



The Fraud

AIM 6344

Group Members

Cenk Tolunay

Yan Wang

Hong Ma

Yuhong Zhang

Background

WorldCom Inc. started as a small long distance telephone service provider in Mississippi in 1983. Then, it was called Long Distance Discount Services Inc. (LDDS). LDDS became a public company in 1989 through a merger with Advantage Companies, Inc. By the end of 1993, LDDS was the fourth largest long distance carrier in the US with revenues of \$1.5 billion. LDDS officially became known as WorldCom after a shareholder vote on May 25, 1995.

WorldCom maintained its fast growth with acquisitions, often using its common stock as currency, in the 90s from \$154 million in 1990 to \$39.2 billion in 2001. Acquisitions included the 1998 takeover of MCI, which made it the second largest US long distance carrier, and purchases of UUNet, CompuServe and America Online's data network, which put WorldCom among the leading operators of Internet infrastructure. Its position as a fast-growing provider of integrated telecommunications services led to a very high market valuation, which in turn made its stock a powerful currency for further acquisitions.

The company's problems started with the dot-com bubble burst and following reduced demand on infrastructure when it had the vast oversupply in telecommunications capacity. The revenue has fallen while debt taken on to finance mergers and infrastructure investment remains. Ultimately, the market value of the company's common stock plunged from about \$150 billion in January 2000 to less than \$150 million as of July 1st 2002. Overall, more than \$9 billion in false or unsupported accounting entries were made in WorldCom's financial systems in order to achieve desired reported financial results.

What Happened

It all started with the company's June 25th statement, WorldCom admitted that the company has classified over \$3.8 billion in payments for line cost as capital expenditures rather than current expenses. Line costs are what WorldCom pays other companies for using their communications networks. These consist of access fees and transportation charges for messages for WorldCom customers which accounted for approximately half of the company's total expenses. Reportedly, \$3,055 billion was misclassified in 2001 and \$797 million in the first quarter of 2002. According to the company, another \$14.7 billion in 2001 line cost was treated as a current expense.

WorldCom increased its net income and assets by transferring part of its current expenses to capital account. By doing this, the expenses were understated and capitalized costs were treated as an investment. The company managed to spread its expenses into the future and showed much higher net income in order to boost its financial performance.

The treatment of line costs as capital expenditure was discovered by WorldCom's internal auditor, Cynthia Cooper, in May 2002. Reportedly, she discussed the issue with the CFO at the time, Scott D. Sullivan and the company's controller at the time, David F. Myers. Mr. Sullivan asked her to delay her review until the third quarter of 2002. According to the June 12 memorandum, Mr. Sullivan indicated the line cost transfers began in the third quarter of 2001, and that previously these costs had been expensed. According to Mr. Sullivan, the line costs were long-term contracts entered into in connection with the company's investment in its network and in anticipation of gaining customers that ultimately were not gained. The CFO, Scott D. Sullivan was asked to justify the issue and later on he was forced to resign on the day WorldCom made its public announcement, June 25th. Mr. Myers resigned that day as well.

Before the June 25th announcement, WorldCom stock had fallen from a high of \$64.50 a share in mid-1999 to less than \$2 a share. The price fell below \$1 a share immediately after the announcement and even further to pennies later on. The WorldCom filed for Chapter 11 bankruptcy protection on July 21st. The WorldCom bankruptcy, with \$103.8 billion assets is the largest in US history in comparison, Enron listed assets of \$63.4 billion when it filed for bankruptcy in December 2001. Immediately after the June 25th announcement, WorldCom stated that it would cut 17,000 of its 85,000 employees.

August 1st, federal prosecutors charged Scott D. Sullivan and the former controller David F. Myers with securities fraud, conspiracy and filing false statement with the SEC.

How Did It Happen

There were three major issues with WorldCom's accounting practices.

