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Behind Closed Doors at WorldCom: 2001

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ABSTRACT: WorldCom was a large telecom company that enjoyed an almost meteoric rise during the 1990s but ran into trouble in the early 2000s. 2001 was particularly difficult. This case gives future generations of accountants the opportunity to study the largest accounting scandal in history from an internal financial accounting perspective. To the extent possible, this case uses the actual "voices" of participants to gain an understanding of their viewpoints and motives. We get a chance to see some participants at their best and others at their worst.

While our primary focus throughout this case is on the financial accounting issues, we also briefly touch on some of the safeguards available in preventing accounting fraud: internal controls, internal audit, external audit, and the Audit Committee. Throughout this case, you should ask yourself, "How would I respond if I were the corporate decision maker?"

INTRODUCTION

The year 2001 was a tumultuous time in the telecom industry. In the midst of the turbulence, WorldCom's Board of Directors explained in the "Report of Investigation" the market conditions existing in 2001:

> The number of competitive local telephone companies in operation dropped to 150 from 330 the previous year, and long distance carriers lost pricing power and market share to the regional Bell and other local telephone companies. Many companies had entered the market for Internet services in the late 1990s, and the resulting expansion in network capacity led to a glut in the market. (Beresford et al. 2003, 51)

At the same time, WorldCom's Chief Executive Officer, Bernard J. (Bernie) Ebbers, along with Mike Armstrong, Chief Executive Officer at AT&T, was at the top of *Fortune* magazine's list of "People to Watch 2001." This was true even though, according to *Fortune*, "Both run telecom companies with struggling consumer long-distance operations that are dragging down the company stock" (Birnbaum et al. 2001, 12). Unbeknownst to *Fortune*, there were other reasons to watch Bernie Ebbers and his management team that year ... like a hawk.

BACKGROUND

WorldCom Is an Important Company

John Sidgmore, then a top WorldCom executive, lauded his company's achievements to the Committee on Financial Services of the U.S. House of Representatives: "We play a vital role in

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America's telecommunications infrastructure:

- WorldCom is a strong, innovative company with tremendous assets. We have annual revenues of more than $30 billion, and even after our recent layoffs, we have more than 60,000 employees.
- WorldCom has more than 20 million customers. On the residential side, our MCI phone service handles 70 million phone calls *every weekend alone*. And, tens of thousands of businesses depend on our services to support their mission-critical applications.
- WorldCom is the largest Internet carrier in the world. Our operations provide Internet services to some 100 countries on six continents.
- WorldCom is a provider of network services for critical applications for the United States Government. These applications include the provision of customer service to 80 million Social Security beneficiaries, air traffic control applications for the Federal Aviation Administration, network management for the Department of Defense, and critical data network services for the U.S. Postal Service. In addition, WorldCom provides long distance voice and data communications services for the House, the Senate, and the General Accounting Office. Our company provides those same kinds of services for virtually every government agency ... In addition, WorldCom provides support for law enforcement and homeland security agencies, as well as agencies concerned with national security" (Sidgmore 2002).

"In other words," Sidgmore (2002) concluded, "WorldCom is a key component of our nation's economy and communications infrastructure."

CEO BERNIE EBBERS IS A SAVVY DEAL MAKER

Bernie Ebbers, though not the founder of WorldCom, was the major force in building LDDS, a small start-up company in Mississippi offering regional long distance discount service, into the self-proclaimed "pre-eminent" global communications company for the digital generation. In 1997, Ebbers made his intentions very clear when he told a *Fortune* reporter, "Our goal is not to capture market share or be global. Our goal is to be the No. 1 stock on Wall Street" (Charan et al. 2002). How? Ebbers was a powerful leader who was able to attract admirers to his Board of Directors and his management team, as well as stockholders, members of the investment community, and the press. He was a risk-seeking, free-spending, over-zealous, deal maker whose accomplishments gained him tremendous respect. Ebbers made as many acquisitions as he could, relying heavily on using WorldCom stock as currency. In all, he orchestrated mergers with 75 companies, including his largest, MCI. With so many acquisitions, Ebbers appeared to be on the right track, but making this many mergers succeed can also be difficult, to say the least.

WORLDCOM STRUGGLES TO INTEGRATE ALL THE MERGERS

The complexity of the unrelenting corporate reorganizations caused by the numerous acquisitions began to take a toll with regard to customer support. It seemed that WorldCom's desire to acquire new companies was greater than its ability to make existing acquisitions work. Some observers wondered if the skills that had served Ebbers so well in building up WorldCom would help him lead the Company through the tough telecom market of 2001 (Mehta 2001).

Pressure to Meet or Beat Analysts' Expectations

Because of Ebbers' goal to reach the top of Wall Street, there was an especially close connection between WorldCom and the stock market. The company outwardly appeared to be doing fine by meeting or beating analysts' forecasts. However, as Henry Schacht, Chairman of Lucent Technologies, stated in an unrelated interview with *Fortune,* "Stock price [should be] a byproduct; stock price [should not be] a driver" (Charan et al. 2002). It appeared that WorldCom's stock price was a byproduct of good business, but all was not as it appeared. James B. Comey of the United States District Court, Southern District of New York, has a special interest in the WorldCom case and explains market tensions at this point in time.

> [T]he management of many public companies provided "guidance" to the investing public regarding anticipated earnings for upcoming reporting periods. Relying in part on the company's "guidance," many professional securities analysts then disseminated to the public their own estimates of the company's expected performance. These "earnings estimates" or "analysts expectations" were closely followed by investors. Typically, if a company announced earnings that failed to meet or exceed analysts' expectations, the price of the company's securities declined ...
>
> Beginning at least in or about July 2000, WorldCom's expenses as a percentage of its total revenue began to increase, resulting in a decline in the rate of growth of WorldCom's earnings ... [T]he decline in earnings created a substantial risk that, unless WorldCom's performance improved, its earnings would fail to meet analysts' expectations and the market price of WorldCom's securities would therefore decline. (United States of America v. Scott D. Sullivan and Buford Yates, Jr. 2002, 6).

Thus, the pressure was on to keep WorldCom stock from declining further. This intense pressure came not just from external investors and analysts, but also from within WorldCom from the CEO himself, whose financial well-being was precariously dependent on WorldCom's stock price. CEO Ebbers pledged his vast holdings of WorldCom stock as collateral for loans to finance the purchase of his personal outside business interests. If WorldCom's stock price fell substantially, the collateral would be of insufficient value to secure his loans, thus forcing margin calls that he could not meet.

Another performance pressure came from the fact that WorldCom marketed itself as a high-growth company, with revenue growth playing a significant role in WorldCom's early success. Analysts marveled at WorldCom's ability to outgrow an industry that was, itself, outgrowing the overall economy. Ebbers repeatedly heralded the Company's impressive record on revenue growth during his quarterly conference calls with analysts. He believed that continuing revenue growth was crucial to increasing WorldCom's stock market value so the stock could be used as currency for corporate expansion through acquisitions. In addition, top executive compensation and bonuses were dependent on achieving a double-digit rate of revenue growth. Corporate performance just *had* to meet expectations. Miraculously, even as market conditions throughout the telecommunications industry deteriorated, WorldCom continued to post impressive revenue growth numbers.

