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GROWTH ELECTRONICS, INC.

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COMPANY AND INDUSTRY BACKGROUND

Growth Electronics, Inc., based in Los Angeles, California, manufactures computer disk drives that are sold to manufacturers of home and business microcomputer systems. After an initial start-up period in the early 1980's, the company expanded by opening two manufacturing and warehousing facilities in the Pacific rim, one in Malaysia and one in Hong Kong; the Los Angeles location continued as a manufacturing site, as well as serving as the company's administrative and marketing headquarters. The company's operations involve frequent shipments of raw materials between the company's three locations, a fact that has created challenges for the company's internal accounting staff.

The microcomputer industry in the 1980's was characterized by rapid change, and disk drive technology in particular was evolving during this period. In 1981, Growth Electronics' disk drives contained state-of-the-art technology, and the company had a reputation as an innovative leader. By the mid 80's, new competitors had appeared, and Growth no longer had the most advanced disk drive on the market.

In 1985 Growth Electronics was headed by a new CEO, Roger Force, who committed the company to earnings growth. All upper and middle level management had annual salaries based in part upon meeting profit targets set by Mr. Force. Not an electronics industry insider, Force's philosophy is to "run the company by the numbers," insisting that profit targets be met and allowing individual managers maximum discretion in running their specific operations. With respect to the company's accounting and control systems, Force states, "We don't want accounting to get in the way of our operating managers doing their job. Our objective is to produce a product, not to be financial historians." Under Force's leadership, the company has experienced ten consecutive quarters of earnings growth.

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RECENT FINANCIAL RESULTS

Selected consolidated financial data is presented below:

RECENT EARNINGS FIGURES (000)

Year	Quarter	Net Income (Loss)
1984	Q1–Q4	$10,279
1985	Q1–Q4	(973)
1986	Q1–Q4	19,782
1987	Q1–Q4	28,161
1987	Q1	971
	Q2	6,587
	Q3	7,255
	Q4	13,348

CONDENSED CONSOLIDATED INCOME STATEMENT (000)

	1987
Net Sales	$ 362,487
Cost of Sales	(269,828)
Operating Expenses	(56,071)
Other Income (Expenses)	(3,367)
Provision for Income Taxes	(5,060)
Net Income	$ 28,161

CONDENSED CONSOLIDATED BALANCE SHEET (000)

	December 1987		December 1987
Cash	$ 16,932	Current Liabilities	$ 74,175
Accounts Receivable	53,740	Long-Term Obligations	157,835
Inventories	85,172	Total Liabilities	232,010
Property and Equipment	107,944	Shareholders' Equity	31,778
Total Assets	$263,788	Total Liabilities & Equity	$263,788

SELECTED RESERVE BALANCES (000)

	Balance Dec. 1986	Balance Dec. 1987	Effect on 1987 Net Income
Allowance for Uncollectible Accounts	$4,058	4,149	$ (91)
Allowance to Reduce Inventories to NRV	4,845	2,775	2,070
Relocation Reserve[1]	3,215	0	3,215
			$5,194

JIT WAREHOUSES

Among the company's new customers in 1987 were two Australian firms that operated their manufacturing plants under a "Just In Time" (JIT) philosophy, keeping very little room in their facilities for inventory and thus demanding that suppliers ship exact quantities on a timely basis to satisfy short-run production needs. Growth Electronics responded by constructing a warehouse in Sidney that could be stocked with the necessary components to serve these customers. In return, Growth negotiated an agreement in which the Australian firms stated their intention to annually purchase, under normal credit and payment terms, target quantities of product at current market prices. Sale terms under the agreement include billing as of the date that goods are shipped from Sidney to the customers' facilities and a 30-day customer right of return. On December 20, 1987 one of the Australian firms indicated that within the next month $4,677,000 of goods (cost of sales of $3,507,000) would be needed. These goods were shipped from Los Angeles to Sidney on December 28, 1987 and included in sales for the year. Growth Electronics officials have obtained an attorney's opinion stating that legal title to the goods transfers when the goods are loaded onto the common carrier at Los Angeles.

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[1] The Relocation Reserve was established in 1985 by Roger Force to reflect expected costs of relocating operations to Malaysia and Hong Kong. The reserve was initially established at $5,000,000, reducing 1985 income by that amount. Despite the fact that relocation efforts were largely concluded by December 1985, the balance was carried on the books for two more years and amortized by $1,785,000 and $3,215,000 in 1986 and 1987 respectively.

Growth Electronics INVOICE		
December 28, 1987 Winchester Disk Drives $4,677,000.00		
Special Instructions: Hold in Sidney until delivery is requested	Shipping Terms: F.O.B. Los Angeles	Customer: Suntech Systems Melbourne, Australia

The $4,677,000 sale to the Australian firm is included in the 1987 year-end balance of accounts receivable. Growth bases its estimate of uncollectible accounts receivable on an aging analysis. The following schedule shows how the valuation allowance at December 1987 was calculated.

ESTIMATE OF UNCOLLECTIBLE ACCOUNTS RECEIVABLE (000)
DECEMBER 1987

Age	Balance	Percentage	Estimate
Under 60 Days	$25,877	2%	$ 517
60–120 Days	24,045	8%	1,923
121–240 Days	5,288	15%	793
241–360 Days	2,122	30%	637
Over 360 Days	557	50%	279
Total	$57,889		$4,149

CUSTOMER SERVICE PARTS

In late 1986 a decision had been made to perform all warranty repair work in the company's Malaysian location. In 1987 parts and supplies with a cost of $4,136,000 were transferred to Malaysia in a series of four shipments, two originating from Los Angeles (one of these was still in transit at year-end), and two originating from Hong Kong. The parts had originally been intended for use in the manufacture of finished products but were now being sent to Malaysia to support repair work on disk drives returned by customers. These parts were recorded on the books in Malaysia under an account titled "other assets," and would be amortized to expense over the following three years, the period over which the parts presumably would be consumed in warranty operations.

Ken Wikil, the controller in Malaysia, did not hesitate to record the spare parts transaction as instructed from corporate headquarters in Los Angeles. Since coming to Growth Electronics two years before, he had never questioned the instructions he received from Los Angeles. He felt that since he and the other local employees were native Malaysian citizens, and Growth Electronics was an American company, he was not in a position to question the accounting policies dictated by Los Angeles, but rather to do as instructed. He was, however, privately puzzled by the wide variation in the level of detail and specificity he observed in the firm's internal accounting and control procedures. While there were required documents and procedures for receiving and inspecting raw materials from outside vendors, no such procedures or documentation existed for internal transfers

like the shipments of spare parts mentioned above. The lack of official written procedures caused problems for Ken's staff accountants, and Ken's time was often taken up answering their questions about how to handle various matters. Ken wondered if a similar situation existed in Hong Kong.

The spare parts were not included in the company's tally sheets used to compile the December 1987 inventory balance. The company evaluates inventory for impairment in value due to obsolescence, damage, and general deterioration as follows: obsolescence is evaluated based upon an activity analysis of inventory movements, and general damage and deterioration is evaluated on the basis of a physical inspection of the inventory. The following table shows how the inventory valuation allowance at December 1987 was calculated.

INVENTORY RESERVES (000)
DECEMBER 1987

Category Description	1987 Inventory Balance	Percentage	1987 Estimated Reserve	1986 Estimated Reserve	Increase (Decrease)
Inventory with no movement in 90 days, primarily raw materials and finished goods	$11,286	10%	$1,129	$1,109	$ 20
Inventory of high dollar parts with no movement in one year	1,098	50%	549	2,617	(2,068)
Review for damage and deterioration based upon physical inspection	75,563	—	1,097	1,119	(22)
Totals	$87,947		$2,775	$4,845	$(2,070)

EXTERNAL FINANCIAL REPORTING

Growth Electronics is searching for external accountants to audit its 1987 results. Having gone public in 1984, Growth Electronics stock has experienced recent price increases on news of strong earnings growth, and the company is contemplating issuing additional shares. To facilitate raising new capital, a clean audit opinion from a reputable accounting firm is essential. Since Growth Electronics does not have an audit committee within its board of directors, Roger Force appointed Gerry Carlson, Chief Financial Officer, to head negotiations to retain a new CPA firm.

Carlson has approached your CPA firm and has expressed an interest in retaining your firm's services as external auditors. Carlson has explained that the company's previous auditor no longer had the necessary resources to audit the company's growing international operations. He further indicated Growth's desire to develop a good relationship with its new audit firm. He offered the following additional comments.

"We have grown very quickly in the last few years and this has created some problems in our operations because our administrative structure in the past was geared toward a smaller domestic operation. We will adjust however, and we are committed to gaining better control of our operations from an administrative standpoint. We also know that we have a couple of areas that may be controversial from an accounting standpoint. We want to be as up front and open with you as possible about these matters from the start.

"We have some significant sales to our new international customers, which we have booked this year, that we know will come under scrutiny due to their proximity to year-end. We sought counsel as to the legality of recording these sales, and we have an attorney's opinion that title to the goods in question has passed to the customer, making them a legitimate sale.

"We also have a substantial number of internal transfers of raw materials which are in transit at year-end. This is due to the nature of our international operations. We are constantly striving to control costs, and this at times means juggling where we obtain things and then shipping to our other locations. We also have decided to take advantage of low labor costs in Malaysia by making that our center for warranty repair work. This has necessitated our making a significant transfer of spare parts to our Malaysian facility this year.

"We certainly hope to work closely with you on these matters and others, and I want to assure you that we will be reasonable if there are audit adjustments that you feel are necessary. We wish to establish a spirit of cooperation; for this reason we want you to become familiar with our situation and consider our position on these and other matters that are sure to arise in an audit of a company of our size and complexity."

QUESTIONS

1. Is the booking of the $4,677,000 sale to the Australian firm in accordance with GAAP? If your answer is yes, indicate why you feel the described transaction meets the definition of a sale. If your answer is no, indicate what elements of a sale you feel are missing.

2. Are the company's accounts receivable valued in accordance with GAAP? What factors would you consider in analyzing the value of the company's accounts receivable?

3. With respect to the shipment of spare parts from Los Angeles to Malaysia:

   a. What is the nature of "Other Assets."? What accounting issues are relevant to this asset category?

   b. What possible explanations exist for the inconsistency in the company's procedures for receiving goods externally versus internally? If you were the manager in charge of Malaysia's operations and financial results, what concern would you have concerning the lack of control over internal shipments?

   c. What international issues are involved in this transaction? How would this transaction have been handled differently if it had involved a U.S. subsidiary?

4. What issues do you see with regard to the company's 1987 inventory valuation? Include the spare parts classified by the company as "other assets" in your analysis.

5. Is there any evidence that Growth Electronics' management may be engaging in fraudulent financial reporting? Make a list of factors that you see as relevant to this question. Do any of the factors you have identified provide direct evidence concerning management integrity?

6. Consider Growth Electronics as a prospective audit client.

   a. What special audit challenges does Growth Electronics pose to a potential auditor?

   b. How would you characterize the risk of material misstatement in Growth Electronics' financial statements (e.g., low, moderate, or high)? Make a list of factors that you see as relevant to this question. Do any of the factors you have identified provide direct evidence concerning management integrity?

   c. Would you accept Gerry Carlson's offer to audit Growth Electronics if your firm had the necessary expertise and could comfortably handle the work load with existing staff?

THE LESLIE FAY COMPANIES CASE

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INTRODUCTION

Leslie Fay, a highly regarded women's apparel firm, shocked almost everybody in early 1993 when its corporate controller suggested that he and several divisional controllers had overstated profits by at least $100 million over the prior two years. Creditors soon forced Leslie Fay into Chapter 11 bankruptcy, and it was not until November 1995 that the firm announced a plan for reorganization and eventual emergence from bankruptcy. By that time, the firm's stock had plunged below 50 cents per share and had been delisted by The New York Stock Exchange.

Pre-tax profits were actually overstated by $131 million. No cash, inventory, or other assets were ever discovered missing. Two investigations found no evidence of top management involvement in, or knowledge of, the financial misstatements.

This case chronicles an investment club that had made purchases of Leslie Fay stock as it reviews the rationale for its past investments and considers whether factors that previously seemed to be positives for the firm might have created an environment in which fraudulent reporting was more likely to result.

THE "BOMBSHELL"

It was 6:44 PM on the evening of February 1, 1993 and Jennifer was watching The Nightly Business Report, syndicated nationally from Miami's public television station WPBT. Co-anchor Paul Kangas was just beginning his daily segment describing the "action" on Wall Street today, where he identified the big up and down movers on each stock exchange. Within moments, Jennifer became concerned as Paul spoke the following:

> "Leslie Fay, the women's apparel maker, down 4 and 5/8 points. The company said it's investigating alleged accounting irregularities and the company says that if this turns out to be the case, it could result in restating '91 earnings and it could wipe out any '92 profits."

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Jennifer turned off her TV and placed an urgent call to Amanda. "I've just been watching The Nightly Business Report, and it appears that our investment in The Leslie Fay Companies got clobbered today amid reports that the firm's books had been cooked," she stated.[1] Both women decided that they should meet with the third member of their investment club to, in Jennifer's words, "review our rationale for having invested in Leslie Fay and see if, upon closer analysis, there were patterns in the reported data or other circumstances within the firm that should have made us suspicious."

Jennifer and Amanda were two-thirds of Windham County Investors. By way of background, the nature of this investment club, its selection strategy, and performance to date will now be described.

WINDHAM COUNTY INVESTORS

Windham County Investors (WCI) was formed following a chance meeting between three retired business professionals in the southern Vermont town of Westminster in early September 1990. Robert Logan had moved to Westminster in 1989, leaving behind a 30-year career as an executive with a clothing distributor headquartered in New York City's garment district. Jennifer Underwood, a retired credit analyst for an upstate New York bank, settled in Bellows Falls in 1984, sufficiently long ago that most of the locals no longer viewed her as a "flatlander." Amanda Knight, a native Vermonter, had worked as a systems analyst in Burlington until 1989 and presently lived just to the south of Westminster in Putney.

INVESTMENT STRATEGY AND SELECTION

Each of the members invested $2,500 at WCI's initial meeting on September 15, 1990. Because all three had made sufficient low-risk investments on their own, they concluded that WCI could restrict its investments to common stocks.

Jennifer had been studying the stock market for some time and she felt that it was poised for a recovery, given that the Dow Jones Industrial Average stood at 2564.11 in mid-September of 1990, almost 15 percent below the 2999.75 level it had attained as recently as July 16.[2] She further noted that stocks of such well-known firms as Marriott and JC Penney were presently trading at new 52-week lows of $15.25 and $42.00 per share, respectively. "Let's follow the old adage of buying low and selling high," she exclaimed to Robert and Amanda.

Robert, who had followed the securities of apparel manufacturers because of his former position with a clothing distributor, suggested the stock of The Leslie Fay Companies, because "it's been a women's apparel leader for decades, has an experienced management team and, at $9.75, has shares that *also* are trading at a new 52-week low." Jennifer recalled reading that the number of working women between the ages of 25 and 54 was expected to grow by 25 percent during the 1990's.[3] "This has to bode well for any major women's apparel firm," she thought.

Amanda had no problem investing in Marriott, JC Penney, and *a* manufacturer of women's apparel, but she suggested that the club consider such Leslie Fay competitors as Bernard Chaus, Inc. (Chaus) and Jones Apparel Group (Jones). Robert acknowledged that Jones had been very successful in recent years, but an ownership investment was impossible at the present time — the firm's IPO (initial public offering) was not expected until May 1991. "Amanda," he continued, "I think we should wait with any Chaus purchase because the firm lost money in 1988 and 1989 and, although it has become profitable in 1990, I believe the stock is presently overvalued, selling at thirty-three times estimated earnings." "What's Leslie Fay's present price-earnings ratio?" Jennifer inquired. "Approximately seven," Robert replied.

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[1] With Leslie Fay shares previously trading at $12.00 each, the 4 and 5/8 drop represented a one-day price decline of 38 percent.

[2] All stock averages and individual prices cited reflect actual close-of-day quotations.

[3] This statistic is cited by Carol Kieltyka in her description of Liz Clairborne, Inc. appearing in Paula Kepos, editor, *International Directory of Company Histories*, St. James Press, Detroit, 1992, Vol 8, p. 331.

In the end, Jennifer and Amanda deferred to Robert's experience in the clothing industry and agreed that Leslie Fay would be the apparel firm in WCI's portfolio. "Leslie Fay's staying power and its solid relationships with department stores should place a floor on its share price," Robert said assuredly.

WCI invested the $7,500 total equally in shares of Leslie Fay, Marriott, and JC Penney. Although Jennifer, Amanda, and Robert became good friends and often saw each other socially, the group had only one subsequent business meeting, and that was on March 7, 1992 — eleven months prior to the Leslie Fay "bombshell."

INITIAL INVESTMENT PERFORMANCE

WCI's performance over its first eighteen months can be gauged from the summary in Exhibit 1. As noted there, the $7,500 invested had grown by 57 percent to $11,782 by February 27, 1992. By comparison, the increases in the Dow Jones Industrial Average, Standard & Poor's 500, and the New York Stock Exchange Composite Index ranged from 28 to 31 percent over this same time period.

EXHIBIT 1

WCI INVESTMENT PERFORMANCE, SEPT. 15, 1990 THROUGH FEBRUARY 27, 1992

Date Purchased	Company	# Shares	Cost[a]	Market at 2/27/92 Amount	Market at 2/27/92 % of Cost
Sept. 15, 1990	Leslie Fay	256	$2,500	$ 5,120	205
	Marriott	164	2,500	2,952	118
	JC Penney	59	2,500	3,710	150
			$7,500	$11,782	157
Change in Market Indices:					
Dow Jones Industrial Average			2564.11	3269.45	128
Standard and Poor's 500			316.83	413.86	131
New York Stock Exchange Composite			174.15	228.75	131

[a] Transaction costs (commissions) have been ignored.

In percentage terms, the stock of Leslie Fay exhibited the greatest appreciation by far — more than doubling during this time period. A sketch of Leslie Fay as of early 1992 follows.

THE LESLIE FAY COMPANIES, INC.

History and Markets

Leslie Fay (LF) was founded in 1947 by Fred Pomerantz, the father of the current CEO, John Pomerantz. Named for Fred's daughter, this women's apparel firm was publicly held from 1959–1982 and returned to that status beginning in 1986.[4]

[4] In April 1982, the business and its assets were purchased in a leveraged buyout transaction by a private company led by Leslie Fay management. It was subsequently sold to a limited partnership in June 1984, and continued as a private concern until a registered public offering of shares occurred in August 1986.

LF ranks second in sales of women's apparel to department stores. Major competitors include Bernard Chaus and Jones Apparel Group. Dresses and suits, constituting approximately 67 percent of LF's sales, are sold under such labels as Leslie Fay, Kasper for A.S.L., Castleberry, and Adolfo New York. Approximately 45 percent of 1991 sales were to its ten largest customers, representing a steady increase from a 35 percent level in 1986.[5]

Company research had identified the "Leslie Fay Woman" as 35 to 55 years old, with an annual income of $30,000 to $50,000. Most of its dresses and pantsuits had traditionally sold at retail for $89 to $139 each. By 1991, however, more than 40 percent of LF's sales were represented by better-price and designer apparel, up from 24 percent just four years earlier.

Management Continuity

Many key management personnel began working for Leslie Fay in their late twenties/early thirties, rose through the ranks, and remained there in early 1992. Included among them were the following:

			Year Joined LF
•	John Pomerantz	CEO	1960
•	Alan Golub	COO	1965
•	Ralph Iannazzone	VP—Mfg.	1972
•	Paul Polishan	CFO	1969
•	Donald Kenia	Controller	1976

Centralization of Financial Functions

Until 1991, all of the above executives worked at Leslie Fay's corporate headquarters on Broadway in New York City. In that year, however, the CFO and Controller moved to the firm's new World Administrative Headquarters in Hanover (Wilkes-Barre), Pennsylvania. The MIS, purchasing, and real estate functions that had been located within individual divisions were also transferred there so "division managers can concentrate more fully on our customers, products, and marketing," (according to LF's 1991 annual report). Added to already existing manufacturing and distribution facilities in Wilkes-Barre, the new facility raised total LF employment in the area to approximately 1,300 workers, or 28 percent of the firm's work force.

Executive Compensation and Performance Incentives

The annual base salary of CEO Pomerantz approximated $800,000 during the 1987–1992 period. In addition, he qualified for a performance incentive (bonus) equal to 4.52 percent of all pre-tax net earnings, as defined by the company. The percentage bonus applied to all earnings whenever they equaled at least $16,000,000. Pomerantz's bonus amounted to $2,850,000 in 1991. COO Golub's salary was approximately two-thirds of the CEO's, as was his earnings-based bonus.

Stock Ownership

During the early 1990's there were approximately 800 holders of record of Leslie Fay stock. As of February 28, 1992, CEO Pomerantz and his wife, Laura, then a Senior Vice President and Director at LF, owned 9.6 percent of the stock. Their ownership interest had been as high as 10.8 percent in 1989.

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[5] Dillard's Department Stores was LF's largest customer, accounting for 10 percent of its 1991 sales.

Credit and Collections

In its 1991 SEC Form 10-K, Leslie Fay added a discussion on credit and collections. There it indicated that substantially all of its credit and collection functions were managed by the Leslie Fay Sales Co., a separate division of the firm. LF also noted that approximately 16 percent of its 1991 sales were to major retailers that had incurred significant debt as a result of leveraged buyouts or similar transactions, although Leslie Fay observed that those firms' obligations were being paid on a timely basis.

THE CASE FOR LESLIE FAY: ROBERT'S MARCH 1992 MEMO

Although Jennifer and Amanda could hardly blame Robert for the meltdown in Leslie Fay's stock, they recalled that just eleven months earlier WCI had *increased* its holdings of LF by 147 shares at Robert's urging. "I still have the memo Robert prepared to back up the additional investment," Amanda noted. "Let's review it before we meet with him, to see if we can detect where or how the strengths cited by Robert might have become weaknesses," she added.

Robert's memo dated March 3, 1992 appears in Exhibit 2. As noted there, he felt that Leslie Fay warranted an additional investment by WCI on the strength of the firm's (1) operating results, (2) liquidity, (3) management continuity, (4) performance incentives, (5) information centralization, (6) marketing initiatives, and (7) future prospects.

EXHIBIT 2
ROBERT'S MARCH 1992 MEMO

To: Jennifer and Amanda
From: Robert
Subject: Upcoming meeting
Date: March 3, 1992

I've just examined the investment performance report for the eighteen months ended February 27, 1992 (Exhibit 1). I was delighted to note that our investment in Leslie Fay had done so well, increasing from $9.75 to $20 per share. This price appreciation is noteworthy because stocks in general only rose 30 percent in that time.

I propose at this point that we sell all of our shares in Marriott, WCI's poorest performing stock, and invest the $2,952 in approximately 147 additional LF shares. As they say, let's stick with a winner. Amanda, I recall that you had wanted us to consider Bernard Chaus, but that company has once again become unprofitable. Jones Apparel is now a possibility, but its price-earnings ratio of twenty-four could suggest that it is overvalued. Before we meet next week, consider the following pluses for Leslie Fay:

OPERATING RESULTS

Investors like steady increases in revenues, profits, and EPS.

- Between 1986 and 1991, revenues grew from $573 million to $837 million, a compound annual rate of 8 percent.
- Since 1987, gross margins stayed between 30–32% of sales and selling, general and administrative expenses remained at approximating 22–23% of sales.
- Net income (EPS) rose *each* year, climbing steadily from $19 million ($1.10) in 1986 to $29 million ($1.55) by 1991.

LIQUIDITY

All the income in the world isn't sufficient if you can't pay your bills.

- LF's year-end cash balance has remained above $4 million.
- The quick ratio has usually exceeded 1.2, and the current ratio has exceeded 2.0 since 1987, suggesting a large cushion of current assets to pay off current liabilities.

