UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

	§	**Chapter 11**
In re:	§	
	§	**Case No. 02-15533 (AJG)**
WORLDCOM, INC., et al.	§	
	§	**Jointly Administered**
Debtors.	§	
	§	

FIRST INTERIM REPORT OF DICK THORNBURGH,

BANKRUPTCY COURT EXAMINER

November 4, 2002

Kirkpatrick & Lockhart LLP
1800 Massachusetts Avenue, N.W.
Washington, D.C. 20036
(202) 778-9000
(202) 778-9100 (fax)

Counsel to Dick Thornburgh, Bankruptcy Court Examiner

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I. INTRODUCTION

On July 21, 2002, WorldCom, Inc. and substantially all of its direct and indirect subsidiaries (collectively, "WorldCom" or the "Company") filed voluntary petitions seeking relief under Chapter 11 of the United States Bankruptcy Code. These cases, which have been consolidated for procedural purposes and are being jointly administered, represent the largest bankruptcy in the history of the United States. WorldCom made its initial bankruptcy filings approximately four weeks after the Company publicly disclosed on June 25, 2002 that it had discovered substantial accounting irregularities that would result in adjustments to its financial statements totaling more than $3.8 billion.

The day after WorldCom filed its bankruptcy petitions, this Court granted the motion of the United States Trustee on July 22, 2002, for the appointment of an Examiner pursuant to 11 U.S.C. § 1104(c)(2). The Court's Order provided that the Examiner "shall investigate any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the management of the affairs of [the Company] by current or former management, including but not limited to issues of accounting irregularities." The Court directed the Examiner to coordinate with the United States Department of Justice, the United States Securities and Exchange Commission ("SEC") and other federal agencies investigating matters related to WorldCom to avoid duplication of effort. The Court also ordered the Examiner to file a report of his examination with the Court within 90 days of his appointment.

On August 6, 2002, the Court signed an Order approving the appointment of Dick Thornburgh, a former United States Attorney General, as Examiner. This required the filing of a report with the Court by November 4, 2002. Mr. Thornburgh, Counsel with Kirkpatrick & Lockhart LLP, engaged his firm as counsel and J.H. Cohn LLP as his forensic accountants and financial advisors to assist him with respect to the examination of the Company. Given the enormity and complexity of this examination, Mr. Thornburgh, through counsel, and with the consent of the Company and its counsel, submitted to the Court on November 1, 2002 an Order modifying its initial scheduling directive to provide for the filing of a First Interim Report by November 4, 2002, and for subsequent reports of examination to be filed every 120 days thereafter until the examination is completed. This constitutes the First Interim Report of the Examiner, his counsel and financial advisors.

It is important to note at the outset that this First Interim Report is the work product of the Examiner and that it is intended to fulfill his responsibilities under this Court's Orders of July 22 and August 6, 2002. Accordingly, this Report should not be used in any other proceeding and the statements and information contained herein should not be viewed as an admission by any person or findings by any other person or entity.

II. PROCESS OF EXAMINATION AND NATURE OF FIRST INTERIM REPORT

Our examination is intended to discharge the broad mandate prescribed by the Court in its Order authorizing the appointment of an Examiner, dated July 22, 2002. Toward that end, we are investigating a large number of issues related to the conduct of WorldCom management prior to the bankruptcy filings. Our goal is to assess thoroughly, objectively and responsibly the acts and omissions of current and former management, as well as the integrity of the Company's management, accounting and financial reporting processes and its internal controls, so that we can report to the Court regarding these matters.

The examination consists of several facets, each of which is active and ongoing. We have requested from WorldCom numerous documents and information that pertain to aspects of the Company's operations and management. The Examiner notes the cooperation of WorldCom during a difficult and tumultuous time for the Company. In all, we have collected more than million pages of documents. Such documents and information include, among others: (i) accounting and financial reporting records; (ii) materials related to the function and organization of the Company's management structure, including the duties and responsibilities assigned to particular individuals or business units; (iii) records regarding the Company's internal oversight or control functions and related reporting systems; (iv) materials concerning executive compensation, bonuses and other benefits conferred upon WorldCom management; (v) records related to loans made by WorldCom to Bernard Ebbers, the former Chief Executive Officer of the Company; (vi) documents respecting certain corporate acquisitions and other transactions involving WorldCom; and (vii) documents related to communications and dealings with securities analysts and investment banks by WorldCom and certain of its officers or employees.[1]

We also have requested materials from, and exchanged certain documents and information with, the Special Investigative Committee of the Company's Board of Directors, its counsel, Wilmer, Cutler & Pickering, and its accountants, PriceWaterhouseCoopers, which commenced an investigation shortly after WorldCom publicly disclosed certain accounting irregularities relating to the capitalization of line costs on June 25, 2002. We have attempted to coordinate our efforts with those of the Special Investigative Committee to avoid duplication and reduce expenses. The Committee and its professionals have provided significant assistance to the Examiner and his professionals, including briefings on the status of their investigation and other work product. Much

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1 Initially, the Company raised certain concerns regarding the potential waiver of the attorney-client privilege or other protections that may be caused by production of certain relevant documents to the Examiner. These concerns served to delay our receipt of a substantial number of materials. In order to address these concerns, we sought, with the Company's consent, an order from the Court providing that the delivery of documents and information to the Examiner by WorldCom and related parties shall not constitute a waiver of the attorney-client privilege, work product protection or any other recognized privilege or protection. We obtained such an order from the Court on September 23, 2002.

of the testimonial evidence that we have received to date was derived from interviews conducted by the Special Investigative Committee. In addition, we have sought the assistance of KPMG LLP ("KPMG"), the Company's newly appointed independent auditors, which have been engaged to audit the financial statements of WorldCom for the years ended December 31, 2000 through December 31, 2002. We anticipate that we will continue to work with the Special Investigative Committee and its professionals, as well as with KPMG.

Consistent with the Court's July 22 Order, we also are coordinating extensively with the United States Department of Justice and the SEC, which are investigating matters related to WorldCom, to avoid unnecessary duplication of effort. As noted above, this First Interim Report constitutes the work of the Examiner and nothing in it should be construed as a statement by, or finding of, these agencies. We anticipate a continuing dialogue with the Department of Justice and the SEC regarding matters related to their investigations and our examination. We also are coordinating with the Honorable Richard C. Breeden, the Corporate Monitor appointed by the United States District Court for the Southern District of New York in a proceeding commenced by the SEC against WorldCom. Mr. Breeden has provided important assistance to the Examiner. The Examiner also notes the significant role played by the Honorable Jed S. Rakoff in proceedings concerning WorldCom. Further, we are maintaining an active dialogue regarding matters related to our examination with the counsel and its financial advisors for the Official Committee of Unsecured Creditors.

Beyond these activities, we have interviewed, or reviewed notes of previous interviews conducted by others of, a significant number of present or former employees, officers or directors of WorldCom. These interviews included a large number of present or former employees of WorldCom who performed accounting or finance functions at various offices or facilities maintained by the Company, as well as members of the Company's Board of Directors, certain of the Company's internal audit personnel, present or former members of its in-house legal team, certain investor relations personnel, and employees who worked primarily on acquisitions or other corporate development matters prior to the filing of the bankruptcy petitions. We anticipate that we will conduct, or participate in, a substantial number of additional interviews in the future. In some cases, we also have directed requests for particular documents or information to certain former officers or employees of WorldCom or their counsel.

Even with all of these efforts, we have gathered only a relatively small portion of the records necessary to enable us to report thoroughly and accurately to the Court regarding the matters outlined in its July 22 Order. The task ordered by the Court is enormous and in the relatively limited time since the Examiner was appointed we have been able to address most of the relevant issues in only a preliminary fashion. Our inability to access many relevant documents and other information until after we obtained an order from the Court that addressed the Company's privilege concerns, further delayed our efforts. Moreover, due to the pending governmental investigations, we have not had access to all persons who have information relevant to our examination. Accordingly, a substantial amount of additional investigation is required before we can reach definitive conclusions – both qualitatively and quantitatively – regarding relevant acts, omissions and events involving the present or former management of WorldCom. Accordingly, in this First Interim Report, we only outline certain of our initial observations and to highlight some of the areas that we believe warrant further investigation and analysis. We intend to refine and expand these preliminary observations, and to detail our specific findings, in subsequent reports to the Court.

Significantly, there are a number of conclusions that we have reached which are not set forth herein due to representations by investigative agencies that their disclosure at this time would adversely affect the process of determining possible criminal or civil liability of persons involved therein.

III. SUMMARY OF INITIAL OBSERVATIONS

Although we have conducted our examination over a relatively short period of time and are not drawing conclusions on many matters, a picture is clearly emerging of a company that had a number of troubling and serious issues. These issues relate to the culture, internal controls, management, integrity, disclosures and financial statements of the Company. The Company's June 25, 2002 disclosure of a $3.8 billion restatement regarding the line cost capitalization may be the largest issue in terms of dollars, but it was by no means the only significant problem related to the Company's financial reporting, public disclosures and related matters. Our initial observations, which are discussed more fully below, can be summarized as follows:

- WorldCom was a company that grew tremendously in both size and complexity in a relatively short period of time. Its management, systems, internal controls and other personnel did not keep pace with that growth.
- WorldCom grew in large part because the value of its stock rose dramatically. Its stock was the fuel that kept WorldCom's acquisition engine running at a very high speed. WorldCom needed to keep its stock price at high levels to continue its phenomenal growth.
- WorldCom did not achieve its growth by following a predefined strategic plan, but rather by opportunistic and rapid acquisitions of other companies. The unrelenting pace of these acquisitions caused the Company constantly to redefine itself and its focus. The Company's unceasing growth and metamorphosis made integration of its newly acquired operations, systems and personnel much more difficult. This dramatic growth and related changes also made it difficult for investors to compare the Company's operations to historical benchmarks.
- One person, Bernard Ebbers, appears to have dominated the course of the Company's growth, as well as the agenda, discussions and decisions of the Board of Directors.

Critical questioning was discouraged and the Board did not appear to evaluate proposed transactions in appropriate depth, even though several members of the Board had a significant percentage of their personal wealth tied to the value of the Company's stock.

- The Audit Committee of the Board of Directors did not appear to operate effectively or aggressively based on our preliminary review. We are in the process of further examining the work of the Audit Committee, as well as its relationships with the Company's Internal Audit Department and with the Company's independent auditors, Arthur Andersen LLP ("Arthur Andersen").

- The Compensation and Stock Option Committee of the Board of Directors seemed largely to abdicate its responsibilities to Mr. Ebbers. It approved compensation packages that appear overly generous and disproportionate to either the performance of the Company or competitive pressures. We are still in the process of reviewing the activities of this Committee.

- Arthur Andersen determined that WorldCom was a maximum risk client. Although we are still reviewing the audit work of Arthur Andersen, it does not appear that the audit procedures employed by Arthur Andersen were appropriate for the risk profile it ascribed to WorldCom.

- WorldCom's Internal Audit Department focused almost exclusively on operational issues – i.e., identifying potential inefficiencies and not financial or accounting matters. Given this focus on operational issues, it was a credit to the personnel of the Internal Audit Department that they investigated the line cost capitalization issue in 2002. WorldCom's failure to have its Internal Audit Department develop and implement a comprehensive risk-based and financial controls oriented internal audit plan contributed to the weakness of WorldCom's internal controls.

- The relationship between WorldCom and Salomon Smith Barney ("SSB"), its primary investment banker, seems to have been unusually close and potentially problematic. We are still investigating this relationship and we will report further on it in future reports. Some of the matters that we are investigating include the relationship of a SSB research analyst, Jack Grubman, with the Company, including his attendance at various meetings of the Company's Board of Directors and evidence that Mr. Grubman alerted the Company ahead of time to the questions he would ask in conference calls between securities analysts and WorldCom management, as well as the wildly enthusiastic analyst reports issued by SSB and others with respect to WorldCom at a time when the stock was plummeting.

- WorldCom put extraordinary pressure on itself to meet the expectations of securities analysts. This pressure created an environment in which reporting numbers that met these expectations, no matter how these numbers were derived, apparently became more important than accurate financial reporting.

- A second restatement in the amount of an additional $3.8 billion, which was announced by WorldCom in August 2002, includes the restatement of reserves of approximately

$2.3 billion. We have identified a number of other entries related to reserves that require review to determine if any were used to boost improperly WorldCom's earnings.

- To accomplish and conceal their financial manipulations, it appears that WorldCom personnel created several false internal financial reports. Although we have significant information on these reports, we are not including details in this First Interim Report in deference to the ongoing governmental investigations.

- It appears that if WorldCom's revenue figures did not meet or exceed the budgeted amounts, the Company would increase improperly revenues. Between the first quarter of 1999 and the first quarter of 2002, adjustments were made to approximately 400 items totaling over $4.6 billion. At least $423 million of this amount already has been restated by WorldCom. We have reached no conclusion on the other adjustments and will be reviewing them in a future report.

- WorldCom manipulated its reported financial performance by drawing down excess or other reserves into earnings. At around the time that the reserves were being drawn down, WorldCom agreed to combine with Sprint Communications, Inc. ("Sprint") in October 1999. This combination would have allowed the Company not only to replenish its reserves, but also to increase them dramatically. When the government ultimately refused to approve the Sprint merger in July 2000, and signaled that it would not be sanctioning other large mergers, WorldCom did not have adequate excess reserves to draw down as a vehicle to increase earnings going forward. Shortly after this time, the Company took the brazen and radical step of converting substantial portions of its line cost expenses into capital items. These conversions ultimately added approximately $3.8 billion improperly to income. The disclosure of these improprieties was the subject of the June 25, 2002 restatement announcement.

- Finally, it seems clear that there were numerous failures, inadequacies and breakdowns in the multi-layered system designed to protect the integrity of the financial reporting system at WorldCom, including the Board of Directors, the Audit Committee, the Company's system of internal controls and the independent auditors. The Company did not have in place sufficient checks to prevent the improper accounting machinations of the Company's management.

IV. FACTUAL BACKGROUND

WorldCom began in 1983 as a small company named Long Distance Discount Services, Inc. in Jackson, Mississippi. Within 15 years, it had become a global telecommunications giant and one of the largest companies in the world. Few companies in the annals of American business have grown so large and so fast in such an intensely competitive marketplace.

A. Overview of the Telecommunications Industry: *The Breakup of AT&T and the Advent of a Highly-Competitive Marketplace.*

Since 1983, the United States telecommunications industry has been transformed from a monopoly to an extremely competitive marketplace. Some of the principal factors that have driven competition include: (i) the elimination and relaxation of legal and regulatory barriers to markets; (ii) the advancement of new technologies and services, including data transmission and Internet services; and (iii) consolidation.

Prior to 1984, AT&T effectively controlled the facilities for both local and long distance service throughout the United States. The government's breakup of AT&T, pursuant to a long-anticipated divestiture order entered by a federal court, brought many new telecommunications companies into the market. The divestiture order generally divided the telecommunications marketplace into providers of local service and providers of long distance service. The divestiture order gave the seven Regional Bell Operating Companies monopoly status in their respective regions for local telephone service, but required them to provide access to long distance service providers to connect with their networks. The order opened long distance service to competition.

Following divestiture, AT&T, which remained a long distance service provider, continued to dominate the long distance marketplace because of, among other things, the perceived quality of its service and customer loyalty to its brand. Two types of long distance competitors to AT&T

emerged – facilities-based carriers, which owned and built transmission facilities, and non-facilities-based carriers or "resellers." "Reselling" generally involved purchasing transmission capacity at wholesale rates from facilities-based carriers and reselling the capacities to commercial and residential customers.

The profitability of a telecommunications carrier is dependent on its ability to generate revenues that exceed its transmission expenses or "line costs." In the evolving competitive environment of the 1980s, AT&T and other facilities-based carriers, with their higher fixed costs, apparently found it difficult to generate sufficient traffic through their internal customer bases. As a result, those carriers sold transmission capacity to resellers at wholesale rates.

Resellers designed their rates generally to be lower than those AT&T charged its residential and commercial customers and competitive with the rates of other facilities-based carriers. By the 1990s, overcapacity of transmission facilities, and other factors, began to reduce profit margins for resellers. In addition, advances in the quality of services provided by fiber optic and digital technology enhanced the ability of other facilities-based carriers to compete with AT&T on the basis of service, as well as price. These various factors intensified the impetus for competitors to consolidate in order to improve efficiency and to finance the acquisition of new technology that might reduce costs and open lines of business and revenue.

The Telecommunications Act of 1996 ("Telecom Act") and concomitant changes in the regulatory policy of the Federal Communications Commission ("FCC") further increased competition by, among other things, removing legal barriers for long distance carriers to provide local telephone services and vice versa. The elimination of these barriers spurred the consolidation of local and long distance service providers into companies that could offer single-source local and long distance service.

Against this backdrop of changing regulation and substantially increased competition, WorldCom grew from a modest reseller within a narrow geographic area to a diversified telecommunications giant with a global presence. For present purposes, the Company's transformation may be summarized as follows.

B. The Evolution of WorldCom: *Growth that Presented Significant Challenges.*

The Company's SEC filings reflect that WorldCom's growth evolved from its commitment to the following principles:

- competition and capital requirements in the telecommunications industry would result in consolidation of competitors to a few dominant companies;
- to survive, WorldCom needed to grow its services, customer base and facilities rapidly and continually;
- the most effective means to grow was the acquisition of existing telecommunications companies with desirable shares of geographic or service markets; and
- investment in new technologies was critical to reducing marginal costs, attracting customers and meeting their demand for new and better services.

From 1985 to 2001, WorldCom acquired other telecommunications companies at an unrelenting pace – over 60 acquisitions in just over 15 years. Regulatory filings reflect that some of these transactions constituted the largest mergers of their time in the telecommunications industry. Public statements by WorldCom executives suggest that these acquisitions were intended to achieve strategically broader geographic coverage of the Company's services, more and better transmission facilities, new services (such as data transmission, Internet, web hosting and wireless services), and new markets. Hindsight has shown, however, that some areas projected to offer high profit margin and growth – such as Internet and wireless service – failed to sustain high growth rates and produce adequate returns, and profit margins declined due to the extensive, industry-wide overcapacity in transmissions facilities.

The Company's focus on acquisitions presented significant challenges. Given its modest early capital base and to minimize reliance on cash outlays for acquisitions, the Company often relied significantly on its stock to pay for many acquisitions. The need to maintain the value and attractiveness of that "currency" placed considerable pressure on WorldCom to achieve consistently impressive share price performance and high stock prices.

Another challenge for WorldCom involved its integration of acquired assets, operations and related customer services. Rapid acquisitions can frustrate or stall integration efforts. Public reports, and our discussions with WorldCom employees, raise significant questions regarding the extent to which WorldCom effectively integrated acquired businesses and operations. A companion set of issues relates to the extent to which the Company integrated or expanded its systems and internal controls to accommodate new and changing businesses, cultures and reporting structures.

Finally, the Company's unprecedented and unceasing growth may have obscured the ability of investors to focus upon and evaluate objectively the actual strength and financial performance of the Company at particular junctures. With the Company so constantly changing form through expansion, reliable benchmarks of historical performance against which investors could measure current performance may have been difficult to find.

C. Five Phases of Growth and Transformation

1. The Emergence of LDDS (1983 – 1989): *Expansion of a Reseller Network and Becoming a Public Company.*

From 1983 to 1985, Long Distance Discount Services, Inc. was licensed to provide long distance service to Mississippi businesses and residents. In 1984, the Company had annual revenues of approximately $1 million.

In 1985, the Board of Directors of Long Distance Discount Services, Inc. elected Bernard Ebbers as the Company's chief executive officer ("CEO"). At that time, Mr. Ebbers, who had been an investor and director in the Company, operated a number of motels through another company known as Master Corporation. Mr. Ebbers had no prior experience in the telecommunications industry.

With Mr. Ebbers at the helm, the Company quickly began acquiring resellers of telecommunication services in other states. The following transactions or events are among those that significantly shaped the Company during this period.

LDDS Communications, Inc. In 1987, LDDS Communications, Inc. ("LDDS"), a Tennessee corporation, was formed as a holding company for the operating entities acquired by Long Distance Discount Services, Inc. By 1989, subsidiaries of LDDS provided long distance telecommunications services in eight southern states and Indiana. It reported annual revenues in 1988 of approximately $53 million and long-term debt of approximately $43.4 million. Its board members included several executives and directors from Mr. Ebbers' motel concern and executives of the acquired resellers. One of these directors, Carl J. Aycock, remains on the Board of Directors of WorldCom today.

Advantage Companies, Inc. In August 1989, LDDS became a public company through a reverse merger with Advantage Companies, Inc. ("Advantage"), a long distance reseller based in Atlanta, Georgia, whose common stock was then listed on the Nasdaq National Market System. LDDS merged into Advantage through a stock conversion with no payment of cash. The surviving entity changed its name to LDDS. The Chairman of the Board of Advantage, Stiles A. Kellett, Jr., became a member of the Board of Directors of LDDS following the merger. Mr. Kellett remained on the Board of Directors of WorldCom through the time of the bankruptcy filings. He resigned from the Board on October 27, 2002.

At the time of the merger, with Advantage, LDDS claimed combined pro forma annual revenues for the merged companies of approximately $116 million.

2. From LDDS to WorldCom (1990 – 1995): *Expansion to a National and International Long Distance Provider and Acquisition of Significant Transmission Facilities.*

The Company aggressively expanded during the early 1990s. By late 1992, LDDS was one of the largest regional long distance companies in the United States, providing telecommunication services to customers in 27 states in the Southeast, Southwest and Midwest. In 1992, the Company reported annual revenues of $948 million. By the end of 1995, it was an international company and changed its name to WorldCom to signify its new stature and broader focus. The Company reported annual revenues of approximately $3.9 billion for 1995. Significant acquisitions in this phase included the following:

Advanced Telecommunications Corp. In December 1992, LDDS acquired Advanced Telecommunications Corp. ("ATC"), a Texas-based reseller that provided long distance services to commercial and residential customers located in 26 states. ATC also was certified to provide long distance services in 11 other states, and it enabled its customers to call all points in the U. S., Puerto Rico, the U.S. Virgin Islands, Canada and 176 other foreign countries. ATC had reported total annual revenues of approximately $354.6 million at the time of the merger. LDDS acquired ATC by converting each share of ATC common stock into .83 shares of LDDS stock, which equated to a value of approximately $850 million.

Scott Sullivan, who had been a vice president and the treasurer of ATC, became an assistant treasurer with LDDS following the merger. He later was promoted to Chief Financial Officer

("CFO") of LDDS in 1994, a position he retained after the Company changed its name to WorldCom. Mr. Sullivan became a member of the Company's Board of Directors in 1996. His tenure on the Board and as CFO ended after the Company discovered substantial accounting irregularities in June of this year.

Metromedia Communications Corp. and Resurgens Communications Group, Inc. In 1993, LDDS became a national provider of long distance telecommunication services through the three-way merger of LDDS, Metromedia Communications Corp. ("MCC") and Resurgens Communications Group, Inc. ("Resurgens"). MCC was a facilities-based carrier that provided long distance service throughout the continental United States. Resurgens was a regional non-facilities-based long distance company that transmitted operator-assisted long distance calls from multi-telephone facilities such as hotels, hospitals and pay telephones located throughout the United States. MCC first merged into Resurgens, creating M/R Corp., a Georgia Company. LDDS then merged into M/R Corp., with the surviving entity being renamed LDDS Metromedia Communications, Inc. The merger was effected through a complicated series of stock conversions, and payment of $150 million in cash. The entire set of transactions was reported to involve an exchange in value of approximately $1.25 billion.

IDB Communications Group, Inc. In 1994, LDDS acquired IDB Communications Group, Inc. ("IDB"). At that time, IDB was the fourth largest international carrier (based on 1992 revenue) and operated a substantial domestic and international communications network. Following the acquisition, IDB became a wholly-owned subsidiary of LDDS. The merger was purely a stock transaction; that is, the common stock of IDB converted into shares of LDDS, with no cash paid by either party. The transaction was valued at approximately $936 million.

Williams Technology Group, Inc. In 1995, WorldCom completed a $2.5 billion cash purchase of Williams Technology Group, Inc. ("WilTel"), by which it acquired WilTel's nationwide common carrier network of approximately 11,000 miles of fiber optic cable and digital microwave facilities. This acquisition gave the Company the capability to serve even the largest companies with both voice and advanced data capabilities. The acquisition of WilTel also added $2.6 billion to the Company's debt.

As of December 31, 1995, the Company's annual reported revenues had climbed to approximately $3.9 billion. The reported notes payable and long-term debt of WorldCom was approximately $3.4 billion on that date.

3. WorldCom (1996): *Expansion into Local Markets and Internet Service.*

Following enactment of the Telecom Act in 1996, WorldCom swiftly seized the opportunity to compete in local markets and greatly advanced its capacity to offer Internet services.

