

2014

Accounting Senior Research Project

Jason Kuck
Grand Valley State University

Follow this and additional works at: <https://scholarworks.gvsu.edu/honorsprojects>

ScholarWorks Citation

Kuck, Jason, "Accounting Senior Research Project" (2014). *Honors Projects*. 259.
<https://scholarworks.gvsu.edu/honorsprojects/259>

This Open Access is brought to you for free and open access by the Undergraduate Research and Creative Practice at ScholarWorks@GVSU. It has been accepted for inclusion in Honors Projects by an authorized administrator of ScholarWorks@GVSU. For more information, please contact scholarworks@gvsu.edu.

Accounting Senior Research Project

Jason Kuck

Advisor: Rita Grant

The complexity that exists at certain levels of businesses once you examine the details can be overwhelming. At least it was for me in my experience last semester. From January to March, I was an audit intern at PricewaterhouseCoopers. During the course of my internship, I worked alongside the audit teams of two separate companies, one of them a large, public utility company, and the other a small, private real estate investment company. The experiences were very different, and each company had different areas of focus that they were involved in. The real estate investment firm was mainly focused on fair value calculations and other complex real estate transactions that I could only understand on the surface level. The utility company was much more massive and would have a similar structure to a lot of public companies. The first section of my paper will discuss Real Estate Investment Trusts and other information to be aware of when investing in real estate. The next section of my paper will be researching the obstacles that companies face as they submit their financial results to the Securities and Exchange Commission (SEC). Part of this will have to do with the Sarbanes-Oxley Act (SOX), and how that changed aspects of the filing process. I was there for a majority of this period, and got to see the prep and audit work that the team provided.

Real Estate Investment Trusts (REITs) are securities similar to stocks that invest directly in real estate property or mortgages. They are something that I heard a lot about as I was auditing my real estate client, but I never looked into the strategies and concepts behind them any more thoroughly. One reason I thought this would be an interesting topic is considering the recent recession we are recovering from. A lot of that was due to the improper valuation of real estate, so I figured talking about some of the

specific problems with REITs and areas of caution when looking at them would be relevant. I will discuss some of the metrics used for valuing REITs, which will make it easier to understand how they can affect the overall economy. REITs are less risky than a lot of possible investments in real estate, so I wanted to research it to learn about a few things to be aware of when considering investment risk.

REITs are securities and follow the swings of the market, so they can constantly be monitored to detect changes in the market. They are the most liquid element of the real estate market, and therefore are one of the easiest methods of evaluation. To qualify as a REIT, it must pay at least 90% of its taxable earnings as dividends. This will likely make the cash flows of REITs more apparent to investors than other investments would provide. This could also make them more reliant on external financing and leverage to sustain growth within the market. Leverage refers to how much debt a company holds, meaning that a portion of earnings is being financed by external money. This makes it possible for gains to yield higher results, but it also makes it possible to send a company into a much deeper hole if they hit hard economic times (Wei & Yang, 2012, p. 295). With this high amount of leverage, “REIT valuation should be very sensitive to cash flow news” (p. 296).

The thing about REITs is that they should be less subjective in valuation compared to most other businesses. They are based in real property, while other businesses have value derived from things such as goodwill or patent technology. Goodwill is inherently subjective because it is the additional value that is estimated coming from the brand of a company. “Additionally, several studies document a low degree of information asymmetry for the REIT industry” (p. 296). This means that most

often, companies do not have any inside information that could benefit them in comparison to other real estate companies. For the most part, everyone is on equal ground. For this reason, it seems that companies should be much more dependent on news concerning cash flows. Even though REITs are still represented by stocks and so they can be swayed by current investor sentiment, it still seems that cash is the driving force within the REIT market. With that being said, it is still possible to have these similar conditions outside of the REIT market. "Comparing REITs to non-REITs with similar degrees of financial leverage, the difference in cash flow components between the two groups is insignificant" (p. 296). This shows that even though cash flow news is the main factor, the reason that is the case is that leverage is driving it.

