WORLDCOM CORPORATE SCANDAL-

LESSONS FOR CORPORATE GOVERNANCE?

Background

1 The corporate world was rocked by the disclosure by US telecommunications giant, WorldCom, on Tuesday, 25 June 2002, that company officials had misstated accounting figures in the amount of \$3,8 billion.[1] This figure was later revised to a staggering \$7.1 billion and could now reach \$9 billion, according to sources close to the case.[2]

2 The company, which emerged from obscurity in 1997 with a \$37 billion takeover of long-distance provider, MCI, became one of the major success stories of the 1990s economic boom.[3]

3 According to a statement released by the Clinton, Mississippi-based company, monies that were actually expenses were booked as capital. This was accomplished outside of the generally accepted accounting rules, the company said.[4]

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[1] Mail & Guardian, Multi-billion WorldCom fraud unveiled, 26 June 2002, M72
[2] News24.com, WorldCom scandal could hit \$9bn, 20 September 2002
[3] Business report, WorldCom will try to stay intact despite bankruptcy, 22 July 2002, M132; Business Report, WorldCom bankruptcy filing marks milestone in corporate failures, 22 July 2002, M134

4 The company notified the US securities regulator, the US Securities and Exchange Commission ("SEC"), of the impropriety.[5]

5 WorldCom CFO, Scott Sullivan, and the controller, David Myers, were the first to be relieved of their duties soon after the news broke.[6]

6 WorldCom's recently appointed CEO since April 2002,[7] former Vice-Chairman[8] John Sidgmore, said at the time that the company's management team was "shocked by these discoveries". They remain "committed to operating WorldCom in accordance with the highest ethical standards".[9]

7 The company said it discovered the problems during a routine internal audit.[10]

8 Proper accounting would have resulted in a reduced cash flow of $6,3 billion in 2001 and $1,4 billion for the first quarter of 2002 and thus forced WorldCom to report a net loss in 2001 and for the first quarter of

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[4] *ibid.*
[5] *ibid.*
[6] *ibid.*
[7] Business Report, Former SEC chairman appointed as WorldCom watchdog, 3 July 2002, M85
[8] Business Report, The rise and fall of a giant, 4 August 2002, M155
[9] Mail & Guardian, Multi-billion WorldCom fraud unveiled, 26 June 2002, M72
[10] Mail & Guardian, WorldCom charged with fraud, 28 June 2002, M75; Business Report, Watchdog slaps fraud charges on WorldCom, 28 June 2002, M77

2002, the company admitted in late June 2002.[11] Instead, WorldCom claimed $1,4 billion in profit in 2001 and $130 million in profit for the first quarter of 2002.[12] Final numbers for those five quarters are awaiting another audit.[13] By late December 2002 they had still not been revealed to the public.

9 WorldCom's stock, once valued at $64.50 per share in June 1999[14] at the height of the high-tech investment boom, is now worthless.[15] WorldCom's shares had closed at 15c a share on Thursday, 30 July 2002.[16]

10 WorldCom is to lay-off 17000 workers, about a fifth of the total workforce in an effort to stay in business.[17]

11 Arthur Andersen had been the auditors to the WorldCom accounts during the critical period. They were replaced earlier in 2002.[18] Already in the spotlight on charges of criminal wrongdoing after their

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[11] Mail & Guardian, WorldCom files for bankruptcy, 22 July 2002, M129; see also Business report, WorldCom will try to stay intact despite bankruptcy, 22 July 2002, M132 and Business Report, WorldCom bankruptcy filing marks milestone in corporate failures, 22 July 2002, M133

[12] *ibid.*

[13] *ibid*; Mail & Guardian, Multi-billion WorldCom fraud unveiled, 26 June 2002, M72

[14] Business Report, The rise and fall of a giant, 4 August 2002, M154

[15] See also Business report, WorldCom will try to stay intact despite bankruptcy, 22 July 2002, M132

[16] Business Report, US gets tough with WorldCom's greased palms, 4 August 2002, M154; At one point its stock price went as low as six cents a share, leading to its de-listing from the Nasdaq exchange (see Mail & Guardian, WorldCom files for bankruptcy, 22 July 2002, M130);

[17] *ibid*; Mail & Guardian, WorldCom charged with fraud, 28 June 2002, M75

[18] Mail & Guardian, WorldCom cooked the books back in 2000, 15 July 2002, M115

misdemeanours were revealed after the collapse of Enron, Arthur Andersen released a statement to the effect that it had acted in accordance with "professional standards at all times" and that it had been kept in the dark about the WorldCom CFO Sullivan's actions.[19]

12 WorldCom said it had received word from Arthur Andersen that in the light of these revelations, audits for 2001 conducted by Arthur Andersen "could not be relied upon".[20]

