QUEST: THE FULL DISCLOSURE PRINCIPLE

Synopsis When Joseph Nacchio became Qwest’s CEO in January 1997, the company’s existing strategy began to shift from just building a nationwide fiber-optic network to include increasing communications services. By the time it re- leased 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.” 1 During 1999 and 2000, Qwest consistently met its aggressive revenue targets and became a darling to its investors. Yet, when the company announced its intention to restate revenues in August 2002, its stock price plunged to a low of $1.11 per share in August 2002, from a high of $55 per share in July 2000.2 Civil and criminal charges related to fraudulent activitity were brought against several Qwest executives, including CEO Joseph Nacchio. Nacchio was convicted on 19 counts of illegal insider trading, and was sentenced to six years in prison in July 2007. He was also ordered to pay a $19 million fine and forfeit $52 million that he gained in illegal stock sales.3

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 ac- quisitions, Qwest entered into a merger agreement with telecommunications com- pany 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 allegedly pressured by CEO Nacchio to meet earnings targets to ensure that the price per share did not fall 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, less than a year after the acquisition. 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.4 These targets were especially ambitious in the face of difficult industry conditions. For example, in Qwest’s earnings release for the second quarter of 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.5 Despite these significant industry challenges, Qwest’s senior management publicly claimed that the company would continue its pattern of dramatic rev- enue 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 subordinate managers and employees to meet or exceed the publicly announced revenue targets. In addition, it paid bonuses to management and employees only for periods when they achieved targeted revenue.6 Sale of Network Assets Initially Held for Use and Capital Equipment 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 communica- tions 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.”7 In its earnings releases during 1999 through 2001, Qwest executives would often fail to disclose the impact of nonrecurring revenues. (See Table 1.3.1.) 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.8

TABLE 1.3.1 Management’s Failure to Disclose Impact of Nonrecurring Revenue

9 2Q 1999 Qwest 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 Qwest 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 nonrecurring revenue, Qwest’s fourth quarter total revenue declined 9 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 revenue earned from sale of IRUs, but Qwest’s CFO and CEO re- jected 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 Qwest 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 by 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 8 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 8 percent over the same period of the previous year.

2Q 2001 Qwest 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 6 percent over the same period of the previous year.

Case Questions

1. Consider the principles, assumptions, and constraints of Generally Accepted Accounting Principles (GAAP). Define the full disclosure principle and explain why it is important to users of financial statements.

2. Explain specifically why Qwest’s failure to disclose the extent of nonrecurring revenue violated the full disclosure principle in this situation.

3. Consult Paragraph 67 of PCAOB Auditing Standard No. 12. Do you believe that Qwest had established an effective system of internal control over financial reporting related to the presentation and disclosure of its nonrecurring revenue? Why or why not?

4. Consult Paragraph A4 (in Appendix A) of PCAOB Auditing Standard No. 5. 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 and analysis section, if any? Do you agree with these responsibilities? Why or why not?

5. Do you believe it is ethical for a CEO to establish a company’s earnings expectation at an unreasonably high number and then require the company’s employees to meet or exceed that expectation to keep their jobs? Why or why not?