

## **For WorldCom, Acquisitions Were Behind Its Rise and Fall**

By Kurt Eichenwald  
August 8, 2002  
(PFD File)

Bernard J. Ebbers, the onetime high school coach and Canadian milkman who rose to chief executive of [WorldCom](#), stepped to the lectern at the National Press Club to applause from scores of Washington journalists. With delight he described how he had transformed an obscure long-distance phone company into one of the country's fastest growing corporations.

It was Jan. 12, 2000, and the mood in this room full of journalists was celebratory. Mr. Ebbers talked of how his company had grown enormously through no fewer than 65 mergers, capped by the granddaddy of them all, its acquisition of MCI. Now, his company was proposing a multibillion-dollar acquisition of the giant [Sprint](#) Corporation.

But even as Mr. Ebbers boasted of WorldCom's successes and even as enraptured investors drove up the company's stock price, behind the scenes the company was already a financial and operational shambles, according to interviews with current and former executives, lawyers and government officials, as well as internal documents and court and government records.

Dozens of acquisitions were never consolidated into a single, seamless enterprise, leaving the company incapable of functioning properly. Moreover, because of accounting maneuvers, each new acquisition allowed the company to report higher per-share profits, even when its core business was barely growing, or losing ground.

Leading it all was Mr. Ebbers, a man who insiders and analysts said was out of his league in the rough and tumble world of telecommunications.

"WorldCom wasn't operated at all, it was just on auto pilot, using bubble gum and Band-Aids as solutions to its problems," said Susan Kalla, an analyst at Friedman, Billings & Ramsey. "Bernie was endearing, but he didn't even have a working knowledge of the business."

Now the company is in bankruptcy, its stock trading for pennies a share, and the way it was run will be central to the expected prosecution of Scott Sullivan, the former chief financial officer, and David Myers, the former controller, on charges of constructing a massive accounting fraud at WorldCom. The alleged fraud involved improperly inflating the company's earnings by more than \$3.8 billion to help keep the stock price high even as the company's finances were deteriorating.

But the story of what happened cuts two ways, criminal lawyers said. Indeed, by demonstrating how poorly Mr. Ebbers managed the company he had so rapidly thrown together, his legal team could argue to criminal investigators that he was a hands-off manager who had little involvement in the sticky details. In other words, if there was fraud at WorldCom, Mr. Ebbers may be able to hold up his poor management skills as evidence of his innocence.

**Mr. Ebbers, tossed out of his job earlier this year, has been transformed from a folk hero for the new economy into a symbol for a new decade of corporate scandal.**

**The rapid rise in WorldCom's stock created vast wealth for many of the top executives. Mr. Ebbers liked to boast about his yacht, and Mr. Sullivan laid plans for a large mansion in Florida. But many investors who bought WorldCom shares — the stock was among the most widely held — were wiped out as the price fell from \$62 in June 1999 to become virtually worthless. (The stock closed yesterday at 13.9 cents a share.)**

**Through his lawyer, Mr. Ebbers declined to comment. Bradford Burns, a company spokesman, said: "WorldCom's heritage of competition and bringing value to the marketplace is as real today as it ever has been. We have more than 60,000 employees who pour their heart out every day to deliver high-quality service to our customers. The recent events have absolutely no impact on that."**

**To be sure, WorldCom's downfall is part of a broader collapse of the telecommunications industry, which proved inept at predicting demand for its services. But, according to insiders and analysts, WorldCom stands out as a primary example of how badly run companies can appear invulnerable, as long as the value of their stocks stay lofty.**

**"The only thing that the market valued was the stock price," said Scott Cleland, chief executive of the Precursor Group, a Washington research firm. "Operational reality, or true creation of value, had nothing to do with the WorldCom story."**

**While the criminal charges of accounting fraud filed last week against Mr. Sullivan and Mr. Myers focus on activities in the last two years, interviews and documents show that long before that time the company was heading for disaster.**

