Case 4.11

Qwest: A Focus on Presentation and Disclosure[291]

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."[292]

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.[293]

Background

As part of its scheme to mislead the marketplace, Qwest executives often made false and misleading disclosures concerning revenues from its directory services unit, Qwest Dex Inc. (Dex). For example, Qwest manipulated revenue from Dex for 2000 and 2001 by secretly altering directory publication dates and the lives of directories.

Dex's Changes to Publication Dates and Lives of Directories

Dex published telephone directories year-round in approximately 300 markets in 14 states. It earned revenue by

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[291] Much of the information in this case is based on SEC v. Qwest, 40–42.

[292] 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.

[293] SEC v. Qwest, 1–2.

selling advertising space in its directories. Each of its directories typically had a life of 12 months, and Qwest traditionally recognized directory revenue over the life of the directory. However, in late 1999, Dex adopted a "point of publication" method of accounting and began to recognize all advertising revenue for a directory as soon as Dex began deliveries of that directory to the public.

In August 2000, Dex executives informed Qwest senior management that Dex would be unable to achieve the aggressive 2000 earnings' targets that management had set for it. As one option for making up for the shortfall, Dex suggested that it could publish Dex's Colorado Springs directory in December 2000 rather than January 2001 as scheduled, thereby allowing Qwest to recognize revenue from the directory in 2000 rather than 2001. One Dex executive expressed opposition, citing his concern that such a schedule change would merely reduce 2001 revenue and earnings. He also expressed his view that Qwest probably would be required to disclose the change in the regulatory filings with the SEC. Despite this executive's opposition, Qwest senior management instructed Dex to move forward with the proposed change.

By recognizing revenue from the Colorado Springs directory in 2000, Qwest generated $28 million in additional revenue and $18 million in additional earnings before interest and tax, depreciation, and amortization (EBITDA) for the year. The additional revenue generated in 2000 accounted for about 30 percent of Dex's 2000 year-over-year revenue increase. It further allowed Dex to show 6.6 percent year-over-year revenue growth versus 4.6 percent if the schedule change had not been made.

In Qwest's 2000 Form 10-K, Qwest informed investors that Dex's revenue for 2000 increased by almost $100 million. It wrote that the increase was due in part to "an increase in the number of directories published." At the same time, it failed to inform investors that Dex generated nearly one-third of that amount by publishing the Colorado Springs directory twice in 2000. It also did not inform investors that the schedule change would produce a corresponding decline in Dex revenue for the first quarter of 2001.

For 2001, Qwest senior management established revenue and EBITDA targets for Dex that were higher than what Dex management believed was possible to achieve. In fact, the EBITDA target was $80–100 million greater than the amount Dex management believed was achievable. Dex management complained to Qwest's senior management about the unrealistic targets. Yet, Qwest's senior management not only refused to change the targets, but it also did not allow Dex a reduction in the targets to compensate for the revenue from the Colorado Springs directory that was recognized in 2000.

In March 2001, Dex management met with some of Qwest's senior management to discuss "gap-closing" ideas for the first two quarters of 2001 in an attempt to achieve its 2001 financial targets. One idea was to advance the publication dates of several directories, thus, allowing Dex to recognize revenue in earlier quarters; another idea was to lengthen the lives of other directories from 12 to 13 months, thereby allowing Dex to bill each advertiser for one additional month of advertising fees in 2001. Senior managers at Qwest instructed the Dex managers to implement the changes. Similar changes were approved by senior management at Qwest and implemented by Dex to allow it to meet its third and fourth quarter financial targets.

During 2001, Dex advanced the publication dates or extended the lives of 34 directories. Those schedule changes produced $42 million in additional revenue and $41 million in additional EBITDA. Qwest's Forms 10-Q for the first three quarters of 2001 stated that period-over-period improvements in Dex's revenue were due in part to changes in the "mix" and/or the "lengths" of directories published. Like the 2000 Form 10-K, these reports did not include any information about the directory schedule changes or the reasons for those changes.

Case Questions

1. Describe why the revenue recognition practices of Dex were not appropriate under GAAP. Please be specific.
2. Please consider Paragraph #63 and Paragraphs #68–70 of PCAOB Auditing Standard No. 2. Identify one relevant financial statement assertion related to revenue recognized at Dex. Why is this assertion relevant?
3. Consult Paragraph #84 of PCAOB Auditing Standard No. 2. For the assertion identified in Question #2, identify a specific internal control activity that would help to prevent or detect a misstatement related to revenue recognition at Dex.
4. Consider the impact of the pressure exerted by Qwest's senior management team to meet aggressive revenue and earnings targets. Please comment about why such a "tone at the top" would always have a pervasive effect on the reliability of financial reporting at an audit client like Qwest.
5. Please consult Paragraphs #49 and 114 of PCAOB Auditing Standard No. 2. Next, comment about the impact that Qwest's revenue disclosure practices would have on an auditor's assessment of Qwest' control environment.