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Smoothing to Maximize

When is it okay? Who does it hurt?

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Ethical Leadership Case Study Collection Case Number 019-005
September 2019

Ryerson University

Table of Contents

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Introduction

Aditi, a generic drug company headquartered in India, acquired Biomed North America, including Biomed's division in Canada, a few years ago. Dennis Richter, a competent and ambitious accounting professional, welcomes the opportunity to move to Canada to become the division's senior finance director. His initiation into the new role is a "trial by fire" as the division's books have been closed and the year-end financials are on his desk waiting for his signoff prior to being sent to the corporate accounting team in North Carolina for consolidation, independent audit and public reporting.

Only after the year-end financial reporting frenzy is behind him does Dennis have a chance to properly meet his accounting team. He discovers that his predecessor, Rajvir Kumar, who is now the senior vice-president and CFO for Aditi North America and his boss, practised a corrosive leadership style. Dennis is uneasy about the consequences of this work culture and carefully combs through the last ten years of financial results. What he finds looks like income smoothing in seven of the last ten, including the year just reported on. Dennis wonders if the levelling out of fluctuations in revenues and net income from one period to the next in one of Biomed's largest divisions helped make the company look more attractive to Aditi at the time of the acquisition talks. He also notices that the continued smoothing ensures performance bonuses are maximized for the Canadian senior leadership team at a time when others in the industry are having a much harder time duplicating previous levels of growth. Is the smoothing intentionally orchestrated?

The Generic Drug Industry and the Acquisition of Biomed North America by Aditi

Today, the vast majority of prescribed drugs are generic. As patents expire, the generic pharmaceutical industry provides lower cost "bioequivalent" versions of branded drugs. With the aging of the population in the developed world, the emergence of a middle class in developing countries, and the pressure for governments and insurers to keep health costs down, the generic drug industry is expected to continue to grow.

The desire to tap into this growing market has led to considerable industry consolidation as competitors race to build global footprints. In addition to gaining access to ever-larger markets, globalization provides more opportunities to be in the right location at the right time when a coveted branded drug comes off patent. Indeed, those first to market reap the greatest benefits.

Since its inception in India, Aditi has developed technologies and processes for the production of complex biologics or cytotoxic drugs that are used increasingly to treat everything from migraines to cancer. As these types of drugs are derived from living organisms, their manufacturing and approval processes are far more complex than those for chemical-based generics. While the time to market is longer, the profit margins are much higher, and the barriers to entry greater. Aditi believes that although short-run growth may be dampened by the long lead time to market, investing in more sophisticated technologies is a winning business strategy for the company in the long run.

The acquisition of Biomed makes business sense to Aditi on several levels. Firstly, it is perfectly aligned with Aditi's strategy to gain access to manufacturing sites and protocols throughout North America that lend themselves to the development of complex biologics. Secondly, it gives Aditi a time hedge against sluggish revenue growth and resultant shareholder impatience as it works to bring complex biologics into production: Biomed's division in Canada has a significant product list of traditional generics approved for the marketplace which are expected to deliver a healthy revenue stream over the next five to ten years.

Immediately following the acquisition, Aditi's annual revenues increase from approximately $1.75 billion to $2.7 billion. At the same time, the M&A integration costs are expected to be minimal since Biomed North America's technology and market niche also comes with highly capable leadership teams both in Canada and in the United States. Biomed North America's financials for the three years prior to the acquisition are a testament to the senior management team's ability to drive predictable and sustainable business results, not an insignificant factor for investors and lenders alike, and, certainly, one that justifies Aditi paying an acquisition premium for Biomed North America shares.

While Aditi still lags in size far behind the two big players in the generic drug market, Pfizer and Teva, the purchase of Biomed does not just expand Aditi's global scope. Biomed helps Aditi secure its technological primacy and keeps its share price going up.

Aditi Restructures in North America

Two years into the Biomed North America acquisition, Aditi completes a restructuring which serves to centralize strategic decision-making for Aditi North America in its North Carolina headquarters. Up to this point, apart from participating in annual strategic planning and goal setting sessions with the U.S. counterparts, Biomed Canada has been largely autonomous.

With reorganization, functional heads in Canada now report directly to their functional head in North Carolina for strategic direction and annual goals setting. The president in Canada has responsibility only for the day-to-day leadership of the Canadian executives.

