CHAPTER 1

THE MANAGER AND MANAGEMENT ACCOUNTING

See the front matter of this Solutions Manual for suggestions regarding your choices of assignment material for each chapter.

**1-1** *Management accounting* measures, analyzes, and reports financial and nonfinancial information that helps managers make decisions to fulfill the goals of an organization. It focuses on internal reporting and is not restricted by generally accepted accounting principles (GAAP).

*Financial accounting* focuses on reporting to external parties such as investors, government agencies, and banks. It measures and records business transactions and provides financial statements that are based on generally accepted accounting principles (GAAP).

Other differences include (1) management accounting emphasizes the future (not the past), and (2) management accounting influences the behavior of managers and other employees (rather than primarily reporting economic events).

**1-2** Financial accounting is constrained by generally accepted accounting principles. Management accounting is not restricted to these principles. The result is that

* management accounting allows managers to charge interest on owners’ capital to help judge a division’s performance, even though such a charge is not allowed under GAAP,
* management accounting can include assets or liabilities (such as “brand names” developed internally) not recognized under GAAP, and
* management accounting can use asset or liability measurement rules (such as present values or resale prices) not permitted under GAAP.

**1-3** Management accountants can help to formulate, communicate and implement strategy by providing information about the sources of competitive advantage—for example, the cost, productivity, or efficiency advantage of their company relative to competitors or the premium prices a company can charge relative to the costs of adding features that make its products or services distinctive.

**1-4** The business functions in the value chain are

* **Research and development**—generating and experimenting with ideas related to new products, services, or processes.
* **Design of products and processes**—detailed planning, engineering, and testing of products and processes.
* **Production**—procuring, transporting, storing, coordinating and assembling resources to produce a product or deliver a service.
* **Marketing**—promoting and selling products or services to customers or prospective customers.
* **Distribution**—processing orders and shipping products or delivering services to customers.
* **Customer service**—providing after-sales service to customers.

**1-5** *Supply chain* describes the flow of goods, services, and information from the initial sources of materials and services to the delivery of products to consumers, regardless of whether those activities occur in one organization or in multiple organizations.

Cost management is most effective when it integrates and coordinates activities across all companies in the supply chain as well as across each business function in an individual company’s value chain. Attempts are made to restructure all cost areas to be more cost-effective.

**1-6** “Management accounting deals only with costs.” This statement is misleading at best, and wrong at worst. Management accounting measures, analyzes, and reports financial *and nonfinancial* information that helps managers define the organization’s goals and make decisions to fulfill those goals. Management accounting also analyzes revenues from products and customers in order to assess product and customer profitability. Therefore, while management accounting does use cost information, it is only a part of the organization’s information recorded and analyzed by management accountants.

**1-7** Management accountants can help improve quality and achieve timely product deliveries by recording and reporting an organization’s current quality and timeliness levels and by analyzing and evaluating the costs and benefits—both financial and nonfinancial—of new quality initiatives, such as TQM, relieving bottleneck constraints, or providing faster customer service.

**1-8** The five-step decision-making process is (1) identify the problem and uncertainties; (2) obtain information; (3) make predictions about the future; (4) make decisions by choosing among alternatives; and (5) implement the decision, evaluate performance, and learn.

**1-9** *Planning decisions* focus on selecting organization goals and strategies, predicting results under various alternative ways of achieving those goals, deciding how to attain the desired goals, and communicating the goals and how to attain them to the entire organization.

*Control decisions* focus on taking actions that implement the planning decisions, deciding how to evaluate performance, and providing feedback and learning to help future decision making.

**1-10** The three guidelines for management accountants are:

1. Employ a cost-benefit approach.
2. Recognize technical and behavioral considerations.
3. Apply the notion of “different costs for different purposes.”

**1-11** Agree. A successful management accountant requires general business skills (such as understanding the strategy of an organization) and people skills (such as motivating other team members) as well as technical skills (such as computer knowledge, calculating costs of products, and supporting planning and control decisions).

