WorldCom:
What Went Wrong and Governance Lessons Learned
• Moving Forward

• Aftermath

• Rise and Fall of WorldCom

• Identifying and Reporting the Fraud

• Auditors, Boards and Management – Minimizing Fraud
MCI - Moving Forward

• Exited Bankruptcy
• New Company Name
• New CEO, CFO, Board of Directors, External Auditors
• New Ethics Office and Fraud Hotline
• Ethics Training for all Employees
• Increased Size of Internal Audit Staff
Aftermath

- Whistleblower
- Sarbanes Oxley
- Press
- DOJ, SEC, FBI
- Congressional Hearings
- Investigators
- Indictments
- Civil Lawsuits
- Criminal Proceedings
- Bankruptcy
Rise and Fall of WorldCom

- Only Fortune 500 Company Headquartered in Mississippi
- Acquired Approximately 70 Companies
- Tech Boom of the 1990s
- Carriers Spent Billions to Build Networks
- CFO – Sullivan, CEO – Ebbers
- Stock Hits $64 in June, 1999
Rise and Fall of WorldCom

• Repercussions of Rapid Acquisitions
  – Executive Focus
  – Complex Environment
  – Systems and Processes not Fully Integrated
  – Clash of Company Cultures, Management Turnover, Reorganization
  – Internal Control Environment
Rise and Fall of WorldCom

• Implosion of Telecom Industry
  – Many Start-Ups Went Bankrupt
  – Expected Internet Growth Fell Short
  – Enormous Network Overcapacity
  – Wireless Substitution
  – Highly Leveraged Company
Rise and Fall of WorldCom

- Board Approves Loans to CEO
- CEO Resigns
- Massive Lay-offs
WorldCom Fraud

• Drawing Down Reserves

• Capitalizing versus Expensing
  – Operating Expenses
  – Capitalized and Expensed Over Time
  – Increasing Current Period Earnings
WorldCom Fraud

- Collusion at High Levels
- Web of Transactions
- On-Top Entries After Books Closed
- Amounts Moved Through Multiple Accounts
- Amounts Spread Across Different Subsidiaries and Fixed Asset Accounts In Smaller Dollar Increments
- Journal Entry Patterns Changed Between Quarters
Detection of Fraud

- Access to Accounting System
- Forensic Auditors
- Followed Instincts
- Highly Qualified Audit Team
- External Audit Testing
- Chronology of Key Events
What Can Auditors Do To Help Minimize Fraud?

• Don’t Think It Can’t Happen In Your Company

• Help Create Ethical Company Culture
  – Audit Fraud Hotline and Ethics Office Regularly, Evaluate Complaints
  – Expand Hotline to Vendors and Third Parties
  – Management Behavior – Tone at Top
  – Training: Ethics, Code of Conduct, Hotline
  – Background Checks Before Hiring
What Can Auditors Do To Help Minimize Fraud?

- Consider Appointing Full Time Forensic Auditors
- Hire More Experienced Staff With Diverse Skills
- Increase Training – Fraud and Financial Auditing
- Ensure You Have the Right Forensic Tools and Know How to Use Them
- Trust Your Instincts
- Interview Mid and Lower Level Accounting Employees Quarterly
- Maintain an Element of Surprise and Flexibility
What Can Auditors Do To Help Minimize Fraud?

• Hold Fraud Brainstorming Sessions
  – If Management was going to perpetrate a fraud, how might they do it?
  – In what areas of accounting would judgment or aggressive accounting be used?
  – Are there indications of increased pressure on management?
  – What is the likelihood and impact of each fraud technique - four quadrant approach?
  – How will we address fraud testing in our audit plan? Both high impact, high risk and high impact, lower risk?
What Can Auditors Do To Help Minimize Fraud?

• Obtain Real Time Access to Accounting System and Train Staff

• Incorporate Forensic Auditing in Regularly Scheduled Audits

• Perform Targeted Financial Statement Fraud Procedures Quarterly
  – Query Unusual Accounting Entries
  – Post close, On-Top, Large Round Dollar
  – Analytical Reviews

• Include Qualitative Procedures: Review MD&A, Press Releases, Footnotes, Litigation
What Can Auditors Do To Help Minimize Fraud?

- Present Audit Committee With Holistic Risk Assessment
  - Define Risks Including Fraud Risks, Impact and Likelihood
  - Map Internal Audits and Time To Each Risk
  - Map Other Groups or Projects Addressing Each Risk
  - Are there any Gaps?
  - Get the Right Risk Balance
What Can Auditors Do To Help Minimize Fraud?

• Maintain Your Independence from Management
  – Regardless of reporting structure, maintain an independent state of mind
  – Define functional versus administrative duties in charter
  – Don’t allow Management to have undue influence
  – Inform Audit Committee of requests to delay audits or limit scope
  – Disagree with Management or the Audit Committee if necessary and go on the record with your beliefs
What Can Auditors Do To Help Minimize Fraud?

- Don’t Over-Rely on Internal Controls, Analytical Reviews, or Management’s Word
  - Balance with appropriate detailed testing
  - Review underlying support
- Don’t Focus Too Much on Lower Level Process Controls, and Too Little on Controls Most Likely to Prevent and Detect Material Frauds
- Make Sure Your Team Knows What Actions to Take if a Fraud or Potential Fraud is Identified
What Can Auditors Do To Help Minimize Fraud?

• Educate the Audit Committee
• Coordinate More Closely with External Auditors
  – Meet regularly with formal agendas
  – Don’t over-rely on External Auditor
  – Quarterly reviews are not audits
  – Evaluate E/A: methodology, risk assessment, approach, experience and number of staff, areas where internal controls are and are not being relied upon
  – I/A and E/A - review each others work papers
  – Ask key questions
Questions to Ask Your Auditors

• If you were responsible for preparing the financial statements, would you have in any way prepared them differently from the manner selected by management?

• If you were an investor, would you have received the information essential to your understanding the company's financial performance during the reporting period?

• Are you aware of any actions – either accounting or operational – that have had the purpose and effect of moving revenues from one reporting period to another?

• Is the company following the same internal audit procedure that would be followed if you were CEO?

Questions to Ask Your Auditors

• Are there any areas of accounting you deem aggressive?

• Do you have real time access to the company’s accounting systems or do you rely on management to provide you with schedules needed?

• Does management attempt to control your audit in any way?

• Does your firm view our company as a high risk client in any way?