Details

Plagiarism is a form of cheating in which students use the work of others and present it as their own. It may include all or any one of the following –

1. Copy extensively from the work of others (from sources such as books, magazines, journal, web sites etc.) and submit the work as your own.
2. Copy another students' work and submit it for assessment under your own name.
3. Allow another student to copy your work and then submit it for assessment under their own name.

What happens if you are caught?

The examining body of CBFS may punish offending students in any manner that they deem fit. Typical punishments may range from reduction in grades, making students re-sit modules and even failing students on a module or an entire award. The college considers this form of cheating as a serious offence. Therefore, be forewarned!

Requirement

Each group should consist of 4 students. Please note that the word limits for each question is provided. All members of the group should participate in the assignment.

You should submit the assignment before the due date.

Read the given below case and answer the questions given:

NORTEL NETWORKS CORPORATION

It has been a long road that brought Nortel Networks Corporation ("Nortel") to its present state. Northern Telecom, known as Northern Electric until 1976, was at one time a wholly owned subsidiary of Bell Canada. By the mid 1980's Northern Telecom was the second largest supplier of telecommunications equipment, largely electronic telephone switches, in North America. Northern Telecom expanded worldwide firstly into Asia then Europe, followed by Latin America. In 1995 Northern Telecom shortens its name to Nortel. Bell Canada, later known as BCE, divested its interest in Northern Telecom throughout the 1970's owning just over 50 percent by 1980. Finally in 2000, BCE distributed its remaining ownership interest in Nortel to the shareholders of BCE.

Not only was Nortel a telecommunications company, it was a major research powerhouse, receiving substantial support from provincial and national governments. The bulk of Nortel's R&D was done in Canada to take advantage of generous R & D tax incentives.

Nortel, despite its large size, international shareholders and global reach, was still a "Canadian" company, with the majority of its management and board of directors' Canadian citizens.

It was John Roth ("Roth") CEO who took Nortel from traditional telephone technology to the Internet.1 Nortel equipment carried 75 percent of the North American Internet traffic in the late 1990's. The company's growth was due to both the explosion in the Internet market and through acquisitions. In 2000 alone, Nortel acquired 11 companies at a cost of US$19.7 billion. By 1998, Nortel was Canada's largest telecommunication company with 73,000 employees and revenues of US$22 billion.2

The bubble burst when Nortel's customers stopped buying telecom equipment in the great high-tech bust in 2001. As the industry imploded, Nortel seemed the most secure, until it announced huge declines in prospective sales.

During 2000, Nortel, with over 3.8 billion shares outstanding, accounted for greater than one third of the value of the entire S&P/TSX 300 composite index. Nortel shares peaked at the end of July 2000 at Cdn$124.50, giving Nortel a total market capitalization of $473.1 billion. As a secure, growing Canadian company, the company's shares were held in a large number of institutional and private investor portfolios. In addition, due to Canada's restrictive rules with respect to pension plans' investing in foreign securities, Nortel was the most widely held security in Canada. The shares took a two-year slide bottoming out in September 2002 at under Cdn$1. The once mighty Nortel risked being de-listed from the NYSE, which, under exchange rules, can happen if a stock closes below US$1 for 30 consecutive trading days.3 By 2002, Nortel's long-term debt was downgraded to "junk" status.

The desperate times from mid 2000 through 2002 called for desperate measures. Roth, who had been named Canada's 'business leader of the year' in 2000, announced in April 2001 his intention to step down as CEO . Roth was replaced as CEO in October 2001 by Frank Dunn ("Dunn"), CMA, Nortel's CFO since 1999. In 2001, Nortel reduced its workforce by 50% to 45,000 with a further 10,000 job cuts in 2002.

In the third quarter of 2002, CFO Doug Beatty directed a company-wide analysis of provisions. Upon completion, Controller Michael Gollogly reported an excess of $303 million of accruals much of which had been left over from charges taken in prior years. Upon determination of the excess, GAAP required that the accruals be immediately released to income. Both Beatty and Gollgoly, officers of the Company withheld disclosure of their discovery from the Audit Committee and the Board. From this point forward, senior divisional finance managers were instructed to report the "hardness" of any excess provisions they were carrying in their divisional records.

undertook another review that resulted in a "top-side" increase of $175 million to the reserve account producing a loss and increasing the "hardness" of consolidated provisions. Unlike the reserves that were identified in the second quarter that mainly related to previously estimated cost for restructuring these new reserves were related to valuations estimates on accounts receivable and inventory.