MFS Communications Company, Inc. and UUNet Technologies, Inc. In December 1996, the Company acquired MFS Communications Company, Inc. ("MFS"), which owned and operated local network access facilities installed in and around major U.S. cities and in several major European cities. MFS also possessed significant transmission and switching facilities in network capacity, which it had leased from other carriers in the United States and Western Europe. The acquisition of MFS enabled WorldCom to offer single source local and long distance services.

UUNet Technologies, Inc. ("UUNet"), a subsidiary of MFS, was a significant component of the transaction. As a leading provider of many Internet access modalities, applications and consulting services, UUNet was perceived to provide a foundation for meeting projected high demand for Internet applications.

The merger with MFS was an all-stock deal, valued at approximately $12 billion, which involved the conversion of each share of MFS common stock into 2.1 shares of WorldCom common stock and conversion of various preferred classes of MFS stock into convertible preferred shares of WorldCom. Following the merger, seven new directors of WorldCom were assigned by MFS. These included John W. Sidgmore, who was the CEO of UUNet. Today, Mr. Sidgmore is WorldCom's CEO and a member of the Company's Board of Directors.

By the end of 1996, the Company reported annual revenues of approximately $4.8 billion and notes payable and long-term debt of approximately $4.8 billion.

4. WorldCom (1997 – 1998): *Consolidation of Its Leadership Position in Local and Long Distance Telecommunications Services.*

In 1997 and 1998, WorldCom completed three major acquisitions. The most significant of these acquisitions involved MCI Communications Corporation ("MCI"). The MCI transaction was, at the time it was announced, the largest merger transaction in history, reported to be valued at approximately $40 billion. This acquisition, which originally was announced in October 1997 but was not completed until September 1998, consolidated the network capacity, business lines and services of two large competitors. The companies expected their integration to generate operating efficiencies through, among other things, reduced leased line costs and the combination of sales and marketing forces. The merger followed a failed effort to acquire MCI by British Telecommunications. Pursuant to the terms of the merger, MCI shareholders generally received 1.2439 shares of WorldCom common stock (a market value of approximately $51 per share) for each share of MCI common stock and British Telecommunications received $51 in cash for each share of MCI class A common stock which it had acquired in its aborted takeover of MCI.

With the acquisition of MCI, the Company changed its name to MCI WorldCom, Inc. and increased its local service to over 100 domestic U.S. markets. In addition to the MCI transaction, the following other transactions and events significantly shaped the Company during this period.

Embratel Participacoes S.A. As part of the merger with MCI, WorldCom acquired MCI's 51.79% voting interest and 19.26% economic interest in Embratel Participacoes S.A. ("Embratel"), which is a Brazilian facilities-based national and international communications provider. MCI had acquired its interest in Embratel for approximately $2.3 billion in cash in August 1998, just before the closing of its merger with WorldCom. At that time, Embratel provided domestic long distance and international telecommunications services in Brazil, as well as over 40 other communications services, including leased high-speed data, internet, frame relay, satellite and packet-switched services. WorldCom included Embratel's operating results in the Company's consolidated financial statements from the date of the MCI merger.

Avantel, S.A. Also as part of its merger with MCI, WorldCom acquired a significant equity interest in Avantel, S.A. ("Avantel"), which provided domestic and international telecommunications services in Mexico. Avantel was formed in the early 1990s by MCI and Grupo Financiero Banamex-Accival ("Banamex"). MCI owned 44.5%, of Avantel and Banamex owned the balance of the company. Banamex was expected to provide governmental relations and management support for Avantel, whereas MCI and, later, WorldCom, was expected to provide network support.

Brooks Fiber Properties, Inc. In January 1998, WorldCom acquired Brooks Fiber Properties, Inc. ("BFP"), a leading facilities-based provider of competitive local telecommunication services in selected cities within the U.S. The acquisition of BFP further advanced the Company's participation in local markets. BFP became a wholly-owned subsidiary of the Company.

<u>CompuServe Corporation and ANS Communications, Inc.</u> In related transactions in January 1998, WorldCom merged with CompuServe Corporation ("CompuServe"), which through two divisions, Internet Services and Network Services, offered, respectively: (i) online and Internet access for consumers, and (ii) worldwide network access, management applications and Internet services to businesses. Each share of CompuServe was converted in 0.40675 shares of WorldCom stock. Concurrently with the acquisition of CompuServe, America Online, Inc. ("AOL") bought CompuServe's Interactive Services Division from WorldCom for $175 million. In addition, WorldCom acquired ANS Communications ("ANS") from AOL and entered into five-year contracts with AOL pursuant to which WorldCom and its subsidiaries would provide network services to AOL.

As of December 31, 1998, WorldCom reported annual revenues of approximately $17.6 billion and notes payable and long-term debt of approximately $21.2 billion, which included operating results for CompuServe, ANS and MCI.

5. WorldCom (1999 – 2001): *Expansion of Wireless and Web Services.*

In 1999, WorldCom acquired greater wireless communications capacity through acquisitions of SkyTel Communications, Inc. ("SkyTel"), CAI Wireless Systems, Inc. and Wireless One. The following other transactions or events also significantly impacted the Company during 1999 and 2000 as it sought greater penetration of the global market.

<u>Sprint Communications, Inc.</u> In October 1999, WorldCom announced an agreement to merge with Sprint, one of its chief competitors, in order to become a formidable competitor for wireless services and to enhance MCI WorldCom's existing fiber optic network and advanced data communications services. The proposed combination with Sprint generated considerable

regulatory scrutiny in the United States and Europe. In July 2000, the companies formally terminated the merger plan after receiving opposition from the U.S. Department of Justice.

Intermedia Communications, Inc. and Digex, Inc. In September 2000, shortly after the Company abandoned plans for the Sprint merger, WorldCom acquired Intermedia Communications, Inc. ("Intermedia") for a reported $5.8 billion in stock and assumed approximately $2.4 billion of long-term debt. One of the principal attractions to the Company was the acquisition of Intermedia's controlling interest in Digex, Inc. ("Digex"), which was perceived to be a leading provider of managed Web and application host services. WorldCom viewed the merger as providing it with premier Web hosting products and services, including comprehensive access, transport and application solutions. The acquisition closed in July 2001, after being delayed due to litigation commenced by the minority shareholders of Digex, which settled earlier in the year.

By the end of 2000, WorldCom had grown into a telecommunications giant, with significant operations in all major aspects of the industry. As of December 31, 2000, the Company reported total annual revenues of over $39 billion and notes payable and long-term debt of $24.9 billion.

D. WorldCom 2001: The Downturn for Telecom: *Falling Share Prices, Failure of a Tracking Stock Initiative and Signs of Trouble.*

In the last half of the 1990s, significant capital flowed to many telecommunications companies based on a widely held view, spurred by Wall Street analysts, that the sector was poised for almost unlimited growth. The Dow Jones Telecommunications Index, which is a weighted index of the common stocks of over 25 telecommunications companies, reflects that share prices for the industry as a whole rose sharply in the late 1990s. Exceeding even the sector's impressive performance, WorldCom's share price rose from the low $20s in January 1995 to over $90 per share by mid-1999. It had six stock splits between 1990 and 1999; two were at a ratio of 2 to 1 and four were 3 to 2 splits.

The industry as a whole, and WorldCom in particular, experienced sharp and continuous declines in share prices from early 2000 to the present. WorldCom common stock fell from a high on June 30, 1999 of $96.766 per share to a low of $46 per share by June 30, 2000. As of December 29, 2000, the stock's high was $18.656. For the next year it generally fluctuated between $24 and $12 per share. It fell precipitously in 2002 and was delisted from the Nasdaq stock market as of July 30, 2002.

Following the severe erosion of the Company's share price in 2000, WorldCom proposed and its shareholders approved a plan of "recapitalization" in 2001 to create two separately traded tracking stocks: WorldCom Group and MCI Group. Each tracking stock was a separate class of the Company's common stock intended to provide a return to investors based upon the financial performance of the distinct business units attributed to each stock. The ownership of the targeted businesses did not change and while each of the classes of stock traded separately, all shareholders remained shareholders of WorldCom and were subject to all of the risks and potential benefits of an investment in WorldCom as a whole.

The theory behind this recapitalization was to give investors the opportunity to invest in distinct lines of the Company's business. The WorldCom Group tracking stock generally was perceived as involving growth areas (data, internet, international and commercial voice businesses) that would be attractive to growth-oriented investors. The MCI Group stock generally was tied to businesses that were perceived as generating significant cash flow (the Company's consumer, small business, wholesale long distance voice and data, wireless messaging and dial up internet access business), and it was expected to pay a cash dividend. The tracking stock initiative, however, did not spawn sufficient investor interest to improve share prices. On May 21, 2002, the Company announced that it was eliminating the tracking stock structure, effective July 12, 2002, apparently to realize an annual cost savings of $284 million by eliminating the dividend on MCI Group stock. The elimination of the tracking stock structure was delayed and it was never completed following the Company's bankruptcy filings. Nevertheless, it appears that the Company does not intend to report results according to the tracing stock structure in the future.

As of December 31, 2001, the Company reported total annual revenues of over $35.2 billion and total debt of $30.2 billion.

E. Recent Developments

In 2002, WorldCom has endured months of extraordinary adverse developments, including reports of substantial accounting and financial reporting improprieties, significant layoffs of employees, the removal of its CEO and CFO, a public admission of preparing and filing false financial statements with the SEC, the filing of petitions for reorganization under Chapter 11 of the Bankruptcy Code, an SEC enforcement action, and criminal charges against, and guilty pleas by, certain former officers and employees. The Company has responded to these developments by, among other things, making significant changes to its management, Board of Directors and organization. The following is a brief summary of these recent events and some of the significant actions taken by the Company.

1. March 2002 – SEC Investigation

In the wake of public reports regarding numerous SEC investigations into the accounting practices of telecommunications and other companies, WorldCom announced on March 11, 2002 that it had received a confidential request from the SEC for voluntary production of documents and information. In a press release, WorldCom listed the areas of inquiry by the SEC, which included, among others, accounting treatment for goodwill, loans to WorldCom's officers and directors, the Company's policies and procedures concerning revenue recognition, accounts receivable-related reserves, and certain write-offs. The Company's press release stated affirmatively that WorldCom believed its policies, practices and procedures had complied, and continued to comply, with all applicable accounting standards and laws.

2. April 2002

a. Significant Reduction of Workforce

On April 3, 2002, the Company announced that, to better align its costs with its projected 2002 revenue guidance of mid-single digit growth, it was reducing its U.S.-based staff relating to the WorldCom Group by 3,700 positions, which equaled approximately 6% of that workforce. The Company reported that the reduction would be realized across the organization. The MCI Group was not affected by this action.

b. Resignation of Mr. Ebbers

By late April 2002, the combination of the Company's sagging performance and share price, Mr. Ebbers' personal financial difficulties, and complications with respect to the Company's loan and guarantee covering a margin loan against Mr. Ebbers' WorldCom stock holdings, convinced the independent directors to call for Mr. Ebbers' resignation. On April 30, 2002, the Company announced that Mr. Ebbers had resigned as President, CEO and Director and that Mr. Sidgmore had assumed the position of President and CEO of WorldCom. The same announcement reflected that Mr. Sullivan had been promoted to Executive Vice President and that Ronald Beaumont had been promoted to COO of the Company. The announcement quoted Mr. Sidgmore as stating that the Company's "low cost structure, [its] are strengths in offering services to every level of the enterprise market and consumers, and [its] solid financial foundation – built on free cash flow production – position us to attack the marketplace with exceptional force."

3. May 2002

a. Change of Auditors

Following the indictment of Arthur Andersen relating to its destruction of documents concerning Enron Corporation, the Company's Board of Directors, upon the recommendation of the Audit Committee, engaged KPMG to replace Arthur Andersen as the Company's independent auditor and accountants. KPMG became the Company's independent auditor and accountants effective May 14, 2002.

b. Draw Down on Line of Credit

In May 2002, WorldCom drew down a $2.65 billion credit line and ultimately moved the funds into money market funds sponsored by non-creditor financial institutions or securities firms. non-creditor banks. The move effectively prevented creditors of the company from freezing the funds in the event of bankruptcy.

4. June 2002

a. Lowering of Credit Rating

Debt securities issued by WorldCom were downgraded several times in 2002. For example, On or about June 17, 2002, Standard & Poor's lowered the corporate credit rating of WorldCom. In reaction to this downgrade, the Company announced in a press release that it was negotiating with its banks on a new $5 billion bank credit facility and that "with plenty of cash on hand and no debt maturing over the next six months, it does not matter whether the new facility is in place today or at any date later this summer."

b. Discovery of the Capitalization of Line Costs

The Internal Audit Department's investigation of the capitalization of line costs is a story that has already been publicly reported. We will briefly summarize the significant events here. In May 2002, the Company's Internal Audit Department began an investigation concerning the capitalization of line costs. On May 21, 2002, an internal auditor received from another WorldCom employee, a featured article from the May 16 edition of Fort Worth Weekly Online, entitled "Accounting for Anguish." The employee indicated that the issues raised in the article might warrant investigation by the Internal Audit Department at WorldCom. "Accounting for Anguish" is based upon interviews with Kim Emigh, a former WorldCom employee who allegedly was fired for whistle blowing, and details a number of alleged accounting improprieties at the Company, although none related to the capitalization of line costs.

Members of the Internal Audit Department continued their investigation over the next few weeks, attempting to gather relevant documents and information. On or about June 12, 2002, the Internal Audit team contacted Max Bobbitt, the Chairman of the Audit Committee of the Board of Directors, and informed him of its discoveries regarding the timing and amounts of certain journal entries. The Internal Audit Department told Mr. Bobbitt that these journal entries included entries amounting to $743 million for the third quarter of 2001, entries amounting to $941 million for the fourth quarter of 2001, and entries amounting to $818 million for the first quarter of 2002, for a total of $2.5 billion in line costs that had been capitalized. Mr. Bobbitt then requested that these issues be discussed with KPMG prior to a meeting of the Audit Committee on June 14, 2002. This discussion occurred on June 12.

Between June 12 and June 20, the Internal Audit team continued its investigation. On June 20, the Audit Committee of the Board of Directors met to discuss the issue. In the course of the meeting, representatives from KPMG summarized the circumstances underlying the capitalization of line costs from the second quarter of 2001 through the first quarter of 2002. KPMG representatives told those present at the meeting that, in their view, the capitalization of line costs did not comply with GAAP and that no documentation supporting such capitalization appeared to exist. KPMG was asked if the Company needed to restate its financial statements at that time and KPMG said that it had not reached conclusions with respect to any issue raised. Mr. Sullivan attempted to explain to those attending the Audit Committee meeting his reasoning behind the capitalization of line costs and he requested additional time to support and document the transfers of line costs from the Company's income statement (where they appeared as expenses) to its balance sheet (where they appeared as assets, generally subject to depreciation).

Between June 21 and June 24, the Board of Directors engaged various attorneys and other professionals to review this matter. On June 24, the crisis surrounding the Company's capitalization of line costs reached its peak following a series of events.

Another meeting of the Audit Committee was scheduled for June 24, 2002. In preparation for that meeting, Mr. Sullivan submitted what has come to be known as the "White Paper," setting forth his rationale for the line cost capitalizations in light of the economic conditions prevailing at the time at which the line cost capitalizations occurred. In the White Paper, Mr. Sullivan stated that, following WorldCom's merger with MCI in September of 1998, WorldCom had sold MCI's SHL Systemhouse business for $1.4 billion and announced that it would use the entire proceeds of the sale to expand WorldCom's network. Through the end of 2000, Mr. Sullivan's White Paper continued, WorldCom had engaged in an extended capital investment campaign to increase the size of the Company's Internet backbone, expand local and data networks, and construct a "Pan European network." Mr. Sullivan observed that, at this time, the telecommunications industry was rapidly developing, WorldCom was facing "increased" and "intense" competition, and it was important that the Company have the ability to enter the market quickly and provide the "best network" to its customers with "little provisioning time." Mr. Sullivan noted that WorldCom's decision to increase capital investment significantly was based upon the prevailing belief that Internet use and data demand would continue at the rate of eight times the annual growth that the telecommunications industry was experiencing.

According to Mr. Sullivan's White Paper, it was during this period that WorldCom entered into long-term, fixed-rate line leases to connect its network with the networks of incumbent local exchange carriers. Mr. Sullivan noted that WorldCom also entered into various network leases to complement its data, Internet, and local services, in order to obtain access to large amounts of line capacity "under the theory that revenue would follow and fully absorb these costs and expedite 'time to market.'" Mr. Sullivan also stated that WorldCom was willing to absorb the line lease costs prior to recognizing the revenue to match them, because "it believed that future revenue would be matched up with these costs." The White Paper referenced Staff Accounting Bulletin No. 101 ("SAB 101") and Financial Accounting Standards Board No. 91 ("FASB 91") to support Mr. Sullivan's conclusion that the lease costs thereby incurred should not be expensed until WorldCom had recognized matching revenue. Mr. Sullivan reasoned that "the cost deferrals for the unutilized portion" of line leases were "an appropriate inventory of this capacity" that ultimately would be amortized before the expiration of the contractual commitment. To support this reasoning, Mr. Sullivan quoted the definition of an asset as "'probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events,'" together with a description of the essential characteristics of an asset, as set forth in Statement of Financial Accounting Concepts No. 6.

In the White Paper, Mr. Sullivan went on to observe that the second quarter of 2002 marked the first time in the Company's history that WorldCom had experienced quarterly revenue decreases for two consecutive quarters and that these decreases were the result of challenges posed by a weak economy and the consequent network downsizing of customers, customer bankruptcies, foreign exchange losses, and "product migrations." According to Mr. Sullivan, these events, together with the resignations of WorldCom's President and CEO, the junk-status of the Company's debt rating, and its liquidity concerns, all contributed to a determination by WorldCom, in the second quarter of 2002, that the "future economic benefits of the deferred costs" of the Company's line leases could not ultimately be realized, necessitating a write-off of the previously capitalized costs. In concluding the White Paper, Mr. Sullivan observed that the preparation of the financial statements of WorldCom "requires the Company to make estimates and assumptions that affect the reported amount of assets and liabilities as well as the reported amount of expenses, including line costs" and that "[s]ignifcant [sic] management judgments and estimates must be made and used in connection with establishing these amounts."

At the Audit Committee meeting on June 24, representatives from Arthur Andersen informed WorldCom that, in light of the line cost transfers that occurred in 2001 and 2002, the opinion of Arthur Andersen concerning the Company's 2001 financial statements no longer could be relied upon. The Arthur Andersen representatives stated that they did not know about the line cost transfers, but they would not answer questions as to why their audit had failed to uncover them. They indicated that they had not seen Mr. Sullivan's White Paper, but that it had been read to them and that they could not accept it as compliant with GAAP. Representatives of KPMG agreed with Arthur Andersen that the capitalization of line costs could not be supported under GAAP. The Audit Committee rejected Mr. Sullivan's reasoning in the White Paper and determined that it would report to the Company's Board of Directors that a full restatement of the financial statements of WorldCom for 2001 and the first quarter of 2002 would be necessary. The Audit Committee advised Messrs. Sullivan and Myers that if they did not resign before the Board of Directors meeting scheduled for the following day, their employment would be terminated.

The full Board of Directors met on June 25, 2002. At that meeting, the Board determined that WorldCom would restate its financial statements for 2001 and the first quarter of 2002. The Board also determined that KPMG would reaudit the Company's financial statements for 2001 and it decided to terminate Mr. Sullivan without severance and to accept the resignation of Mr. Myers without severance. The Board also decided that it would immediately inform the SEC of the Board's decisions and that after representatives of WorldCom had informed the SEC regarding these matters, the Company would inform the public of the Board's conclusions.

c. June 25 Public Announcement of Restatement of Earnings

Following the Board of Directors meeting, WorldCom representatives met with the SEC staff. WorldCom then issued a press release on June 25, 2002 regarding its intention to restate its financial statements for 2001 and the first quarter of 2002.

The Company's June 25 press release announced that the restatement would cause an aggregate reduction of $3.8 billion in its earnings before interest, taxes, depreciation and amortization ("EBITDA") for 2001 and the first quarter of 2002. The announcement further explained that Arthur Andersen had advised the Company that, in light of the inappropriate transfers of line costs, Arthur Andersen's audit report on the Company's financial statements for 2001, as well as its review of the Company's financial statements for the first quarter of 2002, could not be relied upon.

As a reflection of its weakening financial performance, the Company also explained that it was acting to improve liquidity and operational performance by downsizing its workforce by an additional 17,000 positions, selling non-core businesses and paying preferred stock dividends in common stock rather than cash.

d. SEC Enforcement Action Against the Company and Appointment of the Corporate Monitor

On June 26, 2002, the SEC commenced a civil injunctive action against WorldCom in the United States District Court for the Southern District of New York alleging violations of the antifraud and other provisions of the federal securities laws. The SEC complaint sought an injunction, monetary penalties, and prohibitions on destroying documents and making extraordinary payments to WorldCom affiliates. That proceeding is still pending

On June 28, 2002, based upon a joint agreement between the SEC and WorldCom, the District Court ordered, among other things, that WorldCom and its affiliates preserve all items relating to the Company's financial reporting obligations, public disclosures required by the federal securities laws and accounting matters. The District Court further ordered that it would appoint a Corporate Monitor having oversight responsibility with respect to all compensation paid by WorldCom. On July 2, 2002, the Court appointed, upon the request of the SEC and with the Company's consent, former SEC Chairman Richard C. Breeden to serve as the Corporate Monitor.

5. July 2002 – Chapter 11 Filings

As noted above, on July 21, 2002, WorldCom announced that it and substantially all of its active U.S. subsidiaries filed voluntary petitions for reorganization under Chapter 11 of the United States Bankruptcy Code.

6. Further Restatement of EBITDA

On August 8, 2002, WorldCom announced that an internal review of its financial statements had discovered an additional approximately $3.3 billion in improperly reported EBITDA for 1999, 2000, 2001 and the first quarter of 2002. That amount was in addition to the $3.8 billion restatement previously announced by the Company with respect to the improper capitalization of line costs. WorldCom also disclosed that it expected to record further write-offs of assets previously reported, including the likelihood that it may determine that all existing goodwill and other intangible assets, then recorded as $50.6 billion, should be written off when restated 2000, 2001 and 2002 financial statements are released.

7. Criminal and SEC Actions Against Former Officers and Employees

Several former finance or accounting officers of WorldCom have been the subject of criminal or SEC proceedings during the last several months. Specifically, on August 1, 2002, Mr. Sullivan was arrested on seven criminal counts, including securities fraud, conspiracy to commmit securities fraud and filing false statements with the SEC. Later, on August 28, 2002, Mr. Sullivan was indicted for conspiracy to commit securities fraud, filing false statements with the SEC, and other criminal violations of the federal securities laws. These charges are pending.

On August 1, 2002, Mr. Myers also was arrested and charged with securities fraud, conspiracy to commit securities fraud and filing false statements with the SEC. On September 26, 2002, Mr. Myers pled guilty to one count each of securities fraud, conspiracy to commit securities fraud and filing false statements with the SEC. An SEC civil enforcement action against him for securities fraud, which also was filed on September 26, is still pending.

On October 7, 2002, Buford "Buddy" Yates, Jr., the former Director of General Acounting, pled guilty to securities fraud, conspiracy to commit securities fraud and filing false statements with the SEC. An SEC civil enforcement action against him for securities fraud, filed on that same day, is still pending.

On October 10, 2002, Betty Vinson and Troy Normand, who were employed as accountants in WorldCom's General Accounting Department and reported to Mr. Yates, each pled guilty to two criminal counts of conspiracy and securities fraud. The SEC also filed a civil enforcement action against both of them for securities fraud, which remains pending.

F. The Company's Response to Developments in 2002

In response to these developments, the Company has taken certain actions. Among other actions, the Company has announced a search for a new CEO, it has a new CFO, a Corporate Restructuring Officer ("CRO"), new outside auditors, additional legal and financial advisors and three new members of its Board of Directors. WorldCom also is making changes to its internal audit and financial control functions.

1. New Members of Senior Management

On July 28, 2002, the Company announced that Mr. Sidgmore had appointed Gregory F. Rayburn as CRO and John S. Dubel as CFO, both of whom are principals in AlixPartners, LLC, a corporate restructuring firm. Messrs. Rayburn and Dubel report directly to Mr. Sidgmore. Both men have significant corporate management and restructuring experience. Mr. Rayburn, who has been the CEO and CRO of other companies, is a Certified Public Accountant ("CPA") and a Certified Fraud Examiner. Mr. Dubel has served as CRO and COO of another telecommunications company and is a Certified Insolvency and Reorganization Accountant. On September 10, 2002, the Company announced its intention to search for a new CEO to replace Mr. Sidgmore.

