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PAGE ONE

Accounting Spot-Check Unearthed A Scandal in WorldCom's Books

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 Staff Reporters of THE WALL STREET JOURNAL

NEW YORK -- It all started a few weeks ago with a check of the books by Cynthia Cooper, an internal auditor for **WorldCom** Inc. The telecom giant's newly installed chief executive had asked for a financial review, and her job was to spot-check records of capital expenditures.

According to people familiar with the matter, Ms. Cooper soon found something that caught her eye. In quarter after quarter, starting in 2001, WorldCom's chief financial officer, Scott Sullivan, had been using an unorthodox technique to account for one of the long-distance company's biggest expenses: charges paid to local telephone networks to complete calls.

Instead of marking them as operating expenses, he moved a significant portion into the category of capital expenditures. The maneuver was worth hundreds of millions of dollars to WorldCom's bottom line, effectively turning a loss for all of 2001 and the first quarter of 2002 into a profit.

Ms. Cooper contacted Max Bobbitt, the head of WorldCom's auditing committee, setting in motion a chain of events that resulted in Mr. Sullivan's firing late Tuesday. The company said that it had turned up \$3.8 billion of expenses that were improperly booked and will now be restated.

Even in a season when one giant company after another has been laid low by accounting scandals, WorldCom's disclosure stands out. The coming financial restatement will almost certainly be one of the largest in corporate history -- more than six times that of Enron Corp. More important, it offers the clearest warning sign yet of the ease with which telecom companies, operating on the frontiers of accounting amidst a huge speculative excess, could manipulate their books to inflate their earnings.

President Bush himself called for a full investigation into the spiraling scandal, calling the accounting irregularities "outrageous."

The loss of trust by investors, customers and financial institutions has been profound. Shareholders have lost more than \$2 trillion, and more than 500,000 telecom workers have lost their jobs.

"There was so much pressure on companies to continue to grow and support those share prices," says Charles H. Noski, who is a vice chairman of AT&T Corp. and its former chief financial officer. AT&T hasn't come under fire for its accounting, although its stock has tumbled amid the general industry malaise. "People are going to try to figure out how do you know enough to trust what corporations are telling investors. There is an overhang on the market now."

Stock markets around the world reacted swiftly Wednesday to a growing sense of unease that, like WorldCom itself, much of the explosive, double-digit growth of the stock market boom may have been a mirage. The Dow Jones Industrial Average fell 6.7 points. **Qwest Communications International Inc.**, a big Denver telecom company under investigation by the Securities and Exchange Commission for alleged accounting irregularities, saw its stock fall nearly 60% Wednesday, to \$1.79 a share. The company has denied wrongdoing.

For WorldCom, the development could well spell the end of the nation's No. 2 long-distance company, which sells to consumers under the MCI brand name. WorldCom's banks said they wouldn't immediately act on debt covenants that could allow them to call their loans. But people familiar with the matter said a bankruptcy-court filing remains an option. Nasdaq halted trading in WorldCom's stock all day Wednesday. It currently stands at 83 cents, far from its high of \$64.50 in 1999.

The SEC Wednesday filed civil fraud charges against WorldCom, saying the company “falsely portrayed itself as a profitable business.” The U.S. Justice Department has launched a probe that could result in criminal charges, according to people familiar with the situation. These people said WorldCom and Mr. Sullivan could potentially face charges including securities fraud, bank fraud and mail fraud.

Andrew J. Graham, Mr. Sullivan’s attorney, said he wouldn’t comment. But people familiar with Mr. Sullivan say he firmly believes he didn’t do anything wrong.

Brad Burns, a spokesman for WorldCom, declined to comment on the SEC charges but said the company is “very focused on serving our customers, working with our bank lenders and ensuring our employees that we’ll get through these difficult times.”

WorldCom had already been reeling under a heavy debt load and declining revenues. In April, the board ousted the long-time chief executive, Bernard J. Ebbers, in part because of a controversy surrounding a \$408 million loan WorldCom extended to him to cover margin calls on loans secured by company stock. Since then, its new chief executive, John Sidmore, has been trying to hold off a financial crisis and restore investor confidence.