MANAGEMENT CONTINUITY

A top management team that has worked together for decades leads to

- Mutual respect.
- Strong loyalty.

PERFORMANCE INCENTIVES

At LF, top corporate executives and division heads have a real stake in how well the firm/divisions perform. Bonuses are

- Tied to current achievements.
- Sizable enough to influence behavior.

INFORMATION CENTRALIZATION

Centralization of the MIS and corporate reporting functions can

- Free divisions from specialized administrative tasks.
- Reduce costs.

MARKETING INITIATIVES

To be successful, apparel manufacturers must respond to changes in the fashion marketplace.

- LF's in-store boutiques, started in 1987, have grown to 1,000.
- Better-price and designer clothing provides increasing balance to LF's traditional moderate-price apparel.
- A joint venture is planned with a firm that distributes women's sportswear to such retailers as Wal-Mart and Kmart.

FUTURE PROSPECTS

Analysts believe that LF's marketing initiatives and plans bode well for the future. The firm has ready access to sources of capital.

- In mid-1991, Value Line indicated that a strengthening economy and additional boutiques may well lift LF's EPS to $2 by 1992.
- The Fidelity group of mutual funds presently owns 1,261,000 shares of LF stock, 6.58% of all shares outstanding.
- At year-end 1991, LF's *unused* revolving credit facility and existing lines of credit equaled $190 million.
- Department stores that streamline operations will rely further upon suppliers with known, respected brands.

REVISITING ROBERT'S MEMO DURING FEBRUARY 1993

On February 5, 1993, Jennifer and Amanda set out to review each section of Robert's memo, searching for clues to Leslie Fay's eventual problems that might have been overlooked earlier.

Operating Results

Leslie Fay's rising sales seemed impressive in light of the flat overall market for women's dresses since the late 1980's.[6] Sales growth accompanied by nearly constant percentages (of sales) for gross margin (30-32%) and selling, general and administrative expenses (22-23%) seemed to suggest that the firm was able to grow without resorting to lower quality sales or disproportionately higher sales promotion efforts. Nevertheless, Jennifer and Amanda now wished that Robert had furnished WCI with some benchmarks for comparison with the Leslie Fay results.

Liquidity

Upon second glance, Leslie Fay still seemed to have high liquidity. Amanda noted that current and quick ratios in excess of 2.0 and 1.2 were generally considered very satisfactory. Jennifer, while not disagreeing with her, observed that she had seen instances at her bank where overstatements in individual current asset accounts and/or understatements in individual current liability accounts had created an illusion of high liquidity. Once again, both women felt that benchmark comparisons might have helped.

Management Continuity

Amanda and Jennifer remained generally positive about the fact that five top officers of Leslie Fay had been at the firm for anywhere from 15-30 years. "The bank where I worked experienced constant turnover in the executive suite, and it was a nightmare," Jennifer recalled. "I agree that continuity is better," Amanda observed, "as long as executives can somehow avoid Groupthink — the tendency to think alike over time."

Both women were surprised that it was someone who had been with Leslie Fay since 1976, the corporate controller, who volunteered to company officials that he had cooked the books, with help from more than 10 divisional controllers.[7] (He and the CFO, who had been with LF for 24 years, were dismissed "for cause" in September 1993.)[8] "What's a company to do if it cannot trust those who have been a part of the management team for decades?" Amanda asked. "Could term limits for corporate officers be a practical solution?" she stated rhetorically.

Performance Incentives

Although salaries of the corporate controller and the divisional controllers were not tied to company performance, Amanda wondered whether the incentive systems in place for divisional presidents and top management might have created an environment in which the controllers *perceived* the need to report favorable results. Jennifer couldn't say that Amanda was wrong, but she observed that the conventional wisdom today is that corporate leaders should become stakeholders in their firms and be rewarded in relation to the performance of the firms they are guiding.

Jennifer was familiar with a survey of CEOs of 282 large and medium-sized U.S. manufacturers that indicated that their average $1,700,000 total compensation for 1991 included a $595,000 base salary and a $374,000 annual incentive.[9] Amanda felt that benchmarking to other apparel industry CEOs would be more helpful. She examined proxy statements filed with the SEC and learned that 1991 base salaries at Chaus, Jones, and Liz Claiborne were $392,000, $750,000, and $523,000, respectively. Although all three firms had performance incentive programs, only Liz Claiborne's CEO qualified for a bonus that year, equal to $662,000.

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[6] The total value of annual dress shipments from manufacturers to retailers remained constant at $5.4 billion from 1989 to 1991.

[7] Stephanie Strom, "Keeping an Eye on Fashion, Not the Books," *The New York Times*, February 11, 1993, pp. D1 and D5.

[8] The CFO has continuously denied any involvement in the falsification of the company's records.

[9] From a study by the Hay Group, reported in Geoffrey Colvin, "How to Pay the CEO Right," *Fortune*, April 6, 1992, p. 62.

Information Centralization

Leslie Fay's centralization of financial reporting and information systems still made sense to both women. The argument that divisional managers could then concentrate on their customers, products, and sales seemed persuasive. Jennifer, a former banker, was aware that banks routinely have processing and financial centers hundreds or even thousands of miles from their corporate headquarters. She recalled that real-time communication permitted managers at her former bank to review the updated operating results and financial condition on an on-going basis.

Amanda, the former systems analyst, had no problem conceptually with the centralization of information gathering and processing. She was concerned, however, that LF's centralized structure might have precluded widespread distribution of the information itself and the implementation of adequate controls. (In fact, CEO Pomerantz, pointing to a pile of papers on his desk, provided the following description of the information distribution system to a reporter in March 1993: "We get records upon records upon records. The amount of volume we get is voluminous.")[10]

Marketing Initiatives

Most of the company's actions and plans in this area still seemed sound. Jennifer believed that the increasing popularity of in-store boutiques meant that Leslie Fay's strong commitment to this area would keep it even or ahead of its competitors.[11] Amanda wondered if the consumer would continue to associate Leslie Fay with the type of merchandise available in the nation's better department stores if the day ever came when the brand could be purchased at Kmarts and Wal-Marts. Jennifer appreciated Amanda's concern, but noted that "you have to go where the customers are if you want to sell your merchandise."[12]

Future Prospects

Fidelity's ownership of more than one million LF shares had to be interpreted as an expression of confidence in the firm's future. Also, department stores seeking to streamline operations would likely concentrate on suppliers offering nationally known brands at a variety of price points.[13] The $190 million unused credit line was still considered a plus.

Their re-examination of Robert's memo completed, Jennifer and Amanda arranged to meet Robert on February 17 to share insights into what went wrong.

FEBRUARY 1993 MEETING OF WCI

The meeting between Amanda, Jennifer, and Robert had barely begun when Robert expressed his regret at the deterioration in Leslie Fay's share price. "We realize that you lost as much money as each of us from these events," Amanda stated. "We're not here to point fingers, but rather to learn lessons that can make WCI more successful in the future," Jennifer added.

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[10] Elizabeth Lesley, "Who Played Dress-Up with the Books?" *Business Week,* March 15, 1993, p. 34.

[11] Leslie Fay's President Golub reported that sales usually increased 25 to 30 percent in stores that added LF boutiques. Quoted in Robert Hartlein and Constance C.R. White, "Forecast 1990," *Women's Wear Daily,* December 6, 1989, p. 1.

[12] Department stores' share of all apparel expenditures was estimated (by *Women's Wear Daily*) to have fallen from 33.6 percent in 1985 to 24.3 percent in 1992.

[13] Standard & Poor's observed that department stores cut buying, ordering, and communication-systems costs by focusing on fewer vendors. *Industry Surveys: Textiles, Apparel, & Home Furnishings,* July 30, 1992, p. T65.

In Good Company

"Perhaps we can take some solace in the fact that we were in good company in being astonished at the developments at Leslie Fay," Robert observed. He recalled reading a *Value Line* report in November 1992 where the analyst forecast that LF's earnings per share would grow from the then-estimated $1.40 for 1992 to over $3.00 by 1995-1997.[14] As recently as January 8, 1993, Ed Johnson, a highly regarded retail industry analyst, had predicted that Leslie Fay's stock would rise 65 percent during 1993, reaching the $20 per share level by the end of the year.[15]

The CEO's Responsibility

"What role do you think CEO Pomerantz might have played in the events at Leslie Fay?" Amanda asked. "He has denied any involvement and, as the firm's largest shareholder, he has been hurt the most by the scandal," Robert replied. "Shouldn't a CEO have detailed knowledge of what the corporate controller and CFO are up to?" Jennifer wondered. "Not if you believe in the specialization of labor," Robert answered. He continued, "Pomerantz's strengths are in the sales and marketing areas — he is among the best at building strong business relationships with buyers from the nation's leading department stores." "If all CEOs were proficient in financial analysis, there'd be no need for CFOs," Robert concluded. "Besides," Amanda observed, "wasn't the CEO entitled to take some comfort in the fact that Leslie Fay had received unqualified opinions from its outside auditor (BDO Seidman) annually since it had begun auditing LF in 1978?"

Not wanting to get into a full-fledged debate on CEO responsibilities, Jennifer and Amanda sought to focus instead on a review of the LF situation in search of clues they might have initially overlooked. Anticipating that they would feel this way, Robert proposed that WCI analyze LF's financial data in comparison with that of its main competitors.

Financial Statement Comparisons

Robert began by handing out the income statement comparisons depicted in Exhibit 3. Presented there are selected account comparisons for 1989-1991 for Leslie Fay versus Chaus and Jones. All three firms have a reputation for manufacturing quality women's dresses, suits, and sportswear. Amanda, it will be recalled, had inquired about both Chaus and Jones when WCI was considering its initial investment in Leslie Fay.

Robert observed that there were several similar trends and account relationships for the three firms during the 1989-1991 period. "Notice that cost of goods sold and SG&A expenses increased when sales rose and declined when sales fell — exactly the situation one would expect to occur," he observed. Jennifer was not impressed. "If my days in credit analysis taught me anything, it's that balance sheet trends must also be studied individually and then in relation to the income statement numbers," she commented. "I had a feeling you'd say that Jennifer, so I also prepared (in Exhibit 4) a table of balance sheet relationships and comparisons for the same three firms," Robert replied.

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[14] Vik Malhotra, "Analysis of Leslie Fay," *Value Line Reports*, November 27, 1992.

[15] "First Analyst to Predict Christmas 'Bonanza' Gives '93 Stock Picks," *PR Newswire*, January 8, 1993.

EXHIBIT 3

SELECTED INCOME STATEMENT DATA FOR THREE WOMEN'S APPAREL FIRMS 1989–1991 ($000)

Chaus

For Fiscal Year	1989	1990	1991
Sales Revenue	$268,026	$291,101	$232,444
Cost of Goods Sold	223,727	233,657	192,369
Gross Profit	$ 44,299	$ 57,444	$ 40,075
SG&A Expenses	48,140	53,190	51,600
Operating Income	($3,841)	$ 4,254	($11,525)

Leslie Fay

For Fiscal Year	1989	1990	1991
Sales Revenue	$786,257	$858,768	$836,564
Cost of Goods Sold	536,746	589,359	585,050
Gross Profit	$249,511	$269,409	$251,514
SG&A Expenses	186,454	201,830	188,974
Operating Income	$ 63,057	$ 67,579	$ 62,540

Jones

For Fiscal Year	1989	1990	1991
Sales Revenue	$211,911	$289,243	$334,066
Cost of Goods Sold	141,007	194,849	213,124
Gross Profit	$ 70,904	$ 94,394	$120,942
SG&A Expenses	47,930	60,058	68,117
Operating Income	$ 22,974	$ 34,336	$ 52,825

EXHIBIT 4

SELECTED BALANCE SHEET DATA
FOR THREE WOMEN'S APPAREL FIRMS
1989–1991 ($000)

Chaus

At End of Fiscal	1989	1990	1991
Cash and Cash Equivalents	$18,325	$12,547	$10,395
Gross Accounts Receivable	37,030	45,645	44,886
Net Accounts Receivable	32,038	40,302	38,567
Inventories	19,232	17,201	23,993
Prepaid Expenses	1,425	2,538	1,971
Total Assets	82,109	81,757	82,571
Accounts Payable	15,241	12,554	16,115
Accrued Expenses Payable	2,146	3,173	4,043

Leslie Fay

At End of Fiscal	1989	1990	1991
Cash and Cash Equivalents	$5,520	$4,723	$4,670
Gross Accounts Receivable	121,117	143,392	122,333
Net Accounts Receivable	117,275	139,493	118,952
Inventories	121,149	147,899	126,799
Prepaid Expenses	19,418	22,534	19,722
Total Assets	387,250	438,876	395,760
Accounts Payable	38,620	43,299	31,916
Accued Expenses Payable	5,814	6,385	4,344

Jones

At End of Fiscal	1989	1990	1991
Cash and Cash Equivalents	*	$1,399	$17,010
Gross Accounts Receivable	*	30,461	32,991
Net Accounts Receivable	*	27,810	28,517
Inventories	*	46,092	65,131
Prepaid Expenses	*	2,563	4,536
Total Assets	*	88,465	128,712
Accounts Payable	*	19,847	27,726
Accrued Expenses Payable	*	6,978	8,906

*Not Disclosed in Firm's First (1991) Annual Report

Jennifer welcomed the data in Exhibit 4 and looked forward to studying it carefully before relating it to the Exhibit 3 data. Amanda reminded Robert and Jennifer that The Nightly Business Report had indicated that the published 1991 LF data (used by Robert) might be subject to restatement by the firm.[16] "That's why we are benchmarking to Chaus and Jones, to see if any suspect LF data can be revealed," Robert replied.

Industry Benchmarks

Jennifer believed that there was additional information that could possibly aid WCI in interpreting the data in Exhibits 3 and 4. As a former bank credit analyst, she knew that Robert Morris Associates (RMA), a national association of bank lending officers, gathered information on financial statement relationships by type of business. She volunteered to retrieve such data for women's apparel manufacturers from the then-current edition of RMA's *Annual Statement Studies*. These data appear in Exhibit 5.

EXHIBIT 5

FINANCIAL STATEMENT RELATIONSHIPS FOR WOMEN'S APPAREL MANUFACTURERS, 1989-1991*

SIC Code 2335
Manufacturers of Women's Dresses

	1989	1990	1991
Percentage of Sales for Fiscal Year:			
Gross Profit	31.7	30.6	29.2
Operating Expenses	25.7	26.0	25.0
Operating Profit	6.0	4.6	4.2
Percentage of Assets at Fiscal Year End:			
Cash and Cash Equivalents	9.2	6.9	6.6
Trade Receivables (net)	28.1	33.6	38.0
Inventory	34.6	39.8	37.8
Prepaid Expenses	6.8	2.8	2.6
Trade Payables	17.8	14.8	27.2
Accrued Liabilities	10.6	12.4	7.2

SIC Code 2337
Manufacturers of Women's Suits, Skirts, Sportswear, and Coats

	1989	1990	1991
Percentage of Sales for Fiscal Year:			
Gross Profit	28.6	24.3	26.7
Operating Expenses	24.4	20.6	22.2
Operating Profit	4.2	3.7	4.5
Percentage of Assets at Fiscal Year End:			
Cash and Cash Equivalents	7.8	7.1	5.0
Trade Receivables (net)	27.5	32.0	30.1
Inventory	38.8	39.2	42.2
Prepaid Expenses	4.5	2.6	4.7
Trade Payables	17.3	17.0	21.3
Accrued Liabilities	10.6	9.5	8.9

* Source: The Robert Morris Associates, *Annual Statement Studies*, 1992, pp. 71 and 73. Data are based on approximately 40 firms with SIC 2335 and 100 firms with SIC 2337.

[16] Revised operating results for 1991 were not released until September 29, 1993. They revealed that the 1991 *operating income* was $44.2 million, not the $62.5 million originally reported.

Industry-Specific Accounting and Marketing Practices

Before the group set out to analyze the Leslie Fay financial data, Robert felt that a brief description of the apparel-industry practices of pre-billing and markdown money would prove useful. "Pre-billing," he noted, "refers to the practice of including in the sales of one quarter shipments that will not occur until the first few days of the following quarter." "You're not going to tell me that pre-billing is allowed under generally accepted accounting principles, are you Robert?" Amanda asked. "Of course it's not officially sanctioned," Robert replied, "but it is a prevalent industry practice."[17] "At least pre-billing is for actual sales that will be occurring at some point soon," Jennifer observed. "As opposed to what?" Robert inquired. "Booked sales that will *never* occur," Jennifer responded.

Robert next proceeded to describe markdown money. "Markdown money represents promises to retailers of cash (or discounts on future orders) should goods need to be marked down in order to be sold to the retail customer," he stated. "These 'up front' discounts, individually negotiated with each retailer, can be as high as 20 percent," he added.[18] "Neither manufacturers nor retailers like to talk about markdown money," Robert observed, "but it's out there."

THE ANALYSIS BEGINS

Armed with the data appearing in Exhibits 3-5, their additional reflections on Robert's memo in Exhibit 2, and an increased understanding of apparel-industry accounting and marketing practices, the three WCI members felt ready to search for patterns in the reported data or other circumstances within LF that should have made them suspicious. Amanda expressed the hope that WCI would not fall into the trap of calculating every ratio under the sun; "let's find five at the most that we believe could reveal distortions," she continued. In addition, the group realized that a Leslie Fay outlier on some financial measures might be more suggestive of adverse business conditions at that firm than of fraudulent reporting.[19] With these cautions in mind, WCI set forth to consider the discussion questions appearing below. You are invited to join in.

DISCUSSION QUESTIONS

1. Examine the data in Exhibits 3-5 and suggest several patterns in Leslie Fay's reported financial data that should have aroused the suspicions of top management, external analysts, and stockholders? Be specific, showing supporting calculations.

2. What accounting and financial analysis challenges arise from the apparel industry's practices of pre-billing and markdown money?

3. In light of your answers to Questions 1 and 2, suggest several balance-sheet accounts that were probably understated or overstated by LF's controllers.

4. Who is responsible for the reliability of a firm's financial statements? What are the roles of the outsider auditor, the CEO, and the CFO in this regard?

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[17] Bud Konheim, president of apparel manufacturer Nicole Miller, has stated that "pre-billing is done all the time . . . because enough pressure can create any scenario you can imagine." Quoted in Arthur Friedman, "SA Assesses the Blame," *Women's Wear Daily*, August 30, 1994, p. 10.

[18] Markdown-money refunds are often viewed as *chargebacks* assessed manufacturers who "violated" their purchase-order contracts with retailers, rather than as price reductions — perhaps because the Robinson-Patman Act of 1936 prohibits the establishment of different prices to retailers in the same market.

[19] For example, a low inventory turnover could result from overproduction or increased customer indifference toward a firm's product rather than deliberate understatement of cost of goods sold and/or overstatement of inventories.

5. Evaluate Leslie Fay's performance incentive system. How, if at all, would you modify the CEO's compensation arrangement? What considerations, monetary or nonmonetary, might have motivated the corporate and divisional controllers to misstate the firm's financial statements?

6. Discuss Leslie Fay's management information system. Might it have played a role in the events occurring at the firm? Explain.

7. Workers in organizations are often reluctant to relate bad news to their superiors. Groupthink, where members come to think alike over time, can also be a problem. Did the Leslie Fay environment make it more likely that these cultural issues could have presented themselves?

8. What overall lessons can be learned from the events and circumstances at Leslie Fay? How can instances of fraudulent reporting — or the time that they go undetected — be reduced? Explain.

EAGLE MANUFACTURING INTERNATIONAL

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BACKGROUND

You have just received your first major project team assignment as a junior financial analyst at Eagle Manufacturing Company, and you feel somewhat overwhelmed. As you sit down in front of your PC, you wonder if four years of college with a double major in accounting and international business really prepared you for the challenge that lies ahead.

You were hired by Eagle Manufacturing Company six months ago, after graduating from college with a Bachelor of Business Administration degree. You were attracted to the company because of its reputation as a stable, proactive, progressive company which emphasized the importance of its people and invested heavily in their professional development and in helping them succeed. Eagle is a privately held company which is a leading manufacturer of injection molded and extruded plastic products for household and industrial use. Eagle is one of the largest manufacturers in the United States of high quality plastic lawn furniture and toilet seats.

After working part-time weekends for Eagle in a manufacturing position in its injection molding facility in the beginning of your second semester as a senior, you were selected to participate in a part-time accounting internship position, serving as a resource person for various financial areas. This job in turn led to your being hired to a full-time junior financial analyst post. After graduation, the company's controller informed you that the main factors that led to your hiring were (1) the company's confidence in your ability to work as part of a team, (2) your solid accounting and applied computers background, and (3) your training in international business. He informed you that the company's plans call for significant growth in international markets and that an important part of your job will be to support this growth from the financial side of the organization. After rotating through various accounting and finance positions at Eagle as part of your training program, you were assigned to the controller's staff and made responsible for coordination and execution of special projects. After several small projects, which you coordinated and helped the project team assigned to carry out successfully, you were called into the meeting earlier today at which you received your first major league assignment.

THE INTERNATIONAL CREDIT PROJECT

The meeting you recently left was attended by Jim Wilkins, Executive Vice President of Sales; Peter McDonald, Eagle's Director of Corporate Credit; Pete Kroscher, Senior Vice President Finance (your boss), and Sean Smith, the recently hired Manager of International Marketing and Sales for Eagle. The purpose of the meeting was to discuss extension of credit facilities (potential credit availability and terms of payment) to a promising new customer for the plumbing products (toilet seat) division in Buenos Aires, Argentina. As you review your notes, you prepare the following synopsis of what each of the four managers stated during the meeting:

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Jim Wilkins. If this company is going to grow in sales volume while maintaining profitability, we have no choice but to expand internationally. Our domestic markets are becoming increasingly competitive, and it is hard to grow sales and maintain solid profit margins. Certain export markets offer opportunities for growth in volume without having to sacrifice price and gross margin. Eventually we plan to manufacture internationally. In the short to medium term, however, the best way we can develop our international market is by targeting high-potential country markets and developing close partnerships with a few key customers. To be successful, we must give our international customers the same support we offer our domestic customers. This should also include credit support. We do not expect our domestic customers to finance 100 percent of their Eagle product inventories, and we surely cannot expect our foreign customers to do so either. If we want them to see us as business partners and commit to steady sales growth, we will have to help them gradually build up their investment in inventories of our products through reasonable credit availability and terms of payment.

Peter McDonald. Proactive and prudent extension of trade credit is a tool to support sales and marketing efforts. When sales and marketing want to emphasize a particular line of products or group of customers domestically, we go out of our way to support them by extending as much credit as we can reasonably justify under each set of circumstances. We do a lot of work to balance our two objectives, which are (1) to support sales by providing credit facilities and terms of payment as needed by our customers to meet stated sales goals and (2) to ensure that we ultimately get paid for those sales. We look carefully at the amount and level of risk we are considering, and gather information as appropriate based upon the extent of risk (Note: See excerpt of Eagle Manufacturing Domestic Credit Policy in Attachment I) we are considering. We always look at financial statements and evaluate the condition of the company from liquidity and equity perspectives, but it often goes beyond that. We have a good grasp on what information we need and how to get it for our domestic customers, but at this point we do not have a clear idea of what we need or how to obtain it for making well-informed international credit decisions. Many international customers are very protective of their financial information, are often unwilling to share it with us, and seem to go out of their way to make it more difficult for us than it has to be. Until we have obtained a reasonable amount of information, we cannot make prudent extensions of credit internationally. We would be denying credit to some companies who are probably good credit risks while granting it to others who are poor risks and will ultimately not pay us. The company we are currently discussing, Catalina of Argentina, is a classic example. (Note: See Catalina Company Profile in Attachment II). On one hand, this international customer has told us that they need credit support before they can expand their efforts to introduce our products. On the other hand, they take months before they supply us the information we need to make a reasonable credit decision. When they finally send it, the financials are in Spanish and in a currency called pesos. We have sent faxes requesting additional information, and we either get no response or a promise to provide the information which is kept very late or not at all. Besides, there are all sorts of other issues we would need to consider about any foreign country before we would be able to make a complete evaluation about our level of risk and make a well informed credit decision.