Corporate Culture

WorldCom was managed in a rather autocratic fashion, led by two celebrated leaders: CEO Bernie Ebbers and CFO and CPA Scott Sullivan. Ebbers' celebrity has already been discussed. Scott Sullivan's celebrity was close behind; he had been referred to as a "whiz kid" and awarded a CFO Excellence Award by *CFO Magazine* in 1998. Sullivan also enjoyed a reputation of impeccable integrity. The two leaders' fame made it easy to follow their lead without question. Ebbers and Sullivan did create a corporate culture in which leaders and managers were not to be questioned or second-guessed. Kim Emigh, a former budget and financial analyst for WorldCom, reportedly witnessed first-hand the anger of executives when he questioned WorldCom practices (Reaves 2002, 4).

Loyalty was apparently well compensated, with select employees compensated beyond the guidelines of the company's approved salary and bonus schedules allowable for their positions. Ebbers and Sullivan frequently made the decision to grant excessive compensation, perhaps to ensure future employee loyalty. When top management requested compensation outside-of-policy guidelines, approval by the Human Resources Department was virtually assured.

Loyalty was also extended to both Ebbers and Sullivan by the Board of Directors. For example, at one point, Ebbers made a request of the Board that should have been denied, yet the Board granted approval without question. Why? The Board members say they were simply not willing to take the chance of confronting him (Beresford et al. 2003, 285). *BusinessWeek* suspects it was because Bernie Ebbers showered them with perks to win their devotion (Haddad 2002).

Apparently, loyalty to Ebbers, Sullivan, and others was needed at WorldCom to meet Ebbers' demands for results, especially to reach aggressive revenue-growth targets and line cost E/R (Expense/Revenue) targets (explained in a following section). Loyalty helps explain the fact that information at WorldCom was very closely guarded. Even some individuals with a need to know were denied full access to corporate information.

The Telecom Industry's "On-Net" and "Off-Net" Strategies

In the telecom industry, customer communications travel over networks that may or may not actually be owned by the company. Generally, WorldCom employed an "on-net" operating strategy to provide voice calls and data transmissions through its own proprietary communications networks and related facilities. In order to pursue this "on-net" strategy, WorldCom maintained extensive network facilities to connect metropolitan centers and various regions throughout the world. To serve customers that were not directly connected to its owned network, WorldCom paid fees to use or lease "off-net" facilities and connections from other telecommunication companies. The fees paid to use or lease facilities belonging to third parties are referred to as "line costs" or "telco" expenses. Thus, line costs are the costs of carrying a voice or data transmission through any portion of its path from its origin to its destination.

Since WorldCom's own network could not directly connect all potential phones and electronic devices in the world, WorldCom paid outside service providers to carry some portion of its calls. For example, a call from a WorldCom customer in Chicago to London might start on a local Chicago phone company's line, flow to WorldCom's own network, and then get passed to a British phone company to be completed. WorldCom would have to pay both the local Chicago phone company and the British provider for the use of their services. All of these costs are line costs.

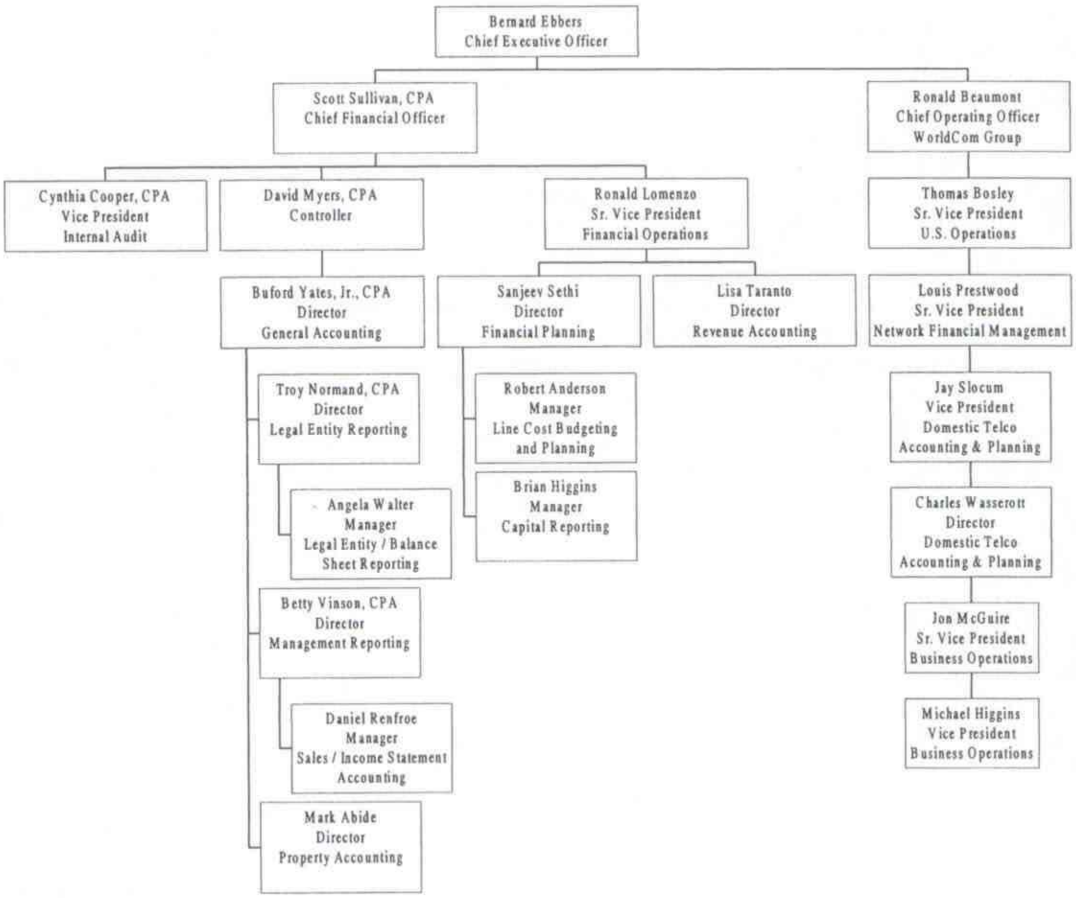
Managing line costs was tremendously important to WorldCom's profitability since they represented approximately half of the Company's total expenses. As a result, WorldCom's management and outside analysts paid significant attention to line cost ratios and trends. WorldCom regularly discussed its line costs in its public disclosures. For example, in its annual report from 2001, WorldCom said that "[t]he Company's goal is to manage transport costs through effective utilization of its network, favorable contracts with carriers and network efficiencies made possible as a result of the expansion of the Company's customer base by acquisition and internal growth," (Andersen, from WorldCom's 10-K405 for the period ending 12/31, 2002, 43).

