



Restructuring At Exozol?

By Larry M. Prober, PhD, CPA

Edward Keys hopes that new blood in the company will foster fresh and creative ideas to help achieve corporate objectives. What is the new CFOs' fiduciary responsibility?

Abstract

Restructuring at Exozol? addresses how restructuring charges can affect financial reports, and the influences of corporate management in the accounting for these costs. It highlights major points, from internal controls for adopting a restructuring plan to developing cost estimates and the year-to-year accounting for these items. The case illustrates some of the major corporate restructuring issues the Securities and Exchange Commission has addressed in its quest to reduce earnings management. Follow James Linwood as he uncovers several potential problems in his investigation of restructuring at the company.

Background

Exozol is a leading provider of lubricants for transportation and industry. Like others in the specialty chemicals industry, the company has recently experienced slowing growth. While this softness in the market can be attributed to the industry's maturity and factors such as improved engines and longer draining intervals, the company hopes that a series of acquisitions and cost cutting initiatives will help restore it to a more favorable status among those following the industry. To improve profitability, Exozol has recently hired James Linwood as its new chief financial officer. Mr. Linwood comes from a smaller industry competitor and brings a strong background in the development of strategic alliances and financial controls. Exozol's president and chief executive officer, Edward Keys, hopes that new blood in the company will foster fresh and creative ideas to help achieve corporate objectives.

Under its new organizational structure, Exozol has recently promoted Linda Sharp to controller, and Al Barkley to assistant controller. These two along with James Linwood are important team players as the company moves toward a more focused effort for accounting and finance to help combat competitive pressures. The importance of the CFO in strategic planning as well as accounting policy is one of the reasons for Mr. Linwood's appointment. These members of the finance team are expected to help minimize the company's cost of capital and provide leadership to meet analysts' revenue and profit growth expectations. Growth is a major concern of Edward Keys and he hopes that all employees, not just those in management, understand its importance to the company's future. This point was best illustrated when executive bonuses were suspended in 20X1



as a result of lackluster performance. Improved results in 20X2 are expected to make it possible to restore the company's bonus program.

As CFO, one of James Linwood's goals is to communicate more effectively with members of the financial community. He hopes to inform analysts and other interested parties of Exozol's efforts to develop a more comprehensive profitable product line for global customers. Included in this effort is the reduction of business risk through better management of foreign currencies and a series of strategic alliances with foreign partners who possess more extensive knowledge of their local markets. Given that most future growth is expected to come from Asian and European demand, Mr. Linwood reasons that the company should make more efforts to take advantage of lower labor and production costs overseas.

One of the more immediate problems confronting the finance group as it embarks on its expanding role within the company is its relationship with Mr. Keys. Long known for his abrasive managerial style, Mr. Keys also pays close attention to industry competitors and Wall Street's reaction to industry trends. He believes that managers have a responsibility to the shareholders and management should do everything in its power to look out for shareholder interests. Accordingly, he has been known to tell the controller to "bend the rules where appropriate but never break them." Since Linda Sharp is acutely aware of the SEC's latest efforts to improve financial reporting, she has some concerns about the degree of power she possesses if Mr. Keys involves himself in specific accounting issues. With acquisitions and corporate restructurings in the works, she believes now is not the time to bend any rules. James Linwood also worries about the potential loose interpretation of accounting rules and believes his relationship with the investment community could be eroded if any problems develop early in his tenure as CFO. Thus, he has instructed the group to be overly cautious in the application of generally accepted accounting principles, since the last thing the company needs is an SEC investigation and subsequent restatement of earnings. He hopes that any differences in opinion can be resolved peacefully and that auditor disagreements can be kept to a minimum.

The Problem

As the 20X2 financial reporting season comes to a conclusion and financial statements are being prepared for auditor review, the finance group has several items to discuss. Chief among them is the accounting for restructuring charges taken last year and continuing this year. Since James Linwood was not employed by Exozol when the company first decided to restructure operations, he was not involved in some of the cost estimates used in last year's financial reports. Thus he has immersed himself in many of the details surrounding the firm's operations, including the \$15 million of cost savings that those changes were expected to deliver in 20X2. He believes that to achieve the company's objectives and the benefits of this program, he should understand as many details as possible. Unfortunately he has discovered a few problems that may make his job more difficult.

For example, he has some doubts regarding the initial approval to restructure operations. Although Mr. Linwood sees substantial benefits in consolidating component production



and reducing certain product lines, he questions whether Mr. Keys had the proper authority to embark on the project since formal approval in prior years for similar activities was usually given by the company's board of directors. Since the decision to proceed with phase one of the restructuring was made late in 20X1, no formal meeting was held to discuss the matter in that year. While subsequent minutes note the board's unanimous approval and a reasonable plan/commitment date, Mr. Linwood would like to implement a formal process to avoid similar concerns in the future.

