

MICHIGAN STATE UNIVERSITY
Eli Broad College of Business

**ACC 852 CORPORATE GOVERNANCE
AND ACCOUNTING CONTROL**
Fall Semester 2006

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Course Description:

In light of the recent corporate scandals such as Enron, Tyco, WorldCom, Xerox, etc. there has been increased concerns over corporate governance and accounting controls. As a result corporations are making both voluntary and mandatory changes to their governance structure. In this class, we will examine corporate governance functions, including top management, boards of directors and audit committees, internal control and risk assessment, external auditors and independence, fraud detection, and SEC reviews of filings and enforcement activities. We will evaluate how these functions have performed historically as well as identify and evaluate the policies, procedures, and controls that can be employed to promote good corporate governance and ethical decisions. Additional topics will include the design and evaluation perspectives of the control environment, risk assessment, control activities, and monitoring. Special attention will be paid to the rapidly changing environment affecting corporate management as they respond to the newly enacted requirements of the Sarbanes-Oxley Act.

Required Course Materials:

Class Packet from College Store Bookstore at the Hannah Plaza

Preparation for Class Sessions

The class covers a large amount of inter-related material; it is extremely important that you do not fall behind. Several of the assignments will be discussed in class and students are expected to actively participate in such class discussions. Since I may call on students who typically do not participate in class discussions, please notify me in advance if you are not prepared for a given session.

Class Etiquette:

Classes will begin on time. Entering the class after it has begun is not only disruptive but also discourteous to your colleagues. Similarly, you are expected to stay in class for its entire duration. If you know ahead of time that you will be missing classes for personal reasons (e.g., religious reasons), please let me know ASAP so that I can plan your assignments accordingly.

Honor Code Requirements:¹

All required assignments should be the result of the individual's or authorized group's unaided effort. Any one who violates this requirement will be subject to disciplinary action under the provisions and policies set forth by Michigan State University.

“The principles of truth and honesty are fundamental to the educational process and the academic integrity of the University; therefore, no student shall:

- claim or submit the academic work of another as one's own.
- procure, provide, accept or use any materials containing questions or answers to any examination or assignment without proper authorization.
- complete or attempt to complete any assignment or examination for another individual without proper authorization.
- allow any examination or assignment to be completed for oneself, in part or in total, by another without proper authorization.
- alter, tamper with, appropriate, destroy or otherwise interfere with the research, resources, or other academic work of another person.
- fabricate or falsify data or results.”²

“From this, it's obvious that you can't -- or at least shouldn't:

- turn in an exam, paper, or project that is not wholly your own work;
- copy answers from another student's exam or test;
- get questions and/or answers from students who have already taken an exam or quiz you are scheduled to take;
- have another person take a test for you;
- submit the same paper for two or more classes;
- use other authors' ideas and phrases without proper attribution; and
- collaborate with other students on projects or assignments without your instructor's permission.”³

In addition to the above honor code requirements, this course requires the following:

¹ Parts of this section on honor code were developed based on Professor Petroni's MBA 802 Financial Accounting course syllabus.

² <http://www.vps.msu.edu/SpLife/reg3.htm#1.00>

³ <http://www.msu.edu/unit/ombud/dishonestystud.html>

1. I may distribute suggested solutions to cases. By registering for this course, you are agreeing not to use any materials obtained, directly or indirectly, from students or others who have seen it before. More importantly, you are agreeing not to provide such materials to other students. Use of such materials violates the honor code and will be harmful to your learning experience.
2. There must be no discussion regarding cases and other homework assignments with members from other teams (with other students when it is an individual assignment). In addition, no outside materials must be used when completing case assignments, e.g., analysis must be based only on the information provided in case assignments. The case assignments will be graded on how well you have used the information that is provided to you. This requirement does not apply to the corporate governance presentation and the litigation consulting project. In these two instances, you may use whatever publicly available information that you see fit, but provide appropriate citation.
3. If you inadvertently violated the honor code or you know of someone who violated the honor code, you are obliged to forthwith report the incident to me. Failing to do so will itself be considered an infraction of the honor code.

I will very strictly enforce these honor code rules and will impose the strictest possible punishment for transgressions. Students who violate the honor code may receive a zero on the assignment or fail the course. Any self-reported violations will be penalized less severely than other violations. If you are unsure about the honor code requirements in a given scenario, please contact me as soon as possible.

