EXPERT REPORT OF DR. JAMES H. VANDER WEIDE
REGARDING DR. SELWYN'S RESPONSE TO BENCH REQUEST NO. 3
DOCKET NO. UT-023003
JUNE 11, 2004

1. During his cross examination by Verizon NW's counsel at the hearing in this matter on May 27, 2004, AT&T Witness Dr. Lee L. Selwyn admitted that some of the underlying data for SBC used in his regression analysis were incorrect. As a result, the Commission asked Dr. Selwyn to file a revised regression analysis based on corrected input data. At the time the Commission made this request, the Commission also noted that Dr. Selwyn had effectively revised his pre-filed testimony and stated that Verizon NW would have an opportunity to respond to Dr. Selwyn's revised testimony and regression results. Verizon NW has asked me to respond on its behalf.

2. Dr. Selwyn provided revised results for his regression analysis that seem to indicate that his results are improved once he "corrects" for the incorrect SBC data identified in his cross examination. However, Dr. Selwyn's "improved" regression results arise solely from errors in his analysis. Once these errors are corrected, Dr. Selwyn's regression results deteriorate, as I suggested at the hearings. Specifically, as explained below:

- Dr. Selwyn purports to "correct" the errors in his SBC data solely by *creating* new data by extrapolation.
- Dr. Selwyn's results are sensitive to his omission of important data that were readily available at the time he did his studies.
- Dr. Selwyn's regression results are highly sensitive to his inappropriate inclusion of outlier "Qwest" data for beta and percent investment in "non-ILEC" assets.
- In addition to being outliers, the Qwest data in Dr. Selwyn's study are incorrectly based on data for U S WEST, not Qwest, and on Qwest's incorrect and misleading accounting entries that were reversed as a result of an audit and presented in Qwest's 2002 10K filed in October 2003.

- Contrary to Dr. Selwyn's hypothesis, once the SBC and Qwest data are corrected, the RBHCs' percentage investment in "non-ILEC" assets does not increase from 2000 to 2003.
- Dr. Selwyn fails to recognize there is insufficient data available to draw reliable conclusions regarding the cause of the RBHCs' increased betas.

A. DR. SELWYN PURPORTS TO HAVE "CORRECTED" THE ERRORS IN HIS SBC DATA SOLELY BY CREATING NEW DATA BY EXTRAPOLATION.

3. Dr. Selwyn used regression analysis in an effort to demonstrate that the RBHC betas (which measure the movement in RBHC stock prices compared to the market as a whole) are inappropriate for use in determining the cost of equity (and therefore the weighted average cost of capital) for unbundled network elements. Dr. Selwyn's hypothesis is that recent increases in the betas of the RBHCs (which would lead to increases in their cost of equity under the CAPM model) is attributable to the diversification of these companies away from the local exchange business. In an effort to prove this hypothesis, Dr. Selwyn ran regressions intended to explain the increases in the RBHC betas. One of the "explanatory" variables he used in his regressions was the share of "non-ILEC" assets held by each of the RBHCs during the study period, which he used as a proxy for diversification. Dr. Selwyn admitted under cross examination that his data relating to SBC's percentage of "non-ILEC" assets for the periods 2001 to 2003 were overstated because he had incorrectly included assets for SBC's ILEC subsidiaries Ameritech, Nevada Bell, and Southern New England Telephone in his "non-ILEC" category. Dr. Selwyn incorrectly included assets for these companies in the "non-ILEC" category because SBC did not separately report data for these ILECs during the period under study. Simply put, the data that Dr. Selwyn requires for his analysis (*i.e.*, the assets for Ameritech, Nevada Bell and Southern New

England Telephone) are not available. But rather than confess that his hypothesis is not testable (at least not in the manner he proposed), Dr. Selwyn *created* data for these companies by extrapolating data from 1997 to the later periods, and by extrapolating values from ARMIS data that are based on an entirely different accounting standard. Although it is impossible to measure the impact of Dr. Selwyn's extrapolations because the necessary data for Ameritech, Nevada Bell, and Southern New England are not available, the Commission should recognize that Dr. Selwyn's basic input data for SBC are merely approximations that may not reflect the true percent of "non-ILEC" assets for SBC.[1/] Furthermore, the Commission should recognize that Dr. Selwyn changed not only the four data points identified in cross examination, but also the first three data points for SBC that had been based on correct SBC-reported data.

B. DR. SELWYN'S RESULTS ARE SENSITIVE TO HIS OMISSION OF DATA THAT WERE READILY AVAILABLE AT THE TIME HE DID HIS STUDIES.

4. Dr. Selwyn claimed in his response to Bench Request No. 3 that Qwest's 2002 Annual Report, which contains Qwest's restated results, was not available at the time of his testimony. Dr. Selwyn's statement is incorrect. Qwest filed its 2002 Annual Report with the restated results for 2000, 2001, and 2002 in October 2003, almost six months before Dr. Selwyn's direct testimony was filed in this proceeding, and eight months prior to the time of his response to Bench Request No. 3. In addition, Qwest reported preliminary restated results in February 2003 that should have alerted Dr.

1/ A similar problem applies to the data for Verizon. Dr. Selwyn admitted under cross examination that the Verizon data for many of its subsidiaries were not available in 2002, and that he had to create the data for Verizon by extrapolation from earlier data. Moreover, the first "Verizon" data point applies solely to Bell Atlantic, not to Verizon, which was formed by the merger of Bell Atlantic and GTE in June 2000.

Selwyn to problems with the Qwest data that he used in his regression analysis, as I explain more fully below.

5. As shown in Table 1 below,[2/] which reproduces the data Dr. Selwyn used in his revised regression analysis,[3/] Dr. Selwyn's revised regression analysis omits data for Qwest in the first half of 2003 ("1H03"), even though he includes such data for BellSouth, SBC, and Verizon. This omission is important because the Qwest data for the first half of 2003 changed dramatically from the Qwest data for the second half of 2002. Moreover, the omitted Qwest data violate Dr. Selwyn's hypothesis that the increase in the RBHCs' beta is caused by an increase in the percentage of non-ILEC assets. Specifically, Qwest's beta was 1.800 in the first half of 2003 and its percent investment in non-ILEC assets was 23.24% (i.e., 0.2324). Thus, Qwest's beta increased at the same time that its percent of investment in "non-ILEC" assets had declined significantly, from approximately 66% to 23%. Had Dr. Selwyn included these data, his results would have deteriorated significantly. Indeed, if Dr. Selwyn had also included readily available Qwest data for the second half of 2003, reflecting a beta of 1.775 and percent non-ILEC assets of approximately 17.03% (17.03), he would have found that the relationship between beta and percent of non-ILEC assets was negative.

2/ For simplicity, the table displays data pertaining specifically to Dr. Selwyn's revised analysis based on his ARMIS-derived non-ILEC data. However, all my comments and conclusions apply equally to his studies based on data he has extrapolated from SBC's 1997 10K reports for all five ILECs, the most recent date at which 10Ks were filed for all of these companies.

3/ Dr. Selwyn's revised Appendices continue to show the value for BellSouth's non-ILEC assets in 1H00 as "0.4719." However, Dr. Selwyn appears to have transposed his figures. His revised results can only be duplicated if the value for BellSouth's non-ILEC assets in 1H00 is "0.4179."

Table 1

Data Underlying Dr. Selwyn's Revised Regression Analysis

	BellSouth		Qwest		SBC		Verizon	
Period	Beta	Non-ILEC	Beta	Non-ILEC	Beta	Non-ILEC	Beta	Non-ILEC
1H00	0.825	0.4719	0.750	0.1415	0.825	**0.3891**	0.850	0.3184
2H00	0.825	0.4260			0.850	**0.4349**		
1H01	0.825	0.4170	1.600	0.6892	0.825	**0.4337**		
2H01	0.800	0.3868	1.475	0.6644	0.800	**0.4010**		
1H02	0.775	0.3861	1.475	0.6603	0.775	**0.3953**		
2H02	0.850	0.3670	1.675	0.6557	0.900	**0.3956**	1.025	0.4483
1H03	0.900	0.3641			0.975	**0.4206**	1.000	0.4472

C. DR. SELWYN'S REGRESSION RESULTS ARE HIGHLY SENSITIVE TO HIS INAPPROPRIATE INCLUSION OF OUTLIER QWEST DATA FOR BETA AND PERCENT INVESTMENT IN NON-ILEC ASSETS.

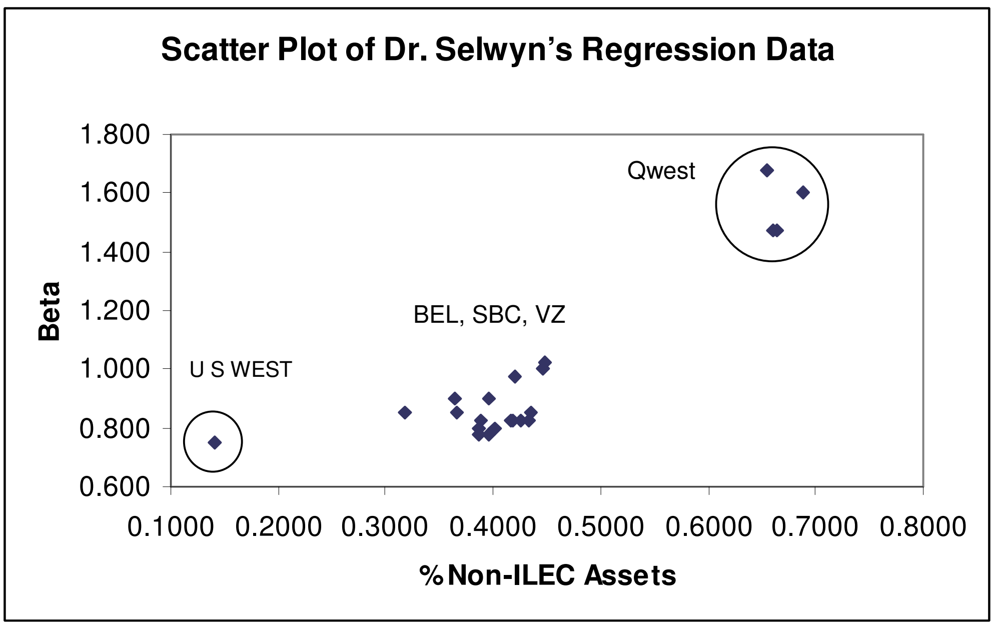
6. The data underlying Dr. Selwyn's revised regression analysis are shown in Table 1 above and graphed in Figure 1 below. These data illustrate the highly unusual character of the beta and "non-ILEC" data for Qwest as compared to the comparable data for BellSouth, SBC, and Verizon. For example, the betas for BellSouth and SBC both increased modestly from 2000 to 2003, even though their percentages of "non-ILEC" assets did not increase over this period. (In fact, contrary to Dr. Selwyn's hypothesis, the percentage of non-ILEC assets for BellSouth actually decreased significantly.) Further, Qwest's beta increased from 1.475 in the second half of 2001 to 1.675 in the second half of 2002, even though its percentage investment in "non-ILEC" assets decreased over this period.[4/] In contrast, the first two data points for "Qwest"

[4/] Verizon's percent investment in "non-ILEC" assets appears to increase along with its beta from the first half of 2000 to the second half of 2002 (intervening data are omitted from Dr. Selwyn's analysis). This increase is based on an accounting adjustment Verizon made at the time it signed its joint venture with Vodafone in 2000.