WorldCom's key measure of line cost management—both internally and externally—was the ratio of line cost expense to revenue, called the "line cost E/R ratio." An increase in the line cost E/R ratio indicates deteriorating performance: either under-usage of leased capacity or overpayment for leased capacity. The Company's reported quarterly line cost E/R ratio hovered within an incredibly narrow range around 42 percent from late 1999 through early 2002, even though the period was an extremely volatile time for the telecom industry.

ACCOUNTING FUNCTIONS AT WORLDCOM

The corporate accounting function at WorldCom was led by CFO Scott Sullivan, who was located at WorldCom headquarters in Clinton, Mississippi. Under his direction were Cynthia Cooper, Vice President of Internal Audit; David Myers, Controller; and others. Buford Yates, Jr., worked for Myers as the Director of General Accounting. Reporting to him were Troy Normand, Betty Vinson, and Mark Abide. Figure 1 presents a partial organization chart of WorldCom during most of 2001 to help you follow the events and participants of this case.

FIGURE 1
Partial Organization Chart



Internal Audit

Bernie Ebbers was very interested in having employees add value to the corporate bottom line. As a consequence, the Internal Audit function at WorldCom justified its existence by concentrating on operational audits where the benefits of its work could be quantified. In fulfilling their oversight function of the company's operational and financial internal controls, they avoided working on financial audits that might overlap with the role of the external auditors on the grounds of cost-savings. Officially, Internal Audit held a dual-reporting role. Each year, Internal Audit presented its final report of completed projects for the year just ended along with its plan for proposed audit projects for the current year to the Audit Committee of WorldCom's Board of Directors for their discussion and approval. The rest of the year, they reported to Scott Sullivan, who controlled and directed their ongoing efforts and approved their promotions, salary increases, bonuses, stock options, and more. The "Second Interim Report of Dick Thornburgh, Bankruptcy Court Examiner," filed in the United States Bankruptcy Court, Southern District of New York on June 9, 2003, described the extent to which management directed Internal Audit's assignments (Thornburgh 2003).

> At times, Mr. Ebbers or Mr. Sullivan would assign "special projects" to the Internal Audit Department … [I]n the fall of 2000, Mr. Ebbers assigned to the Internal Audit Department responsibility for generating the ERP, which was a compilation of schedules and trend analyses for tracking orders, activations, disconnections, and cancellations received by the Company from its customers each month, and estimating the Company's revenues associated with those orders. The reporting package was purely operational in nature and had no audit purpose or use, but enabled senior Management, and Mr. Ebbers in particular, to track on a monthly basis increases or decreases in orders placed with the Company by its customers and potential swings in revenue associated with those orders.
>
> The production of the ERP was time-intensive, consuming most of the time of Internal Audit's staff for at least the first six months of its inception. This effort drained scarce departmental resources and delayed scheduled audits. Internal Audit's staff indicated that, at times, they would work on ERP during the day and stay late into the evening to perform the audit functions they were unable to perform during the day. The use of Internal Audit for the ERP was reportedly defended by Ms. Cooper to a complaining staff member as an important effort that added "value" to the Company, was in keeping with her department's consulting function within the Company, and could demonstrate to the Company's leadership the indispensability of the Internal Audit Department. (Thornburgh 2003, 189–190)

Consider the following paragraphs that are excerpted from the "Report of Investigation by the Special Investigative Committee of the Board of Directors of WorldCom Inc.," referred to as the Beresford Report (Beresford et al. 2003, 134–137).

Revenue Accounting

> Ebbers received Monthly Revenue ("MonRev") Reports—usually both the Preliminary and Final versions (as described further below)—from the Revenue Reporting and Accounting group (the "Revenue Accounting group") … Ebbers was involved in the annual revenue budget process, in which he insisted the budget reflect aggressive growth targets; we were told, for instance, that Ebbers approved WorldCom Group's 2001 annual budget only after it was set at close to 15 percent year-over-year growth. …
>
> The MonRev provided a revenue snapshot of the entire company for any given period. It took computer feeds from the MCI and WorldCom billing systems, and consolidated and organized them into a collection of schedules, broken down into the company's sales channels and segments. It included dozens of spreadsheets detailing revenue data from all of those channels and segments. It also compared those actual results with budgeted numbers. …
>
> The MonRev also contained an attachment detailing adjustments made at the corporate level—and generally not derived from operating activities of WorldCom's sales channels—known as the *Corporate Unallocated* schedule. Sullivan had ultimate responsibility for the items booked on the Corporate Unallocated schedule; however, the Revenue Accounting group, headed by [Ronald] Lomenzo, prepared the schedule and had principal responsibility for booking the entries that appeared on the schedule. …
>
> Distribution of the MonRev was limited and access to it was closely guarded; and this was even more so with the Corporate Unallocated schedule. These reports were prepared principally by Lomenzo's Senior Director of Revenue Reporting and Accounting, Lisa Taranto, and two people reporting to her. In addition to Ebbers and Sullivan, only a handful of employees outside the Revenue Accounting group regularly received the full MonRev. Most managers at WorldCom received only those portions of the MonRev that were deemed relevant to their position; sales channel managers, for instance, received only components of the MonRev that reflected their own sales channel revenue information. It was not uncommon for Sullivan and Lomenzo to deny requests for access to the full MonRev. Sullivan routinely reviewed the distribution list for the full MonRev to make sure he approved of everyone on the list.
>
> Access to the Corporate Unallocated schedule was restricted to Ebbers, Sullivan, and those directly involved in the revenue recording and reporting processes. When Jon McGuire, the Senior Vice President of Business Operations, sought portions of the MonRev in March 2001, Myers commented: "I can't imagine [Sullivan] will say anything other than provide everything but Corporate [Unallocated] and no one gets that regardless of who they are."

Further, from the Beresford Report (Beresford et al. 2003, 102–104):

Property Accounting

The Property Accounting group had responsibility for tracking WorldCom's assets, from office buildings to telephone switches to research computers. The group was charged with keeping an inventory of WorldCom's assets in use (called "in-service" assets) as well as building projects in the works (called "Construction in Progress"). ...

When WorldCom acquired an asset, whether a long distance cable or an office chair, Property Accounting recorded the asset in the Company's main accounting system and in a special database maintained in Tulsa, Oklahoma. The principal internal management report generated by Property Accounting on a monthly basis was called the "Property Plant and Equipment Rollforward," or "PP&E Rollforward." The PP&E Rollforward provided a monthly snapshot of the value of assets WorldCom owned broken down by the Company's lines of business and asset types. It also showed the level of activity during the month. The PP&E Rollforward tracked "additions" (purchase of assets), "retirements" (taking assets off the books), and "transfers" (moving assets into service from Construction in Progress). ...