While in the restructuring Canadian leaders have less authority, many Biomed Canada leaders receive promotions to high-level positions in the United States or India. For example, the former CEO and president of Biomed Canada and the former CFO of Biomed North America move to India to become key members of the Global Leadership Team. Rajvir Kumar, previously the vice-president of finance for Biomed Canada relocates to North Carolina to become the senior vice-president and chief financial officer for Aditi North America. Rajvir's promotion is his reward for the critical role he played in facilitating Aditi's acquisition of Biomed. Aditi is also pleased that Rajvir has agreed to relocate himself and his family to the U.S. as, being from India, he is able to bridge cultural divides that arise in communication from time to time.

Bob Binder, previously the vice-president of sales and marketing in Canada and Rajvir's long-standing personal friend, advances to become president of Aditi Canada.

Rajvir's old position as vice-president of finance for Canada is downgraded to a senior finance director position who reports directly to Rajvir Kumar for strategic and functional direction, including consolidation and financial reporting, as well as to Bob Binder for day-to-day leadership.

Dennis Richter Gets the Job

The promotion of Rajvir Kumar to be the senior vice-president and chief financial officer for Aditi North America is a piece of good luck for Dennis Richter who moves to Canada to take up the position of senior finance director, Aditi Canada.

The restructuring committee unanimously agrees that Dennis deserves the promotion to Canada. He has worked in the accounting department in the North Carolina office for over ten years and has a reputation for being knowledgeable, capable, hardworking, and reliable. The consistently excellent feedback about Dennis's performance along with his extensive experience with the company makes him a perfect fit for the position in Toronto, even though Dennis does not hold a CPA designation, normally expected for a senior finance director in a public company.

Dennis has personal reasons for taking the promotion. He failed the CPA exam—bad luck, really, as his father had died the week before—which severely stalled his career growth. Being highly competent and highly ambitious, he is confident that his direct reporting relationships with both Rajvir Kumar and Bob Binder is his golden opportunity to impress them with his technical expertise, business acumen, and resonating leadership style. He ultimately hopes to build a stellar career for himself by becoming a valuable member of their executive circle.

Dennis's Trial by Fire

Dennis could not have arrived at a more hectic time. His team is rushing to compile Canada's year-end financials before the strict deadline set by the corporate accounting team in North Carolina. Dennis, as one of his first tasks and main responsibilities, is expected to sign off on all year-end financial reports. Dennis feels an enormous amount of pressure as he hasn't had enough time to get into the details as much as he hoped. In the end, he has had to trust in and rely on the experience of his staff and the diligence of the independent auditors.

His concerns are allayed when Bob Binder appears in his office a week later. "Dennis," he says, "I want to thank you for all the good work you have done ensuring we completed the year-end reporting on time. I know that Rajvir will want to congratulate you as well. It really was a trial by fire. We recognize how critically important it is that we have someone like you in the finance position who is able to make Rajvir's transition seamless and continue to report credibly on our sustained ability to meet our performance goals in Canada. We are so glad you are part of our senior leadership team now. As you get more settled, let's make a point of having regular chats. I want to be sure that you feel well supported."