Morale at Nortel was quite low by mid 2002, after the employee base of the company had shrunk to one third of pre-2001 level. Bonus plans involving stock options were substantially "out-of-the-money." To motivate the remaining employees and convince them to stay at Nortel, the board of directors established a bonus plan tied to profitability. One plan, called the Return to Profitability ("RTP") bonus, was to pay a one-time bonus to every employee, except the 43 most senior executives, in the first quarter the company achieved a pro forma profit. The senior 43 executives were eligible to receive 20 percent of their share of the RTP bonus in the first quarter in which Nortel attained profitability, 40 percent after the second consecutive quarter and the remaining 40 percent upon the fourth quarter of cumulative profitability. In order for the RTP bonuses to be paid, the pro forma quarterly profit had to exceed the bonuses paid by at least one dollar. Further, the 43 executives were eligible to receive Restricted Stock Units ("RSU's") tied to internal profit targets. The RTP and RSU allocations were based on internal, non-GAAP metrics. Deloitte & Touche LLP who audited Nortel's annual financial statements did not audit the quarterly statements upon which the bonuses were calculated. Nortel paid out approximately US$50 million in bonuses to the select group of officers based on the pro forma financial statements after profits were reported during the second quarter of 2003. Dunn's share was US$2.15 million.

At a Board meeting in January of 2003, management indicated that Q1 was going to be a loss of approximately $110 million despite the drastic restructuring that had taken place in previous years. By the close of the quarter, the loss had in fact turned into a US$54 million profit in the first quarter of 2003, its first profit in three years. This resulted in the payment of the RTP cash bonus to virtually all employees and the first tranche to 43 executives. Behind the scenes, Dunn and the finance team had established "roadmaps" that would achieve internal EBT targets by the timely, but non-GAAP release of provisions to income. The Q1 2002 results were inflated by the release of $361 million of accruals to income. Dunn, Beatty and Gollogly continued to represent these adjustments to the Audit Committee and Board as "business as usual".

In August 2003, Nortel posted a second quarterly profit. The profit was the direct result of $370 million in excess provisions released to income. The 43 executives now received the second tranche of RTP and the RSU's. On October 23, 2003, in the same press release that Nortel announced third quarter earnings of US$179 million, it advised that a restatement of previous financial statements was required. The restatement would affect the financial statements back to 2000, reducing previously reported net losses and increasing net assets.

As is often the case, the board of directors established a Special Committee to review the reasons for the restatement. The US law firm of Wilmer Cutler was engaged to assist the Special Committee in their review of the restatement. As a result of the review, it was determined that a second restatement of Nortel's financial statements would be required. The second restatement was completed with the issuance of the December 31, 2003 financial statements on January 10, 2005.

As a result of the review, ten employees were terminated for cause including the CEO, Frank Dunn, the CFO Douglas Beatty and the Controller Michael Gollogly. The remaining seven employees all held senior finance positions throughout the global operating units of Nortel. They were all requested to repay bonuses received. A further twelve senior executives who were not terminated, voluntarily agreed to repay their bonuses. William Owen, a former Admiral in the US Navy, and deputy chief of the US Joint Chiefs of Staff, replaced Dunn as CEO.

Findings of the Independent Review

The review of the Special Committee found that financial statement reserves or provisions were recorded in the general ledger and later released in a manner not in accordance with GAAP in all the four quarters from the third quarter of 2002 through the second quarter of 2003. Some of the reserves were originally created when Nortel was undergoing its restructuring in 2001 and had not been used but other reserves were newly created. It is alleged that the purpose of creating and releasing these reserves were to meet internally imposed earnings targets triggering payment of cash bonuses and RSU's. While these reserves were not significant in dollar value to Nortel, they had a significant effect on the bonuses received by top management personally. In the fourth quarter of 2002, Nortel would have made a small profit on a pro forma basis, but by creating reserves, the profit was turned into a loss. These provisions were later released in the first and second quarters of 2003, turning a loss into a profit on a pro forma basis. According to information presented in Nortel's annual report for 2003 and 2004, the motivation behind this manipulation was the bonus plan which was directly tied to unaudited quarterly pro forma profitability.

It was concluded by Wilmer Cutler and reported to the Special Committee that Dunn drove senior management to achieve Earnings Before Taxes (EBT) targets through the use of provisions not in accordance with GAAP. They noted that judgment is required to set provisions, but in Nortel's case the judgment was stretched 'to create a flexible tool to achieve EBT targets'.