13 The damage to confidence is deep and serious.[21] However reassuring the statements by WorldCom may be, the scandal has further eroded confidence in the markets, and people are no longer confident about the accuracy of information that is transmitted to the public.[22] At issue is the question of trust. "If you can't trust the accountants or the companies then the whole thing falls down like a pack of cards", said one investment analyst.[23] "The problem is more than WorldCom", charged another, "it's which companies, which people can you trust? We all knew about Enron and we hoped it would stop the scandals".[24]

[19] *ibid.*
[20] *ibid.*
[21] Business Report, US's claim to corporate supremacy is badly dented, 3 July 2002, M83
[22] Business Report, Watchdog slaps fraud charges on WorldCom, 28June 2002, M77, quoting statement by Canadian Prime Minister Jean Chretien
[23] Mail & Guardian, WorldCom charged with fraud, 28 June 2002, M75
[24] *ibid.*

Other problems

14 It seems that this transgression of WorldCom was just one in a series of problems that were subjecting the company to Securities Exchange Commission ("SEC") scrutiny. It has recently emerged that the company was already being investigated by the SEC because of its accounting practices,[25] loans to directors, Wall Street "boosterism", as one reporter put it, "and much else besides".[26]

15 As far back as April 2000, the then CFO rebuffed complaints from at least two employees that it was artificially inflating profits.[27] It emerged that already beginning in 2000, the company began shifting ordinary expenses over to capital accounts.[28]

16 On 11 March 2002, WorldCom received a request for information from the SEC relating to accounting procedures and loans to officers.[29]

17 It has also been revealed, for instance, that WorldCom attracted the scrutiny of the SEC when it emerged that the company's board had

[25] Mail & Guardian, WorldCom charged with fraud, 28 June 2002, M75
[26] Business Report, US's claim to corporate supremacy is badly dented, 3 July 2002, M83
[27] Mail & Guardian, WorldCom cooked the books back in 2000, 15 July 2002, M115
[28] *ibid.*
[29] Business Report, The rise and fall of a giant, 4 August 2002, M154

approved massive loans to its former CEO, Bernie Ebbers, who quit in April 2002. He now owes the company $408 million.[30]

18 In April 2002, WorldCom announced it would cut 3700 jobs or 6% of its staff.[31]

19 The latest fraud is of an unprecedented magnitude.[32] Patrick Comack, an analyst with Guzman and Co in Miami seemed to express the views of everyone when he said: "One can't help but be blown away by the magnitude of the malfeasance. I'm not surprised they are finding more fraudulent activity but I'm certainly surprised by the size of it".[33]

Court actions

20 The scandal has been followed by court actions launched by various stakeholders.

21 The SEC filed a civil action complaint on Wednesday, 26 June 2002 US District Court in the federal district court in New York. The court

[30] Mail & Guardian, WorldCom charged with fraud, 28 June 2002, M76; Cf Mail & Guardian, WorldCom files for bankruptcy, 22 July 2002, M130 and Business report, WorldCom will try to stay intact despite bankruptcy, 22 July 2002, M132, which both say other federal regulators were already investigating *inter alia* the way in which WorldCom covered $360 million in loans to Ebbers for stock margin calls
[31] Business Report, The rise and fall of a giant, 4 August 2002, M154
[32] Mail & Guardian, WorldCom charged with fraud, 28 June 2002, M75
[33] News24.com, WorldCom scandal could hit $9bn, 20 September 2002

granted preliminary relief. The trial date has been tentatively set for Friday, 21 March 2003.[34]

22 On Sunday, 21 July 2002, WorldCom filed, in the US District Court for the southern district of New York, for protection under Chapter 11 of the bankruptcy code

23 The US Justice Department has launched a criminal investigation into the scandal.[35] Such a probe would look for any evidence of criminal wrongdoing by current and former WorldCom executives.[36]

<u>The SEC civil action and court order</u>

24 It is necessary to restate the complaint in full to understand the issues. The SEC alleged for its complaint that:

- From at least the first quarter of 2001 through to the first quarter of 2002, the defendant, WorldCom, defrauded its investors.[37]
- In a scheme directed and approved by its senior management, WorldCom disguised its true operating performance by using undisclosed and improper accounting that materially overstated its

[34] Business Report, Former SEC chairman appointed as WorldCom watchdog, 3 July 2002, M85
[35] Mail & Guardian, Multi-billion WorldCom fraud unveiled, 26 June 2002, M72; Mail & Guardian, WorldCom charged with fraud, 28 June 2002, M75; Business Report, Former SEC chairman appointed as WorldCom watchdog, 3 July 2002, M85; Mail & Guardian, WorldCom cooked the books back in 2000, 15 July 2002, M115

income before income taxes and minority interests by approximately $3,055 billion in 2001 and $797 million during the first quarter of 2002.[38]