Scott Sullivan

Internal Investigation

At this point, it’s unclear whether anyone else at WorldCom knew what Mr. Sullivan was doing. The company has launched an internal investigation and is trying to determine who knew what and when. WorldCom has hired William McLucas, an SEC former enforcement chief who assisted in an internal probe of Enron’s accounting, to help in the WorldCom investigation. One of the people under scrutiny is Mr. Ebbers, a close confidant of Mr. Sullivan. The two men shared an adjoining office at their Clinton, Miss., headquarters.

Mr. Ebbers couldn’t be reached for comment, and his attorney didn’t have any immediate comment.

What is clear is that over the past five quarters as the market softened, Mr. Sullivan undertook an aggressive approach to the company’s way of accounting for one of its biggest expenses.

This happened just as WorldCom’s acquisition machine was grinding to a halt. Mr. Ebbers had cobbled together his empire from modest roots as a long-distance reseller and motel owner in Mississippi. Mr. Sullivan became a trusted ally after Mr. Ebbers acquired his company, Advanced Telecommunications Corp., in 1992. The two executives worked in tandem as WorldCom, then known as LDDS, acquired dozens of companies, seemingly springing out of nowhere to snag MCI Communications Corp. in 1998. WorldCom’s double-digit growth rates helped it win a takeover battle for MCI, trumping a bid by GTE Corp.

But by early 2001, the growth had started to slow. The booming telecommunications market was beginning to falter from a glut of capacity after a frenzied investment in fiber-optic networks. Suddenly, it found it had too much capacity. It had signed multibillion-dollar contracts with third-party telecommunications firms such as Baby Bells to insure it would be able to complete calls for its customers. An appraisal commissioned by WorldCom showed that roughly 15% of these costs weren’t producing revenue, according to a WorldCom insider.

Mr. Sullivan made an important decision, says a person familiar with his thinking. Instead of reducing profits by those costs whenever WorldCom issued results in 2001, Mr. Sullivan would spread those costs to a future time when the anticipated revenue might arrive.

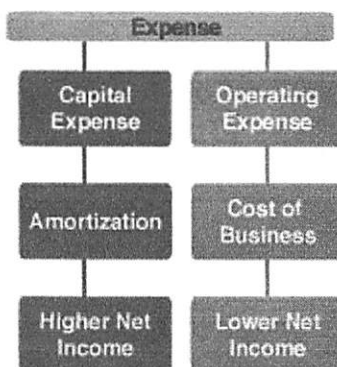
He was in a murky area. One of accounting’s most basic rules is that capital costs have to be connected to long-term investments, not ongoing activities.

CREATIVE ACCOUNTING

By booking certain costs as a capital expense, WorldCom was able to boost its bottom line. A look at how the company conducted such accounting in 2001.

WorldCom's accounting

- ① Accounts \$3.1 billion in 'line costs,' including telecom access and transport charges, as capital expenditure.
- ② Plans to amortize \$3.1 billion over a period of time, possibly as much as 10 years.
- ③ Reports net income of \$1.38 billion for 2001.



Generally accepted accounting principles

- ① The \$3.1 billion 'line-cost' expense is booked as an operating expense.
- ② The entire \$3.1 billion would have been counted as a cost of business for that quarter.
- ③ Net income for 2001 would have been a loss, amount to be determined.

According to WorldCom, the company transferred more than \$3.8 billion in "line cost" expenses to its capital accounts. WorldCom hasn't provided more detail about what those costs included, or what portions of their line costs were improperly capitalized. But line costs, according to the company's most recent annual report filed with the SEC, consist principally of access charges and transport charges. WorldCom's "line costs" totaled \$8.12 billion in 2001, according to the company's income statement.

While companies can capitalize some costs like installation and labor, the magnitude of WorldCom's capitalization appears to be far beyond its industry peers.

A person familiar with the matter says Mr. Sullivan didn't appear to have realized any personal financial gain from his strategy. At WorldCom's peak in 1999, his shares were worth more than \$150 million, and he currently owns about 3.2 million shares. But he hasn't sold any WorldCom stock in nearly two years, according to Thomson Financial/Lancer Analytics, a data service.

