Case 4.6

WorldCom: A Focus on Line Cost Accruals

Synopsis

On June 25, 2002, WorldCom announced that it would be restating its financial statements for 2001 and the first quarter of 2002. On July 21, 2002, WorldCom announced that it had filed for bankruptcy. It was later revealed that WorldCom had likely engaged in improper accounting that took two major forms: the overstatement of revenue by at least $958 million and the understatement of line costs, its largest category of expenses, by over $7 billion. With Bernie Ebbers setting the tone of "hitting" the numbers at all costs, senior members of the corporate finance organization, led by CFO Scott Sullivan, directed the improper accounting.

Line Cost Expenses

WorldCom generally maintained its own lines for local service in heavily populated urban areas. However, it relied on non-WorldCom networks to complete most residential and commercial calls outside of these urban areas and paid the owners of the networks to use their services. For example, a call from a WorldCom customer in Boston to Rome might start on a local (Boston) phone company's line, flow to WorldCom's own network, and then get passed to an Italian phone company to be completed. In this example, WorldCom would have to pay both the local Boston phone company and the Italian provider for the use of their services.[239] The costs associated with carrying a voice call or data transmission from its starting point to its ending point were called *line cost expenses.*

Line cost expenses were WorldCom's largest single expense. They accounted for approximately half of the company's total expenses from 1999 to 2001. WorldCom regularly discussed its line cost expenses in public disclosures, emphasizing, in particular, its *line cost E/R ratio,* the ratio of line cost expense to revenue.[240]

GAAP for Line Costs

Under Generally Accepted Accounting Principles (GAAP), WorldCom was required to estimate its line costs each

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[239] Board of Directors' Special Investigative Committee Report, June 9, 2003, 58.

[240] Ibid., 58–59.

month and to expense the estimated cost immediately, even though many of these costs would be paid at a later date. To reflect an estimate of amounts that had not yet been paid, WorldCom would set up a liability account, known as an *accrual,* on its balance sheet. As the bills arrived from its outside parties, sometimes many months later, WorldCom would pay them and reduce the previously established accruals accordingly.[241]

Because accruals are estimates, a company was required under GAAP to reevaluate them periodically to see if they were stated at appropriate levels. If charges from service providers were lower than estimated, an accrual was "released." The amount of the release was set off against the reported line cost expenses in the period when the release occurred. For example, if an accrual of $500 million was established in the first quarter and $25 million of that amount was deemed excess or unnecessary in the second quarter, then $25 million should be released in that second quarter and, thus, result in reducing reported line cost expenses by $25 million.[242]

WorldCom's Line Cost Releases

Beginning in the second quarter of 1999, management started ordering several releases of line cost accruals, often without any underlying analysis to support the releases. When requests were met with resistance, management made the adjustments themselves. For example, in the second quarter of 2000, David Myers, a CPA who served as senior vice president and controller of WorldCom, requested that UUNET (a largely autonomous WorldCom subsidiary at the time) release $50 million in line cost accruals. UUNET's acting CFO David Schneeman asked that Myers explain the reasoning for the requested release, but Myers insisted that Schneeman book the entry without an explanation. When Schneeman refused, Myers wrote to him in an e-mail: "I guess the only way I am going to get this booked is to fly to DC and book it myself. Book it right now, I can't wait another minute." After Schneeman refused again, Betty Vinson in General Accounting allegedly completed Myers' request by making a "top-side" corporate-level adjusting journal entry releasing $50 million in UUNET accruals.[243]

In 2000, senior members of WorldCom's corporate finance organization allegedly directed a number of similar releases from accruals established for other reasons to offset domestic line cost expenses. For example, in the second

[241] Ibid., 62–63.

[242] Ibid., 63–64.

[243] Ibid., 83.

quarter of 2000, Senior Vice President and Controller David Myers asked Charles Wasserott, Director of Domestic Telco Accounting, to release $255 million in domestic line cost accruals to reduce domestic line cost expenses. Wasserott refused to release such a large amount. It later emerged that the entire $255 million used to reduce line cost expenses came, instead, from a release of a Mass Markets accrual related to WorldCom's Selling General & Administrative expenses.[244]

The largest of the releases of accruals from other areas to reduce line cost expenses occurred after the close of the third quarter of 2000. During this time, a number of entries were made to release various accruals that reduced domestic line cost expenses by $828 million.[245]

In addition to allegations that WorldCom's management released line cost accruals without proper support for doing so and released accruals that had been established for other purposes, there were also allegations that management often did not release certain line costs in the period in which they were identified. Rather, certain line cost accruals were kept as "rainy day" funds that could be released when management needed to improve reported results.[246]

Case Questions

1. Describe what is meant by "releasing" line costs. If you were working as an accountant for WorldCom and there was a legitimate basis to "release" certain line costs, what is the journal entry that would be required to "release" a line cost?
2. Please refer to Paragraphs #68–70 of PCAOB Auditing Standard No. 2. Identify one relevant financial statement assertion related to the line cost expenses account. Why is it relevant? Next, identify one relevant financial statement assertion related to the accrued line cost liability account. Why is it relevant?
3. As an auditor at WorldCom, what type of evidence would you want to examine to determine whether a company was inappropriately "releasing" line costs?
4. Please refer to Paragraph #25 of PCAOB Auditing Standard No. 2. This paragraph requires management to

[244] Ibid., 87–88.

[245] Ibid., 88–89.

[246] Ibid., 10.

design and implement controls to prevent, deter, and detect fraud. For WorldCom's line cost financial reporting process, please discuss an internal control activity that would help to prevent, detect, or deter fraud related to the "releasing" of line costs.