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Commentary by... Joan Fontrodona, IESE Professor

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WEEKLY INSIGHT
The WorldCom scandal unleashes a new crisis of confidence in the markets

The ghost of Enron is back lurking round the markets, this time under the guise of a telecom. WorldCom, the second long-distance operator in the United States, last Tuesday admitted that it had committed certain accounting irregularities to the tune of 3,800 million dollars, which makes it one of the largest frauds in history.

According to the press release by the company, the money spent as expenses over the last five quarters was registered as company capital. This practice goes way beyond the generally accepted accounting principles better known as US GAP.

The scandal has brought about the dismissal of the CFO, Scott Sullivan, thought to be one of America's accounting stars and architect, among other things, of the 37,000 million dollar takeover of MCI by WorldCom back in 1998. The press release revealing the fraud also stated that WorldCom would lay off 17,000 workers. The news hit the stock markets heavily. Just a few hours after the news was made public the Nasdaq was down 3% while Standard & Poor's 500 fell 1.5 points.

The WorldCom crisis adds to the series of scandals threatening the reputation of "corporate America". The U.S. President, George Bush, made it clear that the SEC would open an investigation to find (and punish) those responsible. (From EBCenter) [Full Story]
Highlights
- In 1995 and after making several acquisitions the telephone company, Long Distance Discount Service (LDDS), bought Williams Telecommunications Group for 2,500 million dollars and changed its name to WorldCom. In 1998 WorldCom embarked on the most expensive merger known at that time. They paid 30,700 million dollars for MCI Communications. They became the **second largest telephone company in the United States** after AT&T.
- WorldCom owns more than 22,000 miles of fibre-optic cable in the U.S. and has local networks in over 40 North American and European business centres. At its height it **was valued at some 180,000 million dollars**. At present its **stock is worth 2,460 million dollars**.
- Andersen, WorldCom’s auditing company, discovered that the **company covered up more than 3,800 million dollars** in expenses and warned the audit committee. Last month the operator dispensed with their services and opted for KPMG.
- The scandal may force WorldCom, with a debt of almost 30,000 million dollars, to declare itself **bankrupt**. The North American stock markets announced that the company’s shares, **which have lost 94% of their value this year**, will not be quoted until further notice.

Press Review

From The Economist
"A massive loss of confidence in the company caused by the revelations will be its biggest problem. Telecom firms everywhere are battling to survive a slump caused by **over-inflated ambitions**. A huge consolidation of the industry is likely. Investors will also be casting anxious eyes at the accounts of firms in other capital-intensive industries-mining and transportation, for example. Telecoms may not be the only sector to see some of its stars burn up and die."
[Full Story]

From News.com
"WorldCom may be the fiasco du jour, but it’s just one more dent in corporate confidence in the grand scheme of things. Tech companies will be more closely scrutinized for a wide range of reasons, including ties to auditor Arthur Andersen and use of various earnings measures such as pro forma earnings and EBITDA (earnings before interest, taxes, depreciation and amortization).

(...) While some of WorldCom’s rivals will benefit from poaching customers, analysts said the whole sector is likely to be marred by accounting concerns. Why? Like Enron, which rattled the energy sector, the telecom sector will be put under the microscope."
[Full Story]

From Financial Times (February, 2002)
"Many telecom companies traded with each other, exchanging capacity on each others’ networks, and treated their trades as revenues. But some of those deals may have been "hollow swaps", artificial deals concocted merely to create the illusion of activity, according to a growing chorus of industry analysts. That suspicion has now attracted the attention of the Securities and Exchange Commission and the Federal Bureau of Investigation. [This refers to the investigations into Global Crossing and Qwest Communications]

(...) The **craze for swaps** in the telecoms industry traces its **roots to the emergence of the Internet** as a mass-market medium in the mid-1990s.

(...) Though many of these companies had global ambitions, few had the resources to build a complete global communications network. To fill the gaps, that meant buying capacity in bulk on another company’s network. (...)
One important effect of these transactions was to boost the revenues at both companies, since the swaps were recorded as sales. For an industry that was becoming desperate for revenues, that was a boon.

(...) 

The problem now in the telecoms business is disentangling the bona fide business dealings from the artificial. (...) 

But such arrangements are not justified when they lack economic substance. (...) 

In the end, investors may find that they were as much to blame for turning a blind eye to how telecoms companies accounted for their revenues in the boom days as anyone. The beauty of the sector was at least partly in the eye of the beholder "

**From The New York Times**

"WorldCom might seem just one more carcass on the pile - and one that had already been picked at for months because of questions about its accounting. But experts on accounting say this **case is extraordinary** because of the **amount of money involved** and because of the relative **simplicity of the accounting manoeuvres** used to disguise the truth. (...) 

