The rise and fall of abc learning

Business, Company

The aspects of the business strategy of ABC Learning resulted in increased business risk for the company including: the rapid expansion of market share, over-indebt, and blinding overseas investment. Rapid expansion of market share: ABC, which at its peak had almost 2200 centres in four countries, also had a flawed strategy to handle significant and rapid growth. When A. B. C. Learning Centers listed on the stock exchange in March 2001, it was a tiny operation with a market capitalization of just $25m. But five years later that number is approaching $2. bn as the company has quickly become Australia's leading operator of childcare centers. ABC pursued acquisition after acquisition – buying up as many existing centers as they could, and expanding their appetite by establishing more and more sites off the back of increasing debt. The company's acquisitions are getting larger so there is always a risk with this strategy that they will pay too much for a business or be unable to integrate it effectively. This meant that every new ABC sign that appeared on the horizon – equated to more and more debt.

Ultimately ABC could no longer sustain their rapid expansion. With a falling share price and closer examination of their books it became clear ABC’s true value was significantly lower than previously thought. Over-indebted: In 2005, in order to satisfy the expansion plan, raising capital for domestically and globally expansion was done through issuing shares to public. ABC borrowed an enormous amount ofmoneyfrom Australian big four banks: CBA, NAB, Westpac and ANZ). In the wake of the global financial crisis, it couldn’t refinance its huge debts, so the administrators were called in.

In the end, ABC got too big for its own good, also made itself to the end. Blinding oversea investment: After becoming the dominant player in the domestic market, ABC Learning has pursued an aggressive overseas expansion. The high levels of debt and dilutive capital raisings that have been required to fund its international ambitions have not pleased investors, and doubts about the company’s ability to repeat its local achievements in the US market have weighed on the share price. As the case told, artificially create apparent shareholder value may be misleading to potential investors in the company.

Intangible assets are defined as identifiable non-monetary assets that cannot be seen, touched or physically measured, which are created through time and/or effort and that are identifiable as a separate asset. There are two primary forms of intangibles - legal intangibles (such as trade secrets, copyrights, patents, trademarks, and goodwill) and competitive intangibles (such as knowledge activities, collaboration activities, leverage activities, and structural activities). Legal intangibles are known under the generic term intellectual property and generate legal property rights defensible in a court of law.

Competitive intangibles, whilst legally non-ownable, directly impact effectiveness, productivity, wastage, and opportunity costs within an organization - and therefore costs, revenues, customer service, satisfaction, market value, and share price. ABC Learning valuated billions of dollars worth of now discredited intangible assets that made up most of ABC’s balance sheet. It increased profits rapidly through acquisitions, and cause the underlying problem when valuated the assets it acquired. Especially given that 70 per cent of its assets were intangibles. The inherent risk associated with the valuation of the assets was enormous and should haven been a red flag,' said Dr Ross. In other words, it means that ABC did not have a particularly strong balance sheet. The company lists total assets of $4. 5 billion – of which, more than $3 billion relate to intangible assets (which are predominantly child-care licences and a small amount of goodwill). As a result, ABC has negative net tangible assets.

Principle-based: Accounting standards may take the form of general principles, relying on interpretation and judgment by thefinancial statementpreparers before they can be implemented. Historical cost depreciation provides a better example of a principles-only standard. Whereas, Rule-based: Alternatively, standards may take the form of a series of rules, limiting the flexibility and use of judgment allowed in their implementation. Rules-based standards often provide " bright-lines" tests which can easily be avoided. As a result, representational faithfulness may be avoided and a low degree of comparability will often result. Numerous exceptions may also result. The advantage of principle-based accounting standard is potentially very flexible with those new and changing products and environments.

As such, they should also require less maintenance. For this case, applying principle-based accounting standard would be more flexible with changing conditions, and the trade-off for this flexibility is that strong enforcement is needed to keep the auditors honest; the accountants should be more latitude to address unique situations, and it may reduce manipulation of the rules as it provides financial statements which reflect much closer to the firm's actual performance. While the rule-based accounting standard may include a lack of flexibility, hence require almost continual maintenance at times.

Therefore, the fundamentally change from “ bright-line” rules-based accounting standards to principles-based accounting standards help prevent another ABC-like fiasco. The dangers in removing “ bright-line rules” describes as follows: it is more difficult to audit relative to compliance, and concern over consistent and reliable interpretations across entities. In this case, the system may be less regulated, and to the extent that they rely on individual judgment to interpret and implement the standards, there is a danger that they can be used to manipulate financial results.

Agency cost of debt refers to an increase in cost of debt when the interests of shareholders and management diverge. In this case, the relevant agency cost that lenders face may include large dividend payments that result in less money in the bank for loan repayment and new debt competes with old debt for repayment. Because the lack of symmetry information desires between the management of ABC learning and lenders, managers intended to maximize their personal wealth which may mean lenders’ welfare is not maximized.

Based on the hypotheses that the higher the debt equity ratio the more likely managers are to use accounting methods that increase income, managers of ABC Learning may violate debt arrangements by manipulating equity. Moreover, the lenders are likely to face risk shifting in this case. Therefore, agency cost happens when ABC Learning engages in behaviors that benefit more than lenders. For lenders, they could minimize the agency cost in shortening debt maturity, it can reduces the agency cost of borrowing in two ways. First, the increase in equity value from increasing the risk of he firm's assets is a decreasing function of debt maturity (Barnea, Haugen, and Senbet, 1980). Second, shortening the maturity of debt reduces the likelihood that a firm will have to exercise an option to invest before outstanding debt matures (Myers, 1977). They also can set up a debt covenant to mitigate the risk, and from a lender’s perspective, not only does a covenant reduce default risk but is also mitigates the debt-equity agency cost. Often, individual stockholders as owners of a corporation do not have direct control over the agency contract, but as stockholders they do have certain rights granted to them.

It seems that previous and current auditors had divergent opinions about the company. The new audit team from Ernst ; Young took a very different view from ABC’s previous auditors from Pitcher Partners in several aspects such as the treatment of revenues and earnings, the valuation of intangible assets, for example, after taking over the Pitcher Partners’ place, Ernst ; Young did not allow ABC to place the same high value on the licenses to run childcare centers as Pitcher Partners had done.

Ernst and Young disputed the Pitcher Partners work and the situation escalated to the extent that the ABC board was forced to call in another accounting firm, KPMG, for its opinion. One of the reasons for divergent opinions of auditors is the accounting policy choice, The accounting policy choice research area investigates the inter-relations among the contracts existing between various stakeholders of the firm, the associated economic incentives of the contracting parties, and the consequent accounting choices made by managers to influence the payoffs to the various contracting parties.

The other reason is the degrees of concern of the company are different, in other words, the extent of knowledge for the auditors are different, Pitcher Partners did not have a deep knowledge of the Full Operational Status of the company, so they can not valuate the objective value on the childcare licenses. The recommendations of CLERP 9 to promote auditor independence as follows: Non-audit consultancy income for auditors has been limited and must be clearly disclosed. Auditors must provide their firms with a declaration that they are free from any relationship that may interfere with their independence. And the audit partner must rotate off a company’s audit after 5 years(or 7 years in the case of small or rural firms).

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