Mr. Sullivan never attempted to cover up the aggressive accounting method, the person familiar with the matter says. Details are spelled out clearly enough in internal company documents, this person says, that "other people had to see it unless they were blind." Still, Arthur Andersen, WorldCom's auditor at the time, said it wasn't consulted or notified about the capitalized expenses.

The CFO capitalized costs in amounts ranging from \$540 million to \$797 million each quarter. When April results came out this year, though, he began to doubt whether some of his revenue projections related to the line costs would be realized. In May, according to people familiar with his thinking, Mr. Sullivan was contemplating taking a charge. On May 23, the board was notified that a charge would include the line costs, but didn't signal how much it would be, a person familiar with the matter said.

Then in early June, Ms. Cooper called Mr. Bobbitt, chairman of the board's audit committee, notifying him that she had found suspect entries in the books.

Mr. Bobbitt had been under fire for months for his controversial role in extending Mr. Ebbers the \$408 million personal loan from WorldCom. He quickly notified the newly hired accountants, KPMG LLP, of the discrepancy. The firm set to work.

Two weeks ago, KPMG came to WorldCom's offices in Washington and told the committee there was a problem. The investigation continued through the week and last Thursday the audit committee met at KPMG's Washington offices to ask Mr. Sullivan and company controller David Myers to justify their accounting treatment. Mr. Sullivan, according to people familiar with the situation, gave an impassioned defense of his decision, saying that since WorldCom wasn't receiving revenue, he could defer the costs of leasing the lines until they produced revenue. But KPMG officials weren't satisfied, citing accounting rules that clearly dictate that the costs of operating leases can't be delayed. The KPMG partner in charge of the WorldCom account, told Mr. Sullivan that he couldn't "get past the theory" but gave him the

weekend to produce a so-called white paper that would set out his justification, a person close to the matter said.

Accounting experts say the rules are clear on what costs can be capitalized and what has to be expensed. "If the amounts being paid out are going to have created a long-lasting asset, then the costs depreciate and can be amortized over several years," says Carr Conway, a former SEC official and senior forensic accountant with Dickerson Financial Group in Denver. Unless the asset is going to generate value in future years, the cost for it can't be capitalized, he adds.

Weekend Huddle

Mr. Sullivan spent the weekend huddled with his team in Clinton, Miss., reviewing documents and constructing the white paper. But it wasn't going well. "He was becoming increasingly pessimistic" that he would have enough time to satisfy KPMG, said one person familiar with the matter.

At a board meeting Monday night at WorldCom's offices, Mr. Sullivan again made his case. A national practice specialist at KPMG said, however, that the issue was "an open-and-shut case," said one person who attended. "The KPMG people left no door open." After asking Mr. Sullivan to leave the room, board members concluded at the meeting that they would have to restate earnings. The meeting ended without a vote, which was postponed until Tuesday when Mr. Sullivan was fired and Mr. Myers was asked to resign.

Through it all, Mr. Sullivan was "very calm and articulate," says one person who attended the meetings. "He handled himself very well, though you could tell he was pained." As far as the board members, added another person, "most people were absolutely flabbergasted."

In a speech Wednesday, Mr. Sidgmore tried to make the most out of a bad situation. "We want to make clear that WorldCom reported itself in this matter and moved swiftly to do so," he said. "We turned ourselves in, in other words."

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<http://online.wsj.com/article/0,,SB102512901721030520,00.html>