Tentative Assignment and Grading Scheme:

I will distribute during the first day of class two sheets entitled “ACC 852 Summary Class Schedule and Assignment Points (Tentative)” and “ACC 852 Project/Presentation Assignments and Presentation Sequencing (Tentative)” providing details of point allocation for assignments, companies assigned to each team, and the sequence of presentations.

The course will be graded on a curve. Assuming satisfactory overall class performance, the mean grade will be around 3.5. However, the actual mean grade may be higher or lower than 3.5 depending on the overall class performance.

Note that the grading scheme is tentative. Although the final grading scheme will be highly correlated with this scheme, minor modifications may be made during the duration of the course.

Communication Center

The Department of Accounting and Information Systems has established the *Ernst & Young Center for Accounting Business Communication* to support the Department in developing both the written and oral communication skills of students in the Department’s M.S. program by establishing best practices guidelines for written and oral communications. During the course of the term you will get opportunities to utilize the Center’s resources in preparing your written and oral presentations.

Tentative Class Schedule for Corporate Governance and Accounting Control

Session 1 August 28, 2006

Topic What is corporate governance and what is the state of U.S. corporate governance?

Readings The State of U.S. Corporate Governance: What's Right and What's Wrong? By Bengt Holmstrom and Steven N. Kaplan. (Journal of Applied Corporate Finance, Vol. 15, No. 3, Spring 2003, pp. 8-20).

Session 2 August 30, 2006

Seating Chart Choose your seat wisely during session 2. I will prepare a seating chart based on where you sit today, and the expectation is that you would continue to sit in the same location during the rest of the term. If you need to sit in a specific location for health or other legitimate reasons, please e-mail me ASAP.

Topic Design of Effective Corporate Governance Policies

OECD Principles of Corporate Governance

Review the sections entitled "Preamble," "Disclosure and Transparency," and "The Responsibilities of the Board" (both in parts one and two of the document). The document can be found at

<http://www.oecd.org/dataoecd/32/18/31557724.pdf>

Best Practices in Corporate Governance: What Two Decades of Research Reveals (by Anil Shivdasani and Marc Zenner, Journal of Applied Corporate Finance, Vol. 16, Nos. 2-3, Summer 2004, pp. 29-41)

Remuneration: Where we've been, how we got to here, what are the problems, and how to fix them by Jensen and Murphy with Eric Wruck.

The sections entitled "Introduction and Summary" and "List of Recommendations and Guiding Principles" are included in the class packet. The entire article is 116 pages long and can be found at

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=561305#PaperDownload.

Fuller, Joseph and Jensen, Michael C., "Just Say No To Wall Street".

Journal of Applied Corporate Finance, Vol. 14, No. 4 (Winter 2002) pp. 41-46. <http://ssrn.com/abstract=297156>

Kellogg Company's Proxy Statement (March 16, 2005)

Session 3 September 6, 2006

Topic Corporate Governance, Organizational Architecture and Incentives

Readings Corporate Governance, Ethics, and Organizational Architecture (by James A. Brickley, Clifford W. Smith, and Jerold L. Zimmerman, Journal of Applied Corporate Finance, Vol. 15, No. 3, Spring 2003, pp. 34-45).

Transforming Enron: The Value of Active Management (by Vince Kaminski and John Martin, Journal of Applied Corporate Finance, Vol. 13, No. 4, Winter 2001, pp. 39-49)

Corporate Governance Fitness Questions (K. Ramesh). Note: This is not meant to be an assignment. I have used this questionnaire with business executives to assess the corporate governance fitness of their corporations.

Session 4 September 11, 2006

Topic Introduction to Consulting Project on Corporate Governance

During this session, the instructor will provide an overview of the various aspects of the term-long litigation consulting team project. The session will focus on understanding the objectives of the project, the various project milestones, the project deliverables, etc. The project will be integrative in nature and will involve the use of your expertise in finance, financial reporting, auditing, corporate governance and business communication. Each team will be assigned a historically well-known corporate governance failure that involved an accounting scandal or other governance issues. During the term, each team will make three presentations (by a member who has not presented before⁴).

During this session, the instructor will also discuss the various publicly available data sources that could be used in completing the assignment, including the following:

⁴ I will make an exception for teams with only three members. If your team has only three members, please raise this issue in class.