### **The Beginning** **WorldCom Thrived on Acquisitions**

**The WorldCom saga began, not surprisingly, with a deal.**

**In 1983, on the eve of the breakup of AT&T, a group of Mississippi businessmen decided over coffee at the Days Inn in Hattiesburg to form their own telephone company, LDDS Communications. But business was bad, and the company soon became dependent on cash from an investor, Bernard Ebbers, then the owner of 13 budget hotels.**

**Finally Mr. Ebbers said he would no longer prop up the operation. LDDS directors responded by naming Mr. Ebbers, a man with no real background in phone technology, as head of the company.**

**Quickly, Mr. Ebbers embarked on his strategy of growth by acquisition. By 1988, Mr. Ebbers's company had grown respectably, with accounts in four states. And Mr. Ebbers was developing a reputation for being a different type of corporate leader, one who paid scant attention to the details of operations.**

As the years progressed, Mr. Ebbers continued to snap up competitors. His company, based in Clinton, Miss., became renowned in 1996, the year deregulation enabled competition in the local telecommunications market, setting off a wave of deals.

With the company stock price soaring, Mr. Ebbers paid more than \$12 billion to acquire MFS Communications, a local calling system that itself had just acquired UUnet Technologies, an Internet services giant.

Suddenly, the company now known as WorldCom had an investment story to offer about the value of combining long distance, local service and data communication.

A cycle now familiar on Wall Street was in motion. Investors fell in love with the company's story, pushing up the price of its stock, which in turn provided the currency for further acquisitions, which made investors happier and on and on. With a stock price that was high considering the company's earnings, WorldCom could acquire companies with lower price-earnings multiples, and because of simple math automatically increase its per-share earnings.

The acquisition binge provided other benefits, according to former WorldCom employees and analysts. After many of the deals, WorldCom would subtract many millions and sometimes billions of dollars from its profits in what it described as a write-down of the value of certain assets it acquired. According to former employees, WorldCom included in this charge against earnings the cost of company expenses expected in future quarters.

The result was bigger losses in the current quarter but smaller ones in future quarters, so that its profit picture would seem to be improving.

The idea that huge charges against profits could be taken in the current quarter yet ignored by investors obsessed with profits might seem irrational. But analysts said that with WorldCom and other companies pursuing rapid acquisitions, this was exactly what happened.

Moreover, analysts and former employees said, the company would take large charges for assets like research and development that through accounting methods could be converted to a secret fund the company could tap whenever it needed a boost in earnings. Such cookie-jar reserves, as they are called, were widely used in the late 1990's.

"The boost from post-acquisition accounting was like a drug," one former WorldCom executive said. "But it meant bigger deals had to come along to keep the ball rolling."

The biggest deal, and eventually the largest acquisition charged against earnings, started on Oct. 1, 1997, when Mr. Ebbers telephoned Bert C. Roberts Jr., then the chief executive of the MCI Communications Corporation, who was already entertaining a \$19 billion bid from [British Telecommunications](#). Mr. Ebbers countered with an offer that topped that and then some. He offered \$30 billion in WorldCom stock and the assumption of \$5 billion in debt. MCI took the offer, and Mr. Roberts became the chairman of the merged company.

Even inside WorldCom, people who analyzed the buyout offer were thunderstruck at the price. "MCI was purchased at an unbelievably inflated price," said one person who reviewed the deal while working for the company.

But with the acquisition came another opportunity for raising earnings through an array of accounting maneuvers. For example, WorldCom reduced the book value of hard assets of MCI by \$3.4 billion, simultaneously increasing so-called good will — the value of intangible assets like a brand name — by the same amount. Had the assets been left at book value, the whole expense would have to be charged against earnings over slightly more than four years. But good will was amortized over far more time than hard assets. So with WorldCom's accounting, shifting the \$3.4 billion into good will meant the company spread those huge expenses out over decades rather than just a few years, thus charging smaller amounts against earnings each year.

The result? WorldCom cut its annual expenses significantly for the first four years, while still allowing itself to recognize all revenue from MCI. So profits for the new acquisition went up significantly.

Without the tactic, WorldCom's per-share earnings would have decreased by about 14 cents a share, to \$1.26 from the reported \$1.40, according to a report in 2000 by the Center for Financial Research and Analysis.

