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w/sample answers

VOTRE LIEN AVEC CE QUI COMPTE — CONNECTS YOU TO WHAT MATTERS

ADM 4342B

Fall 2015

Instructor: **B. La Rochelle, Ph.D., C.P.A**
Duration: **75 minutes**
Value: **25% of your final grade**

Note to students: This is a closed-book exam, containing 3 questions, worth 45 marks in total. Apart from sundry writing materials (pens, pencils and the like), no examination aids are permitted

NAME: ______________________________________

STUDENT #: ______________________

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I have read the text on academic integrity and I pledge not to have committed or attempted to commit academic fraud in this exam.

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Note: An exam without this signed statement will not be graded and will receive a grade of zero.

Question 1

Required (15 marks)

With reference to all of the class presentations, discuss the nature of an "accounting failure" and how one might use stock market information to assess whether such has occurred.

Question 2

The article "Inside Agency: The Rise and Fall of Nortel", highlights several alleged factors said to facilitate management malfeasance. Those factors may be summarized as:

Executive Compensation
Corporate Governance Structure
Ownership Structure
Relationship of compensation, governance and ownership to Earnings Management and Earnings Manipulation

Required (15 marks):

Discuss the factors listed and their relationship to the facts of Nortel. In view of the 2013 decision acquitting all three Nortel executives of fraud, how, if at all, might the authors of "Inside Agency: The Rise and Fall of Nortel" revise their views?

Question 3

The following is extracted from Floyd Norris, "Will U.S. accounting rules be irrelevant?", *New York Times*, December 29, **1996**:

In the past, the international standards were notable largely for the wide discretion they gave companies. In effect, they said that if one country allowed an accounting technique, it must be O.K. The international rules are being tightened, but in many areas they will still allow more discretion than do American standards.

There is something to be said for such discretion, if we can trust auditors to enforce the standards rigorously and to stand up to companies that want to use the discretion to put out misleading figures. But the evidence that big accounting firms deserve such confidence is, at best, mixed.

Some business groups are angry at the F.A.S.B. and its rules, and would welcome more freedom. They may see the international route as a way to get around a tiresome busybody.
American stock markets want more foreign listings and have been frustrated by the S.E.C.'s insistence that foreign companies must largely meet American standards before they can trade here. While many foreign companies have listed, some may be stalling in the hope that the weaker international standards will enable them to enter our markets without meeting our rules.

This is important for investors because it is accounting that provides the report card on how their companies are doing. And if accounting standards are perceived as too lax -- as German and British ones have clearly been in the past -- then investor confidence over time can be sapped. The S.E.C. should be very careful to make sure that the international rules are adequate -- in every respect -- before they are deemed adequate for American markets.

Required (15 marks):

With reference to the course material to date, discuss the foregoing.

Question 1.

1st [illegible]

Over the course of the class discussions, we discussed the nature of an accounting failure and how it comes to be. In doing so, we first separated 3 critical roles in "accounting":

① legislative role
- would act as standard setters
ex. FASB, IASB.

② regulatory role
- would aid practioners in the applicat of accounting standards
ex. SEC - accepting questions and giving rulings on best practices in a particular circumstance.

③ judicial role.
- serve as a course of appeal should practioners disagree with a ruling from the regulatory bodies.

relevant

With this separation, we determined that the regulatory and judicial roles are typically intertwined - these roles, within firms, can b played by managers and auditors, who are lar in charge of interpreting and ensuring appropri application of the accounting standards, respectively.

OK

With this separation, and through the class examples, we came to define an accounting ~~standard~~ failure as something that would occur in the legislative branch of accounting. With the standards themselves being our starting point, we saw that an accounting failure could occur in three main instances:

1. when there is no standard in place to address a given issue.
2. when an issue in interpretation is identified, but the standards aren't amended to address the new issue (as was the case in Enron)
3. when the existing standard is too complex to be practically applied

In terms of the stock market, we saw in class the declines in market price are common in light of accounting restatements. However, the stock market tends to behave based on "signals" (ie. not accounting information alone) therefore it cannot be reliably determined if there was an accounting failure simply by looking at the stock market reaction.

However. –

In the case of Quindell, the restatements were made to correct issues with revenue recognition, transactions with related parties, and the treatment of goodwill in an acquisition. With each of these issues, there were fairly clear and simple standards in place, which were reinforced by conservatism principles in the conceptual framework. As such, the restatem were not caused by an accounting failure but rather by manager and auditor fail. The stock market declined significantly in this cas due to lost confidence in management's integrity

In the case of Hertz, the restatements involved the capitalization of assets, depreciation policies, and allowance for doubtful accounts. Each of these areas requires a high level of professional judgement, however, the standards in place (with the conceptual framew were reasonably clear, therefore we did not consider this an accounting failure, but again a management failure. The stock market had a relatively lower negative reaction in this case, seeming to accept the error in application of professional judgement given a wide range of acceptable values.