Capital Reporting

Sanjeev Sethi, the Director of Financial Planning, was responsible for approving capital expenditures and reporting on WorldCom's capital spending by line of business and asset type. Sethi's group prepared weekly, monthly, and quarterly capital expenditure reports. Capital Reporting tracked capital spending in—and generated reports from—a special section of WorldCom's accounting system that drew information from, but was separate from, the general ledger. The monthly capital expenditure report was the most widely circulated. It was received by many senior executives, including Sullivan, Yates, Lomenzo, and engineers in charge of network operations. Although Ebbers had been removed from the distribution list by 2001, the manager who prepared and circulated the report understood that Ebbers continued to receive it through Sullivan. The Capital Reporting group maintained two versions of this report—one that reflected the line cost capitalization entries and one that did not. We were told that only the versions that did *not* include the [line cost] entries (described below) were widely distributed.

Capital Reporting also prepared a quarterly "capital expenditures press release highlights" sheet that became part of the document used by the Financial Reporting group to prepare WorldCom's public filings and by Sullivan in calls with analysts. Because the press release highlights broke capital spending down by the lines of business that WorldCom reported publicly, Capital Reporting was required to allocate the additions to capital expenditures from the "prepaid capacity" entries among those lines of business.

Given that the capital spending information used by Capital Reporting and Property Accounting came from different systems, those groups interacted regularly to make sure that their numbers agreed. The entries capitalizing line costs required coordination between Property Accounting and Capital Reporting. Employees in those two groups described regular conversations about the capitalization entries, which they called "non-cash adjustments." (Beresford et al. 2003, 102–104)

The Monthly Revenue Close Process

WorldCom maintained a fairly automated process for closing and consolidating operational revenue numbers. Four to five days after the end of the month, the billing platforms for both the MCI and WorldCom sides of the business were closed, and the revenue data from these feeds were forwarded to the Revenue Accounting group. By the tenth day after the end of the month, Revenue Accounting employees used this data to prepare a draft "Preliminary MonRev" for Lomenzo's review.

Lomenzo would then bring the draft Preliminary MonRev to Clinton, Mississippi for review with Sullivan. Lomenzo's monthly revenue close meetings with Sullivan typically lasted several hours. We were told that in 2001 Ebbers also attended portions of one or more of these revenue close meetings.

> In non-quarter-ending months, the meetings usually resulted in identifying a small number of follow-up items to be pursued with business units, after which the revenue numbers were closed and a Preliminary MonRev was distributed. The Revenue Accounting group would subsequently prepare a Final MonRev, to account for any additional adjustments. In non-quarter-ending months, the Final MonRev was usually similar, if not identical, to the Preliminary MonRev. To the extent that corporate adjustments were made to revenue in the Corporate Unallocated revenue account during these months, they tended to be relatively modest ... This was not the case in quarter-ending months (described below). (Beresford et al. 2003, 140–141)

MANAGING THE LINE COST E/R RATIO IN 2001

Line Cost Accruals

At the end of each month, WorldCom estimated the costs associated with using "off-net" facilities and connections. While some of the related bills may not have been received or paid for several months, WorldCom prepared an adjusting journal entry each month to recognize immediately the estimated cost as a period expense for financial reporting purposes. Until WorldCom paid the bills, the accrued amounts would remain in a liability account on its balance sheet. As bills arrived from the outside parties, sometimes many months later, WorldCom would pay them and reduce the previously established liability accordingly.

"Since accruals are based on estimates, they may require later adjustment." The Beresford Report explains:

> Line cost accrual estimates are very difficult to make with precision, especially for international service. For example, expenses for the use of lines, particularly those provided by foreign telecommunications companies, sometimes have to be estimated before the company establishes (or the relevant government agency sets) the per-minute rate for the use of those lines. Because accruals are estimates, a company must re-evaluate them periodically to see if they are at appropriate levels. If payments are running higher than the estimated amounts, the accruals should be increased. If they are lower, the accruals should be decreased. WorldCom routinely adjusted its accruals as it learned more about applicable charges it would expect. ...
>
> If an accrual is decreased (or *released*) because charges from service providers are lower than estimated, then the amount of the release is set off against reported line costs in the period when the release occurs. Thus, if an accrual of $100 million is established in the first quarter and $8 million of that amount is deemed excess, or is no longer needed, in the second quarter, then $8 million should be released in that second quarter, thereby reducing reported line costs by $8 million for that quarter. (Beresford et al. 2003, 68)

Given the significance of line costs to WorldCom's bottom line and Ebbers' public promise to manage those costs, WorldCom managers were regularly pressed to find ways to reduce line cost expenses. Senior management, including Ebbers, Beaumont, and Sullivan, assembled to discuss expense-related issues at quarterly line cost meetings. During these line cost meetings, participants discussed operational ideas for line cost reductions. As economic conditions worsened, the search for cost savings became more intense and Ebbers and Sullivan became agitated and raised their voices demanding improved margins.

Line Cost Accrual Release

In an early 2001 effort to reduce line costs, Sullivan directed General Accounting to reduce the Wireless division's expense for line costs by $150 million. When a General Accounting employee (either Director Buddy Yates or his subordinate Betty Vinson) called Delores DiCicco, Vice President of Wireless Finance, requesting her to reduce her line costs, she was surprised because there was no support for the entry. Even after both Yates and Vinson made several follow-up calls, asking her to make the journal entry following Sullivan's instructions, DiCicco firmly refused. In response, Sullivan told DiCicco that she should make the entry because she would eventually find $150 million in savings from disputed billings to WorldCom. Still refusing, she argued that she would not book the entry until she found the savings. As a consequence, the requested journal entry was prepared in General Accounting by Daniel Renfroe, a subordinate of Vinson. Apparently, it was not unusual for Renfroe to prepare large, round-dollar journal entries (Beresford et al. 2003, 84).

Wireless Accounting wondered if Renfroe's entry impacted one of the Company's state tax returns. When a Wireless employee emailed this question to Renfroe, he forwarded the email to his superior, Vinson, who forwarded it to her superior, Yates. Yates replied in writing to Walter Nagel, WorldCom's General Tax Counsel, instead of responding directly to Wireless Accounting. He explained to Nagel that the entry in question was one of the "I'll need to kill him if I tell him" variety. Yates continued, "Will you handle your end?" One of Nagel's subordinates reportedly handled the issue (Beresford et al. 2003, 19).

Capitalization of Line Costs

The sluggish revenue growth and excess "off-net" capacity pushed WorldCom's actual line cost E/R ratio up in late 2000 and early 2001. This development was alarming to senior management. Ebbers, Sullivan, and Beaumont put pressure on many groups responsible for WorldCom's network to reduce line costs. Accordingly, Sullivan and Myers challenged senior line cost managers to produce a plan that would get the line cost E/R ratio back to the level it had been in the first quarter of 2000 (which was 41 percent). One former executive reportedly described the pressure as "unbearable—greater than he had ever experienced in his fourteen years with the Company" (Beresford et al. 2003, 94).