Also related to the operational closings are the estimated costs for plant shutdowns and the related separation payments to displaced employees. While the company has broken these items out and separated impairment costs as required under newly revised accounting standards, Mr. Linwood notes that some estimates were quite high, leading to their reversal during the current year. A review of similar charges in the past shows the company consistently overstated these costs and later credited them to income. He is particularly concerned because some severance costs were estimated for employees and charged to expense even though the affected employees were not told of their job displacement until the subsequent quarter. He believes he should limit the adjustments made from earlier estimates. His discussions with Mr. Keys regarding this issue show the CEO has little concern about estimation error since he believes that "accountants cannot predict the future and would not be called upon to defend these immaterial amounts."

Finally, Mr. Linwood has some questions regarding the relationship of other typical costs, such as research and development. He notes that in most years, industry requirements have justified a consistent percentage of R&D commitment. However, current-year allocations are below this established policy. While this issue may be managerial in nature he believes he should question this changes as part of his role as a strategic adviser. While he recognizes the improved profit that results from the lower expenditure, he also believes that it is likely to affect future profitability. Thus he wonders why the sudden change was needed. In a brief discussion with Ed Keys, he learns that in one of the 20X1 acquisitions there was some duplication of research efforts. Nevertheless, he wonders how the company can maintain its current competitive advantage in certain product lines if it reduces its R&D. In addition, he notes that in the 20X1 acquisition of Puma Lubricants, \$9.5 million was charged against income from technology under development. He knows the company's policy is to write off these amounts if they have no future benefit but believes that some of these projects have already benefited the firm and will continue to do so (see Exhibit 1 for a listing of these accounting concerns).

Linda Sharp has also approached Mr. Linwood about her concerns regarding the company's restructuring charges. She has to meet with the auditors in two days and wonders how the restructuring credit should be handled. She just attended a continuing professional education course where she learned that a new auditing standard about to be released would subject accounting estimates and resulting errors to a higher degree of scrutiny for materiality. She worries that previous estimates that seemed acceptable at the time--and at the worst immaterial--might now be considered material if they affect



earnings trends, or other decisions in which the charge is involved. She is also concerned that the auditors will have questions about accounting quality.

Exhibit 1: James Linwood's Concerns

Fourth quarter 20X1. Ed Keys' approval of restructuring charges for operational shutdown and transfers, with board of directors' approval in next quarter.

Fourth quarter 20X1. Booking of a \$29.975 million charge for restructuring consisting of the following costs:

1. Plant closings and other related charges of \$19.5 million
2. Employee separation costs of \$7.65 million, including \$1.5 million for 45 employees who were not notified of the action until the following quarter.
3. Asset writedowns of \$2.825 million.

First quarter 20X2. Additional expense of \$3.1 million recorded to reflect a greater amount for separation benefits, principally in Japan.

Second quarter 20X2. Reduction of \$4 million from previously estimated severance costs.

Third quarter 20X2. Recorded the second phase of downsizing, consisting of 3% of the workforce and 20 of 30 production systems in a Midwestern plant. Total charges of \$18.45 million included \$8.7 million for employee severance costs and \$9.75 million of other exit costs, including \$4.5 million related to asset impairments for production units taken out of service.

Fourth quarter 20X2. Reduced previous restructuring charge by \$2.8 million due to overestimate of original charges related to shutdown expense.

Exhibit 2: Abbreviated Exozol Income Statement Data for 20X2, 20X1 and 20X0

(\$000's)	20X2	20X1	20X0
Net sales	<u>1,166,565</u>	<u>1,052,876</u>	<u>1,101,762</u>
Cost of sales	779,986	738,224	735,664
Selling & administrative	125,865	115,545	107,285
Research & development	<u>111,996</u>	<u>120,723</u>	<u>117,551</u>
Total Costs & Expenses	1,017,847	974,492	960,500
Restructuring charges	(14,776)	(28,975)	
Gains from litigation	12,434	11,715	



(\$000's)	20X2	20X1	20X0
Other income and expenses, net	<u>(17,556)</u>	<u>(12,565)</u>	
Income before taxes	128,820	48,559	141,262
Income taxes	<u>47,663</u>	<u>17,967</u>	<u>52,267</u>
Net Income	81,157	30,592	88,995

Based on the above information, how appropriate are the concerns expressed by James Linwood and Linda Sharp? Include in your considerations the financial reporting objectives that apply to these issues and the current standards for meeting these objectives.