The reason this comes into play in a recession is that during a recession, leverage is implicitly greater than in a time of prosperity. Therefore, investors may be more irrational during a recession and quickly pull out or put money in with less thought. The value of REITs will be less driven by cash flow news and will be more of a reflection of how the rest of the market is moving. That is why when other market sectors are starting to fail, most often the housing market will follow the trend.

Corporate governance and the nature of the industry can have some strange effects on the market that you would not see in other areas. The free cash flow hypothesis was proposed by Michael Jensen in 1986. "The free cash flow hypothesis states that since managers' compensation and perquisites are directly tied to the size and scope of the firm, self-interested managers, if left unmonitored, will have the propensity to increase firm size through acquisitions, although such investments may destroy shareholder value" (Ghosh, Petrova, and Xiao, 2012, pp. 1953-1954). Since

then, the use of cash within businesses has been heavily scrutinized to make sure it is being properly used and allocated.

Jarrad Harford is a researcher who came along about 10 years later to test this theory. His hypothesis was that managers of cash-rich firms would waste this excess cash on acquisitions. The referenced article features a study by Ghosh, Petrova, and Xiao. It is testing whether this holds true for REITs, and if so, what would the effect be. Corporate finance studies exclude REITs, because of how high their regulation is. That is why a separate study such as this must be performed to get all of the data. As I mentioned earlier, REITs must pay 90% of taxable income out as dividends to qualify as a tax-exempt entity. "Tax-exemption is important for REITs to attract institutional clientele" (p. 1954). This is one of the key regulations that will likely prevent corruption and misuse of cash within management, because most of it does not allow any discretion for how it will be used. Another result from this is that REITs must often go to capital markets to try and raise funds for investment, because there is not a lot of excess money within the REIT. This means that they are constantly being scrutinized by possible investors, so they have a lot of external pressures to provide detailed financial statements on a regular basis.

Some of the regulations are at odds with each other and can have conflicting or confusing results. For instance, even though the 90% rule prevents a lot of corruption with a large amount of capital, the remaining amount of cash often has incentives for misuse by top management. The excess share provision rule states that the five largest owners of a REIT cannot hold more than 50% of the outstanding stock. This regulation makes it much less favorable for a takeover bid. For this reason, Harford argues that it

is nearly impossible to convince entrenched managers of REITs to distribute excess money to shareholders, instead of using it for acquisitions (p. 1954). They are looking out for their own interest of expansion, and could acquire businesses that will do nothing but harm. It is often considered healthy for a company to have somewhat regular turnover, so within the REIT industry it is less likely that you would be able to revive a company once it is failing due to poor management. This is something that investors must be cognizant of. It may not be a huge issue, but it still leaves the possibility for fraud or misuse of funds to occur.

All in all, shareholders probably do not need to be any more concerned about the structure of REITs than other companies, due to the high required cash payout. It is just something that needs to be on everyone's radar as they are considering investments. These researchers tested how large of a concern this was by looking at different REITs to determine the effect cash-flow has on bidding for acquisitions. The sample included 420 instances of REITs that could be observed. It was found that excess cash was insignificant when determining acquisitions. This is significant evidence showing that the high dividend payouts have much more of an effect in preventing poor acquisitions than allowing top management to misuse funds. In addition, it was found that payouts of dividends above the required 90% will decrease cash but it will likely lead to higher valuations of REITs (p. 1955). That is another incentive for management to send the money back to investors rather than foolishly spend it.

That was a little of the technical background behind REITs, and how they are structured for investors to look at. Next I will stay on the topic of real estate, but I will discuss a little bit about it from an institutional level. This next referenced article was

written in 1990, but it has a lot of good information regarding the new technologies that were used to evaluate the high level decisions needed for real estate investment. With the technologies described being more than twenty years old, it is more important to focus on the underlying methods of analysis that were used. The technology will have improved significantly since then, but the overall techniques will still be fundamentally the same.