(continued . . .)

display a very dramatic increase in beta, from 0.750 in the first half of 2000 ("1H00") to 1.600 in the first half of 2001 ("1H01"), and in percent of non-ILEC assets, from 0.1415 in the first half of 2000 to 0.6892 in the first half of 2001. The dramatic increases in these two data points are many times larger than any other increase in beta or "non-ILEC" assets in Dr. Selwyn's data base. The highly unusual nature of "Qwest" data points is especially apparent in Figure 1, where the so-called "Qwest" data for the first half of 2000 appears in the lower left hand corner, and the Qwest data for the later periods are in the upper right hand corner, far removed from any data for BellSouth, SBC, and Verizon.

Figure 1



7. As one would expect, the results of Dr. Selwyn's regression analysis are highly sensitive to his inclusion of the outlier data for Qwest. Indeed, as shown by the

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(. . . continued)
See Verizon Communications' Annual Report 2000 Consolidated Balance Sheet, p. 33, and Note 6, "Wireless Joint Venture," p. 43.

regression results in Tables 2, 3, and 4 below, Dr. Selwyn's hypothesized relationship between increases in beta and increases in "non-ILEC" assets disappears altogether once either the first "Qwest" data point or all the Qwest data points are removed from his analysis. Furthermore, once the outlier Qwest data points are removed, Dr. Selwyn's revised regression results for "non-ILEC" assets are considerably worse than his regression results with the incorrect SBC data.

Table 2

Dr. Selwyn's Revised Regression Results Without Incongruous U S WEST Data Point[5]

	Standardized Coefficient	T	Sig.
(Constant)		3.839	.005
Non-ILEC assets	.158	.696	.506
All Competition	.065	.335	.746
Leverage	.006	.083	.936
2H00	.007	.141	.891
1H01	-.004	-.067	.948
2H01	-.069	-.820	.436
1H02	-.097	-.912	.388
2H02	.078	.532	.609
1H03	.080	.486	.640
QWEST	.785	2.886	.020
SBC	-.083	-1.377	.206
BellSouth	-.089	-.888	.401
Dependent variable:	Beta		

5/ The time and company variables in the left-hand column of this table are dummy variables that control for differences in time and company. The important coefficients for the purposes of Dr. Selwyn's conclusions are: (1) non-ILEC assets; (2) all competition, and (3) leverage. The insignificance of the coefficients for these three variables is indicated by the fact that their associated t values are less than 2.

Table 3

Dr. Selwyn's Revised Regression Results Without Incorrect Qwest Data

	Standardized Coefficient	T	Sig.
(Constant)		5.601	.003
Non-ILEC assets	-.108	-.319	.763
All Competition	.665	1.003	.362
Leverage	.876	1.104	.320
2H00	.073	.537	.614
1H01	-.198	-1.189	.288
2H01	-.363	-1.272	.259
1H02	-.617	-1.556	.180
2H02	-.631	-.727	.500
1H03	-.392	-.483	.649
SBC	.348	.516	.628
BellSouth	.135	.247	.815
Dependent variable:	Beta		

Table 4

Dr. Selwyn's Revised Regression Results Without Incorrect Qwest Data and Using Trend Variable Instead of Dummy Time Variables

	Standardized Coefficient	T	Sig.
(Constant)		4.861	.001
Non-ILEC assets	-.113	-.454	.660
All Competition	1.197	1.505	.163
Leverage	.694	1.722	.116
SBC	.215	.458	.657
BellSouth	.212	.402	.696
Period	-.935	-1.259	.237
Dependent variable:	Beta		

D. IN ADDITION TO BEING OUTLIERS, THE QWEST DATA IN DR. SELWYN'S STUDY ARE INCORRECTLY BASED ON DATA FOR U S WEST, NOT QWEST, AND ON QWEST'S INCORRECT AND MISLEADING ACCOUNTING ENTRIES THAT WERE REVERSED AS A RESULT OF AN AUDIT AND PRESENTED IN QWEST'S 2002 10K FILED IN OCTOBER 2003.

8. Since Dr. Selwyn's conclusion depends entirely on the dramatic increase in "Qwest's" "non-ILEC" assets and beta from the first half of 2000 ("1H00") to first half of 2001 ("1H01"), I examined whether these "Qwest" data points are representative of "Qwest's" actual situation in these two periods. My analysis reveals that Dr. Selwyn's "Qwest" data are not representative of Qwest's actual situation in these two periods for at least two reasons.

9. First, I found that the reported increase in "Qwest's" beta, from 0.750 in the first half of 2000 to 1.600 in the first half of 2001, is not representative of an actual increase in Qwest's beta. Qwest's beta was 1.625 in the first half of 2000, not the 0.75 reported by Dr. Selwyn. Dr. Selwyn's 0.750 reported beta for "Qwest" was not the beta for Qwest. Rather, it was the beta for the pre-merger company U S WEST, which was an entirely different company than either the pre-merger or post-merger Qwest. If Dr. Selwyn had correctly used the Qwest beta and percentage of "non-ILEC" asset values in the first half of 2000, rather than the U S WEST data, he would have found that there was no relationship between Qwest's beta and percentage of "non-ILEC" assets in 2000 and 2001: Qwest's beta remained constant, even though its percentage of investment in "non-ILEC" assets decreased from 100% in the first half of 2000 to 69% in the first half of 2001.

10. Second, I found that the reported increase in Qwest's investment in "non-ILEC" assets in 2001 and 2002, from 14% to 69%, does not accurately represent

Qwest's asset holdings in these two periods. I have already noted that this increase partially arises because Dr. Selwyn incorrectly compared U S WEST data for the first half of 2000 and Qwest data for the first half of 2001. More importantly, however, Dr. Selwyn failed to recognize that the high "non-ILEC" asset percentages he reports for Qwest beginning in 2001 are based on questionable and non-representative accounting data that have been criticized by the SEC and, indeed, completely discredited and formally reversed by Qwest's current management.

11. To improve Qwest's credibility with the SEC and the investment community, Qwest's current management conducted an internal audit of Qwest's financial results for the years since the merger and found numerous errors in Qwest's previous accounting practices. As a result, Qwest's current management reversed many questionable accounting entries that had dramatically increased the value of Qwest's "non-ILEC" assets during the period of Dr. Selwyn's study. These reversals indicate that the Qwest data used in Dr. Selwyn's study do not provide a fair or reasonable indication of the value of Qwest's "non-ILEC" assets over his study period.

12. For example, even though the pre-merger Qwest acquired U S WEST, Qwest's former management chose to account for the merger as a reverse acquisition, assuming counter factually for accounting purposes that U S WEST acquired Qwest. Using the counter factual assumption that U S WEST acquired Qwest, Qwest's management recorded a ***<u>$32 billion</u>*** increase in goodwill, which by itself, more than doubled the value of Qwest's "non-ILEC" assets. (See Table 5 below, which is a copy of Qwest's consolidated balance sheet from its Annual Report for the year 2000). This

one accounting entry alone explains most of the increase shown by Dr. Selwyn in the percentage of Qwest's non-ILEC assets, from 14% in 2000 to 69% in 2001.

Table 5

Qwest's Consolidated Balance Sheets
(Dollars in millions, except per share amounts)

December 31,	2000	1999
Assets		
Current assets:		
Cash and cash equivalents	$154	$ 78
Accounts receivable, net of allowances of $301 and $88, respectively	4,235	2,455
Receivable from sale of investments	-	1,140
Inventories and supplies	275	272
Deferred tax assets	72	46
Prepaids and other	640	201
Total current assets	5,376	4,192
Property, plant and equipment-net	25,583	16,404
Goodwill and other intangible assets-net	**32,327**	**501**
Investments	8,186	1,290
Other assets	2,029	885
Total assets	**$ 73,501**	**$ 23,272**
Liabilities and Stockholders' Equity		
Current liabilities:		
Current borrowings	$ 3,645	$ 2,882
Accounts payable	2,049	1,700
Accrued expenses and other current liabilities	3,806	1,840
Advance billings and customer deposits	393	344
Total current liabilities	9,893	6,766
Long-term borrowings	15,421	10,189
Post-retirement and other post-employment benefit obligations	2,735	2,890
Deferred income taxes	1,768	1,191
Deferred credits and other	2,380	981
Commitments and contingencies (Note 9)		
Stockholders' equity:		
Preferred stock-$1.00 par value, 200,000,000 shares authorized, none issued and outstanding	-	-
Common stock-$0.01 par value, 5 billion shares authorized, 1,672,218,763 and 875,995,661 issued, 1,672,218,763 and 875,469,943 outstanding	17	9
Additional paid-in capital	41,289	647
Retained earnings	24	377
Accumulated other comprehensive (loss) income	(26)	222
Total stockholders' equity	41,304	1,255
Total liabilities and stockholders' equity	$ 73,501	$ 23,272

13. However, Qwest's current management recognized in its 2002 Annual Report that the $32 billion accounting increase in Qwest's non-ILEC assets at the time of the U S WEST merger was grossly overstated. Consequently, Qwest's current management reversed the entire amount of goodwill on its balance sheet at December 31, 2002 (see Table 6, a copy of Qwest's 2002 consolidated balance sheet). Furthermore, Notes 3 and 4 in Qwest's 2002 Annual Report highlight numerous other accounting entries made by Qwest's former management that Qwest's current management considers to be inconsistent with Generally Accepted Accounting Principles ("GAAP"). (Copies of the restated balance sheets and Notes 3 and 4 which explain the restatements are provided in Attachment A.) As the report states in Note 3:

> We have determined that, in certain cases, we misinterpreted or misapplied GAAP in our 2001 and 2000 consolidated financial statements and, accordingly, we have restated our consolidated financial statements for each of the years in the two year period ended December 31, 2001 and related interim periods.

Thus, the dramatic increase in the percentage of Qwest's investment in non-ILEC assets reported by Dr. Selwyn and used in his studies is based on data that Qwest's current management itself has recognized to be inaccurate.

