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gram Information Specialist

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ACTION MEMORANDUM

Date: March 11, 2002
File No. HO-9440

TO:	The Commission
FROM:	Division of Enforcement LAW
SUBJECT:	In the Matter of WorldCom, Inc.
RECOMMENDATION:	That the Commission issue a formal order of investigation to determine whether there have been violations of Section 17(a) of the Securities Act of 1933 ("Securities Act"), Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B) and 13(b)(5) of the Securities Exchange Act of 1934 ("Exchange Act") and Rules 10b-5, 12b-20, 13a-1, 13a-13 and 13b2-2 thereunder
ACTION REQUESTED BY:	Regular Calendar Consideration
SOURCE OF CASE:	Informant complaint on February 6, 2002; company announcement on February 7, 2002
OTHER OFFICES OR DIVISIONS CONSULTED:	Office of General Counsel (Richard Levine, x0886)
PRIOR COMMISSION ACTION:	None
PERSONS TO CONTACT:	William R. Baker III 942-4570 Lawrence A. West 942-4822 Neil J. Welch, Jr. 942-4821 Jose Rodriguez 942-4537 Charles D. Niemeier 942-4594 Matthew W. Rogers 942-4730

I. SUMMARY

This matter involves accounting practices at WorldCom, Inc., one of the world's largest telecommunications companies. Allegations in complaints made to the Commission by a customer and a former employee, in press reports, in a shareholder class action suit filed in federal court in Mississippi, and statements in the company's press releases raise the possibility that beginning in 1999 or earlier WorldCom has been over-billing customers, failing to write off accounts that were no longer collectible, and hiding corrections to improperly recognized revenue or goodwill in large write-offs. We require subpoena power to obtain documents from WorldCom and WorldCom's auditor Arthur Andersen.

II. RELEVANT ENTITY

WorldCom, Inc., a Georgia corporation with its principal office in Clinton, Mississippi, is a global telecommunications company. Its common stock is registered under Section 12(g) of the Exchange Act and traded on the Nasdaq National Market System.

III. FACTS

A number of recent disclosures point to the possibility that WorldCom might have engaged in accounting-related violations. On February 6, 2002, a former WorldCom employee alleged in an email to the staff that the company had systematically over-billed customers and intentionally failed to write down uncollectible accounts receivable. The next day, WorldCom announced that it anticipated a $15 to $20 billion reduction in the value of its goodwill due to the application of recently adopted FAS 142 (which requires that the value of intangible assets, including goodwill, be reviewed yearly). A week later, on February 14, 2002, the press reported that salespeople in various WorldCom offices had fraudulently inflated their commissions. These new disclosures are coupled with earlier allegations (which were directed to other members of the staff but are now consolidated in this investigation) that WorldCom improperly recognized revenue in 1999 and perhaps earlier.

A. Possible Systematic Over-billing

Press accounts and complaints made directly to the Commission staff allege that WorldCom regularly over-billed or double-billed customers for services provided. A former WorldCom employee alleged that "[l]arge customers were being misbilled and this was known to management." The employee also alleged that "[t]here had not been proper disclosure about Receivables Assets" and that she was once told that her department was "only allowed to write-off 60,000 monthly . . . and we have a waiting list a mile long." Similarly, WorldCom customer Infolink Communication Services, Inc. complained to the staff that it had been over-billed by WorldCom every month since becoming a customer in May 2000. Infolink told us that it was over-billed by more than $100,000 and that it was aware of numerous other firms that had also been systematically over-billed.

Similar allegations are made in a class action complaint, *In re WorldCom, Inc. Securities Litigation*, No. 3:00-cv-833 (S.D. Miss.) (filed Nov. 7, 2000). The lawsuit alleges that WorldCom inflated revenue through numerous fraudulent practices, including double billing (accomplished in several ways, including billing an account as both residential and commercial, and renegotiating a contract and billing for both the old and new contract), slamming (switching phone lines to the company's service without customer authorization), cramming (billing for services not provided to, or authorized by, the customer), refusing to cancel accounts when requested by the customer, and failing to write off bad accounts when it became clear that the balances owed on the account would not be collected. Indeed, on March 7, 2002, WorldCom's MCI Group entered into a $8.5 million settlement with the California Public Utilities Commission and Attorney General to settle allegations similar to the allegations above.

Possibly related to the alleged over-billing are recent press reports that WorldCom employees in its Arlington (Va.), Chicago and Baltimore sales offices fraudulently inflated their commissions. WorldCom stated publicly that because sales and commissions are calculated using different systems, these fraudulent commissions do not affect the company's earnings. However, this activity appears similar to the double billing complained of by a former WorldCom employee and a customer, and suggests that WorldCom had weak internal controls, at least.