Decision support systems (DSS) are a fundamental analysis tool that can be used for real estate portfolio management. These are computer systems that allow users to transform data into useful metrics to measure results and perform various analyses. Making investment decisions with property can be much more involved than with other types of investments. One reason is that transaction costs can be very high for real property. These transaction costs “can sometimes exceed seven percent of total asset value and 20 percent of equity” (Trippi, 1990, p. 51). In addition, it often involves a lot more time with senior management to come to a consensus about acquiring or liquidating real estate than would occur for another type of investment. The investment into real estate is usually more sensitive to environmental factors, such as general business conditions, inflation, or interest rates. Another factor that can make it a more time-consuming investment is that information about available investments is often not disseminated to all interested parties in a timely manner (p. 51).

“Because of these factors, financial theorists often characterize the real estate income property market as inefficient” (p. 52). REITs would be one investment vehicle that would fit into this classification. A lot of DSS’s used for analyzing investments in commercial real estate are often focused on the choice phase of the decision process.

This means the selection of projects is based on how suitable they are for acquisition, retention, or improvement. The thing that makes it hard to judge good or bad real estate investments is that most of its performance is based on future actions affecting income. So a lot of the time, investments are made that look good currently, without proper analysis of what could occur in the future. This is one of the reasons that the recent recession occurred and everything that happened relating to the housing bubble. People speculated based mostly on what the current conditions seemed to be yielding, without considering that the values may be inflated or researching the underlying problems.

Coming out of this recent recession, it is a great time to buy, but investors must perform their due diligence and research. There are a lot of factors that must be considered, but if done right, real estate investment can be a very lucrative field. Now is a great time to invest because the interest rates are so low and there are a lot of depressed commercial real estate prices. According to Ashlea Ebeling, “If you’re the queasy or hands-off type, stick to publicly traded REITs” (Ebeling, 2012, p. 166). So most of what I have been talking about with REITs is considered the lower risk option. It is still one of the most common investment tools because it more closely resembles other investments. There are a lot of riskier options for commercial investment.

When you buy real estate, you almost always want to have a plan of owning for at least ten years, if you want to get the full value from it. There are certain calculations that must be taken into effect when investing in property. One of these considerations is vacancy rates, which takes into effect the percentage of vacant spots compared to occupied spaces over the life of the property (pp. 166-167). This is especially important

if you are looking at corporate centers or shopping centers, because the opportunity cost of not filling all spaces is very high.

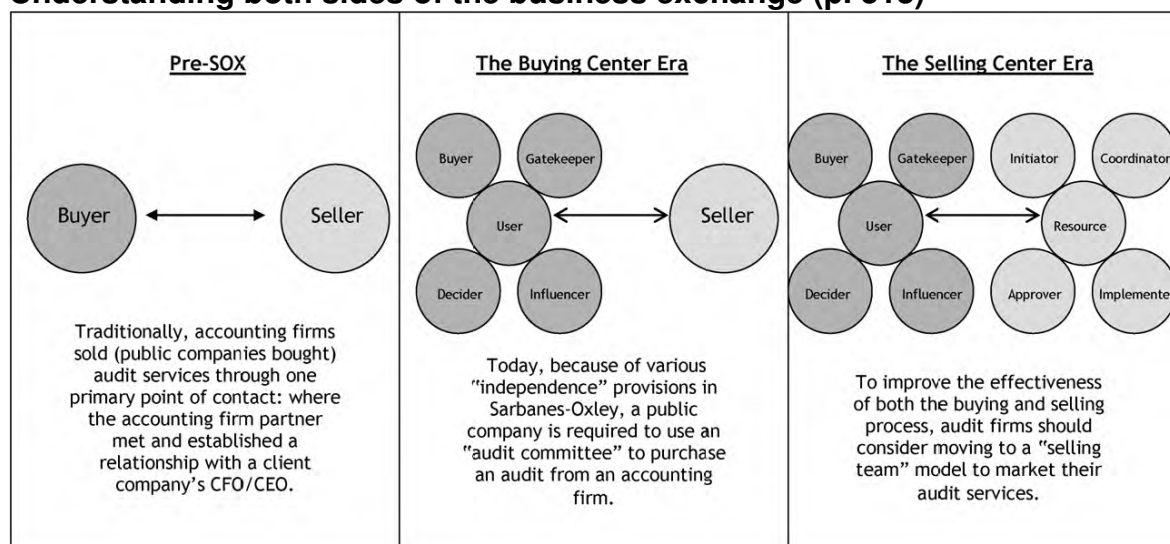
There are a couple terms that are very important when looking at commercial loans and preparing for investment. You want to know if the loan is nonrecourse, meaning it is secured only by the property and no other assets as well. If it is a recourse loan, you need to know if there is a limitation of liability on your other assets if the house goes underwater. This could prevent you from losing everything in the case that another slump in the housing market occurs. You also need to be aware of technical terms such as defeasance penalties, where in certain situations of not paying off a mortgage, you are required to substitute the payments with U.S. Treasuries that provide a similar yield to that of the mortgage (p. 168). Knowing these situations ahead of time will prepare you for the consequences if you are unable to keep up with mortgage payments.