2. New Directors

In the wake of the disclosures concerning improper accounting practices, the Board of Directors added Nicholas deB. Katzenbach, Dennis R. Beresford, and C.B. Rogers, Jr., as directors. Mr. Katzenbach currently is a private attorney. He previously served as Attorney General of the United States (1965-66), Under Secretary of State for the United States (1966-69), and as Senior Vice President and General Counsel of IBM Corporation (1969-86). Mr. Beresford currently is Professor of Accounting at the Terry College of Business, University of Georgia, and previously served as Chairman of the Financial Accounting Standards Board from 1987 to 1997. Mr. Rogers is the former Chairman and CEO of Equifax, Inc., and also has served as a director of Sears, Roebuck & Co., Dean Witter, Discover & Co., Briggs & Stratton Corporation, Oxford Industries and Teleport Communications Group. Mr. Rogers previously served on the Board of Directors of MCI before its merger with WorldCom. Neither Mr. Katzenback nor Mr. Beresford previously was associated with WorldCom.

3. Enhancements to the Company's Accounting, Audit and Internal Control Functions

The Company's new management has advised us that it will implement a number of organizational changes that are intended to help correct the Company's past problems, prevent their reoccurrence and create a system that will permit its independent auditors to opine on the reasonableness of the financial statements for the years 2000, 2001 and 2002. Among the more significant of these measures are the following:

a. Permanent Controller and Establishment of SubControllers

The Company soon will hire a permanent Controller and create positions for four new subcontrollers who will be responsible for, respectively: (1) revenue accounting (accounts receivable, commissions, and credit and collections); (2) operational accounting (accounts payable); (3) financial accounting (SEC filings, general accounting and property accounting); and (4) financial controls, policies and procedures. The Company is seeking to hire highly qualified and experienced personnel for these new positions. Significantly, the new Subcontroller for Financial Controls, Policies and Procedures will be responsible for documenting and communicating to the entire Company controls designed to assure adherence to GAAP, as well as the prevention of fraud and financial wrongdoing. That subcontroller will report directly to the CFO with dotted line authority to the Controller and will be expected to work closely with the Internal Audit Department, which will be responsible for testing the Company's financial information and performance. Beneath this platform of the four subcontrollers will be 19 new positions, organized temporarily to support the Accounting Department, to provide audit assistance to KPMG and prepare the necessary financial schedules that will permit the Company to proceed with an independent audit in a timely fashion.

b. Restatements Group

The Company also is creating a Restatements Group, which the Company intends to be staffed with highly experienced accounting and financial professionals, including at least one senior executive from an outside restructuring firm. Six professionals will be hired to assist this effort over a six-to-nine month period and to identify and correct the Company's accounting irregularities.

c. New CFO Positions

The Company will create two new CFO positions for its Asia-Pacific business and its European business. Each CFO will have dotted line authority to the CFO of WorldCom.

d. An Increase of Internal Audit Staffing

The Company intends to at least double the staff of the Internal Audit Department.

G. WorldCom's Current Business.

Notwithstanding its bankruptcy, WorldCom remains one of the largest global communications companies in the world. Through the work of over 60,000 employees, WorldCom delivers communications services to more than 20 million residential and business customers in over 65 countries throughout North America, Latin America, Europe, Africa, and the Asia-Pacific region. It provides comprehensive global-to-local communications services via its end-to-end owned facilities, reportedly carrying more international voice traffic than any other company. It is the largest competitive local exchange carrier in the United States. It operates an Internet protocol network that provides connectivity in more than 2,600 cities in over 100 countries, and reportedly 65 to 70 percent of the world's Internet traffic runs across its network.

WorldCom owns extensive telecommunications assets and offers a wide array of services. According to its most recently filed Annual Report, it owns domestic long distance, international and multi-city local service fiber optics networks. It also has secured additional fiber optic networks through lease agreements with other carriers. Internationally, WorldCom owns and leases fiber optic capacity on most major international undersea cable systems in the Atlantic and Pacific oceans and owns fiber optic capacity for services to Eastern Europe, Asia, Central America, South America and the Caribbean. WorldCom also owns and operates international gateway satellite earth station antennas, which enable WorldCom to extend public switch and private line voice and data communications to and from locations throughout the world.

Among the principal services WorldCom provides are data transmissions (through frame relay, asynchronous transfer mode and Internet protocol networks), Internet services (including Internet access and value-added options, applications and services), virtual private networks, managed hosting for business on the Internet, and commercial local and long distance voice communications. Most of these services are offered both in the continental United States and internationally. WorldCom provides these services through its own operations and those of a host of direct or indirect subsidiaries, such as Intermedia, Digex, SkyTel, CompuServe, and BFP.

H. The Management Structure at WorldCom

The full breadth of WorldCom's complicated management structure, which governed its diverse telecommunications businesses, separate subsidiaries, international operations, and tens of thousands of employees, is beyond the scope of this First Interim Report. Our review of documents, and interviews of Company personnel, however, reflect the following about the Company's management structure, which is instructive to our investigation.

At least from the merger of WorldCom with MCI to the present, the Company organized its businesses in three geographically-based units – United States operations, European operations and Asia-Pacific operations – with each ultimately reporting to top-tier management in the United States. While some of the Company's businesses have been associated with particular subsidiaries, such as UUNET and BFP, management reporting lines followed business and operational functions regardless of the legal entity that employed particular personnel. Thus, for example, all employees involved in network operations and technology generally reported through a chain of command consisting of persons who performed or oversaw those functions, headed by a senior vice president for network operations and technology located in the United States, irrespective of the fact that they may technically be employed by different affiliates.

Significantly, the offices of top tier management were geographically dispersed. Thus, for example, Mr. Ebbers' principal office as CEO was in Mississippi; Mr. Sullivan, the CFO, ran financial operations out of Mississippi but also had a residence and office in Florida; Network

Operations and Public Affairs were run out of Dallas, Texas; Human Resources was overseen from Boca Raton, Florida, and the Legal Department was headquartered in Washington, D.C.

I. The Board of Directors

1. Composition

WorldCom's Board of Directors has 10 members -- two inside directors and eight independent directors. Six of the ten directors have served on the Board since at least the merger of WorldCom and MCI in 1998. Of those six, four were members of the Company's Board of Directors before the merger: Carl J. Aycock, Max E. Bobbitt, Francesco Galesi and John W. Sidgmore.[2] Three directors were members of the former MCI Board: Chairman Bert C. Roberts, Jr., Judith Areen, and Gordon S. Macklin.

As of July 21, 2002, in response to its financial and accounting crises, the Board elected two new independent directors, Messrs. Katzenbach and Beresford. These new directors have been appointed to a Special Investigative Committee of the Board, which is conducting a review of the Company's accounting practices and preparation of financial statements. On August 29, 2002, the Board added another new director, Mr. Rogers, who also is serving on the Special Investigative Committee.

Our examination to date indicates that, prior to his resignation from the Board of Directors on April 30, 2002, Mr. Ebbers exercised substantial influence over the Board's decision-making process and actions. It appears from interviews of Board members that his sway was attributable to the Board's perception of the Company's success and growth under his direction, the high esteem in the Wall Street financial community in which he seemingly was held, his apparently innately

[2] An Advisory Director, James Tucker, also served as a full director on WorldCom's Board before the MCI merger.

forceful personality, and the loyalty of Board members whose companies had been acquired by WorldCom and whose personal fortunes through ownership of the Company's stock had, for a long period of time, been greatly enhanced during his leadership of WorldCom. It further appears that Mr Sullivan also had significant influence over Board actions and that Board members held him in high regard.

2. Board Meetings

During the relevant time period, the Company's Board of Directors held four regularly scheduled meetings each year, as well as additional special meetings in connection with approving major transactions. Typically, several days before each meeting, Board members received a package of materials, including an agenda, the minutes of the prior Board meeting, financial information, summaries of analysts' expectations, a list of institutional investors, a transcript of the most recent conference calls with analysts and company executives, and draft resolutions that would be discussed and likely voted upon at the meeting. The financial information typically compared actual performance against the budget, cash flow, capital expenditures, revenue trends, line costs, selling, general and administrative expenses, and other financial data.

The minutes of Board of Directors meetings reflect that such meetings included, among other things, a report from the Chairman of the Audit Committee, a report from the Chairman of the Compensation and Stock Option Committee, a financial report from Mr. Sullivan, a "CEO Report" from Mr. Ebbers (which could cover a variety of subjects ranging from diversity issues to business plans), a Legal and Regulatory report from the General Counsel, a Human Resources report, and reports on international operations, corporate developments, ventures and alliances, and operations and technology. Transactions requiring Board approval and ratification would be specifically discussed and voted upon. The minutes of Board meetings reflect that from at least

1999 to May 2, 2002, all matters that required Board approval were approved unanimously. No dissents on any vote are noted in the minutes.

The minutes of Board meetings and interviews with directors indicate that often, after adjournment of the formal meeting, the Company's directors would meet in executive session (typically non-Board members would be asked to leave the room) to address sensitive subjects, such as litigation matters, potential acquisitions and business or financial strategies.

3. Director Compensation and Stock Ownership

Proxy statements for annual meetings disclose that, from 1998 to the present, directors were paid fees of $35,000 per year and $1,000 per meeting, plus certain expenses. Members of Committees of the Board of Directors were paid a fee of $750 for each committee meeting attended on the same day as the Board meeting and $1,000 for any other committee meeting attended. The Chairman of each Committee received an additional $3,000 per year. Under a program implemented in May 1999, each director was allowed to elect to receive some or all of his or her annual fees in the form of WorldCom stock (or later, WorldCom Group stock or MCI Group stock), based on the respective fair market value of the stock on the election date. In addition, pursuant to the Company's 1999 Stock Option Plan, each non-employee director was eligible to receive an annual grant of options. The timing, terms and number of share purchase rights awarded to directors through options were matters left to the discretion of the Compensation and Stock Option Committee.

During 2001, for example, each non-employee director received a grant of options to purchase 10,000 shares of WorldCom Group stock at $15.6265 per share. Such options were immediately exercisable and expired on the earliest to occur of 10 years following the date of grant, one year following termination of service due to disability or death, upon cessation of service for reasons other than death or disability, or the date of consummation of a specified change in control transaction (*e.g.*, the dissolution or liquidation of WorldCom or a merger in which WorldCom was not the surviving corporation).

Many Board members had large holdings of WorldCom stock. The proxy statement and supplemental proxy statement for the Company's 2002 annual shareholder meeting disclosed the following beneficial ownership of WorldCom Group stock and MCI Group stock by directors and executive officers:

	Number of Shares Beneficially Owned	
Name of Beneficial Owner[3]	WorldCom Group Stock	MCI Group Stock
James C. Allen	412,749	14,767
Judith Areen	113,849	1,386
Carl J. Aycock	276,375	37,719
Ronald R. Beaumont	2,063,798	0
Max E. Bobbitt	433,749	13,429
Bernard J. Ebbers	23,972,088	576,837
Francesco Galesi	1,202,738	49,759
Stiles A. Kellett, Jr.	1,169,881	79,878
Gordon S. Macklin	224,387	2,863
Bert C. Roberts, Jr.	1,705,968	79,169
John W. Sidgmore	5,534,544	91,648
Scott D. Sullivan	3,264,438	223
All Directors and current executive officers as a group (12 persons)	40,374,564	947,678

4. Board Committees

The Company's Board of Directors had three committees: an Audit Committee, a Compensation and Stock Option Committee ("Compensation Committee"), and a Nominating Committee. Based on our interviews of individual directors, it appears that the Nominating Committee met infrequently and that its sole purpose was to determine committee appointments in

[3] Footnotes appearing in the proxy statement have been omitted.

consultation with Mr. Ebbers on an as-needed basis. In contrast, it appears that the Audit Committee and the Compensation Committee were more active and had broader responsibilities.

a. The Audit Committee

The Audit Committee is comprised of Mr. Bobbitt, as Chairman, Ms. Areen, Mr. Galesi and Mr. Beresford. Mr. Allen had served on the Audit Committee since 1999, but he left the Committee in July 2002, when Mr. Beresford joined the Board and the Committee. Each of Mr. Bobbitt Mr Galesi and Ms. Areen has served on the Audit Committee since 1998. The Committee's charter provides that it is to perform the following functions: (a) review of periodic financial statements, (b) communications with independent auditors, (c) review of the Company's internal accounting controls, and (d) recommendation to the Board of Directors as to the selection of independent auditors. Since 1998, the Committee has held three to five meetings a year. Typically, these meetings occured the day before each quarterly Board meeting. At each quarterly Board meeting, the Committee's Chairman reported to the full Board regarding the work and actions of the Audit Committee.

b. The Compensation and Stock Option Committee

From 1998 to October 2002, the Compensation Committee consisted of Mr. Kellett,[4] as Chairman, and Messrs. Bobbitt, Macklin and Tucker. As noted above, Mr. Tucker has served only in a role of an advisory director since November 2000. Based on our interviews of directors, it appears that appointment to the Committee largely was influenced by Mr. Ebbers, in consultation with the Nominating Committee. Since 1998, the Committee has held between four and sixteen meetings a year. The Committee's Chairman reported to the full Board regarding the work and actions of the Compensation Committee at each quarterly Board meeting.

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[4] Mr. Kellett resigned his position with the Board on October 27, 2002.

The duties of the Compensation Committee are: (a) to make determinations regarding the annual salary, bonus and other benefits of executive officers of the Company; (b) to administer the stock option or awards plans of the Company, including a determination of the individuals to whom options or awards are granted and the terms and provisions of option awards under such plan; and (c) to review and take actions, including submission of recommendations to the Board concerning compensation, stock option plans and other benefits for the Company's directors, officers and employees. As part of this mandate, the Committee is responsible for reviewing and reporting to the Board with respect to all financial arrangements between the Company and members of senior management or the Board of Directors. At all relevant times, it appears that the Committee had jurisdiction to review not only salaries and stock option compensation, but also loans, personal use of Company property, and any other forms of executive officer or director benefits or obligations. The Committee traditionally began its annual compensation review in November and acted in the first quarter of each year to set the compensation of executive officers, with salary increases made retroactive to January 1 of the year.

The proxy statements for recent annual meetings of WorldCom shareholders explained that the Executive Compensation Policy implemented by the Committee is designed to provide a competitive compensation program to attract, motivate, reward and retain executives who have the skills, experience and talents required to promote the Company's short- and long-term financial performance and growth. The Executive Compensation Policy was stated to be based on the principle that the financial rewards to the executive must be aligned with the financial interest of shareholders. Executive compensation had three elements: base salary, annual incentive compensation and long-term incentive compensation. With respect to base salary, the Committee was to determine the salary ranges for each of the executive officer positions, based on the level and scope of the responsibilities of the office and the pay levels of similarly positioned executive officers at comparable companies. The Committee was to consider the base salaries it established for particular offices to be between the median and high-end range of such salaries at comparable companies in order to attract and retain the best-qualified team available. The proxy statements for the 2001 and 2002 annual meetings specifically explained that the recommendation of the CEO "is of paramount importance in setting base salaries of other executive officers."

Annual incentive compensation was in the form of cash bonus awards. Interviews of members of the Committee reflect that the key components in determining such awards included the Company's financial performance in the context of the overall industry and economic environment, as well as the judgment of each member of the Committee and Mr. Ebbers, as to the impact of the individual on the Company's financial performance. In 1997, the Company adopted a performance bonus plan, which predicated bonuses on the achievement of one or more quantitative performance goals.

Long-term incentive compensation took the form of stock options. Statements by members of the Compensation Committee reflect that the Committee believed stock options were the most direct way of making executive compensation dependent upon increases in shareholder value.

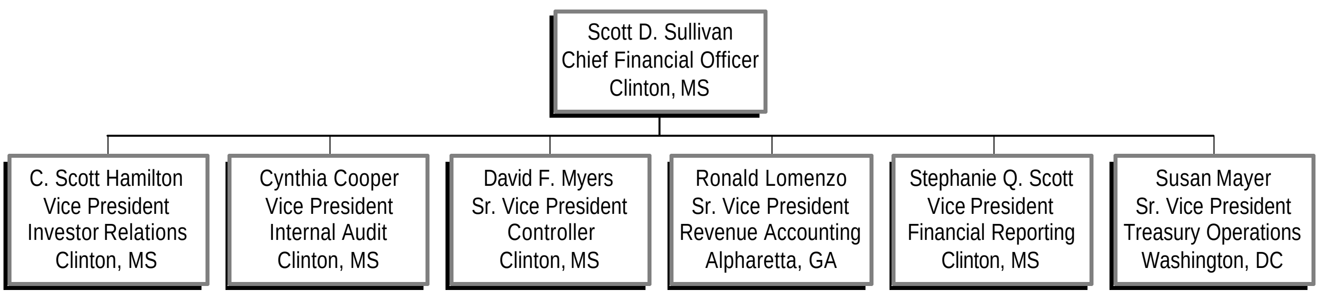
V. The Finance and Accounting Process

A. Introduction

To facilitate an understanding of subsequent sections of this First Interim Report regarding the reporting by WorldCom of its financial results, we sought to assess how the finance functions at WorldCom were organized and operated, as well as the relationship of the Company's finance function to the role of its independent auditors, Arthur Andersen. We also obtained information concerning the Company's accounting systems. In doing so, we hoped to develop an understanding of how the information that eventually comprised WorldCom's financial statements flowed through the organization and was collected, categorized, adjusted and then reported to the public in SEC filings.

B. The WorldCom Finance Group

The WorldCom Finance Group, based principally in Clinton, Mississippi, was organized into several primary groups – investor relations, internal audit, the controller's group, line cost management, revenue accounting, financial reporting, and treasury operations. Below is an organization chart depicting WorldCom's Finance Group, and the principal reporting relationships within the Finance Group, as of January 2, 2002.



The Investor Relations function at WorldCom, headed by Scott Hamilton, was involved in a number of activities, principal among them were: (1) preparation of press/earnings releases; (2) preparation of the quarterly "earnings book," which includes scripts, questions and answers, financial highlights and other relevant documents; (3) preparation of presentations for investor conferences; (4) preparation of presentations for ratings agencies; and (5) assisting the CFO in producing presentations to the Board of Directors.

The Internal Audit Department at WorldCom, headed by Cynthia Cooper, reported both to the CFO and to the Audit Committee of the Board of Directors. As described in greater detail below, the Internal Audit Department was responsible for developing and executing internal audit plans and reporting to the Audit Committee findings based upon its audit activities and its recommendations to improve internal controls and enhance operating efficiencies. During the period under review, the Internal Audit Department focused its efforts substantially on operational matters, as opposed to financial accounting matters.

During the relevant period, the Controller function, headed by Mr. Myers, consisted of several groups, including tax, general accounting, accounts receivable, accounts payable, payroll, property accounting, budgeting, foreign controllers' groups and management reporting. The Controller and his support group were responsible for, among other things, consolidating the worldwide financial results and providing underlying information to the Financial Reporting Group. Reporting to Mr. Myers were, among others, Messrs. Yates and Normand and Ms. Vinson. As would be expected, this was the largest internal financial function at WorldCom.

The Line Cost Management function included both domestic and international Line Cost Management. Line Cost Management was tasked with monitoring and managing expenses at WorldCom, as well as the Company's exposure regarding owned and leased voice and data transmission capabilities. Subsequent sections of this First Interim Report discuss how reserves and expenses relating to line costs were adjusted and reclassified on the Company's financial records in a manner that accounted for a substantial part of the fraudulent misstatement of WorldCom's results of operations.

The Revenue Reporting Group prepared a report, referred to herein as the "MonRev," which on a monthly and year-to-date basis summarized revenue data received from the Company's operating units. The Revenue Reporting Group also dealt with matters affecting the release of revenue reserves, principally billing and collection reserves and penalty reserves.

The Financial Reporting function, headed by Stephanie Scott, was responsible for the preparation of the financial portions of SEC filings by WorldCom. During the annual audit and quarterly review processes, the Financial Reporting group interacted with Arthur Andersen and coordinated the Company's responses to requests by Arthur Andersen for documents or information. The Financial Reporting Group provided the access that Arthur Andersen had to the Company's personnel and records.

The Treasury function at WorldCom was responsible for cash management, insurance and risk management, commercial banking and bond holder relationships, foreign exchange and other hedging activities, as well as the management and monitoring of the MCI WorldCom Venture Fund.

C. Overview of Revenue Budgeting and Planning

1. Annualized Budget Plans

Our review of documents provided by the Company and others, and the interviews of certain WorldCom personnel, paint the following picture regarding the Company's revenue planning. Each year, generally during the third quarter, WorldCom began to develop an annualized budget plan for the following year. The first phase of the planning process consisted of gathering historical revenue and cost data by sales channel and product line. The MonRev was the principal source of the revenue data. A series of cost and capital expenditure schedules were sources for data on the cost side.

In or about December of each year, the Company targeted a growth rate for the upcoming year. This target rate would be for total Company revenue growth. In developing the revenue plan, the total Company target growth rate would be allocated down to the various sales channels and product lines. The allocations were based on trends and conditions within each sales channel or product line. They were not straight "across the board" allocations. For example, if the total revenue growth target for the Company was 10%, one sales channel might show an increase of 14% while another might show an increase of 8%. However, on a composite basis, the annual plan would reflect the target growth rate for the Company.

The resulting revenue plan numbers would then be used as the basis for the budget amounts included on the MonRev reports. Preliminary revenue plan amounts were used at the outset of a year until the plan was finalized, which may not have been until several months into the year to which it applied.

2. Monthly Revenue Forecasts, Analyses and Outlooks

About once per month, after the MonRev report for the previous month had been finalized, discussions would be held among senior management concerning the Company's monthly performance as compared to its revenue targets. In addition, a presentation was made to the Board of Directors concerning the Company's business operations and financial operations. Monthly revenue and cost forecasts, analyses and outlooks were presented to the Board of Directors, although we have no evidence to date that the Mon Rev reports were provided to the Board.

The presentations to the Board of Directors included various comparisons of preliminary actual revenue amounts to budgeted or forecasted amounts, and year-to-year and month-to-month revenue trends for various sales channels and products. The budgeted or forecasted revenue amounts in these monthly presentations were based on the expected revenues reported in current WorldCom press releases.

3. Process to Meet Projected Revenues

By at least the second quarter of 2001, the Company's business revenues were decreasing, which jeopardized its ability to meet the quarterly revenue growth targets that had been announced to Wall Street and the public. Accordingly, the Company undertook an analysis of ways to boost the Company's quarterly revenues. Ultimately, it appears that improper additions to revenue were later booked in connection with this process.

D. The WorldCom Financial Reporting Process

WorldCom, like many large, complex organizations, had sophisticated and detailed financial reporting processes that enabled it to report on its quarterly and annual operations and performance. The quarterly closing process began with closings of the general ledgers maintained by the Company's various operating units. On average, this process was completed approximately ten to twelve days after the close of a quarter. Once all transactions pertinent to a business unit were processed in the general ledger, the affected field locations were blocked from making any additional entries to the general ledger. Any missed field-related general ledger entries were made at the corporate accounting level.

During the field closing process, information flowed from the operating units to groups within the Company's finance and accounting functions as follows:

i) Preliminary and final cash balances – Corporate Accounting;

ii) Preliminary and final long-term debt balances – Corporate Accounting;

iii) Preliminary and final capital expenditures – Line Cost Management;

iv) Capital expenditures by segment – Line Cost Management;

v) Preliminary and final MonRev report – Revenue Accounting, Corporate Accounting and Financial Reporting; and

vi) Final public reporting revenues - Financial Reporting.

After all of the normal, recurring field and corporate entries were recorded, the Corporate Accounting Group undertook the consolidation process. During consolidation, entries were made to eliminate inter-company activity and balances in order to present an overall view of WorldCom's assets, liabilities, revenues and expenses.

Following the initial consolidation, the Corporate Accounting Group recorded post-closing adjustments and reclassifications. As described in greater detail below, it appears that WorldCom personnel may have exploited the opportunity to make adjustments in these areas for the purpose of improperly inflating revenues and reducing expenses.

Upon completion of this consolidation and post-closing adjustment/reclassification process, the Company prepared its consolidated financial statements. The Financial Reporting group took the lead in this process and worked with the Controller's group and the CFO, among others. This process included preparation of the preliminary and final balance sheet, income statement, and statement of cash flows.

After completion of all financial statements, various management reports and an investor relations package (final highlights, earnings press release, and earnings call script) were prepared. The final step in the financial reporting process was the filing of WorldCom's quarterly Form 10-Q or annual Form 10-K.

E. The Role of the Independent Auditors

1. Independent Auditor's Responsibilities vs. Management's Responsibilities

The objective of an audit of a company's financial statements by an independent auditor is the expression of an opinion on the fairness with which the financial statements present, in all material respects, the financial position, results of operations, and cash flows of the company in conformity with GAAP. An independent auditor is required under GAAS to state whether, in its opinion, the financial statements are presented in conformity with GAAP.