**1-12** The new controller could reply in one or more of the following ways:

(a) Demonstrate to the plant manager how he or she could make better decisions if the plant controller was viewed as a resource rather than a deadweight. In a related way, the plant controller could show how the plant manager’s time and resources could be saved by viewing the new plant controller as a team member.

(b) Demonstrate to the plant manager a good knowledge of the technical aspects of the plant. This approach may involve doing background reading. It certainly will involve spending time on the plant floor speaking to plant personnel.

(c) Show the plant manager examples of the new plant controller’s past successes in working with line managers in other plants. Examples could include

* assistance in preparing the budget,
* assistance in analyzing problem situations and evaluating financial and nonfinancial aspects of different alternatives, and
* assistance in submitting capital budget requests.

(d) Seek assistance from the corporate controller to highlight to the plant manager the importance of many tasks undertaken by the new plant controller. This approach is a last resort but may be necessary in some cases.

**1-13** The controller is the chief management accounting executive. The corporate controller reports to the chief financial officer, a staff function. Companies also have business unit controllers who support business unit managers or regional controllers who support regional managers in major geographic regions.

**1-14** The Institute of Management Accountants (IMA) sets standards of ethical conduct for management accountants in the following four areas:

* Competence
* Confidentiality
* Integrity
* Credibility

**1-15** Steps to take when established written policies provide insufficient guidance are as follows:

(a) Discuss the problem with the immediate superior (except when it appears that the superior is involved).

1. Clarify relevant ethical issues by confidential discussion with an IMA Ethics Counselor or other impartial advisor.
2. Consult your own attorney as to legal obligations and rights concerning the ethical conflicts.

**1-16** (a) Communicating financial results and position to external parties is not a primary function of the management accountant. This is the function of the financial accountant.

**1-17** (15 min.) **Value chain and classification of costs, computer company.**

|  |  |  |
| --- | --- | --- |
| **Cost Item** | **Value Chain Business Function** | |
| a.  b.  c.  d.  e.  f.  g.  h. | Production  Distribution  Design of products and processes  Research and development  Customer service or marketing  Design of products and processes  (or research and development)  Marketing  Production |

**1-18** (15 min.) **Value chain and classification of costs, pharmaceutical company.**

|  |  |  |
| --- | --- | --- |
| **Cost Item** | **Value Chain Business Function** | |
| a.  b.  c.  d.  e.  f.  g.  h. | Marketing  Design of products and processes  Customer service  Research and development  Marketing  Production  Marketing  Distribution |

* 1. (15 min.) **Value chain and classification of costs, fast-food restaurant.**

|  |  |
| --- | --- |
| **Cost Item** | **Value Chain Business Function** |
| a.  b.  c.  d.  e.  f.  g.  h. | Production  Distribution  Production  Production  Marketing  Marketing  Design of products and processes (or research and development)  Customer service | |

**1-20** (10 min.) **Key success factors.**

|  |  |  |
| --- | --- | --- |
| **Change in Operations/ Management Accounting** |  | **Key Success Factor** |
| a.  b.  c.  d.  e. |  | Innovation  Cost and efficiency and quality  Time and cost and efficiency  Innovation, sustainability, and cost and efficiency  Cost and efficiency |

**1-21** (10 min.) **Key success factors.**

|  |  |  |
| --- | --- | --- |
| **Change in Operations/ Management Accounting** |  | **Key Success Factor** |
| a.  b.  c.  d.  e. |  | Time and cost and efficiency  Time and cost and efficiency  Innovation and sustainability  Cost and efficiency, time, and quality  Cost and efficiency |

**1-22** (10–15 min.) **Planning and control decisions.**

|  |  |  |
| --- | --- | --- |
| **Action** | **Decision** | |
| a.  b.  c.  d.  e. | Planning  Control  Control  Planning  Planning |

**1-23** (10–15 min.) **Planning and control decisions.**

|  |  |  |
| --- | --- | --- |
| **Action** | **Decision** | |
| a.  b.  c.  d.  e. | Control  Control  Planning  Planning  Planning |