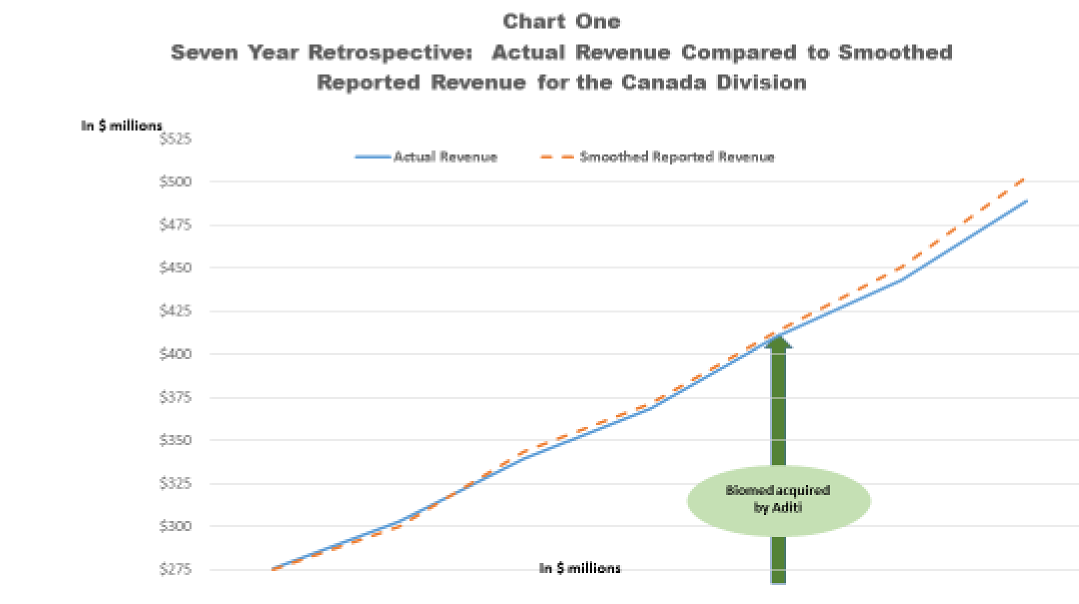
Dennis's Journey of Discovery

Dennis is intent that he never again finds himself in the position where he does not feel fully on top of the work of his department. With the year-end behind him, he decides, as a first step, to interview each member of his team to get to know them, understand each person's roles and responsibilities, and learn how they collaborate as a team.

The feedback from his direct reports and their staff raises concerns. Under the leadership of Rajvir, collaboration was discouraged. Members of the department are siloed, silenced, and know little about what others are doing. Rajvir expected unquestioned loyalty and obedience: "Do as you are told and ask no questions" was the finance department mantra. Whether myth or not, finance employees believe that those who dare to question the status quo will be fired outright and their career prospects trashed.

Dennis is worried about what such a culture might breed. He decides to initiate an internal audit to review the division's financial statements, accounting policies and practices for the last ten years. What he discovers is unsettling.

In seven of the last ten years, financial results appear to have been smoothed. Dennis prepares Chart One to visualize the smoothing impact on revenue over the last seven years. In Years 1 and 2 of this seven-year period, the reported income is below actual income. In these years, some expenses are misclassified and show up in expense categories where they don't belong. For all other years in the period, the reported income appears to have been bolstered by recognizing revenues for orders that have not yet been shipped, and by deferring expenses, mostly sales and marketing related, to the following year. He also notes that the level of smoothing has increased since the acquisition, including the year-end he just completed.



	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7: Last Fiscal
Actual Revenue	$276	$303	$340	$369	$410	$443	$489
Smoothed Reported Revenue	$275	$300	$344	$372	$413	$451	$503

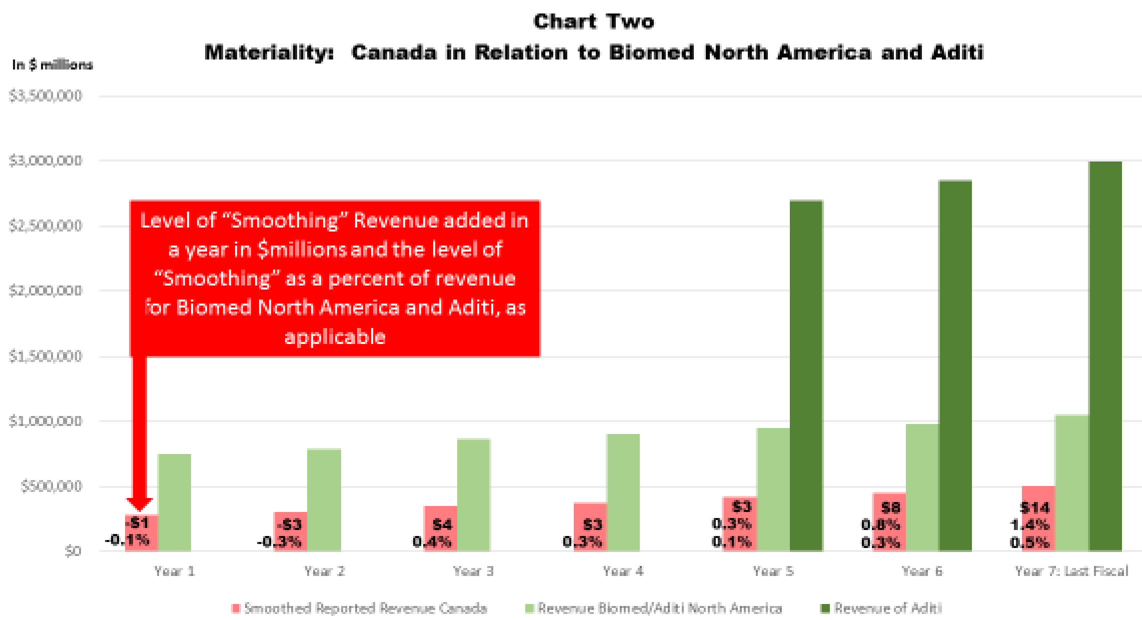
When Dennis compares the reported results to the key performance indicators against which the Canadian senior leadership team's bonuses are assessed, he notes that the years where reported revenue is overstated were years when the division was struggling to meet its financial targets. In the years when reported revenue is understated, in contrast, targets were met easily, and senior leaders had no incentive to report better results as the bonus structure does not reward performance better than budget.

