

Case 2-7 Milton Manufacturing Company

Milton Manufacturing Company produces a variety of textiles for distribution to wholesale manufacturers of clothing products. The company's primary operations are located in Long Island City, New York, with branch factories and warehouses in several surrounding cities. Milton Manufacturing is a closely held company, and Irv Milton is the president. He started the business in 2005, and it grew in revenue from \$500,000 to \$5 million in 10 years. However, the revenues declined to \$4.5 million in 2015. Net cash flows from all activities also were declining. The company was concerned because it planned to borrow \$20 million from the credit markets in the fourth quarter of 2016.

Irv Milton met with Ann Plotkin, the chief accounting officer (CAO), on January 15, 2016, to discuss a proposal by Plotkin to control cash outflows. He was not overly concerned about the recent decline in net cash flows from operating activities because these amounts were expected to increase in 2016 as a result of projected higher levels of revenue and cash collections. However, that was not Plotkin's view.

Plotkin knew that if overall negative capital expenditures continued to increase at the rate of 40 percent per year, Milton Manufacturing probably would not be able to borrow the \$20 million. Therefore, she suggested establishing a new policy to be instituted on a temporary basis. Each plant's capital expenditures for 2016 for investing activities would be limited to the level of those capital expenditures in 2013, the last year of an overall positive cash flow. Operating activity cash flows had no such restrictions. Irv Milton pointedly asked Plotkin about the possible negative effects of such a policy, but in the end, he was convinced that it was necessary to initiate the policy immediately to stem the tide of increases in capital expenditures. A summary of cash flows appears in [Exhibit 1](#).

EXHIBIT 1

MILTON MANUFACTURING COMPANY

Summary of Cash Flows

For the Years Ended December 31, 2015 and 2014 (000 omitted)

	December 31, 2015	December 31, 2014
Cash Flows from Operating Activities		
Net income	\$ 372	\$ 542
Adjustments to reconcile net income to net cash provided by operating activities	(2,350)	<u>(2,383)</u>
Net cash provided by operating activities	<u>\$ (1,978)</u>	<u>\$ (1,841)</u>
Cash Flows from Investing Activities		
Capital expenditures	\$ (1,420)	\$ (1,918)
Other investing inflows (outflows)	<u>176</u>	84
Net cash used in investing activities	<u>\$ (1,244)</u>	<u>\$ (1,834)</u>

Case 2-8 Juggyfroot

“I’m sorry, Lucy. That’s the way it is,” Ricardo said. The client wants it that way.

“I just don’t know if I can go along with it, Ricardo,” Lucy replied.

“I know. I agree with you. But, Juggyfroot is our biggest client, Lucy. They’ve warned us that they will put the engagement up for bid if we refuse to go along with the reclassification of marketable securities,” Ricardo explained.

“Have you spoken to Fred and Ethel about this?” Lucy asked.

“Are you kidding? They’re the ones who made the decision to go along with Juggyfroot,” Ricardo responded.

“I don’t care, Ricardo. I expect more from you. I didn’t join this firm to compromise my values.”

The previous scene took place in the office of Deziloo LLP, a large CPA firm in Beverly Hills, California. Lucy Spheroid is the partner on the engagement of Juggyfroot, a publicly owned global manufacturer of pots and pans and other household items. Ricardo Rikey is the managing partner of the office. Fred and Ethel are the engagement review partners that make final judgments on difficult accounting issues, especially when there is a difference of opinion with the client. All four are CPAs.

Ricardo Rikey is preparing for a meeting with Norman Baitz, the CEO of Juggyfroot. Ricardo knows that the company expects to borrow \$5 million next quarter and it wants to put the best possible face on its financial statements to impress the banks. That would explain why the company reclassified a \$2 million market loss on a trading investment to the available-for-sale category so that the “loss” would now show up in stockholder’s equity, not as a charge against current income. The result was to increase earnings in 2015 by 8 percent. Ricardo knows that without the change, the earnings would have declined by 2 percent and the company’s stock price would have taken a hit. However, he is also very aware of his ethical and professional responsibilities.