Table 6

QWEST COMMUNICATIONS INTERNATIONAL INC.
CONSOLIDATED BALANCE SHEETS
(Dollars in millions, shares in thousands)
As restated (see Notes 3 and 4)

December 31,	**2002**	**2001**	**2000**
ASSETS			
Current assets:			
Cash and cash equivalents. .	$ 2,253	$ 186	$ 207
Restricted cash .	26	29	63
Accounts receivable—net	2,325	2,906	3,165
Inventories	68	156	108
Deferred income taxes	898	417	294
Prepaid and other assets .	489	618	462
Assets held for sale	361	426	433
Total current assets	6,420	4,738	4,732
Property, plant and equipment—net	18,995	29,479	25,986
Goodwill—net .	**—**	**31,233**	**28,960**
Other intangible assets—net .	1,612	3,391	3,056
Investments .	23	1,233	8,147
Deferred income taxes . .	398	—	—
Other assets .	1,897	2,092	1,935
Total assets	**$ 29,345**	**$72,166**	**$72,816**
LIABILITIES AND STOCKHOLDERS' (DEFICIT) EQUITY			
Current liabilities:			
Current borrowings	$ 2,786	$ 4,807	$ 3,616
Accounts payable	904	1,318	1,887
Accrued expenses and other current liabilities .	2,008	2,520	2,711
Deferred revenue and customer deposits .	773	768	696
Restructuring reserves	104	363	—
Merger-related reserve	22	111	454
Liabilities associated with discontinued operations	298	336	332
Total current liabilities	6,895	10,223	9,696
Long-term borrowings (net of unamortized debt discount of $129, $209 and $196, respectively—See Note 11)	19,754	20,230	15,541
Post-retirement and other post-employment benefit obligations	3,075	2,974	2,992
Deferred income taxes . .	—	796	1,122
Deferred revenue .	957	1,092	945
Restructuring reserves . .	421	427	—
Other long-term liabilities .	1,073	995	953
Total liabilities . .	32,175	36,737	31,249
Share repurchase commitment (Note 16) ..	—	16	—
Commitments and contingencies (Notes 20 and 21)			
Stockholders' (deficit) equity:			
Preferred stock-$1.00 par value, 200 million shares authorized, none issued or Outstanding	—	—	—
Common stock-$0.01 par value, 5 billion shares authorized; 1,713,592, 1,687,957 and 1,672,018 issued; 1,699,115, 1,663,966 and 1,671,279 outstanding .	17	17	17
Additional paid-in capital	43,225	43,469	42,934
Treasury stock	(618)	(1,041)	(38)
Accumulated deficit	(45,439)	(6,971)	(1,285)
Accumulated other comprehensive loss	(15)	(61)	(61)
Total stockholders' (deficit) equity	(2,830)	35,413	41,567
Total liabilities and stockholders' (deficit) equity ..	**$ 29,345**	**$72,166**	**$72,816**

E. CONTRARY TO DR. SELWYN'S HYPOTHESIS, ONCE THE SBC AND QWEST DATA ARE CORRECTED, THE RBHCS' PERCENTAGE INVESTMENT IN NON-ILEC ASSETS DOES NOT INCREASE FROM 2000 TO 2003.

14. Again, the hypothesis of Dr. Selwyn's regression analysis is that the increase in the RBHCs' betas over the period 2000 to 2003 is caused by an increase in their investments in non-ILEC assets rather than by an increase in competition. For this hypothesis to be true, the RBHCs' percentages of investments in non-ILEC assets must actually have increased over the period 2000 to 2003. However, as shown in Table 7 below, once the data for SBC and Qwest are corrected, the percentages of the RBHCs' investments in non-ILEC assets are approximately the same in 2003 as in 2000.[6/] Since the percentage of investment in non-ILEC assets did not increase for any of the RBHCs, there is no foundation for Dr. Selwyn's hypothesis that the increase in the RBHCs' betas was caused by an increase in the RBHCs' investments in non-ILEC assets.

6/ See Footnote 3.

Table 7

RBHCs' Percent Non-ILEC Assets Have Not Increased Significantly

	BellSouth	Qwest	SBC	Verizon
Period	Non-ILEC	Non-ILEC	Non-ILEC	Non-ILEC
1H00	0.42	0.14	0.39	0.32
2H00	0.43		0.43	
1H01	0.42	0.69	0.43	
2H01	0.39	0.66	0.40	
1H02	0.39	0.66	0.40	
2H02	0.37	0.66	0.40	0.45
1H03	0.36	0.23	0.42	0.45
2H03		0.17		

F. DR. SELWYN FAILS TO RECOGNIZE THERE IS INSUFFICIENT DATA AVAILABLE TO DRAW RELIABLE CONCLUSIONS REGARDING THE CAUSE OF THE RBHCS' INCREASED BETAS.

15. In addition to the many data errors in Dr. Selwyn's revised regression analysis, his analysis is compromised by the fact that relevant data for his analysis are simply unavailable.[7/] Dr. Selwyn attempts to explain why the RBHCs' betas have increased over time. However, since betas are calculated using five years of historical data, a change in a single explanatory variable, such as competition, will not affect the RBHCs' betas for many periods. Furthermore, when investors consider the effect of competition on risk, they consider the expectation of *future* competition, not merely data on existing competition that excludes significant sources of existing competition, such

[7/] That Dr. Selwyn's revised regression analysis is plagued by too little data is also indicated by the fact that his regression analysis, which contains 12 explanatory variables, is based on only 22 observations. Once the incorrect Qwest data are removed, there are only 17 data observations to estimate the coefficients of 12 explanatory variables. Thus, there are only approximately 1 ½ data observations to determine each regression coefficient.

as competition from wireless, cable TV, and Internet providers. In addition, in a world of bundled telecommunications offerings, Dr. Selwyn's distinction between "ILEC" and "non-ILEC" services is artificial. From both the customers' and the companies' points of view, the telecommunications services offered by the former ILEC subsidiaries are interchangeable with the telecommunications services offered by their primary non-ILEC subsidiaries, namely, wireless. Given these basic problems with Dr. Selwyn's attempt to distinguish the causes of increases in RBHCs' betas, the Commission's best alternative is to take the RBHCs betas as they are, should it choose to use the CAPM model to estimate the cost of equity.

G. SUMMARY

16. In summary, Dr. Selwyn's revised regression analysis fails to correct for the deficiencies in his original analysis. Not only does he base his revised regression analysis on data that he created by extrapolation for SBC, but he continues to use incorrect data for Qwest in the first half of 2000, and he fails to recognize that the subsequent Qwest data in his analysis were totally distorted by incorrect and misleading accounting entries. The fact that the values of Qwest's "non-ILEC" assets were misstated over Dr. Selwyn's study period is not subject to dispute. Qwest's own current management has itself revised the accounting results for this period to reflect the gross accounting misstatements of prior management. Once the deficiencies in Dr. Selwyn's revised regression analysis are corrected, his conclusions no longer hold.

2002 Annual Report

Qwest®

Spirit of Service™

QWEST COMMUNICATIONS INTERNATIONAL INC.
CONSOLIDATED BALANCE SHEETS

	December 31, 2002	2001	2000
		As restated (see Notes 3 and 4)	
	(Dollars in millions, shares in thousands)		
ASSETS			
Current assets:			
Cash and cash equivalents	$ 2,253	$ 186	$ 207
Restricted cash	26	29	63
Accounts receivable—net	2,325	2,906	3,165
Inventories	68	156	108
Deferred income taxes	898	417	294
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Accrued expenses and other current liabilities	2,008	2,520	2,711
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Merger-related reserve	22	111	454
Liabilities associated with discontinued operations	298	336	332
Total current liabilities	6,895	10,223	9,696
Long-term borrowings (net of unamortized debt discount of $129, $209 and $196, respectively—See Note 11)	19,754	20,230	15,541
Post-retirement and other post-employment benefit obligations	3,075	2,974	2,992
Deferred income taxes	—	796	1,122
Deferred revenue	957	1,092	945
Restructuring reserves	421	427	—
Other long-term liabilities	1,073	995	953
Total liabilities	32,175	36,737	31,249
Share repurchase commitment (Note 16)	—	16	—
Commitments and contingencies (Notes 20 and 21)			
Stockholders' (deficit) equity:			
Preferred stock-$1.00 par value, 200 million shares authorized, none issued or outstanding	—	—	—
Common stock-$0.01 par value, 5 billion shares authorized; 1,713,592, 1,687,957 and 1,672,018 issued; 1,699,115, 1,663,966 and 1,671,279 outstanding	17	17	17
Additional paid-in capital	43,225	43,469	42,934
Treasury stock	(618)	(1,041)	(38)
Accumulated deficit	(45,439)	(6,971)	(1,285)
Accumulated other comprehensive loss	(15)	(61)	(61)
Total stockholders' (deficit) equity	(2,830)	35,413	41,567
Total liabilities and stockholders' (deficit) equity	$ 29,345	$72,166	$72,816

The accompanying notes are an integral part of these consolidated financial statements.

Note 3: Restatement of Results

We have determined that, in certain cases, we misinterpreted or misapplied GAAP in our 2001 and 2000 consolidated financial statements and, accordingly, we have restated our consolidated financial statements for each of the years in the two year period ended December 31, 2001 and related interim periods. We have also restated our January 1, 2000 opening retained earnings to correct our accounting for directory publishing services revenues and expenses, as further discussed below.

As discussed more fully below, the restatements involve, among other matters, revenue recognition issues related to optical capacity asset transactions, equipment sales, and directory publishing and purchase accounting. In making these restatements, we have performed an internal analysis of our accounting policies, practices, procedures and disclosures for the affected periods.

Please note that our consolidated financial statements do not include financial results of pre-Merger Qwest for any period prior to the June 30, 2000 merger. This is because U S WEST was deemed the acquirer in the Merger for financial statement accounting purposes. Pre-Merger transactions entered into by Qwest are not being restated, although certain of these transactions (principally the optical capacity asset transactions) may have been accounted for by pre-Merger Qwest under policies and practices similar to those for which post-Merger transactions are being restated.

Summary of restatement items

The following tables set forth the effects of the restatement adjustments discussed below on revenue; pre-tax loss (i.e., loss before income taxes, discontinued operations and cumulative effect of change of accounting principle); net loss; and loss per share as presented in our consolidated statements of operations for the years ended December 31, 2001 and 2000. The restatement adjustments are discussed in the paragraphs following the tables.