Sean Smith. I was hired to develop the international business field for Eagle. Before my arrival, international was essentially a passive activity at Eagle. Now I am traveling internationally and actively seeking business opportunities. Several markets in Latin America offer a significant level of potential for Eagle in both the short and long terms. One of these markets is Argentina. It has a fairly large population and a good statistical profile. Their government has recently stabilized the economy. They have also abandoned a long-standing policy of import-substituting protectionism by opening up their domestic market to imports which compete directly with their own manufacturers. As a result of this, many domestic firms are looking for foreign partners whose world-class products will complement their own lines and can also be sold through their distribution networks. Catalina is just such a company. They are a well-established firm and a leader in the plumbing products industry. We could not possibly find a better way to enter the Argentine market than through Catalina. They are prepared to work closely with us and are willing to pay the $60,000 custom tooling cost that will be needed for the products which are not in our line and which we are proposing to sell exclusively to them. (Note: This type of arrangement is common in Eagle's industry and is often entered into with domestic customers.) However, they insist that given the long delivery times between Wisconsin and Buenos Aires (up to 60 days door to door), the difficulty and high cost of obtaining financing in the Argentine economy (where short-term interest rates of

between 20 and 30 percent are common and commercial credit facilities from banks are relatively hard to obtain), they need to be assured that we will provide adequate credit facilities which will help to finance the inventories that will be required to adequately service their customers. They were offended at our suggestion that they open a Letter of Credit for their purchases in the foreseeable future. Catalina said that it would be too expensive and that even standby LC would tie up part of their limited working capital credit facility. Furthermore, they expressed concern over our mistrust in spite of the fact that their firm had been controlled for many years by the Catalina family. "Either we are going to be partners, and we can trust each other, or we cannot be partners — you North Americans cannot expect to impose this type of one-way relationship..." was roughly what Rodolfo Pruneda told me the last time we discussed this topic. Furthermore, this issue goes a lot farther than Argentina and Catalina. There are other countries right in Latin America, such as Chile, Brazil, and Colombia, where I am discussing similar arrangements with local companies. We will face the same credit support issue in those countries. If we can provide the same level and type of support that we do to each of them as we do to domestic customers, I believe we will see significant sales and high margins growth in each of those countries. If we do not provide the credit support these customers need and expect, we may lose this attractive opportunity.

Pete Kroscher. As Senior VP Finance, I see both sides of this issue. I see our monthly financials and future projections, and we definitely face a challenge as we try to expand sales without eroding our profit margins. We need to grow internationally, and companies like Catalina and others that Sean has mentioned are key to our growth. We need to work closely with them and support their efforts on our behalf. This includes providing appropriate credit support we must be willing to take a reasonable credit risk if we want to grow and support our business internationally just as we do domestically. However, we need to know the level of our credit risk. We must know what information we need to make a prudent decision in each case and how we will get it. We must make certain that we do not lose sales and margin opportunities internationally because we denied credit to a creditworthy customer. At the same time we must also ensure that we do not lose a disproportionate sum of money because we extended credit to international customers who did not have the resources to pay their obligations.

Your assignment is to work with Peter McDonald and Sean Smith and whatever other parties you deem appropriate inside or outside the Eagle organization to accomplish the following:

1. Make a sound and timely decision about extension of credit and terms of payment to Catalina that all members of your team can support.

2. Develop an appropriate set of credit policies and guidelines for Eagle to follow in evaluating Catalina and other customers. This should include country evaluation policies and sound procedures for making international credit decisions so that Eagle can react proactively, timely, prudently, and aggressively to similar opportunities in the future.

GATHERING INFORMATION

After the initial shock passed, you organized your thoughts and planned your assignment. You asked Sean to provide you with as much background information on Catalina as possible, including a projection of future sales, profitability, and credit requirements. You also asked for a similar (albeit tentative) projection about other markets currently being explored (Attachments III and IV). Peter McDonald offers to network with his colleagues in the local and national associations of credit managers and gather information about how other companies are handling their international customers from the credit perspective, and to gather as much information as possible about Argentina and Latin American countries. He also furnishes you with Catalina's latest financial statement, in Spanish and in pesos as discussed previously (Attachment V) for your evaluation. You quickly conclude that two A minuses and two B pluses in four-year college Spanish courses notwithstanding, your grasp of the language is not quite up to the task at hand. You also recall with regret that you sold several of your college accounting texts, including the one with the excellent chapter on financial ratios and financial statement analysis, back to the bookstore to help finance your trip to Florida during spring break of your junior year. For these two reasons,

you make an appointment to see your former international accounting professor. He gives you several articles (Attachments VI), loans you several relevant books (see references), and provides some helpful advice. The next morning you find the following note from him your e-mail, which summarizes what you discussed the previous day:

Dear ______________________ :

It was good to meet with you yesterday, and I'm really glad that you are having the opportunity to use all the of things you learned here at school. As I told you while you were a student, the combination of accounting and international business will help you in the future!

As far as your current project, let me sum up what we discussed:

Financial analysis: Do it, including ratios, but make sure you focus on comparison of the firm from year to year and don't make too much of comparing ratios to U.S. firms, remember, accounting principles and business practices vary a lot between countries.

Translation: As you know, you must translate both the words and the currency. I told you the current exchange rate for Argentina, but I suggest you look it up in the Wall Street Journal (just for practice) and make a copy for your workpapers. I am sending you a file which contains a list of important accounting words in Spanish translated to English (Attachment VII) for your use. I suggest you set up a spreadsheet to allow you to translate these and future statements and to adjust automatically for changes in currency values.

Country/Currency/Political Risks: Remember our discussions and the articles which I gave you. Argentina has been stable for several years, but you will recall that previously the rate of devaluation of their currency was matched only by the rise of their rate of inflation. You will be able to see signs of this from the Catalina financials. Their upcoming presidential election will affect this. The current unrest in Mexico and the collapse of their peso, which should have no direct impact on Argentina's, will definitely have serious ripple effects. Take this into account in evaluating Catalina, Argentina, and any other international company you consider. These factors are always important.

Culture: As you will recall from your intercultural communications course, you must understand the national culture and business subculture of a country to properly understand the behavior of people in their business dealings. As it relates to Catalina, Argentina and most Latin American countries tend to compare to U.S. culture as follows:

Time perspectives: more polychronic/looser sense of value of time. More high context and relationship oriented, rely more on personal trust and friendship than U.S. culture, which tends to be more low context and legalistic in nature.

For many reasons, Latin American cultures tend to be more secretive about company information that is often readily available in the U.S. For example, it is often harder to get information about a company from its bankers.

There are many other cultural comparison tools, as you will recall, but this should point you in the right direction. It certainly explains some of the problems cited by your Director of Corporate Credit as causes of concern regarding Catalina and other customers for that region which make him hesitant to trust and extend credit.

Other thoughts: As we discussed, I am concerned about the large dollar denominated liability on Catalina's balance sheet. It makes sense because of the high peso interest rates they pay in Argentina as compared to the dollar rates they are paying for that credit in dollars. The concern is that, if they have a devaluation, their ability to repay it (and any dollar denominated credit which you at Eagle might eventually extend) could be seriously affected. It's not a stopper, but be careful.

You print a copy of the message and the attached file list of words and include it with the folder of articles, reports, and other resources which you and your teammates have gathered as you prepare to analyze the Catalina financials and other relevant information. You want to prepare a preliminary recommendation regarding Catalina before you meet with Peter McDonald and Sean Smith next week. In addition, you want to draft an outline of the proposed international credit policy guidelines and procedures so the three of you can complete a first draft at your meeting in preparation for a presentation to Jim Wilkins, Pete Kroscher, and other members of Eagle's top management team.

REQUIREMENTS

1. Prepare a spreadsheet to translate the Catalina financial statements provided, using the word list and appropriate exchange rates. Your spreadsheet should allow for retranslation in case the exchange rate for future years is different from the current one.

2. Provide appropriate financial analysis of the Catalina financial statements. Prepare ratios (ideally on your spreadsheet) and discuss their significance. Concentrate on liquidity, which was cited by Corporate Credit Director Peter McDonald as being of the utmost significance. Also, discuss significant differences you observe in the way they are prepared, in contrast to U.S. G.A.A.P. financials.

3. Why is comparison of Catalina to itself from year to year more significant than comparison to similar size U.S. companies, even those in the same business?

4. Why are the upcoming election in Argentina, the collapse of the Mexican peso, and the unfortunate history of Argentina's currency and economy relevant to the decision to grant credit to Catalina?

5. Why is your professor so concerned about the dollar-denominated liabilities on Catalina's balance sheet? What would happen to the answers to questions 1 and 2 above (as a result of this factor) if the Argentine peso were devalued 100 percent?

6. Using Sean's sales, profits, and credit needs forecasts and other information provided about Eagle Corporation's profitability from domestic operations, prepare (in your own format) a cost-benefit analysis to support the decision to grant or not grant credit to Catalina and similar international customers.

7. What is meant by an irrevocable confirmed Letter of Credit and Standby LC terms and why might Catalina object to their use in lieu of credit terms from Eagle?

8. If Eagle normally extends credit for 30 days from date of invoice, with terms of up to 90 days for special stocking promotions, how might this have to be modified for cases like Catalina? Why? How does this affect Eagle's exposure to losses?

9. What cultural factors are confusing and concerning to Eagle management's decision to grant credit to Catalina? Why should some of the things Catalina management is doing normally make a U.S. credit manager nervous? Why is this probably not a cause for concern in dealing with Catalina?

10. Prepare a draft recommendation to Sean and Peter as to how much credit, if any, should be extended to Catalina. Support your recommendation. Also discuss what levels of exposure Eagle might have to be prepared to accept in other Latin American markets it is considering and why it should/should not accept these.

11. Prepare an outline of the factors that should be included in the proposed Eagle Manufacturing Company standard credit policy, using the domestic policy and the work done in evaluating Catalina as a guideline.

ATTACHMENT I

EAGLE DOMESTIC CREDIT POLICY EXCERPTS

ESTABLISHING A CREDIT FACILITY

In establishing a credit facility, five characteristics are considered which are commonly called the five C's of credit. They are as follows:

Character
Capacity
Capital
Condition of times
Collateral

RISK GUIDELINES

It is the policy of the Credit Department to support the Sales Department. We realize that there is a certain degree of risk in building a market. We are willing to take risks, but we wish to minimize the risk overall.

The Credit approval process will be completed within two weeks and will follow the following Matrix of Risk by Credit Requirements and/or Credit Risk Level for New and Existing Customers.

	Under $10K	*$10K-$50K*	*Over $50K*
Is company liquid enough to pay us?	Credit Rating	Credit Rating Financials Add'l.Fin.Info	Credit Rating Financials Addl.Fin.Info. Contact Customer
Is trade support evident?	Industry Reports.....	(same)........... Call Trade	(same)..... Call Trade
Is bank support adequate?		Call Bank	Call Bank Call Customer
Has past experience been acceptable?	...Review Pay History at all 3 Levels............	Review Text in File............	Review w/Analyst Review w/Sales
What is customer's long-term prognosis for success?	Credit Reports	Credit Reports Discuss w/Sales &/or Customer	Credit Reports
How important is this account to us?		Review Relationship with Company Sales, Profits, etc....................	

Sources: Credit Management by George Christie and Albert Bracute © 1981, Credit Research Foundation and National Association of Credit Managers, and Eagle Manufacturing Company internal documents. (used with permission of N.A.C.M).

ATTACHMENT II

CATALINA COMPANY PROFILE

HISTORY

Corporation. Authorized on August 14, 1911, and registered on October 16, 1911, at the Registro Publico de Comercio. Line of business: Manufacture of sanitary appliances and accessories, tiled furniture and ware, wooden boards, pigments and varnish. The activities were originally started by Antonio Sanchez in 1897; followed by Catalina in 1911.

Originally registered in 1911, under business name of CATALINA INDUSTRIA, S.A. On November 15, 1943, the corporate name was modified to CATALINA S.A. DE CERAMICA.

Capital Stock subscribed and paid in: 16,282,605 Pesos. Divided into: 8.764 common shares (Class A) nominal value 0.10 Pesos, five votes per share, and 162.817.284 common shares (Class B) nominal value 0.10 Pesos, one vote per share. Main stockholders are: COMPANIA BASA BUENOS AIRES S.A. with 32 percent of capital; TASCO S.A. with 29 percent of capital; Frayco S.A. with 20 percent of capital. Remaining shares are owned by minority stockholders. Shares are quoted at Buenos Aires Stock Exchange.

From 1927 to 1943, the company created most of its factory structure. In 1927 the plant Laspana (Buenos Aires) was built. In 1941 subject widened its line of basins and iron enameled tubs and started production of porcelain sanitaries. A group of new stockholders entered the company since 1982, year in which subject acquired the control of the block of shares of the LOPASAD holding, which in turn had acquired the SANQUIST holding. After stockholder's meeting held on October 1, 1986, the company PABLEROS S.A. merged by absorption with subject; this was registered on February 9 ,1987. On June 7, 1993, a loan was obtained for the amount of US$ 1.5 million destined to investments in fixed assets. The warranty was a mortgage on real estate located in Buenos Aires.

BACKGROUND

Rodolfo Pruneda, President, born in Argentina on April 8, 1939.
Humberto Pruneda, First Vice President, married, born in Argentina. Industrial Engineer.
Esteban Pruneda, Second Vice President.
Miguel Pruneda, Permanent Director.
Mario Gamba, Permanent Director.
Domingo Vasquez, Permanent Director.
Peter Soto, Manager—Finances.
Enrique Castillo, Manager—Export.

Source: Company Documents

OPERATIONS

- SIC No. 34310000, Manufacture metal sanitary ware,
- Manufacture plumbing fixture fittings and trim,
- Engaged in metal stampings,
- Elaboration paints and allied products,
- Manufacture reconstituted wood products.

SALES

Sales are focused on:

- Distributors of the line of business.

TERRITORY

Products are sold nationwide throughout the country of Argentina.

EMPLOYEES

Total: 1,400

LOCATION

At heading address occupies administration office, sales and industrial plant, occupying own real estate. Real estate of four blocks, with large buildings.
It also has:

- Industrial plant, occupying own real estate, located in Buenos Aires, Argentina.
- Industrial plant, occupying own real estate, located in Santa Fe, Argentina.
- Warehouse, occupying own real estate, located in Buenos Aires, Argentina

ATTACHMENT III

CATALINA SALES, COST, AND PROFITABILITY PROJECTIONS

	1995	*1996*	*1997*
Sales in Units			
Existing Models:			
—Model 1	1,000	2,000	3,000
—Model 2	500	1,000	2,000
—Model 3	10,000	15,000	12,000
—Model 4	5,000	7,000	10,000
Subtotal:	16,500	25,000	27,000
Custom Models:			
—Model 1	3,000	10,000	15,000
—Model 2	0	5,000	8,000
—Model 3	0	0	6,000
Subtotal:	3,000	15,000	29,000
Total Unit Sales	19,500	40,000	56,000
Average Selling Prices			
Standard Models	$8.50	$8.75	$9.25
Custom Models	$7.50	$8.15	$8.50
Average Costs (All Models)			
Raw Materials	$1.50	$1.60	$1.70
Labor	$1.00	$1.05	$1.10
Tool Depreciation	$0.25	$0.28	$0.30
Fixed Factory O.H.	$0.65	$0.70	$0.75
Variable Factory OH	$0.60	$0.65	$0.70
Total Mfg. Cost	$4.00	$4.28	$4.55
Selling Costs	$1.10	$1.15	$1.20
Advertising (U.S. only)	$0.75	$0.80	$0.85
Other Administrative	$1.50	$1.60	$1.70
Total G/A Expenses	$3.35	$3.55	$3.75
Total Costs/Unit	$7.35	$7.83	$8.30

NOTE: On the "Custom" units Catalina will pay in advance for the total cost of designing and manufacturing the "custom" tooling and will own it.

ATTACHMENT IV

ARGENTINA AND OTHER LATIN AMERICAN MARKETS

Category:	ARGENTINA	BRAZIL	CHILE	COLOMBIA
Population:	33 million	158 million	14 million	36 million
Total GNP:	$185 Bill.	$785 Bill.	$96 Bill.	$192 Bill.
GNP/Capita:	$5,500	$5000	$7000	$5500
Inflation:	7.4%	2,709%	12%	22.6%
Devaluation:	0%	>100%	7%	7%
Trade Balance:	−$3.3 Bill.	+$13.1 Bill.	+0.8 Bill.	+$0.2 Bill.
Est. Annual Market For Seats:	2 Million	4 Million	1 Million	2 Million
External Debt	$73 Bill.	$122 Bill.	$19.7 Bill.	$17 Bill.
GDP Growth Rate	6%	5%	5.8%	5.1%
Foreign Exchange (F/X) Rate:	$1=1P	$1=391CR	$1=431CP	$1=921CP

Source: Various U.S. Government Documents on the January 1994 N.T.D.B. CD-ROM.

ATTACHMENT V

CATALINA S.A. FINANCIAL STATEMENTS

ACTIVO	*6/30/94*	*6/30/93*
ACTIVO CORRIENTE		
Caja y Bancos	$ 244,379	$ 670,717
Inversiones	$ 0	$ 0
Creditos por Ventas	$ 15,382,277	$ 9,151,934
Creditos con Sociedades Art. 33 Ley 19550	$ 108,458	$ 0
Otros Creditos	$ 1,465,865	$ 1,232,700
Bienes de Cambio	$ 19,899,410	$ 17,237,666
TOTAL DEL ACTIVO CORRIENTE	$ 37,100,389	$ 28,293,017
ACTIVOS NO CORRIENTES		
Otros Creditos	$ 961,239	$ 12,847
Inversiones	$ 12,194,593	$ 11,277,955
Bienes de Uso	$ 35,535,711	$ 38,513,007
Activos Intangibles	$ 2,980	$ 2,980
Otros Activos	$ 29,982	$ 1,253,456
TOTAL DEL ACTIVO NO CORRIENTE	$ 48,724,505	$ 51,060,245
TOTAL DE ACTIVO	$ 85,824,894	$ 79,353,262
PASIVO		
PASIVO CORRIENTE		
Deudas Comerciales	$ 3,425,974	$ 2,632,611
Deudas Bancarias/Financieras	$ 12,027,121	$ 8,626,775
Deudas con Sociedades Art. 33 Ley 19550	$ 722,197	$ 1,573,702
Remuneraciones y Cargas Sociales	$ 3,168,003	$ 4,155,260
Honorarios Directorio y Consejo	$ 150,000	$ 9,598
de Vigilancia	$ 1,130,964	$ 1,167,845
Deudas Fiscales	$ 63,898	$ 126,047
Otros Pasivos	$ 1,004,098	$ 580,453
Previsiones	$ 5,892,280	$ 4,751,411
TOTAL DEL PASIVO CORRIENTE	$ 27,584,535	$ 23,623,702
PASIVO NO CORRIENTE		
Deudas Bancarias/Financieras	$ 2,401,646	$ 1,298,552
Previsiones	$ 5,175,045	$ 5,494,476
TOTAL DEL PASIVO NO CORRIENTE	$ 7,576,691	$ 6,793,028
TOTAL DE PASIVOS	$ 35,161,226	$ 30,416,730
EQUITY		
Capital Social	$ 16,282,605	$ 16,282,605
Ajuste Integral del Capital	$ 32,653,927	$ 38,105,495
Ganancias Reservadas	$ 0	$ 0
Resultados no Asignados	$ 1,727,136	$ (5,451,568)

	6/30/94	6/30/93
PATRIMONIO NETO	$ 50,663,668	$ 48,936,532
TOTAL DE PASIVO Y PATRIMONIO	$ 85,824,894	$ 79,353,262
Ventas Netas	$ 76,750,777	$ 67,309,042
Costo de los Productos Vendidos	$(54,241,760)	$(52,119,126)
Resultado Bruto	$ 22,509,017	$ 15,189,916
Gastos de Comercializacion	$ (7,651,174)	$ (7,193,442)
Gastos de Administracion	$ (3,438,396)	$ (3,273,468)
Resultado de Explotacion	$ 11,419,447	$ 4,723,006
Resultado de Inversiones Permanentes	$ 917,011	$ 471,872
Otros Ingresos	$ 769,092	$ 729,694
Otros Egresos	$ (565,228)	$ (431,739)
Resultados Financieros y por Tenencia		
—Generados por Activos	$ (294,132)	$ (155,598)
—Generados por Pasivos	$ (2,142,733)	$ (1,534,451)
Subtotal	$ 10,103,457	$ 3,802,784
Egresos por restucturacion y Prevision por Riesgos Contingentes	$ (8,013,192)	$ (7,842,660)
Subtotal	$ 2,090,265	$ (4,039,876)
Impuesto a los Activos	$ (91,447)	$ (650,341)
Resultado ordinario del Ejercicio	$ 1,998,818	$ (4,690,217)
Resultados Extraordinarios	$ (271,682)	$ 0
RESULTADO FINAL DEL EJERCICIO	$ 1,727,136	$ (4,690,217)

EXCERPTS FROM NOTES:

1) Inventories are valued at latest production or acquisition cost.

2) Fixed Assets are valued at original cost restated in constant currency, except for Plant B, which is restated and depreciated based upon the 6/91 technical appraisal.

3) Of the balances in accounts receivable in 1994 and 1993, $14,725,607 and $8,335,901 respectively were in the form of unsecured trade credits. The allowance for doubtful accounts increased to $495,248 in 1994 from $267,757 in 1993.

4) Interest Income and Expense are components of Financial and Holding Results. Interest Income in 1994 was $359,341 and was $365,023 in 1993. Interest Expense in 1994 was $1,473,539 and was $963,138 in 1993. The balance of the Financial/Holding Totals were caused by Foreign Exchange Gains/Losses and by Inflationary/Holding adjustments.

5) Since in prior years losses were in part absorbed by the full amount of the Legal Reserves a total of $1,713,787 is allocated to rebuild said reserve at this fiscal year-end.

6) Of the total Current Liabilities balance in 1994, $12,518,860 is owed in foreign currencies. All but $200,000 of this is denominated in US $'s. The primary components are:

	1994	*1993*
Trade Payables	$ 349,000	$ 114,621
Secured Bank Loans	$ 10,379,422	$ 8,091,837
Unsecured Bank Loans	$ 1,405,010	$ 382,088

ATTACHMENT VI

EXCERPTS FROM ARTICLES ABOUT ARGENTINA

"Until the ripple effects from Mexico have been totally overcome, it may be a good idea to stick to the larger banks when doing business in Argentina..."

"The foreign trade deficit, which caused international investors concern, came in at $6 Billion US$ for 1994...up from around $3.3 Billion in 1993...but seems to have peaked."

"Argentina will not run into any international liquidity difficulties (like Mexico). The country has $17.8 Billion in dollar and gold reserves against a monetary base of $16.2 Billion. While the proportion of short-term foreign debt is high, the country has not developed a short-term debt market and is thus much less susceptible than Mexico to an abrupt withdrawal of short term foreign capital."

"We believe that, given the progress of Dollarization of the economy, that the Peso will retain its Dollar parity for the foreseeable future. The Central Bank has removed even the minimal fluctuation range allowed between the Peso and the Dollar."
Source: S.J. Rundt & Associates Credit Risk Bulletin, 1/15/95.