Pursuant to Statement on Auditing Standards No.1, an auditor has a responsibility to plan and perform the audit to obtain reasonable, but not absolute, assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. A proper audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statements presentation. An audit is not intended to provide a guarantee regarding the accuracy of the financial statements. Accordingly, a material misstatement may remain undetected.

Ultimately, a company's financial statements are the responsibility of management. Management is responsible for adopting sound accounting policies and for establishing and maintaining internal controls that will, among other things, record, process, summarize, and report transactions consistently and accurately.

2. WorldCom's Relationship with Arthur Andersen

We are still in the process of reviewing the relationship between Arthur Andersen and the Company and the access to financial and other information provided to Arthur Andersen. The Arthur Andersen work papers that support its audit opinions on the financial statements of the Company for 1999, 2000 and 2001, reflect that Arthur Andersen concluded that WorldCom was a "maximum risk" client. In planning the 1999 audit of the Company, Arthur Andersen personnel noted in workpapers that (1) historical purchase accounting adjustments represented a significant portion of 1999 budgeted income; (2) WorldCom had misapplied GAAP with respect to certain investments; and (3) due to WorldCom's use of multiple billing systems that require significant human intervention, there was a high degree of risk in the Company's billing and collection areas.

Moreover, a memo in the 1999 Arthur Andersen workpapers states that, “in the past, we have noted situations where management has taken aggressive accounting positions, particularly in the area of purchase accounting.” In addition, in its meetings with WorldCom’s Audit Committee for the 1999 audit, Arthur Andersen expressed that the items in WorldCom’s financial statements that represented particularly sensitive accounting estimates were: Purchase Accounting, Evaluation of Asset Impairment, Line Cost Accrual, Tax Accrual; Litigation, and Depreciation Reserves.

Further, it is noteworthy that Arthur Andersen made the following overall risk assessments of the Company and its management team in connection with the planning of its audits for the years ended December 31, 1999 through 2001.

	Risk Assessment
Accounting and financial reporting risk	Significant
Adequacy of personnel in key management and employee positions	Fair
Behavior towards the scope of the audit work	Fair
Allowing unrestricted access to information and personnel	Fair
Quality of management’s policies to prevent and detect fraud	Fair
Ability to manage the financial reporting function	Fair
Overly aggressive revenue or earnings targets	Significant
Sound accounting and disclosure practices	Fair
Commitment to establish and maintain a satisfactory internal control system (including timeliness and quality of response to known control problems)	Fair
Responsiveness to accounting and reporting advice, including audit adjustments and disclosures	Fair

These and other facts appear to raise questions regarding the extent to which Arthur Andersen should have done more to determine whether the risks of abuses were adequately taken into account by the Company’s internal control systems, most pointedly its internal audit function. We are still reviewing matters concerning the Company’s relationship with Arthur Andersen and issues related to its audits of the Company’s financial statements. We anticipate reporting further on these subjects in a subsequent report.

3. The Company's Internal Audit Function

Fundamental to an effective internal control system is a monitoring process whereby failures are discovered, analyzed and corrected, and remedial policies or procedures are implemented to ensure that failures do not recur. It is axiomatic that, in the finance and accounting areas, an internal audit group should be an integral part of a Company's system of internal controls.

At WorldCom, the Internal Audit Department was the designated group primarily responsible for the most important aspect of the company's internal control system, namely, the periodic review through a formal data-gathering process of information relating to aspects of the Company's operational and financial controls. The Internal Audit Department reported its findings and recommendations directly to the Audit Committee of the Board of Directors, which had overall responsibility for ensuring that the Company's system of internal controls operated effectively. We have conducted a preliminary review of the performance of the Internal Audit Department and its interaction with the Audit Committee. Although we are continuing to examine these areas, our preliminary review suggests that, in several respects, the internal audit function at WorldCom failed to satisfy reasonably its important responsibilities.

The exception - and it is an important one - is that the personnel assigned to the Internal Audit Department apparently attempted to perform their responsibilities in a diligent and professional manner. However, the information provided to us suggests that their ability to do so was limited by two significant factors. First, the efficacy of the Internal Audit Department was limited because its focus was directed to be operational, as opposed to financial matters. Second, the Internal Audit Department suffered from a seeming lack of adequate support from WorldCom's senior management, its Board of Directors and the Audit Committee. Our preliminary investigation also suggests that the Internal Audit Department may have been limited by the lack of adequate staffing and insufficient funding. In this context, the investigation of the fraudulent line cost reclassifications - the event that led to an unraveling of WorldCom - is a testament to the personal diligence of those internal auditors involved in this audit. We are continuing our investigation in this area and will have further information in a subsequent report.

a. The Role of the Internal Audit Department

In its Statement of Accounting Standards ("SAS") 65, the American Institute of Certified Public Accountants defined a company's internal controls as:

> a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
>
> - Effectiveness and efficiency of operations
> - Reliability of financial reporting [and]
> - Compliance with applicable laws and regulations.

In other words, a company's system of internal controls is the way that management structures and implements its efforts to assure itself that its procedures are being complied with and that its most important goals and objectives are being reached and its legal obligations fulfilled.

As articulated in 1987 in the widely circulated and praised "Treadway Report,"[5] the responsibility with respect to a company's financial statements "resides first and foremost at the corporate level. Top management--starting with the chief executive officer--sets the tone and

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[5] The Treadway Report was the final product of the three year effort of the National Commission on Fraudulent Accounting Reporting. James C. Treadway, Jr., a former Commissioner of the SEC, was the Chairman. The Commission was jointly sponsored and funded by the American Institute of Certified Public Accountants (AICPA), the American Accounting Association (AAA), the Institute of Internal Auditors (IIA) and the National Association of Accountants (NAA). A complete copy of the report is available on the web at www.coso.org (search Treadway Report). Since the Treadway Report's publication, the sponsoring organizations formed the Committee of Sponsoring Organizations, commonly referred to in the industry as "COSO," a national entity for the purpose of promoting professional standards consistent with the Report's conclusions and policy recommendations.

establishes the financial reporting environment."[6] As noted in the Report: "One key practice [to reduce the incidence of fraudulent financial reporting] is the board of director's establishment of an informed, vigilant and effective audit committee to oversee the company's financial reporting process. Another is establishing and maintaining an internal audit function." Id. Thus, the Treadway Report concluded that an internal audit department functioning under the informed supervision of the audit committee of the board is critical to an effective internal control system.

Under GAAS, in planning its annual audit, the independent auditor of a public company is specifically tasked with assessing the effectiveness of the company's internal controls as they relate to the accuracy of the company's financial reporting. The quality of a company's internal controls directly affects the "nature, timing and extent of [the auditor's] substantive tests for [the company's] financial statement assertions." AICPA SAS 65, AU Section 319.05. Material to such an assessment is the auditor's evaluation of the effectiveness of the company's internal audit function. AU Section 319.24. And the essence of the internal audit function is its "monitor[ing] the performance of an entity's controls." AICPA SAS 65. AU Section 322.04. To the extent that the independent auditor is satisfied by evidence of the effectiveness of the internal audit unit's testing of the company's control system, the external auditor may scale back the need to (and expense of) independently testing the factual basis of the reporting company's financials. Id. at AU Section 322.15 and Section 322.24-26.

b. Preliminary Observations Regarding the Company's Internal Audit Department

As noted above, our early assessment of matters related to the Company's internal audit function raises significant questions that warrant further review. Fundamentally, it appears that the Internal Audit Department was excessively focused on operational auditing – i.e., trying to identify

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[6] Treadway Report, Part II.

inefficiencies – rather than financial auditing. While in certain companies the internal audit function is focused on operations, an operational focus is inappropriate for a company with weak internal controls. With respect to WorldCom, absent diligent attention by the Internal Audit Department to financial control systems, the risk of financial statement fraud was high due to the complexity and dispersed nature of the Company's organization and financial operations.

1. The Absence of a Comprehensive Audit Plan

Significantly, there does not appear to have been an adequate internal audit plan prepared at the beginning of each fiscal year to identify all auditable units within WorldCom. (Internal audit professionals refer to this as the "Audit Plan Universe".) The Audit Plan Universe should have been risk-rated (i.e., high, medium and low) based upon the importance of each auditable unit to the Company and the risks associated with each unit. This concept of an Audit Plan Universe and risk assessment is supported by the Institute of Internal Auditors.

Further, there appears to have been a lack of consistency regarding the internal audits that were scheduled at the beginning of each audit year and the audits that actually were completed during the year. For reasons we have not yet determined, other audits, not part of the initial internal audit plan, were added and audits originally scheduled were not completed. The changes in the plan, and the reasons therefor, apparently were not presented to the Audit Committee for approval.

2. Audit Committee Oversight

An Audit Plan Universe, or the equivalent, should have been presented to the Audit Committee annually for its review and approval. WorldCom apparently had no such procedure. Indeed, we have not identified any effective participation by the Audit Committee in setting the internal audit plan. Under such circumstances, the ability of senior management to influence the focus of the Internal Audit Department away from sensitive areas may be left without the control check which the Audit Committee is expected to provide.

Our investigation to date has shown only perfunctory attention by the Audit Committee to the audits performed by the Internal Audit Department. Moreover, the Audit Committee minutes and other records did not include reference to the status of significant and unresolved internal control weaknesses cited in prior audits. We are still seeking to identify whether such weaknesses were resolved. If the Audit Committee did not maintain such records, it denied itself a ready means to determine whether the identified weaknesses were subsequently addressed. There is no evidence that the Audit Committee requested from the Internal Audit Department updates on the status of internal control weaknesses. The records of the Audit Committee also appear devoid of timetables for corrective action and resolution.

3. Reports to Company Management

The Internal Audit Department distributed to management a response matrix which indicated the current status of internal control weaknesses identified in prior audits. However, despite its receipt of the response matrix, which clearly disclosed to senior management that internal control weaknesses were not being corrected, management appears to have done little to support the Internal Audit Department roup by correcting the internal control issues.

Indeed, prior to 2002, there was little evidence of follow-up audits where significant weaknesses had been identified in earlier audits. For example, the November 7, 2000 Internal Audit Department Report on the Credit and Accounts Receivable Management System disclosed material weaknesses that had remained uncorrected since 1997. A similar finding was noted in the 2001 audit. We did not find, however, any evidence that the senior management or the Audit

Committee expressed any concern regarding this situation or the fact that five years had passed since these significant internal control weaknesses were discovered.

The Internal Audit Department did not consistently include management's replies with reports, as is expected by industry standards. In addition, they did not differentiate major comments from minor comments in their reports. Thus, it was difficult in many cases for the Audit Committee to determine if management agreed to the findings, or when, and if, management intended to implement appropriate corrective action.

4. Staffing and Compensation

The Internal Audit Department appears to have been understaffed and underpaid. A member of the Internal Audit Department suggested that at a staff level of 27, the Internal Audit Department at WorldCom was half the size of peer telecom internal audit departments according to an Institute of Internal Auditors' peer study that was presented to the Audit Committee. We also were informed that the Company's average cost per auditor was $87,000 compared to the peer group average of $161,000, where such average was calculated by the total cost of the internal audit departments surveyed divided by the number of professional audit personnel in the subject internal audit departments. An internal audit function operating with such limited resources appears particularly inappropriate from an internal controls perspective given the international breadth and scope of WorldCom's operations and the challenges posed by the Company's status as a conglomeration of recently merged or acquired companies.

5. Dealings with Arthur Andersen

We found little evidence of substantive interaction between Arthur Andersen and the Internal Audit Department. This would violate a core requirement of GAAS if Arthur Andersen placed any reliance on the internal audit function for monitoring and testing the status of the

Company's internal controls. See AICPA SAS 65 and 66, and corresponding AU Sections. We are still investigating to determine whether Arthur Andersen relied on any reports or activities by the Internal Audit Department. However, they did have access to internal audit reports distributed at meetings of the Audit Committee. Despite these reports, Arthur Andersen represented to the Audit Committee and the Board of Directors that there were no material weaknesses regarding the Company's system of internal controls.

VI. ACQUISITIONS AND OTHER TRANSACTIONS

The story of WorldCom's rise and of its fall into bankruptcy can be written in terms of its transactions. They epitomize the course of WorldCom's fortunes for the simple reason that, during its entire history through mid-2002, one of the most distinguishing characteristics of the Company was that it was constantly and even feverishly in "deal mode." Although we are still in the process of reviewing and analyzing relevant transactions, we do have some preliminary views as to the impact of those transactions on the subject of our investigation.

The term "transactions" as used here is intended to be all-encompassing. It includes acquisitions, mergers, issuances of equity and debt securities, outsourcing transactions, exchanges and repurchases of securities and financing instruments of every kind, and transactions involving employee retirement plans. An obvious reason for this broad definition is the total strain that is placed on the multiple systems of an organization and its personnel when the sheer volume of activity involved reached the extraordinary proportions that it did in this case.

From the viewpoint of the Company's transactions, we are reviewing a number of major factors to determine the impact that they had on WorldCom's operations and financial reporting processes. We are in a position to report preliminarily regarding some of these factors, while other factors will be addressed in subsequent reports.

A. Volume of Transactions

The volume of the transactions undertaken by WorldCom during its history was enormous, whether measured by number of transactions, in dollars, or by some index of complexity. Indeed, at the time they were undertaken, some of the transactions were the largest ever undertaken by any company in the world. Further, some of the transactions were notably complex and, due in part to the advanced technology involved, dealt with issues that were at the frontier of legal and commercial practice.

Viewed from the standpoint of transactional volume, this data may be summarized briefly as follows. Beginning with the 1992 purchase of ATC, WorldCom made at least one significant acquisition every year. Following the acquisition of ATC, acquisitions of MCC, IDB and WilTel quickly followed. Enactment of the Telecom Act in 1996, which was aimed at deregulation of the telecommunications sector, seemed to have spurred WorldCom's acquisitions activity. Immediately following passage of the Telecom Act, WorldCom acquired MFS for approximately $12 billion. The MFS transaction's purchase price exceeded the total sum of the Company's four prior major acquisitions.

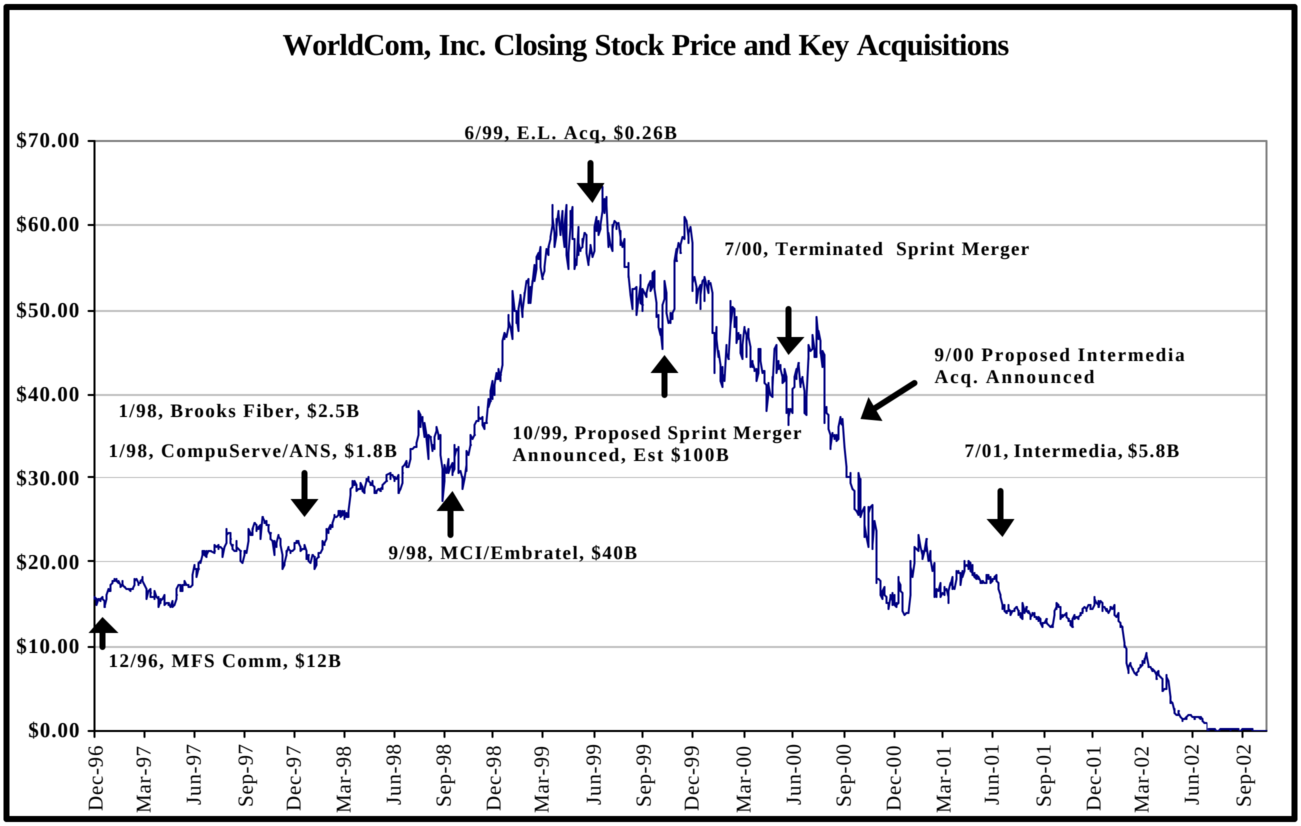
While other acquisitions followed the MFS acquisition, they were relatively insignificant compared to the 1997-98 acquisition of MCI for approximately $40 billion, an acquisition that thrust WorldCom to the forefront of the telecommunications industry. Following the MCI merger, WorldCom promptly began preparations for its biggest transaction yet, a proposed merger with Sprint, which would have exceeded $100 billion. At that time, the Sprint transaction would have been the largest merger by any company and, had it not been rejected on antitrust grounds, would have resulted in the creation of the largest telecom carrier in the country. Following termination of that merger, WorldCom made other acquisitions, but its pace slowed significantly.

While WorldCom's series of impressive acquisitions is notable, the Company also executed numerous other types of transactions. WorldCom issued several large debt offerings, registered equity securities, entered into long-term outsourcing contracts, became a venturer in international joint ventures and issued its two tracking stocks. WorldCom's transactions varied by type and size. However, an analysis of these varied transactions and related circumstances emphasizes a common theme – WorldCom was continually embarking on its next "deal." Major transactions closed within weeks or months of each other. The number, type and size of these transactions contributed to WorldCom's problems and may have placed an unhealthy strain on systems and personnel that is produced when the sheer volume of activity and associated paperwork involved reaches the proportions that it did in this case.

B. Apparent Absence of Defined Strategic Plan

Although WorldCom's most senior executives regularly made speeches and other public comments about corporate strategy, our inquiries to date have not been able to locate any general strategic plans or identify any planning process of the type we have described. Admittedly, we have not had access to all members of senior management due to time constraints and the governmental investigations, but our interviews and document review to date suggest that while WorldCom once may have attempted to establish the type of planning process described above, it never did so and never produced the kind of plan described above. Our review to date suggests that the higher-level planning processes within WorldCom were focused much more on acquisition planning or technological and operational planning than on more general strategic planning.

The graphs below chart WorldCom's stock price and revenue growth from 1997 through June 2002 and reflect the timing of key acquisitions during this five-year period.


WorldCom, Inc. Closing Stock Price and Key Acquisitions
$70.00
$60.00
$50.00
$40.00
$30.00
$20.00
$10.00
$0.00
6/99, E.L. Acq, $0.26B
7/00, Terminated Sprint Merger
9/00 Proposed Intermedia Acq. Announced
1/98, Brooks Fiber, $2.5B
1/98, CompuServe/ANS, $1.8B
10/99, Proposed Sprint Merger Announced, Est $100B
7/01, Intermedia, $5.8B
9/98, MCI/Embratel, $40B
12/96, MFS Comm, $12B
Dec-96
Mar-97
Jun-97
Sep-97
Dec-97
Mar-98
Jun-98
Sep-98
Dec-98
Mar-99
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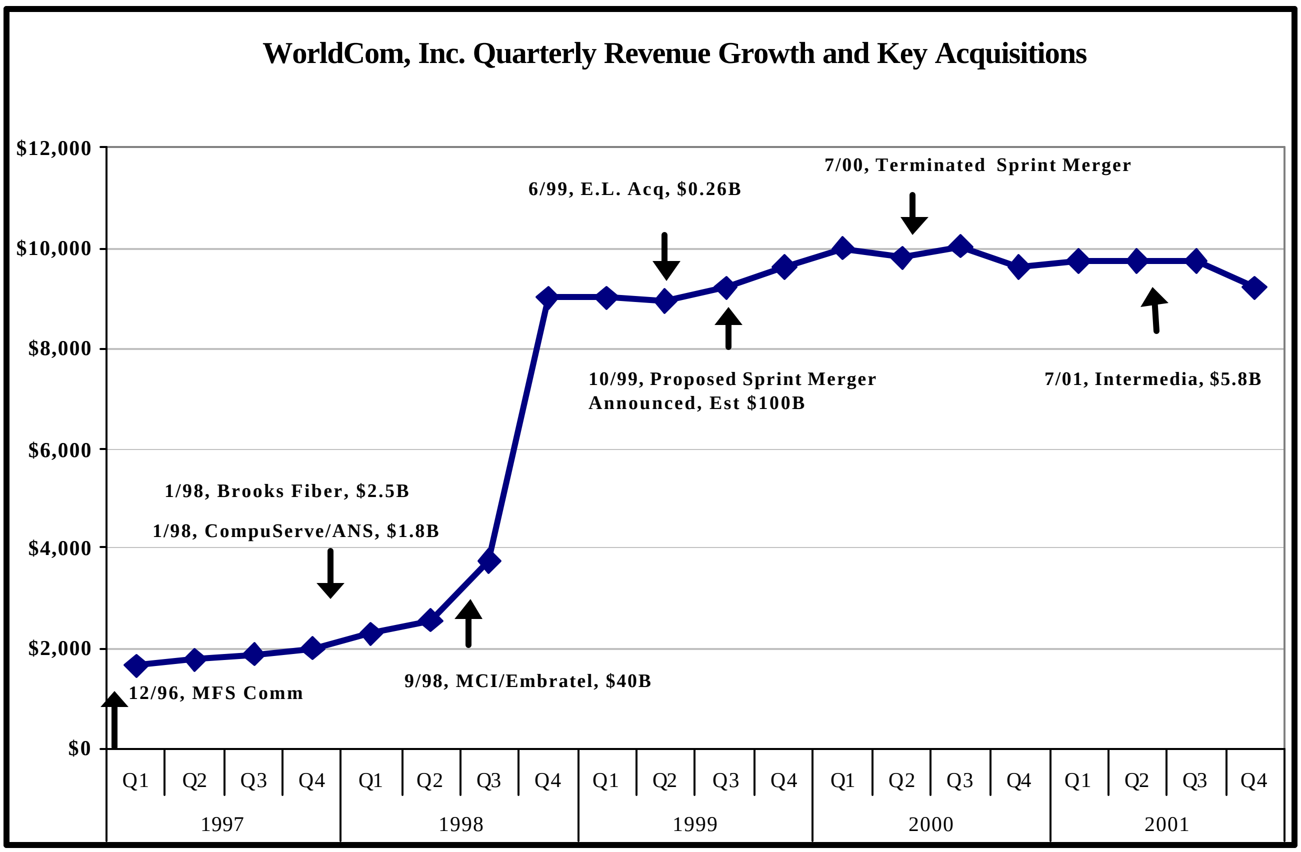
WorldCom, Inc. Quarterly Revenue Growth and Key Acquisitions
$12,000
$10,000
$8,000
$6,000
$4,000
$2,000
$0
7/00, Terminated Sprint Merger
6/99, E.L. Acq, $0.26B
10/99, Proposed Sprint Merger Announced, Est $100B
7/01, Intermedia, $5.8B
1/98, Brooks Fiber, $2.5B
1/98, CompuServe/ANS, $1.8B
12/96, MFS Comm
9/98, MCI/Embratel, $40B
Q1 Q2 Q3 Q4 Q1 Q2 Q3 Q4 Q1 Q2 Q3 Q4 Q1 Q2 Q3 Q4 Q1 Q2 Q3 Q4
1997
1998
1999
2000
2001

It appears that any general strategic planning was in fact done principally by Mr. Ebbers, and to a somewhat lesser extent by Mr. Sullivan, and that this planning activity was largely informal, lightly documented and to some extent consisted of oral discussions among a small number of executives. It appears that general strategic planning processes at WorldCom lacked the kind of rigor, discipline, detail and integration that characterize strong corporate planning processes. There are some discussions of general corporate strategy in regulatory filings, but this discussion is very generalized and legalistically formulaic. It appears, therefore, that the higher-level planning processes that operated on the staff level were tools for the implementation of a highly personal and informal strategic process that operated principally among a very small number of senior executives.