- By improperly transferring certain costs to its capital accounts, WorldCom falsely portrayed itself as a profitable business during the period in question.[39]
- By this transfer, WorldCom violated the established standards of generally accepted accounting principles ("GAAP").[40]
- This improper transfer was not disclosed to investors in a timely fashion, and misled investors about WorldCom's reported earnings.[41]
- This improper accounting action was intended to manipulate WorldCom's earnings during the period in question to keep them in line with estimates by Wall Street analysts.[42]
- By engaging in this conduct, Worldcom violated the anti-fraud and reporting provisions of the federal securities laws and, unless restrained by the court, will continue to do so.[43]

25 The specific fraudulent scheme, it is alleged, revolves around WorldCom's so-called "line costs", which are one of WorldCom's major

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[36] Business Report, Former SEC chairman appointed as WorldCom watchdog, 3 July 2002, M85
[37] SEC civil action against Worldcom, 20 June 2002, M71.1, paragraph 1
[38] *ibid.*
[39] *ibid*, paragraph 2
[40] *ibid.*
[41] *ibid.*
[42] *ibid.*

operating expenses. The "line costs" represent fees WorldCom paid to third party telecommunication network providers for the right to access the third parties' networks. Under GAAP, these fees must be expensed and may not be capitalised. WorldCom's senior management, however, improperly directed the transfer of line costs to its capital accounts in amounts sufficient to keep WorldCom's earnings in line with Wall Street's expectations. In this manner, WorldCom materially understated its expenses, and materially overstated its earnings, thereby defrauding investors.[44]

26 As a result of this improper accounting scheme, WorldCom materially underreported its expenses and materially overstated its earnings in its filings with the SEC.[45] The filings failed to disclose the company's accounting treatment of its line costs, that such treatment had changed from prior periods, and that the company's line costs were actually increasing substantially as a percentage of its revenues.[46]

27 The SEC sought the following relief (briefly stated):[47]

a. Restraining WorldCom from engaging in the aforementioned scheme in violation of the enabling Exchange Act.

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[43] *ibid*, paragraph 3
[44] *ibid*, M71.2, paragraph 5
[45] *ibid*, M71.2, paragraph 6
[46] *ibid*, M71.2, paragraph 9

b. Restraining WorldCom from filing factually inaccurate statements or reports in violation of the enabling Exchange Act.
c. Imposing civil monetary penalties.
d. Prohibiting WorldCom and its affiliates, officers, directors, employees and agents from destroying, altering, or removing from the court's jurisdiction any documents relevant to this matter.
e. Prohibiting WorldCom and its affiliates from making any extraordinary payments to any present or former affiliate, or officer, or director, or employee of WorldCom or its affiliates, including, but not limited to any severance payments, bonus payments, or indemnification payments.
f. Appointing a corporate monitor to ensure compliance with d and e above.
g. Additional relief.

28 Apparently the relief sought in §d seeks to pre-empt the shredding of important documents, such as that occurred in Enron[48]. §e was also a controversial issue during the collapse of Enron, which paid out millions in last-minute bonuses to executives before filing for bankruptcy in December 2001.[49]

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[47] *ibid*, M71.4
[48] Mail & Guardian, WorldCom charged with fraud, 28 June 2002, M75
[49] Business Report, Former SEC chairman appointed as WorldCom watchdog, 3 July 2002, M85

29 On 28 June 2002, US District Court Judge Jed S Rakoff entered an order, based upon a joint agreement between the SEC and WorldCom, directing WorldCom to, *inter alia*, preserve "all items relating to WorldCom's financial reporting obligations, public disclosures required by the federal securities laws, or accounting matters".[50] The Court also approved the appointment of a corporate monitor having oversight responsibility with respect to all compensation paid by WorldCom. The corporate monitor will have responsibility "to prevent unjust enrichment as a result of the conduct alleged in the Commission's complaint and to ensure that WorldCom's assets are not dissipated by payments that are not necessary to the operation of WorldCom's business".[51]

30 Former SEC chairman, Richard Breeden, who headed the SEC from 1989 to 1993,[52] was appointed corporate monitor on Wednesday, 3 July 2002.[53] (Interestingly, before he could assume his $800 an hour job at WorldCom,[54] Breeden was required to sell roughly 6000 shares he owned in WorldCom, which had become worthless, closing at 22c at the time of his appointment[55]).

