found prepaid capacity amounts of $743 million in the third quarter of 2001, $941 million in the fourth quarter of 2001 and $100 million in the first quarter of 2002. The total grew to $3.8 billion, booked as profits though no income supported the entries.

> "With Congress calling, the press roaming my neighborhood and FBI agents at the door, I have been thrust into a world completely foreign to me."

Sullivan led Cooper to believe that Max Bobbitt, her supporter on the board's audit committee, was leaving. He told her to focus on internal auditing. Given that Sullivan was working overtime to arrange billions in new bank financing for WorldCom, Cooper wondered why he suddenly cared about internal auditing. She asked Sullivan if he knew anything about "prepaid capacity." He glibly said it concerned leased fiber lines with little or no customer use, and that the lease expenses were being reclassified as capital assets. Cooper said she did not know of "any accounting standards that would allow for capitalization of line costs." Sullivan told her to stop her capital expenditures audit until later. She contacted Bobbitt.

> "It's not easy to wrap your mind around billions of dollars in potentially fraudulent accounting entries."

Cooper and her team continued their nighttime investigations, eventually finding 28 suspicious prepaid capacity entries. Without those entries, WorldCom's profits turned into losses. Cooper interviewed the accountants who posted the entries, and was shocked to learn that though the individual items covered millions, the accountants had no supporting documents for the entries and no idea what they represented. Responding to Cooper's whistleblower findings, Bobbitt asked her, "Do you have any idea what I'm about to do? I'm about to blow up the company!"

> "Twenty-five years is a long sentence for a white-collar crime, longer than the sentences routinely imposed by many states for violent crimes, including murder."

On June 20, 2002, Bobbitt and his audit committee summoned Sullivan to explain these entries. He could not. Clearly, he and his team had perpetrated a giant fraud. The board asked Sullivan and Myers to resign. As they and their peers departed, and quickly hired lawyers, WorldCom issued a press release about the fraud, adding that the firm would lay off 17,000 employees. The SEC filed a civil suit against WorldCom, later obtaining a $750 million judgment. WorldCom filed for Chapter 11 bankruptcy protection, rendering its stock worthless. Once the brightest light on Wall Street, WorldCom was now thoroughly disgraced, a forlorn and empty shell.

> "The entrepreneur who builds a company is often not the best person to lead it as the company matures."

When Congress opened hearings on this debacle, Ebbers and Sullivan refused to testify, citing self-incrimination. Later, the government levied criminal charges against Ebbers, Sullivan, Myers and other executives. Sullivan and Myers testified against Ebbers, saying that under severe pressure to maintain stock value due to the margin calls on his personal loans, he ordered them to cook the books. Other WorldCom executives also testified against Ebbers. The court found all the executives guilty. The court gave Sullivan, Myers and several accountants reduced sentences due to their cooperation in making the case against Ebbers. He received a 25-year prison sentence, while *Time* magazine named Cynthia Cooper as one of its 2002 Persons of the Year.

Lessons Learned

Most of the WorldCom managers who took part in the fraud were ordinary people who made poor decisions. In Ebbers' mind, he was the company; he felt no compunction about using it as a piggy bank. This was his downfall and WorldCom's. This fraud provides a lesson in character. In business, as in life, making ethical decisions is not always easy. You have to know the difference between right and wrong, and you have to care. Trust your instincts. Down deep, most people know when something is wrong. Be your own harshest moral critic. When you face an ethical choice, seek the counsel of people you respect. Be brave. Your boss may deserve your loyalty, but not the sacrifice of your principles. As John C. Maxwell writes, “There are...two important points when it comes to ethics. The first is a standard to follow. The second is a will to follow it.”

About the Author

Cynthia Cooper is the former head of internal auditing at WorldCom.