- Downloading complaint and related information;
- Stock price and volume data (will be given to you);
- Earnings announcements, analyst conference calls (Regulation-FD);
- News and business press articles (company website, Factiva, Lexis/Nexis, etc.);
- Financial statement information (annual reports, 10-Ks, 10-Qs) from the company and the SEC web sites;
- Other SEC filings (insider trading, 8-K, proxy statements) from the company and the SEC web sites;
- Equity analyst reports (from Investext, etc.);
- SEC investigations and enforcement releases, and
- Others.

Session 5 September 13, 2006

Topic The Sarbanes-Oxley Act

Readings Sarbanes-Oxley: A Closer Look (KPMG, January 2003)

The Sarbanes-Oxley Act of 2002

Understanding the Independent Auditor's Role in Building Public Trust: A White Paper (PricewaterhouseCoopers, 2003)

Janitorial Audit Fees Lead to More Scrutiny of HealthSouth (Building Services Management, June 11, 2003)

A Primer on Regulation Of U.S. Stock Markets (Wall Street Journal, October 20, 2003)

The Investor's Advocate: How the SEC Protects Investors and Maintains Market Integrity (<http://www.sec.gov/about/whatwedo.shtml>)

Team assignment 1 due today

Session 6 September 18, 2006

Topic **Analysis of the Structure of Corporate Governance**

Team assignment 2 due today

Session 7 September 20, 2006

Topic **Review of the Academic Research on the Sarbanes-Oxley Act**

Readings Audit Research after Sarbanes-Oxley, By Mark L. DeFond and Jere R. Francis
(Auditing: A Journal of Practice & Theory, Vol. 24, Supplement 2005, pp. 5-30).

Additional materials to be distributed in class

Session 8 September 25, 2006

Topic **Corporate Governance Audit**

Readings The Warnaco Group, Inc. (K. Ramesh)

Scheduled Quiz

Session 9 September 27, 2006

Topic **Building Tools for Fraud Detection: Strategic Assessment of Business Risk and Accounting Risk**

Readings How Risky is Your Company (by Robert L. Simons, Harvard Business Review, May-June 1999)

Assessing Accounting Risk (by David F. Hawkins, Harvard Business School, February 8, 2005)

Financial Statement and Ratio Analysis (by Paul M. Healy, Harvard Business School, September 5, 2000)

Basic Ratio Analysis and Equity Valuation (by David F. Hawkins, Harvard Business School, December 18, 2002)

Assignment Sound Advice, Inc. (for class discussion)
Best Buy (for class discussion)

Session 10 October 2, 2006

Team assignment 3 due today

Team Presentations for Litigation Consulting Project (Part 1)

Session 11 October 4, 2006

Team Presentations for Litigation Consulting Project (Part 1)

Session 12 October 9, 2006

Topic External Audit and Fraud Detection: Practice

Readings Financial Reporting Fraud: A Practical Guide to Detection and Internal Control (by Charles R. Lundelius, Jr., AICPA, 2003)
Chapter 7: Research Findings on Fraudulent Accounting
Chapter 9: Quantitative Predictors of Financial Statement Fraud
Appendix D: Financial Statement Fraud Supplemental Checklist

Financial Shenanigans by Howard Schilit

Session 13 October 11, 2006

Topic Earnings Management

Readings Earnings Management by Patricia Dechow and Catherine Schrand

How Are Earnings Managed? Examples from Auditors (Nelson, Elliott and Tarpley).

Assignment Stamford International Inc. (HBS case) – for class discussion

Session 14 October 16, 2006

Topic External Audit and Fraud Detection: A Case Study

Team assignment 4 due today (*Spartan Associates* by K. Ramesh)

Session 15 October 18, 2006

Topic A Case Study on Responsibilities of Accountants

Readings Run, Inc. (a case study prepared by the American Accounting Association Committee on Liaison with the Securities and Exchange Commission)

Assignment Be prepared to discuss the differences between accounting for a change in estimate and a correction of an error. Also be prepared to discuss the pros and cons of choosing one method over the other keeping in mind the judgment involved in the choice of the accounting approach, the potential stock market reaction to the accounting choice, the appropriate code of professional standards required of accountants, your personal ethical standards, and anything else that you may consider relevant. In preparing for the class, consider the following questions:

