Case 3.6

WorldCom: A Focus on Internal Controls

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.

"Hit" the Numbers

Even as conditions in the telecommunications industry deteriorated in 2000 and 2001, WorldCom continued to post impressive revenue numbers. In April 2000, CEO Ebbers told analysts that he "remain[ed] comfortable with … 13.5 to 15.5 percent revenue growth in 2000." In February 2001, Ebbers again expressed confidence that WorldCom Group could repeat that performance: "On the WorldCom side of the business, we are sticking with our 12 percent to 15 percent revenue growth guidance for 2001. Let me restate that. On the WorldCom side of the business, we are sticking with our 12 percent to 15 percent revenue growth guidance for 2001."[165]

Monitoring of Revenue at WorldCom

According to several accounts, revenue growth was emphasized within WorldCom; in fact, no single measure of performance received greater scrutiny. On a regular basis, the sales groups' performances were measured against the revenue plan. At meetings held every two to three months, each sales channel manager was required to present and defend his or her sales channel's performance against the budgeted performance.

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[165] Board of Directors' Special Investigative Committee Report, June 9, 2003, 133.

Compensation and bonus packages for several members of senior management were also tied to double-digit revenue growth. In 2000 and 2001, for instance, three executives were eligible to receive an executive bonus only if the company achieved double-digit revenue growth over the first six months of each year.[166]

Monthly Revenue Report and the Corporate Unallocated Schedule

The principal tool by which revenue performance was measured and monitored at WorldCom was the monthly revenue report ("MonRev") prepared and distributed by the revenue reporting and accounting group (hereafter referred to the revenue accounting group). The MonRev included dozens of spreadsheets detailing revenue data from all of the company's channels and segments. The full MonRev contained the Corporate Unallocated schedule, an attachment detailing adjustments made at the corporate level and generally not derived from the operating activities of WorldCom's sales channels. WorldCom's Chief Financial Officer and Treasurer Scott Sullivan had ultimate responsibility for the items booked on the Corporate Unallocated schedule.[167]

In addition to CEO Ebbers and CFO 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. Sullivan routinely reviewed the distribution list for the full MonRev to make sure he approved of everyone on the list.[168]

The total amounts reported in the Corporate Unallocated schedule usually spiked during quarter-ending months, with the largest spikes occurring in those quarters when operational revenue lagged furthest behind quarterly revenue targets—the second and third quarters of 2000 and the second, third, and fourth quarters of 2001. Without the revenue that was recorded in the Corporate Unallocated account, WorldCom would have failed to achieve the double-digit growth it reported in 6 out of 12 quarters between 1999 and 2001.[169]

Process of Closing and Consolidating Revenues

[166] Ibid., 133–134.

[167] Ibid., 135–139.

[168] Ibid., 135–139.

[169] Ibid., 140–141.

WorldCom maintained a fairly automated process for closing and consolidating operational revenue numbers. By the tenth day after the end of the month, the revenue accounting group prepared a draft "Preliminary" MonRev that was followed by a Final MonRev, which took into account any adjustments that needed to be made. In nonquarter-ending months, the Final MonRev was usually similar, if not identical, to the Preliminary MonRev.[170]

In quarter-ending months, however, top-side adjusting journal entries, often very large, were allegedly made during the quarterly closing process, in order to hit revenue growth targets. Investigators later found notes made by senior executives in 1999 and 2000 that calculated the difference between "act[ual]" or "MonRev" results and "target" or "need[ed]" numbers, and identified the entries that were necessary to make up that difference. CFO Scott Sullivan directed this process, which was allegedly implemented by Ron Lomenzo, the Senior Vice President of Financial Operations, and Lisa Taranto, an employee who reported to Lomenzo.[171]

Throughout much of 2001, WorldCom's revenue accounting group tracked the gap between projected and targeted revenue—an exercise labeled "Close the Gap"—and kept a running tally of accounting "opportunities" that could be exploited to help make up that difference.[172]

Many questionable revenue entries were later found within the Corporate Unallocated revenue account. On June 19, 2001, as the quarter of 2001 was coming to a close, CFO Sullivan left a voicemail for CEO Ebbers that indicated his concern over the company's growing use of nonrecurring items to increase revenues reported:

> 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 are, 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 the recurring, uh, service side of the business…[173]

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[170] Ibid., 140–141.

[171] Ibid., 14.

[172] Ibid., 141.

[173] Ibid., 15.

A few weeks later, Ebbers sent a memorandum to WorldCom's COO Ron Beaumont that directed 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.…" Yet, Ebbers did not give any indication of the impact of nonrecurring items on revenues in his public comments to the market in that quarter or in other quarters. For that matter, the company did not address the impact of nonrecurring items on revenues in its earnings release or public filing for that quarter or prior quarters as well.[174]

Case Questions

1. Consult Paragraphs #49 and 114 of PCAOB Auditing Standard No. 2. Please define what is meant by control environment. Why does the control environment have a "pervasive" effect on the reliability of financial reporting at an audit client like WorldCom?
2. Consider Paragraph #63 and Paragraphs #68–70 of PCAOB Auditing Standard No. 2. Please identify one relevant financial statement assertion related to the revenue account that is impacted by corporate unallocated revenue activity. Why is it relevant?
3. Please explain what is meant by a "top-side" adjusting journal entry. If you were auditing WorldCom, what type of documentary evidence would you require to evaluate the propriety of a "top-side" journal entry made to the revenue account?
4. Please consult Q38 of the PCAOB Staff Questions & Answers (May 16, 2005). Comment about how your understanding of WorldCom's control environment and other company level controls would help you implement a "top-down" approach to an internal control audit at WorldCom.
5. Consider Paragraph #25 of PCAOB Auditing Standard No. 2. For WorldCom's corporate unallocated revenue activity, discuss an internal control procedure that would help to prevent, detect, or deter fraud related to the corporate unallocated revenue activity.

[174] Ibid., 15.