	Year ended December 31, 2001			
	Revenue	Pre-tax Loss	Net Loss	Loss per Share
	(Dollars in millions, except per share amounts)			
Previously reported	$19,695	$(3,958)	$(4,023)	$(2.42)
Restatement Adjustments, net:				
Transfers of optical capacity for cash	(339)	(163)	(100)	(0.06)
Contemporaneous transfers of optical capacity	(649)	(251)	(154)	(0.09)
Certain equipment sales	(202)	(58)	(36)	(0.02)
Directory publishing services revenues and costs	(78)	(78)	(48)	(0.03)
Termination fees	(75)	(75)	(46)	(0.03)
Wireless revenue	(46)	(46)	(28)	(0.02)
Customer premises equipment revenue	(31)	(6)	(3)	(0.00)
Balance sheet reconciliations	(29)	(145)	(89)	(0.05)
Installation fees	19	19	12	0.01
Purchase accounting	—	(347)	(222)	(0.13)
Restructuring accrual	—	(240)	(147)	(0.09)
Third-party telecommunications costs	—	(164)	(101)	(0.06)
Deferred commissions	—	(160)	(98)	(0.06)
KPNQwest valuation	—	(156)	(156)	(0.09)
Equipment write-offs	—	(111)	(68)	(0.04)
Network labor costs	—	(84)	(51)	(0.03)
Compensated absences	—	(73)	(44)	(0.03)
Out-of-period expenses	—	64	39	0.02
Cost of removal	—	(40)	(24)	(0.02)
Stock compensation	—	(28)	(17)	(0.01)
Investment in Qwest Digital Media	—	27	17	0.01
Curtailment gain	—	16	10	0.01
Other	(113)	(398)	(226)	(0.14)
Net restatements	(1,543)	(2,497)	(1,580)	(0.95)
As restated, before reclassifications of extraordinary item and discontinued operations	18,152	(6,455)	(5,603)	(3.37)
Reclassification of previously reported extraordinary item	—	(106)	—	—
As restated before reclassification of discontinued operations	18,152	(6,561)	(5,603)	(3.37)
Reclassification for discontinued operations (1)	(1,628)	(834)	—	—
As restated	$16,524	$(7,395)	$(5,603)	$(3.37)

(1) As further discussed in Note 8—Assets Held for Sale including Discontinued Operations, in 2002 we began reporting the operations of our directory publishing business as discontinued. However, certain of the restatement adjustments affect these operations. The reclassification is made to reconcile revenues and pre-tax loss as previously reported, which included our directory publishing business in continuing operations, to the "as restated" amounts under the current presentation.

	Year ended December 31, 2000			
	Revenue	Pre-tax Income (Loss)	Net Loss	Loss per Share
	(Dollars in millions, except per share amounts)			
Previously reported	$16,610	$ 126	$ (81)	$(0.06)
Restatement Adjustments, net:				
Transfers of optical capacity for cash	(150)	(106)	(65)	(0.05)
Contemporaneous transfers of optical capacity	(317)	(169)	(103)	(0.08)
Certain equipment sales	(111)	(83)	(51)	(0.04)
Directory publishing services revenues and costs	(57)	(31)	(19)	(0.02)
Termination fees	(50)	(50)	(30)	(0.02)
Wireless revenue	(57)	(57)	(34)	(0.03)
Balance sheet reconciliations	(48)	(72)	(65)	(0.05)
Installation fees	(90)	(90)	(96)	(0.08)
Purchase accounting	—	(263)	(166)	(0.13)
Equipment write-offs	—	(31)	(19)	(0.02)
Network labor costs	—	(100)	(61)	(0.05)
Compensated absences	—	(14)	(9)	(0.01)
Out-of-period expenses	—	(70)	(43)	(0.03)
Stock compensation	—	(109)	(67)	(0.05)
Investment in Qwest Digital Media	—	(27)	(17)	(0.01)
Curtailment gain	—	(106)	(65)	(0.05)
Other	(65)	(54)	(46)	(0.04)
Net restatements	(945)	(1,432)	(956)	(0.76)
As restated, before reclassification of discontinued operations	15,665	(1,306)	(1,037)	(0.82)
Reclassification for discontinued operations (1)	(1,517)	(728)	—	—
As restated	$14,148	$(2,034)	$(1,037)	$(0.82)

(1) As further discussed in Note 8—Assets Held for Sale including Discontinued Operations, in 2002 we began reporting the operations of our directory publishing business as discontinued. However, certain of the restatement adjustments affect these operations. The reclassification is made to reconcile revenues and pre-tax loss as previously reported, which included our directory publishing business in continuing operations, to the "as restated" amounts under the current presentation.

Transfers of optical capacity for cash

In 2001 and 2000, we engaged in transactions where we transferred the rights to use our optical capacity assets, also referred to as IRUs, on our network primarily to other telecommunications services providers. These IRU transactions involved specific channels on our "lit" network or specific strands of dark fiber. The terms of these IRUs were typically 20 years and reflected the estimated useful life of the optical capacity.

In our previously issued consolidated financial statements we recognized a substantial portion of the total consideration received for transfers of optical capacity for cash as revenue at the inception of the transaction. As part of our internal analysis of our accounting policies, practices and procedures in place in 2001 and 2000, we reviewed this previous accounting model for transfers of optical capacity for cash and concluded that we did not meet the criteria for up-front revenue recognition for sales-type leases under SFAS No. 13 "Accounting for Leases" ("SFAS No. 13"). Revenues related to our transfers of optical capacity assets for cash should have been recognized ratably over the terms of the agreements. Accordingly, we have restated our previously issued consolidated financial statements to defer the revenues on these transactions and recognize them ratably over the terms of the respective IRU arrangements.

We also determined that in certain cases we had recognized revenue from optical capacity cash transfers in the wrong period based on our prior accounting policies. These included instances in which the optical capacity assets had not been transferred at the time of the previously reported recognition of revenue. The restatement now reflects the recognition of the IRU fees beginning in the period the IRU was delivered and when all other criteria for revenue recognition had been satisfied. Also, in certain of these transactions, once a determination to restate was made for one reason, we did not continue to pursue whether there were other reasons for restatement.

In our restated consolidated financial statements we reduced our previously reported revenue by $339 million and $150 million for the years ended December 31, 2001 and 2000, respectively. These amounts reflect the reversal of sales-type lease revenue of $360 million and $151 million, offset by the ratable recognition of revenue of $21 million and $1 million for the years ended December 31, 2001 and 2000, respectively. We have also increased pre-tax loss by $163 million and $106 million in the years 2001 and 2000, respectively, which reflects the adjustment to reduce revenue, partially offset by adjustments to decrease the related cost of sales.

Contemporaneous transfers of optical capacity

In 2001 and 2000, we also engaged in transactions with other providers of telecommunications services to exchange optical capacity assets. We refer to these transactions herein as "contemporaneous transactions." In our previously issued consolidated financial statements, we recorded revenue on these transactions at the estimated fair value of the capacity transferred at the inception of the transaction. Our previous accounting policy was based on the conclusion that we were exchanging assets held for sale for assets to be held for use in the ordinary course of business, as allowed under APB Opinion No. 29, "Accounting for Nonmonetary Transactions" ("APB No. 29"), and related interpretive guidance.

We have since determined that the application of our prior policies and practices did not support a position under APB No. 29 because we did not adequately identify the assets or segregate the costs of capacity held for sale in our records. As a result, we concluded that we could not establish that our contemporaneous transactions were the culmination of an earnings process and determined that they should be recorded as exchanges of similar productive assets based on the carrying value of the optical capacity assets that we provided in the exchanges. Also, in certain of these transactions, once a determination to restate was made for one reason, we did not continue to pursue whether there were other reasons for restatement.

In our restated consolidated financial statements we have decreased our previously reported revenue by $649 million and $317 million for the years ended December 31, 2001 and 2000, respectively, to reflect the reversal of all revenue recognized on contemporaneous transfers of optical capacity assets. We have also increased our pre-tax loss by $251 million and $169 million for the years ended December 31, 2001 and 2000, respectively, which reflects the adjustment to reduce revenue, partially offset by adjustments to decrease the related cost of sales.

Certain equipment sales

Genuity—During the third quarter of 2000, we entered into an arrangement with Genuity in which we sold certain equipment to them for $100 million and agreed to provide services over a five-year period for $160 million on the basis that these were separate agreements. In the third quarter of 2000, we recorded revenue of $100 million and cost of sales of $21 million related to the equipment sale. Additional equipment costs of $7 million and $10 million were charged to cost of sales in the fourth quarter of 2000 and first quarter of 2001, respectively. We recognized revenue under the service contract of $31 million and $11 million in 2001 and 2000, respectively. As a result of our internal analysis, we now believe that the equipment sale should be considered part of a single arrangement to provide services to Genuity. We also determined that we improperly recognized revenue under the services agreement prior to Genuity's acceptance of the underlying equipment's performance. Genuity's acceptance did not occur until the third quarter of 2001. As a result, we have restated our 2001 and 2000 consolidated financial statements to reverse the previously recognized equipment and services revenue of $142 million. In our restated consolidated financial statements we are recognizing the $260 million arrangement fee as revenues ratably by site, over the five-year term of the arrangement beginning in the third quarter of 2001, which amounted to $1 million in 2001. Our restated consolidated financial statements also include adjustments to reverse the amounts of previously recognized cost of sales totaling $38 million. This amount has been reclassified to property, plant and equipment and is being depreciated over the five-year term of the agreement, including $3 million in 2001.

Arizona—In 2001, we received a purchase order for a maximum amount of $100 million from the Arizona School Facilities Board ("Arizona") for design and implementation of a statewide school network. During the second quarter of 2001, we recognized revenue of $36 million and cost of sales of $28 million related to certain equipment to be installed in connection with this arrangement. We subsequently determined that the equipment transaction had been incorrectly recorded as a "bill and hold" transaction because we had not received any payments for the equipment and there was no binding obligation to pay in 2001, despite documentation to the contrary. In the fourth quarter of 2001, we determined that the Arizona arrangement should have been accounted for using long-term contract accounting and we reversed all of the previously recognized revenue and cost of sales. As a result, in the fourth quarter of 2001, we began recognizing revenue and cost of sales using the percentage-of-completion method of accounting. In applying this method, an assumption was made that the total amount of revenue to be received upon contract completion would be substantially greater than the $100 million purchase order amount. We have reviewed this assumption during our internal analysis and found it to be incorrect. We also discovered additional errors related to the Arizona transaction in our previously issued consolidated financial statements resulting in misstatements of revenue and cost of sales in 2001. As a result, we have recorded net restatement adjustments that reduce previously reported 2001 revenue by $24 million and cost of sales by $1 million.

KMC and Calpoint—We entered into arrangements with KMC Telecom, Inc. ("KMC") during the first and second quarters of 2001. In these arrangements we sold equipment to KMC and at or about the same time agreed to purchase services from KMC over terms of approximately four years. In our previously issued consolidated financial statements we recorded equipment sales of $148 million and cost of sales of $67 million during the first and second quarters of 2001. In the fourth quarter of 2001, we determined that we could not separate the equipment sales from the service agreements because they were entered into in contemplation of each other. Accordingly, we recorded an entry in the fourth quarter of 2001 to increase cost of sales by $81 million and defer the previously recognized gross profit on the equipment.

In the third quarter of 2001, we entered into an equipment arrangement with Calpoint LLC ("Calpoint") and at the same time agreed to purchase services from Calpoint over a five-year term. We determined at the inception of the Calpoint arrangement that the equipment agreements did not represent a separate earnings process for which revenue could be recognized because it was entered into in contemplation of the services agreement. Accordingly, the excess of the sales proceeds of $298 million received from Calpoint over the cost of the equipment of $172 million was deferred. In our previously issued consolidated financial statements, the deferred gross profit on the KMC and Calpoint arrangements was being amortized ratably over the terms of the respective services agreement as a reduction to cost of sales.