1. Reduction of line cost and line cost E/R ratio

Line costs are WorldCom's largest single expense. Beginning in 2000 WorldCom had been trying to find ways to reduce line cost expenses. (Transfer amount for each quarter is shown in Table 1) They emphasized one key measure of line costs: the ratio of line cost expense to revenue, called the "**line cost E/R ratio.**" They had tried to keep the E/R ratio at about 42%. (Line cost E/R ratio is shown in Fig. 1)

2. Releases of Accruals to Reduce Line Costs

The improper accounting actions to reduce line costs took two main forms: releases of accruals in 1999 and 2000 and then, when the accruals had been used up, capitalization of operating line costs in 2001 and early 2002. In 1999 and 2000, WorldCom reduced its reported line costs by approximately \$3.3 billion by improperly releasing "accruals".

Proper accounting procedure for the accruals is shown in Fig. 2

WorldCom manipulated the process of adjusting accruals in three ways.

- a. Released accruals without apparent analysis of the accrual account.
- b. It did not release the excess accruals in the period in which they were identified, but to keep them as reserve for bad period.
- c. Reduced reported line cost by releasing accruals that had been reserved.

The identified inappropriate accrual releases that served to reduce line costs and increase reported pre-tax income has a total of approximately \$3.3 billion over a two-year period. (See Table 2)

3. Capitalization of Line Costs

From the first quarter of 2001 through the first quarter of 2002, WorldCom improperly capitalized approximately \$3.5 billion of operating line costs in violation of well-established accounting standards and WorldCom's own capitalization policy. The amount of reduction to line cost by capitalization is shown in Table 3.

Reviewing the income statement of WorldCom for 99 to 2002, and adding up the reduced line cost, we found the real line cost increased a lot in 2000 and 2001.

	1999	2000	2001
Line cost	\$14,980,000,000	\$18,332,000,000	\$17,802,000,000

The increased line cost lies in the long-term, fixed-rate leases for network capacity WorldCom initiated in order to meet the anticipated increase in customer demand. And as later the demand was not as expected, the Company has to pay for the leases that were substantially underutilized to avoid punitive termination provisions.

The line costs that WorldCom capitalized were ongoing, operating expenses that accounting rules required WorldCom to recognize immediately. Instead of expense the cost currently, WorldCom capitalized it to exaggerate its pre-tax income. (See Fig. 4)

Table 4 indicates the accounting numbers before and after WorldCom's reduction of line cost. From the table we can see that the operating performance ratios (Gross Margin, Profit Margin and ROA etc) are decreased after we add the reduced line cost back to the reported numbers and line cost E/R ratio is getting bigger, hardly to keep at 42% level.

Revenue inflation

Between 1999 and the third quarter of 2001, WorldCom manufactured sustained and often impressive revenue growth through improper accounting adjustments and entries. The identified amount of improperly recorded revenue between the first quarter of 1999 and the first quarter of 2002 is \$958 million. (See Table 5)

Another \$1.107 billion of revenue items recorded during this period has been found questionable, based on the circumstances in which they were recorded and the lack of available or adequate support. Total amount is \$2.065 billion.

1. Revenue management mechanism in WorldCom

WorldCom measured and monitored revenue performance using MonRev, a comprehensive, monthly revenue report prepared and distributed by the Revenue Accounting group.

We abstracted the mechanism of MonRev in Fig.5. An important part of it is Corporation Unallocated schedule. The original purpose of this schedule was apparently to reflect certain items for which no individual sales channel was entitled to credit: for example, revenues from the sale of a corporate asset, or a change of accounting policy for a particular contract.

Why pay attention to Corporation Unallocated?

- a. Most of the improper or questionable revenue entries identified were booked to the Corporate Unallocated revenue account.
- b. Those entries appeared only in quarter-ending month.

Without the amount from Corporate Unallocated, the revenue would change a lot. (See Fig. 5.) Most of the revenue boost was manufactured through following items.