[50] SEC: Court order by agreement between SEC & Worldcom, 28 June 2002, M73.1
[51] *ibid.*
[52] Business Report, Former SEC chairman appointed as WorldCom watchdog, 3 July 2002, M85
[53] *ibid.*
[54] *ibid.*
[55] *ibid*, M86

Bankruptcy protection

31 On Sunday, 21 July 2002, WorldCom filed, in the US District Court for the southern district of New York, for protection under Chapter 11 of the bankruptcy code, which allows it to continue operating while it works out a plan to pay its debts, according to court records.[56] Sidgmore said the company expects to remain under bankruptcy protection until at least the first quarter of 2003.[57]

32 In the bankruptcy petition, WorldCom listed assets of $107 billion as of 31 March 2002 against debts of $41 billion.[58] Therefore it is still solvent. By comparison, Enron listed $63,4 billion in assets when it sought the bankruptcy petition in December.[59] This makes WorldCom's failure twice as large as the record-breaking bankruptcy filed by Enron in December 2001.

33 WorldCom's bankruptcy filing was accompanied by a deal that would give WorldCom $2 billion in so-called debtor-in-possession ("DIP")

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[56] Mail & Guardian, WorldCom files for bankruptcy, 22 July 2002, M129; see also Business Report, WorldCom bankruptcy filing marks milestone in corporate failures, 22 July 2002, M133

[57] Business report, WorldCom will try to stay intact despite bankruptcy, 22 July 2002, M131; See also Mail & Guardian, WorldCom files for bankruptcy, 22 July 2002, M130

[58] Mail & Guardian, WorldCom files for bankruptcy, 22 July 2002, M130; see also Business report, WorldCom will try to stay intact despite bankruptcy, 22 July 2002, M132 and Business Report, WorldCom bankruptcy filing marks milestone in corporate failures, 22 July 2002, M133

financing, giving the company cash to continue its operations.[60] This financing was received from JPMorganChase Bank, Citibank and GE Capital Corporation.[61] The court approved $750 million of this amount as interim financing for operations, staff and services to customers.[62] The deal would give these banks priority for any repayment ordered by the court.[63] The court also granted all of WorldCom's motions meant to support its customers, employees and other business partners, and provide other forms of operational and financial stability as it reorganizes its finances.[64]

34 In a rare move, the court also approved a Justice Department request to name an independent examiner to investigate Worldcom with broad authority to delve into its books.[65] The use of an examiner is rare in bankruptcy cases, albeit one was appointed in the Enron bankruptcy cases.[66]

35 It is hoped that the appointment of an independent examiner will further contribute to improving public confidence in the conduct of the case. It

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[59] *ibid.*
[60] Business report, WorldCom will try to stay intact despite bankruptcy, 22 July 2002, M131; Business Report, WorldCom bankruptcy filing marks milestone in corporate failures, 22 July 2002, M134; Business Report, US judge approves naming of independent WorldCom examiner, 23 July 2002, M135
[61] *ibid.*
[62] Business report, WorldCom will try to stay intact despite bankruptcy, 22 July 2002, M131; Business Report, US judge approves naming of independent WorldCom examiner, 23 July 2002, M135
[63] Business report, WorldCom will try to stay intact despite bankruptcy, 22 July 2002, M131
[64] Business Report, US judge approves naming of independent WorldCom examiner, 23 July 2002, M135
[65] *ibid.*

is also hoped that it would provide transparency to the process and enhance accountability.[67]

The Federal criminal investigation

36 Five WorldCom executives are accused of being co-conspirators in the accounting scandal. New charges may yet be levelled and new defendants may still be indicted, according to the federal prosecutors[68], as they continue their probe. They are:

- Former Chief Financial Officer, Scott Sullivan, who has pleaded not guilty. He is free on a $10 million bond.[69]
- Former Controller, David Myers. He pleaded guilty before US District Judge Richard Casey in Manhattan Federal Court on Thursday, 26 September 2002, to false filing of documents with securities regulators, conspiracy to commit fraud and to securities fraud.[70] Judge Casey accepted Myers' guilty plea and set a tentative sentencing date of 26 December 2002.[71] Myers was the first to plead guilty in the alleged conspiracy.[72]

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[66] *ibid.*
[67] *ibid.*
[68] News24.com, WorldCom scandal could hit $9bn, 20 September 2002
[69] News24.com, Another WorldCom exec pleads guilty, 10 October 2002
[70] News24.com, Ex-WorldCom 'was following orders', 27 September 2002
[71] *ibid.*
[72] *ibid.*

- Ex-director of general accounting, Buford Yates, who reported directly to David Myers[73], became the second company official to plead guilty on Monday, 7 October 2002. He pleaded guilty to conspiracy and securities fraud.[74]
- Former director of management reporting in the General Accounting Department, Betty Vinson, who reported directly to Buford Yates[75], pleaded guilty on Thursday, 10 October 2002 to charges of conspiracy to commit securities fraud in a US District Court in Manhattan before magistrate Judge Andrew J. Peck.[76]
- The director of legal entity accounting in the general accounting Department, Troy Normand, who also reported directly to Buford Yates[77], also pleaded guilty to charges of conspiracy to commit securities fraud.[78]