Alcorn, like Quindell, experienced issues with acquisitions in its restatements. In accounting for one company, the inventory account was erroneously double counted. Again, with clear standards in place, we saw this as a management and auditor failure, not an accounting failure. Like Quindell, the market had a severe negative reaction, as management competence was brought into question.

Shiloh also made an error in applying a basic accounting principle, which saw a similar severe decline in market prices due to a lost confidence in manager competence. In not including a surcharge on steel in their cost of goods sold, we defined this not as an accounting failure, but as a management failure.

General Cable had a slightly different case, in that its restatements were somewhat isolated to its operations in Brazil. The market did not decline significantly in this instance, possibly for the reason above. There were, again, clear standards around revenue recognition and foreign currency exchanges, therefore this is not considered an accounting failure by our definition.

The final case, Energy XXI, was the only one in which the restatements may have been caused in part by an accounting failure. The standards and disclosures surrounding cash flow hedges were highly complex, and difficult to apply in practice. The market recovered after the announcement of the restatements, seeing a lesser impact on the financial statements than was previously indicated. Why

These cases together show a trend in the market reaction in that it tends to be more severe in the face of issues with management integrity / competence (as with Quindell, Shiloh, and Akorn) and less so in light of accounting failures / standards involving more professional judgement (Hertz, Energy XXI, General Cable).

(15+) very nice

1. An accounting failure is described as a situation where the accounting standards and underlying conceptual framework either failed to give guidance (did not exist) on a particular issue or they gave guidance in such a way that the financial statements did not reflect the economic reality to the users.

A failure cannot occur if standards are complete, understandable and exist. We can compare the conceptual framework to Khun's notion of the paradigm - it is a way in which accounts address any problems/issues and exists as a reference point for decision making. It is important to remember that the "paradigm" of accounting involves the use of professional judgement. Therefore, a situation where professional judgement on behalf of accountants was incorrect/did not exist is not a failure of accounting but rather a management/auditor/accountant failure.

With this in mind, we can discuss the nature of restatements as seen in class and determine if there was an "accounting" failure:

1) Akorn: This company accidentally overstated 9.8M in inventory. Not an accounting failure as standards exist → rather an issue with

management, internal, and external audit failure

2) General Cable: This organization made restatements as they related to fraud at a Brazilian division and touched on inventory, revenue recognition and foreign exchange. The rules + regulations are clearly in place and this was not an accounting failure

3) Hertz: Here we saw an issue with the choice of depreciation method which involves professional judgement. The Directors of Hertz came out saying that the choice of method was outright incorrect and didn't reflect economic reality. This is therefore not an accounting failure but a failure in management judgement and auditor judgement

4) Shiloh - Issues of overreporting cost of goods sold at Wellington division. Evidence of fraudulent activity. Inventory standards are clear and this was not an accounting failure

5) Quadrell: A company that had multiple restatements involving management and auditor failure to apply professional judgement. Auditors actually folded to management on revenue issues. Not an accounting failure - standards ~~regarding~~ revenue, acquisitions and related party transactions are clear.

⑥ Energy 21: Only situation where it could be argued there was an accounting failure. The complex rules surrounding hedging may not have been understandable and caused the statements to be misrepresented which would lead to failure. It is also arguable that management/auditors involved were not competent enough to understand the guidance.

With this in mind, we can assess whether the stock market is useful in determining if an accounting error has occurred by looking at reactions around all restatements [non-failure and possible accounting failure]:

① Akorn: Saw a drop in share price with the restatement but saw a larger drop in September 2015 when they chose not to buy back options. Signal to the market about the company's worth.

② General Cable: Saw drops in market price close to both of their restatements. More significantly when they related directly to revenue.

③ Hertz: Saw barely any change. This may be because their restatement had to do more with judgement OR because they promptly fired their CFO which is a signal that they are "cleaning up" the company.

④ Shiloh: Saw a drop in market price when the restatement hit but also one of significant magnitude when they were issued a lawsuit. This is a signal to the market who reacted befo

(5) Guindale: saw a drop in it's share price when their CEO was ousted and with a Gotham City Research report. They saw an increase when the restated financial statements were finally issued even though there was a qualified opinion and still an investigation by the SFO. Proof here that market operates on non-financial signals.

(6) Energy 21: This is only case where accounting failure could be argued and the market saw only a slight dip. This could be because of the complexity of the transaction that the market didn't fully understand and were therefore not affected as much.

Considering the above, we can note that in companies 1-5, where there was no accounting failure, there was large fluctuations around not only the restatements but also around signals that the company gave off which affected market reaction. In Energy 21, were there could be argument for an accounting failure, we see barely any change in market reactions.