**1-24** (15 min.) **Five-step decision-making process, manufacturing.**

|  |  |
| --- | --- |
| **Action** | **Step in Decision-Making Process** |
| a.  b.  c.  d.  e.  f.  g. | Obtain information.  Make predictions about the future.  Make decisions by choosing among alternatives.  Implement the decision, evaluate performance, and learn.  Make predictions about the future.  Identify the problem and uncertainties.  Obtain information. |

**1-25** (15 min.) **Five-step decision-making process, service firm.**

|  |  |
| --- | --- |
| **Action** | **Step in Decision-Making Process** |
| a.  b.  c.  d.  e.  f. | Make decisions by choosing among alternatives.  Identify the problem and uncertainties.  Obtain information and/or make predictions about the future.  Obtain information and/or make predictions about the future.  Make predictions about the future.  Obtain information. |

**1-26** (10–15 min.) **Professional ethics and reporting division performance.**

1. Mendez’s ethical responsibilities are well summarized in the IMA’s “Standards of Ethical Behavior for Practitioners of Management Accounting and Financial Management” (Exhibit 1-7 of text). Areas of ethical responsibility include the following:

* Competence
* Confidentiality
* Integrity
* Credibility

The ethical standards related to Mendez’s current dilemma are integrity, competence, and credibility. Using the integrity standard, Mendez should carry out duties ethically and communicate unfavorable as well as favorable information and professional judgments or opinions. Competence demands that Mendez perform her professional duties in accordance with relevant laws, regulations, and technical standards and provide decision support information that is accurate. Credibility requires that Mendez report information fairly and objectively and disclose deficiencies in internal controls in conformance with organizational policy and/or applicable law. Mendez should refuse to book the $200,000 of sales until the goods are shipped. Both financial accounting and management accounting principles maintain that sales are not complete until the title is transferred to the buyer.

2. Mendez should refuse to follow Dalton’s orders. If Dalton persists, the incident should be reported to the corporate controller. Support for line management should be wholehearted, but it should not require unethical conduct.

**1-27** (10–15 min.) **Professional ethics and reporting division performance.**

1. Gilpin’s ethical responsibilities are well summarized in the IMA’s “Standards of Ethical Behavior for Practitioners of Management Accounting and Financial Management” (Exhibit 1-7 of text). Areas of ethical responsibility include the following:

* Competence
* Confidentiality
* Integrity
* Credibility

The ethical standards related to Gilpin’s current dilemma are integrity, competence, and credibility. Using the integrity standard, Gilpin should carry out duties ethically and communicate unfavorable as well as favorable information and professional judgments or opinions. Competence demands that Gilpin perform her professional duties in accordance with relevant laws, regulations, and technical standards and provide decision support information that is accurate. Credibility requires that Gilpin report information fairly and objectively and disclose deficiencies in internal controls in conformance with organizational policy and/or applicable law. Gilpin should use her professional judgment to decide if reclassifying labor costs from cost of goods sold to administrative labor is appropriate. This cost should be classified as cost of goods sold and she should refuse to classify the $50,000 of costs as administrative costs only to avoid allocation of overhead costs.

2. Gilpin should refuse to follow Myers’ orders but should discuss her concerns with Myers. If Myers persists, the incident should be reported to the corporate controller of Blakemore Auto Glass. Gilpin may also want to consider consulting the IMA for ethical guidance. Support for line management should be wholehearted, but it should not require unethical conduct.

**1-28** (15 min.) **Planning and control decisions, Internet company.**

1. **Planning decisions**

a. Decision to raise monthly subscription fee from July

c. Decision to offer e-mail service to subscribers and upgrade content of online services (later decision to inform subscribers and upgrade online services is an implementation part of control)

e. Decision to decrease monthly subscription fee starting in November.

**Control decisions**

1. Decision to inform existing subscribers about the rate of increase—an implementation part of control decisions

d. Dismissal of VP of Marketing—performance evaluation and feedback aspect of control decisions

2. Other planning decisions that may be made at PostNews.com: decision to raise or lower advertising fees; decision to charge a fee from on-line retailers when customers click-through from PostNews.com to the retailers’ websites.