The materials that we have reviewed to date suggest that the Board of Directors played a relatively small role in general strategy formulation, monitoring and revision. That role seems to have been played mainly by the Company's most senior officers and the Board's periodic discussions with management seem not to have affected the outcome to any material extent. Our impression, based on the material we have reviewed to date, is that the Board participated more on an informational basis than as part of a critical review.

From the various sources we have been able to review to date, we have two overall impressions as to WorldCom's general corporate planning process:

The first overall impression is one of the highly personal and ad hoc nature of senior management's efforts at strategic planning and execution. It does not appear that the process was a deeply institutionalized, disciplined, rigorous, cross-departmental process. In a very real sense, it seems that Mr. Ebbers, with the assistance of Mr. Sullivan, was determining the Company's strategic direction without reference to any comprehensive or disciplined staff input.

The second overall impression is that a major criterion in WorldCom's strategy formulation and in its choice of transactions was to meet analysts' expectations as to earnings and stock price. The materials we have reviewed to date give the overall impression that the financing perspective and the Wall Street focus predominated in the formulation of general corporate strategy and in the general management of the Company's operations.

VII. PERSONAL ENRICHMENT AND RELATED CONTROLS

A. Introduction

We are investigating the extent to which a culture of greed may be said to have permeated top management at WorldCom, apparently without any effective check by the Company's Board of Directors.

The compensation and benefits received by members of WorldCom's top management were extremely generous. For reasons that still need to be investigated, the compensation packages of a significant number of senior WorldCom employees became more lucrative in the final two years before the Company declared bankruptcy. As our inquiries continue, we will seek to determine whether these compensation increases were reasonably intended to meet market demand or serve some other purposes.

Under basic principles of corporate governance, the Company's Compensation Committee should have been the first line of defense to check the payment of unreasonable or improper compensation and benefits. The evidence we have reviewed thus far suggests that the Compensation Committee may not have been effective in performing that role and that the Compensation Committee generally accepted the recommendations of Mr. Ebbers without making an independent determination or seeking expert advice that competitive market forces warranted the compensation and benefits he was recommending.

Perhaps the Compensation Committee would have been more effective in performing its assigned role had its members been more independent of Mr. Ebbers. At least two of the three full members of the Compensation Committee were long-standing business associates of Mr. Ebbers. The Compensation Committee's chairman, Stiles A. Kellett, Jr., was a director of WorldCom from 1991 until October 27, 2002. In June 2001, Mr. Kellett, with the approval of Mr. Ebbers, entered into an unusual transaction whereby he leased a WorldCom jet aircraft on terms that some people, including the Corporate Monitor, have questioned. At a minimum, that lease transaction created the appearance that Mr. Kellett and Mr. Ebbers may have entered into a "sweetheart" deal involving a significant WorldCom corporate asset at a time when Mr. Kellett and his Compensation Committee were charged with the responsibility for making important decisions of great personal financial consequence to Mr. Ebbers.

The Compensation Committee faced one of their most serious challenges in the fall of 2000 when it began to give Mr. Ebbers authorization to borrow millions of dollars from the Company in order to help Mr. Ebbers meet massive debt obligations against which he had pledged his shares of Company stock. It would be premature to express a view at this time about the reasonableness of the Company's loans to Mr. Ebbers, but it appears that the decision-making processes that led to those loans were inadequate in several respects.

B. The Compensation Packages Awarded to Mr. Ebbers

The Compensation Committee was responsible for setting Mr. Ebbers' compensation and the amounts he received - in salary, bonuses, and other benefits - suggest it had a very generous attitude. During the three-year period from January 1, 1999, through December 31, 2001, Mr. Ebbers received more than $77 million in total compensation or an average of roughly $25.7

million per year.[7] These amounts include $20.5 million (or an average of $6.8 million per year) in cash compensation in the form of salary and bonuses. When Mr. Ebbers left WorldCom earlier this year, the Committee negotiated, and the Company approved, a severance package that included a cash payment of $1.5 million per year for life, lifetime medical and life insurance, lifetime use of a corporate jet and conversion of approximately $408 million in demand notes into 5-year non-callable term notes with a significant annual interest rate subsidy.

We will discuss Mr. Ebbers' loan transactions in more detail below, but even apart from those transactions, the compensation and benefits he received seem overly generous in light of the Company's deteriorating financial situation during the last three years of his stewardship. While Mr. Ebbers received more than $77 million in cash and benefits from the Company, shareholders lost in excess of $140 billion in value. We are not aware of any analysis by the Compensation Committee that would justify such high compensation levels.

C. A Compensation System That May Have Been Vulnerable to Abuse by Mr. Ebbers and Others

We have not yet gained access to enough information to reach a complete understanding of how compensation generally was set at WorldCom. However, our initial inquiries suggest that Mr. Ebbers and certain other senior officers had a surprising degree of influence over the compensation of many management employees who did not report directly to them, and that the

[7] According to WorldCom's Form 10-Ks for 1999, 2000 and 2001, Mr. Ebbers' total compensation during those years was as follows:

(1) In 1999 Mr. Ebbers received compensation worth more than $36 million, including a salary of $935,000, a "performance" bonus of $7.5 million, approximately $60,000 in other compensation and benefits, and 1,857,420 stock options worth $27,694,123 on December 31, 1999;

(2) In 2000 Mr. Ebbers received compensation worth more than $31.8 million, including a salary of $1 million, a "retention" bonus of $10 million, approximately $50,000 in other compensation and 1,238,280 stock options worth $20,790,721 on December 31, 2000; and

(3) In 2001 Mr. Ebbers received compensation worth more than $9.1 million, including a salary of $1 million, approximately $48,000 in other compensation and 1,238,280 stock options worth $8,085,968 on December 31, 2001.

Company's Compensation Committee does not appear to have properly fulfilled its role in reviewing the compensation recommendations of Mr. Ebbers and those senior officers.

1. The Role Played by Mr. Ebbers in Many Compensation Decisions

Although WorldCom's disclosure documents state that the Company's Compensation Committee determined the salary ranges for WorldCom's executive officers, these same documents also indicate that Mr. Ebbers' recommendations were of "paramount importance in setting base salaries of other executive officers." See 2002 Proxy Statement (April 22, 2002). Preliminary interviews of members of the Compensation Committee and senior executives, and a review of Compensation Committee documents (including minutes and resolutions in January 1999, January 2000 and January 2001), have confirmed that description of Mr. Ebbers' role. We intend to learn more about Mr. Ebbers' role in these salary determinations and whether his influence helps explain why there was such a large range in salaries for employees of the same rank. In 1999, for example, executive[8] base salaries in general ranged from a low of $159,402 to a high of $1,131,923, and salaries of senior vice presidents in particular ranged from a low of $165,808 to a high of $670,259.

Mr. Ebbers apparently also had significant personal influence over the cash bonuses awarded to WorldCom's executive officers and other top management employees. These cash bonuses represented a significant proportion of the compensation packages for many WorldCom employees. Indeed, according to information provided by WorldCom, as summarized on the following table, 0employees earning more than $150,000 annually in total compensation during 1999, 2000 and 2001 received more money in performance bonuses than in base salary:

[8] For these purposes, we have defined "executive" to include division directors, division CEOs, division CFOs, Treasurers, Chairman, Vice Chairman, Controller and Corporate Counsel.

	Base Salaries	Performance Bonuses
1999	$151.3 MM	$167.3 MM
2000	$170.0 MM	$200.2 MM
2001	$166.8 MM	$172.8 MM

Performance bonuses represented an even larger portion of the compensation of the Company's 25 most highly compensated employees. In 1999, these employees received $10.6 million in base salaries and $21.2 million in performance bonuses (including a $7.5 million performance bonus paid to Mr. Ebbers).

Although WorldCom's disclosure documents asserted that cash bonuses for top executives were based on quantitative performance factors, we have reason to believe, based on key interviews, that Mr. Ebbers and certain senior officers could adjust the performance bonuses received by individual employees. Information provided by WorldCom shows that the performance bonuses paid to individuals of the same rank varied tremendously. Some individuals, even at lower ranks, were paid massive performance bonuses equal to many times their base salaries, while others received bonuses equal to only a small percentage of their salaries. Among WorldCom's vice presidents, for example, performance bonuses in 1999 ranged from a low of $15,113 to a high of $628,174.[9] We intend to inquire whether these bonuses were indeed based on quantitative performance factors or were used instead for some improper or other purpose.

[9] Materials received from the Company reveal a number of interesting anomalies. For example, in 1999 the *median* performance bonus for WorldCom executives was $120,000, but the *average* performance bonus was $574,923. In addition, while the highest performance bonus for a senior vice president in 1999 was $125,000, the highest performance bonus among vice presidents (a lower rank) was $628,174. In 2000, one director received a performance bonus of $844,007, while the median bonus for all directors was only $42,616 and the average bonus was $85,271.

2. The May 2000 Retention Bonus Program

As the Company's finances came under more pressure in the first half of 2000 and WorldCom's stock price deteriorated, the Company recognized that it would continue to face significant challenges within the telecom market. Consequently, the Company substituted a generous new program of retention bonuses that had several features that appear unusual.[10]

In May 2000, the Company authorized retention bonuses to more than 400 executives, senior vice presidents, vice presidents and directors who agreed to remain with the Company for approximately two years, *i.e.*, through July 31, 2002. According to members of the Compensation Committee, these retention bonuses generally were calculated to be equal to approximately three times an employee's previous year's total compensation and were awarded primarily in cash and stock options that would vest within two years. The total sum of these retention bonuses exceeded $400 million.[11]

It is not clear why cash compensation of this magnitude was necessary in the spring of 2000 to retain more than 400 senior WorldCom employees. Information provided by the Company indicates that the retention bonus program included payments of $10 million each to Mr. Ebbers[12] and Mr. Sullivan.[13] Messrs. Ebbers and Sullivan chose to take their retention bonuses in cash and we will review the circumstances of these retention bonuses.

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[10] We understand that in 2002, the Compensation Committee also decided to add a bonus structure based on earnings per share.

[11] Of this amount, approximately $238 million was paid in cash and the remainder was stock options.

[12] Under the formula for retention bonuses derived by the Company, Mr. Ebbers apparently was eligible to receive a $30 million bonus. However, he reportedly chose to take a $10 million bonus, which was equal to the bonus given to Mr. Sullivan.

[13] SEC filings reveal that Mr. Sullivan's WorldCom holdings at or about the time in question were almost exclusively in the form of unexercised options as opposed to shares held outright. The Examiner is curious why Mr. Sullivan did not exercise his options and received a $10 million cash retention bonus payment as opposed to a combination of cash and stock options.

Given the program's purpose to retain employees, we are also curious to know why the full amounts of cash taken under the program were paid to employees <u>in advance</u>, *i.e*., in mid-2000, since retention bonuses are typically paid in stages over the retention period or principally at the end of the period. WorldCom has initiated a number of lawsuits to collect retention bonuses from employees who did not remain at the Company through July 31, 2002. In any event, employees who were laid off by WorldCom during 2002 apparently have not been required to repay the retention bonuses they received in 2000.

3. The Compensation Committee's Role: Theory and Practice

Under WorldCom's corporate structure, the Compensation Committee had final authority and responsibility for the billions of dollars in salary and bonuses paid to WorldCom's executives and employees. Our initial view is that the Compensation Committee does not appear to have exercised its authority effectively.

According to WorldCom's public disclosures, the Compensation Committee had responsibility for: (1) making determinations regarding the annual salary, bonuses and other benefits paid to executive officers, (2) administering WorldCom's stock option and other equity plans and (3) reviewing and taking actions, including the submission of recommendations to the Board of Directors, concerning compensation, stock plans and other benefits for WorldCom's directors, officers and employees. <u>See</u> 2002 Proxy Statement (April 22, 2002).

As noted above, from 1998 through the fall of 2002, the Compensation Committee consisted of Chairman Kellett, Mr. Bobbitt and Gordon Macklin. Lawrence C. Tucker, who was formerly a full member of the Compensation Committee and of the Board, was made an advisory member in November 2000.

It appears that the Compensation Committee did not critique or challenge compensation decisions presented by Mr. Ebbers or other members of the Company's management. The Compensation Committee's minutes are surprisingly brief, given the importance of its role. In any event, they do not suggest that the Compensation Committee ever sought the assistance of independent experts to determine whether the compensation or bonus plans proposed by Mr. Ebbers were consistent with industry standards or were required to meet competitive demands. Indeed, we have not found any evidence that the Compensation Committee sought the advice of independent experts on any issue.

We are also troubled that the Committee's Chairman, Mr. Kellett, engaged in conduct that, at a minimum, gave the appearance he was indebted to Mr. Ebbers and, therefore, was less likely to challenge him on matters related to compensation or benefits.

For instance, in early 2001 Mr. Ebbers evidently agreed to give Mr. Kellett a "dry lease" of a Falcon 2OF-5 corporate jet owned by the Company. Apparently, Mr. Kellett began to use the jet for his personal use in April 2001, although a lease for the aircraft was not executed until June 15, 2001. Mr. Breeden, the Corporate Monitor, has taken the position that the payments required of Mr. Kellett under this lease - payments of $1 per month plus operating charges of $400 per flight hour and certain expenses - were well below the levels that would have been paid in a true arms' length transaction and that "the lease represented a very significant implicit payment to Kellett by Ebbers, using the Company's assets." See Letter to WorldCom Board of Directors from Richard C. Breeden (September 6, 2002) at 4. Mr. Breeden has concluded: "In my judgment, [Mr.] Kellett's failure to disclose to the board the secret deal from [Mr.] Ebbers, and his failure to recuse himself from decisions awarding compensation, loans and severance benefits to [Mr.] Ebbers, represent an egregious breach of his fiduciary duties of care and loyalty to the Company's shareholders." See id.

Mr. Kellett sharply disagreed. We understand that Mr. Kellett and the Company recently reached an agreement pursuant to which Mr. Kellett will reimburse the Company for costs incurred by WorldCom with respect to his use of the corporate jet.

Regardless of whether the aircraft lease terms were fair and reasonable from the Company's perspective, as Mr. Breeden's letter points out, the lease created the appearance of a "side deal" between Mr. Ebbers and the chairman of the committee responsible for authorizing millions of dollars in compensation and benefits to him. These appearance problems were aggravated by the fact that neither the aircraft lease nor its terms were disclosed in a timely manner to the full Board of Directors or to investors.

D. The Compensation Committee's Role In Authorizing Over $400 Million in Loans and Guaranty Payments To Mr. Ebbers or His Banks

The Compensation Committee played a critical role in the Company's decision to loan Mr. Ebbers more than $400 million over a period of approximately 18 months, from September 2000 until April 2002.[14]

1. Mr. Ebbers' Increasingly Serious Debt Problems

Throughout the 1990s, Mr. Ebbers routinely guaranteed or pledged shares of his WorldCom stock to secure numerous bank loans made to him or to entities he controlled. Mr. Ebbers appears to have used the proceeds from those loans to purchase business interests or real estate, apparently as an alternative to selling his stock to raise funds for those investments. We have not yet confirmed the precise scope and extent of the indebtedness Mr. Ebbers incurred during the 1990s, or the extent to which he used his WorldCom stock as collateral to secure this indebtedness. We

[14] The issue of the loans to Mr. Ebbers raises additional concerns about the Compensation Committee's competence and independence. Effective July 30, 2002, Section 402 of the Sarbanes-Oxley Act of 2002 prohibits public companies from making nearly any type of personal loan to their directors and executive officers.

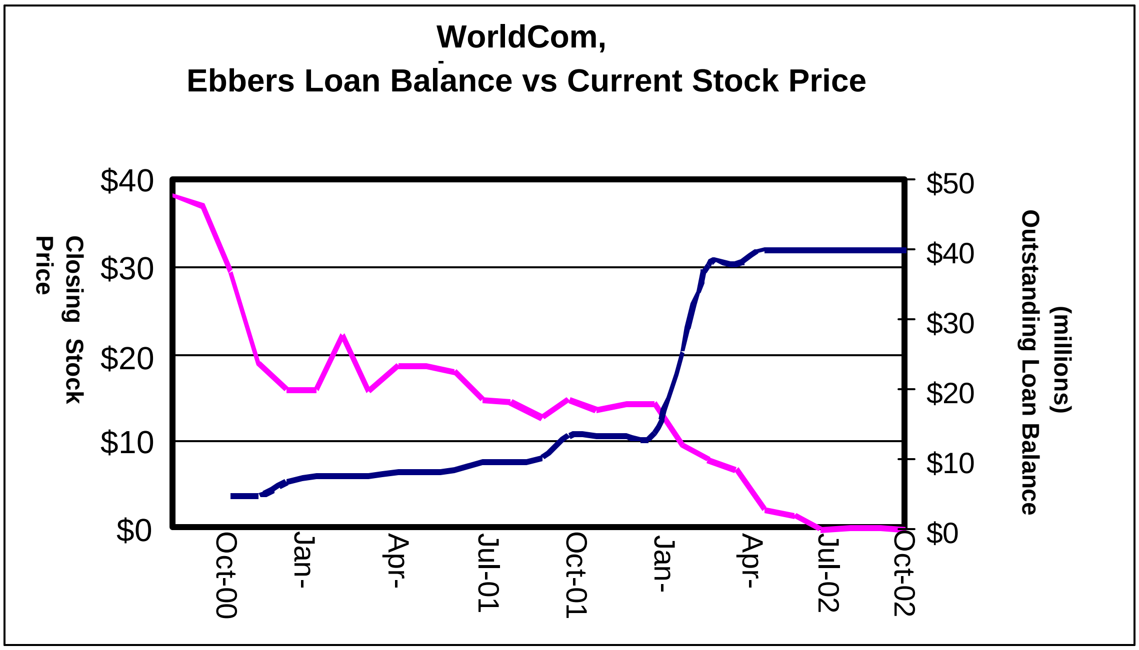
have confirmed, however, that Mr. Ebbers either personally guaranteed or pledged WorldCom stock as security for in excess of $1 billion in personal and business loans, including personal bank loans, personal brokerage loans and loans on behalf of Mississippi College, Douglas Lake Land & Timber Company, Douglas Lake Cattle, BC Yacht Sales, Joshua Timberlands and Master Hospitality Services.

Under Mr. Ebbers' agreements with his lenders, if the value of his WorldCom stock fell below certain levels, such that it was insufficient collateral for his loans, Mr. Ebbers was obligated to make payments to assure that the loan amounts remained sufficiently collateralized. When WorldCom's stock price began falling in 2000, from a high of $51.9375 on January 3, 2000 to a low of $13.875 on December 22, 2000, the value of the collateral for Mr. Ebbers' loans plummeted and his lenders began to demand repayment of some portions of his debts through margin calls.

Between September 2000 and continuing through April 2002, Mr. Ebbers satisfied many of those margin calls through a series of loans and a guaranty from WorldCom. The Company's loans apparently were secured by some of the same stock Mr. Ebbers had used to secure the loans made to him and the entities he controlled in the 1990s. As the price of WorldCom stock decreased, and Mr. Ebbers' margin calls increased, so did WorldCom's loans to Mr. Ebbers. The table below summarizes our current information concerning the disbursements made to Mr. Ebbers during calendar years 2000, 2001, and 2002 pursuant to his loans from the Company and the Company's guaranty:

	WorldCom Disbursements		
Calendar Yr.	Loans	Guaranty	Total
2000	$ 76,844,000	$ -	$ 76,844,000
2001	18,319,478[15]	41,608,777	59,928,255
2002	70,211,344	193,620,261	263,831,604
	$ 165,374,822	$ 235,229,038	$ 400,603,860

As indicated by the graph that follows, the dollar value of Mr. Ebbers' debt to WorldCom was closely related to the falling price of his WorldCom shares:



2. The Compensation Committee's Approval of the WorldCom Loans and Guaranty That Benefited Mr. Ebbers

How the Company came to lend Mr. Ebbers so much money seems to be in dispute. According to Mr. Kellett, Mr. Ebbers first approached him to ask whether WorldCom would provide him with a loan to cover his margin debt and Mr. Kellett then presented Mr. Ebbers' request to the Compensation Committee for its consideration. However, according to the minutes of the quarterly meeting of WorldCom's full Board of Directors on November 16, 2000, when the

15 The 2001 loan disbursement figure includes a $5,700,000 loan repayment on June 29, 2001.

loans and guaranty were first disclosed to the Board, Mr. Ebbers stated that the idea for the loans and the guaranty originated with the Compensation Committee. He also told the Board that he did not necessarily believe that the loans were in *his* best interest. Regardless of where the idea for the Company's loans originated, it appears that a major motivation for those loans was to help Mr. Ebbers avoid the necessity of selling large blocks of WorldCom stock in order to pay his outstanding debts. It appears that certain of the Company's directors believed that large-scale sales of WorldCom stock by Mr. Ebbers would trigger a further downward slide in the Company's share price.[16]

Minutes of meetings of the Compensation Committee indicate that it first authorized a loan of $50 million to Mr. Ebbers on September 6, 2000. On October 27, 2000, the Compensation Committee authorized an additional $25 million loan to Mr. Ebbers and a $75 million guaranty in favor of a lender relating to certain of Mr. Ebbers' liabilities to that bank.

A letter agreement, dated November 1, 2000 (the "November 2000 Letter") signed by Mr. Kellett and Mr. Ebbers memorialized the $50 million and $25 million loans to Mr. Ebbers and the $75 million guaranty in favor of a lender. The November 2000 Letter confirmed that Mr. Ebbers would indemnify WorldCom and that he would grant the Company security interests in all of the shares of WorldCom stock he owned, subordinate to the rights of the lenders. It appears that WorldCom's security interest in that stock was not perfected until April 2002. Further, it appears that on or about November 1, 2000, Mr. Ebbers signed promissory notes to WorldCom for the first two loans made to him earlier that fall. By November 14, 2000, the Compensation

[16] Key witnesses recalled that between September 6, 2000, when the first loan was authorized, and October 27, 2000, when the second loan was authorized, Mr. Ebbers requested that the Compensation Committee authorize an additional loan. Apparently, after this request was denied, Mr. Ebbers entered into a forward sale on September 30, 2000 of 3 million shares of WorldCom stock.

Committee increased the guaranty of Mr. Ebbers' debts to a lender from $75 million to $100 million.

Evidence we have reviewed thus far does not suggest that the full Board knew of, or approved (at least formally), the Ebbers loans or guaranty before they were made. The minutes for the two Board meetings between September 6, 2000, when the first loan was made, and November 14, 2000, when WorldCom publicly disclosed the loans and its guaranty in its third quarter 2000 Form 10-Q, contain no mention of either the loans or the guaranty. According to Mr. Kellett, P. Bruce Borghardt, an in-house lawyer at WorldCom who served as counsel to the Compensation Committee, told the Compensation Committee that Board approval of the loans and guaranty was not necessary. Mr. Borghardt has stated that he was never asked his opinion regarding the need for Board approval.

In late 2000, the price of WorldCom stock continued to fall, triggering additional margin calls. As a result, on December 27, 2000, the Compensation Committee decided to extend an additional $25 million loan to Mr. Ebbers. Soon thereafter, on January 30, 2001, the Compensation Committee replaced the existing $100 million guaranty in favor of a lender with a guaranty for $150 million plus additional payments, including, but not limited to, a letter of credit by a lender relating to Mr. Ebbers' financial support of Mississippi College, Mr. Ebbers' alma mater.[17] Much later, on September 10, 2001, Mr. Ebbers signed a promissory note memorializing his agreement to repay the amounts extended under the guaranty. It appears that, until that date, Mr. Ebbers' repayment obligations under the guaranty were never memorialized.

[17] In the end, WorldCom paid $198.7 million under the guaranty plus a deposit of $36.5 million to collateralize the Mississippi College letter of credit.

On January 25, 2002, the Compensation Committee decided to lend an additional $65 million to Mr. Ebbers.

On April 2, 2002, with the loans and the guaranty payments by WorldCom to Mr. Ebbers now totaling more than $379 million, Mr. Ebbers and the Company amended and confirmed the various contractual agreements between them that previously had been memorialized in the November 2000 Letter. In a letter agreement, dated April 2, 2002 (the "April 2002 Letter"), Mr. Ebbers again agreed to indemnify WorldCom and also agreed to pledge to the Company all of the WorldCom shares he currently owned or later acquired pursuant to stock options, other than those that were the subject of pledges for the benefit of his banks. The Company perfected its interest in a pledge of 9,287,277 shares of WorldCom Group stock, then worth approximately $63 million, and a pledge of 575,149 shares of MCI Group stock, then worth approximately $3 million.[18] This appears to be the first time WorldCom perfected its interest in any of Mr. Ebbers' assets. Under the April 2002 Letter, the pledge of Mr. Ebbers' remaining WorldCom shares was to take effect when the limitations and restrictions under existing lending arrangements terminated. As of May 20, 2002, Mr. Ebbers' remaining holdings consisted of an additional 5,091,483 shares of WorldCom Group stock.

