CASE 3.4

WorldCom
The Story of a Whistleblower

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LEARNING OBJECTIVES

After completing and discussing this case you should be able to

[1] Understand the pressures a person faces when he or she becomes aware of an accounting fraud

[2] Describe possible actions a person can take when he or she suspects fraud may exist

[3] Recommend characteristics of an effective corporate whistleblower program

[4] Describe key requirements in the Sarbanes–Oxley Act related to whistleblower and code of ethics processes for public companies

BACKGROUND[1]

Don't ever tell yourself, "that won't happen to me." Just ask Cynthia Cooper, former Vice President of Internal Audit at WorldCom.

Cynthia Cooper was a typical accounting student as an undergrad at Mississippi State University. Raised in Clinton, Mississippi, Cynthia was "the girl next door." Growing up in a family with a modest income, she attended the local high school, worked as a waitress at the local Golden Corral, and headed off to one of the state's well-known universities.

After graduating from college, she later completed her Master of Accounting degree at the University of Alabama and became a certified public accountant. Her career began like most accounting graduates in the field of public accounting, working with one of the major accounting firms in Atlanta.

Most likely, she never thought she would face the challenge of her lifetime before reaching the age of 40. However, a few short weeks in May and June of 2002 changed her life forever. This case summarizes how she unraveled a $3.8 billion fraud that ultimately grew to over $11 billion and sent one of the country's largest and most visible companies to its knees in bankruptcy. Consider how you would have handled the situation if you had been in her shoes.

WORKING FOR WORLDCOM

Cynthia Cooper joined the company that eventually became WorldCom after returning from Atlanta to her hometown of Clinton, Mississippi in the early 1990s. Following a recent divorce, she moved with her two-year-old daughter to be closer to family. She first joined Long Distance Discount Service (LDDS), which later became known as WorldCom, as a consultant in the finance department earning $12 an hour. She left LDDS for a short stint to join SkyTel, a paging company, but later returned to LDDS to head up its internal audit department in the mid-1990s.

1 Amanda Ripley, "The Night Detective;" Ricardo Lacayo and Amanda Ripley, "Persons of the Year," *Time*, New York, December 30, 2002-January 6, 2003, Volume 160, Issue 27/1 pp. 32 and 45. Gary Perilloux, "WorldCom Whistleblower Speaks to Mississippi State University Students," *Northeast Mississippi Daily Journal*, November 18, 2003. Kurt Eichenwald and Simon Romero, "Inquiry Finds Effort at Delay at WorldCom," *The New York Times*, July 4, 2002, pg C-1.

The case was prepared by Mark S. Beasley, Ph.D. and Frank A. Buckless, Ph.D. of North Carolina State University and Steven M. Glover, Ph.D. and Douglas F. Prawitt, Ph.D. of Brigham Young University, as a basis for class discussion. It is not intended to illustrate either effective or ineffective handling of an administrative situation.

WorldCom started as a small "mom and pop" company in the early 1980s. Bernie Ebbers moved the WorldCom headquarters to Clinton, Mississippi, because it was the college town of his alma mater, Mississippi College. By 1997, the company had emerged within the telecom industry and caught the eye of many on Wall Street when it issued a bid to acquire the much larger and better known company, MCI.

Cynthia Cooper enjoyed the rising status of WorldCom's growth in the business community. She was promoted to Vice President of Internal Audit in 1999, leading the internal audit function in what became the 25th largest company in the United States. WorldCom's stock price continued to rise through 2000, and she and her colleagues dreamed of retiring early and starting their own businesses. Cynthia dreamed of opening a bead shop and actually purchased a couple hundred thousand beads that she stored in her garage.

Establishing internal audit's role in the company wasn't easy. WorldCom's CEO, Bernie Ebbers, was forceful about his distaste for the term "internal controls" and allegedly banned the use of the term in his presence. At one point, Cynthia called a meeting with her boss, WorldCom CFO Scott Sullivan, Bernie Ebbers, and a few others to help them see how an internal audit department could help the company's bottom line. Despite being almost 30 minutes late to the meeting, Ebbers was the last person to leave the meeting. At that point, internal audit's focus on efficiency of operations became its primary charge, leaving the financial audit-related tasks in the hands of the external auditor, Arthur Andersen, LLP. Cynthia, as Vice President of Internal Audit, would report to the CFO, Scott Sullivan.

While WorldCom's growth skyrocketed throughout the 1990s, the telecom market was saturated by 2001 and WorldCom's earnings began to fall. WorldCom executives began to feel tremendous pressure to maintain their stellar track record of financial performance.

UNRAVELING OF A FRAUD

According to press reports, Cynthia Cooper and her internal audit team didn't know about any unusual accounting manipulations until March 2002. It wasn't until a worried executive in a division of WorldCom told Cynthia about the handling of certain expenses in his division. At that point, Cynthia learned that the corporate office accounting team had taken $400 million out of the division's reserve account to boost WorldCom's consolidated income.