Other control decisions that may be made at PostNews.com: evaluating how customers like the new format for the weather information and evaluating whether the waiting time for customers to access the website has been reduced.

**1-29** (20 min.) **Strategic decisions and management accounting.**

1. The strategies the companies are following in each case are:

|  |  |
| --- | --- |
| a.  b.  c.  d. | Cost leadership or low price strategy  Product differentiation strategy  Product differentiation strategy  Cost leadership or low price strategy |

2. Examples of information the management accountant can provide for each strategic decision about the source of competitive advantage follow.

|  |  |
| --- | --- |
| a.  b.  c.  d. | Cost to manufacture and sell the cell phone  Productivity, efficiency, and cost advantages relative to competition  Prices of competitive cell phones  Sensitivity of target customers to price and quality  The production capacity of Julian Phones and its competitors  How the market for cell phones with standard features is growing  Cost of modifying planes for the new first-class cabins  Premium price that customers would be willing to pay for the first-class cabin  Price of first class cabins on competitor airlines  Cost of additional staffing and amenities for first-class service  Cost of producing the new window shades  Premium price that customers would be willing to pay for the window shades  Prices of regular window shades  The production capacity needed to manufacture the window shades  Cost to manufacture, package, and sell new bagged cereal  Sensitivity of target customers to price and quality  Price of competitive low-priced breakfast cereal  Productivity, efficiency, and cost advantages relative to competition  Cash needed to manufacture, package, and sell new bagged cereal |

**1-30** (20 min.) **Strategic decisions and management accounting.**

1. The strategies the companies are following in each case are

|  |  |
| --- | --- |
| a.  b.  c.  d. | Cost leadership or low-price strategy  Product differentiation strategy  Cost leadership or low-price strategy  Product differentiation strategy |

2. Examples of information the management accountant can provide for each strategic decision follow.

|  |  |
| --- | --- |
| a.  b.  c.  d. | Cost related to purchase leather from a cheaper supplier  Productivity and efficiency advantages relative to competition  Sensitivity of target customers to price and quality  Materials and labor usage costs when working with cheaper leather  Cost of delivery service  Premium price that customers would be willing to pay for the service  Price of closest competitive product  Cost to develop new software to check in customers  Efficiency and cost advantages relative to competition  Sensitivity of target customers to change in service  Cost to hire horticultural specialist  Premium price that customers would be willing to pay for expert advice  Price of closest competitive product |

**1-31** (15 min.) **Management accounting guidelines.**

1. Behavioral and technical considerations
2. Behavioral and technical considerations
3. Different costs for different purposes
4. Behavioral and technical considerations (or cost benefit)
5. Cost-benefit approach
6. Cost-benefit approach
7. Behavioral and technical considerations
8. Different costs for different purposes
9. Cost-benefit approach

**1-32** (15 min.) **Management accounting guidelines.**

1. Behavioral and technical considerations
2. Cost-benefit approach
3. Different costs for different purposes
4. Behavioral and technical considerations
5. Cost-benefit approach
6. Different costs for different purposes
7. Different costs for different purposes

**1-33** (15 min.) **Role of controller, role of chief financial officer.**

1.

|  |  |  |
| --- | --- | --- |
| **Activity** | **Controller** | **CFO** |
| Managing the company’s long-term investments |  | X |
| Presenting financial statements to the board of directors |  | X |
| Strategic review of different lines of businesses |  | X |
| Budgeting funds for a plant upgrade | X |  |
| Managing accounts receivable | X |  |
| Negotiating fees with auditors |  | X |
| Assessing profitability of various products | X |  |
| Evaluating the costs and benefits of a new product design | X |  |

2. As CFO, Jimenez will be interacting much more with the senior management of the company, the board of directors, auditors, and the external financial community. Any experience he can get with these aspects will help him in his new role as CFO. George Jimenez can be better positioned for his new role as CFO by participating in strategy discussions with senior management; by preparing the external investor communications and press releases under the guidance of the current CFO; by attending courses that focus on the interaction and negotiations between the various business functions and outside parties such as auditors; and, either formally or on the job, getting training in issues related to investments and corporate finance.