This concludes my section of the paper on REITs and real estate investment. The second half of my paper will focus more on large-scale businesses, discussing the obstacles they go through filing financial statements and other reports with the SEC. A lot of what I focus on will be regarding how public accounting firms have to deal with these challenges as they audit public companies. The Sarbanes-Oxley Act (SOX) was a sweeping set of accounting regulations passed in 2002, and this had significant effects on most of these areas I will discuss. It was passed down from Congress, and the new regulations were aiming to cut down on future corruption within companies by imposing controls over the accounting process. They wanted to make it as hard as possible for more instances of Enron or WorldCom-type scandals occurring. There are a lot of

complexities that companies have to deal with on an annual basis, and this will only scratch the surface of what can cause problems for both companies and auditors.

One of the main areas that SOX has had the biggest effect on is the buying and selling aspect of the client-auditor exchange. Before SOX, most companies just had their executive board meet with public accounting firms to figure out the details for new client-auditor engagements. There are new stipulations from SOX that are often referred to as “independence” provisions. One of the major changes is that the audit purchase decision must be taken out of the hands of the executives, and instead delegated to an audit committee which is required to be completely independent of the company. Also, CPA firms are not allowed to provide both audit and consulting services to the same company. Both of these provisions have changed the entire landscape of how CPA firms operate and sell their services, and still leave a lot of possible independence issues and conflicts. The following diagram does a great job of showing the pre-SOX and post-SOX structures for selling services, and how many members have been added to the decision-making process (Jelinek & Jelinek, 2010, 511-513).

Figure 1. Buying and selling accounting services post Sarbanes-Oxley: Understanding both sides of the business exchange (p. 513)



SOX has changed the buyer-seller transaction from a straightforward process to a fairly complicated one. Sales researchers would say that a “buying center” is emerging on the client side of the exchange. “A buying center is a group of people from multiple parts of an organization, assembled to assist in providing different perspectives and input regarding an organization’s purchase decision toward increasing the likelihood that a correct purchase decision is made” (p. 515). With this new arrangement, even though you have multiple people on the audit committee coming together to make the decision, it differs from a traditional buying center. In this transaction the audit committee is in charge of both authorizing the purchase, and then also paying for it. Another main difference is that in this transaction, the company does not have any “users” represented in the decision process. No one making the decision has any stake in the company, so it is more likely that they would come to an unsatisfactory decision for the company (pp. 515-517).

One benefit of this new arrangement is that now it is more important for lower-level employees within the client company to voice their concerns and observations so that some insiders are still able to affect future decisions being made. On the other side, audit companies must closely monitor their account management approaches. It is especially important to identify potential clients with complex buying situations. This will help them more effectively plan, staff, and train for future engagements. They must also come up with very detailed questionnaires about things like how often the CEO/CFO report to the audit committee, and how they will structure the balance between either audit services or consulting services (pp. 520-521). So overall, these new regulations are probably better in preventing corruption and collusion, but it still leaves a lot of

problems that companies must find solutions for. I think it will take a while for companies to adapt to these changes and run as efficiently as possible, but they will be able to figure it out. The more efficient it is, the more money both sides will bring in.

