The Anomi of Ethics and Governance in the WorldCom Scandal

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Abstract: This paper centers on the WorldCom scandal and analyzes the reasons for the company's serious financial holes from two aspects of ethics and governance. The moral problems are mainly discussed from the responsibility of the board of directors and the structure of the committee. And in terms of governance, corporate governance and internal control are two points of great concern and explained by using three major UK corporate governance codes and agency, stewardship, firm and stakeholders theories, to find out how to manage the company more effectively. Finally, the paper gets a conclusion that, through establishing an independent committee and a board of directors composed of more external directors, the company could greatly improve the management level.

Keywords: WorldCom Scandal; Ethics; Governance; Board of Directors; Committee Structure; Internal Control

1. Background of the WorldCom Accounting Scandal

On June 26, 2002, WorldCom, the second largest long-distance telecommunication company in the United States, was disclosed by the leadership of Cynthia Cooper who served as the vice president of internal audit, to misrepresent its financial statements to overstate its profits by three point eight billion dollars. There was an over nine billion dollars hole in the company's balance sheet caused by falsifying account. The staggering amount of misappropriation by WorldCom greatly shocked the public, and this company went bankrupt soon after due to its unethical behaviour. "Ethics is a fundamental trait which one adopts and follows as a guiding principle of basic dharma in one's life. It implies moral conduct and honorable behavior on the part of an individual" (Paswan, 2015, p.2). This company did not comply with business ethics so as to lose the trust of shareholders. WorldCom failed on two aspects-ethics and governance.

2. Ethics

2.1 Board of Directors and the Responsibility of the Board

"The board of directors is the highest decision-making body in the organization"

(Gabrielsson, Huse and Minichilli, 2007, p.24). It is appointed to run the company and create wealth for shareholders, who can not get involved in the day-to-day operation of the business, but can vote to elect or remove members of the board of directors at shareholders general meeting. On behalf of shareholders, BOD claimed that "has the power to hire, fire, and compensate senior management teams, serves to resolve conflicts of interest among decision makers and residual risk bearers" (Baysinger and Butler, 1985, p.101), etc. It has a duty to ensure the company's activities and financial position are accurately published. Obviously, WorldCom did not meet this responsibility. There is a big hole to the extent of four billion in its balance sheet. Ordinarily, the company's leases for phone lines should be recorded as an operating expenses, which would reduce the firm's monthly income. However, these leases were actually booked as a capital expenditure. "The misstated numbers were not detected until suspicions arose in May 2002 when a 2001 capital expenditures audit resulted in a large variance due to entries to an account called "prepaid capacity." When Cooper, the Vice President of the Internal Audit, questioned other 31 personnel about it, no one appeared to give a straightforward answer" (Ashraf, 2011, p.30). As senior employees in the finance department, they actually agreed to make the financial statements with obvious errors public. Such behaviour of the board of directors and accountants is a serious violation of business ethics and accounting ethics.

2.2 Committee Structure

In addition to the board of directors, the company has a variety of different committees. There are three standing committees of the board including audit committee, remuneration committee and nomination committee. The audit committee is responsible for reviewing the company’s financial statements, but WorldCom’s audit committee failed to do so. The members of WorldCom’s audit committee included an executive of another telecommunication company, the chairman of a real estate company and the dean of Georgetown law school, who are neither professionals engaged in audit and accounting nor experts in the field of audit and accounting. Naturally, they could not recognize the nine billion hole in the firm’s balance sheet and approved the financial statements with errors at the audit meeting. Besides, “at WorldCom, the report of completed projects and the plans for future projects are presented only once a year by the internal audit to the audit committee. The rest of the year, the internal audit would report directly to Scott Sullivan, CFO” (Zekany, Braun & Warder, 2004, p.109). As a result, members of the audit committee relied on the information presented by the top management rather than their independent judgement.

“A nomination committee exists in order to independently give recommendations on replacement of members on the board of directors” (Tricker, 2019, p.39). Bernie Ebbers, the CEO of WorldCom, used to be a milkman, a bar bouncer and a basketball coach. Then he went to run a small motel. He did not have work experience in telecom industry and did not knew anything about the long-distance telephone. Based on this, he is not the right person to lead the company. Nevertheless, WorldCom did not have a nomination committee, so that the company was not led correctly and had been in debt for a long time.

Like other public companies, WorldCom’s board had a remuneration committee. The remuneration committee is charged with reviewing whether the performance of board members is deserved to their packages. Under poor management and a heavy debt, the salary of the CEO and CFO was not been affected accordingly. Moreover, the CEO bought a yacht, a hockey team, a crawfish farm, a Golf course, the largest private ranch in the world, five hundred thousand acres of timberland and so on. In addition, he built a lodge worth five million dollar in Clinton Mississippi. It is doubtful where he got so much money. “Stiles Kellett, the chairman of the remuneration committee at WorldCom, one of the ‘Bernie’s boys’ ” (Jeter, 2003, p.27), was very loyal to CEO Ebbers, which gives a reasonable explanation.