Not all corporate expenses are the same, and for good reason. The costs of a company's operations - salaries, materials and the like - are treated on a company's books as expenses in the year they are incurred. But the purchase price for certain long-lasting, big-ticket items - like buildings or heavy machinery - are treated differently. Rather than forcing companies to recognize such large expenses all in one year, accounting rules effectively allow them to recognize a portion of the cost over the many years in which the items will be used.

Such accounting allows companies to make large investments known as capital expenses without incurring huge hits to profits. So large expenses can appear small, emerging a little bit at a time as each new annual report is issued."

[Full Story]

**Commentary by...**

Joan Fontrodona

**WorldCom: at the heart of the crisis**

Having admitted to falsifying results, WorldCom has added its name to a list, which is getting rather long, of companies that have resorted to accounting stratagems to massage their accounts. Many of the cases involve telecommunications companies. Is this a sector prone to such practices? This may be so, but it is, however, due to the present situation and the particular characteristics of this crisis.

The origin of the present economic crisis must be sought in the boom of the New Economy and the technological share prices at the end of the nineties. Back then it was said that the best placed companies were not only the dotcoms but also all the enterprises working around the Internet: content providers, software manufacturers or communications companies. So the telecommunications operators were riding the crest of the wave or in the eye of the hurricane, depending on your point of view.

On the other hand, their products were quite appropriate for the age when the markets became truly international. The Law of Metcalfe, which says that the value of a network increases exponentially with the number of users, perfectly applies to the world of telecommunications.

However, their core position in the new market made them prone to lead vertical integration processes. The WorldCom case is paradigmatic. Since 1992 it had started a policy of acquisitions and mergers with other companies, among which was MCI in 1998 for almost 40,000 million dollars, which at the time was the biggest merger ever made.

The financial operations came with the spectacular appointments of executives, whose very names seemed to guarantee a promising future for the company. Let us not forget that this sector was one of the most notable for its polemics about the policies of remuneration and the famous **stock options**. At the time it was pointed out that these practices could lead to an excessively centred vision of results in the short term and
the closure of operations that would have a strong reaction on the stock markets, independent of their feasibility or strategic coherence.

The huge investments that these operations brought about affected the financial stability of the companies in the sector and left them in a very weak position in the event of a possible slowdown of the market, which is exactly what happened later. It is well known that when there is an earthquake the worst affected areas are those nearest the epicentre. The telecommunications companies were at the centre and up to a point it is logical that they are the ones that should take the brunt of the damage. However, they must not be seen entirely as victims, because in this case more than victims as such, they are responsible for the crisis of confidence the financial markets are going through, due to a lack of ethics in some of their actions.

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**EBCENTER ARTICLE**

Myths and realities of broadband business

By Susanna Arasa, Contents Manager, ebcenter

The takeoff of broadband infrastructures has seen operators investing huge sums, not knowing how or when they will become profitable. [Full Story]

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**REPORTS**

The broadband residential market will have a turnover of over 100,000 million dollars by 2008

**Title:** Broadband Access 2002: An Assessment of Global Demand for Broadband Access by Technology and Geographic Region

**Source:** Pioneer Consulting

**Date:** June 2002

**Abstract:** Pioneer Consulting has drawn up a report on the present and future state of broadband access throughout the world. According to the experts, in the regions with a high density of subscribers the most used technologies will be cable, ADSL and specially dedicated lines, while in areas of low demand satellite connection will become the main solution in the short term. Notwithstanding, cordless access will gain ground over the next few years.

Income from **broadband services** will jump from 93,400 million dollars in 2002 to **229,00 million dollars in 2008**. However, the turnover from the **sales of computer equipment** will fall from 16,300 million dollars to **11,700 millions** in the same period due to the fall in prices and the reduction in the number of subscribers because of market saturation.

The report points out that in 2008 broadband business services will reach 128,000 million dollars, while the residential services market will undergo a substantial increase, from some 16,800 million dollars in 2002 to 100,000 millions in 2008. [Full Story]

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40% of the audience generate 85% of the page impressions of online advertisements

**Title:** Internet Metrics: The Loyal Audience

**Source:** Online Publishers Association

**Date:** May 2002

**Abstract:** The American association of online editors has published a report on the audience measurement metrics in the electronic media. This report warns that the Internet audience cannot be rated like the traditional media since those who advertise usually contract the publicity per individual impression.

The most popular formula to measure users is 'total reach', which is a measure describing the site’s overall ability to attract any viewer at least once during a month. However, this measurement does not indicate the quality or the value of the advertisement for the visitors.
According to the report, a single exposure to an online advertisement raises Message Association by 7%. Three exposures raised the metric by 20%, and with five exposures the impact goes up to 29%. Given this characteristic, it is essential to differentiate between loyal users and the one-timers who view a page once and never return to it.