**1-34** (30 min.) **Pharmaceutical company, budgeting, ethics.**

1. The overarching principles of the IMA Statement of Ethical Professional Practice are Honesty, Fairness, Objectivity and Responsibility. The statement’s corresponding “Standards for Ethical Behavior…” require management accountants to

* Perform professional duties in accordance with relevant laws, regulations, and technical standards.
* Refrain from engaging in any conduct that would prejudice carrying out duties ethically.
* Communicate information fairly and objectively.
* Provide all relevant information that could reasonably be expected to influence an intended user’s understanding of the reports, analyses, or recommendations.

The idea of capitalizing some of the company’s R&D expenditures (item c) is a direct violation of the IMA’s ethical standards above. This transaction would not be “in accordance with relevant laws, regulations, and technical standards.” GAAP requires research and development costs to be expensed as incurred. Even if Maddox believes his transaction is justifiable, it violates the profession’s technical standards and would be unethical.

The other “year-end” actions occur in many organizations and fall into the “gray” to “acceptable” area. Much depends on the circumstances surrounding each one, however, such as the following:

1. *Cut planned bonuses to the Amiven R&D team that would be paid in the third quarter, knowing that doing so may result in lower productivity and increased turnover of highly skilled staff.* This solution is not a violation of ethical standards but this action may not be in the best interest of the company in the long run. Reducing bonuses may help achieve the budget but losing highly skilled employees would harm the company’s ability to develop new products in the future and hurt long-run profits.
2. *Sell off rights to the drug, Centrix. The company had not planned on doing this because, under current market conditions, it would get less than fair value. It would, however, result in a onetime gain that could offset the budget shortfall. Of course, all future profits from Centrix would be lost.* Again, this solution may solve the company’s short-term budget crisis, but could result in the loss of future profits for Pharmex in the long run. If this action does not create value for Pharmex, it would result in taking an uneconomic action simply to manage accounting earnings in the third quarter.
3. While it is not uncommon for companies to sacrifice long-term profits for short-term gains, it may not be in the best interest of the company’s shareholders. In the case of Pharmex, the CFO is primarily concerned with “maximizing shareholder wealth” in the immediate future (third quarter only) but not in the long term. Because this executive’s incentive pay and even employment may be based on her ability to meet short-term targets, she may not be acting in the best interest of the shareholders in the long run.

Maddox definitely faces an ethical dilemma. It is not unethical on Maddox’s part to want to please his new boss, nor is it unethical that Maddox wants to make a good impression on his first days at his new job; however, Maddox must still act within the ethical standards required by his profession. Taking illegal or unethical action by capitalizing R&D to satisfy the demands of his new supervisor, Emily Alford, is unacceptable. Although not strictly unethical, I would recommend that Maddox not agree to cut planned bonuses for the Amiven R&D team or sell off the rights to Centrix. Each of these appears to sacrifice the overall economic interests of Pharmex for short-run gain. Maddox should argue against doing this but not resign if Alford insists that these actions be taken. If, however, Alford asks Maddox to capitalize R&D, he should raise this issue with the chair of the audit committee after informing Alford that he is doing so. If the CFO still insists on Maddox capitalizing R&D, he should resign rather than engage in unethical behavior.

**1-35** (30–40 min.) **Professional ethics and end-of-year actions.**

1. The possible motivations for the snack foods division wanting to take end-of-year actions include:

(a) Management incentives. Daniel Foods may have a division bonus scheme based on one-year reported division earnings. Efforts to front-end revenue into the current year or transfer costs into the next year can increase this bonus.

(b) Promotion opportunities and job security. Top management of Daniel Foods likely will view those division managers who deliver high reported earnings growth rates as being the best prospects for promotion. Division managers who deliver “unwelcome surprises” may be viewed as less capable.

(c) Retain division autonomy. If top management of Daniel Foods adopts a “management by exception” approach, divisions that report sharp reductions in their earnings growth rates may attract a sizable increase in top management supervision.