37 All the last four defendants are expected to provide evidence against Scott Sullivan.[79]

38 Former Chief Executive Officer, Bernard Ebbers, has not been charged but is under investigation. He has denied any knowledge of the fraud.[80]

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[73] News24.com, Another WorldCom exec pleads guilty, 10 October 2002
[74] News24.Com, Former Worldcom exec pleads guilty, 8 October 2002
[75] News24.com, Another WorldCom exec pleads guilty, 10 October 2002
[76] *ibid.*
[77] *ibid.*
[78] *ibid.*

39 Myers' and Yates' cooperation could help prosecutors build a case against both Sullivan and Ebbers.[81]

40 Myers told the court that he had been instructed on a quarterly basis by senior management to ensure that entries were made to falsify WorldCom's books to reduce WorldCom's reported actual costs thereby increasing reported earnings. He said further that he worked with others under his supervision at the direction of senior management to make these accounting adjustments "for which I knew there was no justification of documentation".[82]

41 Yates, who also insisted that he was following orders from top-level management, stating that he was instructed by supervisors to misreport expenses, admitted he helped WorldCom hide billions of dollars in expenses.[83]

42 Prosecutors say both Vinson and Normand carried out orders from Sullivan and Myers to disguise $3.8 billion in operating expenses as

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[79] *ibid.*
[80] News24.Com, Former Worldcom exec pleads guilty, 8 October 2002
[81] News24.com, Ex-WorldCom 'was following orders', 27 September 2002; *ibid.*
[82] News24.com, Ex-WorldCom 'was following orders', 27 September 2002
[83] News24.Com, Former Worldcom exec pleads guilty, 8 October 2002

capital expenses.[84] "As Sullivan, Myers, Yates, Vinson and Normand well knew, there was no justification in fact or under generally accepted accounting principles for these entries," according to the indictment.[85]

Could the collapse have been prevented?

43 There is little new in the WorldCom debacle, only hard lessons. These lessons emerged even before the Enron scandal. It should therefore not take another collapse before these lessons are learnt and corrective measures are put in place to counter these undesirable practices. Enron should have been the wake-up call,[86] but the call was not heeded.

44 In any event, scandals of this nature need not happen or come as a surprise anymore. Certain types of conduct or activities have evolved into a pattern of malfeasance over the years and, as a matter of course, it is essential that one should always be on the alert for wrongdoing. For example, to charge operational expenses as capital spending is one of the oldest accounting fiddles in the book.[87] It should no longer be an excuse for stakeholders, especially the board and executive management, to maintain, only when the company has collapsed, that

[84] *ibid.*
[85] *ibid.*
[86] Business Day, Corporate health means reform across the board, 12 July 2002, M111
[87] Business Report, US's claim to corporate supremacy is badly dented, 3 July 2002, M83

they were unaware of any wrongdoing. Similarly transactions involving a rapid-fire series of acquisitions should also raise red flags. It should *always* be assumed that such companies are a pack of cards,[88] ready to collapse at any moment owing to efforts by management to employ whatever tactics to stave off the costs that come with such acquisitions. It is known that WorldCom had been involved in 17 mergers between 1994 and 1998.[89] The Audit Committee[90] or the auditors should have scrutinized the financial statements more closely. Another activity that should raise red flags without question is when a company cuts jobs on a large scale.

45 These events highlighted above are but some of the examples that should spur stakeholders to be on a state of high alert when they occur and should motivate them to sharpen their tools of monitoring in order to prevent or mitigate a crisis. To be unprepared for crises soon after these occurrences or events could suggest not only that standards of corporate probity and disclosure have slumped, or analysts' tools for producing reliable forecasts have failed, but also that standards of supervision and oversight are suspect.

[88] Business Report, US's claim to corporate supremacy is badly dented, 3 July 2002, M83
[89] Business Report, WorldCom's ousted CFO drove growth strategy, 1 August 2002, M150
[90] Business Day, Corporate health means reform across the board, 12 July 2002, M111

46 It can strongly be argued, however, that stakeholders cannot always be effective if they act in isolation from each other and not be complementing to each other. This could be done by maintaining an active, yet prudent (given the interests they protect and confidentially issues), relationship with each other. All stakeholders therefore need to holistically address corporate governance in business.[91] It has thus been argued that the reformation process must go beyond the audit profession and regulatory bodies, but should encapsulate management, bankers, non-executive directors, analysts, shareholders/investors and perhaps even the uncritical media.[92] But what are they to do differently to make the world a safer place for investors[93] and, indeed, taxpayers?

