

APPENDIX

Appendix

Qwest Corporation - SEC Form 10-K (Annual Report)

Items 9 and 9A, Pages 104-107

Note 3

Filed January 13, 2004

ITEM 9. *CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE*

Prior to May 29, 2002, QCII had not engaged independent auditors for 2002. Based on the recommendation of the Audit Committee of the Board of Directors of QCII, on May 29, 2002 the Board of Directors of QCII decided, effective immediately, not to re-engage Arthur Andersen LLP as our independent auditor.

Effective May 29, 2002, QCII's Board of Directors engaged KPMG LLP ("KPMG") to serve as our independent auditor for 2002.

Arthur Andersen LLP's reports on our consolidated financial statements for the years ended December 31, 2001 and 2000 did not contain an adverse opinion or disclaimer of opinion, nor were they qualified or modified as to uncertainty, audit scope or accounting principles. During the years ended December 31, 2001 and 2000 and through May 29, 2002, there were (1) no disagreements with Arthur Andersen LLP on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure which, if not resolved to Arthur Andersen LLP's satisfaction, would have caused it to make reference to the subject matter in connection with its report on our consolidated financial statements and (2) no reportable events, as listed in Item 304(a)(1)(v) of Regulation S-K.

During the years ended December 31, 2001 and 2000 and prior to May 29, 2002, we did not consult KPMG with respect to the application of accounting principles to a specified transaction, either completed or proposed, or the type of audit opinion that might be rendered on our consolidated financial statements or any other matters or reportable events listed in Items 304(a)(2)(i) and (ii) of Regulation S-K.

Following our decision not to re-engage Arthur Andersen LLP and the engagement of KPMG, we decided to revise certain of our previous accounting practices and policies. Prior to making these revisions, we sought Arthur Andersen LLP's input and cooperation and notified Arthur Andersen LLP of

our determinations prior to their public announcement. During August 2002, QCII received a letter from Arthur Andersen LLP, indicating its disagreement with QCII's proposed restatement as to certain issues not relevant to our financial statements. Although QCII has continued to seek Arthur Andersen LLP's input following Arthur Andersen LLP's letter as it made further determinations about the restatement of other issues, QCII has not responded to the August correspondence from Arthur Andersen LLP. Following QCII's notification to Arthur Andersen LLP of certain restatement issues it contemplated discussing with the staff of the SEC during February 2003, QCII received a second letter from Arthur Andersen LLP indicating it had not received a response to its positions and expressing Arthur Andersen LLP's disagreement with the other restatement issues that QCII had identified. Arthur Andersen LLP has not withdrawn its previously issued opinion related to our financial statements for the three years ended December 31, 2001.

ITEM 9A. *CONTROLS AND PROCEDURES*

The effectiveness of our or any system of disclosure controls and procedures is subject to certain limitations, including the exercise of judgment in designing, implementing and evaluating the controls and procedures, the assumptions used in identifying the likelihood of future events and the inability to eliminate misconduct completely. As a result, there can be no assurance that our disclosure controls and procedures will prevent all errors or fraud or ensure that all material information will be made known to appropriate management in a timely fashion.

We have completed an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15 under the Exchange Act. This evaluation

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has allowed us to make conclusions in 2003, as set forth below, regarding the state of our disclosure controls and procedures as of December 31, 2002. This evaluation included the following actions:

- Beginning in July 2002, our new auditors, KPMG, at the direction of senior management, the Audit Committee of QCII and the Board of Directors of QCII, conducted a review of our internal controls over financial reporting and communicated to QCII's Audit Committee and senior management its findings with respect to approximately 150 internal control issues;
- Starting in May 2002, our accounting personnel engaged in an extensive effort to analyze and reconcile each of our quarterly balance sheets. These continuing efforts,

along with efforts to satisfy the certification requirements under the Sarbanes-Oxley Act of 2002 and related rules, identified a number of the items for review;

- The QCII internal audit group conducted a comprehensive company-wide risk assessment beginning in the fall of 2002. As part of this assessment, QCII's internal audit group and its controller's organization scrutinized a number of items for potential internal control deficiencies. QCII's internal audit group also reviewed unresolved issues identified in past internal audits for potential internal control deficiencies; and
- QCII's substantial efforts to restate our 2001 and 2000 financial statements included an effort to identify the internal controls over financial reporting that could or should have prevented or mitigated the error. These efforts and the audit of the restated 2001 and 2000 financial statements were designed to provide reasonable assurance that we have recorded all material adjustments.