About this time, the Company was considering capitalizing excess capacity costs that were not generating revenue. Their consideration came from a suggestion by Tony Minert in General Accounting who had been hired to analyze line costs and keep track of any fluctuations. Minert prepared a monthly Line Cost to Revenue report that matched revenues to line costs for the Company's domestic and international operations in the U.S., foreign operating companies, Internet unit, and other businesses. As the Beresford Report explains, "Myers and Yates instructed Minert to isolate corporate adjustments, such as accrual releases, in a separate line item on the report so that the Company's actual underlying operations—without corporate on-top improvements—could be analyzed and reviewed. About four months after Minert started the project, Myers instructed Minert to restrict distribution of the report to Myers and Yates" (Beresford et al. 2003, 103).

On March 5, 2001, Controller David Myers emailed WorldCom executive Tom Bosley, attaching a "gross margin analysis" to emphasize "the need for immediate attention to Telco and Margins." Myers explained, "As you can see, margins have declined significantly and your immediate attention is appreciated. We need to address this during the quarter and not at the end of the quarter." The email said that Bosley, Scott Sullivan, Bernard Ebbers, and Chief Operating Officer Ron Beaumont discussed the issue at a dinner prior to announcing WorldCom's previous quarter's results. Myers had received word from Sullivan that Bosley volunteered at that dinner to "do whatever necessary to get Telco/Margins back in line."

On March 6, Bosley replied to Myers, elucidating his intent: "Actually I asked Scott what numbers he wanted and I would see what could be done to get them." Bosley continued, "The first quarter is pretty well cast at this point but we will define what we can do to reverse the trend." Sullivan, meanwhile, had received a copy of the email from Myers to Bosley relating to Telco/Margins. He responded on March 6, 2001 to Myers in an email by saying, "Well the numbers are in your attached spreadsheet and [Bosley] needs to get to work now."

The Beresford Report (Beresford et al. 2003, 95–97) describes what occurred inside WorldCom's Accounting function that led to the capitalization of line costs:

> At a line cost meeting on March 20, Sullivan and Myers learned that the line cost E/R ratio had continued to increase despite their exhortations. A few days later, Sullivan wrote to Myers that the operating plan was "all about E/R and making sure the starting point is better than the fourth quarter on all counts other than depreciation and interest … This needs to get done ASAP. The numbers and the process need to be pushed."
>
> Employees in the Domestic Telco Accounting group considered the task of reducing the line cost E/R ratio to publicly reported levels in 2000 to be impossible, because 2000 results had been

accomplished by releasing accruals that the group no longer had available. The Domestic Telco Accounting group calculated that, in order to reach 41 percent line cost E/R ratio target, domestic line costs would have to be reduced by $1.5 billion and domestic Internet line costs by $700 million annually. Current and former employees assigned to create this plan told us that they viewed it as pure fantasy. Contemporaneous documents reflect that sentiment. Calling the plan "wildly optimistic," Bosley told his team:

> [A]s many of you know our line cost E/R is becoming a real problem for the company. In 2000, we had the luxury of releasing a substantial reserve, which both helped the company and lowered the effective E/R for the line cost. It is very important that we find a way to deliver the same or better E/R in 2001. While I know this means a dramatic reduction in our real line cost, I am convinced we can find a way to do this. (Beresford et al. 2003, 95–97)
> Beaumont wrote Myers that returning to an early 2000 line cost E/R ratio was unlikely as '[t]he questions get down to one issue—last year we released a good deal of reserves that we don't have this year to release. Are we asking … to get back to early 2000 E/R on an adjusted or nonadjusted basis?' Myers responded that Beaumont was "correct, there are no reserves to take" but they nevertheless needed "to create a plan which demonstrates ways to eliminate costs from our networks." He emphasized that "[w]e need to get back to Q1 2000 after adjustments. Said differently, the target is externally reported E/R at Q1 2000."
> Before the close of the first quarter, the senior line cost managers worked with their teams to identify costly areas of excess capacity. They came up with several items under what they labeled the "Deferred Telco/Line Cost Analysis." The total amount of "deferral opportunities" was about $971 million over all four quarters in 2001. Although several employees involved in collecting the information told us that they thought they were only identifying line costs that could be eliminated, others said they understood Sullivan and Myers wanted to identify the costs of excess capacity so that these expenses could be deferred into the future, when they would produce revenue. Employees considered many of the items to be aggressive opportunities that would have required the Company to incur such substantial penalties to break contracts, and leases that any real savings was unlikely. As the date for the Company to release earnings for the first quarter of 2001 approached, it became apparent that a plan to return to a 1Q00 line cost E/R ratio of 41 percent was not possible. In fact, at the point the projected line cost E/R ratio for the quarter was approximately 50 percent. On April 17, Bosley complained to other senior managers that "we have squeezed this as radically as possible. Looks like David [Myers] is still on the same kick regarding 1Q00. We cannot get there by only screwing down the operational plan." On the same day, he informed Beaumont that his group "turned over all the rocks" and "[w]e have not uncovered the solution that gets us to the 1Q2000 number David [Myers] is looking for."

Although no solution could be found on April 17, "whiz kid" Sullivan had found the support he needed for his decision to capitalize excess line capacity costs and bring reported line cost E/R to 42 percent. He documented his rationale in a report to the Board of Directors on June 24, 2002 referred to as the "White Paper."

Sullivan explained that management felt it was important for the Company to "have the ability to enter the market quickly, and offer the best network to our customers with very little provisioning time" (Sullivan 2002). As a result, WorldCom "significantly increased its capital investment based upon the common belief at the time that the Internet and data demand would continue at the 8 times annual growth factor the industry was experiencing. It was this growth that supported the Company's goal of maintaining a strong double-digit growth rate while expanding margins from using its own facilities." Sullivan's (2002) White Paper, in paragraphs five through nine, continued:

> Additionally, the Company also entered into various network leases to complement the service offerings for data, Internet, and local service. The lease commitments were entered into to obtain access to large amounts of capacity under the theory that revenue would follow and fully absorb these costs and to expedite "time to market" … The commitments were entered into with the knowledge that we would incur an expense prematurely and the revenues would be earned subsequent to that date. The Company was willing to absorb this cost prior to recognizing the

> revenue stream because it believed that the future revenues would be matched up with these costs. These commitments were entered into as the result of customers for which services would be rendered and the lease commitments were entered into to expedite the customer provisioning and revenue stream in accordance with SAB 101, and as further supplemented by FASB 91, direct and indirect costs associated with obtaining a customer may be deferred and amortized over the revenue stream associated with that contract.
>
> Subsequent to the asset being put into service, the Company continued to incur costs associated with network lease commitments as noted above. The portion of these commitments that were not being utilized was deferred until the related benefit (i.e., revenues) was generated. At the time of the cost deferral, management had determined that future economic benefit would be derived from these contractual commitments as the revenues from these service offerings reached projected levels.
>
> At that time, management fully believed that the projected revenue increases would more than offset the future lease commitments and deferred costs under the agreements. Therefore, the cost deferrals for the unutilized portion of the contract were considered to be an appropriate inventory of this capacity and would ultimately be fully amortized prior to the termination of the contractual commitment.
>
> The classification of these costs as an asset does not contradict the definition of an asset in FASB Concept Statement No 6. "Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." (FASB Concept No. 6, para. 25)
>
> At all times, management understood that an expense or loss would be recognized upon evidence that previously recognized future economic benefits of an asset would not ultimately be realized.