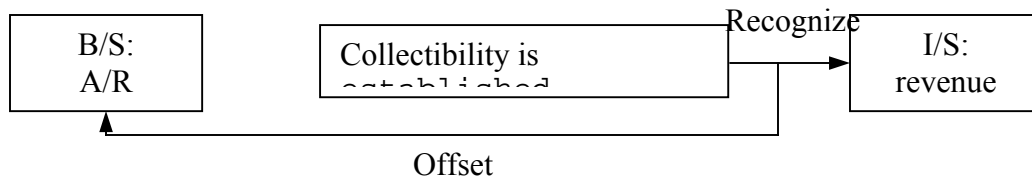
2. Specific revenue items

1). Minimum Deficiency reserves

WorldCom improperly booked approximately \$312 million in revenue associated with Minimum Deficiency charges between the fourth quarter of 1999 and the fourth quarter of 2001.

Minimum Deficiency charges arise from customer agreements that permit a telecommunications company to bill customers for usage amounts that fall below contractual minimum. Usually, those charges are rarely collected later.

When collectibility cannot be established with reasonable assurance, GAAP does not permit recognition of revenue. Before the first quarter of 2000, WorldCom process those accruals according to GAAP. But from the second quarter of 2000, they started to release the reserve to inflate revenue.

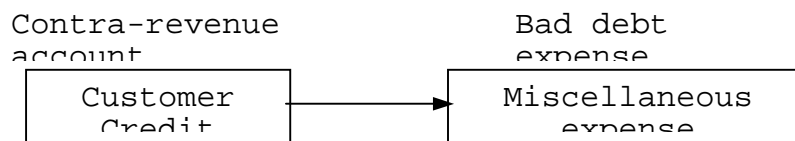


2). Customer Credits

Between the second quarter of 2001 and the first quarter of 2002, WorldCom improperly accounted for over \$215 million of credits that it had issued to telecommunications customers.

2 nd Q of 2001	3 rd Q of 2001	4 th Q of 2001	1 st Q of 2002
69	59	42	45

Normally, customer credits would be treated as discounts, rebates or adjustments. It should be reported as a reduction of revenue on the income statement. Prior to the second quarter of 2001, WorldCom generally appears to have recorded delayed customer credits as an offset to revenue, as required by GAAP. From second quarter of 2001, they started to move customer credit from the contra-revenue account (which reduced revenue) to a bad debt expense (which did not).



3) Early Termination Charges

Early Termination Charges are like Minimum Deficiency charges in that they are based on rarely enforced contractual provisions with customers. In the second quarter of 2001, WorldCom recognized \$22.8 million in revenue from Early Termination penalties billed on the last business day of the quarter, and recognized an additional \$7 million from these billings in the following quarter.

There are some other revenue problems such as some entries related to EDS and Qwest settlement.

Table 6 shows the difference between the accounting numbers before and after adjustment of the boosted revenue. Questionable revenue amount is not included. We found that the operating performance ratios are getting worse, but not so worse as compared to Table 4 which shows the adjustment for line cost. There're two reasons:

- a. The inflated revenue amount is much less than the reduced line cost amount;
- b. The focus for revenue boost is keep a double digit revenue growth rate, not other things while the focus of line cost reduction is to make operating performance better.

That's why in Table 7, when we combine the effect of line cost reduction and revenue inflation, a much more deterioration of the operation performance ratios and line cost E/R ratios show together.

Incentives For Management To Engage In Manipulation

As we know, managers like to manipulate earnings to achieve a variety of objectives, such as income smoothing, long-term bonus maximization, and avoidance of declines or losses in earnings to meet Wall Street expectations and boost its stock price. WorldCom is one of such examples. From the second quarter of 1999 through the first quarter of 2002, it improperly reduced its reported line costs (and increased pre-tax income) over \$7 billion totally.

Why corporate management engages in earnings manipulation? In our opinions, there are three main reasons.