In connection with the KMC and Calpoint arrangements discussed above, in order to assist KMC and Calpoint in obtaining financing, we also agreed to pay the monthly service fees directly to trustees that serve as paying agents on debt instruments for which special purpose entities sponsored by KMC and Calpoint are the primary obligors. These agreements ("consent agreements") require us to pay at least 75% of the monthly service fees for the entire term of the agreements, regardless of whether KMC or Calpoint provide us services. Subsequent to the Merger, we executed consent agreements for two service agreements that were entered into by pre-Merger Qwest. These consent agreements were not contemplated at the outset of these equipment sales and service agreements. Our aggregate unconditional purchase obligations under all of the consent agreements was $1.35 billion at December 31, 2001.

We have now concluded that the previous accounting for the KMC and Calpoint transactions was not in compliance with GAAP, and we have reversed the previously recorded revenues and cost of sales in our restated consolidated financial statements. For each KMC and Calpoint transaction, we now believe that the aggregate cash received plus any outstanding receivable less our cost to acquire the equipment sold should be deferred until such time as our aggregate commitment to make payments of up to 75% of the service fee under the consent agreements is equal to or less than the total amount deferred. We will begin to amortize the deferred credit to cost of sales in an amount equal to the periodic reduction of our obligation under the consent agreements at that time. As a result, we have reversed $12 million of amortization of the deferred gross profit that was recognized in 2001.

The adjustments recorded in our restated consolidated financial statements related to certain equipment transactions with Genuity, Arizona, KMC and Calpoint, as discussed above, resulted in an aggregate decrease in previously reported revenue of $202 million and $111 million for the years ended December 31, 2001 and 2000, respectively. These adjustments also increased our pre-tax loss by $58 million and $83 million for the years ended December 31, 2001 and 2000, respectively.

Directory publishing services revenues and costs

Prior to 1999, we recognized revenues and expenses for our directory publishing business, Qwest Dex, Inc. ("Dex"), under the "deferral and amortization method" whereby revenues and expenses were recognized over the lives of the directories, generally one year. In 1999, we changed to the "point of publication method" of accounting, under which we recognized revenues and expenses at the time the related directory was published. Based on (1) our review of the policy, and (2) the interpretive guidance the Securities and Exchange Commission ("SEC") staff issued in 1999 in SAB No. 101, we determined that our change to the point of publication method for our directory publishing business was not a change to an appropriate or preferable method of accounting, pursuant to APB Opinion No. 20, "Accounting Changes." Instead, we believe the "deferral and amortization method" is appropriate under our circumstances because we have a continuing obligation to our advertisers to maintain the directory in circulation over its life and under our customer agreements, we have the discretion to change the publication dates for the directories.

As a result, in our restated consolidated financial statements we have reduced our previously reported directory publishing services revenue by $78 million and $57 million for the years ended December 31, 2001 and 2000, respectively. These restatements also increased our pre-tax loss by $78 million and $31 million for the years ended December 31, 2001 and 2000, respectively.

In addition, we restated our opening retained earnings balance as of January 1, 2000 to recognize the effect of restating directory publishing services revenues and expenses for the year ended December 31, 1999 to the deferral and amortization method. The cumulative adjustment to opening retained earnings on January 1, 2000 was $353 million, net of the income tax effect of $226 million.

As discussed in Note 8—Assets Held for Sale including Discontinued Operations and Note 21—Subsequent Events, our directory publishing business has been sold and is reported as a discontinued operation in these consolidated financial statements. The impact of the restatement adjustments discussed above is included in income from discontinued operations in the consolidated statements of operations.

Termination fees

In 2001, we recognized revenue related to contractual termination fees that were assessed to several customers. At or about the same time, we entered into new arrangements with these customers to provide services in the future. In connection with our internal analysis, we have determined that the revenues recognized in these instances should have been deferred and recognized as revenue ratably over the term of the new arrangements.

In our restated consolidated financial statements, we have reduced our previously reported revenue and increased our pre-tax net loss by $75 million and $50 million for the years ended December 31, 2001 and 2000, respectively.

Wireless revenue

In our previously issued consolidated financial statements, we erroneously recognized revenue associated with products that were given away through promotions in our wireless business. We also erroneously recognized excess revenue as a result of not reconciling or adjusting our estimates of unbilled and deferred service revenues.

In our restated consolidated financial statements, we have reduced our previously reported wireless revenues and increased our pre-tax loss by $46 million and $57 million for the years ended December 31, 2001 and 2000, respectively.

Customer premise equipment ("CPE") revenue

In 2001, we recorded revenue and related costs for certain sales of CPE based upon the project's scheduled completion date, instead of the actual date of completion of the project. As part of our restatement, we have corrected these errors and have recognized revenue and costs in the periods in which all revenue recognition criteria were met. In our restated consolidated financial statements, we have reduced our previously reported revenues by $31 million and increased our pre-tax loss by $6 million for the year ended December 31, 2001.

Balance sheet reconciliations

During our internal analysis, we were unable to support the balances of certain asset and liability accounts through the reconciliation process that we performed. As a result, we have adjusted certain balance sheet accounts resulting in an aggregate decrease in previously reported revenue of $29 million and $48 million for the years ended December 31, 2001 and 2000, respectively. The adjustments also increased our previously reported pre-tax loss by $145 million and $72 million for the years ended December 31, 2001 and 2000, respectively.

Installation fees

In 2001 and 2000, we recognized revenue for certain up-front fees charged to customers in connection with special plant construction or relocation. These fees were recognized as revenue in full at the time the construction or relocation was completed. Under SAB No. 101, these fees should have been initially deferred and recognized over the estimated life of the customer relationship.

In our restated consolidated financial statements, we have increased our previously reported revenues by $19 million and decreased previously reported revenues by $90 million for the years ended December 31, 2001 and 2000, respectively, resulting in a decrease in our pre-tax loss for 2001 and an increase in our pre-tax loss for 2000 of corresponding amounts. In addition, as a result of this change, our restated net loss for the year ended December 31, 2000 includes a $41 million charge, net of the income tax effect of $26 million, presented as the cumulative effect of change in accounting principle resulting from the adoption of SAB No. 101.

Purchase accounting

As described more fully in Note 4—Merger, we found several errors in the application of purchase accounting for the June 30, 2000 Merger and have recorded adjustments to correct those errors in our restated consolidated financial statements. Additional adjustments to the results of our operations subsequent to the Merger in 2000 and 2001 were also required as a result of adjustments to the post-Merger opening balances. Those adjustments that had a significant impact on our post-Merger operating results are described in the following paragraphs.

Intangible assets. We recorded restatement adjustments to the amounts allocated to the customer lists and technology-in-place intangible assets acquired in the Merger. We also revised the estimated lives that had been originally assigned to these assets. These changes resulted in adjustments to the amortization of those assets. The effect of the adjustments to intangible assets was a reduction of amortization expense of $31 million and $15 million in 2001 and 2000, respectively.

Tangible assets. As a result of restatement adjustments to increase the amount allocated to property, plant and equipment, adjustments were required to increase depreciation expense by $86 million and $40 million in 2001 and 2000, respectively.

Investments. As a result of restatement adjustments to increase the amount allocated to investments, adjustments to subsequent write-downs and gains and losses on sales of investments were required. As a result of the adjustments to investments, we recorded adjustments to increase the loss on sale of investments and other investment write-downs by $27 million in 2001 and to reduce the gain by $71 million in 2000.

Liabilities. As a result of restatement adjustments that reduced the amounts allocated to certain liabilities primarily related to amounts that we inappropriately accounted for as unfavorable contracts at the Merger date, related adjustments were required to correct our consolidated statements of operations in periods subsequent to the Merger. These adjustments to liabilities increased operating expenses by $249 million and $155 million in 2001 and 2000, respectively.

Goodwill. The amount allocated to goodwill was affected as a result of each of the purchase accounting allocation adjustments discussed in the paragraphs above. Goodwill also was affected as a result of an adjustment that increased the amount of consideration paid in the Merger. The net of these adjustments was an increase of $1.634 billion in the amount allocated to goodwill. These adjustments necessitated an adjustment to goodwill amortization. As part of our internal analysis, we corrected the timing of certain previously recorded amortization adjustments. The result of these changes was a net increase in goodwill amortization expense of $16 million and $12 million in 2001 and 2000, respectively.

Restructuring accrual

In our previously issued consolidated financial statements we recorded restructuring expenses in the fourth quarter of 2001 in connection with our permanent abandonment of certain leased real estate facilities. We have determined that we misinterpreted applicable accounting guidance, including EITF Issue No. 94-3, SAB No. 100, "Restructuring Charges," and EITF Issue No. 88-10, "Costs Associated with Lease Modification or Termination," as they relate to leased facilities and excluded certain items that should have been included in the restructuring charges. As a result, we have increased our previously reported pre-tax loss by $240 million for the year ended December 31, 2001.

Third-party telecommunications costs

During 2001, we received and paid for services from third-party telecommunications providers but did not properly record the cost associated with such services in our cost of sales. As a result, we have increased our pre-tax loss by $164 million in the year ended December 31, 2001.

Deferred commissions

In 2001, we erroneously began to defer certain commissions paid to internal and external agents related to contract sales to business customers and amortize over the average term of the related contracts. As a result, in our restated consolidated financial statements we have increased our previously reported pre-tax loss by $160 million in the year ended December 31, 2001.

KPNQwest valuation

In our original December 31, 2001 assessment of the carrying value of our investment in KPNQwest, we concluded that an other-than-temporary decline in value had not occurred as of December 31, 2001. We, therefore, did not adjust the carrying value of our investment at that date. In our internal analysis, we reconsidered the information that was available at the time we originally issued our 2001 consolidated financial statements and determined that our prior assessment did not fully recognize the impact of certain restrictions on our ability to receive market value for our shares. Applying those factors, we determined the estimated fair value of the KPNQwest investment had remained below its carrying value for an extended period of time, indicating that there had been an other-than-temporary decline in value. Accordingly, we have recorded an adjustment in our restated consolidated financial statements to write-down the value of the KPNQwest investment by $156 million to reflect its estimated fair value of $1.15 billion at December 31, 2001. This resulted in an increase of $156 million to our pre-tax loss for the year ended December 31, 2001. See further discussion in Note 10—Investments.

Equipment write-offs

Included in our previously issued 2001 consolidated financial statements was certain capitalized equipment with a carrying value of $142 million. During our internal analysis we determined that this cost should have been expensed during 2001 and 2000. Accordingly, we have increased our previously reported pre-tax loss by $111 million and $31 million for the years ended December 31, 2001 and 2000, respectively.

Network labor costs

In 2000, we began capitalizing certain labor costs that were associated with designing, deploying and testing facilities. During our internal analysis, we determined that certain of these costs should have been expensed as incurred. As a result, in our restated consolidated financial statements we have recorded adjustments to increase operating expenses and decrease net property, plant and equipment by $84 million and $100 million for the years ended December 31, 2001 and 2000, respectively.

Compensated absences

During 2001 and 2000, we recorded entries that reduced our liabilities for compensated absences associated with non-management employees. We have since determined that these adjustments were not in compliance with SFAS No. 43, "Accounting for Compensated Absences." As a result, we have increased our previously reported pre-tax loss by $73 million and $14 million for the years ended December 31, 2001 and 2000, respectively.