This next section will talk a little bit about violations of federal securities laws, and steps that can be taken to try and prevent more of them from occurring. The view is often that the SEC is unsuccessful in its efforts to deter violations, especially as of late. Most of the criticism deals with the severity of the sanctions against wrongdoers. "As with all law enforcement authorities, settlements account for the vast majority of dispositions of SEC cases that end with sanctions" (Becker, 2012, p. 1849). The point of this article is to urge the academic community to think about SEC deterrence more comprehensively, including looking at the reasons behind violations to try and prevent them before they occur. According to Becker, it has long seemed that securities violations increase during times of rapid economic change, where there is a lot of money moving around in the economy. That explains why often right before recessions you have times of extreme prosperity. People start speculating and being more careless with money. This often goes hand-in-hand with less regulation, and can lead to more fraud and violations. According to Becker, it often seems that the most difficult people to deter from crime are the ones that are impulsive and irrational, giving into economic pressures in order to save themselves or their companies from failures (p. 1851).

SOX laid out a few new provisions that relate to whistleblowers or people that are harmed by securities violations. Section 308 granted the SEC with the power to create "Fair Funds". This allows them to add on civil penalties in enforcement actions, which they distribute to harmed investors (p. 1855). This satisfied some of the public demand

for greater accountability and punishments. Another provision is that whistleblowers reporting securities violations are able to collect a portion of the money collected if the case goes to trial and is settled. This hasn't led to as many new reports as was desired, but it is still a good step in trying to ensure that people are not withholding information, but are reporting everything to the SEC. These provisions along with others are meant to prevent as many violations as possible, and create a system that will prevent a future Enron case from happening. It is not possible to stop all fraud, but hopefully these steps will make it harder to commit violations.

This next section will talk a little about the reasons behind late filings with the SEC, and how the market usually reacts to these late filings. There are certain reasons for late filings that will cause severe reactions, and other that aren't as severe. Late filings are going to occur, but companies need to make sure they alert the SEC if it is going to happen. They must provide a reason for the late filing, along with requesting an extension. The filing deadlines became stricter after SOX, going from 90 to 60 days after fiscal year end for the filing of the 10-K, and 45 to 40 days after fiscal quarter end for the 10-Q. The accelerated filing deadlines now make it much more likely that firms will file late, at least until they all are able to fully adjust to the new regulations (Cao, Calderon, Chandra, & Wang, 2010, p. 189).

Because timeliness is such an important factor determining securities price, it is expected that late filings would cause a significant negative market response. This study was meant to determine the differences in impacts depending on whether the reason for filing late was due to information systems (IS) or accounting issues. The IS environment is prevalent in every area of business today, so failures in this could lead to

serious impacts across an entire organization. It could be argued that IS issues are signs of more serious financial reporting issues than would be evident from accounting issues (p. 190).

This study documents significant negative stock market reactions to late filings for both quarterly and annual reports. “In particular, the market response is significantly more negative for IS related issues versus accounting and other reasons” (p. 190).

Even with these results, they did not find any financial distress for the company associated with this market response. They also found that the market reaction is more significant for smaller firms (p. 190). After spending my last few months at two different accounting internships, it is no surprise to me that IS issues are considered much more severe than accounting issues. A lot of times, the accounting issues I notice or hear about are ones that are due to an error in judgment or a mistake, but not anything that is wrong with the entire system. However, with an IS issue, it is more likely that an entire system that is implemented within a company could have inherent problems. This can lead to problems down the line as well, and needs to be fixed as soon as possible to mitigate damages.

