# Accounting Theories

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## Nine 'nearly broke covenants' over debt deal

### Summary

The management of Nine Entertainment reports that they sealed a deal with Apollo and Oaktree hedge funds rescuing the entertainment firm from breaching a debt covenant earlier agreed with creditors. The deal came after Nine Entertainment recorded a loss of $971.7million in the year 2011-2012, falling operating profit and shrinking revenues, situations that put the firm's financial situation in a precarious position. The two major lenders agreed to swap their debt for equity easing Nine Entertainment financial woes. Owners of nine hedge funds bowed to pressure from the original lenders who were seeking to salvage Nine Entertainment from imminent insolvency. The arrangement was reached that allowed lenders to convert their senior loans into equity stakes.

### Accounting Theory

Positive accounting theory is an accounting theory that explains debt covenants agreements. The positive accounting theory is segregated into three hypotheses namely bonus plan hypotheses, debt covenant hypothesis and political cost hypothesis. However, two theories deal with debt restructuring mechanisms, and they include debt covenant hypothesis and political cost hypothesis. According to Deegan (2009), positive accounting theory debt covenant hypothesis proposes that the primary objective of the management of a firm is to minimize lending problems with lenders and creditors during the times when the company is facing challenges. Deegan (2009) further continues to state that debt covenant hypothesis propose shifting future earnings for the current period to minimize the violation of debt covenants. On the other hand, the political cost hypothesis opines that the management can shift current earnings to future periods to minimize the violation of debt covenants.

**Application of Accounting Theory**

The debt covenant hypothesis implies that the management has an obligation to rescue a company from breaching debt covenants. Among the measures that management of a firm can use to minimize cases of debt covenant violation, include negotiating with lenders and creditors to ease debt covenants, making necessary arrangements to pay back the debt and shifting reported profits from future to current reporting periods. The management of Nine Entertainment in keeping with the suppositions of the debt covenant hypothesis, engaging creditors holding senior loans to convert them into equity stakes in a recapitalization initiative that saw the firm reverse imminent debt covenant violation. It is, therefore, evident in the article that debt covenant hypothesis is prominent in the article.

Roberts and Sufi (2009) observe that debt covenant violation cases are costly to the firm because they lead to an increase of the firm's cost of debt capital, thus, reducing the ability of a firm to borrow and invest in potentially viable investments. The management of Nine Entertainment, thus, sought to engage in a dialogue with senior lenders, such as the two major creditors, Apollo and Oaktree hedge funds, to mitigate insolvency of the firm due to violation of the debt covenant. Chava and Roberts (2008) state that firms that are close to violating debt covenants engage in re-negotiations with borrowers to minimize chances of total debt covenant violation. Chava and Roberts (2008) continue to state that the options available on renegotiation of debt covenants include conversion of debt into equity, reduction in loan capital and increasing of loan spreads. In the case of Nine Entertainment, lenders converted a total of $200million owed to equity a move that saved the firm agony of debt violation.

## Conclusion

Debt covenants are financial arrangements that companies enter with creditors requiring a company to ensure that the company operates within certain debt limits. The debt covenant, for example, stipulates the level of gearing a company is to maintain, interest cover, working capital and debt service cover. If these borrowing conditions are breached, creditors demand immediate repayment or renegotiate the debt on unfavorable terms. It is for these reasons that the management of Nine Entertainment entered into renegotiation of debts it owed creditors to ameliorate its debt structure and avoid debt covenant violation.

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## Latest effort at transparency just muddies waters

### Summary

The federal government seeks to introduce new disclosure requirements in order to enhance transparency and reduce regulatory requirements. However, the noble objectives are expected to increase reporting requirements for companies, increasing regulatory burden in compliance. One of the controversial issues surrounding the disclosure reforms centered on disclosures on remunerations. The existing disclosure framework on remuneration is criticized for failing to match company performance and rewards that are offered to executives. The new reforms require additional disclosures that categorize remuneration into “past pay”, “present pay” and “future pay”. The unclear definition of the term “pay” as used in the reforms will result in double counting of executive remuneration, breaking the link between performance and pay in respect of the reporting year and misleading shareholders about executive pay excesses.