Out-of-period expenses

We recorded certain charges in 2001 and 2000 as expenses for contractual sponsorships, service contracts, fines and other costs. We have since determined that we recorded these charges in the wrong period. As a result, in our restated consolidated financial statements, we have decreased our previously reported pre-tax loss by $64 million in 2001 and increased our previously reported loss by $70 million in 2000.

Cost of removal

In 2001, we recorded costs associated with the reconditioning of certain cable lines against the cost of removal reserve. This reserve is a component of accumulated depreciation that was established specifically for costs of removal related to portions of our telecommunications network. During our internal analysis, we determined that these reconditioning costs were not costs of removal and should not have been recorded against the reserve in accumulated depreciation. As a result, in our restated consolidated financial statements we have increased our previously reported pre-tax loss by $40 million for the year ended December 31, 2001.

Stock compensation

During 2001 and 2000, the terms of certain outstanding stock options were modified to allow the extension of the exercise period upon the employee's separation from the Company. In our previously issued consolidated financial statements, we did not record compensation expense in connection with these modifications or with regard to certain other awards where the fair value of the underlying stock at the measurement date was greater than the strike price of the award. As part of our internal analysis, we determined that compensation expense should have been recorded for these matters in accordance with APB Opinion No. 25, "Accounting for Stock Issued to Employees," and FIN No. 44, "Accounting for Certain Transactions involving Stock Compensation" (an interpretation of APB Opinion No. 25). As a result, in our restated consolidated financial statements we have increased our previously reported pre-tax loss by $28 million and $109 million for the years ended December 31, 2001 and 2000, respectively.

Investment in Qwest Digital Media

We account for our investment in Qwest Digital Media ("QDM") under the equity method of accounting. An error was made in calculating our share of the QDM loss in 2000. In our previously issued consolidated financial statements, this error was identified and corrected in our 2001 reported results. In our restated consolidated financial statements we have recorded an adjustment to make the correction in the appropriate year. Accordingly, we have decreased our previously reported pre-tax loss by $27 million in 2001 and increased our previously reported pre-tax loss by $27 million in 2000.

Curtailment gain

During the third quarter of 2000, and in conjunction with the Merger, we changed certain post-retirement benefits as discussed in Note 14—Employee Benefits. The reduction in the accumulated post-retirement benefit obligation was originally accounted for as a plan curtailment, resulting in a one-time gain in our previously issued consolidated financial statements. Based on our internal analysis, and in consideration of SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions" ("SFAS No. 106") and the FASB Staff Implementation Guide for SFAS No. 106, we determined that the elimination of benefits should have been recorded as a negative plan amendment. Negative plan amendments are amortized as a reduction of benefit expense over the expected remaining service period or life expectancy of the participants, as appropriate, or approximately seven years in our case. As a result, in our restated consolidated financial statements we have decreased our previously reported pre-tax loss by $16 million in 2001 and increased our previously reported pre-tax loss by $106 million in 2000.

Other

We reduced our previously reported revenue by $113 million and $65 million and increased our pre-tax loss by $398 million and $54 million for the years ended December 31, 2001 and 2000, respectively, for other errors discovered as a result of our internal analysis. These adjustments have been aggregated in this presentation. The individual adjustments ranged from $100,000 to $27 million for revenues and from $100,000 to $34 million for pre-tax loss in the periods presented and had an average impact of $7 million, to each of revenues and pre-tax loss.

Balance sheet impacts

In addition to the effects on our 2001 and 2000 consolidated statements of operations discussed above, the restatement affected our consolidated balance sheets as of December 31, 2001 and 2000 and our opening retained earnings as of January 1, 2000. The following tables set forth the effects of our restatement adjustments on our condensed 2001 and 2000 consolidated balance sheets:

	Previously Reported	Adjustments for Discontinued Operations	Increase/ (Decrease)	As Restated
		(Dollars in millions)		
As of December 31, 2001:				
Assets:				
Total current assets	$ 5,757	$ —	$(1,019)	$ 4,738
Property, plant and equipment, net	29,977	(220)	(278)	29,479
Goodwill and other intangible assets, net	34,523	—	101	34,624
Other assets	3,524	220	(419)	3,325
Total assets	$73,781	$ —	$(1,615)	$72,166
Liabilities and stockholders' equity:				
Total current liabilities	$ 9,989	$ —	$ 234	$10,223
Long-term borrowings	20,197	—	33	20,230
Deferred income taxes and other liabilities	6,940	—	(656)	6,284
Total liabilities	37,126	—	(389)	36,737
Share repurchase commitment	—	—	16	16
Total stockholders' equity	36,655	—	(1,242)	35,413
Total liabilities and stockholders' equity	$73,781	$ —	$(1,615)	$72,166

	Previously Reported	Adjustments for Discontinued Operations	Increase/ (Decrease)	As Restated
		(Dollars in millions)		
As of December 31, 2000:				
Assets:				
Total current assets	$ 5,199	$ —	$ (467)	$ 4,732
Property, plant and equipment, net	25,760	(212)	438	25,986
Goodwill and other intangible assets, net	32,327	—	(311)	32,016
Other assets	10,215	212	(345)	10,082
Total assets	$73,501	$ —	$ (685)	$72,816
Liabilities and stockholders' equity:				
Total current liabilities	$ 9,676	$ —	$ 20	$ 9,696
Long-term borrowings	15,421	—	120	15,541
Deferred income taxes and other liabilities	7,100	—	(1,088)	6,012
Total liabilities	32,197	—	(948)	31,249
Share repurchase commitment	—	—	—	—
Total stockholders' equity	41,304	—	263	41,567
Total liabilities and stockholders' equity	$73,501	$ —	$ (685)	$72,816

Stockholders' equity has been restated for items other than the adjustments to net loss discussed in the summary of restatement items section above. Among other restatements, it has also been restated for adjustments to purchase accounting, as discussed in Note 4—Merger, and for an adjustment to recognize an obligation to repurchase stock from BellSouth, as discussed in Note 16—Stockholders' Equity. A reconciliation of stockholders' equity between "Previously Reported" and "As Restated" is as follows:

	December 31, 2001	December 31, 2000
	(Dollars in millions)	
Stockholders' equity, as previously reported	$36,655	$41,304
Cumulative effect of restatement adjustments on net loss	(2,536)	(956)
Dex adjustment to opening retained earnings	(353)	(353)
Adjustment to purchase price of Merger for stock options (Note 4—Merger)	1,438	1,438
Cumulative stock compensation adjustments (Note 3—Restatement of Results)	137	109
BellSouth share repurchase obligation (Note 16—Stockholders' Equity)	(16)	—
BellSouth sales discount amortization (Note 16—Stockholders' Equity)	38	—
Rabbi trust share repurchase (Note 16—Stockholders' Equity)	—	(38)
Other comprehensive income	(27)	(42)
Other stock-based expenses (Note 16—Stockholders' Equity)	35	48
Purchase accounting adjustments (Note 4—Merger)	33	11
Other consolidation and reconciliation adjustments	9	46
Stockholders' equity, as restated	$35,413	$41,567

Note 4: Merger

On June 30, 2000, Qwest completed its acquisition of U S WEST. U S WEST was deemed the accounting acquirer and its historical financial statements, including those of its wholly owned subsidiaries, have been carried forward as those of the combined company. In connection with the Merger, each outstanding share of U S WEST common stock was converted into the right to receive 1.72932 shares of Qwest common stock (and cash in lieu of fractional shares). In addition, all outstanding U S WEST stock options were converted into options to acquire Qwest common stock. All share and per share amounts presented for 2000 have been restated to give retroactive effect to the exchange ratio.

The Merger has been accounted for as a reverse acquisition under the purchase method of accounting with U S WEST being deemed the accounting acquirer and Qwest (prior to the Merger "pre-Merger Qwest") the acquired entity. The total value of the consideration has been allocated to the tangible and identifiable intangible assets and liabilities of pre-Merger Qwest. As disclosed in our previously issued consolidated financial statements, a preliminary allocation of the purchase price was made at June 30, 2000 to certain identified tangible and intangible assets and liabilities based upon information available to management at that date. During the second quarter of 2001, we finalized the original allocation of the purchase price to the acquired net assets of pre-Merger Qwest. In connection with our internal analysis of our previously issued consolidated financial statements (see Note 3— Restatement of Results), we found several errors related to the amount of the purchase price itself, the preliminary purchase price allocation and the adjustments to the preliminary allocation to finalize it. The purchase price allocation and related adjustments are summarized in the table below.

	Previously Reported			As Restated	
	Preliminary Purchase Price Allocation	Adjustments	Adjusted Purchase Price Allocation	Restatement Adjustments	Purchase Price Allocation, As restated
	(Dollars in millions)				
Identified intangible assets	$ 4,100	$ —	$ 4,100	$(1,853)	$ 2,247
Investment in KPNQwest, N.V	7,935	(3,180)	4,755	—	4,755
Tangible assets	7,868	(38)	7,830	841	8,671
Liabilities	(7,135)	575	(6,560)	587	(5,973)
Deferred income taxes	(671)	(208)	(879)	229	(650)
Goodwill	27,923	2,851	30,774	1,634	32,408
Purchase price	$40,020	$ —	$40,020	$ 1,438	$41,458

Purchase price. Our original determination of the preliminary purchase price of $40.020 billion reflected 772 million shares of our stock with a fair market value of $38.616 billion and outstanding stock options with an estimated fair value of $1.404 billion. In connection with our internal analysis, we determined that the previously reported fair value of outstanding stock options omitted certain outstanding warrants and stock options (principally unvested employee stock options) and reflected certain inappropriate valuation assumptions. Our restated consolidated financial statements include adjustments totaling $1.438 billion, which increases the total purchase price to $41.458 billion.

Intangible assets. In our original purchase price allocation, we identified a number of intangible assets including: (a) customer lists with a value ascribed of $1.200 billion, (b) technology-in-place with a value ascribed of $2.200 billion, (c) trademarks with a value ascribed of $600 million and (d) an established workforce with a value ascribed of $100 million. In connection with our internal analysis, we reevaluated the value assigned to each of these acquired identifiable intangible assets and concluded that the amounts allocated to customer lists and technology-in-place did not represent their fair values at the date of the Merger. Our reevaluation of the fair values of these intangible assets was done using information that was available at the time the original purchase price allocation was finalized. As a result, we have recorded adjustments to the amounts allocated to customer lists and technology-in-place in our restated consolidated financial statements. These adjustments resulted in a $347 million increase in the value ascribed to customer lists and a decrease in the value ascribed to technology-in-place at the acquisition date of approximately $2.2 billion. We also determined, in connection with our internal analysis, that the previously selected estimated life of ten years for customer lists was not reasonable under the circumstances and thus, was changed to five years. Accordingly, in our restated consolidated financial statements we have decreased amortization expense by $31 million and $15 million for the years ended December 31, 2001 and 2000, respectively, to reflect the fair value adjustments and the change in estimated life.