2. The “Standards of Ethical Conduct . . . ” require management accountants to

* Perform professional duties in accordance with relevant laws, regulations, and technical standards.
* Refrain from engaging in any conduct that would prejudice carrying out duties ethically.
* Communicate information fairly and objectively.

Several of the “end-of-year actions” clearly are in conflict with these requirements and should be viewed as unacceptable by Butler.

(b) The fiscal year-end should be closed on midnight of December 31. “Extending” the close falsely reports next year’s sales as this year’s sales.

(c) Altering shipping dates is falsification of the accounting reports.

(f) Advertisements run in December should be charged to the current year. The advertising agency is facilitating falsification of the accounting records.

The other “end-of-year actions” occur in many organizations and fall into the “gray” to “acceptable” area. However, much depends on the circumstances surrounding each one, such as the following:

(a) If the independent contractor does not do maintenance work in December, there is no transaction regarding maintenance to record. The responsibility for ensuring that packaging equipment is well maintained is that of the plant manager. The division controller probably can do little more than observe the absence of a December maintenance charge.

(d) In many organizations, sales are heavily concentrated in the final weeks of the fiscal year-end. If the double bonus is approved by the division marketing manager, the division controller can do little more than observe the extra bonus paid in December.

(e) If TV spots are reduced in December, the advertising cost in December will be reduced. There is no record falsification here.

1. Much depends on the means of “persuading” carriers to accept the merchandise. For example, if an under-the-table payment is involved, or if carriers are pressured to accept merchandise, it is clearly unethical. If, however, the carrier receives no extra consideration and willingly agrees to accept the assignment because it sees potential sales opportunities in December, the transaction appears ethical.

Each of the (a), (d), (e), and (g) “end-of-year actions” may well disadvantage Daniel Foods in the long run. For example, lack of routine maintenance may lead to subsequent equipment failure. The divisional controller is well advised to raise such issues in meetings with the division president. However, if Daniel Foods has a rigid set of line/staff distinctions, the division president is the one who bears primary responsibility for justifying division actions to senior corporate officers.

3. If Butler believes that Ray wants her to engage in unethical behavior, she should first directly raise her concerns with Ray. If Ray is unwilling to change his request, Butler should discuss her concerns with the Corporate Controller of Daniel Foods. She could also initiate a confidential discussion with an IMA Ethics Counselor, other impartial advisers, or her own attorney. Butler also may well ask for a transfer from the snack foods division if she perceives Ray is unwilling to listen to pressure brought by the Corporate Controller, CFO, or even President of Daniel Foods. In the extreme, she may want to resign if the corporate culture of Daniel Foods is to reward division managers who take “end-of-year actions” that Butler views as unethical and possibly illegal. It was precisely actions along the lines of (b), (c), and (f) that caused an accountant at WorldCom, to be indicted for falsifying WorldCom’s books and misleading investors.

**1-36** (30 min.) **Professional ethics and end-of-year actions.**

1. The possible motivations for Controller Sophie Gellar to modify the division’s year-end earnings are

(i) Job security and promotion. The company’s CFO will likely reward her for meeting the company’s performance expectations. Alternately, Gellar may be penalized, perhaps even by losing her job if the performance expectations are not met.

(ii) Management incentives. Gellar’s bonus may be based on the division’s ability to meet certain profit targets. If the House and Home division is able to meet its profit target for the year, the Controller may receive incentive bonuses for the year, for example, by using lighter weight paper to reduce both paper and postage costs even if there is an impact on future sales from lower quality, or by manipulating operating income by questionable revenue and/or expense recognition.

2. The overarching principles of the IMA Statement of Ethical Professional Practice are Honesty, Fairness, Objectivity and Responsibility. The statement’s corresponding “Standards for Ethical Conduct…” require management accountants to

* Perform professional duties in accordance with relevant laws, regulations, and technical standards.
* Refrain from engaging in any conduct that would prejudice carrying out duties ethically.
* Communicate information fairly and objectively.
* Provide all relevant information that could reasonably be expected to influence an intended user’s understanding of the reports, analyses, or recommendations.