As a result of our efforts in 2003 and 2002 to evaluate the effectiveness of the design and operation of our disclosure controls and procedures, we have now concluded that the following internal control deficiencies constituted "material weaknesses" or "significant deficiencies," as defined under standards established by the American Institute of Certified Public Accountants, during the three fiscal years that were the subject of the audit:

•Deficiencies related to the structure and design of certain financial information and reporting processes.

These deficiencies related to our complex multiple practices and processes that were not fully integrated following the Merger. Certain of these deficiencies were a consequence of the manual intervention that became necessary as a result of the lack of complete integration. Among the problems evidencing these deficiencies were those that had occurred in our accounting processes for intercompany transactions and the recognition of revenue in the Company's wireless business;

•Deficiencies related to design of policies and execution of processes related to accounting for operating activities. These deficiencies included problems that occurred in our accounting policies and processes for verifying account balances and transactions such as accounts receivable, posting cash to the general ledger, balance sheet reconciliations, facilities costs, fixed assets and inventory. In 2003 and 2002, we confirmed our restatement findings with detailed activity reconciliations;

•Deficiencies related to inadequate or ineffective policies for complex transactions and certain other matters. These deficiencies related to problems that occurred in accounting for complex transactions. In 2002, we implemented a new policy for the initiation and processing of complex transactions and we introduced interim and mitigating controls that address certain of these other issues; and

•Deficiencies related to the internal control environment. As a result of the various issues raised in connection with the restatement process, current management has also concluded that deficiencies in the internal control environment (relating to accounting, financial reporting and

internal controls) during the three fiscal years subject to audit constituted, at times, a material weakness and, at other times, a significant deficiency. In 2002, the Board of QCII appointed new senior management, and the Company undertook subsequent efforts to resolve internal control problems. The Audit Committee of QCII and the Company also took steps to address these issues and continue to emphasize the importance of establishing the appropriate environment in relation to accounting, financial reporting and internal controls.

In October 2003, in connection with the delivery of the Statement on Auditing Standards No. 61 report on the audit of QCII's consolidated financial statements for 2002 and restated financial statements for 2001 and 2000, KPMG reported to QCII's management and its Audit Committee reportable conditions consistent with the items described above and characterized them as material weaknesses. The Company, in performing its evaluation, also considered KPMG's findings.

We believe that many of the restatement adjustments are the result of the ineffective internal control policies and procedures, as indicated above. We also believe that, in some cases, certain of our employees did not follow our policies, processes and procedures. We have taken these cases into account when evaluating our responsibilities to restate certain matters that otherwise may not have met quantitative standards of materiality.

While performing our internal analysis, we identified various transactions in which employees misapplied policies or procedures in a manner that permitted us to prematurely recognize revenue. Several employees were disciplined after we determined that they had engaged in misconduct in transactions that allowed us to prematurely recognize revenue.

In our review of the matters leading to the restatement of our wireless revenue, we determined that some of our employees violated our policies by failing to report known errors to proper management personnel and attempting to correct the errors only prospectively. We have taken disciplinary action against the employees who did not follow our policies.

