DM Extra!

Alert Edition

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Alert Edition

Timely Commentary on Critical Events and Regulatory Developments

WorldCom: Six Questions for Directors

Director Summary

On June 26, 2002, the world woke up to headlines about the discovery of a $3.8 billion accounting misstatement at **WorldCom**. This misstatement, like other troubling financial disclosures in the past several months (at **Enron**, **Global Crossing**, **Tyco**, **ImClone**, **Xerox**, and **Adelphia**, to name a few) raises (or should raise) at least six basic questions in the minds of corporate directors everywhere.

1) Facts: ***What happened—what was misstated at WorldCom and how?***

On the day the WorldCom board announced the discovery of a misstatement, the **Securities and Exchange Commission** filed a **civil action in federal district court in New York** naming the global communications provider.[1]

In its complaint, the Commission alleges that WorldCom fraudulently overstated its income before income taxes and minority interests by approximately $3.055 billion in 2001 and $797 million during the first quarter of 2002. The complaint claims that WorldCom portrayed itself untruthfully as a profitable business during 2001 and the first quarter of 2002 by reporting "earnings that it did not have." The SEC alleges that WorldCom did this by "capitalizing (and deferring) rather than expensing (and immediately recognizing) approximately $3.8 billion of its costs." The company transferred these costs to capital accounts in violation of established generally accepted accounting principles (GAAP) as well as certain provisions of federal securities law.[2] In a related action, the Commission ordered WorldCom to file with the Commission, under oath, a detailed report of the circumstances and specifics of these matters by 8 a.m. Monday, July 1. However, SEC Chairman **Harvey Pitt** characterized their response negatively, saying "WorldCom's statement is wholly inadequate and incomplete. It demonstrates a lack of commitment to full disclosure to investors and less than full cooperation with the SEC."

2) Definitions: ***What exactly is an accounting misstatement and are all accounting misstatements punishable?***

The SEC defines an accounting misstatement as a failure to follow GAAP. Material misstatements are punishable by law.

The SEC's **Staff Accounting Bulletin No. 99** (SAB No. 99, issued in August 1999) explains what makes a misstatement "material." Some of the circumstances listed in SAB No. 99 that should be considered are whether a misstatement:

- masks a change in earnings or other trends
- hides a failure to meet analysts' consensus expectations for the enterprise
- changes a loss into income or vice versa
- concerns a segment of the registrant's business that plays a significant role in the registrant's present or future operations or profitability
- affects compliance with loan covenants or other contractual requirements, and
- has the effect of increasing management's compensation.

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1 Litigation Release No. 17594 / June 28, 2002. Securities and Exchange Commission v. WorldCom, Inc., Civil Action 02 CV 4963 (S.D.N.Y.) (June 27, 2002)

2 Sections 10(b) and 13(a) of the Securities Exchange Act of 1934 (Exchange Act) and Exchange Act Rules 10b-5, 13a-1, 13a-13, and 12b-20.

Intentional misstatements, even of small amounts, that were made to manage earnings may be inappropriate. Public companies must maintain books, records, and accounts that "in reasonable detail, accurately and fairly reflect the transactions of a company."[3] SAB No. 99 sets forth various factors, in addition to those used to evaluate materiality, that a company may consider in deciding whether a misstatement violates its obligation to keep books and records that are accurate "in reasonable detail." Some of these factors are:

1. the significance of the misstatement, which means inconsequential misstatements may be treated differently than more significant ones
2. how the misstatement arose, for example, whether it is part of an effort to manage earnings or an insignificant flaw in an operations system
3. the cost of correcting the misstatement, and
4. the clarity of the authoritative accounting guidance with respect to the misstatement.

Research from **Prof. Thomas Weinrich** of **Central Michigan University** shows that there are several common techniques to misstate financial results, based on a study of 96 accounting and auditing enforcement releases (AAERs) issued from July 1, 1997, to December 31, 1999, involving 38 audits by the **Big Five** firms. The most frequently misstated transactions and accounts were as follows:

- revenues and accounts receivable (26 cases)
- expenses (13) (this was the kind of misstatement WorldCom made)
- cost of sales and inventory (9)
- sales discounts and allowances (8)
- property, plant, and equipment (7)
- accounts paying and accrued liability (5), and
- securities valuations (3).

These findings were consistent with a study issued in 1999 by the **Committee on Sponsoring Organizations of the Treadway Committee (COSO)**, and reported in the September 1999 issue of *Director's Monthly*, pp. 4-5.