1. After reviewing the composition of Run, Inc.'s Board of Directors, what concerns do you have regarding the company's corporate governance structure? What would you recommend to improve the Board's governance structure?
2. When Martin asked John regarding the inventory and receivables buildup, John said that Run, Inc. has "to exercise a little more control than we have in the past. And you can help us do that..." If you were Martin, what would your advice be?
3. Pressure, opportunity and rationalization are the three sides of the fraud triangle (See <http://www.aicpa.org/pubs/jofa/jan2003/ramos.htm>). How did these factors manifest in this case?
4. White indicated to Martin that "some of those receivables you have been so concerned about are the result of sales that we are sure will happen, and some of that inventory is stuff that we have shipped but not yet recorded as cost of goods sold." Could this accounting "problem" explain the differences between the financial performance of Run, Inc. and its industry as indicated in

Exhibit II?

5. Two accounting approaches were proposed to correct the accounting “problem” identified by Martin. Could you identify and propose a third approach? Purely from a GAAP perspective, which one of the three would you recommend and why?
6. Could you guess how the stock market would react to each one of the proposed approaches? Which one of the proposed accounting approaches is likely to lead to shareholder lawsuits? To what extent the potential stock market reaction and the possibility of shareholder lawsuits should be considered in recommending the appropriate accounting approach?
7. Was it appropriate for Martin to tell the auditors that “[s]ome of those things in that write-off don’t pass the smell test”?
8. Was it appropriate for Martin to sit quietly when the auditors agreed with John’s belt tightening philosophy? What would you have done if you were Martin?
9. Why should Martin care? Martin will not be asked to sign anything this year.
10. Assuming you were Martin and you did not agree with the company’s reporting choice in this matter, would you consider resigning from the company? Do you have any other professional responsibilities?

Session 16 October 23, 2006

Review session for exam

Session 17 October 26, 2006 (6:00 to 9:00 p.m.) (This is a Thursday)

N100 BCC

Session 18 October 30, 2006

Topic Understanding Audit Failures: Lincoln Savings and Loan

Readings Why do audits fail? Evidence from Lincoln Savings and Loan (by Erickson, Mayhew and Felix, Journal of Accounting Research, Vol. 38, No. 1, Spring 2000, pp. 165-194) – See previous session.

Top Ten Audit Deficiencies (by Beasley, Carcello and Hermanson, Journal of Accountancy, April 2001)

Assignment Assume you were part of the Lincoln Savings and Loan audit team. Based on the facts, statistics and analyses provided in Erickson, Mayhew and Felix (2000), you should be prepared to discuss with your audit team (i.e., the class) whether the accounting method chosen by the company was appropriate.

Session 19 November 1, 2006

Topic Understanding Audit Failures: Enron through the Accounting Lens

Readings Year 2000 Annual Report of Enron Corp and related spreadsheets.

1. Using only the data in the spreadsheets, conduct an analysis of the financial performance of Enron Corp., including an assessment of its earnings quality. Please review p. 36 “Accounting for Price Risk Management” for a definition of “Other Revenues”.
2. Enron reviews its cash flows under the section titled “Financial Condition” on p. 26. Assess the quality of Enron’s disclosures regarding its cash flows. What additional information would you like to know from Enron regarding its cash flows?
3. Page 21 indicates that Wholesale Services accounted for a large portion of IBIT for the year 2000. Also, the operating segment data on p. 21 indicates that Enron was in Broadband Services during 2000. Based on a review of the section entitled “Results of Operations,” what accounting issues are key to understanding the financial performance of these two operating segments? Explain.
4. P. 36 “Accounting for Price Risk Management Activities” indicates that Enron is using mark-to-market accounting for its price risk management activities. Assume that Enron used a cash basis accounting for tax purposes. Based on your review of the income tax footnote (p. 40), estimate how much mark-to-market profit Enron had booked through December 31, 1999 that it did not yet realize in cash through December 31, 1999? How did this change during the year 2000? If you are an equity analyst, what would you ask Enron regarding its accounting for price risk management activities?
5. Enron discusses its transactions with related parties on pp. 48-49. What corporate governance issue is raised by the organizational structure of the related

party? What were the stated business purposes for the related party transactions entered into during the year 2000? Why might a company such as Enron need a related party to achieve these business purposes? What would have been the impact on Enron's earnings if it had not entered into the related party transactions during the year 2000? As an auditor, what issues would you examine as part of auditing the related-party transactions and their disclosure in the financial statements?