- Management had a desire to conceal its poor performance. The fact is that in 1999, the company spent billions on expanding its systems and had incurred costs, but revenues did not grown thereafter.
- They paid too much attention to Wall Street to meet its expectations to maintain high stock value, which in return worked like a currency for acquisitions.
- Thirdly, management had generous stock options and would like to boost their compensations.

Warning Signs

Though they were not so obvious, there were some warning signs from the financial statements originally reported by WorldCom.

- Data in the income statement states that from 1999 to 2000, revenue increased from \$37,120 million to \$39,090 million, while cost of goods sold decreased from \$15,951 million to \$15,462 million.
- The gross margin increased 1 percent but COGS to sales ratio decreased 3 percent, and there is no evidence showing that corporate improved operation efficiency during that time, so it implied some improper adjustments on the cost of goods sold accounts.
- Meanwhile, the cash flow statement and balance sheet showed that, net income increased from \$4,013 million to \$4,153 million, and accounts receivable increased from \$5,746 million to \$6,815 million, while free cash flow decreased from \$2,289 million to the red flag of \$3,818 million. It implied some adjustments of accrual accounts or high amounts of bad debts.
- From 1998 to 2001, SG&A expenses increased from \$4,312 million to \$11,046 million, and SG&A to sales ratio increased 7 percent, which implied the high expense ratio due to the poor operating performance.

Consequences

Stock: WorldCom stock had fallen from a high of \$64.50 a share in mid-1999 to less than \$1 a share. While much and perhaps most of this decline might be attributed to the firm's changing economic prospects, the accounting maneuver described above is likely to have hurt investors who continued to hold the shares or even bought more in anticipation of a rebound.

Retirement: WorldCom employees who hold the company's stock in their retirement plans have also suffered losses. At the end of 2000, about 32%, or \$642.3 million, of WorldCom retirement funds were in company stock; those investment have fallen to less than 4%, or less than \$18.7 million, of the funds. WorldCom does not require employees to own company stock in their retirement plans, and they are permitted to sell the shares they do have.

Bankruptcy: WorldCom filed for Chapter 11 bankruptcy protection on July 21st, 2002 (The goal of a Chapter 11 bankruptcy is to keep the firm in business under a court-supervised rehabilitation plan.) While the company reported \$103.8 billion in assets as of the end of March 2002, it also has \$41 billion in debt on which it must make payments. The WorldCom bankruptcy is the largest in U.S. history. One factor affecting WorldCom's future is whether its customers switch to other telecommunications carriers. On July 1st, the Bush Administration announced that it was considering disqualifying WorldCom from further federal government contracts. (The Federal Aviation Administration has rejected WorldCom's bid to modernize its communications systems.) How bankruptcy would affect service to customers retaining WorldCom contracts is an issue the Federal Communications Commission is monitoring.

Layoff: After the June 25th announcement, WorldCom stated that it would cut 17,000 of its 85,000 employees.

New organization: July 29th, WorldCom named a new chief financial officer (John S. Dubel) and a chief restructuring officer (Gregory F. Rayburn). A committee was named to represent the company's creditors.

The Nasdaq stock market announced that it would delist WorldCom stock.

Fraud Charge: August 1st, Federal prosecutors charged Scott D. Sullivan (the former chief financial officer) and David F. Myers (the former controller) with securities fraud, conspiracy, and filing false statements with the SEC.

WorldCom Today

April 14, 2003, WorldCom, Inc. announced the appointment of Robert T. Blakely as its new CFO, a brand name change to MCI. By changing its name, WorldCom hopes to distance itself from its still-mounting accounting.

WorldCom has a new Board of Directors and a new Chief Executive Officer; and it has new outside auditors. With the participation of the Court-appointed Corporate Monitor, Richard C. Breeden, it has changed many of its compensation and other practices and all of its governance practices are currently under review.

August 27, 2003 Oklahoma Attorney General W.A. Drew Edmondson filed criminal fraud charges against WorldCom Inc. and six of its former executives, including former CEO and founder Bernard Ebbers.