"Argentine Foreign Minister Domingo Cavallo said his country's government would seek $2 Billion more than the $420 Million previously requested from the International Monetary Fund (IMF) to replenish an emergency fund providing liquidity to its troubled banking sector. Until recently, Dr. Cavallo had said Argentina didn't need any additional funding from the IMF, but the slide in bank deposits and a persistent outflow of hard currency reserves have put a chokehold on the economy."
Source: Wall Street Journal 3/10/95

"South American Markets bounced back strongly yesterday as Argentina made progress assembling its package of international assistance for its troubled banking system and Brazil appeared to win a skirmish with the currency speculators. The rebound was in part on the coattails of the earlier Mexican rebound (just as the initial crash came in great part as an aftershock of the Mexican Peso devaluation) as the Mexican Peso jumped 18%...in Argentina, investors bid up local stocks by nearly 13% as details of the plan to allow the government to prop up its troubled banks and its dollarized currency became clear."
Source: Wall Street Journal 3/13/95

"As Argentina goes to the polls, it is widely anticipated that President Carlos Menem will handily win reelection to a second term. Menem's reelection would bolster investor confidence that the financial plan instituted by Finance Minister Dr. Domingo Cavallo during Menem's first term, and which ended years of triple digit inflation (now under 10%) and massive devaluations (the Peso has been pegged at U.S. Dollar parity for years), will continue. It also provides reassurance as the Argentine economy travels through the current period of difficulties caused by the outflow of foreign hard currency deposits from the region in the wake of the Mexican Peso devaluation. Menem and Cavallo have pledged to do whatever is necessary to prevent devaluation of the Argentine currency."
Sources: Author's summary/paraphrasing of articles which appeared over several days in The Economist and Wall Street Journal.

ATTACHMENT VII

LISTING OF SPANISH ACCOUNTING TERMS — WITH ENGLISH TRANSLATIONS

SPANISH TERM	ENGLISH EQUIVALENT
BALANCE GENERAL	BALANCE SHEET
ACTIVO	ASSETS
ACTIVO CORRIENTE	*CURRENT ASSETS*
Caja y Bancos	Cash and Banks
Inversiones	Investments
Creditos por Ventas	Trade Accounts Receivable
Creditos con Sociedades Art. 33 Ley 19550	Receivables with Corporations Art. 33 Law 19550
Otros Creditos	Other Receivables
Bienes de Camio	Inventories
TOTAL DEL ACTIVO CORRIENTE	TOTAL CURRENT ASSETS
ACTIVOS NO CORRIENTES	*NONCURRENT ASSETS*
Otros Creditos	Other Receivables
Inversiones	Investments
Bienes de Uso	Fixed Assets
Activos Intangibles	Intangible Assets
Otros Activos	Other Assets
TOTAL DEL ACTIVO NO CORRIENTE	TOTAL NONCURRENT ASSETS
TOTAL DE ACTIVO	TOTAL ASSETS
PASIVO	LIABILITIES
PASIVO CORRIENTE	*CURRENT LIABILITIES*
Deudas Comerciales	Commercial Liabilities
Deudas Bancarias/Financieras	Bank and Financial Debts
Deudas con Sociedades Art. 33 Ley 19550	Debts With Corporations Art. 33 Law 19550
Remuneraciones y Cargas Sociales	Payroll & Soc. Sec. Taxes
Honorarios Directorio y Consejo de Vigilancia	Directors and Statutory Audit Committee Fees
Deudas Fiscales	Taxes Payables
Otros Pasivos	Other Liabilities
Previsiones	Allowances
TOTAL DEL PASIVO CORRIENTE	TOTAL CURRENT LIABILITIES
PASIVO NO CORRIENTE	*NONCURRENT LIABILITIES*
Deudas Bancarias/Financieras	Bank and Financial Debts
Previsiones	Allowances
TOTAL DEL PASIVO NO CORRIENTE	TOTAL NONCURRENT LIABILITIES
TOTAL DE PASIVOS	TOTAL LIABILITIES
EQUITY	*EQUITY*
Capital Social	Capital Stock
Ajuste Integral del Capital	Adjustments to Capital
Ganancias Reservadas	Reserved Earnings
Resultados no Asignados	Unappropriated Earnings
PATRIMONIO NETO	TOTAL EQUITY
TOTAL DE PASIVO Y PATRIMONIO	TOTAL LIABILITIES AND SHAREHOLDERS EQUITY

SPANISH TERM	ENGLISH EQUIVALENT
ESTADO DE RESULTADOS	INCOME STATEMENT
Ventas Netas	Net Sales
Costo de los Productos Vendidos	Cost of Products Sold
Resultado Bruto	Gross Profit
Gastos de Comercializacion	Selling Expenses
Gastos de Administracion	Administrative Expenses
Resultado de Explotacion	Operating Income
Resultado de Inversiones Permanentes	Equity & Earnings of Unconsolidated Subsidiaries
Otros Ingresos	Other Income
Otros Egresos	Other Expenses
Resultados Financieros y por Tenencia	Financial/Holding Results
—Generados por Activos	—Generated by Assets
—Generados por Pasivos	—Generated by Liabilities
Egresos por restructuracion y Prevision por Riesgos contingentes	Expenses for Restructuring and Allowances for Contingent Risk
Impuesto a los Activos	Asset Tax
Resultado ordinario del Ejercicio	Ordinary Gain/(Loss) for the year
Resultados Extraordinarios	Extraordinary Gain/(Loss)
RESULTADO FINAL DEL EJERCICIO	GAIN/(LOSS) For the Year

INTRODUCING THE ARC PLAN: ACCOUNTING FOR OTHER POSTRETIREMENT EMPLOYEE BENEFITS IN THE 1990's

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"So long. Don't forget to send your bill."
"Sure dad. Good-bye."

You have just hung up the phone after a conversation with your father which went something like this:
"It looks like I may be able to cash in already on that Accounting degree I bought you."
"What do you mean dad?"
"Well, the company has asked me to consider changing my retirement health care benefits and I think there may be more here than meets the eye. They've given us a brochure to read that describes several options we have."
"Why don't you send it along to me; I'll do some research and get back to you as soon as I can. On second thought, if you can get your hands on some of the company's recent financial statements, those might be helpful too."

You have decided to spend an afternoon at the local college library getting reacquainted with issues related to postretirement benefits while you wait for your father's information to arrive. Your research has gone quite well. In recent years the popular press has carried numerous articles focusing on the aging of the current workforce along with the rising cost of providing postretirement health care benefits and the implications of these trends for businesses. In addition, quite a few references were made to the FASB and the new "106 rule" issued in 1990 and the response of U.S. firms. You have extended your research to include this recently issued accounting standard, sensing its likely relevance to your father's dilemma.

Your research findings are summarized on the following pages:

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OTHER POSTRETIREMENT EMPLOYEE BENEFITS (OPEB) IN THE 1990's

Recent trends

A 1993 KPMG Peat Marwick report, *Retiree Health Benefits: An Era of Uncertainty,* highlighted recent trends in company sponsored retiree benefits: the percentage of mid-size firms (200–900 employees) that offered retiree benefits dropped from 44 percent in 1991 to 37 percent in 1992. The percentage of large firms (1,000 to 4,000 employees) that offered retiree benefits dropped from 56 percent to 52 percent between 1991 and 1992. These declines had started in the mid-1980's. Before that time, more than 60 percent of firms having 500 to 999 workers provided retiree benefits. In addition, the study found that the percentage of health care premiums paid by retirees for single coverage jumped from 15 percent in 1988 to 31 percent in 1992 and for family coverage, from 23 percent to 41 percent during the same period. A more recent study of 2,395 employers by benefits consultant Foster Higgins indicated that 36 percent of the large employers currently offering retiree health benefits planned to make changes in the coverage by the end of 1995. The most common of these changes included raising retiree contributions or increasing employee cost-sharing. About 7 percent planned to eliminate the coverage for future retirees and 3 percent planned to eliminate coverage for *all* retirees. These trends were documented for a period during which both the size of the retiree population and the cost of health care were rising. An August 1993 report by the Employee Benefits Research Institute of Washington, D.C. emphasized the fact that while the elderly segment of the population stood at 32 million, or 13 percent of the total population, it accounted for a full one-third of all health care expenditures. The report predicted that this segment of the population would continue to grow as baby boomers aged and the average life span continued to increase. On a more positive note, a 1994 study by the Employee Benefits Information Center of Tower Perrin analyzed the most recent two years' health care costs for active and retired employees in insured health insurance plans from 202 large employers, and found that health care cost increases had declined from 1993 to 1994 for both active and retired employees. In 1994 health care costs for active employees grew at about one-fourth of the peak annual growth rate of the late 1980's, and for retirees over 65, costs rose by 8% in 1994, down from 12% in 1993.

Company examples

General Motors announced in September 1993 that beginning in January of 1994, current retirees would be responsible for making monthly contributions ranging from $20 to $107 toward their medical benefits. A similar announcement had been made to the salaried active work force one year earlier.

Westinghouse Electric amended its plans several times in recent years, each time resulting in larger employee co-payments and deductibles. Employees who make higher salaries are now being asked to contribute more, whereas at one time everyone paid the same amount toward their coverage.

AT&T and Rochester (NY) Gas & Electric are among a large number of companies who have revised benefit plans in order to cap employer contributions. AT&T now pays fixed-dollar amounts of benefits to retirees that vary according to the employee's age and years of service.

American Airlines informed its employees in 1990 that they would only be eligible for retiree medical benefits if they contributed to them for at least 10 years before retiring. This pre-funding includes no promise about the level of benefits. That ultimately depends on what happens to health care costs.

In 1989, Houston-based *Cooper Industries* eliminated all medical coverage for employees retiring after September of that year. At the same time as they eliminated medical coverage for future retirees, Cooper increased monthly pension contributions for employees who were younger than 50 and offered older employees the choice of smaller pension contributions as well as transitional retiree medical coverage for up to 5 years.

Twenty-seven salaried retirees sued *Universal Components* of Orland, Indiana when it stopped paying for their medical coverage. They claimed that Universal had promised them lifetime benefits. The retirees won their case in trial court, however in February 1993 a U.S. Court of Appeals reversed the lower court's decision and ruled

in favor of the company. In any number of similar decisions the courts have found that health benefits do not automatically vest like pension benefits, and that the entitlements to benefits established by collective bargaining agreements do not survive the agreements' expiration or modification unless specifically provided therein.

Accounting for OPEB — Background

In 1979, the FASB added OPEB to its project on employers' accounting for pensions. The Board was concerned at the time about the lack of information in financial statements about the cost of, and obligation for other postemployment benefits. Evidence at the time suggested that most large employers, and many small ones as well, provided health care benefits to their retirees and were accounting for those benefits on a pay-as-you-go (cash) basis. OPEB were first considered in a 1981 Discussion Memorandum, *Employers' Accounting for Pensions and Other Postemployment Benefits.* In its 1982 Preliminary Views on this subject, the FASB took the position that OPEB are a form of deferred compensation and that their cost should therefore be recognized during the service lives of employees expected to receive benefits, that is, on the accrual basis. By 1983 it had become clear that the accounting issues related to OPEB were being overshadowed by pension issues, and, in 1984, as an interim measure, the FASB issued Statement No. 81, *Disclosure of Postretirement Health Care and Life Insurance Benefits.* In 1987, FASB Technical Bulletin 87-1 provided temporary guidance to employers making a voluntary change in their method of accounting for OPEB provided outside a pension plan. In 1989 the Board issued an Exposure Draft, *Employers' Accounting for Postretirement Benefits Other Than Pensions,* and in December 1990, FAS 106 was issued.

FAS 106 — Overview

FAS 106 required that OPEB costs be recognized on the accrual basis as opposed to the cash basis. FAS 106's specific accounting requirements are similar in concept to those of FAS 87 and FAS 88 (both 1985) which deal with pension and termination benefits, respectively. FAS 106 became effective for most companies for fiscal years beginning after December 15, 1992, but the Board encouraged early adoption.

While the new standard focused primarily on accounting for single-employer, defined benefit plans, FAS 106 also addressed defined contribution plans and multi-employer plans. Life insurance and other welfare benefits provided outside of a pension plan were covered as well as health care benefits, which represent the bulk of OPEB costs.

The FASB included the following four objectives in Statement 106:

1. To enhance the relevance and representational faithfulness of the employer's reported results of operations (income statement) by recognizing net periodic postretirement benefit cost as employees render the services necessary to earn their postretirement benefits.

2. To enhance the relevance and representational faithfulness of the employer's statement of financial position (balance sheet) by including a measure of the obligation to provide postretirement benefits based on a mutual understanding between the employer and its employees of the terms of the underlying plan.

3. To enhance the ability of users of the employer's financial statements to understand the extent and effects of the employer's undertaking to provide postretirement benefits to its employees by disclosing relevant information about the obligation and cost of the postretirement benefit plan and how these amounts are measured.

4. To improve the understandability and comparability of amounts reported by requiring employers with similar plans to use the same method to measure their accumulated postretirement benefit obligations and the related costs of the postretirement benefits.

FAS 106 — The OPEB Obligation

The starting point for OPEB calculations is the measurement by the employer of the expected postretirement benefit obligation (EPBO) and the accumulated postretirement benefit obligation (APBO).

The **EPBO** is the actuarial present value, as of a specific date, of the postretirement benefits expected to be paid to or for an employee, his/her beneficiaries, and any covered dependents, less the present value of contributions expected to be received from plan participants and others. This EPBO calculation for an employee requires that assumptions be made about future health care costs, discount rates, the employee's expected retirement date, probability of payment, the employee's future compensation, retiree and employee contributions to the plan, among others. The EPBO is neither recognized nor disclosed, but is used in calculating the APBO and the service cost component of a period's OPEB expense. The **APBO** is the actuarial present value, at a particular date, of the proportionate amount of EPBO attributed to services rendered to that date, and is reported in the funded status disclosures in the notes to the financial statements.

After the company has calculated its APBO, it can determine its transition obligation (i.e., the unfunded APBO for active employees and retirees). This off-balance sheet liability is determined at the beginning of the year in which FAS 106 is adopted. For companies with unfunded OPEB plans the transition obligation will equal the APBO. This is typically the case for companies adopting FAS 106, as there has been no federal legislation as yet requiring or encouraging the funding of postretirement benefit plans. The Employee Retirement Income Security Act (ERISA) of 1974, a federal law, applies only to pension plans, requiring that companies fund pension liabilities during employees' working years. The Internal Revenue Code provides tax incentives for pension plan funding, but none as yet for funding OPEB plans.

FAS 106 allowed companies to choose either immediate recognition of the transition obligation ***or*** deferral and amortization over the average remaining service period of active plan participants or twenty years if the average remaining service period was less than twenty years, whereas FAS 87, *Employers' Accounting for Pensions,* had required deferred recognition and amortization of any transition obligation or asset.

FAS 106 — Net Periodic Postretirement Benefit Cost and Disclosures

The six components of the net periodic postretirement benefit cost are similar to the net periodic pension cost reported under FAS 87. They are: 1) service cost — the amount of the EPBO accrued for the current period; 2) interest cost—the increase in APBO due to the passage of time; 3) actual return on plan assets — the change in the fair value of plan assets from the beginning to the end of the period, adjusted for contributions and benefit payments; 4) amortization of prior service cost — the cost of benefits granted for prior service in a plan initiation or amendment; 5) gains and losses (three components) a) the difference between the actual and the expected return on plan assets; b) amortization of unrecognized net gain or loss from previous periods; c) an amount immediately recognized because of a decision to temporarily deviate from the substantive plan; 6) annual amortization of the transition obligation or asset.

Financial statement disclosures are similar to those required by FAS 87 except that additional disclosures are required under FAS 106 for health care cost trend rate assumptions and for the sensitivity of OPEB periodic cost and the APBO to a one percentage point increase in the health care trend rates.

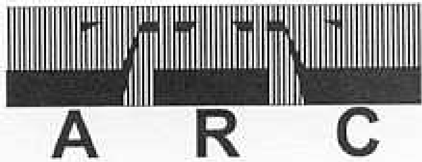
Your father's packet has finally arrived and you now have the following to review as well:

Exhibit A ARC Plan brochure

Exhibit B your father's employer's 4 year balance sheet and income statement summary

Exhibit C your father's employer's 3 year footnote summary: Postretirement medical benefits and other accrued employee benefits

EXHIBIT A



Additional
Retirement
Contribution
PLAN

You must elect between ARC and earning eligibility toward our Medicare Complementary Plan by December 9, 1994. Your election is a one-time irrevocable decision.

The definition of career has changed a lot in the last few years. For some, the concept of having the same job for 20 or 30 years is hard to imagine. All across America, dual career families, interrupted careers, even multiple careers are redefining the workplace.

These changes have prompted an important new trend in employee benefits known as portability. Simply put, it means having access to what you have earned if you leave your employer.

Redesigning Benefits to Meet Your Needs

The concept of portability is already one of the cornerstones of our Retirement Program. And, we're always looking for ways to better meet your needs.

That's why, when certain new accounting standards became effective—standards that affect the way we treat our retiree medical benefits—rather than terminate retiree medical coverage, as many employers did, we decided to take a different approach.

Introducing an Alternative to Retiree Medical Benefits

We call it the Additional Retirement Contribution Plan (ARC). It's a retirement benefit that you can choose in place of company-sponsored retiree medical benefits. It's portable. It offers cash. And, it integrates with our Retirement Program.

Here's how it works.

If you elect to participate in ARC, you will earn the equivalent of 1% of your regular budgeted salary, tax deferred, for as long as you remain benefits eligible. There are even guaranteed minimums for longer service employees.

You can invest your proceeds in any of the same investment options that our Retirement Program offers. And, provided you participate in the Retirement Program for at least five calendar years, you are free to take your ARC money with you should you ever leave the company.

The Choice is Yours

ARC is an alternative to our Medicare Complementary Plan. You can either choose to continue to earn eligibility toward our Medicare Complementary Plan or choose ARC.

In other words, you must now choose either to participate in ARC or to continue to earn eligibility toward our Medicare Complementary Plan. You will only have the opportunity to make this choice one time.

Tools to Help You Choose
While the choice will be easy for some, it won't be easy for everyone. That's why, in addition to this brochure and the enclosed worksheet, we will:
* ****Hold informational meetings;****
* ****Make additional materials available, including brochures on Medicare and a computer software program that will help you perform certain calculations; and****
* ****Give you plenty of time to seek financial advice, if that's important to you.****

Election forms are not due until December 9, 1994.

A Closer Look at ARC

Now that you understand the big picture, here are some more details about ARC. If you select ARC, starting January 1, 1995:

* *You receive the equivalent of 1% of your regular budgeted salary each pay period.* Contributions will be deposited into your existing retirement account or a new one if you do not currently participate in our Retirement Program. Proceeds are itemized on your paycheck stub. You also receive a quarterly statement that shows all your retirement account activity.

* *You select how to invest your contributions,* using any of the many investment options available through our Retirement Program. If you are already enrolled in our Retirement Program, your ARC contributions will be invested according to the instructions you have already provided.

* *Your contributions, plus any earnings, are tax-deferred,* which means you pay no taxes on the money until you withdraw it. IRS rules currently provide for special tax treatment upon retirement that reduces many people's tax burdens.

* *If at any point you decide to leave the company, you may take the value of your ARC account with you,* provided you have participated in ARC or our Retirement Program for five or more calendar years.

Guaranteed Minimum Contribution

If you select ARC and then go on to retire under company rules, ARC provides a guaranteed minimum contribution of at least $10,000 in many cases. In other words, provided you meet the service guidelines as shown on this page, we will deposit the difference, if any, between the contributions you've received to date and the guaranteed amount when you retire. As this chart shows, eligibility for the minimum contribution depends on your years of service — both when you enroll *and* at the time you retire.

If Your Years of Service As of 6/30/94 are	You Are Eligible for the $10,000 Guaranteed Minimum When You Retire Under Our Rules and You are
Less than 10	Age 62 or older and have 20 or more years of service
10 or More	Age 62 or older and have 10 or more years of service
Plus, every year of service beyond 20 at retirement earns an additional guarantee of $1,000.	

Our Medicare Complementary Plan

The following is a brief description of the Medicare Complementary Plan.

We provide medical benefits to retirees and their eligible family members through our Medicare Complementary Plan. This plan supplements Medicare, the national health care insurance program that is available to most Americans over age 65.

To be eligible for our Medicare Complementary Plan, you must:

* Have been employed by us in a benefits-eligible position as of 6/30/94.

* Have accrued at least 10 years of full-time service after reaching age 52.

* Have participated in our Retirement Program for at least 10 years; and

* Formally retire on or after age 62.

How the Plan Works

Our Medicare Complementary Plan supplements benefits you and your spouse receive through Medicare, much like a private supplemental insurance plan.

* Covers the Medicare Part B deductible for doctors' fees and certain other expenses;

* Pays the 20% copayment on Part B eligible expenses;

* Covers the inpatient deductible and copayments under Medicare part A, up to the maximum days allowed by Medicare;

* Pays the deductible and copayment fees for home health and medically-necessary nursing facility care (custodial care is not covered); and

* Provides for additional benefits, like prescription drugs, as well as added coverage if and when you reach maximum Medicare benefits. These additional benefits are subject to a $100 annual deductible, a 20% copayment, and are limited to a $20,000 lifetime maximum.

Getting Coverage Elsewhere

Our Medicare Complementary Plan is designed to supplement a foundation of medical benefits already provided by Medicare. But our plan is not the only supplemental plan out there.

Dozens of insurers and other organizations including the American Association of Retired Persons (AARP) sell private supplemental insurance, sometimes known as "Medigap." If you are considering ARC, you may also want to consider — now or in the future — one of these private supplemental plans.

Recent regulations have standardized all Medigap plans — regardless of who offers them. There are 10 levels of plans (Plan A through Plan J). By law, each insurer must offer the same coverage for each level. In fact, the only thing that's not standardized is the price. That's why it pays to shop around. Coverage at the level of our Medicare Complementary Plan should cost approximately $1,500 per person elsewhere.

Selecting Option 2

If you are reasonably confident you are going to retire from our company and

* You or your spouse have specific health care concerns; or

* You are worried about not being able to keep up with medical inflation; or

* You don't think that the ARC contribution you will receive — even if you're eligible for the $10,000+ minimum benefit — will be enough to offset health care costs above what Medicare covers; then it may make sense to elect to continue to earn eligibility toward our Medicare Complementary Plan and select Option 2 on the election form.

The Next Step

If you were employed on or before June 30, 1994, you must choose between ARC and continuing to accrue eligibility toward retiree medical benefits. You may not change your election at a later date. ARC will automatically be made available to eligible individuals hired after June 30, 1994.

All eligible employees must complete and return the election form no later than December 9, 1994.

IMPORTANT: Failure to return your form by the deadline means you forfeit your right to choose and will be placed in a default status, which will be determined according to your age.

When you make your election, you are choosing between ARC and continuing to earn eligibility toward our Medicare Complementary Plan. The only way you can actually receive coverage under the Medicare Complementary Plan is if you meet certain eligibility rules, as outlined on this page.