To keep the momentum going, WorldCom needed an even bigger deal and found it with its \$145 billion bid for Sprint. But despite heavy lobbying by Mr. Ebbers and other WorldCom executives, in June 2000 the Justice Department scuttled the deal, arguing that the combination threatened competition for long distance.

With that, the juggernaut driven by acquisition profits was finally derailed.

"The kiboshing of the Sprint merger was, for all intents and purposes, the end of WorldCom," said Howard J. Schilit, whose Center for Financial Research and Analysis conducted several reviews of WorldCom's accounting for institutional clients. "When you have companies that have to make acquisitions to survive, once the music stops, the dance is over."

Now, all WorldCom could do was figure out how to grow the company by running a better, more innovative business. But that was not where Bernie Ebbers's talent lay.

### Losing Control Billing Problems Plague Company

It was August 2000, and Marc Perkel's software company in Springfield, Mo., was effectively out of business. WorldCom, for some reason, had shut down his phone lines. Angrily, he called customer service, only to be told he was not listed as a customer. He was repeatedly transferred, and he tape recorded the conversation to insure he had a record.

"My phone service was turned off when I was on a trip to San Francisco, and now everybody is telling me that I don't have an account with you," Mr. Perkel told the third representative, according to the recording. "You have my business shut down and nobody there seems to be able to figure out how to turn it back on."

The representative was puzzled. "Were you on the WorldCom side possibly?" he asked. "Here, we have all the MCI accounts, that sort of thing. WorldCom, on the other hand, they handle all their accounts."

**Mr. Perkel, whose account was eventually found on the MCI side, was stumbling across a problem stemming from WorldCom's acquisition binge: For all its talent in buying competitors, the company was not up to the task of merging them. Dozens of conflicting computer systems remained, local network systems were repetitive and failed to work together properly, and billing systems were not coordinated.**

**Indeed, as Mr. Perkel found, the computer problems could lead to large errors in billing. Frustrated with WorldCom's performance, he canceled the company's service and eventually moved to San Francisco. Yet, WorldCom continued to bill him for more than a year, adding charges each month, for phone lines to an office that no longer existed.**

**"Don't think of WorldCom the way you would of other corporations," said one person who has worked with the company at a high level for many years. "It's not a company, it's just a bunch of disparate pieces. It's simply dysfunctional."**

**Tracking down overdue bills, or determining if they were even collectable, was a particular problem. For years after the MCI merger, at least two software programs — IX Plus for WorldCom and A/R 2000 for MCI — were in place to list such receivables, according to court records.**

**Moreover, people who work at the company said, an internal battle for control among executives from different corporate backgrounds — known internally as Legacy MCI executives and Legacy WorldCom executives — resulted in those with the least experience in charge of collecting debts.**

**"In the area of accounts receivable and credit collections, WorldCom picked the wrong people to run it," one former executive said. "It's a complex area, and you have to have skilled business people involved. But there were big power struggles at the vice president level, and they put some of their own guys in there who were from Clinton, Miss., who didn't know much about the business."**

**The results showed up in 1999, when the company tripled the number of receivables it could sell to others to collect. By June 2000, the length of time receivables had been on the company's books without collection had jumped to an average of 77 days, from 63 days a year earlier.**

**By September, WorldCom took a \$685 million charge, finally acknowledging that a huge amount of its billings were simply uncollectable. A number of employees interviewed by lawyers for a class-action lawsuit against the company reported that, until then, billings that were known to be uncollectable were simply carried on the books to avoid decreasing earnings.**

**The problems of consolidating technology did not end with the computers.**

**Indeed, engineering experts at WorldCom said that, other than with long distance, the company failed to properly merge various systems in its communications network, creating large technical problems and unnecessary expenses.**

**Bitter struggles among the various companies undermined efforts to work out the network problems, current and former executives said. Largely, these executives said, this internal**

bickering was driven by the failure of top officers to instill any sense of unity as they dashed off to dig up the next acquisition.

"MCI people had more expertise, better systems," one Legacy MCI executive said. "But we had to subordinate ourselves to WorldCom being the priority."