The external auditors and accountants

47 There has been strong calls, in the US and SA, for the establishment of an independent oversight body for the auditing and accounting professions.[94] This comes in the wake of investors' questions about the role of accountants in not picking up problems before the collapse of Enron, or closer to home, Regal Bank, LeisureNet and Masterbond,[95] to name a few. To have an oversight body would follow the example of

[91] *ibid.*
[92] *ibid*, M110
[93] *ibid*, M111
[94] Business Report, Reserve Bank joins calls for body to supervise auditors & accountants, 5 July 2002, M90

UK and Ireland, where such independent oversight bodies for the auditing profession have been created.[96]

48 Lewis Gottschalk, the executive partner at Moores Rowland Chartered Accountants, a member of Moores Rowland International, has also suggested that a new body be established for the profession, to be named the Public Audit Control Panel.[97]

49 Among the areas to be regulated by this proposed body and thereby increase the profession's accountability[98] include:

- Award audits of listed companies and those firms that met certain turnover and asset criteria.[99]
- Auditors to rotate after serving a certain period.[100]
- Introduce more rigorous criteria for appointing auditors and assessing their independence.[101] It has been suggested that the profession spends too much time on auditing techniques and procedures and not sufficient time of assessing independence.[102]
- Introducing protection for auditors reporting unorthodox accounting treatments.

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[95] *ibid.*
[96] *ibid.*
[97] *ibid.*
[98] *ibid.*
[99] *ibid.*
[100] *ibid.*
[101] *ibid.*

50 Experts have however expressed concern that it is difficult even for conscientious auditing staff in large firms to detect senior management collusion.[103]

Management

51 Sidgmore, who took the helm in April 2002, has blamed past management and Arthur Andersen for the company's plight and pledged cooperation as the government investigates.[104]

52 As already stated, the problems were discovered during a routine internal audit.[105] The company had been accounting for day-to-day costs, such as network maintenance, as capital investments, and therefore not offsetting them against earnings. As a result, they say, they were unaware of the losses.[106]

53 However, in the case of WorldCom, it has emerged that its executives had repeatedly brushed off warnings about shady accounting

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[102] *ibid*, M91
[103] *ibid.*
[104] Business Report, Former SEC chairman appointed as WorldCom watchdog, 3 July 2002, M85
[105] See footnote 9 above
[106] Mail & Guardian, WorldCom charged with fraud, 28 June 2002, M75

practices.[107] It was reported that certain documents that were seized have revealed a strange pattern of people inside the corporation discovering bad practices, trying to do something about it, and ultimately failing, that is, until recently.[108] A finance department employee, for example, pointed out bookkeeping problems in 2000 to Sullivan and Myers, and contemplated resigning after he was assured that there was nothing wrong.[109] In a separate incident in April 2000, a London employee contacted Arthur Andersen after Sullivan reclassified $33,6 million in expenses as capital spending, allowing the charges to be written off over several years.[110]

54 These examples suggest that bad practices in a company can and often are detected earlier, or can simply be prevented, if the pleas of the four WorldCom executives under indictment are anything to go by. However, due to a lack or weakness of systems or mechanisms to communicate them effectively or to protect "whistleblowers", no decisive action is taken. It took a woman "of demeanour but exceptional guts and sense"[111], Cynthia Cooper, to explode the bubble that was WorldCom, when she informed its board that the company had

[107] Mail & Guardian, WorldCom files for bankruptcy, 22 July 2002, M129; see also Mail & Guardian, WorldCom cooked the books back in 2000, 15 July 2002, M115; Business Report, WorldCom bankruptcy filing marks milestone in corporate failures, 22 July 2002, M134
[108] Mail & Guardian, WorldCom cooked the books back in 2000, 15 July 2002, M115
[109] *ibid.*
[110] *ibid.*
[111] Expression used by Time Magazine issue of December 30, 2002/January 6, 2003, page 38

concealed $3.8 billion in losses through the prestidigitations of phony bookkeeping.[112] Ms Cooper has since been honoured by Time Magazine in its December 30, 2002/January 6, 2003 issue as one of its three Persons of the Year for 2002 for her courageous conduct.

Non-executive directors

55 The objectivity of non-executive directors should be beyond reproach and should not be questioned. This could not have been the case in Enron where some non-executive directors are reported to have offered consulting services to the company.[113] As independent agents, non-executive directors have a particular responsibility.[114] They should have leadership, a full understanding of the business and thereby maintain an effective check on executive actions.[115] The ultimate responsibility for ensuring effective corporate governance rests with the board as a whole,[116] especially non-executive directors.