EXHIBIT B

(in thousands of dollars)

FOUR YEAR CONSOLIDATED BALANCE SHEET

	At June 30,			
	1991	1992	1993	1994
ASSETS				
Cash and Investments	90,834	107,426	117,943	129,249
Accounts receivable & other current assets	16,076	13,633	19,004	20,734
Notes receivable & other assets	28,921	23,565	70,270	54,574
Property & equipment, net	203,584	216,291	234,967	261,882
Total assets	339,415	360,915	442,184	466,439
LIABILITIES				
Accounts payable and accrued expenses	34,149	40,097	48,099	54,672
Accrued postretirement benefits		22,459	24,910	27,602
Long-term debt	75,049	72,432	128,318	125,478
Total Liabilities	109,198	134,988	201,327	207,752
SHAREHOLDERS' EQUITY				
Beginning balance	207,252	230,217	225,927	240,857
Net income	22,965	(4,290)	14,930	17,830
Total shareholders' equity	230,217	225,927	240,857	258,687
LIABILITIES & SHAREHOLDERS' EQUITY	**339,415**	**360,915**	**442,184**	**466,439**

FOUR YEAR CONSOLIDATED INCOME STATEMENT

	1991	1992	1993	1994
REVENUES	276,370	295,515	317,545	341,077
EXPENSES				
Postretirement benefit costs		3,013	3,619	3,930
Cumulative effect of accounting change		20,463		
Other expenses	253,405	276,329	298,996	319,317
NET INCOME	22,965	(4,290)	14,930	17,830

POST RETIREMENT MEDICAL BENEFITS

Summary of Expense	1991	1992	1993	1994
Gross Expense		3,013	3,619	3,930
Cash Paid		(1,017)	(1,168)	(1,238)
Net Increase in Unfunded Liability		**$ 1,996**	**$ 2,451**	**$ 2,692**

EXHIBIT C

Postretirement medical benefits and other accrued employee benefits

The company adopted Statement of Financial Accounting Standards No.106 in 1992 which requires accrual, during the years that an employee renders the necessary service, of the expected cost of providing medical and other benefits to the employee and dependents upon retirement. The company sponsors a defined benefit postretirement medical plan that covers all its full time status employees and their dependents. The eligibility requirement, for which certain modifications were adopted in August 1992, requires retired employees to have completed 10 years of service after age 52, to have participated in our active retirement plans during that 10 year period, and to have participated in the active medical plan at the time of retirement. The cumulative effect of the accounting change of $20,463,000 was calculated based on the above eligibility requirement and reflects current recognition of the accumulated postretirement benefit obligation as of July 1, 1991. Retired employees are not required to contribute to the plan. The plan is not funded. The following table shows the plan's unfunded status at June 30

Accumulated postretirement benefit obligation (*in thousands*):

	1994	1993	1992
Retired employees	$13,973	$14,130	$12,398
Fully eligible active employees	4,836	4,478	3,487
Other active employees	7,903	5,848	6,574
Total	26,712	24,456	22,459
Unrecognized net gain	890	454	—
Accrued postretirement benefits	$27,602	$24,910	$22,459

Net periodic postretirement benefit cost included the following components (*in thousands*):

	1994	1993	1992
Service cost—benefits attributed to service during the period	$1,470	$1,361	$1,411
Interest cost	2,460	2,258	1,602
Net periodic postretirement benefit cost	$3,930	$3,619	$3,013

For measurement purposes, annual rates of increase in the per capita cost of covered health care benefits of 10%, 10.5%, and 11% were assumed for 1994, 1993 and 1992 respectively; the rate is assumed to decrease gradually to 6% for 2002 and remain at that level thereafter. The health care cost trend rate assumption has a significant effect on the amounts reported. To illustrate, increasing the assumed health care cost trend rates 1% in each year would increase the accumulated postretirement benefit obligation by $5,877,000, $5,453,000 and $4,599,000 as of June 30, 1994, 1993 and 1992 respectively and the net periodic postretirement benefit cost by $804,000, $787,000 and $583,000 for fiscal 1994, 1993 and 1992 respectively. The weighted average discount rate used in determining the accumulated postretirement benefit obligation was 8%.

REQUIREMENTS:

1. Compare the new ARC Plan to the Medicare Complementary Plan in place before June 30, 1994. Include in your answer advantages and disadvantages of each option from both management and employee perspectives. What other alternatives might this company have pursued?

2. a. Which option would you have chosen for yourself? You have been employed for 3 years now and your annual salary is $28,000. Justify your choice. No calculations are necessary for this requirement.
   b. Which plan should your father choose? He is 51, earns $40,000 annually, and has worked for the company for 13 years. At this point he anticipates that he will stay in his present job until retirement. In this case a simple present value computation would be helpful in justifying your choice.
   c. **Writing Assignment:** Here's your chance to impress your dad. Prepare your recommendation in the form of a memorandum. Remember, he is not an accountant. Discuss the rationale behind your choice of Option 1 (elect the ARC Plan) or Option 2 (remain with the Medicare Complementary Plan) in terms that he will understand. Be sure to highlight the risks and uncertainties that you weighed in making your decision.

3. Consider the effect FAS 106 had on the company's financial statements from 1992–94:

   a. Compare postretirement medical benefits expense for each year with and without the effects of FAS 106. Calculate the debt ratio and the return on assets ratio for each year with and without the effects of FAS 106.

   Now answer the following questions:

   b. FAS 106 was effective for fiscal years beginning after December 15, 1992. With a June 30 year-end, your father's employer was not required to adopt the new standard until the year ending June 30, 1994. What reasons can you suggest for management's accounting policy choices in 1992 (i.e. early adoption of FAS 106 and immediate recognition of the transition obligation)?

   c. Was FAS 106 a significant factor in management's decision to revise retiree medical benefits in 1994? What additional reasons can you suggest for management's decision at this time?

4. How do you expect the ARC Plan to impact the company's financial statements in 1995 and beyond? Assume that two-thirds of the company's employees elected ARC, and that the majority in this group are less than 50 years of age.

   Discuss the impact of each of the following on the company's expenses and liabilities:

   * The 1995 decrease in the number of Medicare Complementary Plan participants

   * The 1% employer cash contributions under the ARC Plan

   * The elimination of benefits previously earned under the Medicare Complementary Plan by employees who elected ARC

   * The minimum guaranteed payment under the ARC Plan

5. What assumptions and estimates must the company make in calculating OPEB cost and the APBO? What information does the company's footnote provide about the significance of these assumptions and estimates? According to the FASB an item must be "measurable with sufficient reliability" to be recognized in the

financial statements (SFAC No. 5). Do you believe the company's OPEB calculations meet this recognition criterion?

6. **Research Assignment:** Refer directly to FAS 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, paragraphs 118–132. What are the FASB's key points regarding benefits and costs of this new standard? As an employee do you believe the benefits of FAS 106 outweigh the costs? What would your position be as a manager?

REFERENCE MATERIALS:

Financial Accounting Standards Board. *Statement of Financial Accounting Concepts No. 2* "Qualitative Characteristics of Accounting Information," (Norwalk, CT: FASB, 1980).

______. *Statement of Financial Accounting Concepts No. 5* "Recognition and Measurement in Financial Statements of Business Enterprises," (Norwalk, CT: FASB, 1984).

______. *Statement of Financial Accounting Concepts No. 6* "Elements of Financial Statements," (Norwalk, CT: FASB, 1985).

______. *Statement of Financial Accounting Standards No. 87* "Employers' Accounting for Pensions," (Norwalk, CT: FASB, 1985).

______. *Statement of Financial Accounting Standards No. 106* "Employers' Accounting for Postretirement Benefits Other than Pensions," (Norwalk, CT: FASB, 1990).

BACKGROUND MATERIALS:

Gunsch, Dawn. "How Companies Fund Retiree Medical Benefits." *Personnel Journal* (November, 1993), pp. 78–86.

Light, L., Holland, K. and Kelley, K. "Honest Balance Sheets, Broken Promises." *Business Week* (November 23, 1992), pp. 106–107.

Strazewski, Len. "Benefit Trends." *Human Resource Executive* (July, 1994), p. 17.

William M. Mercer Incorporated. "Medigap and Retiree Medical Plans." *The Bulletin, No. 206* (August, 1992).

Wilson, P.A. "The Financial Statement Effect of SFAS 106: Employers' Accounting for Postretirement Benefits Other than Pensions." *Paper presented at the Annual Meeting of the Northeast Business and Economics Association, Burlington, Vermont,* September, 1992.

CAL TEMP SERVICES, INC.
REVENUE RECOGNITION AND ACCOUNTS RECEIVABLE COLLATERAL REPORTING
(Year 2002 Update)

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COMPANY BACKGROUND AND HISTORICAL FACTS

Cal Temp Services, Inc. ("CTS") was founded by Jack C. Williamson in 1991 to provide engineering services, temporary personnel and personnel training services for the defense contracting industry. Due to the technology-intensive nature of the defense contracting industry, there exists a constant need for well-trained technical personnel. CTS attempted to fill certain aspects of these needs by offering temporary personnel and training services ranging from general employee training to computer systems design and implementation.

Jack Williamson started the Company in 1991 after he was laid off from his job with a major defense contractor as a result of a 1990 reorganization. As with similar entities in the start-up phase, CTS was minimally capitalized, as it was originally funded with only Jack's small savings. However, with Jack's technical expertise, CTS was profitable from its formation and grew rapidly, as reported in its audited financial statements, with revenues reaching $5.4 million in 1997.

As CTS expanded in the 1990's it became necessary to obtain additional financing to fuel the growth of the business. The Company established a line of credit with a local bank with collateral for the loan consisting of a first security interest in CTS's accounts receivable. The bankers were comfortable in lending against the accounts receivable since CTS's customers were mostly large well-established companies and the credit risk on those accounts receivable was expected to be minimal. The maximum amount available on the line of credit was $600,000.

At the request of the bank, Williamson made the commitment to have audited financial statements for CTS. He did not resist this request, as he believed that an audit by an independent CPA added creditability to CTS and its financial statements. Therefore, CTS's financial statements were audited annually for the years ended December 31, 1993 through 2000 by the

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accounting firm of Miller & Starr, CPAs ("M&S"). Each year M&S, following their audit, provided CTS with a signed audit report that stated that in their opinion CTS's financial statements were prepared in accordance with generally accepted accounting principles ("GAAP"). These audits were usually completed within four months of the CTS fiscal year-end (December 31).

1998

While CTS had made some efforts to diversify into other product lines prior to 1998, its primary business remained temporary personnel and personnel training services for the defense contracting industry. This market became extremely competitive in the late 1990's due to defense industry downsizing, which resulted in CTS's profit margins and market share coming under pressure. Certain of CTS's customer contracts were expiring in 1998 and Williamson felt the Company needed to focus on selling larger engineering projects and other value-added services in order to continue its growth.

In order to provide additional financing for the larger project work, Williamson in early 1998 contacted Second Union Bank ("Second Union"), to establish a new banking relationship with a larger bank. Jack concluded that a new banking relationship would help in the expansion plans for CTS. The introduction to the bankers was assisted by Dennis Starr of M&S, who had a good working relationship with Second Union. In May 1998, Second Union agreed to establish an asset-based line of credit for CTS for the greater of $1,000,000 or 75% of the eligible accounts receivable. To complete the agreement, CTS had to provide a first security interest in all of their business assets as collateral for loans under the line-of-credit. However, only receivables less than 90 days old would be considered by Second Union in determining the maximum advances under the line of credit. Second Union, like the prior bank, believed that if the CTS business ever failed, the only assets which would likely have remaining value would be the receivables. The Bank's security interest in other assets such as inventory, prepaids, and equipment would have little realizable value in the event of a liquidation of assets.

Second Union therefore agreed to advance the greater of 75% of eligible accounts receivable or $1.0 million as a loan to CTS. The loan agreement specifically required that CTS furnish Second Union audited financial statements prepared in accordance with generally accepted accounting principles. In addition, the agreement stipulated that CTS provide a collateral report consisting of an aged listing of accounts receivable within 20 days after the close of each month. These reports were also to be accompanied by a certification from an officer of CTS that the reports were complete and accurate.

1999

In 1999, Second Union became aware that CTS's financial condition had taken a turn for the worse. Upon receipt of the 1998 audited financial statements, the bank learned that revenues for 1998 had declined by approximately 7%, while gross profit margins declined and administrative expenses increased. The combination of these factors resulted in a pre-tax loss of $(279,931). This was particularly distressing to the Bank because the interim financial statements they had been shown had not reflected a problem of this magnitude.

Following receipt of the audited financial statements in Apri1 1999, Ron Gray, Second Union's loan officer, informed Jack Williamson that in view of the CTS's deteriorating financial condition, CTS's line of credit would be under review by Second Union's loan committee. Ron

Gray notified CTS's management that the loan would not be renewed if CTS did not promptly act to eliminate its operating losses. Upon receipt of this notice from Second Union, Jack Williamson called an executive meeting of top management and informed them that CTS would go out of business without the continuance of this loan. Heated discussion took place as to the options available to CTS.

In an effort to offset these declines in revenues and eliminate the losses, CTS's management decided to implement the following steps to reduce costs:

1. Reduction in marketing and sales costs.
2. Salary reductions.
3. Reduce administrative support, including one of the Company's two accounting personnel.

On June 2, 1999, James Roberts, CTS's Vice-President of Finance, wrote Second Union stating that CTS, with the aid of Miller & Starr, was in the process of preparing interim financial statements for May 1999, together with a forecast for the balance of 1999. The financial statements showed an improvement in results and the forecasted financial statements projected a return to profitability in 1999. Based on the forecast and the management actions, Union extended the line of credit to June 30, 2000 at the existing limit of $1.0 million, but raised the loan interest rate (from prime rate plus 1% to prime rate plus 2%).

2000

Upon receipt of the 1999 financial statements in May 2000, the bank became convinced that CTS had made great progress on the resolution of their problems. The audited financial statements showed a significant improvement over 1998 results. Sales totaled only $5.1 million but operating profits (income before interest and taxes) were $122,764 and the Company had a modest net income. The Company's financing requirements continued to grow, however, due to an increase in accounts receivable attributed by management to administrative delays in payments on customer contracts. CTS requested an increase in their credit limit and on August 3, 2000, Ron Gray called CTS to inform Jim Roberts that Second Union was pleased with CTS's results, and the bank's loan committee authorized an extension on the line of credit, with an increase in the limit to $1,300,000.

Throughout the balance of 2000, CTS apparently continued to profitably maintain and expand their business. The 2000 audited financial statements, which Second Union received in Apri1 2001, showed increases in revenue to almost $6.0 million, operating profits of $284,138 and net income of $92,441.

2001

On May 10, 2001, Ron Gray of Second Union became concerned about the deterioration in the aging of accounts receivable and the continual increase in CTS's accounts receivable balance, as well as the frequent overdrafts on the CTS checking account. He met with James Roberts and insisted, over Roberts' strong objection, that the Bank be allowed to contact certain major customers of CTS regarding the substantial amounts they owed CTS. Gray felt this step was necessary to provide Second Union with comfort that the amounts shown as accounts receivable would be eventually paid.

After some discussion, Roberts admitted that many of CTS's accounts receivable (which at that time were shown on the books as $1.8 million) would not prove to be collectible and that he regretted having done anything that misled the bank. He told Gray that everything he and Williamson had done was done just to save the jobs of the CTS employees and that they had expected they would be able to work themselves out of their financial problems. Second Union immediately stopped advancing funds to CTS and CTS closed its doors, agreeing to forfeit all assets to Second Union. After collecting all valid accounts receivable and selling all other assets of CTS at auction, Second Union still incurred a loss on its loan of $900,000. The CTS trade creditors received nothing.

YOUR LITIGATION CONSULTING ENGAGEMENT

As a result of the sudden demise of CTS and the resulting loss that occurred when Second Union attempted to collect on their seemingly adequate loan collateral, legal counsel for Second Union has requested you to perform an investigation of the accounting records of CTS. Your engagement scope was to determine the nature and extent of any misrepresentations in the financial information provided to Second Union and the extent of management's participation in any fraud which resulted in losses to the bank.

In connection with the investigation, counsel has indicated that it will be critical to their case against the former management of CTS to prove the extent of any fraud as of December 31, 1999 and December 31, 2000. This is because Williamson signed the collateral report certifications that were sent to Second Union for 1999, Roberts signed the reports for 2000 and the officers apparently had a clerical employee sign the reports in 2001. The bank intends to use you as an "expert" witness in connection with their suit against management personnel, including Roberts and Williamson, if the investigation concludes that they were participants in any fraudulent collateral reporting.

Legal counsel for Second Union believes that the overstatement of accounts receivable began prior to 2001, since it seemed impossible for the Company to have lost so much money in just the first few months of 2001. If it can be demonstrated that the delay in terminating the loan agreement was caused by fraud on the part of management, they believe they can make an argument that the portion of Second Union's losses caused by that delay should be recovered from management. Therefore, if fraud is uncovered at the end of either 1999 or 2000, they have requested that you calculate an estimate of the amount, if any, that the bank would have lost if the loan had been terminated at those times, compared with the amount they lost in May 2001. Legal counsel understands that various legal defenses will be asserted by legal counsel for CTS's management. However, since you are an independent accountant/analyst and not a lawyer, this is not your area of concern.

The accounting records of CTS have been obtained by Second Union's legal counsel and made available for your review in an off-site storage facility. The certified collateral reports for 1999 and 2000 are available from the Bank. Also, Second Union's counsel has obtained the working papers of M&S related to their audits of CTS. All employees of CTS are terminated and you are informed that all former CTS personnel contacted to date have declined to cooperate with the investigation. The Bank's legal counsel has told you that if a fraud claim is asserted against management, it is likely that you will be called upon to prepare a written report of your

findings, that you will likely be subpoenaed to appear for formal deposition testimony and, if the case goes to trial, that you will be required to testify in court.

Information Obtained During Your Preliminary Review

You have obtained the audited financial statements of CTS for the years 1997 through 2000 and have prepared a summary of those financial statements, as shown on **EXHIBIT I**. You have prepared a timeline of major known events on **EXHIBIT II**. You have also obtained the M&S accounts receivable working papers, engagement memoranda and work programs and the following records from CTS files and the Bank:

CTS Financial Statements (including Notes to the financial statements)

The accounting policies note includes the following:

"*Engineering Services*

Revenues for engineering services are recognized upon completion of projects, which are generally of short duration. Direct costs associated with customer engineering projects in process are included in inventory at the lower of cost or realizable value."

Second Union—CTS Line of Credit Loan Agreement

Section 7.2 of the Agreement defines "eligible accounts receivable" for lending purposes:

"Accounts receivable shall represent amounts owed by customers on invoices outstanding less than 90 days and uncollected to the extent such invoices relate to services rendered or products delivered to and accepted by the customer. The determination of eligible accounts receivable for purposes of calculating available line-of-credit advances under Section 3.4 shall be made as of the last day of the month preceding the request for an advance."

CTS General Ledgers for each year

CTS Accounts Receivable/Sales Subledgers and Transaction Registers

- -Accounts receivable trial balances
- -Monthly sales registers
- -Monthly debit/credit memo adjustment registers
- -Cash receipt records
- -CTS invoices
- -Customer purchase orders
- -Customer remittance advices

CTS Work Order Log (Documenting costs incurred by project)

CTS bank statements and deposit slips

You also have performed a preliminary review of M&S's audit working papers. Since 1999 was the seventh year that Miller & Starr had audited CTS, Miller felt comfortable with CTS's operations, management, and financial reporting procedures. In conducting the first four audits, the audit procedures included direct confirmation of accounts receivable with customers. When confirmations were sent, the auditors would include copies of the current invoices to make it as easy as possible for CTS's customers to confirm the balances. In four years of sending out confirmations, only two were ever returned that questioned the balance owed to CTS, and those differences were subsequently resolved. However, it was often difficult to get the customers to return the confirmations, with second requests and telephone follow-up often required, which created an inefficient audit process.

Starting with the fifth year's audit, M&S decided to use "alternative procedures" rather than confirmations. These procedures consisted of checking whether the accounts receivable were collected after year-end as evidence of their validity, since the best evidence of a valid receivable is actual customer payment. Where subsequent payment was not received prior to the end of the audit, the unpaid invoices were reviewed with CTS's management to determine the reasons for nonpayment, and M&S would also review the actual CTS invoice, along with any other documents available in the invoice file. In most years, the auditors were able to verify between 70-90% of the accounts receivable balance with subsequent cash receipts.

M&S performed detailed testing of the costs accumulated in inventory based on the CTS Work Order Log. However, there is no evidence that they found it necessary to examine any work order records for jobs which were fully billed prior to year-end (therefore having no inventory balance).

Investigation of **1999** *Information*

Your preliminary investigation related to the accounts receivable balances at December 31, 1999 has revealed that as required by the loan agreement, CTS furnished to Second Union their aged accounts receivable schedule as of December 31, 1999, together with the certification signed by Jack Williamson (**EXHIBIT III**). The M&S auditors were provided with the same detail of accounts receivable. After reviewing the details supporting the accounts receivable aging schedule for December 31, 1999, your staff has brought to your attention the following information for selected major accounts receivable balances included in CTS's financial statements. They have also brought you the related portions of the CTS work order log (**EXHIBIT IV**) for use in your review:

1. Penns Engineering Services, Inc. ("Penns")

   On December 10, 1999, Penns issued purchase order No. 34A508347 to CTS for project engineering services related to a robotic welding application in the amount of $75,000. The required completion date on the purchase order was "ASAP". On December 30, 1999, CTS's accounts receivable clerk recorded invoice No. 31290 for services rendered to Penns Engineering Services, Inc. in the amount of $75,000.

   The M&S audit working papers indicated that the auditors looked at the Penns purchase order and the CTS invoice. Payment had not been received from the customer by the March 29, 2000 date of the auditors report but management had explained that the Penns invoice approval/payment cycle was typically 120 days or more. Your staff's

review has determined that on April 28, 2000, CTS issued and recorded credit memo No. 31290 to Penns for $75,000, reversing invoice No. 31290. On May 14, 2000, CTS recorded invoice No. 32150 to Penns in the amount of $75,000. On June 22, 2000, CTS received a payment from Penns of $75,000, with the remittance advice referring to "Inv. 32150-5/14/00".

2. Tempco, Inc. ("Tempco")

CTS recorded invoice No. 29934 on November 4, 1999 in the amount of $45,000 for "Development of SPC Training Module I." CTS then recorded invoice No. 31065 on December 23, 1999 in the amount of $23,000 for "Module II" development.

The M&S working papers documented that these charges agreed with the amounts for those services on Tempco purchase orders No. 3058 and 3059, each dated June 30, 1999, which specified delivery no later than January 31, 2000. M&S also had examined documentation proving that on December 21, 1999, CTS received payment for $25,000 from Tempco which CTS credited against invoice No. 29934 and that Tempco made the final payment on both invoice No. 29934 and No. 31065 with a check for $43,000 on February 3, 2000.

3. McDonald Douglas, Inc.

CTS recorded invoice No. 30489 to McDonald Douglas, Inc. in the amount of $58,995 on November 29, 1999. The M&S working papers documented that on March 22, 2000, the invoice was paid in full. However, in our review of the customer's remittance advice accompanying the payment, the customer referenced payment of invoice No. 30489 dated January 22, 2000 for $58,995.

4. Nexus Software

On November 30, 1999, CTS recorded invoice No. 30510 for programming services rendered to Nexus Software in the amount of $119,432. M&S working papers revealed that they had examined the CTS invoice and the related purchase order dated October 15, 1999, which did not specify a completion date but stated a price of $32.50 per programmer hour. No payment had been received by the end of the auditor's fieldwork, which management attributed to a cash flow problem on the part of Nexus which they expected to be resolved shortly.

Our work has revealed that on March 31, 2000, debit memo No. 30510 was issued in the amount of $2,443 to increase the amount due to $121,875. On April 12, 2000 a check for $121,875 was received from Nexus in payment of invoice No. 30510.

5. Boeing Defense Services

CTS issued and recorded invoice No. 31266 dated December 15, 1999 to Boeing Defense Services for engineering services on a classified government program in the amount of $75,411. The M&S working papers indicate that on February 14, 2000, Boeing paid $40,000 on invoice No. 31266 and paid the balance on March 30, 2000.

Investigation of **2000** *Information*

You have obtained the aged accounts receivable trial balance CTS furnished to Second Union as of December 31, 2000, together with the certification signed by James Roberts (**EXHIBIT V**). This schedule agreed with the M&S working paper detail of accounts receivable. After reviewing the details supporting this accounts receivable aging schedule for December 31, 2000, your staff has brought to your attention the following information for selected major accounts receivable balances included in CTS's financial statements. They have also brought you the related portions of the CTS work order log (**EXHIBIT VI**) for use in your review.