Several of the “year-end” actions are clearly in conflict with the statement’s principles and required standards and should be viewed as unacceptable.

(c) Subscription revenue received in December in advance for magazines that will be sent out in January is a liability. Showing it as revenue falsely reports next year’s revenue as this year’s revenue.

(d) Delaying the shipment of the January issues to January 2 to defer recognition of the postage expense is not an ethical violation. However, recognizing subscription revenue of the January issue in December violates GAAP and is unethical. It falsely reports next year’s revenue as this year’s revenue.

(e) Booking advertising revenues that relate to January in December falsely reports next year’s revenue as this year’s revenue.

The other “year-end” actions occur in many organizations and fall into the “gray” to “acceptable” area. Much depends on the circumstances surrounding each one, however, such as the following:

(a) *Cancelling two of the division’s least profitable magazines, resulting in the layoff of twenty-five employees.* While employee layoffs may be necessary for the business to survive, the layoff decision could result in economic hardship for those employees who lose their jobs, as well as result in employee morale problems for the rest of the division. Many companies would prefer to avoid causing hardship for their existing employees due to layoffs unless beneficial from a long-term perspective or for the survival of the business as a whole.

(b) *Changing to a lighter weight paper that would reduce both paper and postage costs by five percent. It is uncertain what effect the lower quality would have on future sales.* If it is determined that the cost savings from shifting to the lower grade of paper will outweigh any lost revenue from the reduction in quality, then this is not an ethical violation. Gellar should present to management a fair, unbiased report of the data so that management can make a decision that is in the best interest of the company in the long run. If the future lost revenues were greater than the savings in costs and Gellar were not to present this information clearly, it would violate the IMA’s ethical standards of competence and credibility by not communicating information fairly, objectively and accurately.

(f) *Switching from declining balance to straight line depreciation to reduce depreciation expense in the current year.* Many companies switch their depreciation policy from one method to another. Phoenix Press could argue that straight-line depreciation better represents the decrease in the economic value of the asset compared to the declining balance method. Straight-line depreciation may also be more in line with what its competitors do. If, however, the company changes to straight-line depreciation with the sole purpose of reducing expenses to meet its profit goals, such behavior would be unacceptable. The Standards of Ethical Behavior require management accountants to communicate information fairly and objectively and to carry out duties ethically.

3. Gellar should directly raise her concerns first with the CFO, especially if the pressure from the CFO is so great that the only course of action on the part of the controller is otherwise to behave unethically. If the CFO refuses to change his direction, then the controller should raise these issues with the CEO, and next to the Audit Committee and the Board of Directors, after informing the CFO that she is doing so. The Controller could also initiate a confidential discussion with an IMA Ethics Counselor, other impartial advisers, or his/her own attorney. In the extreme, the Controller may want to resign if the corporate culture of Phoenix Press is to reward executives who take year-end actions that the Controller views as unethical and possibly illegal. It was precisely actions along the lines of (c), (d) and (e) that caused an accountant at WorldCom, to be indicted for falsifying WorldCom’s books and misleading investors.

**1-37** (40 min.) **Ethical challenges, global company.**

1. The overarching principles of the IMA Statement of Ethical Professional Practice are Honesty, Fairness, Objectivity, and Responsibility. The statement’s corresponding “Standards for Ethical Conduct…” require management accountants to

* Perform professional duties in accordance with relevant laws, regulations, and technical standards.
* Refrain from engaging in any conduct that would prejudice carrying out duties ethically.
* Communicate information fairly and objectively.
* Disclose all relevant information that could reasonably be expected to influence an intended user’s understanding of the reports, analyses, or recommendations.

Several of the suggestions made by Armstrong’s staff are clearly in conflict with the statement’s principles and required standards and should be viewed as unacceptable.

**a.** *Pay local officials to “certify” the ramin used by CI as sustainable. It is not certain whether the ramin would indeed be sustainable or not.* If the payment could be considered a bribe, the company would be in violation of the Foreign Corrupt Practices Act. Knowledge of such a violation of law would be considered a violation of professional ethics.