Session 20 November 6, 2006

Topic Transaction Structuring and the Management of Financial Reporting: The Case of Enron

Readings Enron Corp., JEDI and Chewco (case by K. Ramesh)

Scheduled Quiz

Session 21 November 8, 2006

Topic Bias in Audit Judgment

Readings Why Good Accountants Do Bad Audits? (Bazerman, Loewenstein and Moore).

Session 22 November 13, 2006

Team assignment 5 due today.

Team Presentations for Litigation Consulting Project (Part 2)

Session 23 November 15, 2006

Team Presentations for Litigation Consulting Project (Part 2)

Session 24 November 20, 2006

Topic A Case Study on Breakdowns in Organizational Culture & Management

Readings The Barings Collapse (A)

Assignment Be prepared to discuss the following questions:

1. Describe a typical employee of BB&Co and BSL. How was Leeson's behavior driven by the BSL culture?
2. Did the bonus scheme contribute to Barings' downfall? If so, how?
3. How did Nick Leeson manage to lose £843 million in just over two and a half years?
4. How did the formation of BIB add to the problems?
5. What were the problems with Barings' management system and how did they contribute to the collapse of the bank?

Please use this session to ask questions regarding any terms used in The Barings Collapse (B) that you don't fully understand (see next session).

Session 25 November 22, 2006

Team assignment 6 due today.

Topic A Case Study on Failures in Control and Information Use

Readings The Barings Collapse (B)

Session 26 November 27, 2006

Topic A Case Study on Governance and Investor Communication Challenge

Readings Computer Associates International, Inc. (HBS 9-103-007)

Assignment Please be prepared to discuss the following questions (You may find it useful to discuss these issues before hand with your team. No write-up is required):

1. What was Computer Associates trying to accomplish by the change in the business model? How did the change accomplish its goals? What risks does

- the new model create?
2. How does the change in accounting fit with the new business model?
 3. Do you agree with the company's decision to produce pro forma earnings numbers?
 4. What action plan would you recommend for Sanjay Kumar?

Note: The statements of cash flows are for the years ended March 31, 2002, 2001 and 2000, and not 2001, 2000 and 1999 as indicated in the case.

Session 27 November 29, 2006

Topic **Professionalism and Ethical Behavior**

Readings Accounting Professionalism—They Just Don't Get It! (By Art Wyatt, AAA Annual Meetings, Hawaii, August 4, 2003)

Remarks By Arthur Levitt, Jr., KPMG Partners Meeting; Orlando, Fl, Thursday, 20 November 2003,

Excerpts from Code of Conduct, and "Targeted Behaviors"
(PricewaterhouseCoopers)

Financial Execs Who Do the Right Thing, By Jeffrey Marshall and Ellen M. Heffes, Financial Executives International, 5-November-2003

Guest Speaker Mark Matthews, Partner, PricewaterhouseCoopers. During his nearly 25 years of public accounting service, Mark has led the firm's delivery of audit and transaction support services to North American- and European-based companies in a variety of industries, particularly consumer and industrial products, manufacturing, and financial services. He also has extensive experience with mergers and acquisitions and the full range of public security offerings. Currently Mark is involved with 5 public company Boards either in a lead or concurring partner role.

Mark's career began in 1979 in Grand Rapids. He transferred to the Detroit office in 1984 and was admitted to the partnership in 1989. During his service to various major international clients, Mark has worked closely with PwC's national technical resources assisting clients with the resolution of complex SEC and financial reporting issues including direct correspondence and discussion with the SEC staff.

Mark also serves as leader for the Assurance practice and the Consumer and

Industrial Products and Services teams in Michigan and Northwest Ohio. In this role, he is responsible for all aspects of our audit practice in the Detroit market.

Mark is a graduate of Michigan State University and serves on its College of Business Advisory Board.

Session 28 December 4, 2006

Team assignment 7 due today.

Team Presentations for Litigation Consulting Project (Part 3)

Session 29 December 6, 2006

Team Presentations for Litigation Consulting Project (Part 3)