Based on the date in the auditors' report of M&S, they completed their audit fieldwork on March 15, 2001:

1. Nexus Software

   CTS recorded invoice No. 36998 for $69,000 on October 31, 2000, and invoice No. 37330 for $87,210 to Nexus Software dated November 31, 2000. Then on December 16, 2000 invoice No. 37330 was adjusted upward by $31,000 through an account maintenance routine available in the CTS billing software. M&S, seeing no subsequent receipt, interviewed Williamson and Roberts regarding these transactions. Roberts indicated that all of the "paperwork" for this project was at CTS's Florida branch, but that CTS would be paid in April 2001 when Nexus' customer paid them. Williamson pointed out that the staff auditor should know that Nexus had long been one of CTS's best customers and they always paid slow.

   Because of the size of the Nexus account and since there were no records available locally in support of this account, the staff auditor decided to seek direct confirmation of the Nexus account with the customer. A faxed confirmation response was received on March 12, 2001, indicating that the account was correct, with a note stating that the invoices were scheduled for payment on April 15.

   On March 29, 2001 a credit memo for $187,210 was issued to reverse invoices 36998 and 37330. The only 2001 check from Nexus Software you have located was for $15,000 received on April 11, 2001. The remittance advice on this check referenced invoice No. 38500 dated March 3, 2001.

2. CMI K\P Modules

   CMI K\P Modules was billed with invoice No. 37331 on November 30, 2000 for $197,697. On February 6, 2001 CTS issued and recorded credit memo No. 37331 for $107,697. Then on March 12, 2001 an accounts receivable clerk issued another credit memo for $90,000 completely reversing the invoice transaction. Roberts informed the M&S auditor checking subsequent receipts to original Second Union checking account deposit slips dated February 4, 2001 for $106,000 and March 9, 2001 for $90,000, that he was unable to locate the original remittance advices due to their short-staffed situation, which had caused them to fall behind on filing. The difference between the $107,697 and the $106,000 was deemed immaterial.

Your investigation has revealed that the bank deposits examined by the auditor were actually for draws made against the Second Union line of credit. Dun & Bradstreet has no record of a company by this name.

3. JLO Contracting Services

CTS issued and recorded invoice No. 37603 in the amount of $77,200 for JLO Contracting Services on December 31, 2000. The M&S auditors examined evidence of a payment from JLO Contracting Services on March 14, 2001 for $77,200. Williamson showed the M&S auditor the actual check on the day it arrived, indicating that he knew it must be one of the items they needed to wrap up their work.

Your staff has located the JLO remittance advice, which referenced invoice No. 37603 dated February 28, 2001.

4. DCS, Inc.

CTS issued and recorded invoice No. 37588 on November 21, 2000, to DCS, Inc. for $57,339. On January 17, 2001, a credit memo for invoice No. 37588 was recorded for $30,000. On the same day a payment from DCS, Inc. was recorded in the amount of $27,339. The M&S auditor examined the evidence of the payment, and was informed that DCS did not pay the $30,000 because of an offsetting account payable in that amount that CTS owed to DCS. The M&S auditor verified the existence of the account payable by examination of the December 31, 2000 accounts payable trial balance and the invoice from DCS.

A review of the bank files revealed a collection letter from an attorney representing DCS dated June 29, 2001, threatening legal action if the bank does not release the $30,000 his client is owed.

5. Vortext, Inc.

CTS recorded invoice No. 37607, related to CAD engineering services to Vortext in the amount of $174,135 on December 31, 2000. The M&S auditors were told that no formal purchase order was received and the project manager had failed to ask for one from this new customer. However, Roberts was able to provide a copy of a Vortext Request for Quotation, the CTS Quote form which agreed with the invoice and a UPS shipping form dated December 31, 2000 addressed to Vortext.

Your staff has determined that this invoice was reversed by credit memo on March 31, 2001 and rebilled that same day on invoice No. 39521. That invoice was on the CTS accounts receivable listing at the time CTS terminated its operations. A call to the Vortext engineering manager identified in the Vortext request for quotation confirmed that Vortext had requested a quotation from CTS for the CAD services but that Vortext had given the business to another vendor because of industry rumors that CTS was in trouble.

Other Documents Reviewed

Your review of the Accounts Receivable Debit/Credit Memo Adjustment registers for 2000 and 2001 indicates that in the typical month several hundred thousand dollars of credit memos were processed, as well as significant amounts of debit memos. Your review of the CTS general ledger for December 2000 revealed that the net sales CTS recorded for the month were approximately $502,000.

The M&S working papers for 1999 and 2000 contained management representation letters signed by Jack Williamson and James Roberts which included all appropriate representations regarding compliance with GAAP.

Your testing of the CTS work order records has found that the cost accumulation data in the CTS work order logs is complete and accurate.

QUESTIONS

Accounting Issues

1. Per Generally Accepted Accounting Principles (GAAP), when should revenue be recognized? Also, how are accounts receivable to be valued and reported?

2. Are the stated revenue recognition policies of CTS on engineering services, as stated in the footnotes, appropriate and in accordance with GAAP?

3. For the accounts receivable balances specifically discussed above, what is your opinion as to amount, if any, of the overstatement of accounts receivable:

   a. As of December 31, 1999?
   b. As of December 31, 2000?

4. With the exception of accounts receivable, are there any other balance sheet accounts that you believe should be appropriately adjusted based on your findings?

   a. As of December 31, 1999?
   b. As of December 31, 2000?

5. What would have been the impact of the adjustments you have proposed on the pre-tax income of CTS:

   a. For the year ended December 31, 1999?
   b. For the year ended December 31, 2000?

Litigation Consulting Engagement Issues

1. What, if any, evidence have you identified that would indicate knowledge of any financial statement and collateral reporting fraud on the part of Williamson and Roberts?

2. What were the apparent motives of management to commit a fraud in this situation?

3. Compute your best estimate of the damages that Second Union incurred as a result of delaying termination of the loan agreement with CTS until May 12, 2001, versus the result if they had terminated the agreement on:

   a. December 31, 1999
   b. December 31, 2000

(For purposes of this "damages analysis" calculation you may assume that the net liquidation value of all assets other than cash and accounts receivable is zero and that the bank would have had a first priority claim on the cash and the proceeds of accounts receivable.)

Auditing Issues

The Bank's legal counsel is also concerned that the loss on the CTS account followed so closely the completion of the apparently problem-free 2000 audit of M&S. They expect that management may use that clean audit opinion as a defense at trial. Accordingly, legal counsel has also asked you to determine whether the fraud, if any, would have been detected by the proper application of Generally Accepted Auditing Standards (GAAS) and how any fraud was concealed from the auditors.

1. Distinguish between an error and fraud. Would management's actions in this case be considered an error or fraud? What is the auditor's responsibility for discovering errors and/or fraud?

2. What are some of the risk factors (red flags) that are apparent in the case?

3. Do you believe that the audit approaches employed by M&S were in accordance with GAAS? Why or why not?

4. What additional evidential matter could have been acquired by M&S (based on your knowledge of CTS's customers and accounting records)?

5. Based only on your analytical review of the CTS financial statements and accounts receivable trial balances as of December 31, 1999 and 2000, was information available which should have alerted the auditors to the potential of fraud and financial statement misstatement?

6. Was it appropriate for M&S to accept a fax confirmation from Nexus Software as audit evidence in the confirmation process? What special concerns are there for the auditor in accepting faxes as audit evidence?

7. Was M&S justified in their reliance on management representations? Why or why not?

EXHIBIT I

CAL TEMP SERVICES, INC.
BALANCE SHEETS

	December 31			
Assets	**2000**	**1999**	**1998**	**1997**
Current assets:				
Cash	$1,700	$1,898	$6,455	$16,803
Accounts Receivable, net	1,744,807	1,023,623	818,513	934,209
Inventory	229,023	125,112	42,305	0
Prepaid expenses	31,958	17,402	15,605	14,527
Total current assets	2,007,448	1,168,035	882,878	965,539
Property and equipment, net	204,451	212,359	262,603	266,561
Total Assets	$2,211,939	$1,380,394	$1,145,481	$1,232,100
Liabilities and Stockholders' Equity				
Current liabilities:				
Line-of-credit	$1,273,300	$683,100	$534,800	$469,804
Accounts payable—trade	362,336	209,620	221,874	156,329
Taxes accrued and withheld	29,590	44,182	4,977	25,115
Accrued expenses	44,816	34,036	1,304	24,769
Total liabilities	1,710,042	970,938	762,955	676,017
Stockholders' equity				
Common stock	$6,003	$6,003	$6,003	$6,003
Retained earnings	495,894	403,453	376,523	550,080
Total stockholders' equity	501,897	409,456	382,526	556,083
Total liabilities and stockholders' equity	$2,211,939	$1,380,394	$1,145,481	$1,232,100

EXHIBIT I (cont'd.)

CAL TEMP SERVICES, INC.
STATEMETNS OF OPERATIONS
FOR THE YEARS ENDED DECEMBER 31

	2000		1999		1998		1997	
Sales	$,962,610	100%	$5,139,795	100%	$5,050,887	100%	$5,409,655	100%
Cost of operations	4,368,487	73%	3,761,229	73%	3,802,744	75%	3,850,423	71%
Gross profit	1,594,123	27%	1,378,566	27%	1,248,143	25%	1,559,232	29%
General and administrative expenses	1,309,985	22%	1,255,802	24%	1,479,652	29%	1,345,923	25%
Income from operations	284,138	5%	122,764	2%	(231,509)	-5%	213,309	4%
Interest expense, net	(135,040)	-2%	(79,328)	-2%	(48,422)	-1%	(27,843)	-1%
Net income before provision for income taxes	149,098	3%	43,436	1%	(279,931)	-6%	185,466	3%
Provision for income taxes	(56,657)	-1%	(16,506)	0%	106,374	2%	(70,477)	-1%
Net income	$92,441	2%	$26,930	1%	$(173,557)	-3%	$114,989	2%
Analysis of Retained Earnings								
Beginning balance	$403,453		$376,523		$550,080		$435,091	
Net income (loss)	92,441		26,930		(173,557)		114,989	
Ending balance	$495,894		$403,453		$376,523		$550,080	

EXHIBIT II

Second Union v. Cal Temp Services, Inc. et a1
Timeline of Events
1991-2001

1991- Cal Temp founded by Jack Williamson

March 1994 -The accounting firm of Miller & Starr , CPAs completes their first audit of the financial statements of CTS for the year ended December 31, 1993. Relationship established with local bank and line of credit approved for $600,000.

May 1998 -Banking relationship transferred to Second Union Bank. Line of credit approved for $1,000,000.

Apri11999- 1998 audited financial statements reveal a significant loss and the first sales decline in the history of CTS. Second Union informs CTS management that the lending relationship will be under review by the Bank's loan committee.

June 1999 -CTS management provide Second Union with unaudited May 1999 financial statements showing improved results and a forecast for 1999 showing a return to profitability. Second Union extends the line of credit to June 30, 2000 and increases the interest rate by 1%.

May 2000- Audited CTS financial statements for the year ended December 31, 1999 confirm the improved results and return to profitability. Second Union approves extension of line of credit to June 30, 2001.

August 3, 2000- Second Union increases the line of credit to $1.3 million based on the request of CTS management.

April 2001 -Audited CTS 2000 financial statements reflect improved results and significant increases in the levels of accounts receivable, amounts outstanding on the line of credit and accounts payable.

May 10, 2001 -Ron Gray becomes concerned over the accounts receivable collateral of CTS and the frequent overdrafts of CTS's bank accounts. He begins to investigate the situation and meets with CTS management.

May 12, 2001- CTS terminates operations and lays off all employees.

June 2001- CTS surrenders all assets to Second Union bank.

EXHIBIT III
CAL TEMP SERVICES, INC.
Accounts Receivable Aged Summary Trial Balance
December 31, 1999

Customer	1-30 Days	31-60 Days	61-90 Days	Over 90 Days
BJP Defense Technology Systems	$23,000			$56,987
Boeing, Inc.	$75,411			
Glorcom Industrial				$46,544
Harris Engineering			$27,900	
JLO Contracting Services	$91,752			
McDonald Douglas, Inc.		$58,995		
Nexus Software		$119,432		
Penns Engineering Services, Inc.	$75,000			
RTS Molding, Inc.			$16,726	
Torrington Manufacturing & Engineering	$119,005			
U. S. DTS			$89,560	
Vortext, Inc.		$34,128	$74,610	
Other receivables (individually under $500)	$22,916	$15,983	$25,736	$6,938
Total by Aging Category	$430,084	$248,538	$234,532	$110,469
	42%	24%	23%	11%
TOTAL ACCOUNTS RECEIVABLE	$1,023,623			

I, JACK C. WILLIAMSON hereby certify that the amounts shown above (except for the amounts classified as over 90 days) have been determined in accordance with the provisions of Section 7.2 of the loan agreement between Cal Temp Services, Inc. and Second Union Bank and represent "Eligible Accounts Receivable" as defined therein.

Jack Williamson

Jack C. Williamson
January 6, 2000

EXHIBIT IV

Cal Temp Services -Work Order Log Excerpts

Customer: Penns Engineering Services

Report Date 8/31/00

Customer P.0.	34A508347	12/10/99
Order start date		12/20/99
Amount Billed to Date		$75,000
Project status		Complete

Activity	**Cumulative Cost to 12/31/99**	**Cumulative Cost to Date 8/31/00**	**Date of Last Activity**
Employee Salaries	$4,873.00	$26,875.00	4/28/00
Subcontracted Services	-	13,110.00	5/10/00
Project & Facility Costs	-	2,400.00	4/10/00
Travel & Entertainment	250.00	4,750.00	4/28/00
Per Diem	105.00	1,200.00	4/28/00
Meals & Lodging		852.00	4/28/00
Shipping Charges		350.00	5/10/00
Employee Taxes & Benefits	1,462.00	8,063.00	4/28/00
Other Direct Expense	1,650.00	2,350.00	5/10/00
Costs Total	**8,340.00**	**59,950.00**	
Inventory Balance	-0-	-0-	

EXHIBIT IV (cont'd.)

Cal Temp Services -Work Order Log Excerpts

Customer: Tempco, Inc.

Report Date 4/30/00

Customer P.0.		3058, 3059	6/30/99
Order start date			6/28/99
Amount Billed to Date			$68,000
Project status			Complete

Activity	**Cumulative Cost to 12/31/99**	**Cumulative Cost to Date 4/30/00**	**Date of Last Activity**
Employee Salaries	$52,956.00	$52,956.00	12/22/99
Subcontracted Services	6,222.00	6,222.00	8/12/99
Project & Facility Costs	-	-	
Travel & Entertainment	-	-	
Per Diem	1,543.00	1,543.00	12/22/99
Meals & Lodging	640.00	640.00	12/5/99
Shipping Charges	42.00	42.00	12/22/99
Employee Taxes & Benefits	15,887.00	15,887.00	12/22/99
Other Direct Expense	50.00	50.00	8/31/99
Costs Total	**77,340.00**	**77,340.00**	
Inventory Balance	-0-	-0-	

EXHIBIT IV (cont'd)

Customer: McDonald Douglas, Inc.

Report Date 4/30/00

Customer P.0.	9993548254	11/1/99
Order start date		11/1/99
Amount Billed to Date		$58,995
Project status		Complete

Activity	**Cumulative Cost to 12/31/99**	**Cumulative Cost to Date 4/30/00**	**Date of Last Activity**
Employee Salaries	$29,654.00	$32,871.00	1/18/00
Subcontracted Services	-	2,350.00	1/15/00
Project & Facility Costs	-	-	
Travel & Entertainment	-	-	
Per Diem	-	15.00	1/15/00
Meals & Lodging	-	-	
Shipping Charges	65.00	89.00	1/22/00
Employee Taxes & Benefits	8,896.00	9,861.00	1/18/00
Other Direct Expense	4,577.00	4,577.00	12/18/99
Costs Total	**43,192.00**	**49,793.00**	
Inventory Balance	-0-	-0-	

Exhibit IV (cont'd)

Customer: Nexus Software

Report Date 4/30/00			
Customer P.0.		NX40005967	10/15/99
Order start date			10/1/999
Amount Billed to Date			$121,875
Project status			Complete
Activity	**Cumulative Cost to 12/31/99**	**Cumulative Cost to Date 4/30/00**	**Date of Last Activity**
Employee Salaries	$1,396.00	$52,333.00	3/12/00
Subcontracted Services	-	12,569.00	3/12/00
Project & Facility Costs	650.00	6,214.00	3/12/00
Travel & Entertainment	392.00	1,250.00	3/12/00
Per Diem	15.00	940.00	1/15/00
Meals & Lodging	85.00	3,444.00	3/12/00
Shipping Charges	-	19.00	3/12/00
Employee Taxes & Benefits	419.00	15,700.00	3/12/00
Other Direct Expense	1,005.00	4,577.00	2/12/00
Costs Total	**3,962.00**	**97,046.00**	
Inventory Balance	-0-	-0-	

Exhibit IV (cont'd)

Customer: Boeing Defense Systems

Report Date 4/30/00

Customer P.0.		Classified	Classified
Order start date			11/12/99
Amount Billed to Date			$75,411
Project status			Complete

Activity	**Cumulative Cost to 12/31/99**	**Cumulative Cost to Date 8/31/00**	**Date of Last Activity**
Employee Salaries	$ 42,880.00	$42,880.00	12/22/99
Subcontracted Services	-	-	
Project & Facility Costs	-	-	
Travel & Entertainment	-	-	
Per Diem	-	-	
Meals & Lodging	-	-	
Shipping Charges	-	-	
Employee Taxes & Benefits	12,864.00	12,864.00	12/23/99
Other Direct Expense	-	-	
Costs Total	**55,744.00**	**55,744.00**	
Inventory Balance	-0-	-0-	

EXHIBIT V

CAL TEMP SERVICES, INC.
Accounts Receivable Aged Summary Trial Balance
December 31, 1999

	Days Outstanding			
	1-30 Days	**31-60 Days**	**61-90 Days**	**Over 90 Days**
Customer				
BJP Defense Technology Systems	$136,290.00			
Boeing, Inc.		$27,456.00		
CMI K/P Modules		$197,697.00		
DCS, Inc.		$57,339.00		
Glorcom Industrial	$24,358.00			
Harris Engineering			$65,301.00	
JLO Contracting Services	$77,200.00			
McDonald Douglas, Inc.		$65,836.00		
Nexus Software		$118,210.00	$69,000.00	
RTS Molding, Inc.				$29,550.00
Tempco			$57,009.00	
Torrington Manufacturing & Engineering	$55,630.00		$93,700.00	
U. S. DTS	$245,592.00	$127,882.00	$45,000.00	$12,300.00
Vortext, Inc.	$174,135.00			
Other Receivables (Individually $500 or less)	$21,578.00	$19,975.00	$18,739.00	$5,030.00
Total by Aging Category	$734,783	$614,395	$348,749	$46,880
	42%	35%	20%	3%
TOTAL ACCOUNTS RECEIVABLE	$1,744,807			

I, JAMES ROBERTS hereby certify that the amounts shown above (except for the amounts classified as over 90 days) have been determined in accordance with the provisions of Section 7.2 of the loan agreement between Cal Temp Services, Inc. and Second Union Bank and represent "Eligible Accounts Receivable" as defined therein.

James Roberts

EXHIBIT VI

Cal Temp Services—Work Order Log Excerpts

Customer: Nexus Software

Report Date 5/10/01

Customer P.0.		NX40008301	
Order start date			
Amount Billed to Date			$15,000
Project status			Complete

Activity	**Cumulative Cost to 12/31/00**	**Cumulative Cost to Date 5/10/01**	**Date of Last Activity**
Employee Salaries	-	$4,558.00	3/12/00
Subcontracted Services	-	3,500.00	3/12/00
Project & Facility Costs	-	1,214.00	3/12/00
Travel & Entertainment	-	-	11/15/99
Per Diem	-	-	1/15/00
Meals & Lodging	-	-	3/12/00
Shipping Charges	-	50.00	3/12/00
Employee Taxes & Benefits	-	1,367.00	3/12/00
Other Direct Expense	-	2,121.00	3/12/00
Costs Total	**-**	**12,810.00**	
Inventory Balance	-0-	-0-	

Customer:

Report Date 5/10/01

(You and your staff have been unable to locate any work order records for CMI K/P Modules)

EXHIBIT VI (cont'd.)
Cal Temp Services—Work Order Log Excerpts

Customer: JLO Contracting Services

Report Date 5/10/01			
Customer P.0.		J23X94X6382	10/23/00
Order start date			11/1/00
Amount Billed to Date			$77,200
Project status			Complete

Activity	**Cumulative Cost to 12/31/00**	**Cumulative Cost to Date 5/10/01**	**Date of Last Activity**
Employee Salaries	$15,266.00	$24,699.00	2/26/01
Subcontracted Services	9,211.00	15,730.00	2/26/01
Project & Facility Costs	1,259.00	3,407.00	2/26/01
Travel & Entertainment	580.00	1,192.00	2/26/01
Per Diem	-	58.00	2/26/01
Meals & Lodging	1,820.00	3,293.00	2/26/01
Shipping Charges	-	160.00	2/26/01
Employee Taxes & Benefits	4,580.00	7,410.00	2/26/01
Other Direct Expense	1,200.00	1,200.00	2/26/01
Costs Total	**33,917.00**	**57,149.00**	
Inventory Balance	-	-	

Exhibit VI (cont'd)

Customer: DCS, Inc.

Report Date 5/10/01

Customer P.0.	3721	9/15/00
Order start date		9/12/00
Amount Billed to Date		$57,339
Project status		Complete

Activity	**Cumulative Cost to 12/31/99**	**Cumulative Cost to Date 8/31/00**	**Date of Last Activity**
Employee Salaries	$12,900.00	$12,900.00	11/20/00
Subcontracted Services	1,533.00	1,533.00	10/30/00
Project & Facility Costs	1,816.00	1,816.00	11/20/00
Travel & Entertainment	-	-	
Per Diem	-	-	
Meals & Lodging	-	-	
Shipping Charges	-	-	
Employee Taxes & Benefits	3,870.00	3,870.00	11/20/00
Other Direct Expense	92.00	92.00	11/5/00
Costs Total	**20,211.00**	**20,211.00**	
Inventory Balance	-	-	

Customer: Vortex, Inc.

Report Date 5/10/01

Customer P.0.	
Order start date	8/25/00
Amount Billed to Date	$174,135
Project status	Complete

Activity	**Cumulative Cost to 12/31/00**	**Cumulative Cost to Date 5/10/01**	**Date of Last Activity**
Employee Salaries	-	-	
Subcontracted Services	-	-	
Project & Facility Costs	-	-	
Travel & Entertainment	-	-	
Per Diem	-	-	
Meals & Lodging	-	-	
Shipping Charges	-	-	
Employee Taxes & Benefits	-	-	
Other Direct Expense	-	-	
Costs Total	**-**	**-**	
Inventory Balance	-	-	

STOWE CANOE AND SNOWSHOE COMPANY, INC.

Dennis W. Voigt, Assistant Professor
Saint Michael's College, Colchester, Vermont

Michael D. Flynn, Managing Partner
Gallagher Flynn & Company, Burlington, Vermont

BACKGROUND

After many years of helping entrepreneurs sell their successful businesses, Ed Kiniry finally decided to take the plunge and buy one of the businesses he was asked to sell. The business — Stowe Canoe and Snowshoe Company, Inc. — seemed simple enough. He could probably assemble a group of private investors, buy the company and manage it on a part-time basis while he continued as a business broker. He did assemble a group of investors and he did buy the business. But things did not turn out exactly the way he planned.

By the end of 1992, he had been working full-time in the business for some time, he was just beginning to launch a new line of lightweight aluminum snowshoes, and despite two recent rounds of investments by his private investors he was just about out of capital. He was probably thinking to himself, "So this is what it's like to own your own business;" and "Now, what do I do?"