In the April 2002 letter, Mr. Ebbers affirmed that his December 31, 2001 financial statement, which he had previously provided to the Company, was correct,[19] and he agreed to

[18] As of April 2, 2002, the market value of the perfected shares of Mr. Ebbers' WorldCom Group stock was $62,967,738, based on that day's share price of $6.78, and the market value of the perfected shares of Mr. Ebbers' MCI Group stock was $3,215,083, based on that day's share price of $5.59.

[19] It appears that by the time the April 2002 Letter was signed, Mr. Ebbers' financial statement as of December 31, 2001, was, in fact, substantially out of date. That financial statement indicated that the value of Mr. Ebbers' primary asset, his approximately 20 million shares of WorldCom Group stock, was $286.6 million (based upon a share price of $14.08 on December 31, 2001). However, by April 2, 2002, Mr. Ebbers' holdings of WorldCom stock had decreased to approximately 17 million shares, which was worth only approximately $117.6 million (based upon a share price of $6.78 on April 2, 2002).

provide to the Company, within ten days, information about his interests in Joshua Holdings, BC Yacht Sales, Savannah Yacht & Ship, BCT Real Estate, Douglas Lake Land & Timber Company and Douglas Lake Properties.[20]

Evidence suggests that, on April 18, 2002, Mr. Ebbers for the first time pledged his other business interests to WorldCom as security for his debts. In that pledge agreement, Mr. Ebbers granted to WorldCom a security interest[21] in all of his holdings in BC Yacht Sales, Douglas Lake Land & Timber Company, Douglas Lake Properties, and BCT Holdings. He also agreed to grant to WorldCom a security interest in 35 percent of his 86.25 percent share of Joshua Holdings LLC until restrictions imposed by another pledge were lifted. The two other minority owners of Joshua Holdings LLC, James Truett Bourne, Jr. and W. Mark Lewis, also granted WorldCom a perfected security interest in their shares of that company.

On April 29, 2002, in connection with Mr. Ebbers' resignation, WorldCom consolidated his various loan and guaranty arrangements into a single promissory note in the principal amount of approximately $408.2 million, repayable beginning April 2003 over five years at a floating interest rate, which was 2.32 percent per annum at the time the loans were consolidated. The $408.2 million principal amount includes: (1) approximately $198.7 million the Company had paid to a lender to satisfy outstanding indebtedness of Mr. Ebbers or certain companies controlled by him that WorldCom had guaranteed; (2) approximately $36.5 million that WorldCom had deposited to collateralize a letter of credit used to support Mississippi College; (3) approximately $165.4 million

[20] We understand that Mr. Ebbers' companies were able to secure loans and other financial benefits during the 1990s because of pledges and/or guarantees by Mr. Ebbers.

[21] Based upon our review of documents available to date, it is unclear to the Examiner to what extent WorldCom "perfected" these interests.

that WorldCom had loaned to Mr. Ebbers; and (4) approximately $7.6 million in accrued interest on the foregoing amounts as of April 29, 2002.

3. Matters Relating to the Loans and Guaranty Requiring Further Investigation

The Company's large loans to, and guaranty on behalf of, Mr. Ebbers, and the role of the Compensation Committee with regard to them, are important subjects. The fact that Mr. Ebbers leveraged his substantial share holdings in the Company for his own private purposes put the interests of all of the Company's shareholders at risk, since a forced sale of his WorldCom stock might have precipitated a rapid downward spiral in the Company's share price. Furthermore, by using his WorldCom shares to collateralize massive debt obligations, Mr. Ebbers placed himself under intense pressure to support the Company's share price.

Beyond the questionable behavior of Mr. Ebbers, there are serious questions about the role of the Compensation Committee and its members in approving the growing debt burden that Mr. Ebbers transferred from his banks to the Company. The following issues warrant further investigation and analysis.

a. Due Diligence by the Compensation Committee

On each occasion that a loan was made to Mr. Ebbers, the Compensation Committee's minutes repeated the statement that such a loan was in the best interests of WorldCom and its shareholders. The premise for this conclusion was the concern that, if Mr. Ebbers were to sell his shares to satisfy his margin calls, the price of WorldCom's stock would fall, as it apparently had fallen once before when Mr. Ebbers sold some of his shares. Even if that premise were true, it remains unclear whether the Compensation Committee considered:

(a) Whether Mr. Ebbers had other assets with which to satisfy his margin calls,[22] and, if not, whether he had the financial wherewithal to repay his obligations to WorldCom; and

(b) Whether the Company's approval of the loans and of the guaranty would breach any of WorldCom's own loan covenants. While Mr. Kellett has advised us that Mr. Sullivan has indicated to him that this was not the case, no documents demonstrating an analysis of this possibility have yet been located.

We are still in the process of examining these issues.

b. Documentation of the Loans and Guaranty

It appears that loan proceeds were provided to Mr. Ebbers before any loan agreements between him and the Company were reduced to writing and that some of the loan documentation may have been backdated. For example, although Mr. Ebbers first received loan payments in early September 2000, it appears that he did not sign his first promissory note to WorldCom until November 2000 - even though the promissory note was dated September 8, 2000. In addition, we are not aware of any pledge of security by Mr. Ebbers to collateralize any of these payments until November 1, 2000, after WorldCom had already paid out $50 million to him. It also appears that the Company's interest in Mr. Ebbers' WorldCom shares may not have been perfected until April 2002, long after Mr. Ebbers first agreed to pledge those shares. Finally, it appears that payments were made under the guaranty in favor of a lender before Mr. Ebbers signed a promissory note agreeing to repay the amounts paid under that guaranty. We intend to inquire further to determine if loan proceeds were in fact disbursed before appropriate documentation was executed.

c. The Below-Market Interest Rate

[22] Mr. Ebbers' financial statement as of December 31, 2001, reflects that Mr. Ebbers' net worth at the end of 2001 was $295 million.

The four loans and the guaranty extended by WorldCom to Mr. Ebbers were payable upon demand and bore interest at a floating rate equal to the applicable rate under WorldCom's then-existing credit facilities. This interest rate was substantially lower than the interest rates Mr. Ebbers had been charged by commercial banks, resulting in millions of dollars in interest savings to Mr. Ebbers.[23] Mr. Borghardt indicated that several individuals suggested that a below-market interest rate was justified because Mr. Ebbers was "forced" to pay interest on the amounts he had borrowed rather than sell his stock for cash. This argument seems suspect given that Mr. Ebbers or his businesses were already paying interest on the loans collateralized by his WorldCom stock. We intend to inquire into the basis for this proposition.

d. Use of the Loan Proceeds and Proper Disclosures

According to the documents we have reviewed thus far, the stated purpose of the Company's loans and guaranty was to help Mr. Ebbers meet his margin calls. However, interviews with members of the Compensation Committee and others, and a review of WorldCom documents and Mr. Ebbers' own records suggest that, during the period when WorldCom was extending Mr. Ebbers hundreds of millions of dollars in credit, he used more than $27 million for purposes unrelated to his margin calls, including payments of $1.8 million for the construction of his new house, $2 million to a family member for personal expenses, approximately $1 million in loans to

[23] The interest rate applicable to the $408.2 million consolidated promissory note Mr. Ebbers signed in April 2002 was equal to the "Eurodollar rate applicable to each one-month Interest Period commencing on the date hereof [April 29, 2002] plus the Applicable Margin during the corresponding period applicable to Eurodollar Rate Borrowings by the Lender…." At that time, the applicable interest rate was 2.32 percent. Mr. Ebbers' previous promissory notes, as well as the guaranty, reflected a similar interest rate based on WorldCom's prior Eurodollar credit facility. Over the course of the time during which WorldCom extended loans and its guaranty on behalf of Mr. Ebbers, Mr. Ebbers' lenders charged him and his related entities an interest rate that was as much as two percent greater than that charged by WorldCom. While we have not performed a detailed analysis of what interest rates would have been available to a similarly situated borrower, we have confirmed that, as of April 29, 2002, the Prime Rate was 4.75 percent and the interest rate paid on the 5-year Treasury note was 4.56 percent. Thus, WorldCom's loans and guaranty saved Mr. Ebbers millions of dollars in interest payments.

his family, his friends, and a WorldCom officer, and payments of $22.8 million to his own business interests. Evidence suggests that Mr. Borghardt learned about at least some of these uses of the WorldCom loan proceeds from Mr. Ebbers' personal financial advisor, and that Mr. Borghardt communicated that information to members of the Board, including Compensation Committee members, who apparently were surprised.

It is not clear that Mr. Ebbers' use of the Company's loans for purposes other than to reduce indebtedness was ever properly disclosed. The Company's amended Form 10-K for FY 2000, filed with the Securities and Exchange Commission on April 26, 2001, stated that "Mr. Ebbers has used, or plans to use, the proceeds of the loans from us to repay certain indebtedness under margin loans secured by shares of our common stock owned by him and the loans guaranteed by us are also secured by such stock and the proceeds of such loans *were used for private business purposes*." (Emphasis added.) This language does not make clear whether the reference to loan proceeds "used for private business purposes" was intended to refer to the Company's loans to Mr. Ebbers or to the loans from private sources that the Company's loans were intended to retire.

VIII. WorldCom's Relationships With SSB and Jack Grubman

A. Introduction

In the months following WorldCom's bankruptcy, a great deal of attention has been focused on the Company's relationships with Salomon Smith Barney ("SSB"). Public officials and members of the financial media have strongly suggested that an unhealthy relationship developed between WorldCom and SSB. They have alleged that SSB used the promise of lucrative IPO allocations and flattering analyst reports to entice corporate executives, like Mr. Ebbers, to reward them with highly profitable investment banking assignments.[24] In addition, they have suggested that SSB's chief telecommunications analyst, Jack Grubman, combined forces with corporate executives, like Mr. Sullivan, to project inflated prospects for WorldCom's fortunes, resulting in bloated stock valuations.

Although we do not intend to duplicate investigations being undertaken by regulators and government authorities, we intend to investigate whether Mr. Ebbers and/or other WorldCom officers and directors exploited their corporate positions for private gain. We will also give attention to allegations that Mr. Grubman and other analysts may have combined with corporate insiders to exaggerate WorldCom's current and future financial strength. Although it would be premature to reach any conclusions on these subjects, the following facts have begun to emerge:

1. In the transactions we have reviewed to date, SSB and its predecessors, Salomon Brothers and Smith Barney, collectively received more engagements from WorldCom than any other investment banking firm during the past five years.

2. SSB and its predecessors also allocated millions of dollars of valuable IPOs to a number of WorldCom directors, including Mr. Ebbers. These directors, in turn, sold their IPO shares for an aggregate profit of more than $18 million.

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[24] For example, on September 30, 2002, the New York Attorney General filed a civil suit against several corporate directors and officers, including Mr. Ebbers, to recover profits the defendants realized from the sale of IPOs they purchased from investment banking firms that had been retained by their companies. <u>State of New York v. Philip F. Anschutz, et al.</u>, Index No. ________, Supreme Court, N.Y. County. In his complaint, the New York Attorney General alleges that Jack Grubman, the SSB telecommunications analyst who covered WorldCom, issued unduly favorable reports on WorldCom for the express purpose of obtaining the Company's investment banking business. Relying, in part, on the allegations set forth by the New York Attorney General, H. Carl McCall, the Comptroller of the State of New York, filed a class action suit on or about October 11, 2002 against SSB and other financial institutions involved in underwriting WorldCom debt issues, as well as against Mr. Grubman, for various alleged violations of securities laws in connection with improper analyst recommendations and IPO allocations. In Re WorldCom Securities Litigation, Master File No. 02 Civ. 3288 (DLC).

3. Until April 2002, Mr. Grubman and SSB repeatedly gave WorldCom's stock its highest ratings, enthusiastically urging investors to purchase WorldCom shares, even at times when Mr. Grubman was privately advising WorldCom management on business strategy, acquisitions and investor relations.

4. Until the third quarter of 2000, WorldCom's reported earnings per share consistently met or came close to analyst expectations. In subsequent quarters, WorldCom management publicly attributed its faltering financial performance to a series of allegedly non-recurring causes.

At a minimum, the generous IPO allocations given by SSB to Mr. Ebbers and others created the appearance that valuable corporate business opportunities were being traded for personal gain. Mr. Grubman's behavior also created at least an appearance of impropriety. As this investigation continues, we will try to determine: (1) the full extent to which WorldCom and its key officers did in fact have an unhealthy relationship with SSB, and (2) whether the Company has grounds to recover losses incurred by the Company or profits realized by WorldCom executives, SSB, or its employees as a result of conduct that is determined to be improper.

Given the predominant roles played by SSB and Mr. Grubman in matters related to WorldCom, this First Interim Report will focus primarily on them. However, we also intend to review and analyze information about WorldCom's other investment banking relationships and about other analysts who were covering WorldCom.

B. SSB Was WorldCom's Primary Investment Bank

As described in Chapter VI, WorldCom pursued a fast-paced and aggressive campaign of acquisitions and stock purchases, which in turn required the Company to issue a great deal of debt and to extend its credit facilities. Although WorldCom retained several large investment banks to work on these transactions, the documents that we have reviewed to date indiate that WorldCom engaged SSB (and Salomon Brothers, Inc. before it) more frequently than any other firm as its lead investment bank.

We are in the process of gathering information about the fees received by SSB in connection with its WorldCom engagements, but we note that, in his recently filed Complaint, the New York Attorney General alleges that between October 1997 and February 2002 SSB earned more than $107 million from its work for WorldCom on approximately 23 investment banking deals.

C. SSB Allocated Lucrative IPOs to Mr. Ebbers and Other WorldCom Directors

In light of the allegations made by the New York Attorney General, we have examined evidence that Mr. Ebbers and other WorldCom directors received highly profitable allocations of IPOs from SSB. This evidence, which consists largely of information provided by SSB to Congressional investigators, indicates that at various times between April 22, 1996 and March 21, 2002, SSB allocated millions of dollars in IPOs to Mr. Ebbers and certain other officers and directors who in turn sold them for an aggregate profit in excess of $18 million. The following chart summarizes the SSB IPOs received by Mr. Ebbers and the profits earned from those IPO allocations:

Ebbers					
IPO Issue Date	Firm	Subject IPO Company / Issuer	Shares	Total Realized Gain/(Loss)	Total Unrealized Value (as of 8/23/02)
6/10/96	Salomon Brothers	McLeod Inc. Com.	200,000	$ 2,155,000	
9/26/96	Salomon Brothers	Tag Heuer Intl Spon ADR	5,000	2,250	
6/23/97	Salomon Brothers	Qwest Commicns Intl Com	205,000	1,957,475	
8/15/97	Salomon Brothers	TV Azteca SA Spon ADR	1,000	937	
9/16/97	Salomon Brothers	Box Hill Sys Com	5,000	23,125	
9/26/97	Salomon Brothers	Nextlink Communications Inc.	200,000	1,829,869	
10/16/97	Salomon Brothers	China Telecom Ltd	2,000	(8,000)	
10/28/97	Salomon Brothers	Metromedia Fiber Net A	10,000	4,558,712	
11/21/97	Salomon Brothers	Teligent Inc. Com	30,000	76,563	
3/23/98	SSB	Earthshell Corp. Com.	125,000	(73,945)	
4/6/99	SSB	Rhythms Netconnections Inc.	10,000	66,900	
5/25/99	SSB	Juno Online Services Inc.	10,000	(6,662)	
6/24/99	SSB	Juniper Networks Inc.	5,000	440,125	
7/27/99	SSB	Focal Communications Corp	5,000	100,700	
10/1/99	SSB	Williams Communications Group	35,000		(804,405)
10/18/99	SSB	Radio Unica Communications Crp	4,000	8,010	
10/29/99	SSB	Chartered Semiconductor	5,000	291,250	
11/9/99	SSB	KPNQwest NV CL C	20,000	371,926	
11/9/99	SSB	United Parcel Services CL B	2,000	17,625	
7/26/00	SSB	Tycom Ltd	7,500	32,813	
8/2/00	SSB	Signalsoft Corp	5,000	59,094	
Aggregate Gain:					$ 11,099,361[25]

The New York Attorney General has alleged that Mr. Ebbers unjustly enriched himself and violated New York's Martin Act when he received his lucrative IPO allocations from SSB. In a complaint he filed on September 30, 2002,[26] the New York Attorney General alleged that Mr. Ebbers participated in a practice called "spinning" whereby SSB allocated to top executives of corporations from which it sought investment banking business valuable, nearly risk-free shares of

[25] We are still in the process of reviewing the facts and circumstances of the IPO allocations to other members of the Board.

[26] State of New York v. Philip F. Anschutz, et al.

stock in companies that were about to engage in IPOs.[27] According to the Attorney General's allegations, these IPO shares were distributed to Mr. Ebbers and others in order to influence their decision to choose SSB as the Company's investment banking firm.[28]

The Attorney General's complaint alleges that Mr. Ebbers made a personal profit of more than $11 million from 21 "hot" IPO allocations he received from SSB between June 10, 1996 and August 2, 2000.[29] The Attorney General also alleges that, in return for these profitable IPO allocations, Mr. Ebbers used his influence to assure that SSB was awarded much of WorldCom's valuable investment banking business.[30] According to the Attorney General's complaint, SSB did not receive its first investment banking assignment from WorldCom until <u>after</u> it began to allocate valuable IPOs to Mr. Ebbers, and thereafter, between October 1997 and February 2002, WorldCom employed SSB for 23 investment banking deals that earned SSB investment banking fees in excess of $107 million.[31] The Attorney General seeks restitution from Mr. Ebbers of the profits he realized from his IPO allocations.

We intend to give close attention to the Attorney General's allegations and to assess whether Mr. Ebbers and others may have breached fiduciary duties by receiving IPO profits that may have belonged to the Company. We are also considering "corporate opportunity" and other theories that might give rise to claims for recoveries on behalf of the WorldCom bankruptcy estate.

We understand that SSB has taken the position that it allocated valuable IPOs to Mr. Ebbers and other WorldCom directors because of their status as significant private customers of the firm,

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27 The Attorney General has alleged that Mr. Ebbers violated New York's Martin Act by failing to disclose: 1) his receipt of IPO shares through the practice of "spinning," and 2) the nature of WorldCom's investment banking relationship with SSB.

28 <u>Anschutz</u> at <u>7</u>.

29 <u>Id</u>. at <u>23</u>.

30 <u>Id</u>. at <u>12</u>.

31 <u>Id.</u> at <u>23</u>.

not because of their ability to direct investment banking business to SSB. We intend to investigate this subject more thoroughly. But even if SSB's position is correct, these lucrative IPO allocations created the appearance he was trading corporate business for private gain because Mr. Ebbers played a primary role in directing investment banking business to SSB.

D. The Enthusiastic Ratings and Reports of SSB Securities Analyst Jack Grubman

As noted previously, the New York Attorney General, among others, has asserted that SSB secured WorldCom engagements, at least in part, because Mr. Grubman gave WorldCom's stock unduly favorable ratings.[32] An assessment of this allegation requires a basic understanding of the fundamental role of analysts and their influence over the securities markets.

1. The Role of Securities Analysts

Analysts review and report information provided by regulators, the media and other sources regarding the companies they follow and their industries. The Supreme Court has recognized that a securities analyst's work is "necessary to the preservation of a healthy market."[33] In theory, at least, analysts promote market efficiency by providing investors with a distillation and interpretation of all relevant information about the companies they follow, including public filings, press releases, presentations and conference calls.

Some analysts work for private research services that either provide their reports and research to widely circulated publications or to a limited group of subscribers. More frequently, however, analysts are employed by investment firms. Such firms use the research of their analysts

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[32] The New York Attorney General has alleged that Mr. Ebbers' choice of SSB as WorldCom's investment bank helped ensure that the Company received an inflated stock rating by SSB's chief telecommunications analyst, Jack Grubman. The Attorney General has alleged that Mr. Grubman inflated WorldCom's stock ratings without merit from June 2000 until the company was on the verge of bankruptcy in April 2002, and that these inflated ratings enabled Mr. Ebbers to make at least $23 million by selling his WorldCom shares. State of New York v. Philip F. Anschutz, et al.

[33] Dirks v. S.E.C., 463 U.S. 646, 658 (1983).

as a basis for their published lists of recommended securities and research reports and for the advice they give to their institutional and retail clients.

In recent months there has been a great deal of discussion and debate about the potential conflicts that arise when securities firms provide analytic, banking and brokerage services. It is generally accepted that, while investment banking generates substantial profits, research, standing alone, is at best a loss leader. Some believe that an analyst can only contribute to a firm's profits if he or she enhances its investment banking business. Some also believe that analysts may be encouraged by their transactional colleagues to publish favorable reports to ingratiate their firms with existing or potential investment banking clients. Indeed, this encouragement may include financial incentives, if an analyst's compensation is tied to the brokerage firm's investment banking revenues. In the view of some regulators, the objectivity of the analyst's research and conclusions may be compromised by these incentives.

The use of analyst reports is also complicated by the lack of uniformity among the ratings systems employed by analysts today. At one firm, "buy" might be the best ranking possible, while at another firm it may be merely second best. Some firms use a 4 or 5 step scale for their recommendations. Without a uniform rating system, it is extremely difficult to compare "apples to apples."

Although we do not intend to address general issues relating to the independence of securities analysts, we do intend to investigate whether an unhealthy relationship developed between WorldCom and the analysts who covered its stock, particularly Mr. Grubman.

2. WorldCom's General Interactions with Securities Analysts

As a large and rapidly growing public company, WorldCom had frequent interaction with the many securities analysts who covered its stock. WorldCom executives generally held teleconferences with securities analysts on a quarterly basis. Each call would normally begin with prepared statements from Company executives regarding WorldCom's financial position, financial outlook, and issues of particular importance to the Company. The executives would then answer analysts' questions regarding their prepared statements and other subjects.

WorldCom's management and directors paid very close attention to the views expressed by Wall Street's securities analysts and carefully tracked their stated expectations of the Company. The Company's Investor Relations Department regularly sent memoranda and charts to senior management describing analysts' expectations regarding the Company's quarterly and annual financial performance. Even the materials prepared for Board meetings regularly included transcripts of the most recent teleconference with analysts, a memorandum regarding analysts' expectations, and a summary of their reactions to WorldCom's quarterly financial announcements. Clearly, senior management and the Board recognized the significance of maintaining Wall Street's confidence.

3. Mr. Grubman's Extremely Favorable Analyst Reports

Prior to their merger in late 1997, Salomon Brothers and Smith Barney expressed substantially different views concerning the future performance of and risks associated with WorldCom stock. In 1997, Smith Barney issued four WorldCom reports by analysts Timothy Horan and Charles W. Schelke. These reports reflected a relatively restrained assessment of the stock's prospects.

In their first report, Messrs. Horan and Schelke rated the stock "neutral" and maintained an "outperform" rating for the remaining three reports. In 1997 neutral and outperform ratings represented a mild endorsement at best. Moreover, Messrs. Horan and Schelke consistently maintained a high risk rating on WorldCom stock.

At the same time, Mr. Grubman, who worked for Salomon, issued a report in which he rated WorldCom a strong buy and declared that "no telecom company of WorldCom's market cap can come close to matching WorldCom's top-line growth, margin expansion potential or strategic position, much less having all of these attributes which is why WorldCom remains our favorite stock."[34] Mr. Grubman's strong buy rating represented an emphatically higher recommendation than Smith Barney's neutral and outperform ratings. Notably, Mr. Grubman said little about the stock's risk factors in his report.

In the wake of the Salomon Smith Barney merger, Mr. Grubman emerged as SSB's chief telecommunications analyst and the author of all its WorldCom reports from the time of the merger until March 2002. Consistent with Mr. Grubman's pre-merger view, each and every SSB report during this period included a "buy" recommendation (SSB's highest rating) and a "medium" assessment of risk.[35] Mr. Grubman's reports during this period consistently proclaimed ringing endorsements of WorldCom and its stock.

After the merger of Salomon and Smith Barney, SSB reinitiated coverage of WorldCom on March 16, 1998, after the completion of the MCI shareholder vote, with a "buy" rating. SSB disclosed in its report that it was the financial advisor to WorldCom on the MCI transaction. As the chart below reveals, the first SSB/Grubman report in April 1998 set a target price for WorldCom stock which represented a 40% increase over the actual price of the stock at the time of the report.

[34] *See* Salomon report, August 1997.