56 Audit committees who oversaw the preparation of the financial statements, or the non-executive directors who are by definition consultants to the company, should have been more vigilant. Audit

[112] Time Magazine issue of December 30, 2002/January 6, 2003, page 38
[113] Business Day, Corporate health means reform across the board, 12 July 2002, M110
[114] *ibid.*
[115] *ibid.*

committees are an essential cog in the governance wheel of the modern organisation, and should be concerned about the independence of the auditor, rather than what happened in Enron where the audit committee sanctioned practices such as the internal audit being carried out by the auditors.[117]

Investors/shareholders

57 Investors also have a duty to protect themselves.[118] Not many companies can continue to grow at the rate Enron or WorldCom grew. It comes back to the same perception that some investors are greedy too. One often sees investors in SA caught out by iniquitous schemes that offer disproportionate high rates of interest. It must always be borne in mind by the investors that the higher the return, the higher the risk.[119]

58 Shareholder apathy, such as the propensity of shareholders to not attend the oft-crucial shareholders' meetings, thereby allowing for executive actions to go unchecked, has also contributed to corporate failures.

[116] *ibid.*
[117] *ibid*, M111
[118] *ibid.*
[119] *ibid.*

Bankers

59 Using Enron specifically as an example, banks played an important role in aiding it to create its special purpose entities.[120] Surely these banks knew Enron was shifting liabilities "off balance sheet"?[121] In addition the banks are accused of having been aware that loss-making contracts were also being shifted into the entities.[122] It is ironic, therefore, that some of the main losers in these disasters have been the banks themselves.[123]

Analysts

60 Analysts have also been asleep at the switch. Is it not the analysts who should have detected that profit was not backed by cash flows?[124] The news of the resignation of Jack Grubman, an analyst with the Salomon Smith Barney brokerage house, a firm sullied by the WorldCom crisis, on Thursday, 15 August 2002[125] should come as a reassuring step in the right direction to interested persons, for it recognizes the vital, but often understated, role played by analysts in the fortunes of corporate

[120] Business Day, Corporate health means reform across the board, 12 July 2002, M110, M111
[121] *ibid*, M110
[122] *ibid.*
[123] *ibid.*
[124] *ibid*, M111
[125] News24.com, Shamed WorldCom analyst quits, 16 August 2002

institutions. Grubman, who earned US$20 million a year, failed to foresee the meltdown of the telecommunications industry, or of WorldCom.[126] He also testified before Congress in 8 July 2002 that despite repeated meetings with WorldCom directors, he had no idea of the company's questionable accounting practices.[127]

The Regulator

61 The scandal has thrown the spotlight on the SEC and the role of regulators in general. Has the SEC's reputation as the most powerful and feared watchdog been compromised, as some people seem to think? It has been attacked for its lack of independence and its inability or failure to push through regulatory changes that would have helped prevent the series of US corporate meltdowns.[128]

62 What of its independence? Apparently Harvey Pitt, the Bush-appointed SEC chairman, made his name as a private lawyer by defending insider-trading kingpins.[129] And defended them well he did too! One columnist has said Pitt's old client list reads like "a rogue's gallery of the

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[126] *ibid.*
[127] *ibid.*
[128] Business Report, The feared watchdog that refuses to bite, 30 June 2002, M80
[129] Business Report, US trading watchdog blamed for pit bull past, 17 July 2002, M117

corporations accused of driving the economy south".[130] Is this probe a needless diversion, or should one be wondering whether Pitt's CV is fit for the SEC chairman?[131] Some critics, including a few Republicans, strongly feel that somebody totally independent[132] should be appointed. Question is, how do you define "totally independent"? Indeed, is it fair to hold his past against him? Some will argue that defending unsavoury clients is par for the legal course.[133] One academic has even said forcing Pitt out because of past clients was a precedent that would make filling the job nearly impossible.[134] Even former SEC chairman, Arthur Levitt, credited for his tough regulatory policies, blew hot and cold on this tactic to unseat Pitt.[135]

63 However, Pitt has also been accused of being too close to the business community to be truly independent.[136] He has been criticised for his recent meetings with former client, KPMG, an accounting firm whose audits of Xerox are being investigated by the SEC. He also met with the CEO of Xerox. However, SEC officials note that after meeting with Pitt, Xerox agreed to pay a stiff $10 million civil fine to settle the

[130] *ibid.*
[131] *ibid.*
[132] *ibid.*
[133] Pitt, *ibid.*
[134] *ibid*, M118
[135] *ibid.*
[136] Business Report, The feared watchdog that refuses to bite, 30 June 2002, M80

allegations.[137] This raises the question of the extent and depth of the regulator's interaction with people from whom it is supposed to save its clients. At the end of the day, the regulator should take care to protect its image against negative perceptions.