B. Large Charges that Might Mask Prior Improper Accounting

In its Form 10-Q for the third quarter of 2000 (ended September 30th), WorldCom reported a $685 million pretax charge against revenues for accounts receivable "that are no longer deemed collectible due to bankruptcies, litigation and settlements of contractual disputes that occurred in the third quarter 2000." It is possible that this charge was intended to hide uncollectible or fraudulent billings that should have been accounted for earlier.

It is also possible that the company intends to bury further corrections to past improper revenue recognition in its forthcoming large reduction of goodwill (described above with reference to FAS 142). It is also possible that the company improperly failed to reduce goodwill in previous periods.

C. Materiality

Absent the alleged over-billed revenues WorldCom would not have met analysts' estimates in various periods. Also, WorldCom's $685 million charge to revenue in its 2000 third quarterly report represented 8.3% of the company's pre-tax profit for 2000. It therefore appears that the possible accounting problems could be material.

IV. LEGAL DISCUSSION

A. Reporting Provisions

Section 13(a) of the Exchange Act requires all issuers whose securities are registered with the Commission pursuant to Section 12 of the Exchange Act to file with the Commission periodic reports containing the information prescribed by Commission rules and regulations. Pursuant to Section 13(a), the Commission has promulgated Rules 13a-1 and 13a-13, which require issuers to file annual and quarterly reports, respectively. Rule 12b-20 requires periodic reports to contain any additional information necessary to ensure that other statements in the reports are not, under the circumstances, materially misleading. The filing of reports containing materially false or misleading information constitutes a violation of the reporting provisions of the federal securities laws. *See, e.g.*, *SEC v. Kalvex, Inc.*, 425 F. Supp. 310, 316 (S.D.N.Y. 1975). No showing of scienter is necessary to establish liability under the reporting provisions. *Id.* at 1167.

If WorldCom reported revenue from questionable billings and failed to write down uncollectible accounts receivable, or reported charges to revenue in part designed to hide corrections of past improper revenue recognition, WorldCom, aided and abetted by others, might have filed materially incorrect reports in violation of some or all of the above provisions.

B. Record Keeping Provisions

Section 13(b)(2)(A) of the Exchange Act requires issuers to keep books, records and accounts that, in reasonable detail, accurately and fairly reflect company transactions and disposition of assets. Section 13(b)(2)(B) of the Exchange Act requires an issuer to "devise and maintain a system of internal accounting controls" that is sufficient to provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted principles and to maintain accountability for assets. Violations of Sections 13(b)(2)(A) and 13(b)(2)(B) do not require a showing of materiality or scienter. *SEC v. World-Wide Coin Invs., Ltd.*, 567 F. Supp. 724, 749-51 (N.D. Ga. 1983).

Section 13(b)(5) of the Exchange Act prohibits persons from knowingly (1) circumventing or failing to implement a system of internal controls or (2) falsifying books, records, or accounts described in Sections 13(b)(2)(A) and (B) of the Exchange Act. Rule 13b2-2 further prohibits a director or officer of an issuer from, directly or indirectly, making or causing others to make materially false or misleading statements or omitting to state material information to an accountant in connection with an audit of financial statements included in filings with the Commission, or the preparation or filing of any document or report filed with the Commission.

If WorldCom recorded revenue from questionable billings and failed to write down uncollectible accounts receivable, improperly recorded sales on its books and records, or failed to implement procedures designed to provide reasonable assurances of detecting accounting errors and irregularities, WorldCom and others might have violated some or all of the above provisions.

C. Antifraud Provisions

Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit materially false or misleading statements or omissions in connection with the purchase or sale of securities. Section 17(a) of the Securities Act prohibits similar conduct in the offer or sale of a security. The antifraud provisions prohibit issuers from making materially false or misleading statements, with scienter, in financial statements filed with the Commission and in other public statements. Also, corporate insiders can violate the antifraud provisions if they trade the issuer's securities while knowing or recklessly disregarding the fact that its financial statements or other public utterances are materially false and misleading.

If WorldCom recognized revenue from questionable billings and failed to write down uncollectible accounts receivable in violation of generally accepted accounting principles, WorldCom and others might have violated the above provisions.

V. NEED FOR A FORMAL ORDER

We need a formal order to subpoena documents from WorldCom, WorldCom's auditor Arthur Andersen, and third parties.

VI. RECOMMENDATION

Based upon the foregoing, we recommend that the Commission issue a formal order of investigation in this matter.