Comments on “Restructuring at Exozol”

Stephen J. Cosgrove is Vice President, Consumer Sector Finance, at Johnson and Johnson Inc.

Johnson and Johnson is engaged in the manufacture and sale of a broad range of products in the health care field in many countries of the world.



“If the chosen level of R&D spending doesn’t support the business in the long run, the investment community will discount any short-term profit impact.”

In today’s business world, it is increasingly common for new finance teams to be hired into companies in the midst of transition. In the Exozol case, a new chief financial officer and his staff are faced with the opportunity of taking a fresh look at past accounting and management practices while simultaneously establishing credibility and providing financial leadership to a new organization. To succeed at both, the team will need a strong understanding of accounting practices and the ability to use their knowledge and experience to move the organization forward.



Mr. Linwood was hired because of his potential to be a key player in setting company strategic direction, as well as his ability to institute strong accounting practices. He was brought in to “foster fresh and creative ideas to help achieve corporate objectives.” This represents a wonderful opportunity for James Linwood and his staff.

However, in meeting this challenge, Mr. Linwood worries about his new boss’s style and perceived attitude toward accounting standards, which is to “bend the rules but never break them.” This type of uncertainty does not help in establishing the strong partnership that will be necessary for Mr. Linwood to bring about positive changes to the business while carrying out his professional responsibilities to accurately portray company results. One of the first steps Mr. Linwood should take is to “educate” Mr. Keys on the current Securities and Exchange Commission environment and the impact that could have on Exozol.

There are two separate business issues that Mr. Linwood and his staff need to address to provide value to the company while insuring proper compliance with generally accepted accounting principles. One has to do with the various compliance issues uncovered during the review of the prior year’s restructuring charge. The other is a business strategy issue concerning the business impact of the current year’s research and development spending. How Mr. Linwood handles the two issues will likely determine the health of his relationship with Mr. Keys.

There were clearly some mistakes made in establishing the restructuring reserves before Mr. Linwood came to Exozol. Proper board approvals, severed employee notifications and cost estimations all were problem areas. Given the threat of an SEC investigation and his desire to establish credibility with the investment community, Mr. Linwood urges his staff to be “overly cautious in the application of GAAP.” These instructions will probably cause a strain between the finance group and Mr. Keys. The finance team at Exozol has a fiduciary responsibility to accurately account for the company results using GAAP, not to be overly cautious, avoid SEC investigations or establish credibility with the investment community. Mr. Linwood can review with Mr. Keys the proper way to handle all of the issues arising from the restructuring accrual and how any adjustments must be reported. In particular, he should explain that gains due to restructuring reserves must be handled separately from ongoing results, under SEC Staff Accounting Bulletin 100, *Restructuring and Impairment Charges*. Accounting for these gains in any other fashion is not bending but breaking the rules.

Mr. Linwood is on the right track when he recommends establishing a procedure for proper documentation of the approval of major events, but he needs to create other procedures to enhance accounting controls in this area to ensure these issues are handled properly in the future.

The R&D issue gives Mr. Linwood an opportunity to learn more about Exozol, the potential R&D economies of a recent acquisition and the importance of understanding competitive investment levels. Selecting R&D spending levels is a critical strategic decision on which Mr. Linwood, as a member of the management team, should have



input. Mr. Keys hired him, after all, in part because he could benchmark spending levels in other industry companies. Mr. Linwood should also explain to Mr. Keys that the investment community will focus on this critical area of spending. If the chosen spending doesn't support the business in the long run, the investment community will discount any short-term profit impact.

Mr. Linwood's relationship with Mr. Keys will depend on how well the CFO communicates his assessment of the current situation, meeting all the GAAP reporting requirements while acting as a strong business partner and adviser. While some issues should not be negotiable, compliance does not mean being over cautious. Managing for the long-term health of a business must be a factor when making short-term spending decisions.

Mike Cohen, CPA, is Director of Technical Services for the NJSCPA.

He previously worked at Ernst & Young as a specialist in technical matters and before that he was a project manager with the FASB.

“Mr. Keys has to learn that restructuring reserves are not cookie jars in which reserves can be stashed for future reversal when needed.”

This case illustrates the extreme ethical pressures that weigh on senior financial executives, particularly when they work for Securities and Exchange Commission registrants under severe profit constraints. Such pressures can be much greater than those affecting CPA practitioners, who at worst will lose a client. Mr. Linwood is at risk of losing his job if he doesn't satisfy Mr. Keys, and suffering long-term damage to his career. But he also should be aware of the AICPA Ethics Interpretation ET 203.05, which provides that CPA employees who are responsible for the preparation of their employers' financial statements cannot state that those statements are in accordance with generally accepted accounting principles if they contain any departure from GAAP. Mr. Linwood will have to sign such a representation letter to Exozol's auditors and the Form 10-K, containing the financial statements, that is filed with the SEC. If he signs those documents, and Exozol's financial statements are later found to be materially inaccurate, he may be subject to severe ethical sanctions.