Ebbers has been under investigation by federal officials for more than a year for WorldCom accounting fraud that allegedly totaled more than \$11 billion. But he hasn't been charged with any crimes.

The six former employees and WorldCom itself were charged with 15 counts of violating the Oklahoma Securities Act. All 15 counts are felonies, and each one is punishable by a maximum \$10,000 fine and 10 years in state prison.

Appendix:

Table 1: Improper Adjustments to Line Costs
(millions of dollars)

1Q99	2Q99	3Q99	4Q99	1Q00	2Q00	3Q00	4Q00	1Q01	2Q01	3Q01	4Q01	1Q02	Total
(41)	103	140	396	493	683	832	862	771	606	744	942	798	7,329

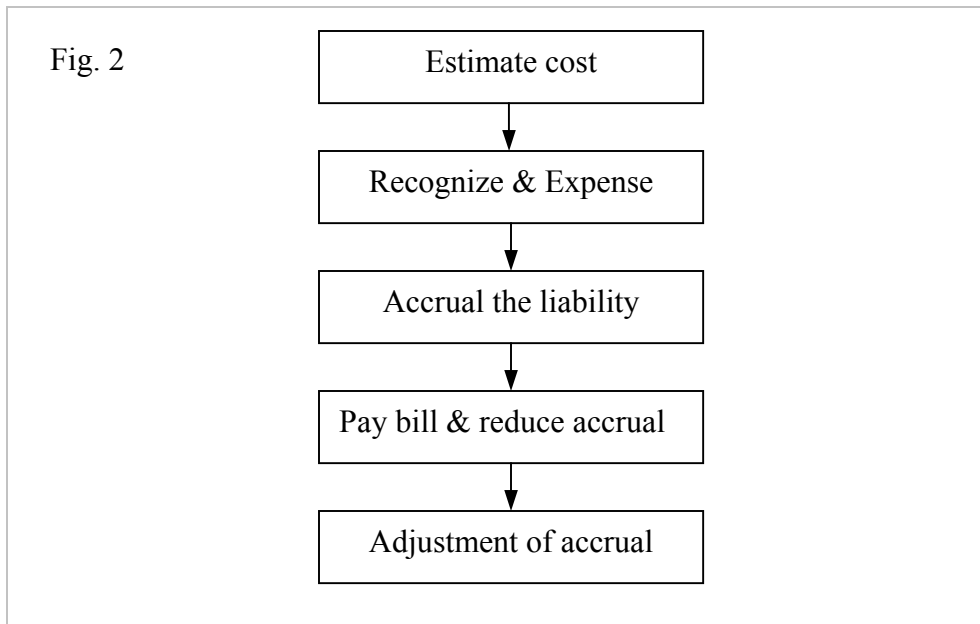
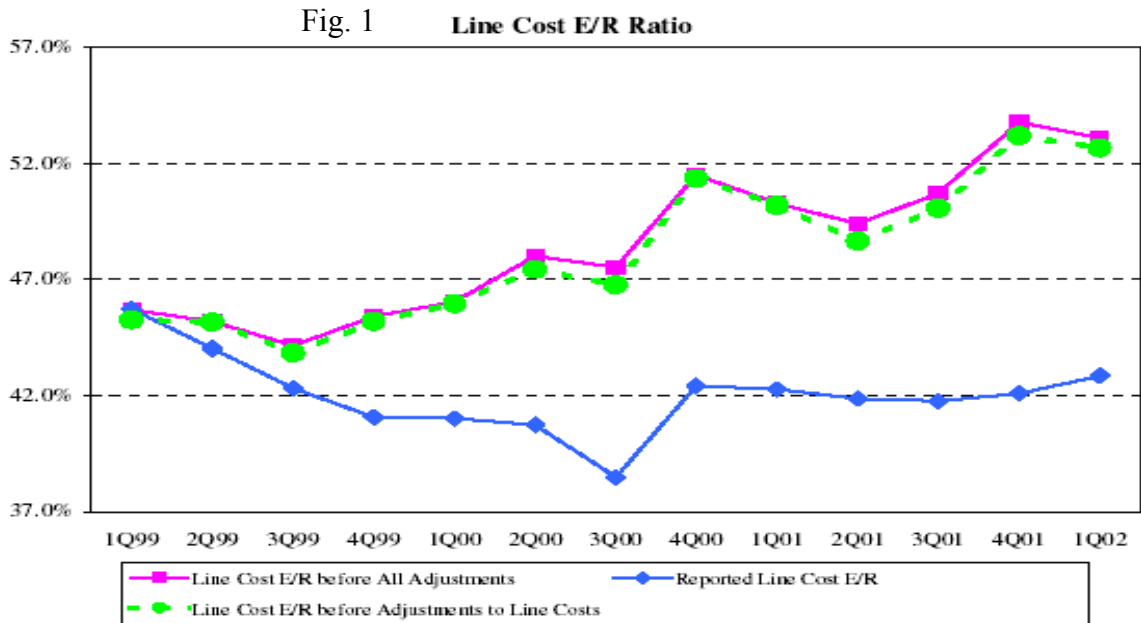