Organizational problems were everywhere. For example, WorldCom scuttled the three centers MCI had in place for what is known as network ordering and provisioning — essentially, the job of making sure the system is repaired and maintained and proper equipment is on hand when needed.

Instead, 12 centers were opened, requiring many new hires. And tasks were divided in ways that resulted in many unnecessary shipments of equipment. "It was inefficient with duplication," one engineer involved in the process said.

The biggest problems turned up in local phone networks — known as competitive local exchange carriers, or Clecs. WorldCom had purchased numerous Clecs, overlapping in various cities.

Efforts to consolidate the local networks failed, according to current and former employees. "The WorldCom model was a vast wasteland of Clecs, and all that capacity was expensive and very underutilized," one executive said. "There was far too much redundancy, and we paid far too much to get it."

### Cash Pressure Accounting Becomes Creative

The pressures of too much expense and too little business planning came together in June 2000, as the Sprint deal fell apart. The company's debt was rising, and revenue from the wholesale and consumer markets was falling. Total cash flow from operations was also dropping.

That same month, John Sidgmore, the founder of the UUnet Internet division, publicly disclosed that the widely celebrated entity that was at the center of WorldCom's data strategy was simply not profitable. That shocked numerous investors, who had come to believe the boasts of other UUnet executives that internet traffic was doubling about every three months; WorldCom officials now say that capacity, not traffic, was growing at that speed.

"WorldCom perpetuated the misrepresentation of data traffic," said Mr. Cleland of Precursor. "The \$4 billion accounting fraud is baby stuff compared to the fraud of data traffic growth, which allowed WorldCom's stock to appreciate tenfold."

The company still had benefits from the MCI acquisition, but now it needed more accounting tricks. Just three months before its charge against earnings for uncollectable accounts, its proportion of reserves against such problems actually fell. That meant more money was available to go to the bottom line.

**WorldCom also appears to have begun its first steps into what Congressional investigators contend could be fraud.**

**According to internal e-mail messages, senior officers directed shifts in expenses that did not comply with accounting rules. For example, Steven Brabbs, director of international finance and control, was ordered to insert in his division's books a \$33.6 million lowering of expenses for access to foreign telecommunications lines. He resisted, arguing the adjustment was not legal or proper.**

**But he was told that Mr. Sullivan, the chief financial officer, wanted it done, according to an internal e-mail written by Mr. Brabbs. Through a complex process, Mr. Brabbs made the adjustment on July 10, according to an internal e-mail message.**

**The move was necessary, because WorldCom was on the edge. Even with that adjustment, the company met its projected earnings for the quarter ended June 30 only through the miracle of rounding. Per-share earnings were 45.552 cents, below Wall Street's projections of 46 cents. Had profits been 0.003 cent lower, WorldCom would have been forced to round down, missing its target by a penny. In the overheated markets of the time, a hot stock that missed its target by as little as a penny could easily plunge.**

**At that point, according to the criminal complaint filed last week, Mr. Sullivan and WorldCom's controller, Mr. Myers, knew the days of an endlessly rising stock price were all but over. In July 2000, according to the complaint, they held discussions about the company's rising expenses as a percentage of total revenues, which was creating an increasing likelihood that it would miss analysts' earnings projections in the quarters that followed.**

**At that time, months before the improper transfers described in last week's complaint's began, the two men and other executives "devised a scheme to hide WorldCom's increasing expenses," in the words of the complaint, by shifting billions of dollars in line costs around in the books in a way that bolstered profits by sharply reducing the annual expenses the company would report.**

**By the end of the scheme, WorldCom had improperly reduced its expenses by more than \$3.8 billion, changing money-losing quarters into periods of profit.**

**According to institutional investors and analysts, the smart money on Wall Street quickly began to recognize that the wild ride on WorldCom stock was over. While individual investors continued to hear from Wall Street analysts about WorldCom's promising future, institutional investors started bailing out.**

**"It was a game of chicken, where you get as close as possible to the end before getting out," said one money manager who was a heavy seller of WorldCom stock in 2000. "We all knew that WorldCom couldn't go on forever."**