Since mid-2002, we or QCII have taken a number of steps that will impact the effectiveness of our internal controls, including the following:

- Appointed a new Chief Executive Officer ("CEO"), following the resignation of the former CEO;
- Appointed a new Chief Financial Officer, a new Senior Vice President-Finance and Controller, and a number of other new individuals in our finance and controller groups. We also restructured the finance group in a manner that places greater emphasis on control and accountability issues;
- After completing an extensive balance sheet review and reconciliation process, we identified improved processes and procedures that have been or are being implemented;
- QCII substantially increased the number of employees in its internal audit group;
- QCII appointed a new Chief Compliance Officer who reports to its CEO;
- We improved the effectiveness of our corporate compliance programs. This effort included the hiring of additional personnel and the establishment of a management compliance committee that is staffed by senior-level business unit employees;

- QCII amended its Code of Conduct and Compliance Policies to include company-wide principles and procedures for maintaining the integrity of our compliance, accounting and reporting systems. We have established compliance training programs in connection with the amended Code of Conduct;

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- We re-evaluated prior policies and procedures and established new policies and procedures for such matters as complex transactions, account reconciliation procedures and contract management procedures;
- QCII established a Disclosure Committee, consisting of senior personnel from the business units and the finance and legal groups, and we now follow an extensive review and certification process in connection with our filings with the SEC;
- We have taken advantage of significant outside resources to supplement our finance and controller groups and to support the preparation of financial statements and reports that are to be filed with the SEC;
- We have developed and implemented interim mitigating controls, involving manual procedures by a substantial number of employees, in order to reduce to a low level the risk of material misstatement in the financial statements; and
- QCII's Board modified its Audit Committee's Charter so that it complies with the Sarbanes-Oxley Act of 2002 and the rules issued thereunder.

We believe that these efforts have addressed the material weaknesses and significant deficiencies that affected our internal controls in 2002, 2001 and 2000. The Company continues to improve and refine its internal controls. This process is ongoing, and the Company seeks to foster an exemplary internal control environment. However, the Company can give no assurances that all material weaknesses and significant deficiencies have been entirely corrected. Our management, including our CEO and Chief Financial Officer, has concluded that, except for the internal control deficiencies as described herein and taking into account the efforts to address those deficiencies described herein, as of the evaluation date, our disclosure controls and procedures are designed, and are effective, to give reasonable assurance that information we must disclose in reports filed with the SEC is properly recorded, processed and summarized, and then reported within the time periods specified in the rules and forms of the SEC.

Other than as summarized above, since the evaluation date there have been no significant changes in our internal controls over financial reporting or in other factors that could significantly affect the internal controls. We will continue to assess our disclosure controls and procedures as we prepare our remaining delinquent filings and will take any further actions that we deem necessary.

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.

As discussed more fully below, the restatements involve, among other matters, revenue recognition issues related to termination fees, installation fees and wireless revenue. In making these restatements, we have performed an internal analysis of our accounting policies, practices, procedures and disclosures for the affected periods.

Summary of restatement items

The following tables set forth the effects of the restatement adjustments discussed below on revenue; pre-tax income (i.e., income before income taxes and cumulative effect of change in accounting principle); and net income 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 Income | Net Income |
| | (Dollars in millions) | | |
| Previously reported | \$ 12,675 | \$ 2,778 | \$ 1,737 |
| Restatement Adjustments, net: | | | |
| Termination fees | (75) | (75) | (46) |
| Wireless revenue | (46) | (46) | (28) |
| Transactions with affiliates | 20 | 30 | 18 |
| Installation fees | 19 | 19 | 12 |
| Balance sheet reconciliations | (14) | (11) | (7) |
| Out-of-period expenses | — | (114) | (70) |
| Network labor costs | — | (84) | (51) |
| Compensated absences | — | (73) | (44) |
| Cost of removal | — | (40) | (24) |
| Contested liability trust | — | (22) | (13) |
| Stock compensation | — | (1) | — |
| Curtailement gain | — | 7 | 5 |
| Other | (42) | (123) | (82) |
| Net restatements | (138) | (533) | (330) |
| As restated | \$ 12,537 | \$ 2,245 | \$ 1,407 |