As Cynthia and her team pursued the matter with WorldCom's CFO, Scott Sullivan, she immediately faced tremendous resistance and pressure. In fact, Sullivan informed Cynthia that there was no problem and that internal audit shouldn't be focused on the issue. She received a similar reaction when she approached the external auditors at Arthur Andersen, who told Cynthia there was no problem at all with the accounting treatment.

Fortunately, Cynthia did not let the intimidation of her boss or the opposition of a major national accounting firm dampen her concerns about getting to the truth. In fact, Sullivan's harsh reaction only increased her skepticism surrounding the matter. She and others within the internal audit team began to secretly work on the project late at night. At one point, they began making backup copies of their files in response to fears that if their investigation was revealed, files might be destroyed.

Within two months—at the end of May 2002—Cynthia and her team had unraveled the key aspects of the fraud. They discovered that the company had erroneously capitalized billions of dollars of network lease expenses as assets on WorldCom's books. The accounting gimmickry allowed the company to report a profit of $2.4 billion instead of a $662 million loss.

In some ways the fraud was simple. The corporate accounting team led by Sullivan had merely transferred normal operating lease expenses to the balance sheet as an asset. The expenses were for normal fees WorldCom paid to local telephone companies for use of their telephone networks and were not capital outlays.

On June 11, 2002 Scott Sullivan summoned Cynthia to his office demanding to know what was going on with her investigation. At that meeting, Sullivan asked Cynthia to delay her audit investigation until later in the year. Cynthia stood her ground and told him at that meeting the investigation would continue. Imagine the pressure Cynthia felt as she faced her boss, believing he was covering-up the large accounting fraud.

Cynthia decided to go over Sullivan's head, which was a huge gamble for her. She would not only be risking her career, but she would also personally suffer following any devaluation of her investment in WorldCom stock. Furthermore, it was likely she would experience rejection from others around town for upsetting a good thing. In any event, on the very next day, June 12, 2002, Cynthia contacted Max Bobbitt, chairman of WorldCom's audit committee. Feeling tremendous pressure from the encounter, Cynthia cleaned the personal items out of her desk that day in anticipation of the backlash she might face.

At first, Cynthia was disappointed to see the audit committee chairman delay taking action based on her report. However, he soon passed her report along to the company's newly appointed external auditors, KPMG LLP. WorldCom had replaced its former auditor, Arthur Andersen, due to Andersen's quick demise following the firm's guilty verdict related to the Enron debacle. This occurred about the same time Cynthia and her team were investigating the WorldCom fraud.

Later that week, Max Bobbit and the KPMG lead partner, Farrell Malone, went to Clinton, Mississippi to meet with Cynthia face-to-face. Over the next several days, Cynthia and the KPMG partner began interviewing numerous people in the corporate office, including Scott Sullivan. Following each interview, they would keep the audit committee chairman informed of their findings. Soon, the audit committee chairman decided it was time to inform the rest of the audit committee of their discoveries.

Bobbitt presented information to the audit committee at a June 20, 2002 meeting in Washington. Scott Sullivan was instructed to attend, along with Cynthia Cooper and key members of her internal audit team, to discuss the matter. At that meeting, Scott Sullivan made every attempt to justify the accounting treatment claiming that certain SEC staff accounting bulletins supported his handling of the expenses as assets. Despite his reasoning, WorldCom's new auditors, KPMG, tactfully offered the firm's view that the treatment didn't meet generally accepted accounting principles.

The audit committee instructed Scott Sullivan to document his position in writing. Four days later, on June 24, 2002, Sullivan submitted a three-page memo justifying his accounting treatment. The main theme of his argument was that WorldCom was justified in classifying the lease expenses as assets. The expenses, in his view, related to payments for network capacity that would be used in future years as business demand increased and new customers were added to the WorldCom network. In essence, he argued that the company needed to spend money on additional network capacity to entice new customers to come on board.

Most experts agreed that his justification was a "stretch" at best. Other companies in the industry did not take a similar approach to accounting and instead expensed network lease costs as incurred. The audit committee didn't buy Sullivan's arguments. Later that day, the audit committee informed Sullivan and the WorldCom controller, David Myers, that they would be terminated if they didn't resign before the board meeting the next day. Myers resigned, but Sullivan refused, and was fired. By August 2002, Sullivan had been indicted by a grand jury.

The next day WorldCom announced the fraud to the public and the unraveling of Mississippi's largest public company began. Soon the company would be in bankruptcy.

THE AFTERMATH

The nightmare for Cynthia Cooper didn't end following Sullivan's termination. For the next several days, Cynthia and her team worked around the clock trying to gather more evidence about the underlying fraud and to help KPMG redo the previous financial statement audits conducted by Andersen. She moved to her parents' home because it was close to the WorldCom headquarters.