Investment in KPNQwest, N.V. Pre-Merger Qwest's investment in KPNQwest had a book value of approximately $552 million. On June 30, 2000, our preliminary estimate of the value of the investment in KPNQwest was $7.935 billion, which was based upon the closing price of $39.625 of KPNQwest's publicly traded Class C shares on that date. The Class C shares comprised approximately 11% of the equity ownership of KPNQwest. Our ownership interest in KPNQwest was held in Class B shares, which, as of the acquisition date, were subject to restrictions on marketability through 2004. Because of the size of our ownership interest in KPNQwest and the fact that the shares we held were subject to a number of restrictions, the fair value of our investment was determined in June 2001 to be $4.755 billion. We then recorded an adjustment of $3.180 billion to reduce the amount of the purchase price allocated to our investment in KPNQwest. This adjustment also increased goodwill by a corresponding amount. This revised amount allocated to KPNQwest was not affected by our internal analysis or the restatement process. See discussion at Note 10—Investments.

Tangible assets. Pre-Merger Qwest had tangible assets with a book value of approximately $9.148 billion. Included in these assets were cash of $407 million, accounts receivable of $1.372 billion, other assets of $1.386 billion and property, plant and equipment of $5.983 billion, which consisted mainly of pre-Merger Qwest's fiber optic broadband network. In our original allocation of the purchase price, the book values of these assets were adjusted to our initial estimate of fair value. The most significant adjustment was to reduce the carrying value of the fiber optic broadband network by approximately $1.145 billion based on our initial estimate of replacement cost. We also reduced the carrying amounts of accounts receivable and other assets by a total of $135 million. In finalizing the purchase price in 2001, the value of the fiber optic broadband network was increased by $25 million and the value of the accounts receivable and other assets reduced by an additional $63 million.

In connection with our internal analysis, we reevaluated the replacement cost of the fiber optic broadband network using information that was available at the time the original allocation was done and estimated that the replacement cost of the fiber optic broadband network at the Merger date was approximately $5.760 billion. As a result, we have adjusted the purchase price allocation in our restated consolidated financial statements to reflect a $897 million increase in the value of the acquired property, plant and equipment at June 30, 2000. In addition, as part of our internal analysis we also reduced the carrying value of accounts receivable and other assets by a total of $56 million.

Liabilities. Pre-Merger Qwest had debt with a book value of $4.560 billion and accounts payable and accrued liabilities with a book value of $1.459 billion. We made adjustments in the initial purchase price allocation to increase these liabilities by $1.116 billion, primarily to reflect the fair value of certain unfavorable contractual commitments that were inappropriately recognized at the date of the Merger. These liabilities were subsequently reduced by $575 million in 2001 in the course of finalizing our purchase price allocation. In connection with our internal analysis, we reconsidered the amounts determined as unfavorable contractual commitments and certain other accrued expenses. Our analysis indicated that credits and certain accrued expenses totaling $587 million established in connection with the Merger were not appropriate. Accordingly, in our restated consolidated financial statements we have reduced the amount attributed to unfavorable contract credits by $587 million.

Deferred income taxes. The $208 million adjustment made to deferred income taxes in finalizing the purchase price allocation resulted from adjustments to pre-Merger Qwest's tangible assets and liabilities. As a result of our internal analysis, the net deferred income tax liabilities recorded in the purchase price allocation have been reduced by $229 million to give effect to the expected future tax consequences resulting from the restatement adjustments to the values of the acquired assets and liabilities.

Goodwill. As a result of the finalization of the allocation of the purchase price in 2001, goodwill was adjusted. As part of our internal analysis as discussed above, we made adjustments to that final allocation. The aggregate impact of the restatement adjustments on goodwill was $1.634 billion.

The final restated allocation of the purchase price resulted in goodwill of $32.408 billion. Adjustments were also made to amortize this goodwill on a straight-line basis over a 40-year life. Amortization was recorded through December 31, 2001. Beginning January 1, 2002, in accordance with the adoption of SFAS No. 142, we ceased amortization of goodwill and other intangible assets with indefinite lives. See discussion at Note 7—Goodwill and Other Intangible Assets.

Note 5: Accounts Receivable

The following table presents a breakdown of our accounts receivable balances:

	December 31,		
	2002	2001	2000
		(As restated, see Note 3)	
	(Dollars in millions)		
Trade receivables	$2,133	$2,572	$2,146
Earned and unbilled receivables	353	376	414
Purchased receivables	104	148	213
Other	95	212	697
Total accounts receivable	2,685	3,308	3,470
Less: Allowance for bad debts	(360)	(402)	(305)
Accounts receivable—net	$2,325	$2,906	$3,165

The fair value of accounts receivable balances approximates their carrying value because of their short-term nature. We are exposed to concentrations of credit risk from customers within our local service area and from other telecommunications service providers. We generally do not require collateral to secure our receivable balances.

We have agreements with other telecommunications service providers whereby we agree to bill and collect on their behalf for services rendered by those providers to our customers within our local service area. We purchase these accounts receivable from the other telecommunications service providers on a full-recourse basis and include these amounts in our accounts receivable balance. Purchased receivables included in our accounts receivable balances were $104 million, $148 million and $213 million at December 31, 2002, 2001 and 2000, respectively. We have not experienced any significant losses under the recourse provisions related to these purchased receivables.

In addition, we also have billing and collection arrangements with other telecommunications service providers for certain services we provide to our customers outside our local service area. While these amounts are billed by the other telecommunications service providers on our behalf, we continue to include the receivables in our accounts receivable balances due to the full-recourse provisions of the billing and collection agreements.

Note 6: Property, Plant and Equipment

The components of property, plant and equipment are as follows:

	Depreciable Lives	December 31, 2002	2001	2000
			(As restated, see Note 3)	
		(Dollars in millions)		
Land		$ 116	$ 105	$ 103
Buildings	30-38 years	3,524	4,706	3,269
Communications equipment	2-25 years	18,948	21,941	17,491
Other network equipment	8-57 years	18,635	22,941	20,603
General purpose computers and other	3-11 years	3,007	3,530	3,554
Construction in progress	—	350	1,214	3,380
		44,580	54,437	48,400
Less: accumulated depreciation		(25,585)	(24,958)	(22,414)
Property, plant and equipment—net		$ 18,995	$ 29,479	$ 25,986

Asset impairments

A summary of asset impairments recognized is as follows:

	Year ended December 31, 2002	2001	2000
		(As restated, see Note 3)	
	(Dollars in millions)		
Impairment of property, plant and equipment	$10,493	$ —	$ —
Facilities and other projects	—	134	—
Other real estate assets	28	—	—
Impairment due to Merger	—	16	35
Special purpose access lines	—	—	191
Capitalized software due to restructuring activities (Note 7—Goodwill and Other Intangible Assets)	4	68	—
Capitalized software due to Merger (Note 7—Goodwill and Other Intangible Assets)	—	33	114
Total asset impairments	$10,525	$251	$340

Effective June 30, 2002, pursuant to SFAS No. 144, a general deterioration of the telecommunications market, downward revisions to our expected future results of operations and other factors indicated that our investments in long-lived assets may have been impaired at that date. In accordance with SFAS No. 144 we performed an evaluation of the recoverability of the carrying value of our long-lived assets using gross undiscounted cash flow projections. For impairment analysis purposes, we grouped our property, plant and equipment and projected cash flows as follows: traditional telephone network, national fiber optic broadband network, international fiber optic broadband network, wireless network, web hosting and Application Service Provider ("ASP"), assets held for sale and out-of-region Digital Subscriber Line ("DSL"). Based on the gross undiscounted cash flow projections, we determined that all of our asset groups, except our traditional telephone network, were impaired at June 30, 2002. For those asset groups that were impaired, we then estimated the fair value using a variety of techniques, which are presented in the table below. For those asset groups that were impaired, we determined that the fair values were less than our carrying amount by

$10.613 billion in the aggregate of which $120 million has been reclassified to income from and gain on sale of discontinued operations for certain web hosting centers in our consolidated statements of operations at December 31, 2002.

Asset Group	Impairment Charge (Dollars in millions)	Fair Value Methodology
National fiber optic broadband network	$ 8,505	Discounted cash flows
International fiber optic broadband network	685	Comparable market data
Wireless network	825	Comparable market data and discounted cash flows
Web hosting and ASP assets	88	Comparable market data
Assets held for sale	348	Comparable market data
Out-of-region DSL	42	Discounted cash flows
Total impairment charges	$10,493	

Calculating the estimated fair value of the asset groups as listed above involves significant judgments and a variety of assumptions. For calculating fair value based on discounted cash flows, we forecasted future operating results and future cash flows, which included long-term forecasts of revenue growth, gross margins and capital expenditures. We also used a discount rate based on an estimate of the weighted average cost of capital for the specific asset groups. Comparable market data was obtained by reviewing recent sales of similar asset types in third-party market transactions.

A brief description of the underlying business purpose of each of the asset groups that were impaired as a result of our analysis as of June 30, 2002 is as follows:

- Our national fiber optic broadband network ("National Network") provides long-distance voice services, data and Internet services, and wholesale services to business, residential and wholesale customers outside of our local service area.
- Our international fiber optic broadband network ("International Network") provides the same services to the same types of customers, only outside of the United States.
- Our wireless network provides Personal Communications Service ("PCS") in select markets in our local service area.
- Our web hosting and ASP assets provide business customers shared and dedicated hosting on our servers as well as application hosting services to help design and manage customers' websites and hosting applications.
- Assets held for sale primarily consist of excess network supplies. See Note 8—Assets Held for Sale including Discontinued Operations for further information.
- Our out-of-region DSL assets provide DSL service to customers outside our local service area.

In accordance with SFAS No. 144, the fair value of the impaired assets becomes the new basis for accounting purposes. As such, approximately $1.9 billion in accumulated depreciation was eliminated in connection with the accounting for the impairments. The impact of the impairments will reduce our annual depreciation and amortization expense by approximately $1.3 billion, effective July 1, 2002.

Other asset impairments

In 2002, we recorded other asset impairment charges of $28 million associated with the write-down of other real estate assets that were held for sale.

As part of our restructuring activities in 2001, we reviewed our existing construction projects. As a result of this review, we recorded an asset impairment charge of $134 million for the abandonment of web hosting centers and other internal use construction projects.

Subsequent to the Merger, we reevaluated all of our assets for potential impairment and, in certain instances, we concluded that the fair value of some of our assets were below their carrying value. As a result, we recorded impairment charges in 2001 and 2000 of $16 million and $35 million, respectively, writing off the full carrying value of certain internal use construction projects and equipment.

Also, in connection with the Merger, we evaluated our dedicated special-purpose access lines that we lease to Competitive Local Exchange Carriers ("CLECs") for potential impairment. After considering the declining industry conditions and regulatory changes affecting CLECs in 2000, as well as the fact that these access lines had no alternative use and could not be sold or re-deployed, we concluded that sufficient net cash flows would not be generated to recover the carrying value of these assets. Therefore, we concluded that the fair value of these assets was minimal and we recorded an impairment charge of $191 million in our 2000 consolidated statement of operations.

