Case 2.5

Qwest: A Focus on Fraud and Inherent Risk Assessment

Synopsis

When Joseph Nacchio became Qwest's CEO in January 1997, its existing strategy to construct a state-of-the art 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."[113]

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.[114]

Strategic Direction

In the mid-1990s, Qwest Communications International embarked on building a fiber-optic network across major cities within the United States. The network would consist of a series of cables that contained strands of pure glass that could transmit data by using light and the appropriate equipment. Qwest's initial strategy was to build the network of fiber cable and sell it in the form of an Indefeasible Right of Use (IRU), an irrevocable right to use a specific amount of fiber for a specified time period.

However, when Joseph Nacchio became Qwest's CEO in January 1997, the strategy of the company shifted toward communications services. Nacchio envisioned that Qwest had the potential of becoming a major

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[113] 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.

[114] SEC v. Qwest, 1–2.

telecommunications company that offered Internet and multimedia services over its fiber-optic network, in addition to offering traditional voice communications services as well.[115]

Qwest's Construction Services Business

A fiber-optic network consisted of a series of cables that contained strands of pure glass and allowed the transmission of data between any two connected points by using beams of light. While each cable of the fiber optic network typically contained at least 96 strands of fiber, Qwest intended to use 48 of the fiber strands for its own use and to sell the remaining strands to help finance the cost of construction of the network.[116] Total revenue from its construction services business was approximately $224.5 million, $688.4 million, and $581.4 million in 1999, 1998, and 1997, respectively.[117]

Competition

As of 1999, Qwest faced competition in the construction services segment from three other principal facilities-based long-distance fiber-optic networks: AT&T, Sprint, and MCI WorldCom. In its 1999 annual filing with the SEC, Qwest warned investors that others—including Global Crossing, GTE, Broadwing, and Williams Communications—were building or planning networks that could employ advanced technology similar to Qwest's network. Yet, Qwest assured investors that it was at a significant advantage because its network would be completed in mid-1999, at least a year ahead of the planned completion of other networks, and it could extend and expand the capacity on its network using the additional fibers that it had retained.[118]

Qwest's Communications Services Business

As part of its communications services business, Qwest provided traditional voice communications services, as well as Internet and multimedia services to business customers, governmental agencies, and consumers in domestic and international markets. Qwest also provided wholesale services to other communications providers, including Internet

[115] 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.

[116] 1997 10-K, 10.

[117] 1999 10-K, 12.

[118] 1999 10-K, 13.

service providers (ISPs) and other data service companies. Total revenue from its communications services business was approximately $3,703.1 million, $1,554.3 million, and $115.3 million in 1999, 1998, and 1997, respectively.[119]

Regulation

The impact of regulatory change was significant in the highly regulated telecommunications industry. The Telecommunications Act of 1996 increased competition in the long distance market by allowing the entry of local exchange carriers and others. Indeed, Qwest warned investors in its 1999 annual filing with the SEC that its costs of providing long distance services could be affected by changes in the rules controlling the form and amount of "access charges" long distance carriers had to pay local exchange carriers to use the local networks they needed to provide the local portion of long distance calls.[120]

Competition

Qwest's primary competitors in its communications services business included AT&T, Sprint, and MCI WorldCom, all of whom had extensive experience in the traditional long distance market. In addition, the industry faced continuing consolidation, such as the merger of MCI and WorldCom.

In the markets for Internet and multimedia services, Qwest competed with a wide range of companies that provided web hosting, Internet access, and other Internet Protocol (IP) products and services. Significant competitors included GTE, UUNET (a subsidiary of MCI WorldCom), Digex, AboveNet, Intel, and Exodus.[121]

Qwest's Mergers and Acquisitions

Like its competition, Qwest pursued several mergers and acquisitions to strengthen its service offerings. From October 1997 to December 1998, it acquired, SuperNet, Inc., a regional ISP in the Rocky Mountain region; in March 1998, it acquired Phoenix Network, Inc., a reseller of long distance services; in April 1998, it acquired EUnet International Limited, a leading European ISP; in June 1998, it purchased LCI International, Inc., a provider of long distance telephone services; and in December 1998, it acquired Icon CMT Corp., a leading Internet solutions

[119] 1999 10-K, 10.

[120] 1999 10-K, 14–17.

[121] 1999 10-K, 13.

provider.[122] In many of these acquisitions, Qwest used its own company stock as the tender that was needed to acquire the companies.

Qwest's string of acquisitions culminated during 1999 when it entered into a merger agreement with telecommunications company US West on July 18, 1999. The merger agreement required Qwest to issue $69 worth of its common stock for each share of US West stock, and it 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.

Case Questions

1. Based on your understanding of fraud risk assessment, what three conditions are likely to be present when a fraud occurs? Based on your understanding of the Qwest audit, which of these three conditions appears to be most prevalent and why?
2. Consult Paragraph #39 of PCAOB Auditing Standard No. 2. Based on your understanding of inherent risk assessment and the case information, please identify three specific factors about Qwest's business model that might cause you to elevate inherent risk if you were conducting an audit of internal control over financial reporting at Qwest.
3. Consult Q39 and Q43 of the PCAOB Staff Questions & Answers (May 16, 2005). Please comment about how your understanding of the inherent risks identified at Qwest (in Question 2) would influence the nature, timing, and extent of your audit work at Qwest.
4. Please consult Paragraphs #71–72 of PCAOB Auditing Standard No. 2. Next, consider revenue earned in the construction services and the communication services businesses. Do you believe that any of the different types of revenue earned by Qwest would have a "different level" of inherent risk? Why or why not?

[122] 1998 10-K, 5.