3. Governance

3.1 Corporate Governance and Internal Control

“Corporate governance is the broad term describes the processes, customs, policies, laws and institutions that directs the organizations and corporations in the way they act, administer and control their operations. It works to achieve the goal of the organization and manages the relationship among the stakeholders including the board of directors and the shareholders” (Khan,2011, p.1). If we want to govern a corporation properly, we need the audit committee to play the role of internal control. After the accountant has finished the account, the auditor needs to oversee the financial statements and discloses problems in financial statements. The audit committee of WorldCom did not identify the big hole in the firm’s balance sheet in time, which means that it did not perform its function of internal control. Besides, the audit committee should work closely with external auditors and act as a bridge to facilitate communication between them and senior management.

3.2 Corporate Governance Codes and the regulatory framework for corporate governance

The three major UK Corporate Governance Codes are Cadbury Report, Greenbury

Report and Hampel Report. These reports provided some good guidelines on corporate governance. For example, the Cadbury Report recommended the positions of chairman and CEO should be held by different people. The chairman of WorldCom’s board is Bert Robbers, and however, it is just an honorary title because “Ebbers presided over board meetings and determined their agendas” (Kaplan and Kiron, 2007, p.120) in fact. The Greenbury Report put forward a opinion which is executives’ performance should be linked to their salaries. If the company's performance is poor, executives should be given a pay cut. In the case of the company’s long-term loss, Bernard Ebbers’ salary was not affected accordingly. Under this kind of management, no one had the incentive to improve the company's operations. Apart from the regulatory framework based on the corporate governance code, there also has legal framework from the law perspective. According to Sarbanes-Oxley Act of 2002, listed companies “require management and auditors to prepare an internal control report”. Cynthia Cooper once wanted to establish an effective internal control audit system within the company to control the risk of the enterprise, but this proposal was opposed by Ebbers. He completely dominated the board of directors, and deliberately reduced the expenses on the financial statements and recorded them as capital expenditure. In addition, the price of the management buyout company was much higher than the market price, and all the amount of difference between them went into the pockets of managers. It was because the internal control system of this company was not good enough that the corruption of senior officials occurred.

3.3 Agency, Stewardship, Firm and Stakeholders Theories

"Agency theory focuses upon relationships between parties where one delegates some decision making authority to the other. In these situations, one party (the 'principal'), delegates responsibility to another party (the 'agent') to take decisions on their behalf. In the modern corporation for instance the 'principal' would be a shareholder, whilst the 'agent' would be the manager" (Angwin, 2015, p.1). The agency theory states that Managers hired by the company pay more attention to their own interests than the interests of shareholders when managing the company. Contrary to this is the stewardship theory. This theory points out the managers have worked in a company for many years so that the two sides have established a long-term relationship of mutual trust, and the managers will run the company in the same way as they manage their own assets. Clearly, The behavior of WorldCom's CEO and CFO confirms the former theory. They regarded the company as a personal cash machine and harmed the interests of shareholders in order to pursue their own interests. In 1962, Milton Friedman put forward a opinion that the sole

purpose of a company is to maximize its profits and make money for its shareholders, which is the firm theory. In this regard, the stakeholder theory holds a different point of view. The interests of a modern enterprise are bound to be related to the interests of stakeholders. Take the example of WorldCom. When the business was on the verge of bankruptcy, it was forced to lay off 20 percent of its staff to save money. As a result, these employees lost their jobs and had no source of income. What is more, The supplier and bank, which were creditors of this company, can not get their receivables and loans back, and this money can only be treated as bad debts. While WorldCom's own interests were damaged, it also harmed the interests of stakeholders. From the perspective of corporate governance, the responsibilities of the board of directors include supervising the management, formulating the correct development strategy and protecting the interests of shareholders and stakeholders, None of which WorldCom's board achieved.

4. Conclusions

To sum up, WorldCom's fall was attributed to its ineffective committee, mismanagement of board, lack of business ethics and accounting ethics and the imperfection of the internal audit system. To improve this situation, we can take some measures. First of all, "the monitoring effect theory claims that outside directors are superior in monitoring a company-their careers do not depend on the firm's CEO. They also feel freer to express opinions that contradict the CEO, as they have incentives to build a credible reputation as an expert monitor" (Dionne and Triki, 2005, p.5). Therefore, the membership of the board can be made up of more outside directors than CEO's friends and acquaintances to avoid the autocracy of CEO. Secondly, the company's committees, especially the audit committee, need to be completely independent with the board of directors. It is best not to appoint a person who has friendship tie with CEO or CFO as the chairman of committee. Last but not least, the board meeting can only be productive if the directors carefully understand and correctly grasp the information of the company before the meeting

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