In the meeting, Ricardo decides to overlook the recommendation by Fred and Ethel. Ricardo points out to Baitz that the investment in question was marketable, and in the past, the company had sold similar investments in less than one year. Ricardo adds there is no justification under generally accepted accounting principles (GAAP) to change the classification from trading to available-for-sale.

What happened next shocked Ricardo back to reality? The conversation between Baitz and Ricardo went this way.

“I hate to bring it up, Ricardo, but do you recall what happened last year at about the same time?”

Case 2-9 Phar-Mor

The Dilemma

The story of Phar-Mor shows how quickly a company that built its earnings on fraudulent transactions can dissolve like an Alka-Seltzer.

One day, Stan Cherelestein, the controller of Phar-Mor, discovered cabinets stuffed with held checks totaling \$10 million. Phar-Mor couldn't release the checks to vendors because it did not have enough cash in the bank to cover the amount. Cherelestein wondered what he should do.

Background

Phar-Mor was a chain of discount drugstores, based in Youngstown, Ohio, and founded in 1982 by Michael Monus and David Shapira. In less than 10 years, the company grew from 15 to 310 stores and had 25,000 employees. According to Litigation Release No. 14716 issued by the SEC, Phar-Mor had cumulatively overstated income by \$290 million between 1987 and 1991. In 1992, prior to disclosure of the fraud, the company overstated income by an additional \$238 million.

The Cast of Characters

Mickey Monus personifies the hard-driving entrepreneur who is bound and determined to make it big whatever the cost. He served as the president and chief operating officer (COO) of Phar-Mor from its inception until a corporate restructuring was announced on July 28, 1992.

David Shapira was the CEO of both Phar-Mor and Giant Eagle, Phar-Mor's parent company and majority stockholder. Giant Eagle also owned Tamco, which was one of Phar-Mor's major suppliers. Shapira left day-to-day operations of Phar-Mor to Monus until the fraud became too large and persistent to ignore.

Patrick Finn was the CFO of Phar-Mor from 1988 to 1992. He brought Monus the bad news that, following a number of years of eroding profits, the company faced millions in losses in 1989.

John Anderson was the accounting manager at Phar-Mor. Hired after completing a college degree in accounting at Youngstown State University, Anderson became a part of the fraud.

Coopers & Lybrand, prior to its merger with Price Waterhouse, were the auditors of Phar-Mor. The firm failed to detect the fraud as it was unfolding.

How It Started

The facts of this case are taken from the SEC filing and a PBS *Frontline* episode called "How to Steal \$500 Million." The interpretation of the facts is consistent with reports, but some literary license has been taken to add intrigue to the case.

Case 2-10 WorldCom

The WorldCom fraud was the largest in U.S. history, surpassing even that of Enron. Beginning modestly during mid-year 1999 and continuing at an accelerated pace through May 2002, the company—under the direction of Bernie Ebbers, the CEO; Scott Sullivan, the CFO; David Myers, the controller; and Buford Yates, the director of accounting—“cooked the books” to the tune of about \$11 billion of misstated earnings. Investors collectively lost \$30 billion as a result of the fraud.

The fraud was accomplished primarily in two ways:

1. Booking “line costs” for interconnectivity with other telecommunications companies as capital expenditures rather than operating expenses.
2. Inflating revenues with bogus accounting entries from “corporate unallocated revenue accounts.”

During 2002, Cynthia Cooper, the vice president of internal auditing, responded to a tip about improper accounting by having her team do an exhaustive hunt for the improperly recorded line costs that were also known as “prepaid capacity.” That name was designed to mask the true nature of the costs and treat them as capitalizable costs rather than as operating expenses. The team worked tirelessly, often at night and secretly, to investigate and reveal \$3.8 billion worth of fraud.

Soon thereafter, Cooper notified the company’s audit committee and board of directors of the fraud. The initial response was not to take action, but to look for explanations from Sullivan. Over time, Cooper realized that she needed to be persistent and not give in to pressure that Sullivan was putting on her to back off. Cooper even approached KPMG, the auditors that had replaced Arthur Andersen, to support her in the matter. Ultimately, Sullivan was dismissed, Myers resigned, Andersen withdrew its audit opinion for 2001, and the Securities and Exchange Commission (SEC) began an investigation into the fraud on June 26, 2002.