Table 2: Reductions to Line Costs from Accrual Releases
(millions of dollars)

<i>LineCosts</i>	2Q99	3Q99	4Q99	1Q00	2Q00	3Q00	4Q00	TOTAL
Domestic	40	100	90	89	305	828	477	1,929
International	--	31	239	370	374	--	170	1,184
UK	--	--	--	34	--	--	--	34
Other	--	--	--	--	--	--	150	150
Total	40	131	329	493	679	828	797	3,297

Table 3: Reductions to Line Costs by Capitalization and Other Adjustments
(millions of dollars)

	1Q01	2Q01	3Q01	4Q01	1Q02	Total
Capitalization	544	560	743	841	818	3,506
Other Adjustments	227	50	--	100	--	377
Total	771	610	743	941	818	3,883

Fig. 3

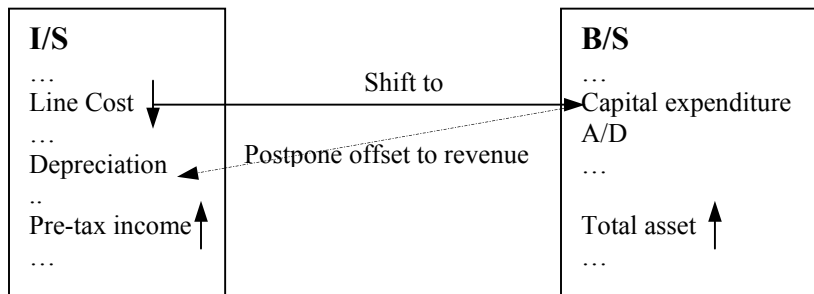


Table 4: Adjustment of financial data for line cost only:

	99	Adjusted	2000	Adjusted	2001	Adjusted	2002 1Q	Adjusted
Revenue	35,908	35,908	39,090	39,090	35,179	35,179	8,120	8,120
Line cost	14,739	15,337	15,462	18,332	14,739	17,802	3,479	4,277
Gross Profit	21,169	20,571	23,628	20,758	20,440	17,377	4,641	3,843
Operating income	7,888	7,290	8,153	5,283	3,514	451	843	45
Net Income	4,013	3,415	4,153	1,283	1,501	(1,562)	172	(626)
Asset	91,072	91,072	98,903	98,903	103,914	101,226	103,803	100,297
Gross Margin	59%	57%	60%	53%	58%	49%	57%	47.3%
Profit Margin	11%	9.5%	10.6%	3.3%	4.2%	(4.4%)	2.1%	(7.7%)
ROA	4.4%	3.7%	4.2%	1.3%	1.4%	(1.5%)	0.18%	(0.6%)
Line cost E/R	41%	42.7%	39.5%	47%	41.8%	50.6%	42.8%	52.6%

