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Should Finance Make the Numbers "Come Out?"

BY ROLAND L. MADISON, CPA

The following case study presents a management accountant who knows how to correctly apply technical knowledge but feels pressured to make inappropriate estimates to achieve a desired end result. How would you or your subordinates react under such pressure?

Amy Kimbell, a member of IMA, holds certifications as both a CPA and a CMA. She has an advanced degree in business from a well-known university and recently joined ABC Metals and Molding, Inc. (ABC) as a senior financial analyst in charge of planning and financial analysis after spending nearly five years with a large regional accounting firm. Tony Smith, chief financial officer of ABC, joined the company two years earlier after being a partner in a national accounting firm. He is a CPA in several states.

One of ABC's goals is to get their products into international markets. This requires the company's sales and management personnel to travel to Canada, Mexico, and South America with great regularity. Over the last 10 years, ABC developed a fleet of four corporate aircraft. The fleet is adequate for serving the domestic market, but only one of the four planes is capable of efficiently reaching the international target markets for ABC.

Smith has obtained information on the purchase price of a new medium-sized, long-range corporate executive jet that could reach the targeted global markets for ABC. He believes that any flight time not used by ABC can be subleased. He has instructed Kimbell to perform the standard net present value (NPV) analysis required by ABC's board of directors when any capital asset costing more than $1 million is being considered.

After making necessary inquiries within the company, Kimbell made what she thought were reasonable estimates, did the analysis, and gave her report with supporting documentation to Smith. The results were a negative NPV. Seeing this, Smith knew that the board's budget committee wouldn't approve the project. He told Kimbell to "recheck her work" because his preliminary estimate showed the result should have been positive. As a team player aware of ABC's wish to expand its markets beyond the United States, Kimbell wanted to provide Smith with the needed documentation.

Specifically, Smith told Kimbell to increase the estimated salvage value by 50% and the sublease usage rate by one-third. He also told her to see if the economic useful life (e.g., the total sublease rental period) should be changed from the 15 years she used to 25 years.

Upon receiving these suggestions from Smith, Kimbell contacted a

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representative of the aircraft manufacturer. The representative informed her that the residual value she had originally estimated was slightly conservative but that the new amount she received from Smith was extremely optimistic—even to the point of being excessive.

The manufacturer's representative went on to tell Kimbell that while the sublease usage rate she had developed for the aircraft also was slightly conservative, the revised rate she was given by Smith simply wasn't reasonable in the present market for subleased or shared-ownership aircraft.

Finally, while it wasn't unusual for the aircraft in question to be flown for a period of 15, even 20, years before being nearly totally rebuilt (e.g., new cabins, engines, avionics), operating costs typically increased significantly after about 10 years. By the time the plane has been used for 15 years, operating costs would become prohibitive to the point of causing the timing of rebuild work to be accelerated by up to five years. In other words, a useful life of 25 years for the aircraft couldn't be utilized in the NPV budgeting process without acknowledging the additional expenses needed to keep the plane in the air that long: the significantly increased operating costs after 10 years and the rebuild costs required after 15 years.

After Kimbell made the revisions that reflected her conversations with the aircraft manufacturer's representative, the revised NPV analysis showed an even larger negative net present value. She knew Smith wouldn't be happy because the board's budget committee would surely reject the proposal now. They rarely made exceptions to policy without extenuating circumstances.

When Kimbell showed the report to Smith, he became extremely angry that she hadn't followed his earlier suggestions. He directed her to make the changes exactly as he said and to remove any changes that were based on information she had obtained from the manufacturer's representative. He charged her to have the revised analysis to him by the end of the week for the budget committee's next meeting in 10 days.

QUESTIONS:

1. What additional facts, if any, do you need to help you solve this case?
2. What actions should Kimbell take to comply with IMA's Standards of Ethical Conduct? What specific portions of the Standards are applicable in this case?
3. Can you think of any way Kimbell can resolve this ethical dilemma?
4. Should Kimbell consider following the instructions Smith gave her and make the changes he directed, noting that the source of the most critical estimates is the CFO?
5. If she decides to go along with what Smith wants and also doesn't say anything about the source of the estimates, should she send an unsigned note to the chair of the budget committee, detailing the flaws contained in the proposal? Should she mention this subject to ABC's banker, whom she has met on a social basis?
6. Should Kimbell report Smith's behavior to the state CPA societies in which he is licensed?

Restatements Continue as SOX 404's Influence Extends

Restatements of public company financial statements increased a dramatic 28% in 2004, according to the annual survey by Huron Consulting Group. Huron's spokesperson, who attributed the rise to increased scrutiny on internal controls and other pressures while noting a rising trend in the number of periods contained in each restatement, said, "Multiple period restatements point to flawed accounting policies, practices, and errors occurring over a period of time." For the fifth consecutive year, restatements of at least three prior annual periods amounted to nearly 40% of the restatements reported.

Further supporting the belief that systemic problems are the usual cause, 15% of the 2004 restatements were by "repeaters"—those reporting erroneous financial information on more than one occasion since 1997. In a possibly related development, the number of shareowner class action lawsuits in 2004 increased by 17%, according to Stanford's Law School.

According to a report by Financial Executives International, more and more lenders and states are asking private companies about the status of their internal control environment. Private companies can also expect that the audit procedures used by their external audit firm may become more "integrated" with internal controls as many audit firms change their firm audit procedures.—*Curtis C. Verschoor*

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