In an interview with David Katz and Julia Homer for *CFO Magazine* on February 1, 2008, Cynthia Cooper was asked about her whistleblower role in the WorldCom fraud. When asked when she first suspected something was amiss, Cooper said: “It was a process. My feelings changed from curiosity to discomfort to suspicion based on some of the accounting entries my team and I had identified, and also on the odd reactions I was getting from some of the finance executives.”

Cooper did exactly what is expected of a good auditor. She approached the investigation of line-cost accounting with a healthy dose of skepticism and maintained her integrity throughout, even as Sullivan was trying to bully her into dropping the investigation.

When asked whether there was anything about the culture of WorldCom that contributed to the scandal, Cooper laid blame on Bernie Ebbers for his risk-taking approach that led to loading up the company with \$40 billion in debt to fund one acquisition after another. He followed the same reckless strategy with his own investments, taking out loans and using his WorldCom stock as

Chapter 2 Discussion Questions

Suggested Discussion and Solutions

Sometimes in life things happen that seem to defy logic, yet that may be a sign of the times we are living in today. The following story applies to questions 1 and 2:

On October 15, 2009, in Fort Collins, Colorado, the parents of a six-year-old boy, Falcon Heene, claimed that he had floated away in a homemade helium balloon that was shaped to resemble a silver flying saucer. Some in the media referred to the incident as “Balloon Boy.” The authorities closed down Denver International Airport, called in the National Guard, and a police pursuit ensued. After an hour-long flight that covered more than 50 miles across three counties, the empty balloon was found near the airport. It was later determined that the boy was hiding in the house all along in an incident that was a hoax and motivated by publicity that might lead to a reality television show. The authorities blamed the father, Richard, for the incident and decided to prosecute him. Richard Heene pleaded guilty on November 13, 2009, to the felony count of falsely influencing authorities. He pleaded to protect his wife, Mayumi, a Japanese citizen, whom he believed may have been deported if Richard was convicted of a more serious crime. Richard also agreed to pay \$36,000 in restitution.

1. **Identify the stakeholders and how they were affected by Heene’s actions using ethical reasoning. What stage of moral reasoning in Kohlberg’s model is exhibited by Richard Heene’s actions? Do you believe the punishment fit the crime? In other words, was justice done in this case? Why or why not?**

The stakeholders in the “Balloon Boy Hoax” are the boy, Falcon Heene; the parents, Richard and Mayumi Heene; brothers, Bradford and Ryo Heene; Larimer County sheriff, Jim Alderman; Denver International Airport travelers and employees; National Guard unit; local police; search and rescue teams; media and news services; Colorado taxpayers; and the public.

The public through the media watched and worried about the fate of the boy in the balloon. Colorado taxpayers footed the bill for the \$50,000 costs of personnel time, equipment and other incidentals to track the balloon, search and rescue mission, and investigation of the hoax. Denver International Airport closed to avoid collision with the balloon. Travelers were delayed and flights rerouted or rescheduled. Airport employees had to remain calm and courteous as travelers became frustrated with delays, missed flight times, and rescheduling.

Local police, the National Guard unit, and search and rescue teams spent hours and used expensive equipment to track and hunt for the balloon and boy while Falcon was safe the whole time. Sheriff Jim Alderman had to conduct investigations under intense media scrutiny. At first, the media was incredulous that the parents were being questioned and investigated. Then Sheriff Alderman was ridiculed for not detecting the hoax sooner.

Case 2-1 A Team Player? (a GVV case)

Barbara is working on the audit of a client with a group of five other staff-level employees. During the audit, Diane, a member of the group, points out that she identified a deficiency in the client's inventory system that she did not discover during the physical observation of the client's inventory. The deficiency was relatively minor, and perhaps that is why it was not detected at the time. Barbara suggests to Diane that they bring the matter to Jessica, the senior in charge of the engagement. Diane does not want to do it because she is the one who identified the deficiency and she is the one who should have detected it at the time of the observation. Three of the other four staff members agree with Diane. Haley is the only one, along with Barbara, who wants to inform Jessica.