Table 5: Improper Revenue Entries

(millions of dollars)

1Q99	2Q99	3Q99	4Q99	1Q00	2Q00	3Q00	4Q00	1Q01	2Q01	3Q01	4Q01	1Q02	Total
85	5	65	50	19	121	161	27	17	132	117	92	67	958

Fig. 4

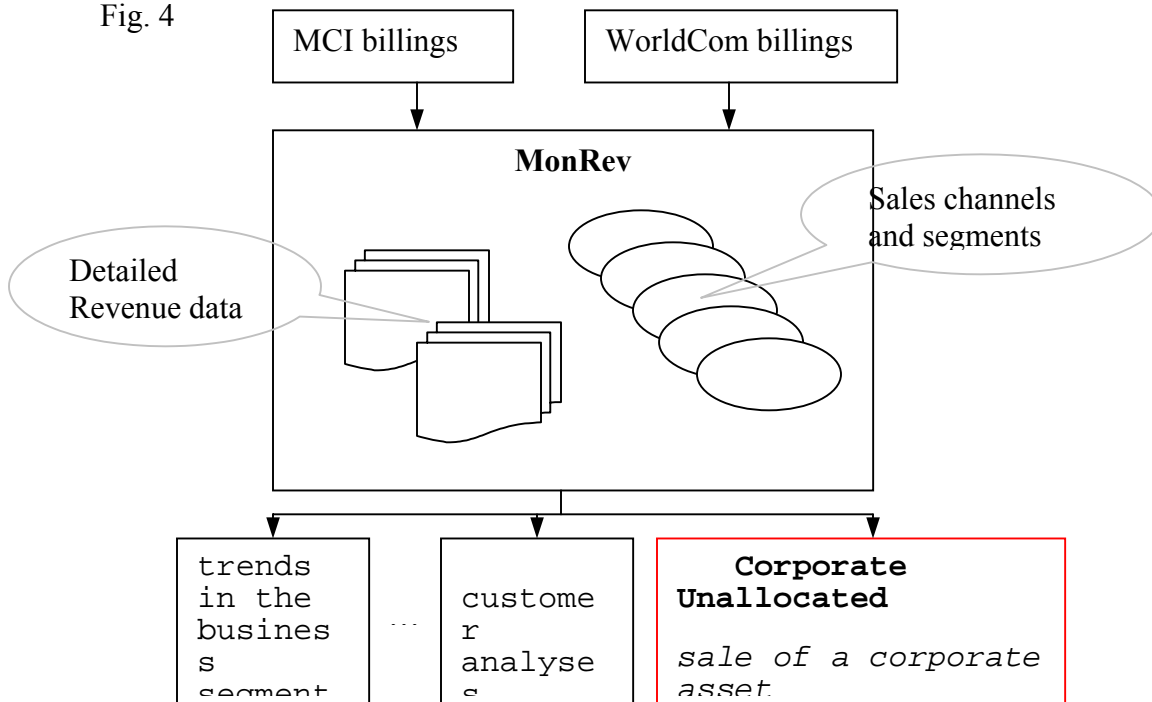


Fig. 5 WorldCom Revenue Growth (with and without Corporate Unallocated)