Another interesting thing in the article relates to a previous study that looked at the results of 58 industrial firms filing for bankruptcy between 1975 and 1981. It was found that a “significant number of bankrupt firms delay releasing their annual reports for the final fiscal year before bankruptcy, and that some even file for bankruptcy before the release of the report” (p. 193). This shows that tracking late filings might be a more significant metric than it often appears on surface level. Of course it is not clear evidence that a company is headed for bankruptcy just because of a late filing. This is

highly unlikely, but to get more information, you can look deeper at the reasoning behind the late filing. "As Information Systems have direct effects on a company's internal control over financial reporting, addressing IS issues may resolve some SOX related and internal control issues" (p. 205). There are many reasons that companies can fail or face financial distress, and there is not a simple formula that will give you the answer. However, as investors, it is important to know many different factors that could affect companies adversely. This is just one of the ways that being more knowledgeable about reasons behind late filings can tell you a lot more about a company than it seems at first glance.

This final section will look more closely at the decision by the SEC to accelerate the filing deadlines for the 10-K following SOX. They argued that it would increase the relevance of the disclosures, which would make the reports more useful. This study tracks changes in reporting quality and information content, and also the actual result that the change did have on representational faithfulness and relevance (Doyle & Magilke, 2013, p. 549). Starting with companies that had fiscal years ending after December 15, 2003, the SEC accelerated the deadline to file the 10-K from 90 to 75 days for accelerated filers (market capitalization of at least \$75 million). After December 15, 2006, this deadline went down to 60 days for any firms with a market capitalization of at least \$700 million (p. 550).

The worry about this change was that it would compromise the quality of the reports. To test the overall usefulness of this acceleration, the study looks at the absolute value of the three-day market reaction to the 10-K filing. They compared companies that accelerate their 10-K filings that year to similar companies that did not

accelerate that year. Small accelerated filers experience a decrease of -0.78% in market reaction in the year that they accelerated their filings, relative to the companies that did not accelerate their filings. This shows that the costs of accelerating the filings outweigh the supposed benefits that the SEC claimed would occur. For the large accelerated filers, moving from 90 days to 75 days yielded no significant differences. However, for the firms that further went down to 60 days, there is an increase in the reaction of 0.46%, relative to the sample that did not accelerate their filings. It is hard to tell whether this result is because it will take more than a year for the differences between 75 and 60 days to take effect, or whether 60 days really does yield more benefits due to the increased timeliness (p. 551).

A little bit more detailed analysis showed that both small and large firms that accelerated from 90 to 75 days experienced significant decreases in reporting quality. However, once the large companies' reporting requirements went down to 60 days, the reporting quality actually increased (p. 552). These are interesting yet somewhat confounding results. It doesn't clearly show one way or the other whether the accelerated deadlines were more helpful or harmful overall. It seems to point to the fact that large companies are able to handle the shorter time period, and it sometimes even benefits them. However, small companies are most often harmed by having to accelerate their filing deadlines. The first study that I looked at tested what the market reaction was for companies that file late. This study was for companies that file on time, which is still critical information because it shows us that filing on time is not the only factor to consider. The quality of the report is crucial, and can be easily detected within a few days of release. This highlights the importance of the audit process, and that

companies must remain efficient as the timeline shortens, so that the report is not released before it is fully prepared and ready.

This paper was meant to research a couple accounting topics that I had an interest in coming out of my internship. I knew that REITs are a good investment option for a more risk-averse investor, but I did not know a lot of the more detailed things to consider when looking at REITs. I tried to provide a guideline of some things to consider when looking at them. The reason I included the second half of my paper was because Sarbanes-Oxley is a common topic, and I often heard people during my internship discuss some of the implications it has had. That is why I wanted to research a little bit more about some of the major changes it has caused, and how that directly affected the relationship between CPA firms and other companies. It is very interesting to research some of the areas that could be impacting me as I start a career in public accounting. I tried to provide enough information that someone outside of accounting would find this interesting, have a much better understanding of both of the topics, and hopefully motivate someone to take a closer and more detailed look into these subject areas.