Recommendations of the Independent Review

In addition to the findings Wilmer Cutler reported to the Special Committee, it made a series of recommendations, designed to prevent a recurrence of the inappropriate accounting conduct6. Many of the recommendations focused on improving the skill set of employees in Nortel's finance area and strengthening internal controls and processes. But, their first recommendation was to establish standards of conduct to be enforced through appropriate discipline. One of the ways to carry out this recommendation was for the board of directors to communicate its expectations that every employee adhere to the highest ethical standards. The following statement was made in•Wilmer Cutler's report:

'An effective "tone at the top" requires effective policies and procedures, but these alone are not sufficient. Those who manage and lead the Company, and are its officers, must exercise the highest fiduciary duties to the Company and shareholders and must be accountable, both to corporate management and the Board, for accurately reporting financial results.'

It was further recommended that all employees should acknowledge annually, in writing, that he/she has read Nortel's code of conduct and will adhere to the code.

Following the recommendations made by Wilmer Cutler, the board did establish the position of a Chief Ethics and Compliance Officer in 2004. Susan Shepard was appointed to the position in February 2005. A lawyer by training, she is a former commissioner for the New York State Ethics Commission and Chief Counsel for New York State Commission of Investigations. The Board also adopted a code of ethical conduct and business practices which outlines principles to guide ethical decision-making and answers ethics questions that might be asked by Nortel employees. The Wilmer Cutler report also commented:

"Employees must view compliance with the Company's code of conduct, standards, and control systems as a central priority, and understand they will be rewarded for ethical behavior, even if it uncovers some problem that others might prefer to remain undisclosed."

Outcome

Throughout 2004 Nortel repeatedly missed filing deadlines. It was not until January 10, 2005 that the 2003 financial statements were finally issued, 12 months after year-end. Nortel's 2003 earning were US$424 million, down from the US$732 million originally reported. The cost of the financial review and restatement was over US$100 million. In addition to the work of Wilmer Cutler more that 600 Nortel employees worked full-time on the restatement. Nortel held more than 80 board of director and audit committee meeting since it was announced in October 2003 that a restatement was necessary.8 Included in the MD&A section of the annual report was a section titled 'Material Weaknesses in Internal Controls over Financial Reporting Identified During the Second Restatement".9 Management addresses six identified material weaknesses:

1. Lack of compliance with written Nortel procedures for monitoring and adjusting balances related to certain accruals and provisions, including restructuring charges and contract and customer accruals;

2. Lack of compliance with Nortel procedures for appropriately applying applicable GAAP to the initial recording of certain liabilities, including those described in SFAS No. 5, and to foreign currency translation as described in SFAS No. 52;

3. Lack of sufficient personnel with appropriate knowledge, experience and training in U.S. GAAP and lack of sufficient analysis and documentation of the application of U.S. GAAP to transactions, including, but not limited to, revenue;

4. Lack of a clear organization and accountability structure within the accounting function, including insufficient review and supervision, combined with financial reporting systems that are not integrated and which require extensive manual interventions;

5. Lack of sufficient awareness of, and timely and appropriate remediation of, internal control issues by Nortel personnel;

6. An inappropriate 'tone at the top', which contributed to the lack of a strong control environment. As reported in the Independent Review Summary, there was a "Management 'tone at the top' that conveyed the strong leadership message that earnings targets could be met through application of accounting practices that finance managers knew or ought to have known were not in compliance with U.S. GAAP and that questioning these practices was not acceptable".

Notwithstanding the material weaknesses identified above, Nortel's auditors Deloitte & Touche LLP, Toronto issued an unqualified opinion on the restated 2003 financial statements on January 10, 2005.

The 2004 financial statements were issued on April 29, 2005. Nortel's auditors again issued an unqualified opinion, but added a fourth and final paragraph where they "... expressed an unqualified opinion on management's assessment of the effectiveness of Nortel's internal control over financial reporting and an adverse opinion on the effectiveness of Nortel's internal control over financial reporting because of material weaknesses."

While no charges have been laid to date, in April 2004 the OSC informed Nortel that its enforcement department was investigating the restatements. That same month the SEC issued a formal investigation order. In May 2004, a criminal probe in a Dallas Texas court subpoenaed Nortel for financial information. Finally, in August 2004, the RCMP Integrated Market Enforcement team announced that it had launched a criminal probe into Nortel's accounting practices. In addition, there have been numerous class action lawsuits filed in both the US and Canada against Nortel, its current and former officers, directors and auditors, brought by shareholders alleging financial improprieties following the restatements.