Case 4.9

Qwest: A Focus on Revenue Recognition

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."[270]

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.[271]

Background

Included within the $3.8 billion of revenues that were fraudulently recognized by Qwest were prematurely recognized revenues from sales of IRUs for its network. Qwest treated IRU sales as sales-type leases, which allow a seller to treat a lease transaction as a sale of an asset with complete, upfront revenue recognition. According to GAAP, this type of upfront revenue recognition required: (1) completion of the earnings process; (2) that the assets sold remain fixed and unchanged; (3) full transfer of ownership, with no continuing involvement by the seller; and (4) an assessment of fair market value of the revenue components. In addition, as part of the completion of the earnings process, the assets being sold had to be explicitly and specifically identified.

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[270] 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.

[271] SEC v. Qwest, 1–2.

Portability

Qwest generally allowed customers of IRUs the ability to *port,* or exchange, IRUs purchased for other IRUs. By mid-2001, Qwest had ported at least 10 percent of assets sold as IRUs. Portability was not uncommon in the telecommunications industry, because companies needed the flexibility to change their network as demand changed.[272]

However, because the practice of porting jeopardized Qwest's ability to recognize revenue on IRUs upfront, Qwest salespeople would often grant its customers the right to port through secret side agreements or verbal assurances. For example, in the fourth quarter 2000, Qwest sold to Cable & Wireless $109 million of capacity in the United States (and recognized $108 million in upfront revenue) by providing a secret side agreement, which guaranteed that Cable & Wireless could exchange the specific capacity it purchased at a later date.[273]

As another example, in the first quarter of 2001, Qwest sold IRU capacity to Global Crossing and recognized $102 million of upfront revenue, after it gave secret verbal assurances to Global Crossing that Qwest would agree to exchange the capacity when the IRU capacity that Global Crossing actually wanted became available.[274]

Ownership Transfer

Qwest also had a significant continuing involvement with all IRUs sold in the form of ongoing administrative, operating, and maintenance activities. While Qwest's IRU sales agreements generally provided for title transfer at the end of the lease term, conditions also existed that would require that the title remained with Qwest, in reality. In addition, there was significant uncertainty about whether the title would ever transfer in certain other situations.[275]

Interestingly, there was no statutory title transfer system for IRUs that is comparable to what exists for real property. In addition, some of Qwest's "right of way" agreements on the underlying IRUs actually expired prior to the end of the IRU terms. Further, some of the underlying IRU agreements (concerning IRUs that Qwest purchased from a third party, and then resold) did not allow Qwest to sublease its "rights of way" or did not provide title to

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[272] SEC v. Qwest, 20.

[273] SEC v. Qwest, 26–27.

[274] SEC v. Qwest, 26–27.

[275] SEC v. Qwest, 22–23.

Qwest. Therefore, Qwest could not legally provide those rights to a third party.[276]

In some IRU contracts, Qwest specifically stated that the purchaser did not receive any ownership interest in the fiber. Similarly, in many contracts, Qwest prohibited the purchaser from assigning, selling, or transferring the fiber-optic capacity, without Qwest's prior written consent. For example, on March 31, 2000, Qwest entered into a $9.6 million IRU transaction with Cable & Wireless in which Qwest included a clause preventing assignment, sale, or transfer without Qwest's consent.[277]

Other Characteristics That Failed to Comply with GAAP

Qwest's upfront revenue recognition of IRUs was also premature because Qwest routinely neglected to specify the assets it was selling. For example, in the first quarter ended March 31, 2001, Qwest sold $105 million of fiber-optic capacity to Global Crossing and recognized approximately $102 million in revenue on the sale. This was done despite the fact that the majority of the capacity was not specified in the contract by the end of the quarter. Rather, the contract exhibit intended to list the assets sold simply stated—"to be identified." Further, Global Crossing and Qwest did not identify the geographic termination points of some of the capacity purchased by Qwest until June 2001, three months after Qwest recognized the revenue on the sale transaction.[278]In addition, to circumvent problems on its network or to optimize the network's efficiency, Qwest often moved IRUs previously sold, without customer consent, to different wavelengths and different routes as required. This process was known as *grooming*. During the third and fourth quarters of 2001, Qwest senior management knew of numerous IRUs that had been rerouted on different fibers. Qwest personnel informed senior management that the IRUs could not be restored to their original routes and advised senior management to reverse the revenue recognized from the IRU sales. Qwest senior management, however, rejected the employees' recommendations. From the fourth quarter of 2001 through early 2002, Qwest continued to reroute IRU fibers as necessary.[279]

Independent Auditor Arthur Andersen and the SEC

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[276] SEC v. Qwest, 22.

[277] SEC v. Qwest, 22.

[278] SEC v. Qwest, 28.

[279] SEC v. Qwest, 21.

The SEC brought charges against Mark Iwan, the Global Managing Partner at Arthur Andersen—the outside auditor for Qwest from 1999 to 2002—alleging that Iwan "unreasonably relied on management's false representations that certain revenue recognition criteria for immediate revenue recognition on IRUs were met." On account of these charges and others, the SEC ordered that Iwan was denied the privilege of appearing or practicing before the SEC as an accountant for a minimum of five years.

Specifically, the SEC found that Iwan learned that Qwest's porting of capacity had risen to approximately 10 percent of the capacity sold by mid-2001. Although Iwan required Qwest to stop the practice of porting, he allegedly did not go back and ensure that the prior revenue recognition was in conformity with GAAP. Rather, Iwan exclusively relied on management's representations that "Qwest had made no commitments to allow its customers to port capacity, that it was never Qwest's intention to allow customers to port capacity, and that Qwest would not honor any future request to port capacity."[280]

The SEC also found that Iwan relied on representations from Qwest's management and legal counsel that title did actually transfer on IRUs. In fact, Iwan allegedly knew by early 2000 that Qwest senior tax personnel believed there were "significant uncertainties as to whether title transfer would occur" and, thus, Qwest would treat IRUs as operating leases for tax purposes. Surprisingly, Iwan failed to reconcile Qwest's position on title transfer for IRUs for income tax reporting purposes with its different position for financial reporting purposes under GAAP.[281]

In 2001, Iwan required Qwest to obtain an outside legal opinion that Qwest had the ability to transfer title to the IRUs it sold over the past three years. Qwest provided to Iwan an abridged summary of the legal opinion that contained significant assumptions, qualifications, ambiguities, and limitations that were critical to evaluating whether Qwest met the ownership transfer requirements. Yet, Iwan continued to rely on the false representations of management and legal counsel in this regard.[282]

Case Questions

1. Please describe why the upfront revenue recognition practices for sales of IRUs by Qwest was not appropriate

[280] A.A.E.R. No. 2220, 3–4.

[281] A.A.E.R. No. 2220, 3–4.

[282] A.A.E.R. No. 2220, 3–4.

under GAAP. Please be specific.

2. Based on your understanding of audit evidence, did Arthur Andersen rely on sufficient and competent audit evidence in its audit of the Qwest's upfront revenue recognition processes? Why or why not?
3. Please consider Paragraph #63 and Paragraphs #68–70 of PCAOB Auditing Standard No. 2. Identify one relevant financial statement assertion related to revenue recognized for IRU sales by Qwest. Why is it relevant?
4. Consult Paragraph #84 of PCAOB Auditing Standard No. 2. For the assertion identified in Question #3, please identify a specific internal control activity that would help to prevent or detect a misstatement related to the practice of upfront revenue recognition of IRUs by Qwest.