After an extended discussion of the matter, the group votes and decides not to inform Jessica. Still, Barbara does not feel right about it. She wonders: What if Jessica finds out another way? What if the deficiency is more serious than Diane has said? What if it portends other problems with the client? She decides to raise all these issues but is rebuked by the others who remind her that the team is already behind on its work and any additional audit procedures would increase the time spent on the audit and make them all look incompetent. They remind Barbara that Jessica is a stickler for keeping to the budget and any overages cannot be billed to the client.

Questions

- 1. Discuss these issues from the perspective of Kohlberg's model of moral development. How does this relate to the established norms of the work group as you see it?**

Diane and the ones who did not want to take the matter to Jessica, the senior, are reasoning at the preconventional levels of avoiding punishment and satisfying one's own needs. They want to avoid having more work to do or receiving a low evaluation from missing a mistake (Diane) or going over the time budget. Barbara and Haley are reasoning at the conventional and, possibly, postconventional levels. They want to be fair to the firm, the client, and the public, and know that they are following audit standards (law and order). It is possible that they are reasoning at level 5, social contract. They fully understand the social contract CPAs undertake to protect the public interest in financial markets. Barbara understands that the deficiency could be more serious than the group of staff auditors understands or that the deficiency could portend other problems. It could also portend problems with internal control deficiencies over financial reporting, which is the most cited deficiency of audit firms by the PCAOB.

Often groups want to have a clear cut leader or work by majority rule. However, ethics does not go along well with majority rule. If a group decides by majority rule to rob someone, it does not make the theft right or ethical. Barbara should tell Jessica about the deficiency.

- 2. Assume you are in Barbara's position. What would you do and why? Consider the following in answering the question:**

Case 2-2 FDA Liability Concerns (a GVV case)

Gregory and Alex started a small business based on a secret-recipe salad dressing that got rave reviews. Gregory runs the business end and makes all final operational decisions. Alex runs the creative side of the business.

Alex's salad dressing was a jalapeno vinaigrette that went great with barbeque or burgers. He got so many requests for the recipe and a local restaurant asked to use it as the house special, that Alex decided to bottle and market the dressing to the big box stores. Whole Foods and Trader Joe's carried the dressing; sales were increasing every month. As the business grew, Gregory and Alex hired Michael, a college friend and CPA, to be the CFO of the company.

Michael's first suggestion was to do a five-year strategic plan with expanding product lines and taking the company public or selling it within five to seven years. Gregory and Alex weren't sure about wanting to go public and losing control, but expanding the product lines was appealing. Michael also wanted to contain costs and increase profit margins.

At Alex's insistence, they called a meeting with Michael to discuss his plans. "Michael, we hired you to take care of the accounting and the financial details," Alex said. "We don't understand profit margins. On containing costs, the best ingredients must be used to ensure the quality of the dressing. We must meet all FDA requirements for food safety and containment of food borne bacteria, such as listeria or e coli, as you develop cost systems."

"Of course," Michael responded. "I will put processes in place to meet the FDA requirements."

At the next quarterly meeting of the officers, Alex wanted an update on the FDA processes and the latest inspection. He was concerned whether Michael understood the importance of full compliance.

"Michael," Alex said, "the FDA inspector and I had a discussion while he was here. He wanted to make sure I understood the processes and the liabilities of the company if foodborne bacteria are traced to our products. Are we doing everything by the book and reserving some liabilities for any future recalls?"

Michael assured Alex and Gregory that everything was being done by the book and the accounting was following standard practices. Over the next 18 months, the FDA inspectors came and Michael reported everything was fine.

After the next inspection, there was some listeria found in the product. The FDA insisted on a recall of batch 57839. Alex wanted to recall all the product to make sure that all batches were safe.

"A total recall is too expensive and would mean that the product could be off the shelves for three to four weeks. It would be hard to regain our shelf advantage and we would lose market share," Michael explained.