Thus, WorldCom began to capitalize "line costs" as *prepaid capacity*.

Internal control correspondence documenting a meeting of Troy Normand with Cynthia Cooper and Glyn Smith on June 24, 2002 regarding the capital expenditures explains: Troy Normand, an employee in General Accounting, felt uncomfortable with this accounting treatment, believing that even considering capitalizing prepaid capacity was "wrong and beyond aggressive accounting" (Cooper 2002). Normand brought his concerns to Sullivan who explained the business rationale behind the entries, saying that these things were occurring to "bring the cost structure down." As the meeting came to a close, Sullivan assured Normand that everything would be okay. As the two parted ways, Normand said nothing more, not knowing enough to refute Sullivan's explanation.

Later, Normand shared his concerns with David Myers, WorldCom Senior Vice President and Controller, who reported directly to Sullivan. This was after he spoke to two colleagues at WorldCom: his direct superior, Buddy Yates, the Director of General Accounting, and a co-worker, Betty Vinson, also in General Accounting. All three expressed concern over the prepaid entries. Yates skeptically stated, "I might be narrow-minded, but I can't see a logical path for capitalizing excess capacity" (Beresford et al. 2003, 99).

Normand wanted to resign, but did not have another job available. Despite his concern, he did nothing to communicate the issue regarding prepaid accruals or other aggressive accounting maneuvers to either internal or external auditors because he was concerned for his job and had a family to support. Similarly, David Myers also did nothing to stop the capitalization of line costs despite the fact that he, too, felt uncomfortable with these entries. To the contrary, he seemed to encourage the questionable accounting treatment of "line costs," or "telco" expenses.

The Beresford Report describes what happens next:

> [O]n April 17, 2001, operating managers had concluded they could not reduce line costs enough to bring the line cost E/R ratio for the first quarter of 2001 down to 2000 levels. On Friday, April 20, Yates sent an email (copied to Myers) to Sethi and Robert Anderson saying that "[w]e will have an on top telco adjustment ready for posting this morning, which will need to be pushed down to each tracker/segment." Myers also went to Sethi's office and told him that a corporate

adjustment would be made to increase capital expenditures for the first quarter. Myers requested that Capital Reporting adjust the capital expenditure press release highlights accordingly.

By April 20, Troy Normand, a Director in General Accounting, told Angela Walter, a manager in that department, to book an entry that would reduce line costs by $771 million and increase two asset accounts by that total amount—$629 million into Other Long-Term Assets and $142 million into Construction in Progress. Normand gave Walter a one-page document titled "March 2001 Adjustments" that provided the amounts and account numbers, but he did not provide any other support or explanation for the entry. Walter prepared a journal entry based on Normand's instructions and referred to the amounts being transferred as "Prepaid Capacity Costs," the term used in the document provided by Normand. She booked the entries on Friday, April 20. She did not have any concerns with this entry at the time. Indeed, Walter often booked entries in amounts between $500 million and $1 billion without any detailed support, and often received instructions from Normand in the form of the March 2001 Adjustments schedule.

The placement of $629 million of line costs into Other Long-Term Assets was only temporary. In response to a question by Walter, Normand explained that they were just "parking" line costs in the Other Long-Term Assets account until they figured out what to do with them. Over the course of April 23 and 24, Walter, on Normand's instruction, transferred $402 million of the $629 million from Other Long-Term Assets to the Construction in Progress asset account, bringing the total corporate adjustment moved into Construction in Progress to $544 million. The remaining $227 million of the $629 million temporarily moved into Other Long-Term Assets was offset by an accrual release from an account for Ocean Cable Liability ... The final result was that of the $771 million reduction in line costs, $544 million was … capitalized in the Construction in Progress asset account.

Both Property Accounting and Capital Reporting had to make adjustments to maintain consistency with the increase in capital expenditures. In Property Accounting, a staff accountant, upon noticing the adjustments to Construction in Progress, asked her supervisor, Mark Abide, how to treat the "prepaid capacity" entry on the PP&E Rollforward. Abide told her to code the adjustment as a "capex addition," meaning a new capital project or addition for WorldCom. We were told that the instruction to code the prepaid capacity adjustments as "capex additions" came to Property Accounting from Myers. When the capitalized line costs found their new homes, Property Accounting made the necessary adjustments to the PP&E Rollforward.

The initial capital expenditures press release highlights produced by Sethi's Capital Reporting group did not include the newly transferred capitalized line costs. Sullivan and Myers received the preadjustment version of the highlights, as did a number of others. Sullivan noticed the "error" in these numbers, and had his administrative assistant alert Myers, who in turn asked Sethi to make sure he was using the latest capitalization number. The highlights were updated through several iterations as the capitalization entries moved among asset accounts. Ultimately, Capital Reporting included the $544 million "prepaid capacity" adjustment in an updated version of the press release highlights and distributed it for use by Financial Reporting and Investor Relations for public disclosures. It is not clear that the Financial Reporting and Investor Relations recipients understood the significance of the increase in capital expenditures.

WorldCom issued its first quarter 2001 results press release on April 26. In the analyst call, Sullivan reported that "capital expenditures were $2.1 billion," a total that included that $544 million capitalization of line costs. He detailed how much was being spent in specific areas, and the numbers he used reflected apparently arbitrary allocations of the prepaid capacity adjustment to various lines of business. Moreover, both the release and the quarterly report stated that WorldCom had $2.235 billion in capital expenditures instead of the $1.691 billion it actually spent. The earnings press release, as well as the quarterly report filed by WorldCom, reported $4.108 billion in line costs, which reflected the $771 million reduction in line costs, resulting in a line cost E/R ratio of 42% rather than 50%. (Beresford et al. 2003, 105–108)

Revenue Accounting's "Close the Gap" Exercise

As previously mentioned, senior WorldCom management was intensely focused on achieving double-digit revenue growth. Perhaps because of their demands to meet Ebbers' aggressive targets, the process of closing the Company's revenue numbers at quarter end was much different than that described for non-quarter-ending months. In quarter-ending months, the Final MonRev numbers were more similar to the Budgeted MonRev numbers than the Preliminary MonRev numbers, with most of the adjustments (in millions or tens of millions of dollars) being booked to the Corporate Unallocated revenue account, separate from revenues recorded in the operating activities of WorldCom's sales channels.