64 The SEC's efforts to push through regulatory changes have either been frustrated by influential members of Congress or come under pressure from the business lobby[138] because they were seen as being too tough[139], or were trivialised in order to undermine them.[140]

65 Some of the measures the SEC has sought to introduce, but were apparently frustrated or undermined, include:

- The proposal to separate the audit and consultancy functions of the big accountancy firms so that they would have been able to undertake either audit or consultancy work for clients, not both.[141]
- To introduce a system whereby listed companies would be required to disclose how much they were paying in audit fees and how much for consultancy. Consultancy fees typically dwarf audit fees by seven to one.[142]

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[137] Business Report, US trading watchdog blamed for pit bull past, 17 July 2002, M117-M118
[138] Business Report, The feared watchdog that refuses to bite, 30 June 2002, M80
[139] *ibid.*
[140] *ibid.*
[141] *ibid.*
[142] *ibid.*

66 Former SEC chairman, Arthur Levitt, who left in August 2001, conceded that the system of financial reporting was seriously flawed.[143] He said the problem is that the accountants were compromised by the fact that they felt and acted as if their loyalties belonged to management rather than to the stakeholders.[144]

67 The SEC has since tabled a fresh set of proposals designed to tighten regulation of company auditors. On 20 June 2002, less than a week before the Worldcom scandal broke, but six weeks after the Enron crisis, the SEC proposed a series of rules designed to restore reliability and integrity of the financial reporting process.[145] Key elements of the proposals include:

- Introduction of a public accountability board, which would regulate the accountancy profession but not be controlled by it.[146]
- Instead of being funded by the profession on a voluntary basis, there would be mandatory contributions from the audit firms and the public companies whose books they monitor.[147]

[143] *ibid*, M81
[144] *ibid.*
[145] *ibid.*
[146] *ibid.*
[147] *ibid.*

68 This would replace the existing self-regulatory system of "peer reviews" where firms periodically review other firms. Cynics say that such reviews have rarely found anything untoward.[148]

69 The SEC is expected to publish additional proposals on the subject of auditor independence. The strongest element is a move to bar audit partners from having any part of their pay or bonuses affected by the fees from other services such as management consultancy.[149]

70 Other suggestions include:

- Firms must be able to undertake both audit and consultancy work for clients if approved by the audit committee, and not just by the CEO.[150] But what of companies that are dominated by one senior figure such as a combined chairman and CEO? This remains to be addressed.[151]
- A disclosure of the non-audit fees.[152]
- The compulsory rotation of a company's auditors every five or six years.[153]

[148] *ibid*, M81
[149] *ibid.*
[150] *ibid*, M82
[151] *ibid.*
[152] *ibid.*
[153] *ibid.*

The Government

71 President Bush, already under a cloud after revelations of his own record as a Texan oil executive,[154] promised to pursue executive lawbreakers and restore trust in corporate America. The Bush administration has argued for rigorous enforcement of existing laws instead of introducing new legislation.[155] He has called for:

- Stiffer prison terms for executives guilty of criminal fraud, and doubling the maximum prison term for mail and wire fraud to 10 years.[156]
- Tougher laws for the shredding of documents or obstructing justice.[157]
- A 20% increase in funds and greater powers for the SEC. He urged Congress to approve a $20 million funding request to allow the regulator to hire 100 new enforcement officers, and an extra $100 million in the fiscal year ending September 2003.[158]

[154] Mail & Guardian, Bush vows to rein in corporate crooks, 9 July 2002, M100; Business Report, Scandal spotlight now on Bush, 5 July 2002, M87
[155] Business Report, Bush seeks to double prison term for fraud, 11 July 2002, M107
[156] Business Report, Bush lashes boardroom criminals, 10 July 2002, M104
[157] *ibid.*
[158] *ibid*, M105

Indeed, as some legal experts argue, prosecutors already can put executives in prison for securities fraud, obstructing justice and falsifying business records in terms of the existing laws. [159]

Stock markets

72 President Bush has said stock markets should require that the majority of company directors be truly independent, including all members of the audit committee and compensation committee.[160]

73 It has also been suggested that stock markets should require listed companies to receive shareholders' approval for all stock option plans.[161]

Media

74 The media has been accused of being uncritical in their reporting.[162] A major acquisition or investment has often been met with praise by the media rather than scepticism. Deals are rarely questioned. If anything,

[159] Business Report, Bush seeks to double prison term for fraud, 11 July 2002, M107
[160] Business Report, Bush lashes boardroom criminals, 10 July 2002, M104
[161] *ibid.*
[162] Business Day, Corporate health means reform across the board, 12 July 2002, M110

once a major deal is pulled off, it makes a celebrity of the executive involved.

Conclusion

75 On the face of it, there is nothing to suggest that WorldCom's corporate governance structures were lacking in form. A clear lesson here is that "corporate governance" is not a list of procedures[163] and the quantity of board committees. Rather, it is the old principle of substance over form. It is a state of mind.[164]

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[163] *ibid.*
[164] *ibid.*