[35] SSB's guide to its investment rankings states that a stock's rank reflects its expected total return and risk factors over the following 12 to 18 months of the report. The higher the risk, the higher the required return. A buy rating is supposed to be reserved for a total return ranging from 15% or greater for a low-risk stock to 30% or greater for a speculative stock. Estimated returns for other risk categories are to be scaled accordingly. Risk takes into account predictability of earnings and dividends, financial leverage, and stock price volatility.

As WorldCom's stock price steadily rose in 1998 and 1999, Mr. Grubman gave and maintained his highest ratings on WorldCom stock and set target prices that were 17% to 60% (and 100% over a 2 year time frame) higher than the current value of the stock. The chart below summarizes these reports:

SSB REPORTS ON WORLDCOM FROM 4/98-10/99

Date	Price of WCOM[36]	Rating	Risk Factor	Target Price	% Forecasted Increase
04/09/98	$42.75	1-Buy	Medium	$60.00	40.35%
10/09/98	$45.00	1-Buy	Medium	$90.00 in 2 yrs.	100% (2 years)
11/16/98	$54.00	1-Buy	Medium	$80 - $90	57.41%
11/17/98	$55.05	1-Buy	Medium		
02/23/99	$85.00	1-Buy	Medium	$100.00	17.6%
05/24/99	$86.75	1-Buy	Medium	$130.00	49.86%
08/20/99	$75.75	1-Buy	Medium		
10/08/99	$67.94	1-Buy	Medium		

Mr. Grubman consistently maintained that WorldCom represented the cheapest S&P large cap growth stock at the time,[37] remained the "must-own" large-cap growth stock in anyone's portfolio,[38] represented one of the premier large cap growth companies in any industry,[39] and represented the single best idea in telecom.[40] Mr. Grubman urged investors to "load up the truck" with WorldCom stock.[41] In fact, he declared that any investor who did not take advantage of current prices to buy every share of WorldCom should seriously think about another vocation.[42]

36 "Price of WCOM" stock has not been retroactively adjusted for a 3 for 2 stock split in November 1999.

37 *See* SSB report 10/9/1998.

38 *See* SSB report 11/16/1998.

39 *See* SSB report 2/23/1999.

40 *See* SSB report 8/20/1999.

41 Id.

42 Id.

Mr. Grubman continued his extremely bullish outlook on WorldCom after a 3-for-2 stock split distributed on December 31, 1999, and while the Sprint merger was pending.[43] He aggressively reiterated his buy rating and predicted that the Department of Justice would approve the merger with Sprint in June 2000.[44] He also declared that when the Sprint deal closed, WorldCom stock could easily be trading at prices that were 50-60% higher than existing prices, and still would appear inexpensive.[45] Mr. Grubman attributed WorldCom's declining stock price during the early part of the year 2000, to the market's ignorance in assessing the realities of the Company's compelling story and to the fact that the market instead was acting on sentiment.[46] Mr. Grubman stated that "investors who are selling WorldCom in the $40s will be buying WorldCom in the $60s in six months."[47]

From the beginning of 2000 through August 2001, when WorldCom's stock fell from $50.06 to $12.44 per share, SSB consistently set target prices that were 90% to 244% higher than the current stock quote. The following chart summarizes the actual stock prices and Mr. Grubman's ratings and target prices from February 2000 until August 2001:

43 SSB disclosed in its 2/15/2000 report that the firm was advising WorldCom on its pending merger with Sprint.

44 *See* SSB report 2/15/2000.

45 Id.

46 Id.

47 Id.

SSB REPORTS ON WORLDCOM FROM 2/00 UNTIL 8/01

Date	Price of WCOM	Rating	Risk Factor	Target Price	% Forecasted Increase
02/15/00	$50.06	1-Buy	Medium		
06/27/00	$37.50	1-Buy	Medium	$87.00	132.00%
07/12/00	$44.44	1-Buy	Medium	$87.00	95.77%
07/27/00	$45.25	1-Buy	Medium	$87.00	92.27%
08/02/00	$38.06	1-Buy	Medium	$87.00	128.59%
08/11/00	$33.38	1-Buy	Medium		
09/05/00	$33.75	1-Buy	Medium	$87.00	157.78%
10/04/00	$29.88	1-Buy	Medium	$87.00	191.16%
10/26/00	$25.25	1-Buy	Medium	$87.00	244.55%
11/01/00	$18.94	1-Buy	Medium	$45.00	137.59%
11/02/00	$18.94	1-Buy	Medium	$45.00	137.59%
12/05/00	$14.81	1-Buy	Medium	$45.00	203.85%
01/02/01	$14.06	1-Buy	Medium	$45.00	220.06%
01/09/01	$18.19	1-Buy	Medium		
01/26/01	$20.38	1-Buy	Medium	$45.00	120.80%
02/02/01	$22.19	1-Buy	Medium	$45.00	102.79%
02/08/01	$20.75	1-Buy	Medium	$45.00	116.87%
02/15/01	$17.50	1-Buy	Medium	$45.00	157.14%
02/16/01	$16.19	1-Buy	Medium	$45.00	177.95%
03/13/01	$15.75	1-Buy	Medium	$45.00	185.71%
04/26/01	$19.39	1-Buy	Medium	$45.00	132.08%
06/01/01	$17.84	1-Buy	Medium	$45.00	152.24%
06/07/01	$18.37	1-Buy	Medium	$45.00	144.96%
07/03/01	$14.81	1-Buy	Medium	$45.00	203.85%
07/05/01	$14.47	1-Buy	Medium	$45.00	210.99%
07/26/01	$13.35	1-Buy	Medium	$35.00	162.17%
08/30/01	$12.44	1-Buy	Medium	$35.00	181.35%

In June 2000, Mr. Grubman stated categorically that WorldCom was by far the cheapest stock in the world of global telecom and that analysts who continued to worry about WorldCom's failure to excel in the wireless area would be sorely disappointed that they downgraded the stock.[48] As the stock continued to decline, from a high of $49 per share in July to $14 per share in

48 *See* SSB report 6/27/2000.

December, Mr. Grubman continued to project a tripling of WorldCom's stock price and labeled the stock "dirt cheap."[49] In November 2000, Mr. Grubman lowered his price target from $87 to $45 a share, but held steadfast to his buy-medium risk ratings.

In 2001, WorldCom revised its earnings estimates downward on several occasions. At the same time, the stock price fell below $20.00 and ultimately to the $12.00 range in September and October 2001. Yet Mr. Grubman maintained his highest rating on WorldCom and announced that WorldCom stock continued to be undervalued. He even claimed that if the Company made its numbers, the stock price could double or triple over the next 12-18 months.[50] In his January 9, 2001 report, Mr. Grubman conceded that WorldCom's line costs would likely be higher, but depreciation would be lower due to intercompany classifications.[51] Mr. Grubman continually advocated that investors take advantage of misguided analysis by aggressively buying WorldCom's shares,[52] noting that there were very few sponsors on "the Street" for the stock[53]

Mr. Grubman lowered his price target to $35 in July 2001, and subsequently lowered it again in October 2001 to $22 and again in January 2002 to $20. While these downward revisions appear significant on a relative basis, the revised targets still reflected price targets that were 50% to 174% more than contemporaneous stock prices. Moreover, Mr. Grubman maintained his buy-medium risk ratings on the Company.

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49 *See* SSB report 10/26/2000. At this same time, Mr. Grubman lowered his rating of AT& T, WorldCom's principal competitor.

50 *See* SSB report 1/2/2001.

51 Assuming that the higher line costs were dollar for dollar offset by lower depreciation costs, EPS would not be affected. However, increased line costs would negatively impact EBITDA, and thus, cash flow from operations.

52 *See* SSB report 2/15/2001.

53 *See* SSB report 6/1/2001.

SSB REPORTS ON WORLDCOM FROM 9/01 TO 1/02

Date	Price of WCOM	Rating	Risk Factor	Target Price	% Forecasted Increase
09/19/01	$12.75	1-Buy	Medium	$35.00	174.51%
10/25/01	$12.45	1-Buy	Medium	$22.00	76.71%
01/17/02	$13.15	1-Buy	Medium	$20.00	52.09%
01/29/02	$12.00	1-Buy	Medium	$20.00	66.67%

By the first quarter of 2002, even Mr. Grubman acknowledged that widespread rumors were circulating that: (1) WorldCom was going to be dropped from the S&P 500;[54] (2) the Company's debt rating was being lowered to junk status;[55] (3) the Company's stock was going to be downgraded by a competitor;[56] (4) UUNET's business from AOL was going elsewhere;[57] (5) the Company's accounting and balance sheets were under scrutiny;[58] and (6) Mr. Ebbers was having significant financial problems.[59] Despite all of these significant concerns, Mr. Grubman maintained his buy-medium risk ratings on WorldCom's stock and set a stock price target that was almost 150% of the current price at that time. In fact, Mr. Grubman maintained his buy-medium risk ratings[60] even after the SEC initiated its inquiry into WorldCom's financial reporting, and did not change his risk rating to a buy-*high* risk rating until a week later.[61]

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54 *See* SSB report 1/29/2002.

55 Id.

56 Id.

57 Id.

58 *See* SSB report 2/4/2002.

59 Id.

60 *See* SSB report 3/12/2002.

61 *See* SSB report 3/18/2002.

SSB REPORTS ON WORLDCOM FROM 2/02 TO 4/02

Date	Price of WCOM	Rating	Risk Factor	Target Price	% Forecasted Increase
02/04/02	$8.13	1-Buy	Medium	$20.00	146.00%
02/07/02	$7.52	1-Buy	Medium	$12.00	59.57%
02/08/02	$7.52	1-Buy	Medium	$12.00	59.57%
03/12/02	$9.01	1-Buy	Medium	$12.00	33.19%
03/18/02	$7.06	1-Buy	High	$12.00	69.97%
04/21/02	$5.98	3-Neutral	High	$5.00	-16.39%
04/25/02	$3.53	3-Neutral	High	$5.00	41.64%

As the above table indicates, SSB's first downgrade of WorldCom stock came in April 2002. In that report, Mr. Grubman set a target price for WorldCom stock that was below WorldCom's stock price at the time of the report. Mr. Grubman also lowered his rating from "buy" to "neutral", and designated WorldCom stock a high risk. In this report, Mr. Grubman admitted that his previous evaluations of WorldCom were clearly wrong.[62] Mr. Grubman stated that he decided to downgrade the stock even though it "would obviously be easier not to downgrade the stock, and therefore not to suffer the inevitable and justified slings from various parties.'[63]

In May 2002, Mr. Grubman further downgraded his risk rating to speculative in response to the deterioration of WorldCom's debt ratings.[64] A final downgrade, to "underperform - speculative," followed on June 21, 2002,[65] a little over a month before WorldCom's filing for bankruptcy.

62 *See* SSB report 4/21/2002.

63 Id.

64 *See* SSB report 5/9/2002.

65 *See* SSB report 6/21/2002.

SSB REPORTS ON WORLDCOM FROM 4/02 TO 8/02

Date	Price of WCOM	Rating	Risk Factor	Target Price	% Forecasted Increase
04/30/02	$2.48	3-Neutral	High	$5.00	101.61%
05/09/02	$2.15	3-Neutral	Speculative	$2.00	-6.98%
05/09/02	$2.01	3-Neutral	Speculative	$2.00	-0.50%
05/22/02	$1.42	3-Neutral	Speculative	$2.00	40.85%
06/21/02	$1.22	4-Under perform	Speculative	$1.00	-18.03%
08/02/02	NR[66]				

By then, WorldCom shareholders had lost more than $180 billion in market capitalization since 1999. Conversely, from 1998 until 2001, when he consistently encouraged investors to buy WorldCom's stock, it is alleged that Mr. Grubman reportedly averaged approximately $20 million per year in compensation. When Mr. Grubman resigned from SSB on August 15, 2002, he stated in his resignation letter that "the current climate of criticism has made it impossible to perform my work to the standards I believe the clients of SSB deserve." SSB reportedly agreed to buy out the rest of Grubman's 1998 $32.2 million contract, which included $12 million in stock and options and forgiveness of a $15 million loan, plus about $4 million in interest. Grubman further maintained publicly that he and other analysts were simply "wrong" about the future of telecom.

4. Mr. Grubman's Departures From The Role of An Independent Securities Analyst

We intend to investigate whether Mr. Grubman simply "got it wrong" or whether he had other motivations for enthusiastically recommending WorldCom stock. Although we are not currently in a position to reach any conclusion on this point, Mr. Grubman's behavior seems to have departed from the role of an independent securities analyst as described above.

66 NR=Not rated. The August 2, 2002 report was in response to WorldCom's filing for bankruptcy, after which SSB's coverage of WorldCom was discontinued.

Our review of internal WorldCom and SSB documents has revealed a large number of meetings, conferences, e-mail messages and other contacts between Mr. Grubman and WorldCom executives. These include at least four instances in which Mr. Grubman attended WorldCom Board meetings to discuss major transactions, such as the proposed merger between WorldCom and MCI in late 1997 and the proposed merger between WorldCom and Sprint in October 1999. Minutes from these meetings indicate that Mr. Grubman and other SSB representatives were invited to make extensive presentations to the Board analyzing the financial impacts of these mergers on WorldCom's operations as well as other transactions involving the merger parties.

These minutes indicate that Mr. Grubman attended the Board's meetings as a "financial advisor" to the Company and performed roles that seem inconsistent with that of an independent securities analyst. For example, the minutes of the October 4, 1999 Board meeting, when WorldCom was considering its merger with Sprint, indicate that Mr. Grubman described the possible impact of that merger on WorldCom's growth metrics and pro forma earnings.

WorldCom employees also consulted with Mr. Grubman from time to time to obtain information about the Company's investors, the opinions and actions of other Wall Street analysts and Mr. Grubman's reactions to negative press reports regarding WorldCom. Moreover, there is evidence that Mr. Grubman consulted with WorldCom's management in advance of analyst conference calls to suggest how they should handle certain topics during those calls. Further, we have seen evidence that Mr. Grubman even suggested a question he might ask during an analyst conference call that might elicit a favorable response.

There is also some evidence to suggest that Mr. Grubman may have played a role in the allocation of valuable IPOs to Mr. Ebbers, since he was copied on internal SSB e-mails regarding those allocations. In March and May 1999, Mr. Grubman received copies of internal SSB e-mails indicating that Mr. Ebbers was on a list of "private wealth clients" who had requested shares in the IPOs for Rhythms Net Connections, Inc. and Juno Online Services, Inc., respectively.

As part of our examination, we intend to review the recommendations and behavior of other securities analysts who covered WorldCom. WorldCom was covered by a broad range of analysts from every corner of the investment banking community. For the period January 1996 through July 2002, we have identified 884 reports on WorldCom issued by 61 different investment banking houses or research firms. As indicated above, it appears that WorldCom closely tracked the reports of the many analysts who covered it the Company.

E. WorldCom's Record In Meeting Analyst Expectations

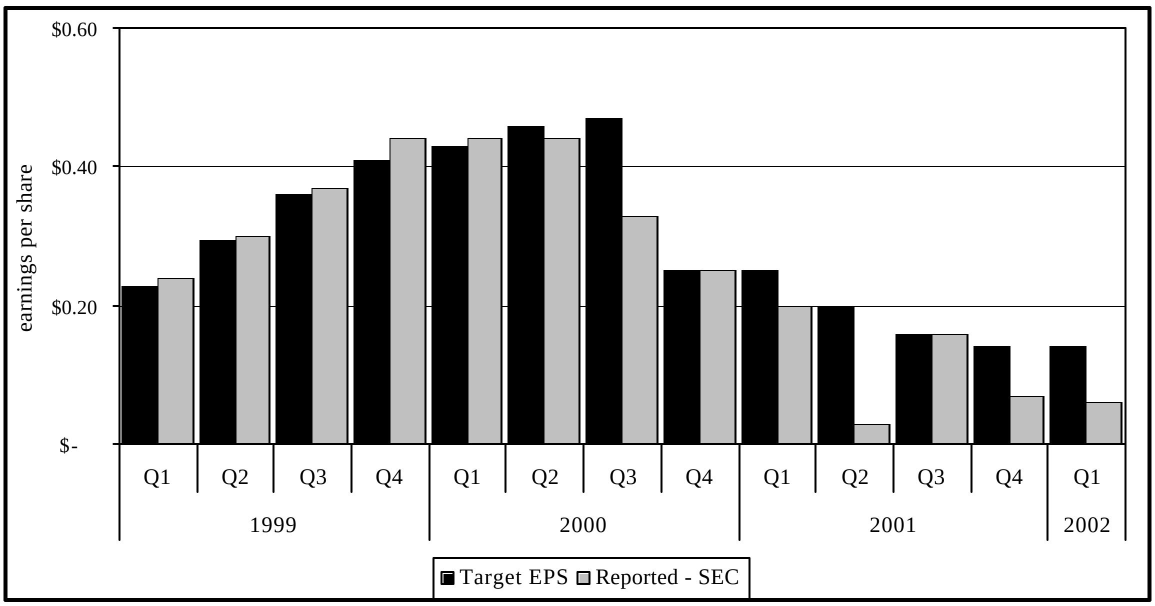
Favorable analyst reports and optimistic target prices can lead to higher stock prices, if a company regularly meets the analysts' stated expectations. For WorldCom, a higher stock price was extremely important as they often used their stock as currency for acquisitions. For Mr. Ebbers, maintaining or increasing the Company’s stock price was critical due to the large amounts of WorldCom stock he had purchased on margin or had pledged as collateral for non-WorldCom related business ventures. In fact, it was the stock’s decline that exacerbated Mr. Ebbers' distressed financial condition.

For five consecutive quarters, from the first quarter of 1999 through the first quarter of 2000, WorldCom met analysts' earnings estimates (measured by earnings per share), as the following table demonstrates.

Earnings Per Share: Reported SEC vs. Wall Street Expectations								
	1999		2000		2001		2002	
Qtr	Estimated	Reported-SEC	Estimated	Reported-SEC	Estimated	Reported-SEC	Estimated	Reported-SEC
Q1	0.23	0.24	0.43	0.44	0.25	0.20	0.14	0.04
Q2	0.29	0.30	0.46	0.44	0.20	0.03		
Q3	0.36	0.37	0.47	0.33	0.16	0.16		
Q4	0.41	0.44	0.25	0.25	0.14	0.07		
FY	$ 1.31	$ 1.35	$ 1.62	$ 1.43	$ 0.72	$ 0.48		

Sources/notes: Reported financial performance was taken from SEC 10Q/10K filings. FY totals may not equal quarters as revisions/reallocations were often made for Q1-Q3 at year-end. All EPS numbers reflected fully diluted EPS (GAAP). Subsequent revisions and restatements are not reflected in actual data.

Estimated data was taken from "First Call" estimates. First Call, a research organization whose estimates are a culmination of various analysts' expectations, provided coverage of WorldCom's stock. FY99 earnings per share have been restated to reflect the November 1999 stock split to allow comparability.



Viewing this same data in graphical form illustrates how well WorldCom performed at achieving their estimated earnings until mid-2000. The fact the Company was able to meet or exceed its estimates lent credibility to the Company's management, its proposed strategies and forward looking earnings estimates. As the above graph demonstrates, the Company began to have difficulty hitting its earning targets starting with the third quarter of 2000. On November 1, 2000, a few months after the collapse of the Sprint merger, WorldCom held a conference call with analysts during which management significantly lowered the Company's earnings estimates for the fourth quarter of 2000. They attributed their lowered earnings outlook to an increase in WorldCom investment for growth, lower pricing (both WorldCom and MCI) and a change in their Internet traffic mix.

The significant reduction in earnings estimates for the fourth quarter 2000, coupled with the Company’s inability to achieve earnings estimates in the third and fourth quarters of 2000 compelled management to explain why. They did so by attributing "missed numbers" to a series of allegedly non-recurring events. For example, when WorldCom missed its earnings per share target by $0.16 cents in the third quarter of FY 00, management included in its earnings release the following description of non-recurring events:

> This quarter WorldCom recognized after tax charges of $405 million associated with specific domestic and international wholesale accounts that are no longer deemed collectible due to bankruptcies, litigation, and settlements of contractual disputes that occurred in the third quarter. For comparative purposes, the discussion excludes these charges.

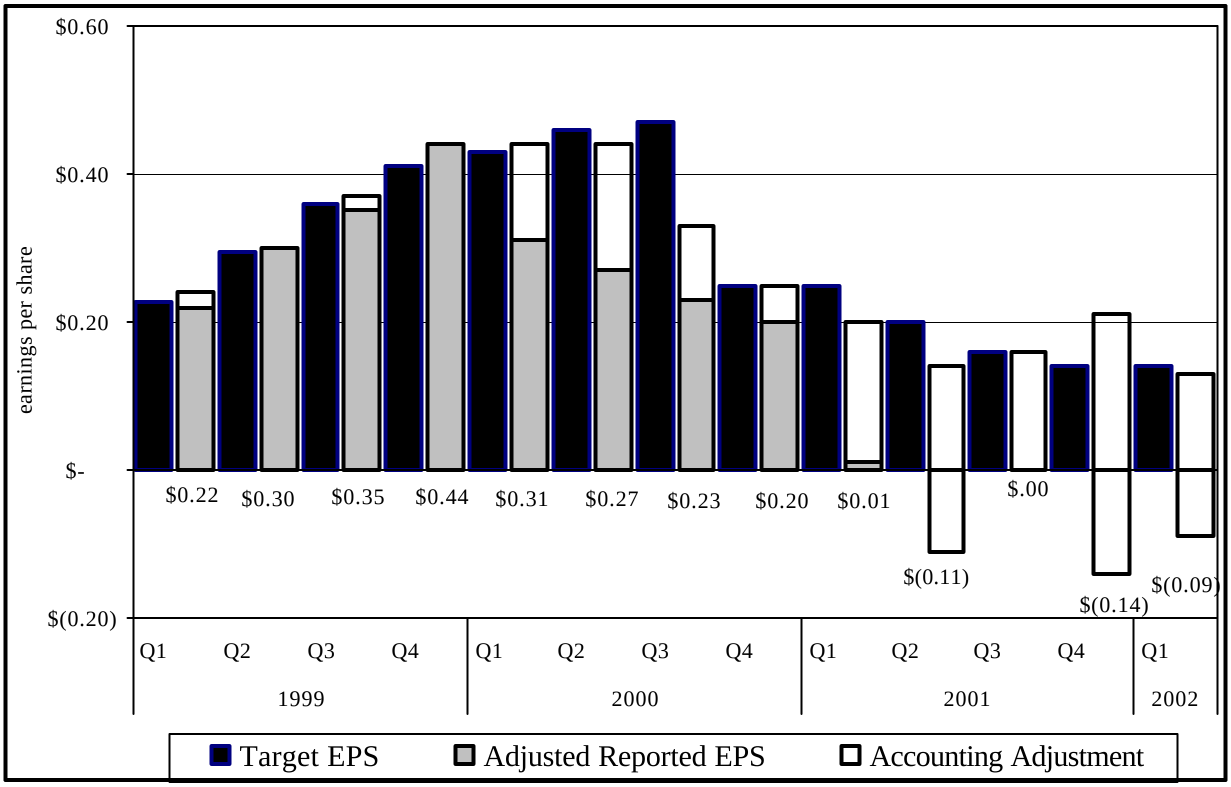
In a subsequent conference call with analysts, Mr. Sullivan, in response to a question from Mr. Grubman, claimed that, when these uncollectable amounts were disregarded, the Company's earnings per share were $0.47, which was in line with analysts' expectations of $0.49.

Similarly, when the Company's earnings per share in the first quarter of 2001 missed analysts' expectations by $0.06 per share, WorldCom issued its earnings press release attributing most of the shortfall to non-recurring expenses associated with work-force reductions and currency exchange issues. According to the Company, absent these non-recurring charges, the Company would have missed analysts' expectations by only $0.01 per share. Mr. Grubman congratulated the Company on its quarterly performance, commenting during the analysts’ conference call “By the way Bernie, normally these kinds of calls people will congratulate folks on the numbers. I’d like to say its nice to see someone a) not hiding behind the economy and b) not fantasize [sic] about this flight to quality stuff."