In spite of incredible hours and effort required by Cynthia to uncover and expose the fraud, Cynthia was now a key person in the massive federal investigation; both as a source of information and even as a potential suspect. At one point she returned to her office only to find eight federal investigators going through her files. Copies of her phone and email messages were being captured, which likely created concerns for her about personal legal risk exposure as well. She was even asked to appear before a Congressional investigations committee. She quickly realized she needed to have her own attorney to help guide her steps through the maze of events.

Like most whistleblowers, Cynthia was facing the crisis of a lifetime. Friends noticed the toll the stress was taking on Cynthia. In a few short months, she had lost close to 30 pounds. At times she couldn't stop crying. Looking back on this time period, she later stated that she felt like she was in a "very dark place." She repeatedly reread Psalm 23, "Yea, though I walk through the valley of the shadow of death, I will fear no evil, for thou art with me."

Imagine the reaction she faced from the 50,000 or so employees working for the defunct WorldCom. To some, she was a hero. To others, she was a villain. Asked by one interviewer if she had been publicly thanked for her actions, all she could do was laugh.

Fortunately, Cynthia had a tremendous support network of family and close friends. Despite the trend for most whistleblowers to be isolated and suffer from depression and alcoholism, Cynthia has managed to keep her head above it all. She continued to head up the internal audit department at WorldCom (now MCI) for a couple more years before deciding to pursue another career path. Now she has her own consulting firm and frequently travels around the U.S. speaking to corporations, associations, and universities about her experience and the need for ethical and leadership reform. In 2008, she released her book, *Extraordinary Circumstances: The Journey of a Corporate Whistleblower*, summarizing her experience.

In December 2002, *Time* magazine named Cynthia Cooper as one of its "Persons of the Year" along with two other whistleblowers: Sherron Watkins of Enron and Coleen Rowley of the FBI. She has received notes and emails from hundreds of strangers thanking her for her actions. She is now widely known across the country as the key whistleblower of the WorldCom fraud.

Cynthia does not feel like her actions warrant hero status. She has noted that she was merely doing her job. Cynthia attributes her actions to the guidance and leadership she received as a child at home. She has quoted her mother as saying "Never allow yourself to be intimidated; always think about the consequences of your actions." Fortunately for Cynthia, she heeded her mother's advice. It most likely saved her career and family.

REQUIRED

[1] At the time Cynthia Cooper discovered the accounting fraud, WorldCom did not have a whistleblower hotline process in place. Instead, Cynthia took on significant risks when she stepped over Scott Sullivan's head and notified the audit committee chairman of her findings. Conduct an Internet search to locate a copy of the Sarbanes–Oxley Act of 2002. Summarize the requirements of Section 301.4 of the Act.

[2] Use the Internet to conduct research related to whistleblower processes. Prepare a report summarizing key characteristics for the operation of an effective corporate whistleblower hotline. Be sure to highlight potential pitfalls that should be avoided.

[3] As Vice President of Internal Audit, Cynthia Cooper reported directly to WorldCom's CFO, Scott Sullivan, and not to the CEO or audit committee. Research professional standards of the Institute of Internal Auditors to identity recommendations for the organizational reporting lines of authority appropriate for an effective internal audit function within an organization.

[4] Conduct an Internet search to locate a copy of the Sarbanes–Oxley Act of 2002 and summarize the requirements of Section 406 of the Act. Then, search the SEC's website (www.sec.gov) to locate the SEC's Final Rule: "Disclosure Required by Sections 406 and 407 of the Sarbanes–Oxley Act of 2002 [Release No. 33-8177]. Summarize the SEC's rule related to implementation of the Section 406 requirements.

[5] Often the life of a whistleblower involves tremendous ridicule and scrutiny from others, despite doing the "right thing." Describe your views as to why whistleblowers face tremendous obstacles as a result of bringing the inappropriate actions of others to light.

[6] Describe the personal characteristics a person should possess to be an effective whistleblower. As you prepare your list, consider whether you think you've got what it takes to be a whistleblower.

[7] Assume that a close family member came to you with information about a potential fraud at his or her employer. Prepare a summary of the advice you would offer as he or she considers taking the information forward.

[8] Conduct an Internet search to locate a copy of the Sarbanes–Oxley Act of 2002. Read and summarize the requirements of Section 302 of the Act. Discuss how those provisions would or would not have deterred the actions of Scott Sullivan, CFO at WorldCom.

[9] Document your views about the effectiveness of regulatory reforms, such as the Sarbanes–Oxley Act of 2002, in preventing and deterring financial reporting fraud and other unethical actions. Discuss whether you believe the solution for preventing and deterring such acts is more effective through regulation and other legal reforms or through teaching and instruction about moral and ethical values conducted in school, at home, in church, or through other avenues outside legislation.