Note 7: Goodwill and Other Intangible Assets

A summary of the changes in the carrying amount of our goodwill during the year ended December 31, 2002 is as follows. All of the goodwill relates to our wireline segment.

	(Dollars in millions)
Balance as of December 31, 2001 (as restated, see Notes 3 and 4)	$ 31,233
Reclassification of assembled workforce	50
Cumulative effect of adoption of SFAS No. 142	(22,800)
Goodwill impairment charges under SFAS No. 142	(8,483)
Balance as of December 31, 2002	$ —

The components of goodwill and other intangible assets are as follows:

	Life Prior to Adoption of SFAS No. 142	December 31, 2002 Carrying Cost	2002 Accumulated Amortization	2001 Carrying Cost (As restated, see Note 3)	2001 Accumulated Amortization (As restated, see Note 3)	2000 Carrying Cost (As restated, see Note 3)	2000 Accumulated Amortization (As restated, see Note 3)
		(Dollars in millions)					
Intangibles with indefinite lives:							
Goodwill	40 years	$ —	$ —	$32,408	$(1,175)	$29,338	$(378)
Other	3-40 years	146	—	817	(80)	801	(30)
Total intangibles with indefinite lives		146	—	33,225	(1,255)	30,139	(408)
Intangibles with finite lives:							
Capitalized software	5 years	2,032	(577)	1,910	(341)	1,163	(272)
Customer lists and other	5 years	33	(22)	1,549	(464)	1,549	(155)
Total intangibles with finite lives		2,065	(599)	3,459	(805)	2,712	(427)
Total goodwill and intangible assets		$2,211	$(599)	$36,684	$(2,060)	$32,851	$(835)

We recorded amortization expense of $579 million in 2002 for intangibles with finite lives. Based on the current amount of intangible assets subject to amortization, the estimated amortization for each of the succeeding 5 years is as follows:

	(Dollars in millions)
2003	$ 429
2004	400
2005	328
2006	226
2007	83
	$1,466

Adoption of SFAS No. 142

On January 1, 2002, we adopted SFAS No. 142, which requires companies to cease amortizing goodwill and intangible assets which have indefinite useful lives. SFAS No. 142 also requires that goodwill and indefinite-lived intangible assets be reviewed for impairment upon adoption on January 1, 2002 and annually thereafter, or more often if events or circumstances warrant. Under SFAS No. 142, goodwill impairment may exist if the carrying value of the reporting unit to which it is allocated exceeds its estimated fair value.

Based on the transition provisions of SFAS No. 142, we reclassified the $50 million net carrying value of our assembled workforce intangible asset, which was recognized in connection with the Merger, into goodwill effective January 1, 2002. The assembled workforce intangible asset no longer met the criteria for recognition as a separate intangible asset apart from goodwill. Amortization of goodwill, including the addition to goodwill from the reclassification of the assembled workforce intangible asset, ceased on January 1, 2002. We also ceased amortizing our intangible assets with indefinite lives, including trademarks, trade names and wireless spectrum licenses on January 1, 2002. Upon adoption of SFAS No. 142, we reviewed the useful lives of our amortizable intangible assets—primarily capitalized software and customer lists, and determined that after restatement, they remained appropriate. See Note 4—Merger, for further discussion regarding the revisions of the useful lives of our customer lists.

In accordance with SFAS No. 142, we performed a transitional impairment test of goodwill and intangible assets with indefinite lives as of January 1, 2002. The first step of the transitional test of impairment was performed by comparing the fair value of our reporting units to the carrying values of the reporting units to which goodwill was assigned. Because we do not maintain balance sheets at the reporting unit level, we allocated all assets and liabilities to each of our reporting units based on various methodologies that included specific identification and allocations based primarily on revenues, voice grade equivalents (the amount of capacity required to carry one telephone call), and relative number of employees. Goodwill was allocated to reporting units based on the relative fair value of each reporting unit. We did not allocate any goodwill to our wireless and directory publishing reporting units because they were not expected to benefit significantly from the synergies of the Merger and are not considered sources of the goodwill which arose from the Merger.

Upon implementation of SFAS No. 142, we identified 13 reporting units. Goodwill was allocated to four of these reporting units on a relative fair value basis. Reporting units that were non-revenue producing or that were not expected to benefit significantly from the synergies of the Merger were not allocated goodwill. In addition, insignificant reporting units were not allocated goodwill. As discussed in Note 18—Segment Information, operating segments were changed in the fourth quarter of 2002 after goodwill had already been reduced to zero through the impairments discussed in the following paragraphs.

We estimated the implied fair value of goodwill for each reporting unit by subtracting the fair value of the reporting unit's assets, including any unrecognized intangibles, from the total fair value of the reporting unit. The excess was deemed the implied fair value of goodwill. The implied fair value of the goodwill was then compared to the carrying amount of goodwill for the reporting unit. Based on this analysis, we recorded a charge for the cumulative effect of adopting SFAS No. 142 of $22.8 billion on January 1, 2002. This charge related to the reporting units in the table below:

Reporting Unit	Impairment Charge
	(Dollars in millions)
Global	$ 5,151
National	2,147
Consumer	4,856
Wholesale	10,646
Total	$22,800

Changes in market conditions, downward revisions to our projections of future operating results, and other factors indicated that the carrying value of the remaining goodwill should be evaluated for impairment as of June 30, 2002. Based on the results of that impairment analysis, we determined that the remaining goodwill balance of $8.483 billion was impaired and we recorded an impairment charge on June 30, 2002 to write-off the remaining balance. In accordance with SFAS No. 142, we will continue to perform impairment tests on the remaining indefinite-lived intangible assets on an annual basis, or more often if events or changes in circumstances indicate the assets may be impaired.

The following table adjusts loss from continuing operations, net loss and the related per share amounts in 2001 and 2000 to exclude amortization, net of any related tax effects, of goodwill and indefinite lived intangible assets.

	Year ended December 31,	
	2001	2000
	(As restated, see Notes 3 and 4) (Dollars in millions, except per share amounts)	
Reported loss from continuing operations	$(6,138)	$(1,442)
Amortization associated with goodwill	797	378
Amortization associated with excess basis in investment in KPNQwest	205	92
Amortization associated with trade name	9	5
Amortization associated with assembled workforce	20	10
Amortization associated with wireless spectrum licenses	1	1
Total amortization associated with intangible assets with indefinite lives	1,032	486
Adjusted loss from continuing operations	$(5,106)	$ (956)
Reported net loss	$(5,603)	$(1,037)
Amortization associated with goodwill	797	378
Amortization associated with excess basis in investment in KPNQwest	205	92
Amortization associated with trade name	9	5
Amortization associated with assembled workforce	20	10
Amortization associated with wireless spectrum licenses	1	1
Total amortization associated with intangible assets with indefinite lives	1,032	486
Adjusted net loss	$(4,571)	$ (551)
Basic and diluted loss per share:		
Reported loss from continuing operations per share	$ (3.69)	$ (1.13)
Amortization associated with goodwill	0.48	0.30
Amortization associated with excess basis in investment in KPNQwest	0.12	0.07
Amortization associated with trade name	0.01	—
Amortization associated with assembled workforce	0.01	0.01
Amortization associated with wireless spectrum licenses	—	—
Total amortization associated with intangible assets with indefinite lives	0.62	0.38
Adjusted loss from continuing operations per share	$ (3.07)	$ (0.75)
Reported net loss per share	$ (3.37)	$ (0.82)
Amortization associated with goodwill	0.48	0.30
Amortization associated with excess basis in investment in KPNQwest	0.12	0.07
Amortization associated with trade name	0.01	—
Amortization associated with assembled workforce	0.01	0.01
Amortization associated with wireless spectrum licenses	—	—
Total amortization associated with intangible assets with indefinite lives	0.62	0.38
Adjusted net loss per share	$ (2.75)	$ (0.44)

Other intangible information

In June 2002, pursuant to SFAS No. 144 as discussed in Note 6—Property, Plant and Equipment, we recorded an asset impairment charge to other intangible assets with finite lives. These included impairments related to capitalized computer software of $411 million and our customer lists of $812 million.

We also recorded asset impairment charges of $4 million and $68 million in 2002 and 2001, respectively, related to internal software projects that we terminated, including customer database system projects.

Following the Merger, we reviewed all internal use software projects in process, and determined that certain projects should no longer be pursued. Because the projects were incomplete and abandoned, the fair value of such software was determined to be zero. Capitalized software costs of $33 million and $114 million were written off in 2001 and 2000, respectively, and reported as asset impairment charges on our consolidated statements of operations at the time they were abandoned. The abandoned projects primarily included a significant billing system replacement.

In 2002, realization of a $396 million tax benefit ($647 million on a pre-tax basis) became probable as a result of the completion of the first phase of the sale of our directory publishing business. The tax benefit existed at the time of the Merger, but was not recognized in the purchase because at that time it was not apparent that the temporary difference would be realized in the foreseeable future. In 2002, in accordance with SFAS No. 109, "Accounting for Income Taxes" ("SFAS No. 109"), we recorded the tax benefit, on a pre-tax basis, as a $555 million reduction to our trade name intangible asset and as a $92 million reduction to our customer lists intangible asset. The credits were applied to these two non-current intangible assets because these assets were created in connection with the original purchase price allocation.

Note 8: Assets Held for Sale including Discontinued Operations

The following table presents the summarized results of operations for each of the years in the three-year period ended December 31, 2002 related to our discontinued operations. These results primarily relate to our directory publishing business. Other discontinued operations represent immaterial operations.

	Years ended December 31,		
	2002	2001	2000
		(As restated, see Note 3)	
	(Dollars in millions)		
Revenue	$1,535	$1,628	$1,517
Costs and Expenses:			
Cost of services	502	581	585
Selling, general and administrative	399	176	168
Depreciation and amortization	29	32	35
Income from operations	605	839	729
Gain on sale of directory publishing business	2,615	—	—
Other income (expense)	(26)	(5)	(1)
Income before income taxes	3,194	834	728
Income tax provision	1,237	323	282
Income from and gain on sale of discontinued operations	$1,957	$ 511	$ 446

Independent Auditors' Report

The Board of Directors and Stockholders
Qwest Communications International Inc.:

Under date of October 8, 2003, we reported on the consolidated balance sheets of Qwest Communications International Inc. and subsidiaries as of December 31, 2002, 2001, and 2000, and the related consolidated statements of operations, stockholders' (deficit) equity, and cash flows for each of the years then ended, as contained in the annual report on the 2002 Form 10-K. In connection with our audits of the aforementioned consolidated financial statements, we also audited the related accompanying consolidated financial statement schedule, Schedule II—Valuation and Qualifying Accounts. This financial statement schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement schedule based on our audits.

In our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

As discussed in Notes 3 and 4 to the consolidated financial statements, the Company has restated its consolidated balance sheets as of December 31, 2001 and 2000, and the related consolidated statements of operations, stockholders' (deficit) equity, and cash flows for each of the years then ended, which consolidated financial statements were previously audited by other independent auditors who have ceased operations.

/s/ KPMG LLP

Denver, Colorado
October 8, 2003