S5-4 Ethical Decision Making: A Real-Life Example

LO 5-1, 5-2, 5-7

On February 18, 2000, the board of directors of Aurora Foods Inc.—the maker of Duncan Hines® and Mrs. Butterworth's® products—issued a press release announcing that a special committee had been formed to conduct an investigation into the company's accounting practices. During the financial statement audit for the year ended December 31, 1999, Aurora's auditors had discovered documents that raised questions about how the company accounted for marketing costs incurred to entice grocery stores to promote Aurora's products. The company's stock price fell by 50 percent in the week following this announcement.

After nearly a year of investigation, Aurora filed revised quarterly reports with the SEC, showing that the company had not accrued adequately for liabilities and expenses that had been incurred during the third and fourth quarters of 1998 and during the first three quarters of 1999. Key financial figures for these quarters as initially reported and as later restated are shown below.

	1998 Q3 (September 30)		1998 Q4 (December 31)		1999 Q1 (March 31)		1999 Q2 (June 30)		1999 Q3 (September 30)	
(in millions of U.S. dollars)	Initial Report	Restated Report	Initial Report	Restated Report	Initial Report	Restated Report	Initial Report	Restated Report	Initial Report	Restated Report
Assets	$1,457	$1,455	$1,434	$1,448	$1,474	$1,463	$1,558	$1,521	$1,614	$1,553
Liabilities	869	879	830	868	862	882	937	944	983	972
Revenues	220	219	280	277	261	254	222	214	238	231
Net income (loss)	1	(12)	16	5	8	0	8	(4)	11	4

The SEC also investigated and filed a legal claim alleging that Aurora's 36-year-old chief financial officer (CFO) had violated federal securities laws by instructing accounting staff to make false journal entries and prepare two sets of records—one for the company's internal use and another to be provided to the auditors. The SEC alleged that her actions allowed Aurora to meet the net income targets set by Wall Street analysts and the expectations of Aurora investors and to obtain loans from Chase Manhattan Bank and other lenders. The CFO pled guilty to the charges, was sentenced to 57 months in prison, was barred for life from ever serving as an executive of a public company, and had to return to the company the stock and bonuses that had been awarded to her on the basis of Aurora's false and substantially inflated financial results.

Epilogue: On December 8, 2003, Aurora Foods filed for bankruptcy protection after violating several of its lenders' loan covenants. On March 19, 2004, Aurora emerged from bankruptcy and has since merged with Pinnacle Foods, the maker of Vlasic pickles and Swanson TV dinners.

Required:

1. Using the initially reported numbers, calculate the debt-to-assets, asset turnover, and net profit margin ratios at the end of each quarter. (Note that the asset turnover ratio will be substantially less than the examples shown earlier in this chapter because they use only three months of revenues. Do not attempt to convert them to annual amounts.)
2. Using the restated numbers, calculate the debt-to-assets, asset turnover, and net profit margin ratios at the end of each quarter.
3. On an overall basis, did the initially reported numbers suggest more or less financing risk than the restated numbers? Of the financial statement users mentioned earlier in this chapter in Exhibit 5.1, which would be most influenced by this impact on the debt-to-assets ratio?
4. On an overall basis, did the initially reported numbers or the restated numbers present Aurora's efficiency in using assets to generate sales in a better light? Of the financial statement users mentioned earlier in this chapter in Exhibit 5.1, which would be most influenced by this impact on the asset turnover ratio?

5. On an overall basis, did the initially reported numbers or the restated numbers present Aurora's profitability in a better light? Of the financial statement users mentioned earlier in this chapter in Exhibit 5.1, which would be most influenced by this impact on the net profit margin ratio?
6. What important role(s) did Aurora's auditors play in this case?
7. Based on specific information in the case, identify the incentives or goals that might have led the CFO to misreport Aurora's financial results. Looking back at the consequences of her dishonest actions, did she fulfill those goals in the short run and long run? Speculate about how the requirements of the Sarbanes-Oxley Act might have affected the CFO, had this legislation existed prior to 1998.