Case 3.8

Qwest: A Focus on Company Level Controls

Synopsis

When Joseph Nacchio became Qwest's CEO in January 1997, its existing strategy to construct a fiber-optic network across major cities in the United States began to shift toward communications services as well. By the time it released earnings in 1998, Nacchio proclaimed Qwest's successful transition from a network construction company to a communications services provider. "We successfully transitioned Qwest … into a leading Internet protocol-based multimedia company focused on the convergence of data, video, and voice services."[188]

During 1999 and 2000, Qwest consistently met its aggressive revenue targets and became a darling to its investors. Yet, it was later uncovered that Qwest had fraudulently recognized $3.8 billion in revenues and fraudulently excluded $231 million in expenses. When the company announced its intention to restate revenues, its stock price plunged to a low of $1.11 per share in August 2002, from a high of $55 per share in July 2000. During this period, its market capitalization declined by 98 percent, from a high of $91 billion to a low of $1.9 billion.[189]

Background

To facilitate its growth in communications services revenue, Qwest unveiled an aggressive acquisition strategy in the late 1990s. Indeed, after a slew of other acquisitions, Qwest entered into a merger agreement with telecommunications company US West on July 18, 1999. The merger agreement gave US West the option to terminate the agreement if the average price of Qwest stock was below $22 per share or the closing price was below $22 per share for 20 consecutive trading days. Less than a month after the merger announcement, Qwest's stock price had dropped from $34 to $26 per share. So, to prevent any further drops in its stock price, executives and managers were pressured by CEO Nacchio to meet earnings targets to ensure that the price per share did not fall

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[188] SEC v. Joseph P. Nacchio, Robert S. Woodruff, Robin R. Szeliga, Afshin Mohebbi, Gregory M. Casey, James J. Kozlowski, Frank T. Noyes, Defendants, Civil Action No. 05-MK-480 (OES), 11–14.

[189] SEC v. Qwest, 1–2.

below the level specified in the agreement. Although Qwest's stock price had dropped from $34 to $26 per share less than a month after the merger announcement, Qwest stock was trading above $50 per share by June 2000; Qwest was, therefore, able to acquire US West by using Qwest's common stock.

Following the merger, Qwest's senior management set ambitious targets for revenue and earnings of the merged company.[190] These targets were especially ambitious in the face of difficult industry conditions. For example, in Qwest's earnings release for the second quarter 2000, on July 19, 2000, Nacchio said that Qwest would "generate compound annual growth rates of 15–17 percent revenue … through 2005." At a January 2001 all-employee meeting, Nacchio stated his philosophy on the importance of meeting targeted revenues:

> [T]he most important thing we do is meet our numbers. It's more important than any individual product, it's more important than any individual philosophy, it's more important than any individual cultural change we're making. We stop everything else when we don't make the numbers.

Challenges

By 1999, Qwest encountered several obstacles that challenged its ability to meet its aggressive revenue and earnings targets. It faced increased competition from long distance providers, steep declines in the demand for Internet services, an overcapacity in the market resulting from the formation of other major fiber-optic networks, and a decline in the price at which Qwest could sell its excess fiber-optic capacity due to the increase in capacity.[191]

Despite these significant industry challenges, Qwest's senior management publicly claimed that the company would continue its pattern of dramatic revenue increases because of a "flight to quality" that customers would enjoy when they left competitors to use Qwest's services. Within the company, Qwest senior management exerted extraordinary pressure on their subordinate managers and employees to meet or exceed the publicly announced revenue targets. In addition, they only paid bonuses to management and employees for periods when they achieved targeted revenue.[192]

Sale of Network Assets Initially Held for Use and Capital Equipment

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[190] SEC v. Qwest, 6–7.

[191] SEC v. Qwest, 7–8.

[192] SEC v. Qwest, 8.

To help meet revenue targets, senior management also began to sell portions of its own domestic fiber-optic network. Originally, this network was to be held for Qwest's own use and had previously been identified as the "principal asset" of Qwest. Specifically, Qwest sold indefeasible rights of use (IRUs), for specific fiber capacity that it had constructed and used in its own communications services business. In addition, Qwest sold pieces of the network it had acquired from other third parties. Finally, Qwest sold used capital equipment to generate additional revenue.