As such, I conclude that using stock market reaction to conclude there is an "accounting failure" is not possible. The media is quick to deem management/audit failures accounting failures and these see large variations in stock market but does not point to an accounting failure. Also the market reacts on signals more than actual financial statements so it would

In general, the market is an innefficient means to det if there was a failure – too many confounding variab

(18) mid

(2)

The authors discuss the factors as follows:

(1) Executive compensation: Usually assumed that aligning management compensation to shareholder interests is a good way to reduce agency. However, the authors point out that when compensation is based on stock price, managers are incentivized to favour short term gains (like through acquisitions) instead of long term growth. Nortel's managers had large stock based compensation packages which they say encouraged them to work for short term results and meeting the overvalued market expectations

(2) Corporate governance: Usually monitoring with a good BOD is considered a way to reduce agency. Authors point out that Nortel's board was a) too large (no cohesive decisions, slacking) b) lacked financial knowledge (enables management to "capture" the board) and c) many members were active on other boards (lack of focus on monitoring Nortel). They claim this created opportunity and a lack of moral hazard at Nortel and contributed to malfeasance

(3) Ownership structure: Usually agency involves institutional investors who help control management by their large presence/influence. At Nortel, the authors claim transient institutional investors increased which further pushed management to

the new investors instead of focusing on the long term and contributed to agency issues

d) Earnings Management and Manipulation: This only occurs when there is incentive (stock price based compensation at Nortel) and a lack of moral hazard (no BOD oversight). They elaborate on 3 points for Nortel:

(1) Smoothing earnings: Nortel used accruals, they claim, to meet earnings targets and earn bonuses

(2) Financial analysts + Positive surprises: They claim Nortel managed earning to give only positive surprises in meeting analysts forecasts and "talked down" forecasts ahead of time

(3) GAAP vs. Street earnings: Claim that Nortel released pro-forma EPS to manage their earnings.

This all occurs because they could no longer meet the overvalued market expectations

The authors made these statements 6 years before judgement was issued. As a result of execs being found not guilty, I believe they should revise their claims on corporate governance. Deloitte's relationship with Nortel is evidence of a strong monitoring style relationship that existed regardless of the board's composition.

The Nortel judgement reviewed the accruals and their release into income and the judge found them not material. In the judgement Marrocco actually claims: "While he had determined that the overestimated accruals and unsupported liabilities resulted from real risks. this does not

mean they weren't used for earning menqunagement. In general, they m
have used the 900M in accruals to smooth earnings but because
were not material it couldn't be concluded that there was proof o
fraud. Proof in a criminal case is beyond reasonable doubt. I think
the authors should consider revising their point about earnings
management slightly to account for the fact that Nortel allege
did not "manipulate" earnings as it didn't change a reasonable inv
opinion (since they were non material) - but they can conclude that
perhaps, on a balance of probabilities basis, their was some earnings ma
ment - it just was not manipulation/Fraud. Also important to note, th
portion on executive compensation: it was determined that even
if the 80M were released bonuses would be achieved either way. They
could modify this section by stating that while it is not proof of malf
ance - it is still evident that this form of compensation [continue after Q3 -

Q2 cont...

encouraged Nortel to invest heavily in acquisitions and selling shares to boost stock price without considering their cash flow/earnings quality which ultimately did contribute to the demise. They could also note the benefit of tying bonus/earnings metrics to quality of earnings instead of memo.

In general, they should revise their report considering they were acquitted of fraud but not necessarily on the basis of balance of probabilities. They should also consider the use "of the term "malfeasence" and potentially change it to highlight that they were factors that could hypothetically have contributed to the demise of Nortel, with or without malfeasence.

Question 2:

14/15

→ Executive compensation (especially stock options) was thought to be an effective way to align the goals of managers with those of shareholders in seeing the company as a long-term investment. However, with options that mature in shorter periods (5 yrs. for example) it has been seen that managers treat them as somewhat of a deadline - they attempt to maximize their own short term gains then move to something more prosperous.

↳ this was seen in Nortel, as the executives were mainly compensated based on high levels of options, which were largely rewarded based on growth in revenues.

→ Governance is argued to act as a deterrant of agency behaviour by acting in an oversight role over management. However in practice, with larger boards made up of members who serve on multiple other boards with minimum financial expertise, governance can be seen to have a negative affect as managers perceive the board to be not as focused on their actions (allowing them more freedom)

↳ the authors show that in Nortel's case, the board had little idea of how the company made money, and each member served on 2-5 other boar[ds]

The ownership structure, particularly through ownership by institutional investors (ex. pension funds) is supposed to, in theory, provide similar management oversight through imposing covenants on the firm's performance and disclosures. However, as was seen in Nortel's case, a rapidly growing firm can attract many transient institutional investors, which can have the same effect as stock options in emphasizing a short-term focus on performance and therefore promoting certain agency behaviours.