**c.** *Record executive year-end bonus compensation accrued for the current year when it is paid in the next year after the December fiscal year-end.* GAAP requires expenses to be recorded (accrued) when incurred, not when paid (cash basis accounting). Therefore, failure to record the executives’ year-end bonus would violate the IMA’s standards of credibility and integrity.

**f.** *Pressure current customers to take early delivery of goods before the end of the year so that more revenue can be reported in this year’s financial statements.* This tactic, commonly known as channel stuffing, merely results in shifting future period revenues into the current period. The overstatement of revenue in the current period may mislead investor’s to believe that the company’s financial well-being is better than the actual results achieved. This practice would violate the IMA’s standards of credibility and integrity. Channel stuffing is frequently considered a fraudulent practice.

**i.** *Recognize sales revenues on orders received but not shipped as of the end of the year.* GAAP requires income to be recorded (accrued) when the four criteria of revenue recognition have been met:

**1.** The company has completed a significant portion of the production and sales effort.

**2.** The amount of revenue can by objectively measured.

**3.** The major portion of the costs has been incurred, and the remaining costs can be reasonably estimated.

**4.** The eventual collection of the cash is reasonably assured.

Because criteria 1 and 3 have not been met at the time the order is placed, the revenue should not be recognized until after year-end. Therefore, recording next year’s revenue in the current year would be a violation of GAAP and would be falsifying revenue. This would be a violation of the IMA’s standards of credibility and integrity and considered fraudulent.

Three of the suggestions appear to be acceptable:

**d.** *Reject the change in materials. Counter the bad publicity with an aggressive ad campaign showing the consumer products as “made in the USA,” since manufacturing takes place in North Carolina.* This is an acceptable strategy. Consumers could then weigh the employment benefits in the United States against the negative environmental effects of the company’s actions.

**e.** *Redesign upholstered furniture to replace ramin contained inside with less expensive recycled plastic.* Creative changes in product design using recycled materials will allow CI to address sustainability concerns as well as protect company profits.

**g.** *Begin purchasing sustainable North American hardwoods and sell the Indonesian lumber subsidiary. Initiate a “plant a tree” marketing program, by which the company will plant a tree for every piece of furniture sold.* While this solution would increase cost of materials and the price CI must charge for its product, sales and profits may not decline if consumers perceive the value of sustainability and corporate social responsibility.

The other “year-end” actions occur in many organizations and fall into the “gray” to “acceptable” area. Much depends on the circumstances surrounding each one, however, such as the following:

**b.** *Make deep cuts in pricing through the end of the year to generate additional revenue.* Again, this is only a short-term tactic to improve this year’s financial results. Investors may be content in the short run, but in the long run, the company may see reduced margins from these actions.

**h**. *Sell-off production equipment prior to year-end. The sale would result in one-time gains that could offset the company’s lagging profits. The owned equipment could be replaced with leased equipment at a lower cost in the current year.* While this course of action does not necessarily violate the IMA’s code of ethical standards, it may be only a short-term tactic to improve this year’s financial results. Armstrong will need to weigh his options in the long term to make the most cost effective decision for his company.

2. It is possible that any of the “year-end” actions that fall into the “gray” area may be good for investors, depending on the credible evidence that supports the management decision. For example, replacing owned equipment with leased equipment may result in both short-term gains for the company and long-term cost reduction. If so, this decision would be in the best interest of the investors. If the decision only results in short-term gains, but higher costs in the long-run, then the decision may not be in the best long-term interest of the company’s investors and should not be implemented solely to prop up short-term earnings.

Those decisions that clearly violate the IMA code of ethical standards (a, c, f, and i) would never be in the best interest of the investor. These options would result in misleading financial statements and could result in the demise of the company or even in criminal charges, as was the case with companies such as Enron and WorldCom. If Armstrong asks the management accountant to take any of the actions that are clearly unethical, he should raise this issue with the chair of the Audit Committee after informing Armstrong that he is doing so. If Armstrong still insists on the management accountant taking these actions, he should resign rather than engage in unethical behavior.