Since the most common kind of accounting misstatement involves inappropriate recognition of revenues, it is good to know when revenues may be recognized. Under GAAP, revenue is recognized when it is earned and realized or realizable. The SEC's **SAB No. 101** addresses this topic. It sets forth four underlying conditions that must exist in order for revenue to be recognized. First, there must be persuasive evidence that the company has an *arrangement* to receive the revenue. Second, the company recognizing the revenue must have actually *delivered* the goods or rendered the service. Third, the *price* of the goods or services must be fixed or at least determinable. And finally, the company must have reasonable assurance that it can *collect* the revenue. For more on SAB No. 99 and SAB No. 101, see **http://www.sec.gov/news/speech/spch359.htm.**

3) Risk: ***Are accounting misstatements relatively common—and thus likely to be a problem at companies where I serve?***

Accounting misstatements that are "material" (important) enough to warrant regulatory action have been relatively rare in recent years, but seem to be increasing in frequency. According to the COSO study cited above, only 300 companies were named in fraud-focused AAERs from the SEC between January 1987 and December 1997.[4] Furthermore, the COSO study found that most of the companies accused of fraud were small—with median assets of $16 million, and not listed on the major stock exchanges.

In the past five years, however, the number of larger companies named in such matters has grown, raising broader problems. In a letter to the editor of the *COA Journal* in April 2001, **Abraham J. Briloff**, Emanuel Saxe Distinguished Professor Emeritus, **Baruch College**, New York City, wrote that the AAERs that served as the basis for the COSO report did not reflect the "periodic high-profile cases of fraudulent financial reporting," such as **Cendant**, that "raise concerns about the credibility of the U.S. financial reporting process" and that "call into question the roles of auditors, regulators, and analysts in financial reporting." Interestingly, this letter appeared at the precise time that WorldCom managers began to capitalize some expenses. Sadly, Professor Briloff's warning about more widespread problems went unheeded.

3 As stated in the footnotes to SAB No. 99, "Criminal liability may be imposed if a person knowingly circumvents or knowingly fails to implement a system of internal accounting controls or knowingly falsifies books, records, or accounts. 15 U.S.C. §§ 78m(4) and (5). See also Rule 13b2-1 under the Exchange Act, 17 CFR 240.13b2-1, which states, 'No person shall, directly or indirectly, falsify or cause to be falsified, any book, record, or account subject to Section 13(b)(2)(A) of the Securities Exchange Act.' Further, SAB No. 99 clarifies that "The books and records provisions of Section 13(b) of the Exchange Act originally were passed as part of the Foreign Corrupt Practices Act (FCPA). In the conference committee report regarding the 1988 amendments to the FCPA, the committee stated, 'The conference committee adopted the prudent man qualification in order to clarify that the current standard does not connote an unrealistic degree of exactitude or precision. The concept of reasonableness of necessity contemplates the weighing of a number of relevant factors, including the costs of compliance.

Cong. Rec. H2116 (daily ed. April 20, 1988).' "

4 Rule 10(b)-5 of the 1934 Securities Exchange Act or Section 17(a) of the Securities Act.

4) Exposure: ***If a major accounting misstatement is discovered at a company where I serve, can I be sued as a director for failing to detect it?***

Depending on the allegations made in the lawsuit, there is some chance of legal exposure under state law, common law, and/or federal law. The duties, responsibilities, and powers of all corporations, whether publicly traded or not, and whether large or small, are defined under state law, which varies from state to state. Additional principles for boards have evolved under common law, which automatically applies nationwide through judicial interpretation on a case-by-case basis. Additional legal restraints may be imposed by federal law—for example federal securities law or broadly applicable federal laws such as the Foreign Corrupt Practices Act. Finally, stock exchanges also impose rules in the form of listing requirements (e.g., independent audit committees). Each of these sources of rules can add an extra layer of liability exposure for a board.

Under state law, expressed with various nuances, certain powers of the corporation are reserved to the board. Only the board has these powers. These include the power to sell the corporation or substantial assets, to declare dividends, and to declare bankruptcy. In addition, there are certain functions normally expected of the board, under state law: to oversee management of the corporation, to review strategic plans, etc. In exercising its powers and in fulfilling its functions, state law requires that directors must act with care (duty of care) and loyalty (duty of loyalty). Thousands of court cases have helped define exactly what these duties imply.