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WORLDCOM, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In Millions, Except Share Data)

| | <u>December 31,</u> <u>2000</u> | <u>December 31,</u> <u>2001</u> |
|--|------------------------------------|------------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 761 | \$ 1,416 |
| Accounts receivable, net of allowance for bad debts of \$1,532 in 2000 and \$1,086 in 2001 | 6,815 | 5,308 |
| Deferred tax asset | 172 | 251 |
| Other current assets | 2,007 | 2,230 |
| Total current assets | 9,755 | 9,205 |
| Property and equipment: | | |
| Transmission equipment | 20,288 | 23,814 |
| Communications equipment | 8,100 | 7,878 |
| Furniture, fixtures and other | 9,342 | 11,263 |
| Construction in progress | 6,897 | 5,706 |
| Total property and equipment | 44,627 | 48,661 |
| Accumulated depreciation | (7,204) | (9,852) |
| Total property and equipment, net | 37,423 | 38,809 |
| Goodwill and other intangible assets | 46,594 | 50,537 |
| Other assets | 5,131 | 5,363 |
| Total assets | \$ 98,903 | \$ 103,914 |
| LIABILITIES AND SHAREHOLDERS' INVESTMENT | | |
| Current liabilities: | | |
| Short-term debt and current maturities of long-term debt | \$ 7,200 | \$ 172 |
| Accrued interest | 446 | 618 |
| Accounts payable and accrued line costs | 6,022 | 4,844 |
| Other current liabilities | 4,005 | 3,576 |
| Total current liabilities | 17,673 | 9,210 |
| Long-term liabilities, less current portion: | | |
| Long-term debt | 17,696 | 30,038 |
| Deferred tax liability | 3,611 | 4,066 |
| Other liabilities | 1,124 | 576 |
| Total long-term liabilities | 22,431 | 34,680 |
| Commitments and contingencies | | |
| Minority interests | 2,592 | 101 |
| Company obligated mandatorily redeemable and other preferred securities | 798 | 1,993 |
| Shareholders' investment: | | |
| Series B preferred stock, par value \$.01 per share; authorized, issued and outstanding: 10,693,437 shares in 2000 and none in 2001 (liquidation preference of \$1.00 per share plus unpaid dividends) | — | — |
| Preferred stock, par value \$.01 per share; authorized: 31,155,008 shares in 2000 and 30,967,637 shares in 2001; none issued | — | — |
| Common stock: | | |
| WorldCom, Inc. common stock, par value \$.01 per share; authorized: 5,000,000,000 shares in 2000 and none in 2001; issued and outstanding: 2,887,960,378 shares in 2000 and none in 2001 | 29 | — |
| WorldCom group common stock, par value \$.01 per share; authorized: none in 2000 and 4,850,000,000 shares in 2001; issued and outstanding: none in 2000 and 2,967,436,680 shares in 2001 | — | 30 |
| MCI group common stock, par value \$.01 per share; authorized: none in 2000 and 150,000,000 shares in 2001; issued and outstanding: none in 2000 and 118,595,711 in 2001 | — | 1 |
| Additional paid-in capital | 52,877 | 54,297 |
| Retained earnings | 3,160 | 4,400 |
| Unrealized holding gain (loss) on marketable equity securities | 345 | (51) |
| Cumulative foreign currency translation adjustment | (817) | (562) |
| Treasury stock, at cost, 6,765,316 shares of WorldCom, Inc. in 2000, 6,765,316 shares of WorldCom group stock and 270,613 shares of MCI group stock in 2001 | (185) | (185) |
| Total shareholders' investment | 55,409 | 57,930 |
| Total liabilities and shareholders' investment | \$ 98,903 | \$ 103,914 |

The accompanying notes are an integral part of these statements.

WORLDCOM, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(In Millions, Except Per Share Data)