WorldCom's business Operations and Revenue Accounting groups tracked the shortfall between projected and budgeted revenue in an exercise called "Close the Gap." The purpose of this exercise was to keep a running tally of accounting "opportunities" that could be exploited to makeup the shortfall. As the Beresford Report describes, "What emerged was a coordinated and institutionalized process in which 'opportunities' were identified, measured and booked in the amount needed to hit the Company's external growth projections" (Beresford et al. 2003, 141). The Beresford Report continues on page 150:

> Ebbers, along with Sullivan, was aware of the use of nonrecurring items to increase reported revenues. Eventually, Sullivan apparently became concerned because a number of the revenue items they were recording were masking operating results. Sullivan's description of the situation survives in a voicemail he left for Ebbers on June 19, 2001 … as the second quarter was coming to a close:
>
> > Hey Bernie, it's Scott. This MonRev just keeps getting worse and worse. The copy, um the latest copy that you and I have already has accounting fluff in it … all one time stuff or junk that's already in the numbers. With the numbers being, you know, off as far as they were, I didn't think that this stuff was already in there … We are going to dig ourselves into a huge hole because year to date it's disguising what is going on on the recurring, uh, service side of the business …

Ebbers himself sent a memorandum to WorldCom's Chief Operating Officer, Ron Beaumont, some three weeks later directing him to "see where we stand on those one-time events that had to happen in order for us to have a chance to make our numbers …"

Nonetheless, in this quarter—as in other quarters in which the same process occurred—Ebbers did not give any indication in his comments to the market, nor did the Company in its earnings release or in any other public filings, that WorldCom was using nonrecurring revenue items, much less what his Chief Financial Officer called "accounting fluff" and "junk," to "make our numbers" (Beresford et al. 2003, 15).

A WorldCom contract with Electronic Data Systems provides one of these "Close the Gap" opportunities (Beresford et al. 2003, 169–174):

> On October 22, 1999, WorldCom signed a substantial exchange-of-services contract with Electronic Data Systems Corporation ("EDS"), which in part bound EDS to outsource its network and communication services to WorldCom over an eleven-year period, the usage of which was valued to WorldCom at approximately $6 billion. This contract proved to be the source for several Close the Gap opportunities. Under the terms of the contract, EDS agreed to minimum commitments for such outsourcing services, including an agreement on penalty payments if EDS failed to meet these required minimums on an annual basis (called "Take or Pay" minimums by Business Operations employees), or cumulatively measured at the end of five-year, eight-year, and eleven-year periods. …
>
> In the second quarter of 2001, as Business Operations employees searched for revenue opportunities to close the gap, they began to focus on the EDS Ratable Accrual. By mid-June 2001, internal forecasts were showing that EDS would again [for the second year in a row] fall short of its annual Take or Pay commitment. Under the terms of the contract, if EDS continued on this trend over the next several years, Business Operations was forecasting that it was likely EDS would miss the five-year minimum commitment, and would therefore be required to refund the $100 million prepayment starting in 2005.
>
> The EDS Ratable Accrual was teed up as a revenue opportunity for the first time in mid-June 2001. On June 14, Myers emailed Sullivan and Lomenzo a presentation prepared by the Business

Operations group entitled "Revenue Opportunity Discussions," pointing out that they should "pay attention" to the discussion of a new revenue opportunity involving the EDS contract. The Business Operations group proposed that WorldCom could begin *immediately* recognizing revenue for the payments EDS might be obligated to make starting in 2005 if EDS were to fall short of its five-year commitment; the proposal also suggested that WorldCom post a "catch up" entry in the second quarter of 2001 for revenue it could have recognized in prior quarters under the same theory. In total, the opportunity was valued at $30 million in the second quarter, and $5 million in each subsequent quarter. Myers noted his initial reservations, suggesting that "it is pretty soft" and that he would have to re-examine the accounting of the prepayment to EDS "to see if this is even an option."

On June 21, 2001, Sullivan, Myers, Lomenzo, McGuire, and M. Higgins met to discuss the May MonRev results. McGuire and M. Higgins again raised the EDS Ratable Accrual as a Close the Gap item for the second quarter of 2001. Sullivan appears not to have reached a decision on this item at the meeting. On June 25, McGuire emailed Sullivan (copying Myers, M. Higgins, and Lomenzo), again describing the EDS revenue opportunity, and stating that he "wanted to make sure [Sullivan was] aware of the action that we expected to take in June."

Later that day, Sullivan responded by email that booking revenue on the EDS Ratable Accrual was not appropriate: "I do not think it is legitimate. Unlike the take or pay commitment, I believe this looks like a contingent asset and cannot be recorded until the final legal settlement." ...

Although not booked in the second quarter, the EDS Ratable Accrual was recorded as revenue in the third quarter of 2001. By mid-September 2001, Business Operations was again forecasting a significant gap between operational and targeted revenue results. On September 11, 2001, when Business Operations employees met with Sullivan to begin discussions on accounting "Opportunities" to Close the Gap, the first item on their list was the EDS Ratable Accrual. By September 24, 2001, when Business Operations employees presented their Close the Gap analysis to Ebbers, the EDS Ratable Accrual was highlighted as an "identified" opportunity. By early October 2001, the EDS Ratable Accrual was a fixture on the Close the Gap analyses. We were told that Sullivan provided Lomenzo with booking instructions at third quarter revenue close meeting in October, and the Revenue Accounting group recorded a $35 million EDS Ratable Accrual item to the Corporate Unallocated revenue account for September 2001. WorldCom continued to record EDS Ratable Accrual revenue, at a rate of $5 million per quarter, in the fourth quarter of 2001 and the first quarter of 2002.

ARTHUR ANDERSEN'S AUDIT OF 2001

The 2001 audit process was similar to previous years despite the ominous cloud that hung over WorldCom's auditor, Arthur Andersen. Concerns had been mounting since Andersen's indictment in the wake of Enron's collapse.

Andersen recognized that WorldCom was a "maximum risk." Based on their own audit work papers, Andersen noted that WorldCom had "misapplied GAAP with respect to certain investments" (Thornburgh 2002, 50). The independent auditors also wrote that "in the past, we have noted situations where management had taken aggressive accounting positions" (Thornburgh 2002, 51).

Audit Committee Meeting, February 6, 2002

Despite having some serious concerns, the Auditors' Report to the Audit Committee of the Board of Directors of WorldCom in Clinton, Mississippi on February 6, 2002 shared none of these concerns. The audit work on the balance sheets and income statements was complete while work continued of the review of financial statement disclosures and other information to be included in the WorldCom Annual Report and Securities and Exchange Commission (SEC) filings. In its signed audit opinion for 2001, Andersen reported that the balance sheets and income statements "present fairly, in all material respects, the financial position of WorldCom ... in conformity with accounting principles generally accepted in the United States" (Andersen, from WorldCom's 10-K405 for the period ending 12/31/2001).