Mr. Linwood's focus should be to persuade Mr. Keys of the necessity to comply, to the letter, with the rigid, complex accounting standards that apply to restructurings. Mr. Keys has to learn that restructuring reserves are not cookie jars in which reserves can be stashed for future reversal when needed. Ms. Sharp, Mr. Barkley, Exozol's board of directors and its auditors all should be allies in this effort. Like most accounting problems, these issues are better addressed sooner rather than later. Mr. Linwood can point out that these restructuring charges will receive high-level scrutiny and heightened professional skepticism from the auditors. Failure to accurately estimate restructuring costs, as evidenced by subsequent significant adjustments, will damage the company's (and its top executives') credibility with analysts and may lead to embarrassing inquiries

from the SEC staff. Those reserves must be accurately estimated, recorded in the proper period and fully disclosed.

The technical accounting standards dealing with restructuring charges are the consensuses in EITF 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)* and 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination*; and SEC Staff Accounting Bulletin 100, *Restructuring and Impairment Charges*. It appears that in 20X1 Exozol has at least technically violated two of those standards. They provide that restructuring charges should not be recorded until “management having the appropriate level of authority” commits to the exit plan. Exozol recorded its charges before its board of directors approved the plan. In addition, employees must be notified of their pending involuntary termination before the charge is recorded. In this case, severance costs were charged to expense before the employees were told of their displacement. Linwood should inform Keys of these significant problems—immediately--and enlist the help of the company’s auditors to persuade Keys of the need for careful, thorough estimates of restructuring costs, and the importance of recording them in the proper periods.

Grace Pownell, Ph.D., joined the Goizueta Business School Faculty, Emory University in the fall of 1993.

She is the author of "How Frequently Do Managers Disclose Prospective Earnings Information?" The Journal of Financial Statement Analysis, Spring 1998. (Co-authors: C. Kile & G. Waymire).



“Exozol's main financial reporting problems appear to be a function of Ed Keys' autocratic management style.”

This case is a good illustration of the complexity and inter-relatedness of various accounting and internal control issues, including the relations among managers' personal incentives (including bonus payments and personal credibility), investor relations programs, earnings management, cost of capital and accounting controversies with auditors and regulators.

Turning first to the earnings management issues, although the abbreviated income statement shows a pattern that is consistent with Exozol having taken a Big Bath in 20X1



(intentionally accelerating the recognition of expenses in a year during which earnings are below the long-term trend line to improve accounting profitability in future years), the discretionary charges taken in 20X2 are not consistently of the income-increasing variety. In 20X1, Ed Keys took estimated restructuring charges in excess of the amount that was ultimately justified. In 20X2 some of the charges were reduced, but another set of restructuring charges was recognized, some of which (particularly those related to shutdown expenses for the production systems in the Midwestern plant) proved to be excessive before the end of the year. These 20X2 restructuring charges caused net income for that fiscal year to fall below the trend line, although not by as much. In addition, the issue is clouded by the pattern of research and development charges, which in 20X1 were summarily reduced from the percentage of commitment typically recognized in the industry but were also increased by the immediate charge-off of in-process R&D purchased in the acquisition of Puma Lubricants. Because a clear pattern does not emerge from these unusual charges, investors and analysts are likely to be confused about management's intentions and are also likely to find it difficult to forecast future cash flows and earnings. This confusion could well lead to an increased cost of capital for Exozol, and to be inconsistent with Ed Keys' stated focus on shareholder interests.

To his credit, James Linwood is concerned about his relationship with the investment community. He no doubt understands the results of the research on the inverse relations between increased disclosure and transparency in financial statements and cost of capital to a business. Other factors that have been shown to be inversely related to share prices are controversies with auditors and regulators that lead to restatements of prior year financial statements. These events should be avoided as part of a good investor relations program.

Exozol's main financial reporting problems appear to be a function of Ed Keys' autocratic management style. He is not committed to good process and proper authorization by the board of directors for plans and commitments. He does not respect chain of command in making accounting decisions, and appears to be using the suspension of bonuses for decision-making personnel as a tool to exercise power over managers rather than as an incentive structure to facilitate delegated decision making in shareholders' best interests. A useful exercise might be to attempt to construct and evaluate a justification of Ed Keys' actions, decisions and incentives.