In order to test this theory the authors created five groups of users in 19 sites depending on their loyalty. The most loyal group, 20% of the visitors, represented 64.5% of all the page impressions. If we add to these the second most loyal group, they accounted for 85% of all the page impressions. The authors conclude that most of the advertisements on these sites are seen by loyal users and that 60% of the audience, their non-loyal users, account for only 15% of the page impressions and the advertisements. [Full Story]

Words on the Internet, a source of information
Title: Electric Symbols: Internet Words and Culture
Source: First Monday
Date: June 2002
Abstract: The Internet has a great potential for the observation and analysis of words. A good example of this is the browsers, which enable you to find out which words are the most sought and therefore the subjects that mean most to the Internet users. According to this study on culture and words on the Internet, it will soon be possible to distinguish searches by community as well as per company and nation, which will provide information about the interests of each group. The ability to segment the information into several communities has two major consequences: the first is to find out the interests of a community of members and the second is to able to make comparisons between the different groups. Apart from studying the ranking of the most sought words, it is quite useful to analyse the movement of the positions of the words. In April 2002, the most looked for words were Spiderman, the biggest box office hit in history in its first weekend; and Lisa Lopes, a singer who died in the same month. Among the words that dropped positions was Oscars, an event that had taken place in March. This capacity of the Internet to capture the subjects that most interest users can be exploited to carry out market studies and launch new products. For example, a film producer could postpone the launching of a film if he observes that another film in direct competition with his is more sought after on the Internet. [Full Story]

COMPANIES

eBay will offer medical insurance to its best sellers
eBay, the online auction site will provide medical insurance for the users who generate sales of at least 1,000 dollars per month. According to the company, the measure will benefit between 100,000 and 115,000 users. The site will not pay out any money but will act as a mediator between its users and the insurance company. From eCommerce Times. [Ful Story]

Price war between Amazon and Buy.com
Buy.com guarantees it sells all its books at a cheaper price than at Jeff Bezos's bookshop. And just to make sure that nobody has any doubts, it promises to return the price of the purchase plus 10% of the price at Amazon to anyone who finds a title cheaper at its competitor's site. This measure is added to the elimination of shipping costs when purchases are over 49 dollars, something Amazon also adopted. From Reuters. [Full Story]

BBC, best news and radio site
San Francisco hosted the sixth edition of the Webby Awards, known as the Oscars of the Internet. The jury and the public have once again awarded Google the best practice prize. The news website of the BBC got the vote of the jury for the best news website, and BBC Radio 4 got the best radio site. Three new categories have been added to the thirty traditional ones, based on the ratings of Nielsen/NetRatings: Star Rising (to the
site with the fastest growing number of users in 2002), which was won by Emode; Top US Property, which went to AOL; and Top Global Property for Yahoo!. From *Webby Awards.* [Full Story]

**General Electric sells its marketplace**

General Electric, the US giant, has sold its marketplace Global eXchange Services (GXS) to the firm Francisco Partners, an investment fund specialising in technological companies, who will pay **818 million Euros** for the acquisition. General Electric foresees a pre-tax profit of 500 million dollars and it will keep a 10% stake in GXS. From *Infoworld.* [Full Story]

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**WE RECOMMEND**

**The reinvention of Nokia**

After a decade making literally everything from rubber boots to toilet paper, at the end of the nineties Nokia became the world's leading mobile telephone manufacturer with a market share of 37%. However, in the last two years the company has entered a phase marked by stalling sales and commodity phones. The appearance of new competitors coming from the electronic consumer markets, such as Sony and Microsoft from the PC world, add to the difficulties of the Finnish giant.

In order to face these challenges, the company has undergone profound restructuring that divides the behemoth division of mobile phones into **nine new autonomous cost centres**, each directed at different types of public. Nokia's reorganisation, which has been in place since 1st. May, has meant the commitment to **sharing its operating system** with other hardware manufactures, a movement based on the premise that it is better to enlarge the pie than to hold on to its share of a stagnant market.

Other changes are expected. According to Matti Alahuhta, president of the mobile phone business and the primary architect of the reorganisation, the goal is to "renew the whole industry in the next two years". From *Business Week.* [Full Story]

**Microsoft's big secret**

Microsoft calls it 'Palladium' and with it they have started a crusade to ensure security, privacy and intellectual property rights. *Newsweek* magazine revealed this project and called it one of the riskiest ventures Bill Gates's company has ever attempted. According to the article, Microsoft's plans for 'trustworthy computing' integrate a system of chips that redefine the present architecture of personal computers and improve their capacity to control and protect personal and corporative information. In other words, Palladium aims to become the new platform for the services of **authentication, electronic commerce and entertainment** in the coming decades.

Palladium is forecast to see the light in a future version of Windows (maybe in 2004), but Microsoft will have to convince most of the sector that its bet is worthwhile. At present microprocessor manufactures like Intel and AMD have already embraced the idea and it remains to be seen whether the hardware and software companies follow suit. They are the ones who will make Palladium the god of security as it was in Greek mythology. From *Newsweek.* [Full Story]

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