Year ended December 31, 2000

| | Revenue | Pre-tax Income | Net Income |
|--------------------------------------|-----------------------|-------------------|---------------|
| | (Dollars in millions) | | |
| Previously reported | \$ 12,300 | \$ 1,904 | \$ 1,196 |
| Restatement Adjustments, net: | | | |
| Termination fees | (50) | (50) | (30) |
| Wireless revenue | (57) | (57) | (34) |
| Transactions with affiliates | 17 | (40) | (24) |
| Installation fees | (90) | (90) | (96) |
| Balance sheet reconciliations | — | 24 | 15 |
| Investment transfer | — | — | (82) |
| Out-of-period expenses | — | 169 | 103 |
| Network labor costs | — | (100) | (61) |
| Compensated absences | — | (14) | (9) |
| Stock compensation | — | (51) | (31) |
| Curtailment gain | — | (47) | (29) |
| Other | (36) | (2) | (16) |
| Net restatements | (216) | (258) | (294) |
| As restated | \$ 12,084 | \$ 1,646 | \$ 902 |

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 revenue 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 decreased our pre-tax income 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 revenue and decreased our pre-tax income by \$46 million and \$57 million for the years ended December 31, 2001 and 2000, respectively.

Transactions with affiliates

In 2001 and 2000, we inaccurately recorded revenue and expenses related to transactions with affiliated companies within the QCII group of companies. These transactions included billings for data processing services, allocations of corporate overhead costs and payments made on behalf of affiliated companies, among other items.

In our restated consolidated financial statements, we have increased our previously reported revenue by \$20 million and \$17 million for the years ended December 31, 2001 and 2000, respectively, and increased our pre-tax income by \$30 million and decreased our pre-tax income by \$40 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 revenue by \$19 million and decreased previously reported revenue by \$90 million for the years ended December 31, 2001 and 2000, respectively, resulting in an increase in our pre-tax income for 2001 and a decrease in our pre-tax income for 2000 of corresponding amounts. In addition, as a result of this change, our restated net income 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.

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 \$14 million for the year ended December 31, 2001. The adjustments also reduced our previously reported pre-tax income by \$11 million for the year ended December 31, 2001 and increased our pre-tax income by \$24 million for the year ended December 31, 2000.

Investment transfer

In 2000, we transferred an appreciated investment with a carrying value of \$220 million to QSC at our original cost of \$10 million. This investment was subsequently sold by a QSC subsidiary later in that year. As part of our internal analysis, we determined that tax expense should have been recorded by us relative to the transfer. As a result, we have increased the income tax expense by \$82 million in our restated consolidated financial statements for the year ended December 31, 2000.

Out-of-period expenses

We recorded certain charges in 2000 as expenses for contractual sponsorships. 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 income by \$114 million in 2001 and increased our previously reported pre-tax income by \$169 million in 2000.

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, we have recorded adjustments in our restated consolidated financial statements to increase operating expenses and decrease net property, plant and equipment by \$84 million and \$100 million in 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 decreased our previously reported pre-tax income by \$73 million and \$14 million for the years ended December 31, 2001 and 2000, respectively.

Cost of removal

In 2001, we recorded costs associated with the reconditioning of certain cable lines against a 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 are not costs of removal and should not have been charged against the reserve in accumulated depreciation. As a result, in our restated consolidated financial statements we have decreased our previously reported pre-tax income by \$40 million for the year ended December 31, 2001.

Contested liability trust (Grantor trust)

In 2000, we recorded a \$286 million asset transfer from an affiliate as a note receivable related to the contested liability trust. We subsequently recognized affiliate interest income of \$22 million on this note receivable in the year ended December 31, 2001. As part of our internal analysis we determined that the note receivable due from an affiliate should have been classified in equity. In our restated consolidated financial statements, we have decreased our previously reported pre-tax income for 2001 by \$22 million relative to the reversal of the interest income.

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 Accounting Principles Board ("APB") 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 decreased our previously reported pre-tax income by \$1 million and \$51 million for the years ended December 31, 2001 and 2000, respectively.