Director decisions, if made with due care and loyalty, are protected by the common law judicial doctrine known as the Business Judgment Rule. This judicial tradition (which is not written up in any legal code or rule) says that directors who make decisions with due care and loyalty cannot be sued for their decisions, even if the decisions turn out to be wrong. In the case of an accounting misstatement, if it is found that directors exercised due care and had no conflicts of interest, there would be no liability. A litigant may charge that directors failed to exercise due care with respect to the corporations internal accounts or external audit. To disprove this charge, and thus gain the protection of the Business Judgment Rule, directors would have to show that they received reasonable assurances that the internal auditor system was sufficient, and the the external auditors were competent and had no conflicts of interest. Furthermore, to show that they met the duty of loyalty standards, directors would have to show that they had no conflicts of interest with regard to the misstatement.

It is generally agreed that the duty of care implies a duty to be reasonably informed. In the **Delaware Chancery Court** case *In Re Caremark International, Inc.* (1996), Judge William Allen opined that the board cannot meet its duty to be reasonably informed "without assuring [itself] that information and reporting systems exist in the organization that are reasonably designed to provide to the senior management and to the board itself timely, accurate information sufficient to allow management and the board, *each within its scope*, to reach informed judgments concerning both the corporation's compliance with law and its business performance." (Emphasis added.)

Although there is some question as to what the "scope" of a board's understanding should be, in the case of public companies, this is becoming clearer. The **New York Stock Exchange** and **Nasdaq** require listed companies to have independent audit committees composed of members who are "financially literate." This new requirement does not imply that audit committee members have an affirmative duty to use their financial literacy to detect fraud. Given the increasing frequency of discovery of major accounting frauds in recent months, however, directors would do well to refresh their knowledge of this topic—known generally as "forensic accounting."[5]

5) Prevention, Detection, and Reporting: ***What can directors do to ensure the prevention, detection, and proper reporting of accounting misstatements?***

As for *prevention*, it is best to follow the guidelines of the **Federal Sentencing Commission** pertaining to compliance. These seven guidelines outline steps for an effective compliance program. For details on this and other sources referenced in this DMX, see the "Research Edition" at **www.nacdonline.org**.

5 See David B. Kaufman, "Employing Forensic Accounting Techniques to Detect Fraud in Financial Statements," Director's Monthly, February 1999, pp. 13-15. See also Report of the NACD Best Practices Council: Coping with Fraud and Other Illegal Activity (1998), "Procedures and Red Flags to Help Stop Fraud," by Herrington Bryce, Director's Monthly, March 1999, p. 14; The Report of the NACD Blue Ribbon Commission on Audit Committees: A Practical Guide (2000).

6 See AICPA Statement on Auditing Standards 82, "Consideration of Fraud in a Financial Statement Audit" (1997). That statement was issued to provide guidance to auditors in fulfilling their responsibility "to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud." Although these risk factors cover a broad range of situations, they are only examples. In the final analysis, audit committee members should use sound informed judgment when assessing the significance and relevance of fraud risk factors that may exist.

Detection means looking for red flags in both financial reporting and management behavior. See the "red flags" list of the **NACD Blue Ribbon Commission on Audit Committees**, and the financial risk list from the **American Institute of Certified Public Accountants**' Statement on Audit Standards No. 82 (SAS No. 82) on "risk factors."[6]

As for *reporting*, the following should occur. Whoever finds the misstatement should report it to the audit committee, which should report it to the SEC, or ask the external auditor to do so. In the WorldCom case, this correct procedure was followed. The problem is that the reporting took place too late—15 months after the misstatement first appeared.

6) Policy: ***What is the single most important thing corporate America can do to restore confidence in equity markets?***

This question came from corporate director **Barbara Hackman Franklin** when she recently shared a forum with SEC Chairman **Harvey Pitt**. The former Secretary of Commerce and current NACD director was present as a designated questioner during SEC chairman's **June 26 speech at the Economic Club of New York**. Chairman Pitt said that the main answer lies in "better and faster disclosure" as an integral part of the many reforms he emphasized in his speech—including holding corporate leaders more accountable, and punishing them if they violate the corporate trust. In response to Hon. Franklin's questions, Chairman Pitt emphasized the value of having a new, independent oversight board to monitor the work of auditors. Currently, there are multiple proposals for such a board—including an SEC proposal and the ones contained in Congressional bills—including **S. 2673**, introduced by **Sen. Paul Sarbanes** (D-MD) on June 25, 2002, and the **House-passed H.R. 3763, Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002**, introduced by **Rep. Michael G. Oxley** (R-OH). Chairman Pitt that the main proposals are trying to do the same thing. Whatever happens, he said, the SEC will be "ready to go." If there is legislation, he added, the SEC will incorporate whatever it says. He emphasized the need for speed in getting this body set up.

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