THE BUSINESS

The original business was to manufacture and sell canoes. Along the way, the Tubbs snowshoe business was added. The snowshoe business brought with it a line of snowshoe furniture. By 1992, with the introduction of the new Tubbs' lightweight aluminum snowshoes and their innovative binding/crampon system, it appeared that the snowshoes just might become the dominant segment of the business.

This somehow seemed fitting. Founded in 1906 in Norway, Maine, by Walter F. Tubbs to manufacture ash snowshoes, skis, sleds and snowshoe furniture, Tubbs has a long heritage of opening new frontiers. Individually crafted by skilled woodworkers, Tubbs snowshoes carried Admiral Byrd on his expedition to the South Pole.

The introduction of the aluminum snowshoes marked a potential change in the manufacturing processes as well. While the wooden snowshoes and the canoes required a hand-crafted manufacturing process subject to the whims of wood and the effects of weather and humidity changes, the aluminum and other modern materials used in the metal snowshoes proved to be much more predictable and adaptable to a more automated manufacturing process.

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THE MARKETS

By 1992, the market for canoes, particularly premium canoes was rather crowded. Margins were shrinking and new customers seemed more inclined to purchase the less expensive, lower margin canoes.

Snowshoes, on the other hand, seemed to be enjoying a renaissance of sorts. While snowshoe sales, in general, were growing, there were also early indications that the new aluminum snowshoes just might revolutionize the market and introduce a whole new group of enthusiasts to this winter sport.

THE DILEMMA OF 1992

Just when the prospects for the future seemed to be brightening, there were still storm clouds on the horizon. To capitalize on the opportunities that the new aluminum snowshoes seemed to promise, would require capital. The shareholders had willingly provided $470,000 of new capital during 1992 for that purpose. But somehow things went desperately wrong in 1992.

The budget for the year called for an approximately $17,000 loss owing to the fact that the new line of snowshoes would be introduced in 1992. But by the end of the year, the company had suffered a whopping $300,000 loss — more or less eating up all of the new capital that had been provided for the expansion. To make matters worse, it was not immediately clear from the accounting and information system what went wrong. Selected data from their 1992 financial statements are presented in Exhibit I.

Ed was now in a fairly uncomfortable position, to say the least. He needed capital desperately. He knew something big was about to happen in the snowshoe market and he just had to be there to capitalize on it. But he couldn't go to the bank. And how could he go back to the shareholders and ask for more money from them? And more importantly, how could he figure out what happened in 1992 — not just to be able to explain it to the shareholders, but also to make sure that it didn't happen again. He needed some answers and he needed them very fast.

THE ACCOUNTING & INFORMATION SYSTEMS

As fate would have it, Ed's path soon re-crossed with a CPA by the name of Phil McKinnis. Ed had helped sell an inn that Phil owned and managed at a nearby ski resort. While owning and operating his own business, Phil had developed some elaborate systems for managing the business and controlling costs. Ed remembered that these systems and the financial success of the inn had been impressive. It turned out that Phil was filling his days by working as a consultant — sort of a management accountant/controller for hire. With a little coaxing, Phil agreed to try to help.

What Phil found was an accounting and information system that was simply not up to the task of providing timely and accurate financial information — particularly for their changing situation. While they knew what materials went into each product, they did not have a good idea of what their costs were. And because of the way that certain indirect costs and overhead were accounted for, it was very difficult to determine what the relative gross profit margins were for each product line.

Phil analyzed the financial statements for each month of 1992 and reconstructed cash flow statements for each month as well. He put together a make-shift manual cost accounting system. And together, Phil and Ed analyzed the actual results for 1992 against the budget, determined the variances and their causes, and devised corrective actions to be taken in 1993.

According to their analysis, very little of the variance was attributable to problems in the selling, general and administrative expense categories. Virtually all of the problems were attributable to sales volume, product mix, and product costing problems as follows:

Budgeted loss	$ (17,428)
Actual loss	(313,369)
Variance	(295,941)
Accounted for as follows:	
Selling expense	(6,525)
General and administrative expense	(7,340)
Sales volume	(31,450)
Price/product mix	(45,225)
Cost of goods manufactured & cost of goods sold	(205,401)
Total variance	$(295,941)

Clearly the cost and management accounting systems needed work.

THE PLAN & THE REQUEST

They also put together a plan to help the company break even immediately, if not sooner. They created a budget and plan for 1993 that was virtually a break-even scenario with a slight profit. They went back to the shareholders, presented the results for 1992, presented their analysis of the variances, and outlined their plans for 1993. Their planned budget for 1993, in condensed form, is presented in Exhibit II.

Their plans for 1993 included the continuation of the introduction of the new snowshoe line and made what they thought was a very compelling argument for the need for additional capital of approximately $400,000. Ed was convinced that they were poised to take the snowshoe market by storm; all they needed was a little more capital. He tried to convince the shareholders of this. Phil was convinced that they would be out of business if they didn't get some new capital and get it soon. He tried to convince the shareholders of the seriousness of the situation.

To put it politely, the shareholders were not particularly pleased that the nearly half a million dollars of fresh capital that they had contributed in 1992 was gone and that they were now being asked to contribute another $400,000 to protect their previous investments. As Phil put it, "We got beat up pretty bad."

QUESTIONS

Financial Accounting Issues

1. Assume you are one of the investors in the company. Assume you have just attended the shareholders' meeting. You've heard the plans. You've heard the explanations. You've been asked to invest more money in the business. What would you do?

2. Independent of your answer to question 1 above, assume that you have reluctantly agreed to invest additional funds in the business. What assurances from Ed and Phil would you want that there are internal controls and systems in place to protect this latest investment, to insure that the company is put on the right track, and to be absolutely sure that there are no more surprises? Try to be specific in your discussion of controls and systems. For instance, what additional information should the system provide about costs and products? As a major shareholder in a small corporation would you expect the information to be reported to you to be more detailed, especially as to product segments and costs, than the condensed form that is often reported in published financial statements?

Management Accounting Issues

1. Assume you are Phil McKinnis. What steps would you take to upgrade the internal management information systems. Specifically, what would you recommend for a cost accounting system?

2. Assume that as a condition to investing additional funds into the business the shareholders have asked you for assurances that proper controls and systems have been put into place to protect this additional investment and to be sure there were no more surprises. What assurances can you give them? What additional management accounting information, if any, might you suggest reporting to them on a periodic basis to keep them informed of the company's progress.

EXHIBIT I

SELECTED FINANCIAL STATEMENT INFORMATION FROM 1992

STOWE CANOE AND SNOWSHOE COMPANY, INC.
INCOME STATEMENT
For the Year Ended December 31, 1992

Net sales	$1,281,552
Cost of goods sold	1,020,774
Gross Profit	260,778
Selling, general and administrative expense	426,139
Operating income	(165,361)
Other income (expense)	(147,858)
Net income (loss) before taxes	(313,219)
Income taxes	150
Net income (loss)	$ (313,369)

STOWE CANOE AND SNOWSHOE COMPANY, INC.
BALANCE SHEET
December 31, 1992

ASSETS

CURRENT ASSETS	
Cash	$ 11,300
Accounts receivable (net)	370,806
Inventory	243,949
Prepaid expenses	11,000
Total current assets	637,055
PROPERTY AND EQUIPMENT (NET)	474,255
OTHER ASSETS	62,713
	$1,174,023

LIABILITIES AND STOCKHOLDERS' EQUITY

CURRENT LIABILITIES	
Notes payable — stockholders	$ 390,500
Current maturities of long-term debt	85,038
Accounts payable	206,949
Accrued liabilities	53,285
Income taxes payable	150
Total current liabilities	735,922
LONG-TERM DEBT	585,544
STOCKHOLDERS' DEFICIENCY	
Common stock	18,247
Additional paid-in capital	1,461,753
Accumulated deficit	(1,627,443)
Total Stockholders' Deficiency	(147,443)
	$1,174,023

EXHIBIT II

THE PLANNED BUDGET FOR 1993

Net sales	$1,860,153
Cost of goods sold	1,221,918
Gross profit	638,235
Selling, general and administrative	502,939
Operating income	135,296
Other income (expense)	125,534
Net income before taxes	9,762
Income taxes	0
Net income	$ 9,762

TUBBS SNOWSHOE COMPANY

Dennis W. Voigt, Assistant Professor
Saint Michael's College, Colchester, Vermont

Michael D. Flynn, Managing Partner
Gallagher Flynn & Company, Burlington, Vermont

BACKGROUND

After many years of helping entrepreneurs sell their successful businesses, Ed Kiniry had bought one of the businesses he was asked to sell. The business — Stowe Canoe and Snowshoe Company, Inc. — was later renamed to Tubbs Snowshoe Company in recognition of the prominent role he hoped the snowshoe business would play in the future. In order to buy the business he had assembled a group of private investors, who over the course of several years had contributed to several rounds of financing.

He had managed to weather a very difficult year in 1992, where they lost approximately $300,000. But now in 1993 he faced a new set of challenges.

THE BUSINESS

The original business was the manufacture and sale of canoes. Along the way, the Tubbs snowshoe business was added. The snowshoe business brought with it a line of snowshoe furniture. By 1992, with the introduction of the new Tubbs' lightweight aluminum snowshoes and their innovative binding/crampon system, it appeared that the snowshoes just might become the dominant segment of the business.

This somehow seemed fitting. Founded in 1906 in Norway, Maine, by Walter F. Tubbs to manufacture ash snowshoes, skis, sleds and snowshoe furniture, Tubbs has a long heritage of opening new frontiers. Individually crafted by skilled woodworkers, Tubbs snowshoes carried Admiral Byrd on his expedition to the South Pole.

The introduction of the aluminum snowshoes marked a potential change in the manufacturing processes as well. While the wooden snowshoes and the canoes required a hand-crafted manufacturing process subject to the whims of wood and the effects of weather and humidity changes, the aluminum and other modern materials used in the metal snowshoes proved to be much more predictable and adaptable to a more automated manufacturing process.

THE MARKETS

By 1993, the market for canoes, particularly premium canoes was rather crowded. Margins were shrinking and new customers seemed more inclined to purchase the less expensive, lower margin canoes.

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Snowshoes, on the other hand, seemed to be enjoying a renaissance of sorts. While snowshoe sales, in general, were growing, there were also early indications that the new aluminum snowshoes just might revolutionize the market and introduce a whole new group of enthusiasts to this winter sport. All indications at the end of 1993 were that the earlier prognosis had been correct — the new aluminum snowshoes were taking the market by storm.

THE DILEMMA OF 1992 AND THE ACCOUNTING & INFORMATION SYSTEMS PROBLEM

1992 together with the first part of 1993 had been a very difficult time. During 1992, the shareholders had willingly provided $470,000 of new capital to finance the expansion into the metal snowshoe business. But by the end of 1992 that capital was virtually all gone. And the new snowshoe line was still a long way from being fully launched.

The budget for 1992 had called for an approximately $17,000 loss owing to the fact that the new line of snowshoes would be introduced. But by the end of the year, the $300,000 loss had more or less eaten up all of the new capital that had been provided for the expansion. To make matters worse, it was not immediately clear from the accounting and information system what went wrong. The financial statements for 1992, in condensed form, are presented in Exhibit I.

Ed could not have been in a more uncomfortable position. He needed capital desperately. He knew something big was about to happen in the snowshoe market and he just had to be there to capitalize on it. But he couldn't go to the bank. And he couldn't to go back to the shareholders and ask for more money from them until he could figure out what happened in 1992 — not just to be able to explain it to the shareholders, but also to make sure that it didn't happen again. He needed some answers and he needed them very fast.

As luck would have it, Ed's path re-crossed with a CPA by the name of Phil McKinnis. Ed had helped sell an inn that Phil owned and managed at a nearby ski resort. While owning and operating his own business Phil had developed some elaborate systems for managing the business and controlling costs. Ed remembered that these systems and the financial success of the inn had been impressive. It turned out that Phil was filling his days by working as a consultant — sort of a management accountant/controller for hire. With a little coaxing, Phil had agreed to try to help.

What Phil found was an accounting and information system that was simply not up to the task of providing timely and accurate financial information — particularly for their changing situation. While they knew what materials went into each product, they did not have a good idea of what their costs were. And because of the way that certain indirect costs and overhead were accounted for, it was very difficult to determine what the relative gross profit margins were for each product line.

Phil analyzed the financial statements for each month of 1992 and reconstructed cash flow statements for each month as well. He put together a make-shift manual cost accounting system and updated the accounting and information system to provide gross profit margin information by product. And together, Phil and Ed had analyzed the actual results for 1992 against the budget, determined the variances and their causes, and devised corrective actions to be taken in 1993. Since virtually all of the variances were attributable to sales volume, product mix, and product costing problems, a great deal of attention was given in the accounting and information systems for product costing and control.

They created a budget and plan for 1993 that was virtually break even with a slight profit. They went back to the shareholders, presented the results for 1992, presented their analysis of the variances, and outlined their plans for 1993. Their planned budget for 1993, in condensed form, is presented in Exhibit II.

Their plans for 1993 included the continuation of the introduction of the new snowshoe line and made what they thought was a very compelling argument for the need for additional capital of approximately $400,000. Ed was convinced that they were poised to take the snowshoe market by storm; all they needed was a little more capital. He tried to convince the shareholders of this. Phil was convinced that they would be out of business if they didn't get some new capital and get it soon. He tried to convince the shareholders of the seriousness of the situation.

While the shareholders were not particularly pleased that the nearly half a million dollars of fresh capital that they had contributed in 1992 was gone, they reluctantly agreed to contribute another $400,000 to protect their

previous investments and see the launch of the new snowshoe line to completion. This did not come without tough questions put to both Ed and Phil. As Phil put it, "We got beat up pretty bad."

THE DILEMMA OF 1993

At least one of the shareholders suggested that if they really believed that the snowshoe business was the key to their future, why not sell the canoe business in order to free up more capital. Ed was reluctant to part with this part of the business. After all this was the original business he had bought. And the whole idea of adding the snowshoe business to the canoe business was to have two seasonal products — one for the winter and one for the summer. The suggestion of selling the canoe business seemed to fly in the face of this logic. And Ed still felt that with a little bit of time, he could bring it around to be a vital part of their overall business.

By the end of 1993, they had beat their plan with an approximate profit of $73,000. They had a reasonable cost accounting system in place and they experienced a favorable overall variance in manufacturing costs. The new snowshoe line was contributing revenues greater than the canoe line and seemed to be poised for further growth.

Ed had to make a decision. Certainly he could always use more capital. But he wasn't ready to give up on the canoe business just yet. And the balance of two products for two separate seasons seemed to have a certain logic. Yet several shareholders, successful business people in their own right, had argued very strongly that the canoe business should be sold. Maybe if he just had some more capital he could make the canoe business work.

QUESTIONS

Financial Accounting Issues

1. Assume you are the independent CPA for the company. Ed and Phil have described the shareholders' suggestion regarding sale of the canoe business. You have been a trusted business advisor to Ed for many years. He values your opinion. What would you recommend?

2. Independence is the cornerstone of the public accounting profession. This generally means that the CPA will not get involved in management decisions. What role do you think an independent CPA can play as a business advisor to small businesses like Tubbs?

Management Accounting Issues

1. Assume you are Phil McKinnis. Ed admits to you that he is having a hard time viewing the decision to sell or not sell the canoe business objectively. He asks you to prepare an analysis. Assume that the net sales will increase in 1994 by approximately $1,200,000 over 1993. If the canoe business is not sold, $200,000 of that increase will be attributable to the canoe business and the balance will be attributable to the snowshoes. If the canoe business is sold, net sales will still grow by the $1,200,000 in total. The snowshoe business will grow by $1,200,000 plus the $520,000 necessary to replace the 1993 net sales from the canoe business. Selling, general and administrative expenses will also increase by approximately $30,000 in order to support the increase in sales. Prepare a comparative analysis of the two possibilities.

2. Ed has asked you for your recommendation. Based on your analysis prepared for question 1 above, and the other factors such as seasonal balance, market conditions, manufacturing issues, and the like discussed in the case above, what would you recommend? Support your answer with a discussion of some of the operational issues discussed in the case, the product gross profit analysis provided in Exhibit III, as well as your comparative analysis prepared for question 1.

EXHIBIT I

SELECTED FINANCIAL STATEMENT INFORMATION FROM 1992

STOWE CANOE AND SNOWSHOE COMPANY, INC.
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For the Year Ended December 31, 1992

Net sales	$1,281,552
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STOWE CANOE AND SNOWSHOE COMPANY, INC.
BALANCE SHEET
December 31, 1992

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Inventory	243,949
Prepaid expenses	11,000
Total current assets	637,055
PROPERTY AND EQUIPMENT (NET)	474,255
OTHER ASSETS	62,713
	$1,174,023

LIABILITIES AND STOCKHOLDERS' EQUITY

CURRENT LIABILITIES	
Notes payable — stockholders	$ 390,500
Current maturities of long-term debt	85,038
Accounts payable	206,949
Accrued liabilities	53,285
Income taxes payable	150
Total current liabilities	735,922
LONG-TERM DEBT	585,544
STOCKHOLDERS' DEFICIENCY	
Common stock	18,247
Additional paid-in capital	1,461,753
Accumulated deficit	(1,627,443)
Total Stockholders' Deficiency	(147,443)
	$1,174,023

EXHIBIT II

THE PLANNED BUDGET FOR 1993

Net sales	$1,860,153
Cost of goods sold	1,221,918
Gross profit	638,235
Selling, general and administrative	502,939
Operating income	135,296
Other income (expense)	125,534
Net income before taxes	9,762
Income taxes	0
Net income	$ 9,762

EXHIBIT III

SELECTED FINANCIAL STATEMENT INFORMATION FROM 1993

STOWE CANOE AND SNOWSHOE COMPANY, INC.
INCOME STATEMENT
For the Year Ended December 31, 1993

Net sales	$2,163,097
Cost of goods sold	1,359,861
Gross Profit	803,236
Selling, general and administrative expense	625,953
Operating income	177,283
Other income (expense)	(93,352)
Net income (loss) before taxes	78,931
Income taxes	6,234
Net income (loss)	$ 72,697

DETAIL BY PRODUCT LINE

	Canoes	Snowshoes	Furn. & Other	Total
Net sales	$518,936	$1,581,984	$62,177	$2,163,097
Cost of goods sold	392,225	916,894	50,742	1,359,861
Gross profit	126,711	665,090	11,435	803,236
Gross profit % of sales	24.42%	42.04%	18.39%	37.13%

THE EVOLVING ROLE OF THE AUDIT COMMITTEE: THE CASE OF BELLSOUTH CORPORATION

(Year 2001 Update)

Wanda A. Wallace, The John N. Dalton Professor of Business Administration
The College of William and Mary, Williamsburg, Virginia

G. Thomas White, Accounting Program Coordinator
The College of William and Mary, Williamsburg, Virginia

Victor E. Jarvis, Chief Corporate Auditor
BellSouth Corporation

"The directors of . . . companies, . . . being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in private copartnery frequently watch over their own." (Adam Smith, 1776, *Wealth of Nations*, Book V, Chapter 1, part III, as cited by the Institute of Chartered Accountants of Scotland, *Auditing Into the Twenty-First Century*, William M. McInnes, Editor, 1993, p.1.)

As indicated in the opening quotation, the inherent limitations of non-resident ownership in maintaining control of companies in a capitalistic economic system have long been recognized. This case is about how organizations exercise control over their complex and ever-changing set of activities. When companies like Miniscribe are able to materially mislead their stockholders, creditors, and even the external auditors, many questions are raised about the fundamental conduct of modern-day business. In the case of Miniscribe an autocratic and strong-willed CEO was apparently able to override the company's internal control system, and the result is now well-documented history. With the advanced state of our accounting and auditing standards, and with other forms of regulation ever increasing how can situations like Miniscribe occur? A partial answer to this perplexing question may lie at the very highest level of organization governance – the board of directors. More specifically, many of the participants

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in the economic process have turned their attention to a sub-group of the board of directors, the audit committee. The Institute of Internal Auditors Research Foundation felt so strongly about the role of this group in maintaining or regaining control over their respective organizations, they commissioned a special research study. Conducted by Price Waterhouse and published in 1993, the best practices of effective audit committees were identified and reported. These are recent events; to get a more complete perspective on the perceived problems and possible solutions we need to go back a few more years.

Since 1987, considerable attention has been devoted to the role of the audit committee in corporate governance affairs in the United States. As information on numerous celebrated business failures surfaced, and as the facts concerning widespread problems in the financial institutions industry became known, focus was often directed towards management responsibility for these problems. Naturally, the question was raised about the oversight function of the board of directors (and the audit committee) in these instances.

This case will review some of the business community and regulatory responses concerning the role of the audit committee, with particular emphasis on the importance of monitoring and reporting on internal controls. The case of BellSouth Corporation will be presented in the context of these environmental events.

THE PRIVATE SECTOR RESPONDS

Treadway Commission

In October 1987, a report by the National Commission on Fraudulent Financial Reporting (Commission) focused on the roles of various participants in the financial reporting process. Specific recommendations were made addressing various components of this process, including top management responsibility for "maximizing the effectiveness of the functions within the company that are critical to the integrity of financial reporting: the accounting function, the internal audit function, and the audit committee of the board of directors" (page 31). Regarding the role of the audit committee in financial reporting matters the Commission made six recommendations, four of which are summarized below:

- The board of directors of all public companies should be required by SEC rule to establish audit committees composed solely of independent directors.

- Audit committees should be informed, vigilant, and effective overseers of the financial reporting process and the company's internal controls.

- All public companies should develop a written charter setting forth the duties and responsibilities of the audit committee . . .

- Audit committees should have adequate resources and authority to discharge their responsibilities.

In another section of the report, the Commission stated its belief that top management and the audit committee should communicate explicitly their respective responsibilities for the company's financial reporting to those who use that information. The Commission

recommended that a Securities and Exchange Commission (SEC) rule should require all public companies to include in their annual reports to stockholders a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year. See Exhibit 1 for the "Good Practice Guidelines for the Audit Committee" taken from the Treadway Commission report.

Committee of Sponsoring Organizations (COSO) of the Treadway Commission Report – Internal Control – An Integrated Framework

In 1992, the COSO report pointed out that although audit committees have received increased attention over the years, they are not universally required, and, their duties and activities have not been prescribed. Importantly, this report reaffirmed the key role that the audit committee plays in overseeing an organization's internal control process. In addition, it officially defines this process to broadly include the following categories:

- ❖ Effectiveness and efficiency of operations.
- ❖ Reliability of financial reporting.
- ❖ Compliance with applicable laws and regulations.

The report states: "The audit committee, in conjunction with or in addition to a strong internal audit function, is often in the best position within an entity to identify and act in instances where top management overrides internal controls . . . . Thus, there are instances where an audit committee, or board, must carry its oversight role to the point of directly addressing serious events or conditions" (page 83).

To assist management and boards of directors in fulfilling their responsibilities for their internal control process, the report identified five interrelated components of internal control:

- ❖ Control Environment
- ❖ Risk Assessment
- ❖ Control Activities
- ❖ Information and Communication
- ❖ Monitoring

The case authors, in a research report that followed the COSO report, suggest that the objective of safeguarding of assets be added to the COSO list of internal control categories.

1993 Public Oversight Board (of the SEC Practice Section) Report

In this report entitled "In the Public Interest: Issues Confronting the Accounting Profession," the Board makes a number of recommendations about the self-regulatory process of the accounting profession. There are several recommendations directed to audit committees, including the following:

"The SEC should require registrants to include in a document containing the annual financial statements a statement by the audit committee that describes its responsibilities and how they were discharged. This disclosure should state whether the audit committee members: (a) have reviewed the financial statements; (b) have conferred with management and the independent accountant about them; (c) have received from the independent auditor all information that the auditor is required to communicate under auditing standards; (d) believe the financial statements are complete and consistent with information known to them; and (e) believe the financial statements reflect appropriate accounting principles."