### Accounting Theory

The issue of disclosures is dealt by the normative accounting theories. Under the normative accounting theories. According to Deegan (2009) normative theories are theories in accounting theories that posit what should occur in certain circumstances. Instead, the theories distance themselves from observation by not reflecting the actual accounting practice, and in some instances advocating for radical accounting practices that deviate from the normal accounting practice. The normative theories of accounting are classified into two categories, namely true income theories and decision useful theories. The true income theories are based on assumptions about a given accounting practice, which then prescribes the solution to the problem. Decision useful theories, on the other hand, attribute specific type of financial information to a particular class of users in the assumption of their decision-making needs.

Belkaoui (2004) posits that the normative accounting theories look at the needs of accounting information users and develop the practices that should be used in preparation of accounting/financial reports.

**Application of Accounting Theory**

The article on the “Latest effort at transparency just middies water” can be linked to the normative theories of accounting, and largely to the branch true income theories. The federal government seeks to fix the problem of the mismatch between companies performance and the rewards that senior executives of these companies derive by introducing new disclosure requirements requiring classification of executive remuneration into three classes namely past pay, present pay and future pay. This is in line with the assumptions of the normative theories of accounting that are prescriptive in nature. The federal government in their effort to introduce the reforms is to enhance disclosure on executive compensation.

According to Reedy (2004) normative accounting theory holds various weaknesses that include the theories do not derive reality from observation and do not reflect actual accounting practice. The architects of the standards did not address the weaknesses of the current disclosure standard but proposed companies to make additional disclosures in their financial reports. Therefore, it is evident that the reforms that the federal government proposes are not based on observation but rather on what need to be implemented, which is a prescriptive remedial action. In addition, the reforms breaks from traditional accounting practice and introduce radical changes of alienating reporting earnings from the year they are earned for the year they are paid out. According to Deegan (2009) the true income theories seeks to provide “a single best measure” of profits. Linking the observations of Deegan (2009) to the article, it is evident that the reforms seek to create a one-size fit all approach.

## Conclusion

Accounting standards require that companies in their financial statements disclose all information that is material to the performance of a company. Shareholders are interested with information on executive remuneration to assess what executives derive from the agency contracts. The government , thus, through the proposed reform seeks to enhance disclosure of executive remuneration by matching executive pay with the year it is paid. However, the proposed framework lacks proper guideline on the treatment and apportionment of compensation over the period. A situation explained by the normative theories of accounting.

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**THE former Manhattan flatmate of Australian financial research analyst Trent Martin has entered a guilty plea to being part of the alleged IBM insider trading scandal that netted $US1 million ($A961,307).**

Thomas C Conradt, a stockbroker, pleaded guilty to conspiracy to commit securities fraud and two counts of securities fraud on Wednesday in the US District Court in New York.

Conradt was Sydney-raised Mr Martin's flatmate in 2009, while Mr Martin worked at a Connecticut financial firm.

US prosecutors allege a friend of Mr Martin's, a New Zealand banker who can't be named as he is a prosecution witness, was working on IBM's secret $US1.2 billion takeover of software company SPSS in 2009.

The banker told Mr Martin in confidence about the acquisition, but it is alleged Mr Martin then told Conradt, who told another stockbroker David J. Weishaus.

The trio was accused of buying up SPSS positions before the secret acquisition was announced, then selling at a profit.

"I understood this information was inside information and that it was not publicly available," a remorseful Conradt told US District Judge Andrew L. Carter Jr.

"I can assure the court that I will never put myself in this position again."

Conradt, who worked at the Manhattan office of Euro Pacific Capital, faces up to 45 years in prison.