In discussing significant accounting policies, Andersen's PowerPoint® presentation prepared for the Audit Committee reported, "There were no significant changes in accounting policies in the current year." Further, they noted, "no significant or unusual transactions, or material transactions in controversial or emerging areas for which there is lack of authoritative guidance or consensus" (Dick 2002, slide 4). In short, the WorldCom financials got a clean opinion.

Audit Committee Meeting, March 6, 2002

The final Andersen Audit Report was delivered as scheduled at the regular meeting of the Audit Committee of the Board of Directors of WorldCom, March 6, 2002 at 4:00 PM by Melvin Dick, Partner in Charge of the WorldCom Audit, along with Kenny Avery, also from Andersen.

The minutes of the regular meeting of the Audit Committee of the Board of Directors of WorldCom, Inc. record a discussion about the quality of WorldCom's accounting principles and underlying estimates in the financial statements. Judith Areen, a member of the WorldCom Audit Committee, asked a question that Warren Buffet had suggested. The question essentially was: "If Andersen had to prepare WorldCom's financial statements again, would they be prepared the same way?" Kenny Avery, representing Andersen, replied "Yes" (Bobbit 2002). So, despite internal concerns about WorldCom's accounting practices, Andersen plainly stated that everything was legitimate.

The Internal Audit Discussion was next on the agenda that day. Cynthia Cooper, Vice President of Internal Audit, gave a thorough presentation. First, Cooper discussed staffing changes. She reported that at least three internal audit positions would be lost in 2002: one from attrition and at least two would be provided a severance package. Board member Jim Allen asked if the Company should consider increasing the audit staff. Sullivan explained that Ebbers sought a 50 percent reduction in the internal audit staff compensation expense in order to save money, but had reluctantly accepted the current 10 percent reduction. The board had no further concerns.

Second, Cooper submitted the 2002 Proposed Internal Audit Plan for Audit Committee approval. The minutes reflect that "as in prior years, the scope of internal audit work focuses heavily on operational effectiveness and efficiency, systems and internal controls" (Bobbit 2002). The proposal was accepted without discussion.

Finally, the minutes reflect that Cooper reported on the 37 projects that were completed since January 1, 2001. The range of activities included primarily operational audits. The financial audits were rather limited in scope so as not to overlap with the work of the external auditors.

CASE QUESTIONS:

1. Two General Accounting employees—Dan Renfroe and Angela Walter—made journal entries in the amount of $150 million and $771 million, respectively, without detailed support. It was noted that this was not out of the ordinary at WorldCom. In your opinion, was this a proper accounting practice? Explain.
2. Based on GAAP, describe the propriety or impropriety of releasing of $150 million in line cost accruals in the Wireless division over Deloris DiCicco's objections. Support your position using the authoritative accounting literature.
3. On the topic of capitalizing line costs, critique the rationale included in CEO Scott Sullivan's White Paper. Based on your own analysis of GAAP, explain the propriety or impropriety of capitalizing line costs in the telecom industry.
4. Consider the journal entry that recognizes $35 million of revenue in 2001 from the EDS contract based on WorldCom's expectation that the five-year required cumulative minimum payment would not be met. Based on your own analysis of GAAP, explain the propriety or impropriety of this journal entry.
5. Why do you think the professionals in this case, most of whom were CPAs, would agree to record a material journal entry contrary to their best professional judgment?

6. In general, how does the role of Internal Auditing differ from the role of Independent (or External) Auditing? What is the role of Internal Auditing in a well-run corporation? When performed by internal auditors, what is a financial audit versus an operating audit? Do you think WorldCom's Internal Audit Department was functioning as it should have been? Explain.

CASE LEARNING OBJECTIVES AND IMPLEMENTATION GUIDANCE

This case was culled from hundreds of pages of now-public documents produced by the actual participants in this case: from the employees of WorldCom, from the Board of Directors of WorldCom, from the independent auditors of WorldCom, and from key investigators of WorldCom. We felt there was no better way to convey the participants' message and to raise our students' awareness of both positive and negative professional behavior than to use the participants' own words whenever possible.

We compiled this case for use in a junior-level intermediate accounting course. As such, this case focuses on the technical accounting issues relating to WorldCom's improper reduction of reported line costs; WorldCom's largest category of expenses and exaggeration of reported revenues. Hints as to the individual motivations that led to such disastrous results at WorldCom are also given. The role of internal auditing and a management control system are secondary foci. To date, we have used this case with intermediate accounting students. They responded to the case with overwhelming interest in the words of the participants. Some were in disbelief, and others were fascinated that the schemes were both so simple and also so potentially simple to detect. All were touched by the indictments, the guilty pleas, and the ruined lives resulting from the wrong decisions made by a few accountants with morally weak character.

We believe this case is best suited for use in either intermediate accounting or other financial accounting classes, with different aspects emphasized or reinforced in each. For those students who have already used the case in a financial accounting course, reuse to focus on internal auditing or the management control system would be beneficial to students. A third possible venue for this case is with M.B.A. students to: (1) illustrate the role of accountants, internal auditors, managers, external auditors, and the audit committee of a corporate board of directors to ensure the reliability of the financial statements; and (2) highlight the tremendous impact from the breakdown of these critically important corporate roles.

The WorldCom scandal has many more facets to it than we could present in a single case. The full scandal includes accounting and auditing issues, corporate governance issues, finance issues, management issues—all intensified by economic problems. The actual fraud spanned four years: 1999–2002, not just the few incidences that are the focus of this case. And the range of fraudulent activities extended beyond line cost under accrual, the improper capitalization of line cost expenses, over-recognition of revenue, and disclosure omissions. Income tax accruals, among others, were also manipulated. WorldCom's Board of Directors was far too passive. Management was not forthcoming with the independent auditors. Andersen auditors accepted much less than full cooperation from management and failed to communicate their serious concerns to the Audit Committee. Internal Audit was understaffed and distracted with special projects and operational audits. The formal and informal management control systems within WorldCom appeared to encourage blind loyalty from employees rather than adherence to professional standards and high ethical norms of behavior. With all this lack of proper oversight, WorldCom was led by a risk-seeking CEO who seemed to live for the next big deal. As acquisition opportunities dried up for the Company, WorldCom's CEO, Bernie Ebbers, turned to making personal business acquisitions. As the economy slumped, Ebbers caused the Company to take progressively riskier actions that ended, ultimately, in bankruptcy and scandal.

Our pedagogical intent in using this case is: (1) to ask students to compare their own interpretation of GAAP to Scott Sullivan's accounting treatment of line costs, (2) to encourage students to assume responsible roles as corporate accountants and auditors, and (3) to emphasize the point that an accountant's integrity is critically important throughout his or her career.

TEACHING NOTES

Teaching Notes are available through the American Accounting Association's electronic publications system at http://aaahq.org/ic/browse.htm. Full members can use their personalized usernames and passwords for entry into the system where the Teaching Notes can be reviewed and printed.

If you are a full member of AAA and have any trouble accessing this material, please contact the AAA headquarters office at office@aaahq.org or (941) 921-7747.

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