THE PUBLIC SECTOR RESPONDS

The summary of two regulatory events is included here to indicate the wide range of recent actions affecting the structure and activities of audit committees. While these relate directly to financial institutions, they may suggest a trend that could affect many other organizations.

In 1991 the General Accounting Office (GAO) issued a report which cited the perceived need for additional bank regulation in light of the significant problems associated with the industry during the late 1980's. Specifically, the GAO report evaluated audit committee effectiveness in the banking industry citing lack of independence by committee members. Also, lack of expertise in banking was also noted among many audit committee members.

Congress passed the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) that required the following for banks with $500 million or more in total assets:

"Audit committees are required to review with management, the independent accountant, and the director of internal auditing the basis for the newly mandated reports on the effectiveness of the institution's internal control structure and procedures and other reports required by the Act, as well as to review the basis for independent accountant's report on the annual financial statements."

THE CASE OF BELLSOUTH CORPORATION

Responsibility for BellSouth's financial reporting lies with top management, with oversight by the Board of Directors. The corporate structure of BellSouth Telecommunications also requires external financial reporting and a Board of Directors with similar oversight responsibilities. A significant part of these oversight activities is carried out by the Audit Committees of the Boards of Directors in regularly scheduled meetings to review the financial reporting process and system of internal controls. The audit committees also are charged with evaluating and recommending the services of the independent public accountants. In carrying out its responsibilities, each committee receives such reports and assistance as are required from Internal Auditing.

BellSouth had three audit committees at the end of 1992, each involved in oversight responsibilities. The BellSouth Corporation Audit Committee has oversight responsibilities corporate wide, whereas the BellSouth Telecommunications and BellSouth Enterprises Audit

Committees have oversight responsibilities for their respective entities. The Boards of Directors for BellSouth Corporation and BellSouth Telecommunications each have an Audit Committee composed of independent, outside directors who bring a broad range of management skill and experience to the assessment of the business environment and the goal of objective financial reporting. To assist these committees in carrying out their responsibilities, Internal Auditing provides each member an "Audit Committee Reference Binder" with background information about the respective company. The BellSouth Enterprises Audit Committee is composed of senior members of management from BellSouth Corporation and BellSouth Enterprises whose expertise enhances the oversight function of BellSouth Enterprises. Specifically, the Audit Committees carried out their responsibilities during 1992 in the following ways:

BellSouth Corporation Audit Committee

This committee met five times during the year. The four members of this Committee are all directors from outside of BellSouth. Senior management, the Assistant Vice President (AVP)—Chief Corporate Auditor, and representatives of the independent accounting firm also attended the meetings. At the meetings, the Committee reviewed audit activities and significant audits, the financial reporting process and adequacy of internal controls. The Committee also reviewed items of current interest and approved the 1993-1994 BellSouth Annual Audit Plan. The Committee made a recommendation as to the selection of the independent accountants, subject to the approval by the shareholders, and considered factors related to auditor independence. The Chief Corporate Auditor and the independent accountant met privately with the Audit Committee on occasion to encourage confidential discussions of auditing matters.

BellSouth Telecommunications Audit Committee

The BellSouth Telecommunications Audit Committee consists of four independent Directors who are neither officers nor employees of the respective companies. The Audit Committee met four times during the year. The Committee reviewed with the AVP—Chief Corporate Auditor, the Director—Internal Auditing, the independent accountant, and management the various audit activities and results of selected internal audits. The Committee also reviewed and approved the 1993-1994 BellSouth Telecommunications Internal Audit Plan. The Audit Committee reviewed the financial reporting process and the adequacy of internal controls. In addition, the Committee recommended the appointment of the independent accountants for BellSouth Telecommunications for 1993 and considered factors relating to their independence. The Director—Internal Auditing and the independent accountants met privately with the Audit Committee on occasion to encourage confidential discussions of auditing matters.

BellSouth Enterprises Audit Committee

This Committee met four times during the year to review the results of the previous quarter's audit activities. Significant audits were reviewed in detail along with management's plans for any necessary corrective action. The 1993-1994 Annual Audit Plan for BellSouth Enterprises was reviewed and approved. This Committee is composed of one officer from BellSouth Corporation and three from BellSouth Enterprises. Meetings were also attended by senior

management of BellSouth Enterprises, the AVP—Chief Corporate Auditor, and representatives from the independent accounting firm.

Other BellSouth Audit Committee Activities

In addition to the activities cited above, a number of other considerations came before BellSouth Audit Committees. Each audit committee reported its activities to the Board of Directors immediately after each meeting.

- Procedures for review of electronic data processing procedures and controls were covered as part of the annual audit plans. Any significant issues resulting from performance of these audits were covered with the Audit Committees.

- An annual review of all payments to the external auditors and other CPA firms with explanations was conducted; also, external auditors' engagement letters and proposed audit fees were discussed.

- Results of the external auditors' annual audit and management response to any issues raised in the management letter were discussed.

- Related party transactions of Board Members were reviewed for possible disclosure in the proxy statement.

- Formal replies to audits and management plans for corrective action were reviewed.

- Ethical considerations and issues related to conflicts of interest were reviewed.

- Credentials and competency of internal auditing staffs were evaluated.

Audit Committee Chairman's Letter

The following letter is included in the SEC Form 10-K for BellSouth Corporations for the fiscal year ended December 31, 1992:

The Audit Committee of the Board of Directors consists of four Directors who are neither officers nor employees of BellSouth Corporation. Information as to these persons, as well as the scope of duties of the Audit Committee, is provided in the Proxy Statement. The Audit Committee met five times during 1992 and reviewed with the Chief Corporate auditor, the independent accountant and management the various audit activities and plans, together with the results of selected internal audits. The Audit Committee also reviewed the financial reporting process and the adequacy of internal controls. The Audit Committee recommended, subject to shareholder ratification, the appointment of the independent accountants and considered factors relating to their independence. The Chief Corporate Auditor and the independent accountant met privately with the Audit Committee on occasion to encourage confidential discussions as to any auditing matters.

Signed: Thomas R. Williams
Chairman, Audit Committee

February 3, 1993

ADDENDUM—SUBSEQUENT EVENTS

Several developments in the financial reporting environment have occurred subsequent to the writing of the original case. These developments have direct implications for the structure and responsibilities of the audit committee and for overall corporate governance. In recent years, details have emerged about a disturbing number of financial reporting fraud cases in the United States, for example, Cendant, Microstrategy, and Sunbeam. While the specific circumstances in each of these cases are unique, subsequent investigation and analysis reveal some common threads. The Securities and Exchange Commission has identified what it believes are two areas of concern in these and similar alleged fraud cases—use of accounting techniques to inappropriately manage reported earnings, and perceived lack of independence with respect to the outside auditors. This addendum will summarize three related and recent reports, and/or regulatory action, that identify the need for increased audit committee involvement and effectiveness.

Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees

This report, issued in February 1999, resulted from an initiative of the New York Stock Exchange and the National Association of Securities Dealers. Ten recommendations for audit committees were made in the report.

- ❖ Adherence to a definition of independence of the audit committee members that prescribes no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation
- ❖ Listed companies with a market capitalization of $200 million or more to have an audit committee comprised solely of independent directors
- ❖ Listed companies with a market capitalization of $200 million or more to have an audit committee comprised of a minimum of three directors, each of whom is financially literate, and that at least one member of the audit committee have accounting or related financial management expertise
- ❖ Require the audit committees of listed companies to adopt a formal written charter approved by the full board of directors that specifies the scope of the committee's responsibilities, and that the charter be reviewed for adequacy on an annual basis
- ❖ The SEC should promulgate rules requiring the audit committee to disclose in the company's proxy statement adherence to the formally adopted written charter, and to include the charter in the proxy statement at least triennially
- ❖ Listing rules to require that the audit committee charter for every listed company specify that the outside auditor is ultimately accountable to the board of directors and the audit

committee (as shareholder representative), including selection and evaluation of the outside auditor

- ❖ The audit committee charter should specify that the audit committee ensures receipt of a formal written statement from the outside auditor delineating all relationships between the auditor and the company

- ❖ That generally accepted auditing standards require an outside auditor to discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles related to its financial reporting

- ❖ That the SEC require all reporting companies to include a letter from the audit committee in the company's annual report to stockholders--representing that the audit committee has discharged its financial reporting responsibilities relative to company management and the outside auditor

- ❖ That the SEC require a reporting company's outside auditor to conduct a SAS 71 interim financial review prior to the filing of its Form 10-Q

It is apparent that the Blue Ribbon Committee's recommendations have influenced later reports and SEC regulations, related to the entire corporate financial reporting process. Recent research (e.g., COSO, March 1999, and Cravens and Wallace, July-August 1999) has attempted to identify characteristics of audit committees and boards of directors, especially for those companies committing fraud. For example, the COSO commissioned research reported that the audit committees and boards of fraud companies appeared weak, rarely met, and were dominated by insiders or those with significant financial ties to the company. Cravens and Wallace reported that without uniform disclosure requirements for the board, it will be very difficult for the public or regulators to assess audit committee compliance with required guidelines and best practices.

Report of the Panel on Audit Effectiveness

This report from the Public Oversight Board in August 2000 made several recommendations for audit committees, including:

- ❖ Obtain annual reports from management assessing the company's internal controls

- ❖ Specify in audit committee charter that the outside auditor is ultimately accountable to the board and its audit committee

- ❖ Inquire about time pressures on the auditor

- ❖ Pre-approve non-audit services provided by the auditor

The report provides fairly specific guidance for the audit committee to use in determining the appropriateness of non-audit service by the auditor. This is an area that the SEC has targeted for close scrutiny as it relates to outside auditor compliance with the independence standard.

Final Rule: Revision of the Commission's Auditor Independence Requirements

This SEC rule became effective on February 5, 2001 and signaled a renewed regulatory emphasis on outside auditor independence. Specifically, the SEC ruling cited five areas of particular concern for auditor independence:

- Financial relationships
- Employment relationships
- Business relationships
- Transactions or situations involving the provision of non-audit services
- Transactions or situations involving the receipt of contingent fees

The SEC ruling contains additional detailed guidance for each of these five areas. For example, under the heading of financial relationships are guidelines for :

a. investments in audit clients
b. other financial interests
    1. loans/debtor-creditor relationships
    2. savings and checking accounts
    3. broker-dealer accounts
    4. futures commission merchant accounts
    5. credit cards
    6. insurance products
    7. investment companies
c. exceptions
    1. inheritance and gift
    2. new audit engagement
    3. employee compensation and benefit plans
d. audit clients' financial relationships
    1. investments by the audit client in the auditor
    2. underwriting

Similar detailed guidelines are identified for the remaining four targeted independence areas. Finally, as an indication of just how critical it perceives the need to strengthen outside auditor independence, the SEC issued a policy statement on July 17, 2001 amending Financial Reporting Release No. 50 to state that it will no longer look to the Independence Standards Board (a private sector initiative to develop auditor independence guidelines) for leadership in establishing and improving auditor independence standards applicable to auditors of the financial statements of Commission registrants.

QUESTIONS FOR DISCUSSION

1. Considering that the Good Practice Guidelines for the Audit Committee in Exhibit 1 are used as a model for audit committee structure and activity by many organizations, assess the audit committee activity described for BellSouth Corporation.

2. Given the movement toward more public reporting about the state of an organization's internal control process, evaluate the Audit Committee Chairman's letter for BellSouth Corporation for 1992 in relation to:

    a. COSO guidelines

    b. Legislative guidelines (i.e., FDICIA for banks)

3. As the role of audit committees will likely continue to evolve, identify other potential areas of audit committee activity not specifically addressed in the case.

4. Why do you believe the Blue Ribbon Committee focused on accounting or related financial management expertise as being essential for one member of the audit committee and a "financially literate" standard being applicable to all audit committee members? Access the most recent filings by BellSouth Corporation, comparing the disclosures to those provided in this case, with particular focus on the expertise represented on the audit committee. [Hint, you will particularly want to access the DEF14A filing.]

5. Optional Student Assignment—The SEC has made it clear that it expects the audit committee to serve as an essential component ensuring adherence to the independence standard by the outside auditor. Access the web pages of the Public Oversight Board and the SEC to document additional recommendations regarding the following:

    a. What guidelines exist for an audit committee to determine the appropriateness of a non-audit service provided by the outside auditor?

    b. What non-audit services have been identified by the SEC that potentially impair outside auditor independence?

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WHEN IS RESIGNATION NOT ENOUGH – AN ETHICAL DILEMMA

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In 1989, when Page Nolan decided to leave Smith, Jones, & Brown CPA firm and go to work in private business, the job with Anonymous Company seemed like an excellent opportunity. Anonymous Company had been a client of Smith, Jones, & Brown and Nolan had been involved on work for Anonymous Company. Nolan knew that Anonymous Company was a growing, basically healthy concern whose owners were notable people in the community. Having had the opportunity to work with them, Nolan knew that both the owners and the employees were congenial.

The work could be very challenging. Anonymous Company consisted of a series of more than twenty small businesses owned in part or in full by the Green family. The businesses were interrelated in that one business, run by one member of the family, would be involved in one stage of a project and another business, run by another member of the family, would be involved in another. Funds would flow from one segment to another depending on the stage of the projects. Several of these projects involved government financing. As controller, Nolan would be expected to see that the books for all the interrelated businesses were kept correctly, that incomes and expenses were assigned properly, and that government requirements were met.

As is not unusual, it was especially important and difficult to make sure that the government work was properly documented. One of the factors that added to the difficulty was that the agency concerned with financing Anonymous Company's projects would allow only a certain percentage of profit on each project. It was actually in conjunction with this government work that Nolan had become acquainted with Anonymous Company. Nolan had been involved in a review that was designed to ensure that Anonymous Company was following all the proper government guidelines. The review was done carefully in accordance with government agency standards and no problems were found.

Not long after starting work, Nolan noticed that a number of checks made out to an outside consultant and billed to the government work were endorsed over to one of the Schedule C units of the business and regularly deposited in the account of that unit. The consultant did, in fact, do work for the concern and was paid by the firm for his work. Such work and such charges were ordinary and customary in Anonymous Company's line of business. But Nolan discovered that a significant number of checks (totalling approximately $225,000) made

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out to the consultant were being deposited in the account of the most volatile of the business units. Profits for this unit were in excess of $4,000,000.

The bank had asked for second signatures on only about two out of fifty checks made out to the consultant and deposited in the Anonymous Company unit's account. The deposits were recorded on Anonymous's books as donated capital. Nolan was instructed not to send the consultant a 1099 form.

Nolan, wanting to clear up the apparent contradictions in the process and assuming that there was a logical explanation, approached one of the family members/unit managers for information. The manager admitted quite freely that they were adding the consultant's fee to the costs associated with the government projects and a secretary was writing the signature of the consultant on the checks. The manager was not a particularly sophisticated business person and seemed to see nothing particularly wrong with the practice.

Nolan went to the family member who was managing the unit receiving the funds and that member simply referred Nolan to the family member who had the greatest authority for the overall business. Nolan approached this person with the information and was told that it was necessary to do this to survive and that if a problem were to develop that it would be "handled when it got there." As the manager had considerable political clout, it might be quite true that it could be handled.

Nolan insisted that the unit show the funds from the checks as income, convincing the manager that a tax audit would be certain to question regular infusions of donated capital. Beyond that, Nolan did not know what to do. Revealing the information to the government agency would be likely to stop its occurrence, but it might have several other consequences as well. If it escalated to a full-blown court case, those who were responsible would be punished, but so would a number of people who had nothing to do with the issue. If, on the other hand, the owner's political pull was sufficient to hush the whole issue, Nolan would have sacrificed a job and possibly a career for no real results.

One of the steps that Nolan thought was immediately appropriate was, as a professional courtesy, to talk to one of the partners of Smith, Jones, & Brown to warn them of the risks associated with having Anonymous Company as a client. The response was confusing. The partner appeared to resent the visit. The assumption seemed to be that Nolan was wanting a job or was expecting some sort of reward. One thing that Nolan may have expected, but didn't get, was guidance on what the next step should be.

In Nolan's college classes, ethics were discussed, but those discussions nearly always centered around the ethics associated with being a member of a public accounting firm. Confidentiality was one of the ethical cornerstones. Nolan had serious questions about whether it was a breach of confidentiality to go to anyone outside the business with the information. What's more, there was a very real chance that nothing would ever be done.

Nolan took the most direct approach and went to the guiding force behind the business. In clear terms, Nolan communicated that the procedures that were being done were not what would be considered appropriate and that they would not continue under Nolan's tenure as controller. The upstanding community member said, "Well, you know where the door is." Nolan submitted a notice of resignation, worked out a month's notice, and left the firm behind.

QUESTIONS

1. What is the nature of the specific practice at Anonymous Company that raised the greatest concern for Page Nolan? Why is this a questionable practice? What purpose does it serve for the owners? What group or groups would have the most serious objections to the practice?

2. What are some alternatives that a principled CPA can consider when he/she discovers that an employer is engaging in these practices? Did Nolan do everything reasonably possible?

3. Was it appropriate for Nolan to go back to Smith, Jones & Brown and ask one of the partners for advice? Was this a violation of confidentiality?

4. Did the partner give an appropriate response to Nolan? Should he have done more?

5. What risks, rather than the obvious immediate financial loss, does Nolan take by resigning from this job? What risks would Nolan take by continuing to act as the controller for Green?

6. Should Nolan have resigned? If you knew more about Nolan's financial situation, would that make a difference in your answer?

7. Should Nolan have done more? Should Nolan report this practice to the appropriate governmental agency?

APPLICATION OF ABC AND ABSORPTION COSTING IN A DEVELOPING ECONOMY: IMPORTING RICE IN WEST AFRICA

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Rice is one of the staple foods in Mali, West Africa; and, happily for this country, most of what is consumed annually, between 72 and 85%, is grown on the rice paddies along the Niger River. However, a certain amount must be imported every year to make up for the deficit. About 90% of this importation is done so legally by two or three major importers, one of whose operations is described in the following case.

Mali's role in the world rice market is small; the country imports only 4% of the total rice traded in the world; the average over the past five years is about 60,000 tons. Still, for rice traders in Mali, an extra thousand or two tons in inventory can mean disaster for the trader's bottom line, and too little will mean lost revenues and serious shortages for the population. So making final decisions regarding the future marketability of rice is difficult business, and Amadou Takoure, an executive at one of the largest rice trading companies in Mali, was currently facing this process.

It was 10 a.m. on June 15, 1993, when Takoure, the Chief Financial Officer, was already feeling that the day had stretched too long in this hottest season of the year. He needed to budget rice imports for the year, and this was the season for making difficult importing decisions. Currently prices stood at $610, about $30 above the variable costs of importing rice (half of these variable costs is transportation and customs charges). Prices usually rise in the fall, but by how much depends on the rains and whether demand is rising.

Making the final decision on how much rice to import for arrival on August 15, in time for the fall market, is an exercise in information gathering (calling large rice associations in Segou, Mopti, Baguineda, and Selingue to find out what their harvests may be), historical analysis (looking at the past for any evidence of trends), inventory taking (assessing the total amount of rice in stock currently in the country), psychology (anticipating what the other importers are going to do, as well as what the smugglers are going to smuggle), and star-gazing (trying to anticipate rains and the resulting prices for rice three months from now in a highly unstable economy with several unpredictable factors). He called over his trusted assistant, Dramane Coulibaly, to talk through the company's cost constraints and get some fresh ideas.

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Takoure: Dramane, I need to get the right marketing mix among our main products — rice, refrigerators, air conditioners, and tiles — to cover our overhead and realize a profit. I have to say that I am thoroughly frustrated with our inability to bring down our overhead costs, which continue to average about $100,000 a month.

Coulibaly: Well, you know, we have the electric company, which seems to enjoy it enormously when we turn on a bit of air conditioning. And at $10 per minute for the boss's overseas calls, no wonder our phone bill is so huge. Plus we have those huge interest payments on the financing of our imports. It won't help to complain — we just need to get the right product mix to cover it. And, as you know, part of covering the overhead is deciding on a reasonable allocation system. You know that we have been using your system for a few quarters, where we allocate based on relative sales dollars, but we never predict accurately what sales will be. We really need to be sure that we are at least trying to get prices adequate to cover all the costs.

Takoure: You're right. We need to determine an allocation base that reflects our biggest headache, which is getting our merchandise sold as quickly as possible. Our tiles languish in the warehouse for an average of six months, our air conditioners for as long as four months, and our refrigerators as much as three months. Currently our variable costs on tiles per ton are about $12,016; on air conditioners, per unit about $418; and on refrigerators per unit, about $582.

Coulibaly: Did I tell you that interest rates have just gone up 50 basis points to 18%? You know this means that the longer our goods stay in those warehouses, the more we pay in interest, which is part of our overhead. I know we have very favorable arrangements at the bank where principal is due 120 days after the merchandise lands. Still since we are borrowing 100 percent of our variable costs, the faster we can sell, the faster we can pay the principal.

Takoure: By the way, what are we paying for our new warehouse?

Coulibaly: The warehouse for the durable goods costs $1,500 per month, and can hold 30,000 cubic feet of merchandise. I asked our warehouse supervisor to tell me how much of each item we can fit into the place. He told me that the refrigerators take up about thirty cubic feet, the air conditioners require five, and each ton of tiles requires about fifty. Oh, and each ton of rice takes up one hundred cubic feet in a grain warehouse. And you may want to know that the price of each of those 560,000 cubic foot grain warehouses, available as we need them, just doubled to one cent per cubic foot.

Takoure: OK. According to my market calculations, during this season we can import, store, and eventually sell 600 refrigerators, 1,000 air conditioners, and 15 tons of tiles. I estimate prices on these will be about $720, $600, and $18,000. Before I can make a decision on rice imports, I am going to have to do a little inventory study on current rice stocks in the country, and call around to the rice associations. Rains have begun to fall and though it is probably too early to tell, some of these farmers are pretty good at predicting the harvest for December anyway. We need to make a decision by this afternoon on the total we will import.

After calling the associations, he determined that the harvest would probably increase from last year (rains have been good so far), and there would be at least 270,000 tons harvested in the 1993–94 season. [See exhibit A.] If total consumption continued to rise, as it had over the past four years, an average of 13.7% annually, then the consumption for 1994 would be 378,000 tons. If contraband imports returned to the 36,000 ton level (a conservative estimate), then the total deficit would be 68,000 tons. This company traditionally had a large share of the rice import market, about 40%, so Takoure figured that he should import at least 27,000 tons. Right now he can buy rice at $580 per ton, including the cost of transportation and customs duty; and it would arrive on August 15. He expected that prices would rise, even with a good harvest, because of rising demand. He wanted to sell the first sacks of rice by mid-September for about $635 per ton, and he hoped to raise prices by 1% for each of the months of October and November. Takoure expected that he would have to reduce prices to $630 in

December during the harvest, and he hoped to have sold at least 26,000 tons by the New Year. He wondered if fully absorbed costs would be covered by these prices.

He began work on a spreadsheet that he would finish after lunch. He hoped by the time he met with his boss he would have an overhead allocation method which made sense.

EXHIBIT A

RICE STOCKS AND PRODUCTION

(all in thousand tons)

Fiscal Year: April 1–March 31	89–90	90–91	91–92	92–93	93–94**
Beginning balance, National stocks	34	55	23	22	24
+ Local rice production	158	186	155	245	270**
+ Imports of rice	40	8	118	70	68**
Legitimate resources available	232	249	296	337	362**
+ Contraband estimates	50	35	36	20	36**
Total available for consumption	282	284	332	357	398**
- Ending balance, National stocks	55	23	22	24	20**
Total consumption	227	261	310	333	378**

** Projection based on available local agricultural data