The authors go on to argue that earnings management and manipulation occurs when the three aforementioned controls over agency behaviour are relatively lacking. Left to their own devices, manager as also highlighted in Revsine's article on selective misrepresentation, will typically act so as to satisfy their performance requirements without earning so much that they prompt higher regulatory observance intervention. In the case of Nortel, this "smoothing" occured through the release of certain accrued liabilities, thus helping the firm in some ways to meet its growth expectations while not raising suspicion about the company itself.

As summarized by Soloman, the executives of Nortel were not found guilty of fraud.

In light of this trial, the article could be revised in the area of corporate governance. While Nortel's board was shown to be incompetent, Nortel sought another form of external oversight through its auditors, by seeking their approval for changes in estimates of their accrued liabilities and therefore maintaining a culture of conservatism. The changes that were approved by the auditors were found to be reasonable and supported by due diligence, and did not have a material impact on Nortel's earnings picture to investors.

The article took the assumption that Nortel would be convicted of fraud, however, in light of the trials it seems as though the lack of controls over the executives' agency behaviours was not as significant as the authors initially thought.

fault intent

criminal intent

Question 3. (18) more application of course material

This article sees accounting largely in a stewardship role (or acting as a "thermometer" as per Robb & Robinson) by showing investors the actual results of a company.

The article mentions how the SEC has been looking at international accounting standards in light of the demand in the U.S. for more interational investment options. The concern is that in moving away from a more rules-based approach to accounting (as is said to be present in the U.S.) the quality of accounting information will decline.

This ~~[illegible]~~ aligns with Rosen & Rosen's view that increased amounts of professional judgement leads to accounting standards and practices that are not legally defensible. However, as Thornton argues, there is no evidence that increased professional judgement decreases the quality of earnings. In fact, he found that "looser" standards tend to encourage managers to better justify their accounting choices.

In Taub's speech, he acknowledges the concerns of practitioners in increasing professional judgement, however, also highlights that standards, whether "rules-based" or not will always involve a certain degree of judgement.

The article argues that more discretion in accounting policies could be beneficial, if auditors are able to consistently enforce their application. With this there is some blurred vision, mixing the legislative role of accounting with the judicial/regulatory roles. As highlighted in class, to solve this issue it may be beneficial to have an independent "Interpretation Panel" in order to maintain auditor independence (not allowing them to much of a role in applying the standards) while also giving practitioners a way to inquire about how to apply a given standard.

In saying that "if one country allowed a technique, it must be O.K", the author is implying that the IASB and countries that adopt IFRS are using deductive reasoning in setting their policies. He then emphasizes the importance for the SEC to employ inductive reasoning in determining whether international standards would work well in the U.S.

Since this article was written, the U.S. has still not adopted IFR. There has been more convergence in U.S. GAAP to more closely align with international standards, but there has not been an overwhelming amount of evidence to support the U.S. shifting its entire accounting paradigm and delegate its standard setting authority to the IASB, therefore it has not done so.

could modify this section by stating that while it is not [illegible]
once - it is still evident that this form of compensation [Continues after Q3 →]

(3) This article was written in 1996, approximately 6 years before the advent of SOX and the dangers that were seen for having strict rules that allowed managers to "dance among them" at Enron and its SPE's.

The auther shares a view that is very in line with the Rosen's thinking: strict rules are necessary to keep management in line. Also, this relates to Falk's line of thinking where he claims that accountants would not want to have to exercise judgement and would prefer to have "bright lines". At the time of the article, there was still thought that the "stop light" approach as presented

by Robb and Robinson, which stipulates that standards exist solely to signal when to go and stop was still the dominant train of thought and their "baby bonus" view of wealth distribution was discredited as too political and "nonneutral".

In a post-Enron world, more credence is being give to the baby bonus approach - where standards should exist to relieve some pressures of informatio asymmetry. This necessarily involves some amount of professional judgement. The view now is closer to Browns, Collins and Thornton's view that accounting standard are necessary but not sufficie rules. Also considers judgement important to report substance over form of transactions which leads to more accurate stewardship reporting.

We can also discuss the article with reference to the CICA's decision to abdicate its judgeme to the IASB. Even in 1996, the US was still strict on protecting its rules/regulations and being "in charge" of their own standards. They are still cautious in "ensuring the international rules are adequate" as they sit on IASB boards and did not resume projects with the IASB for a revised framework. On the other hand, Canada in the past decided to sign away its sovereign rights to the IASB. This marked difference between US. and Canadian involvement in regulation is still seen today.

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Q3 conti

The last point made here is:
Auditors trust ⟶ issue with agency of auditors. As presented by Revsine auditors will want standards that are actually either more strict or allow bargaining with their clients. This is [illegible] concept and work even in 1996 then

were concerned that auditors would be willing to