| | For the Years Ended December 31, | | |
|--|-------------------------------------|------------------|------------------|
| | 1999 | 2000 | 2001 |
| Revenues | \$35,908 | \$39,090 | \$35,179 |
| Operating expenses: | | | |
| Line costs | 14,739 | 15,462 | 14,739 |
| Selling, general and administrative | 8,935 | 10,597 | 11,046 |
| Depreciation and amortization | 4,354 | 4,878 | 5,880 |
| Other charges | (8) | — | — |
| Total | <u>28,020</u> | <u>30,937</u> | <u>31,665</u> |
| Operating income | 7,888 | 8,153 | 3,514 |
| Other income (expense): | | | |
| Interest expense | (966) | (970) | (1,533) |
| Miscellaneous | 242 | 385 | 412 |
| Income before income taxes, minority interests and cumulative effect of accounting change | 7,164 | 7,568 | 2,393 |
| Provision for income taxes | 2,965 | 3,025 | 927 |
| Income before minority interests and cumulative effect of accounting change | 4,199 | 4,543 | 1,466 |
| Minority interests | (186) | (305) | 35 |
| Income before cumulative effect of accounting change | 4,013 | 4,238 | 1,501 |
| Cumulative effect of accounting change (net of income tax of \$50 in 2000) | — | (85) | — |
| Net income | 4,013 | 4,153 | 1,501 |
| Distributions on mandatorily redeemable preferred securities and other preferred dividend requirements | 72 | 65 | 117 |
| Net income applicable to common shareholders | <u>\$ 3,941</u> | <u>\$ 4,088</u> | <u>\$ 1,384</u> |
| Net income attributed to WorldCom group before cumulative effect of accounting change | <u>\$ 2,294</u> | <u>\$ 2,608</u> | <u>\$ 1,407</u> |
| Cumulative effect of accounting change | <u>\$ —</u> | <u>\$ (75)</u> | <u>\$ —</u> |
| Net income attributed to WorldCom group | <u>\$ 2,294</u> | <u>\$ 2,533</u> | <u>\$ 1,407</u> |
| Net income (loss) attributed to MCI group before cumulative effect of accounting change | <u>\$ 1,647</u> | <u>\$ 1,565</u> | <u>\$ (23)</u> |
| Cumulative effect of accounting change | <u>\$ —</u> | <u>\$ (10)</u> | <u>\$ —</u> |
| Net income (loss) attributed to MCI group | <u>\$ 1,647</u> | <u>\$ 1,555</u> | <u>\$ (23)</u> |
| Earnings (loss) per common share: | | | |
| WorldCom group: | | | |
| Net income attributed to WorldCom group before cumulative effect of accounting change: | | | |
| Basic | <u>\$ 0.81</u> | <u>\$ 0.91</u> | <u>\$ 0.48</u> |
| Diluted | <u>\$ 0.78</u> | <u>\$ 0.90</u> | <u>\$ 0.48</u> |
| Cumulative effect of accounting change | <u>\$ —</u> | <u>\$ (0.03)</u> | <u>\$ —</u> |
| Net income attributed to WorldCom group: | | | |
| Basic | <u>\$ 0.81</u> | <u>\$ 0.88</u> | <u>\$ 0.48</u> |
| Diluted | <u>\$ 0.78</u> | <u>\$ 0.87</u> | <u>\$ 0.48</u> |
| MCI group: | | | |
| Net income (loss) attributed to MCI group before cumulative effect of accounting change: | | | |
| Basic | <u>\$ 14.32</u> | <u>\$ 13.61</u> | <u>\$ (0.20)</u> |
| Diluted | <u>\$ 14.32</u> | <u>\$ 13.61</u> | <u>\$ (0.20)</u> |
| Cumulative effect of accounting change | <u>\$ —</u> | <u>\$ (0.09)</u> | <u>\$ —</u> |
| Net income (loss) attributed to MCI group: | | | |
| Basic | <u>\$ 14.32</u> | <u>\$ 13.52</u> | <u>\$ (0.20)</u> |
| Diluted | <u>\$ 14.32</u> | <u>\$ 13.52</u> | <u>\$ (0.20)</u> |

The accompanying notes are an integral part of these statements.

WORLDCOM, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Millions)