Unlike recurring service revenue from its communication services business that produced a predictable amount of revenue in future quarters, revenue from IRUs and other equipment sales had no guarantee of recurrence in future quarters. In fact, both IRUs and equipment sales were referred to internally as "one hit wonders."[193]

In its earnings releases during 1999 through 2001, Qwest executives would often fail to disclose the impact of nonrecurring revenues. (See Table 3.8.1.) In its earnings releases and the Management's Discussion and Analysis portion of its SEC filings, Qwest improperly characterized nonrecurring revenue as service revenue, often within the "data and Internet service revenues" line item on the financial statements. Qwest's nonrecurring revenue was included primarily in the wholesale services segment, and to a lesser extent, the retail services segment.[194]

TABLE 3.8.1 Management's Failure to Disclose Impact of Nonrecurring Revenue[195]

2Q 1999	Failed to disclose that nonrecurring revenue made up 96 percent of data and Internet services revenue, 192 percent of the growth in data and Internet services, and 19 percent of total revenue. Excluding nonrecurring revenue, data and Internet services revenue actually declined 92 percent from the same quarter of the previous year.
3Q 1999	Failed to disclose that nonrecurring revenue made up 140 percent of Qwest's reported data and Internet services revenue, and 32 percent of total revenue. Excluding nonrecurring revenue, total revenue actually declined 13 percent from the same quarter of the previous year.
4Q 1999	By the end of 1999, nonrecurring revenue comprised 33 percent of total revenue for the fourth quarter, and 26 percent of Qwest's total revenue for the year. Without inclusion of the non-recurring

[193] SEC v. Qwest, 9–10.

[194] SEC v. Qwest, 12–13.

[195] SEC v. Qwest, 13–18. Data for 4Q 2000 unavailable.

revenue, Qwest's fourth quarter total revenue declined nine percent from the same quarter of the previous year. Qwest's corporate accounting department drafted proposed disclosure language for the company's 1999 Form 10-K detailing the amount of IRU revenue, but Qwest's CFO and CEO, rejected the language and refused to disclose any material information about nonrecurring revenue in the 1999 Form 10-K filed on March 7, 2000.

1Q 2000	By the end of the quarter, nonrecurring revenue comprised 97 percent of data and Internet services revenue, and 29 percent of total revenue. Without nonrecurring revenue, data and Internet services declined 92 percent from the same quarter of the prior year, and total revenue grew only 17 percent over the same quarter of the previous year. (This information was not disclosed.)
2Q 2000	Did not disclose that nonrecurring revenue made up 86 percent of data and Internet services revenue, and 29 percent of total revenue. Excluding nonrecurring revenue, total revenue grew only 23 percent.
3Q 2000	Even after acquiring US West, which resulted in a fivefold increase in revenue, nonrecurring revenue made up 35 percent of data and Internet service revenue, and eight percent of total revenue. The company continued not to disclose this information to the public.
1Q 2001	Contrary to Qwest's statements, during the first quarter 2001, nonrecurring revenue was 36 percent of data and Internet services revenue, 11 percent of total revenue, and 35 percent of Qwest's total revenue growth. Excluding nonrecurring revenue, Qwest's total revenue grew only eight percent over the same period of the previous year.
2Q 2001	Did not disclose that nonrecurring revenue had grown to 13 percent of total revenue, and 39 percent of data and Internet services revenue. Without including the nonrecurring revenue, Qwest's total revenue grew only six percent over the same period of the previous year.

Case Questions

1. Please consult Paragraphs #49 and 114 of PCAOB Auditing Standard No. 2. Define what is meant by control environment. Why does the "tone at the top" have a "pervasive" effect on the reliability of financial reporting at an audit client like Qwest? Based on the case information, do you believe that the proper "tone at the top" was established at Qwest? Why or why not?

2. Please consult Q38 of the PCAOB Staff Questions & Answers (May 16, 2005). Comment about how your understanding of Qwest's control environment and other company level controls would help you implement a "top-down" approach to an internal control audit at Qwest.
3. Consider Paragraph #63 and Paragraphs #68–70 of PCAOB Auditing Standard No. 2. Please identify the most relevant financial statement assertion related to the nonrecurring revenue (i.e., "one-hit wonders"). Why is it the most relevant?
4. Please consider Paragraph #72 of PCAOB Auditing Standard No. 2. How would you classify the nonrecurring revenue (i.e., "one-hit wonders")? Why?
5. Consult Q5 of the PCAOB Staff Questions & Answers (June 23 2004) and your primary audit text. What is the auditor's responsibility related to information disclosed by management at the time of an earnings release, if any? What is the auditor's responsibility related to the information disclosed by management in the Management's Discussion & Analysis section, if any? Do you agree with these responsibilities? Why or why not?