Case 2-3 The Tax Return (a GVV case)

Brenda Sells sent the tax return that she prepared for the president of Purple Industries, Inc., Harry Kohn, to Vincent Dim, the manager of the tax department at her accounting firm. Dim asked Sells to come to his office at 9 a.m. on Friday, April 12, 2016. Sells was not sure why Dim wanted to speak to her. The only reason she could come up with was the tax return for Kohn.

“Brenda, come in,” Vincent said.

“Thank you, Vincent,” Brenda responded.

“Do you know why I asked to see you?”

“I’m not sure. Does it have something to do with the tax return for Mr. Kohn?” asked Brenda.

“That’s right,” answered Vincent.

“Is there a problem?” Brenda asked.

“I just spoke with Kohn. I told him that you want to report his winnings from the lottery. He was incensed.”

“Why?” Brenda asked. “You and I both know that the tax law is quite clear on this matter. When a taxpayer wins money by playing the lottery, then that amount must be reported as revenue. The taxpayer can offset lottery gains with lottery losses, if those are supportable. Of course, the losses cannot be higher than the amount of the gains. In the case of Mr. Kohn, the losses exceed the gains, so there is no net tax effect. I don’t see the problem.”

“You’re missing the basic point that the deduction for losses is only available if you itemize deductions,” Vincent said. “Kohn is not doing that. He’s using the standard deduction.”

Brenda realized she had blown it by not knowing that.

Brenda didn’t know what to say. Vincent seemed to be telling her the lottery amounts shouldn’t be reported. But that was against the law. She asked, “Are you telling me to forget about the lottery amounts on Mr. Kohn’s tax return?”

“I want you to go back to your office and think carefully about the situation. Consider that this is a one-time request and we value our staff members who are willing to be flexible in such situations. And, I’ll tell you, other staff in the same situation have been loyal to the firm. Let’s meet again in my office tomorrow at 9 a.m.”

Questions

- 1. Analyze the alternatives available to Brenda using Kohlberg’s six stages of moral development. Assume that Brenda has no reason to doubt Vincent’s veracity with**

Case 2-4 A Faulty Budget (a GVV Case)

Jackson Daniels graduated from Lynchberg State College two years ago. Since graduating from college, he has worked in the accounting department of Lynchberg Manufacturing. Daniels was recently asked to prepare a sales budget for the year 2016. He conducted a thorough analysis and came out with projected sales of 250,000 units of product. That represents a 25 percent increase over 2015.

Daniels went to lunch with his best friend, Jonathan Walker, to celebrate the completion of his first solo job. Walker noticed Daniels seemed very distant. He asked what the matter was. Daniels stroked his chin, ran his hand through his bushy, black hair, took another drink of scotch, and looked straight into the eyes of his friend of 20 years. “Jon, I think I made a mistake with the budget.”

“What do you mean?” Walker answered.

“You know how we developed a new process to manufacture soaking tanks to keep the ingredients fresh?”

“Yes,” Walker answered.

“Well, I projected twice the level of sales for that product than will likely occur.”

“Are you sure?” Walker asked.

“I checked my numbers. I’m sure. It was just a mistake on my part.”

Walker asked Daniels what he planned to do about it.

“I think I should report it to Pete. He’s the one who acted on the numbers to hire additional workers to produce the soaking tanks,” Daniels said.

“Wait a second, Jack. How do you know there won’t be extra demand for the product? You and I both know demand is a tricky number to project, especially when a new product comes on the market. Why don’t you sit back and wait to see what happens?”

“Jon, I owe it to Pete to be honest. He hired me.”

“You know Pete is always pressuring us to ‘make the numbers.’ Also, Pete has a zero tolerance for employees who make mistakes. That’s why it’s standard practice around here to sweep things under the rug. Besides, it’s a one-time event—right?”

“But what happens if I’m right and the sales numbers were wrong? What happens if the demand does not increase beyond what I now know to be the correct projected level?”

Case 2-5 Gateway Hospital (a GVV case)

Troy just returned from a business trip for health-care administrators in Orlando. Kristen, a relatively new employee who reports to him, also attended the conference. They both work for Gateway Hospital, a for-profit hospital in the St. Louis area. The Orlando conference included training in the newest reporting requirements in the health-care industry, networking with other hospital administrators, reports on upcoming legislation in health care, and the current status of regulations related to the Affordable Care Act. The conference was in late March and coincided with Troy's kids' spring break, so the entire family traveled to Orlando to check out Walt Disney World and SeaWorld.