| | For the Years Ended December 31, | | |
|--|-------------------------------------|-----------------|-----------------|
| | 1999 | 2000 | 2001 |
| Cash flows from operating activities: | | | |
| Net income | \$ 4,013 | \$ 4,153 | \$ 1,501 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Cumulative effect of accounting change | — | 85 | — |
| Minority interests | 186 | 305 | (35) |
| Other charges | (8) | — | — |
| Depreciation and amortization | 4,354 | 4,878 | 5,880 |
| Provision for deferred income taxes | 2,903 | 1,649 | 1,104 |
| Change in assets and liabilities, net of effect of business combinations: | | | |
| Accounts receivable, net | (875) | (1,126) | 281 |
| Other current assets | 143 | (797) | 164 |
| Accounts payable and other current liabilities | 692 | (1,050) | (1,154) |
| All other operating activities | (403) | (431) | 253 |
| Net cash provided by operating activities | <u>11,005</u> | <u>7,666</u> | <u>7,994</u> |
| Cash flows from investing activities: | | | |
| Capital expenditures | (8,716) | (11,484) | (7,886) |
| Acquisitions and related costs | (1,078) | (14) | (206) |
| Increase in intangible assets | (743) | (938) | (694) |
| Decrease in other liabilities | (650) | (839) | (480) |
| All other investing activities | 1,632 | (1,110) | (424) |
| Net cash used in investing activities | <u>(9,555)</u> | <u>(14,385)</u> | <u>(9,690)</u> |
| Cash flows from financing activities: | | | |
| Principal borrowings (repayments) on debt, net | (2,894) | 6,377 | 3,031 |
| Common stock issuance | 886 | 585 | 124 |
| Distributions on mandatorily redeemable and other preferred securities and dividends paid on other equity securities | (72) | (65) | (154) |
| Redemptions of preferred stock | — | (190) | (200) |
| All other financing activities | — | (84) | (272) |
| Net cash provided by (used in) financing activities | <u>(2,080)</u> | <u>6,623</u> | <u>2,529</u> |
| Effect of exchange rate changes on cash | (221) | (19) | 38 |
| Net increase (decrease) in cash and cash equivalents | (851) | (115) | 871 |
| Cash and cash equivalents at beginning of period | 1,727 | 876 | 761 |
| Deconsolidation of Embratel | — | — | (216) |
| Cash and cash equivalents at end of period | <u>\$ 876</u> | <u>\$ 761</u> | <u>\$ 1,416</u> |

The accompanying notes are an integral part of these statements.

WORLDCOM, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
DECEMBER 31, 2001

(1) The Company and Significant Accounting Policies—(Continued)

Our equity in Embratel's loss for 2001 is included in miscellaneous income/(expense) in the accompanying consolidated financial statements.

Fair Value of Financial Instruments:

The fair value of long-term debt and company obligated mandatorily redeemable and other preferred securities is determined based on quoted market rates or the cash flows from such financial instruments discounted at our estimated current interest rate to enter into similar financial instruments. The carrying amounts and fair values of these financial instruments were \$25.7 billion and \$25.3 billion, respectively, at December 31, 2000 and \$32.2 billion and \$32.9 billion, respectively, at December 31, 2001. The carrying values for all our other financial instruments approximate their respective fair values.

Cash and Cash Equivalents:

We consider cash in banks and short-term investments with original maturities of three months or less as cash and cash equivalents.

Property and Equipment:

Property and equipment are stated at cost. Depreciation is provided for financial reporting purposes using the straight-line method over the following estimated useful lives:

| | |
|--|---------------|
| Transmission equipment (including conduit) | 4 to 40 years |
| Communications equipment | 5 to 10 years |
| Furniture, fixtures, buildings and other | 4 to 39 years |

We evaluate the recoverability of property and equipment when events and circumstances indicate that such assets might be impaired. We determine impairment by comparing the undiscounted future cash flows estimated to be generated by these assets to their respective carrying amounts. In the event an impairment exists, a loss is recognized based on the amount by which the carrying value exceeds the fair value of the asset. If quoted market prices for an asset are not available, fair market value is determined primarily using the anticipated cash flows discounted at a rate commensurate with the risk involved. Losses on property and equipment to be disposed of are determined in a similar manner, except that fair market values are reduced for the cost to dispose.

Maintenance and repairs are expensed as incurred. Replacements and betterments are capitalized. The cost and related reserves of assets sold or retired are removed from the accounts, and any resulting gain or loss is reflected in results of operations.

We construct certain of our own transmission systems and related facilities. Internal costs directly related to the construction of such facilities, including interest and salaries of certain employees, are capitalized. Such internal costs were \$625 million (\$339 million in interest), \$842 million (\$495 million in interest) and \$858 million (\$498 million in interest) in 1999, 2000 and 2001, respectively.