Mr Martin, 34, who last week entered a not guilty plea to one count of conspiracy to commit securities fraud and one count of securities fraud, and Conradt pocketed relatively small amounts from the alleged inside trading.

Mr Martin confessed to his banker friend before IBM announced the deal and sold some of the SPSS stock, but ended up profiting $US7900, while Conradt only pocketed $US2538, prosecutors alleged.

Mr Weishaus and two others, code-named CC-1 and CC-2, allegedly yielded profits of $US129,290, $US629,954 and $US254,360.

Mr Martin was arrested in Hong Kong just before Christmas and spent three months in custody there until he was extradited to New York last week.

AAP

**Flatmate of Australian Trent Martin pleads guilty in IBM insider trading scandal**

## Summary

Thomas Contradt, who is a stockbroker, faces insider-trading charges in New York. The Sydney-raised financial analysts together with his flatmate Mr Martin are involved to have been involved in IBM insider trading scandal that netted $1million. According to the prosecution team, Mr Martin, in 2009, was tipped by his friend a New Zealand banker, who was working on the $1.2Billion IBM takeover of SPSS, a software company, of the takeover deal. Martin then told Conradt and Contradt told David Weishaus, a stockbroker. The trio made profits of $1million from the alleged insider trading. If found guilty Conradt faces a jail term of 45 years.

## Accounting Theory

Harder (2010) posits that the market hypothesis theory states that financial markets have information efficiency. As a result no investor can earn excess returns over the average market returns based on the market information in the market. The article can be linked to the market hypothesis theory. Harder (2010) continues to state that there are three forms of information efficiency proposed by the market hypothesis theory, and they include weak form of efficient market hypothesis, semi-strong form of efficient market hypothesis and strong form of efficient market hypothesis. The weak form of EMH states current stock prices reflect past prices. The semi-strong EMH states that current stock prices reflect all publicly available information. The strong form of EMH states that current stock prices reflect both public and private information.

## Application of the Theory

According to theorists financial markets are informational efficient. However, empirical findings, according to Palan (2007), reveal that no single market has achieved strong form of the efficient market. Therefore, current stock prices do not reflect all the available public

information and private information. In addition, Palan (2007) observes that markets are not semi-strong efficient for investors are able to achieve an excess return above average market returns by using fundamental analysis. Harder (2010) asserts that in an informational efficient market stock prices follow a random walk pattern. Stock prices are independent of each other, current stock prices will not determine tomorrow stock prices because market news and information is unpredictable. However, because global markets, whether developed or developing, are informational inefficient investors can profit from information asymmetry. One way that investors can beat the market is through insider trading.

Wang & Steinberg (2010) assert that insider trading involves trading of stocks or other tradable securities in the financial markets using information that is not publicly available. This constitutes a criminal offense as financial markets deems that all investors should receive material information simultaneously, with no single investor possessing information before other investors. In the case of the article, Mr Martin was privy to private information he obtained from a New Zealand banker who was involved in the IBM takeover deal of SPSS Inc. Mr Martin shared the information with Contradt who later shared the information with Weishaus and others. As a result, when information of the takeover deal was released to the market, the trio yielded profits of over $1million, Mr Martin made a profit of $7900, Contradt made $2538, Weishaus $129,290, and the two brokers, who were assigned code names CC-1 and CC-2, making $629,954 and $254, 260 respectively. The profit was made as a result of trading using information that was not in the public domain, therefore breaching the secrecy of material information principle and therefore committing a securities fraud.

## Conclusion

It is against securities laws and ethical principles of financial markets to disclose material information to a third party before it is made public, as it constitutes a criminal offence punishable by law. Insider trading is a vice that capital market regulators and criminal investigations units in Australia and other global countries have enhanced the fight against because it erodes public confidence in the market. An individual privy to material information, in the case of the article, the New Zealand banker, who was taking part in the takeover deal, is supposed to maintain secrecy of information because releasing the private information before it is made public distorts the market by disadvantaging investors who are not privy to the information.

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