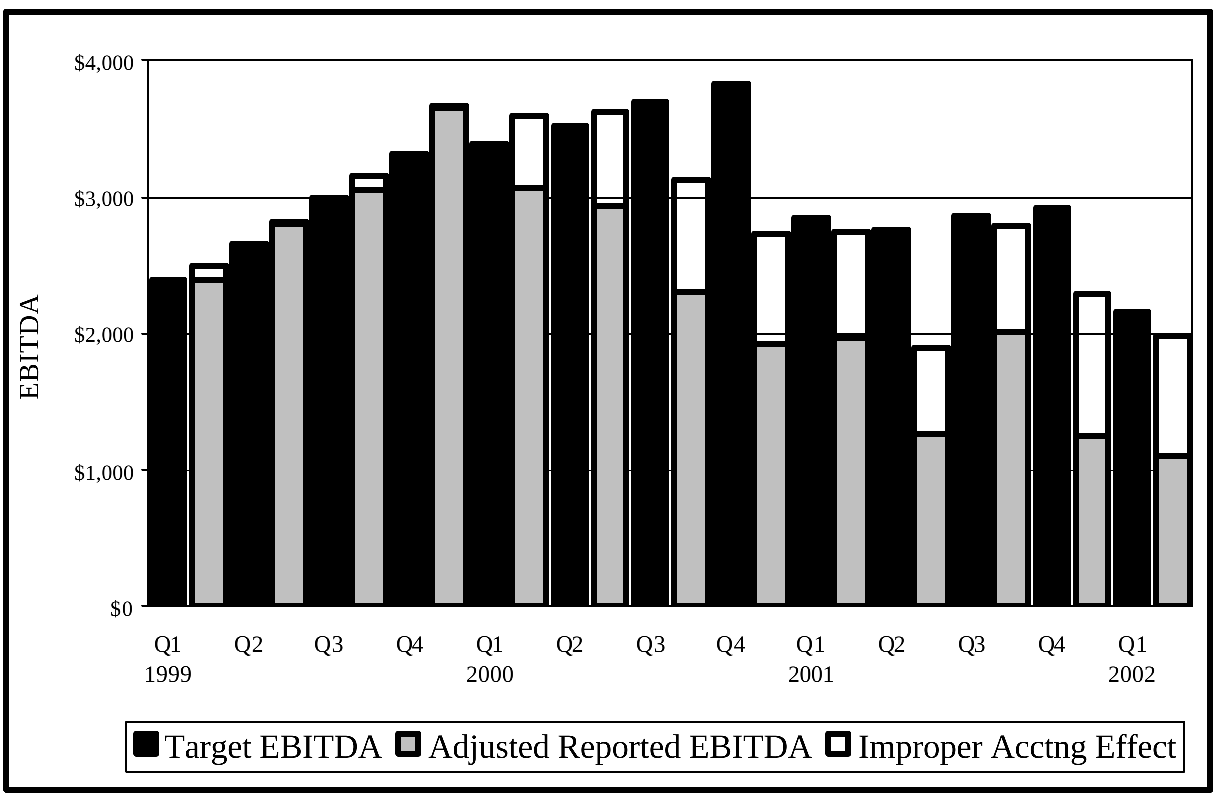
The available records suggests that the Company's explanations for "missed numbers" would not have had any credibility at all by 2001 if the Company's financial statements had not been substantially distorted by improper accounting adjustments, relating to the misallocation of "line costs" from expenses to capital costs and the overstatement of revenues. In June and August 2002, the Company publicly disclosed that its financial statements would be restated, correcting what was then known about the effects of improper accounting entries. The Company is continuing its internal financial investigation and may announce further adjustments to previously released financial results. When the Company's financial operating results are corrected and restated on a quarterly basis for the period from 1999 through the first quarter of 2002, and compared to its previously reported financial results, the disparity between actual performance and analysts' expectations becomes dramatic.

The graphs below reflect WorldCom's publicly reported results (both in terms of earnings per share ("EPS") and, "EBITDA", restated for known adjustments announced by the Company through August 2002, compared to analyst expectations.[67]

[67] The Company's publicly announced restatements were on a pre-tax basis. Our EPS analyses incorporates an imputed tax rate of 37.3% to 37.6%, which was derived from the Company's historical tax rates.



$0.60
$0.40
$0.20
$-
$(0.20)
earnings per share
$0.22
$0.30
$0.35
$0.44
$0.31
$0.27
$0.23
$0.20
$0.01
$(0.11)
$.00
$(0.14)
$(0.09)
Q1 Q2 Q3 Q4 Q1 Q2 Q3 Q4 Q1 Q2 Q3 Q4 Q1
1999
2000
2001
2002
Target EPS
Adjusted Reported EPS
Accounting Adjustment



$4,000
$3,000
$2,000
$1,000
$0
EBITDA
Q1 1999
Q2
Q3
Q4
Q1 2000
Q2
Q3
Q4
Q1 2001
Q2
Q3
Q4
Q1 2002
Target EBITDA
Adjusted Reported EBITDA
Improper Acctng Effect

As these graphs demonstrate, the Company's improper accounting treatment known to date grossly overstated both EPS and EBITDA. After correction for these improper adjustments, WorldCom actually missed its earnings targets in eleven out of the thirteen quarters from 1999 through the first quarter of 2002. In fact, upon restatement, WorldCom sustained losses in four out of the last five quarters ending with the first quarter of 2002. Moreover, as the revenue of WorldCom's accounting activities continue, additional restatements to earnings are likely.

IX. ACCOUNTING AND FINANCIAL REPORTING ISSUES

Long before the collapse of Enron Corporation in December 2001 and the recent succession of highly visible failures of telecommunication companies - many of which were precipitated by accusations of massive fraudulent misstatements in their financial statements - the SEC had made its concern for accounting fraud unmistakably known to market participants through a succession of public pronouncements and enforcement actions focused on accounting abuses designed to provide investors and Wall Street with the appearance of increased revenues and steady earnings growth.

The accusation that the companies, their officers and in some instances, their external auditors defrauded the public by intentionally distorting revenues and earnings to enhance the price of their stock is a common thread in each of the SEC enforcement actions. The fraudulent practices included: (i) "managing" earnings by manipulating reserve accounts to pump up income in lean times while storing excess profits during good times in "cookie jars" so that they may be drawn down on when current performance lagged;[68] (ii) capitalizing expenses to remove such expenses

[68] See, In re W.R. Grace, File No. 3-9926 (June 30, 1999), In re Thomas J. Scanlon, CPA, File No. 3-9938 (June 30, 1999) and In re Eugene Gaughan, CPA, File No. 3-9927 (June 30, 1999). In re Cendant Corporation, Exchange Act Rel. No. 42933 (June 14, 2000) and SEC v. Cosmo Corigliano, Anne M. Pember, Casper Sabatino, and Kevin Kearney, Lit. Rel. No. 16587 (June 14, 2000; SEC v. Ron Messenger,

from the income statement where they would be charged against current income and instead repositioning them on the balance sheet as an asset where charges against income would be spread out over an extended amortization period;[69] (iii) engaging in sham sales with related parties designed for the principal purpose of inflating income to meet market expectations;[70] and (iv) prematurely recognizing revenues and understating expenses.[71]

It was in this environment that WorldCom's management prepared, and Arthur Andersen opined on, the Company's financial statements in the 1999 to 2001 period. Although we must qualify our conclusions due to the limitations of time and the complexity of the Company's financial operations, we have found that in at least as early as 1999, responding to the pressures on WorldCom's earnings, management undertook a succession of measures designed to shore up the Company's income statement. These measures deteriorated into a concerted program of manipulation that gave rise to a smorgasbord of fraudulent journal entries and adjustments — many of them of the precise kind contemporaneously and publicly prosecuted by the SEC.

In August 2002, WorldCom announced the restatement of approximately $3.3 billion, which included $2.3 billion of reserve releases principally related to line costs reclassification adjustments of $718 million, and other adjustments of $265 million that related to periods beginning in 1999. It appears that once income could no longer be sufficiently enhanced by the release of reserves, Mr. Sullivan and certain other WorldCom personnel directed a series of

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James T. Rush, Scott Barton and Gary Hubschman, Lit. Rel. No. 17042 (June 20, 2001); In re Microsoft Corporation, Exchange Act Rel. No. 46017 (June 3, 2002).

69 *See* e.g., In re Livent, Inc., File No. 3-9806 (January 13, 1999); SEC v. America Online, Inc., Litigation Rel. No. 16552 (May 15, 2000); SEC v. Dean Buntrock, Phillip Rooney, James Koening, Thomas Hau, Herbert Getz and Bruce Tobeckson, Lit. Rel. No. 17435 (March 26, 2002).

70 In re Centennial Technologies, Inc., Exchange Act Rel. No. 43345 (September 26, 2000).

71 *See*, e.g., In re MicroStrategy, Inc., Exchange Act Rel. No. 43724 (December 14, 2000); In re Boston Scientific Corp., Exchange Act Rel. No. 43183 (August 21, 2000); SEC v. Computone Corp., Thomas J. Anderson, Gregory A. Alba, Donald A. Pierce, Duncan E. Hume, and Brian D. Kretschman, Lit. Rel. 16307 (September 28, 1999).

adjustments to its line costs in successive reporting periods beginning with the first quarter of 2001. The result was that over $3.8 billion of line costs that would otherwise have been charged against income were capitalized as assets resulting in an additional $3.8 billion overstatement of WorldCom's income.

We describe very briefly here how some of this manipulation was accomplished, beginning with a discussion of the accounting principles applicable to some of the accounts manipulated by WorldCom. As noted herein, we are not disclosing at this time significant details of the methods and processes used to manipulate WorldCom's revenues and income in deference to the ongoing governmental investigations.

A. Reserves and their Role in a Company's Financial Statements

The manipulation of reserve accounts comprises a prominent part of the story of the irregularities in the WorldCom financials statements. Generally, companies establish reserves to account for the portions of the realizable value of assets that they are doubtful will be realized. Companies also record reserves when it is probable that they will incur a liability. Reserves for assets and liabilities are required to be recorded when the risk to an asset's realizable value or the incurrence of a liability is determined to be "probable" and the amount of that risk can be estimated with reasonable accuracy, as prescribed by Statement of Financial Accounting Standards No. 5, Accounting for Contingencies ("SFAS No. 5"). Conversely, it is inappropriate to record reserves unless a risk is probable and estimable. Although we have not reached any final conclusions, WorldCom appears to have violated this accounting rule.

Companies generally maintain several types of reserves. Companies record reserves for probable liabilities, but for which the company has not yet been assessed, such as taxes and litigation. Companies also maintain reserves that are "contra-asset accounts" or valuation allowances for assets representing the company's reduction in the total cost of an asset in order to arrive at the asset's net carrying value. The purpose of contra-asset accounts or valuation allowances is to ensure that assets are recorded at the lower of their cost or their realizable value. To the extent excess reserves are identified in the company's assessment of its exposures, they should be released. It is the inappropriate release of reserves that results in one form of earnings management.

A company also may establish reserves in connection with the acquisition of another company, where it has a sound basis for anticipating that the value of some of the assets of the acquired company has permanently declined. This would be the case, for example, if a company planned to close a facility owned by the acquired company. An acquisition reserve allows the Company to record an offsetting accounting entry on its balance sheet in the category of goodwill instead of making a charge to the income statement.

We will be investigating the appropriateness of the establishment and release of certain reserves. Some areas that we will review include the following:

1. Revenue reserves
2. Bad debt reserves
3. Tax reserves
4. Depreciation
5. Purchase acquisition accounting reserves
6. Legal reserves
7. Line Cost Reserves

The chart below summarizes the effect on EBITDA and Minority Interests of the reserves related restatement entries of $2.3 billion, which were included in the restatement entries announced in August 2002.

Effect of Reserves Related Restatement Entries on EBITDA and Minority Interests ($ in Millions)

Period	EBITDA Minority Interests as Reported	Reserves Related Restatement Entries	EBITDA and Minority Interests as Reported After Reserve Related Restatement Entries
1st Qtr 1999	$2,611	$ 95	$2,516
2nd Qtr 1999	$2,868	$ 5	$2,863
3rd Qtr 1999	$3,278	$ 72	$3,206
4th Qtr 1999	$3,485		$3,485
1st Qtr 2000	$3,571	$519	$3,052
2nd Qtr 2000	$3,573	$661	$2,912
3rd Qtr 2000	$3,089	$518	$2,571
4th Qtr 2000	$2,798	$374	$2,424
1st Qtr 2001	$2,532		$2,532
2nd Qtr 2001	$1,791		$1,791
3rd Qtr 2001	$2,704	$13	$2,691
4th Qtr 2001	$2,367	$65	$2,302
1st Qtr 2002	$2,165	$25	$2,140
TOTAL	$36,832	$2,347	$34,485

We will be reviewing these reserves to determine the appropriateness of the accounting treatment. The release of reserves became one vehicle by which WorldCom's management manipulated its publicly reported results of operations. However, the order of magnitude of the release of reserves was dwarfed by management's capitalization of line cost expenses. The capitalization of line cost expenses, among other issues, led to the removal and prosecution of certain of WorldCom's financial personnel.

B. Line Cost Capitalization

Our preliminary review has revealed that certain members of WorldCom's management grew concerned that customer demand would outpace the Company's line capacity. We have identified significant information concerning these matters, but are not providing more details in deference to the ongoing governmental investigations. To summarize, beginning in the first quarter of 2001 and ending in the first quarter of 2002, WorldCom's sizeable line costs were recharacterized as "Prepaid Capacity" and transferred from the Company's income statements to its balance sheets. These recharacterizations resulted in an overstatement of pretax income before minority interests aggregating more than $3.8 billion as follows:

Effect of Line Cost Capitalization Restatement Entries on Reported Income (in Millions)

Period	Income before Taxes and Minority Interests, as Reported	Restatement Entries	Income (Loss) before Taxes and Minority Interests After Restatement Entries
1st Qtr 2001	$ 988	$ 771	$ 217
2nd Qtr 2001	$ 159	$ 560	($ 401)
3rd Qtr 2001	$ 845	$ 743	$ 102.3
4th Qtr 2001	$ 401	$ 941	($ 540)
1st Qtr 2002	$ 240	$ 818	($ 578)
TOTAL	$2,633	$ 3,833	($1,200)

C. The Preparation of Misleading Reports

Our investigation to date has revealed a number of internal financial reports prepared by WordCom that were false. These reports were some of the tools employed by WorldCom to perpetrate and obfuscate a massive accounting fraud. In deference to the governmental investigations, we will identify and detail the facts and circumstances of these reports at a later time.

D. Other Accounting Issues Under Investigation

The following additional accounting issues are being reviewed by the Examiner.

1. Intercompany Balances

In a large corporation such as WorldCom, there are many subsidiaries, domestic and foreign. These subsidiaries engage in transactions with each other and with the corporate parent company that are known as intercompany transactions. These transactions result in intercompany balances. These transactions may include, among other things, the following:

- Intercompany revenue and related expenses (e.g., revenue earned by one subsidiary by providing services to another subsidiary)
- Investments in and loans to and from subsidiaries by the corporate parent company. (Results in an investment or receivable/payable on the parent's books and equity or a payable/receivable on the subsidiary's books.)
- Management charges from the parent to a subsidiary (results in income and receivable to the parent and expense and liability to the subsidiary).
- Dividends paid by the subsidiary to the parent.
- Disputes between the parties (one entity records the transaction and the other does not).

When the overall entity prepares its consolidated financial statements, the corporate accounting function makes accounting entries to eliminate the intercompany transactions and balances between the subsidiaries (with each other and with the parent). The purpose of these elimination entities is to present consolidated financial statements of the overall entity; in other words, to show the overall company net of intercompany activity. This elimination or consolidation process is required under Accounting Research Bulletin No. 51, Consolidated Financial Statements.

In theory, all intercompany transactions and balances should be easily identified and eliminated. However, for various reasons, the transaction or balance recorded on one subsidiary's books may not agree with the corresponding or offsetting amount on the other subsidiary's/parent's books. This is known as an "intercompany out-of-balance."

As noted above, intercompany out-of-balances can be caused by various factors, including, but not limited to, the following:

- Timing of recording of transactions (for example, parent company ships inventory to subsidiary in December and records the sale and the receivable in December; the subsidiary receives the inventory in January and records the purchase and the payable in January).
- Effects of foreign exchange rate changes; and

Based on our review of Arthur Andersen–U.K.'s management letters, it appears that WorldCom does not revalue intercompany balances that are denominated in different currencies (as required by Statement of Financial Accounting Standards No. 52, Foreign Currency Translation). The result is that at the dates of financial statements, losses or gains are not being reflected in the consolidated financial statements. These unrecorded losses or gains and corresponding intercompany out-of-balances are not currently quantifiable. This foreign intercompany situation represents one type of intercompany out-of-balance condition. Although our analysis is ongoing, there are likely other reasons, as noted above, for the WorldCom intercompany out-of-balances.

We have been informed by current management that the out-of-balances date back at least to 1998 and likely earlier. Our current understanding, is that the unresolved intercompany out-of-balances aggregate approximately $200 million. This could mean that income was misstated by up to approximately $200 million. The Company's current management has represented that they are considering reserving for the $200 million out-of-balance until the differences can be identified and corrected.

2. Goodwill Impairment

Goodwill represents the excess of the purchase price for acquisitions over the fair value of the net assets acquired. Under Statement of Financial Accounting Standards No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of (SFAS 121), goodwill is reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of goodwill may not be recoverable. Pursuant to SFAS 121, the following are examples of events or changes in circumstances that indicate that the recoverability of the carrying amount of an asset should be assessed:

- A significant decrease in the market value of an asset;
- A significant change in the extent or manner in which an asset is used or a significant physical change in an asset;
- A significant adverse change in legal factors or in the business climate that could affect the value of an asset or an adverse action or assessment by a regulator;
- An accumulation of costs significantly in excess of the amount originally expected to acquire or construct an asset; and,
- A current period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with an asset used for the purpose of producing revenue.

Under SFAS 121, in performing the review for recoverability, the entity should estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized.

Under the new goodwill rules, Statement of Financial Standards No. 142, Goodwill and Other Intangible Assets (SFAS 142), which became effective for WorldCom on January 1, 2002,[72] goodwill is no longer amortized. Instead, it is reviewed at least annually for impairment using a different approach than SFAS 121 employed.

As of December 31, 2001, WorldCom had recorded as an asset an aggregate of $49.8 billion of goodwill on its balance sheet. Goodwill approximated 48 percent of total assets and 86 percent of total shareholders' investment (equity) as of December 31, 2001. WorldCom, through December 31, 2001, amortized goodwill over periods ranging from five to forty years, principally 40 years. As of December 31, 2001, goodwill related to the following acquisitions (in billions):

Legacy WorldCom	$ 1.9
MCI	28.2
WNS	2.2
Technologies, Telecom, MFSI, MFSCC	8.3
Intermedia, PA	4.7
Other*	4.5
	$ 49.8

* Includes more than 12 acquisitions.

Through December 31, 2001, WorldCom did not recognize any impairment losses under SFAS 121. Based on reported profits, EBITDA, cash flow, etc., it would appear that no write-down was necessary. However, under the SFAS 142 model, Ernst & Young (who was originally engaged in 2002 to perform an impairment valuation) estimated an impairment of $15-$20 billion. Given the bankruptcy filing in July 2002, WorldCom has announced a potential goodwill write off of up to approximately $50 billion. The Company has since engaged American Appraisal to perform an impairment valuation under SFAS 142. The expected completion date of their

[72] SFAS 121 as related to goodwill, was effective through December 31, 2001.

valuation report is December, 2002. It should be noted that, conceptually, there could be a large impairment under SFAS 142 and no impairment under SFAS 121 due to the different methodologies employed under the different standards.

Consideration needs to be given to potential SFAS 121 impairment in 2001 if the financial results were accurately reported (i.e., losses rather than profits).

3. Capitalized Labor

Generally, payroll/labor costs are expensed (charged to operations) as incurred, as a recurring period cost. However, when a company self-constructs a long-lived asset (e.g., a new plant), capitalization of labor costs is generally appropriate. When internal labor is used to construct a long-lived asset, that labor, to the extent directly related to the construction, is considered part of the cost of the asset.

Based on our review of WorldCom documents, including internal audit reports, we have learned that WorldCom incurred internal labor costs related to installing various lines (phone, cable, fiber optic, etc.) that have a long useful life. Accordingly, WorldCom capitalized certain labor costs related to line installation. This accounting treatment is common in the telecommunications industry and is an appropriate application of relevant accounting principles.

The amount of labor costs capitalized should be determined based on actual hours worked and based on labor rates in effect for personnel involved in the installation of the lines. The determination should be supported by appropriate documentation, including labor reports and other supporting evidence. We are investigating the procedures and support used by WorldCom to determine the amounts of labor to be capitalized.

4. Accounting for Avantel S.A. and Embratel Participacoes, SA

Statement of Financial Accounting Standards No. 94, Consolidation of All Majority-Owned Subsidiaries (SFAS 94), requires consolidation in financial statements of all majority-owned subsidiaries unless control is temporary or does not rest with the majority owner. The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one company, directly or indirectly, of over 50 percent of the outstanding voting shares of another company is a condition pointing toward consolidation. Accounting Principles Board Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock (APB 18) states that the power to control may also exist with a lesser percentage of ownership, for example, by contract, lease agreement with other stockholders, or by court decree. Absent these conditions, a 20-50 percent investment is accounted for under the equity method.

When a subsidiary is consolidated, all of its assets, liabilities, revenues, and expenses are added to those of the parent and the portion of the subsidiary not owned by the consolidating entity is reflected as minority interest, a credit on the consolidated balance sheet. Under the equity method, the assets, liabilities, revenues, and expenses are not added to those of the investor. Instead, the investor's share of the investee's equity and profit/loss is reflected on one line on the balance sheet and one line on the income statement. According to APB 18, the equity method tends to be most appropriate if an investment enables the investor to influence the operating or financial decisions of the investee. APB 18 also indicates that the equity method of accounting for an investment in common stock should also be followed by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee. In addition, APB 18 notes that an investor's voting stock interest in an investee should be based in those currently outstanding securities where holders have present voting privileges, and those which may become available to holders of securities of an investee should be disregarded.

a. Avantel

Avantel is a business venture between Banamex , Mexico's largest financial group, and WorldCom, in which WorldCom owns a 44.5 percent equity interest. Avantel built Mexico's first all-digital fiber long distance network. In 1996, Avantel became the first company to provide alternative long distance telecommunications services in Mexico in competition with Telefonos de Mexico (Telmex). Avantel Services Locales, SA (Avantel Local) is another business venture between Banamex and WorldCom in which WorldCom also owns a 44.5 percent equity interest. Avantel Local has obtained a license to offer a full range of local telephone services. Telmex, the former Mexican monopoly telecommunications provider, is the primary competition of both Avantel and Avantel Local.

Based on the nature of the letter (which purportedly reduces to writing the actions by WorldCom noted above) and the 44.5 percent voting interest coupled with WorldCom's day-to-day involvement in the operations of Avantel, WorldCom determined that consolidation of Avantel was appropriate as of March 31, 2000. It was Arthur Andersen's understanding that WorldCom provided more than 60 percent of the total equity (voting and non-voting) of Avantel and continued to provide funding for the operations since inception. Based on this understanding, Arthur Andersen concluded that WorldCom, by managing Avantel's day-to-day operations was also controlling Avantel.[73]

b. Embratel

[73] *See* Memo to File re Avantel Consolidation by Kenneth U. Avery, dated April 25, 2000.

In 1998, prior to its acquisition by WorldCom, MCI acquired a 51.79 percent voting interest and a 19.26 percent economic interest in Embratel Participacoes, SA (Embratel), Brazil's facilities-based national and international communication provider for approximately R$2.65 billion (US $2.3 billion). Embratel provides domestic long distance and international long distance and international telecommunications services in Brazil, as well as over 40 other communications services, including leased high-speed data Internet, frame relay, satellite, and pocket-switched services.

The Company has announced that it is restating prior financial statements to deconsolidate Avantel and to consolidate Embratel. However, we have a number of concerns about the circumstances surrounding the accounting for these transactions and will investigate further.

X. CONCLUSION

Our investigation of matters related to the integrity of the Company's management, compensation structure, relationship with investment bankers, accounting and financial reporting systems, and related internal controls is ongoing. This First Interim Report contains only some of our preliminary observations regarding these matters, and we have not included many of our detailed observations or factual discoveries with respect to these issues in deference to ongoing governmental investigations. We will supply further details and conclusions regarding these matters in subsequent reports to the Court.

Our preliminary observations reflect cause for substantial concern regarding the Company's past practices, particularly with respect to the reasonableness and integrity of its accounting and financial reporting functions and related oversight by persons within the Company, the Board of Directors and the independent auditors of WorldCom. Our investigation strongly suggests that WorldCom personnel responded to changing business conditions and earnings pressures by taking extraordinary and illegal steps to mask the discrepancy between the financial reality at the Company and Wall Street's expectations. It appears clear that some of these steps involved various manipulations of periodic revenue and income figures. It also appears clear that these efforts culminated in the brazen and fraudulent capitalization of line costs. We still are investigating to determine which of the Company's revenue, income or other adjustments were improper, but we believe our investigation will reveal that there were improper and unsupported adjustments that go beyond the more than $7 billion in adjustments already restated by the Company.

Respectfully submitted,

/s/Dick Thornburgh
Dick Thornburgh
Examiner

KIRKPATRICK & LOCKHART LLP
1800 Massachusetts Avenue, N.W.
Second Floor
Washington, D.C. 20036
(202) 778-9000
(202) 778-9100 (fax)