Curtailment gain

During the third quarter of 2000, and in conjunction with the Merger, QCII changed certain post-retirement benefits as discussed in Note 11—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 Post-retirement 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 increased our previously reported pre-tax income by \$7 million in 2001 and decreased our previously reported pre-tax income by \$47 million in 2000.

Other

We reduced our previously reported revenue by \$42 million and \$36 million and decreased our pre-tax income by \$123 million and \$2 million for the years ended December 31, 2001 and 2000, respectively, for other adjustments discovered as a result of our internal analysis. These adjustments have been aggregated in our presentation. The individual adjustments ranged from \$100,000 to \$15 million for revenues and from \$100,000 to \$16 million for pre-tax income in the periods presented and had an average impact of \$6 million to revenues and \$7 million to pre-tax income.

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.

The following tables set forth the effects of our restatement adjustments on our condensed 2001 and 2000 consolidated balance sheets:

| | Previously Reported | Increase/ (Decrease) | As Restated |
|---|------------------------|-------------------------|------------------|
| | (Dollars in millions) | | |
| As of December 31, 2001: | | | |
| Assets: | | | |
| Total current assets | \$ 2,945 | \$ (288) | \$ 2,657 |
| Property, plant and equipment—net | 19,431 | (244) | 19,187 |
| Other and intangible assets—net | 2,690 | (148) | 2,542 |
| Total assets | \$ 25,066 | \$ (680) | \$ 24,386 |
| Liabilities and stockholder's equity: | | | |
| Total current liabilities | \$ 6,295 | \$ 2,209 | \$ 8,504 |
| Long-term borrowings | 5,781 | — | 5,781 |
| Deferred income taxes and other liabilities | 5,699 | (177) | 5,522 |
| Total liabilities | 17,775 | 2,032 | 19,807 |
| Total stockholder's equity | 7,291 | (2,712) | 4,579 |
| Total liabilities and stockholder's equity | \$ 25,066 | \$ (680) | \$ 24,386 |

| | Previously Reported | Increase/ (Decrease) | As Restated |
|---|------------------------|-------------------------|------------------|
| | (Dollars in millions) | | |
| As of December 31, 2000: | | | |
| Assets: | | | |
| Total current assets | \$ 2,444 | \$ 19 | \$ 2,463 |
| Property, plant and equipment—net | 18,100 | (17) | 18,083 |
| Other and intangible assets—net | 2,298 | (282) | 2,016 |
| Total assets | \$ 22,842 | \$ (280) | \$ 22,562 |
| Liabilities and stockholder's equity: | | | |
| Total current liabilities | \$ 6,156 | \$ 538 | \$ 6,694 |
| Long-term borrowings | 6,247 | — | 6,247 |
| Deferred income taxes and other liabilities | 5,174 | (134) | 5,040 |
| Total liabilities | 17,577 | 404 | 17,981 |
| Total stockholder's equity | 5,265 | (684) | 4,581 |
| Total liabilities and stockholder's equity | \$ 22,842 | \$ (280) | \$ 22,562 |

Stockholder's equity has been restated for items other than the adjustments to net income discussed in the summary of restatement items section above. Among other restatements, it has also been restated for adjustments to dividends declared and for the contested liability trust. The adjustments to dividends declared are attributed to our failure to record dividends that were

declared in 2000 and 2001 under a standing declaration policy. A reconciliation of stockholder's equity between "Previously Reported" and "As Restated" is as follows:

| | December 31, | |
|--|-----------------------|----------|
| | 2001 | 2000 |
| | (Dollars in millions) | |
| Stockholder's equity, as previously reported | \$ 7,291 | \$ 5,265 |
| Cumulative effect of restatement adjustments on net income | (624) | (294) |
| Adjustments to dividends declared | (1,884) | (477) |
| Note receivable—contested liability trust | (286) | — |
| Stock compensation | 92 | 87 |
| Other consolidation and reconciliation adjustments | (10) | — |
| Stockholder's equity, as restated | \$ 4,579 | \$ 4,581 |