He further speculates that, as a result of the smoothing, Biomed Canada would have stood out as a division that can be relied upon to produce consistently high returns. Given the significance of Canada to the Biomed acquisition overall, this would have helped to elevate its value to Aditi. Indeed, it is public knowledge that when Biomed was acquired for an above market price, members of the Canadian senior leadership team received both generous payouts and a significant number of stock options in Aditi.

Dennis wonders whether the smoothing that has taken place is an intentional act or a consequence of incompetence. In the culture of fear cultivated by Rajvir, both hypotheses are possible. And why did the auditors never pick up on these misstatements?

Materiality

Dennis prepares Chart Two to understand the significance of the smoothing that has taken place.



In relation to the scale of Biomed North America and now the Aditi enterprise, the amount of smoothing does not look material. This explains why the auditors would not have necessarily noticed the discrepancies.

Dennis Ponders His Next Steps

The decision before Dennis is not an easy one. Some might argue that the smoothing he has documented is a result of common error. He is also familiar with the argument that smoothing is not really a clear-cut ethical issue, but a judgement call. Some finance professionals in fact argue that: "Everyone does it. It only matters if the degree of smoothing crosses the line of what is material, thereby adjusting results significantly and thus, seriously misleading investors and other stakeholders."

Material or not, Dennis nonetheless cannot easily explain away the connection between the smoothing with the acquisition share price premium, payouts, and performance bonuses that have so benefited Canadian senior leaders. It suggests that the manipulation of accounts has been intentional. He himself is a witness to the fact that senior leaders in Canada are always very much attuned to the division's progress relative to their performance goals. Would this attention to progress, however, be common to senior leaders in most public corporations which are, today, so driven by a need to report favourable short-term results to their shareholders?

Should the intentional nature of the transactions alone make this an ethical issue? If so, to what extent, have his bosses, Rajvir Kumar and Bob Binder, as well as the Canadian executives now on Aditi's global leadership team, been the driving forces behind a scheme to maximize executive compensation? Rajvir is a CPA, CA. Isn't it his role to set up internal controls to prevent such errors from happening?

Since the acquisition by Aditi, the generic drug industry has hit tougher times. With the entrance of new players, the market has become more competitive. With more options available, pharmacies, insurance companies and governments have been taking steps to put downward pressure on the prices that they are willing to pay for generic drugs. These conditions, Dennis surmises, can fuel a desire to escalate the amount of overstating of revenues since the acquisition. And, indeed, relative to Biomed North America and Aditi overall, the Canadian division has continued to do surprisingly well. As he doesn't expect market conditions to improve in the near future, the pressure to overstate results can be expected to continue.

With all the doubts and suspicions swirling in his mind, Dennis wonders what his next steps should be. Should he call the Aditi whistleblower hotline that was set up following Sarbanes Oxley? Will the whistleblower process protect him as he will be identified as the obvious source of the information? Does anyone even care and categorize this as an issue? Does he have other options? What is the right thing to do? He is not a CPA, CA, and not formally bound by the Code of Ethics. What steps must he take? How can he protect himself in the process?

Questions

1. Is Dennis right in thinking the smoothing is an ethical issue? Who does it benefit? Who does it harm? When is smoothing okay?

2. Are there other ethical issues to consider?

3. What factors and stakeholders does Dennis need to take into account?

4. What leverage does he have?

5. What options and next steps are open to him?

6. What is your evaluation of those options?

7. Which option is best for Dennis? How would you implement the chosen option in chronological order?