The hospital's expense reimbursement policy is very clear on the need for receipts for all reimbursements. Meals are covered for those not provided as part of the conference registration fee, but only within a preset range. Troy has never had a problem following those guidelines. However, the trip to Orlando was more expensive than Troy expected. He did not attend all sessions of the conference, to enjoy time with his family. Upon their return to St. Louis, Troy's wife suggested that Troy submit three meals and one extra night at the hotel as business expenses, even though they were personal expenses. Her rationale was that the hospital policies would not totally cover the business costs of the trip. Troy often has to travel and misses family time that cannot be recovered or replaced. Troy also knows that his boss has a reputation of signing forms without reading or careful examination. He realizes the amount involved is not material and probably won't be detected.

Kristen is approached by Joyce, the head of the accounting department, about Troy's expenses, which seem high and not quite right. Kristen is asked about the extra night because she did not ask for reimbursement for that time. Kristen knows it can be easily explained by saying Troy had to stay an extra day for additional meetings, a common occurrence for administrators, although that was not the case. She also knows that the hospital has poor controls and a culture of "not rocking the boat," and that other employees have routinely inflated expense reports in the past.

Assume you, as Kristen, have decided the best approach, at least in the short run, is to put off responding to Joyce so that you can discuss the matter with Troy. Answer the following questions.

Questions

- 1. What are the main arguments you feel Troy will make and reasons and rationalizations you need to address?**

Troy may want to argue that it is only one night, he has been a long time employee, the amount is not material, everyone else does the same, and that he will cover for Kristen in the future. Kristen will need to be prepared to counter each of those rationalizations. She may also want to explain why she does not want to go against her values of honesty, integrity, responsibility, and trustworthiness. She can also explain in fairness to other employees, the firm cannot pay personal expenses for one employee but not for others.

Case 2-6 LinkedIn and Shut Out

The facts of this case are fictional. Any resemblance to real persons, living or dead, is purely coincidental.

Kenny is always looking to make contacts in the business world and enhance his networking experiences. He knows how important it is to drive customers to his sports memorabilia business. He's just a small seller in the Mall of America in Bloomington, Minnesota.

Kenny decided to go on LinkedIn. Within the first few weeks, he received a number of requests that said, "I'd like to add you to my professional network." At first almost all of such requests came from friends and associates he knew quite well. After a while, however, he started to receive similar requests from people he didn't know. He would click on the "view profile" button, but that didn't provide much useful information so he no longer looked at profiles for every request. He simply clicked the "accept" button and the "You are now connected" message appeared.

One day Kenny received the following message with a request to "connect":

"I plan to come to your sports memorabilia store in the future so I thought I'd introduce myself first. I am a financial planner and have helped small business owners like yourself to develop financial plans that provide returns on their investments three times the average rate received for conventional investments. I'm confident I can do the same for you. As a qualified professional, you can trust my services."

Kenny didn't think much about it. It certainly sounded legitimate. Besides, he would meet the financial planner soon and could judge the type of person he was. So, Kenny linked with the planner.

A week later, the financial planner dropped by Kenny's store and provided lots of data to show that he had successfully increased returns for dozens of people. He even had testimonials with him. Kenny agreed to meet with him in his St. Paul office later that week to discuss financial planning.

The meeting took place and Kenny gave the financial planner a check for \$30,000, which was most of Kenny's liquid assets. At first the returns looked amazing. Each of the first two quarterly statements he received from the planner indicated that he had already earned \$5,000; a total of \$10,000 in six months. Three months later Kenny did not receive a statement. He called the planner and the phone had been disconnected. He sent emails but they were returned as not valid. No luck with text messages.

Kenny started to worry whether he ever would see his money – at least the \$30,000. He was at a loss what to do. A friend suggested he contact LinkedIn and see if it could help. His online contact led to the following response in an email: