

Case 2.3

WorldCom: A Focus on Fraud and Inherent Risk Assessment

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 it had filed for bankruptcy. It was later revealed that WorldCom had 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.

Growth through Acquisitions

WorldCom evolved from a long-distance telephone provider named Long Distance Discount Services (LDDS), which had annual revenues of approximately \$1.5 billion by the end of 1993. LDDS connected calls between the local telephone company of a caller and the local telephone company of the call’s recipient by reselling long distance capacity it purchased from major long distance carriers (e.g., AT&T, MCI, and Sprint) on a wholesale basis.⁹² LDDS was renamed WorldCom in 1995.

A change in industry regulation was the primary catalyst for WorldCom’s growth. That is, the Telecommunications Act of 1996 allowed long-distance telephone service providers to enter the market for local telephone services and other telecommunications services, such as Internet related services. Like many players in the industry, WorldCom turned to acquisitions to expand into these markets.

WorldCom’s revenues grew rapidly as it embarked on these acquisitions. Between the first quarter of 1994 and the third quarter of 1999, WorldCom’s year-over-year revenue growth was over 50 percent in 16 of the 23 quarters;

⁹² Ibid., 44–45.

the growth rate was less than 20 percent in only 3 of the quarters. WorldCom's stock price experienced rapid growth as well, from \$8.17 at the beginning of January 1994 to \$47.91 at the end of September 1999 (adjusted for stock splits). Importantly, its stock performance exceeded those of its largest industry competitors, AT&T, and Sprint.⁹³

MFS and Subsidiary UUNET

In late 1996, WorldCom acquired MFS, which provided local telephone services, for \$12.4 billion. In that transaction, WorldCom also gained an important part of the Internet backbone through MFS's recently acquired subsidiary, UUNET.⁹⁴

Brooks Fiber Properties, CompuServe Corporation, and ANS Communications

In 1998, WorldCom purchased Brooks Fiber Properties for approximately \$2.0 billion and CompuServe Corporation and ANS Communications (a three-way transaction valued at approximately \$1.4 billion that included a five-year service commitment to America Online). Each of these companies expanded WorldCom's presence in the Internet arena.

MCI

In September 1998, WorldCom acquired MCI, using approximately 1.13 billion of its common shares and \$7.0 billion cash as consideration, for a total price approaching \$40 billion. MCI's annual revenues of \$19.7 billion in 1997 far exceeded WorldCom's 1997 annual revenues of \$7.4 billion. As a result of this merger, WorldCom became the second-largest telecommunications provider in the United States.

SkyTel Communications and Sprint

In October 1999, WorldCom purchased SkyTel Communications, adding wireless communications to its service offerings, for \$1.8 billion. A few days after its SkyTel acquisition, WorldCom announced that it would merge with Sprint in a deal valued at \$115 billion. In the proposed deal, WorldCom would gain Sprint's PCS wireless business, in addition to its long distance and local calling operations.⁹⁵

⁹³ Ibid., 48.

⁹⁴ Ibid., 46.

⁹⁵ Ibid., 47–48.

Challenges

By 2000, WorldCom started to face some difficult challenges. For starters, WorldCom faced fierce competition in its industry. In addition, WorldCom's proposed merger with Sprint failed to receive approval from the Antitrust Division of the United States Department of Justice. As a result, the companies officially terminated their merger discussions on July 13, 2000.⁹⁶

Although WorldCom's revenue continued to grow, its rate of growth slowed. On November 1, 2000, WorldCom announced the formation of two tracking stocks: one—called WorldCom Group—to capture the growth of its data business, and the other—called MCI—to capture the cash generation of its voice business, which experienced a lower growth rate. WorldCom also announced reduced expectations for revenue growth of the consolidated company, from its previous expectation of 12 percent to between 7 percent and 9 percent in the fourth quarter of 2000 and all of 2001. By the close of market on the day of its announcement, WorldCom's stock price had fallen by 20.3 percent, from \$23.75 on October 31, 2000, to \$18.94.⁹⁷

Industry conditions worsened in 2001. Both the local telephone services and Internet segments experienced downturns in demand. The impact of the downturn in the Internet segment was particularly severe because of the industry's increased investment in network capacity (supply). Many competitors found themselves mired in long-term contracts that they had entered into to obtain the capacity to meet anticipated customer demand. As the ratio of their expenses to revenues was increasing, industry revenues and stock prices plummeted. For example, the stock prices of WorldCom, AT&T, and Sprint each lost at least 75 percent of its share price value between January 2000 and June 25, 2002.⁹⁸

Case Questions

1. Based on your understanding of inherent risk assessment and the case information, please identify three specific factors about WorldCom's strategy within its industry that might cause you to elevate inherent risk.
2. Please consult Q39 and Q43 of the PCAOB Staff Questions & Answers (May 16, 2005). Comment about how

⁹⁶ Ibid., 48–49.

⁹⁷ Ibid., 50.

⁹⁸ Ibid., 51–55.

your understanding of the inherent risks identified at WorldCom (in Question #1) would influence the nature, timing, and extent of your audit work at WorldCom.

3. Please consult Paragraphs B1 and B6 in Appendix B of the Internal Control Standard. If you were conducting an internal control audit of WorldCom, comment about how WorldCom's acquisition strategy would impact the nature, timing, and extent of your audit work at WorldCom.
4. Based on your understanding of fraud risk assessment, what are the three conditions that are likely to be present when a fraud occurs? Based on the information provided in the case, which of these three conditions appears to be most prevalent, and why?