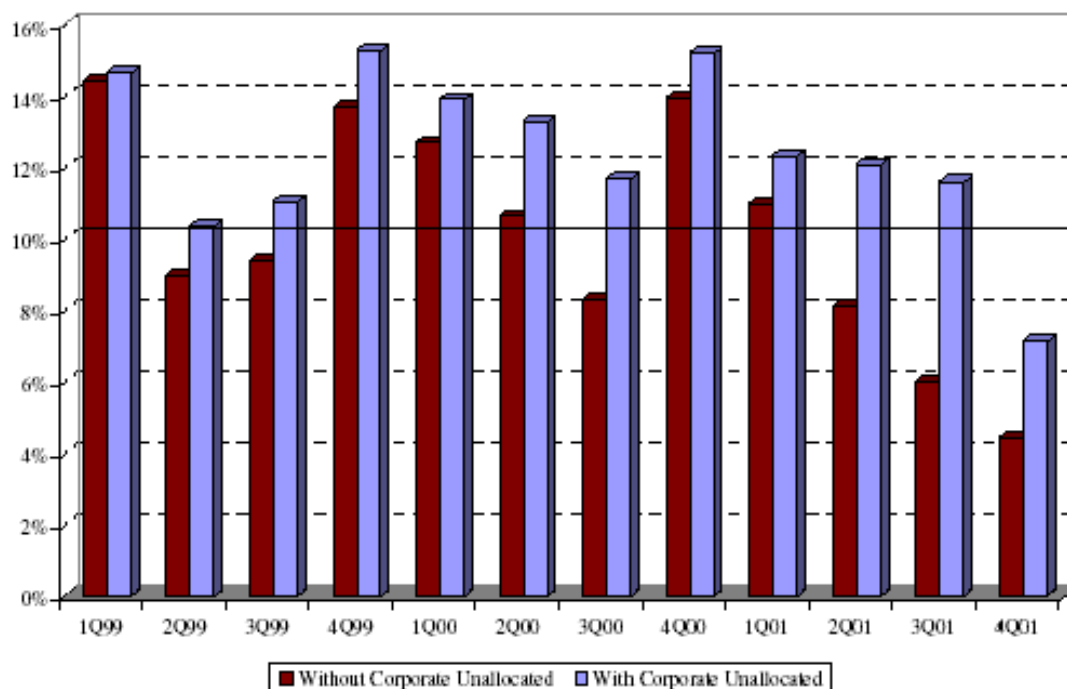


Table 6: Adjustment of financial data for revenue only

	99	Adjusted	2000	Adjusted	2001	Adjusted	2002 1Q	Adjusted
Revenue*	35,908	35,703	39,090	38,762	35,179	34,821	8,120	8,053
Line cost	14,739	14,739	15,462	15,462	14,739	14,739	3,479	3,479
Gross Profit	21,169	20,964	23,628	23,300	20,440	20,082	4,641	4,574
Net Income	4,013	3,808	4,153	3,825	1,501	1,313	172	150
Asset	91,072	91,072	98,903	98,903	103,914	103,914	103,803	103,803
Gross Margin	59%	58.7%	60%	60%	58%	57.6%	57%	56%
Profit Margin	11%	10.6%	10.6%	9.8%	4.2%	3.7%	2.1%	1.8%
ROA	4.4%	4.2%	4.2%	3.9%	1.4%	1.26%	0.18%	0.13%
E/R	41%	41.2%	39.5%	39.8%	41.8%	42.3%	42.8%	43.2%

*Questionable revenue inflation is not included.

Table 7: Adjustment of financial data for line cost and revenue

	99	Adjusted	2000	Adjusted	2001	Adjusted	2002 1Q	Adjusted
Revenue*	35,908	35,703	39,090	38,762	35,179	34,821	8,120	8,053
Line cost	14,739	15,337	15,462	18,332	14,739	17,802	3,479	4,277
Gross Profit	21,169	20,366	23,628	20,430	20,440	17,019	4,641	3,776
Net Income	4,013	3,210	4,153	955	1,501	(1750)	172	(648)
Asset	91,072	91,072	98,903	98,903	103,914	101,226	103,803	100,297
Gross Margin	59%	57%	60%	52.7%	58%	48.8%	57%	46.9%
Profit Margin	11%	8.9%	10.6%	2.5%	4.2%	(5%)	2.1%	(8%)
ROA	4.4%	3.5%	4.2%	1%	1.4%	(1.7%)	0.18%	(0.62%)
E/R	41%	42.9%	39.5%	47%	41.8%	51%	42.8%	53.1%

*Questionable revenue inflation is not included.