Works Cited

- Becker, D. M. (2012). What more can be done to deter violations of the federal securities laws? *Texas Law Review*, 90(7), 1849-1889. Retrieved from <http://ezproxy.gvsu.edu/login?url=http://search.ebscohost.com/login.aspx?direct=true&db=bth&AN=77663799&site=ehost-live&scope=site>
- Cao, J., Calderon, T., Chandra, A., & Wang, L. (2010). Analyzing late SEC filings for differential impacts of IS and accounting issues. *International Journal of Accounting Information Systems*, 11(3), 189-207. Retrieved from <http://web.ebscohost.com.ezproxy.gvsu.edu/ehost/detail?vid=13&sid=9b5e893d-6548-43d4-ad54-0dbd3053269b%40sessionmgr104&hid=117&bdata=JnNpdGU9ZWhvc3QtbGl2ZSZzY29wZT1zaXRl#db=bth&AN=53793400>
- Doyle, J. T., & Magilke, M. J. (2013). Decision usefulness and accelerated filing deadlines. *Journal of Accounting Research*, 51(3), 549-581. Retrieved from <http://web.ebscohost.com.ezproxy.gvsu.edu/ehost/detail?vid=11&sid=9b5e893d-6548-43d4-ad54-0dbd3053269b%40sessionmgr104&hid=117&bdata=JnNpdGU9ZWhvc3QtbGl2ZSZzY29wZT1zaXRl#db=bth&AN=86927605>
- Ebeling, A. (2012). Buying Main Street. *Forbes*, 190(10), 164-168. Retrieved from <http://web.ebscohost.com.ezproxy.gvsu.edu/ehost/detail?vid=3&sid=c860b89a-d4e2-4f31-93b3-40ce07d83bea%40sessionmgr198&hid=118&bdata=JnNpdGU9ZWhvc3QtbGl2ZSZzY29wZT1zaXRl#db=bth&AN=84399673>
- Ghosh, C., Petrova, M., & Xiao, Y. (2012). Do REITS use cash reserves efficiently? Evidence from corporate acquisitions. *Journal of International Money and Finance*, 31(7), 1953-1970. Retrieved from <http://web.ebscohost.com.ezproxy.gvsu.edu/ehost/detail?vid=3&sid=9b5e893d-6548-43d4-ad54-0dbd3053269b%40sessionmgr104&hid=117&bdata=JnNpdGU9ZWhvc3QtbGl2ZSZzY29wZT1zaXRl#db=bth&AN=83295883>
- Jelinek, R., & Jelinek, K. (2010). From clear to complicated: Buying and selling accounting services post Sarbanes-Oxley. *Business Horizons*, 53(5), 511-522. Retrieved from <http://web.ebscohost.com.ezproxy.gvsu.edu/ehost/detail?vid=7&sid=9b5e893d-6548-43d4-ad54-0dbd3053269b%40sessionmgr104&hid=117&bdata=JnNpdGU9ZWhvc3QtbGl2ZSZzY29wZT1zaXRl#db=bth&AN=52877073>

Trippi, R. R. (1990). Decision support and expert systems for real estate investment decisions: A Review. *Interfaces*, 20(5), 50-60. Retrieved from <http://web.ebscohost.com.ezproxy.gvsu.edu/ehost/detail?vid=3&sid=ca92af28-6370-4823-974c-b72ff5725fd9%40sessionmgr115&hid=117&bdata=JnNpdGU9ZWhvc3QtbGl2ZSZzY29wZT1zaXRl#db=bth&AN=4486600>

Wei, P., & Yang, X. (2012). Do investors value REITS and non-REITS differently? *International Review of Economics & Finance*, 24, 295-302. Retrieved from <http://web.ebscohost.com.ezproxy.gvsu.edu/ehost/detail?sid=1e10a39b-641b-4f2b-a52f-87157418e0ae%40sessionmgr111&vid=1&hid=120&bdata=JnNpdGU9ZWhvc3QtbGl2ZSZzY29wZT1zaXRl#db=bth&AN=76917442>