**WorldCom: The Expense Recognition Principle**

Synopsis On June 25, 2002, WorldCom announced that it would be restating its financial statements for 2001 and the first quarter of 2002. Less than one month later, 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. Several executives pled guilty to charges of fraud and were sentenced to prison terms, including CFO Scott Sullivan (five years) and Controller David Myers (one year and one day). Convicted of fraud in 2005, CEO Bernie Ebbers was the first to receive his prison sentence: 25 years. 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 these 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. 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. World- Com 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.2 GAAP for Line Costs Under Generally Accepted Accounting Principles (GAAP), WorldCom was required to estimate its line costs each month and to expense the estimated cost immediately, even though many of these costs would be paid later. 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.3 Because accruals are estimates, a company is required under GAAP to reevaluate them periodically to see if they have been stated at appropriate levels. If charges from service providers were lower than estimated, an accrual is “released.” The amount of the release is 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 un- necessary in the second quarter, then $25 million should be released in that second quarter, thus reducing reported line cost expenses by $25 million.4 WorldCom’s Line Cost Releases Beginning in the second quarter of 1999, management allegedly started ordering several releases of line cost accruals, often without any underlying analysis to sup- port the releases. When requests were met with resistance, management allegedly 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 World- Com, 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’s request by making a “top-side” corporate- level adjusting journal entry releasing $50 million in UUNET accruals.5

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 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.6 The largest release 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.7 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.

1. Consider the principles, assumptions, and constraints of Generally Accepted Accounting Principles (GAAP). Define the matching principle and explain why it is important to users of financial statements.

2. Based on the case information provided, describe specifically how World- Com violated the matching principle. In your description, please identify a journal entry that may have been used by WorldCom to commit the fraud.

 3. Consult Paragraph A5 (in Appendix A) of PCAOB Auditing Standard No. 5. Do you believe that WorldCom had established an effective system of internal control over financial reporting related to the line cost expense recorded in its financial statements? Why or why not?

 4. Consult Paragraphs 13–21 of PCAOB Auditing Standard No. 15. As an auditor at WorldCom, what type of evidence would you want to examine to determine whether the company was inappropriately releasing line costs? Please be specific.

5. Consult Paragraphs 1–2 of Ethics Rule 102 (ET 102). Next, consider the actions of David Schneeman and Charles Wasserott. Assuming that they were CPAs, do you believe that these employees should have recorded the journal entries as directed by Senior Vice President and Controller David Myers? Why or why not?