Carl Menconi Case Writing Competition

Virtues in Conflict

By Elizabeth Dunn, CPA

The Institute of Management Accountants (IMA®) Committee on Ethics and IMA Professor-in-Residence Sandra B. Richtermeyer, CMA, CPA, are proud to announce that Elizabeth Dunn, CPA, has won the Best Case Award of the first annual Carl Menconi Case Writing Competition for her case, "Virtues in Conflict." The competition is named in memory of Carl Menconi, who held leadership positions in IMA for many years and served as the chair of the IMA Committee on Ethics. The objective of the competition is to develop and distribute business ethics cases with specific application to management accounting and finance issues and that use IMA's Statement of Ethical Professional Practice *as a reference or guidance tool. The winning case and teaching notes are available for use in a classroom or business setting.*

CASE NARRATIVE: VIRTUES IN CONFLICT

Sarah Grant is the CFO of Frame Tec, Inc., a large regional construction contractor with approximately 300 employees. The owners are exceptionally kind and intelligent carpenters who worked their way up in the business world through hard work and solid ethics. Sarah has enjoyed working with them for more than 10 years. They have accepted her as an essential part of the upper management team, and they rely on her judgment.

Sarah and the upper management team had a rough stretch about a year ago. Against Sarah's strongest recommendations, the owners decided to buy lumber directly from lumber mills and hired Jack Jones, a lumber professional, to handle the purchasing. Prior to this, Frame Tec utilized the services of resellers. Resellers usually provide fixed bids for lumber pricing when a project is estimated. They hold their prices and normally bear the risk for changing market conditions. Sarah was very concerned that the company was taking an unnecessary risk by losing protection from market fluctuation because lumber is Frame Tec's largest single cost. The market had been relatively stable historically, however, so Sarah accepted the owners' decision and hoped for the best.

The lumber market stayed fairly stable, and the past year was an excellent one for the company. Frame Tec's projects were profitable, and it signed new contracts sufficient for all of next year. Sarah is planning her portion of the next scheduled board meeting, where she will speak to the two owners of Frame Tec. They are anticipating the meeting to be filled with conversations about holiday bonuses and customer appreciation gifts, but Sarah has just received bad news. Her staff compiled the purchase orders for the projects in progress, and the actual cost of those orders is far above the expected costs for the projects.

Frame Tec's construction projects are long-term, fixed-price contracts. Construction accounting requires a close watch on estimated and actual costs. The company recognizes income using "cost-to-cost" percentage of completion. This means that actual cost incurred is compared to expected total cost for each project, and income is recognized based on the resulting percentage of completion. Generally accepted accounting principles proscribe the revenue recognition process very carefully, even to the extent of requiring recognition of 100% of projected losses as soon as they are apparent. Sarah had expected to recognize a substantial addition to income this month because many of the new contracts in progress are more than 20% complete. Booking a loss would be a major reversal of her expectations.

Concerned, Sarah headed to the purchasing department where Jack hesitantly tells her that market prices have skyrocketed. The combination of the recently declared war and a huge hurricane in Florida has driven lumber prices to unusually high levels. A new look at the project estimates shows them that the projected losses are significant. In addition to the current contracts in progress, the company signed several additional fixed-price contracts to complete in the coming year. The contracts were bid based on Jack's projection of standard lumber prices.

Jack encourages Sarah not to worry about the market fluctuations. Although he has signed and committed to purchase orders at very high prices, he is optimistic that the lumber market will level off and that prices will return to normal. He understands profit recognition for construction contractors but encourages Sarah to keep her work-in-process schedules based on original estimates for a few months. He tells her, "Revenue recognition is based on management judgment, and everyone will understand if we don't disclose the problem immediately." Jack is confident that there will be enough low-priced lumber by the end of the year (to generate income on later projects) that will be more than sufficient to offset the losses from the current projects in process. He reminds her that he has many years of experience in the construction industry and that she should trust his judgment.

Back in her office, Sarah completes the estimate of the loss. If she follows accounting standards and records the entire projected loss for projects in progress, the amount will be substantial and very material to Frame Tec's financial statements. She plans to tell the owners about the problem and to discuss the reporting requirements. She knows they'll be disappointed. She's worried that they will probably trust Jack's judgment and not be overly concerned, content with thinking that future projects will be profitable. She expects the owners to encourage her not to worry and to report the loss at a later date, after future profitable projects are started.

Unfortunately, the owners aren't the only stakeholders in this situation. The regular work-in-process reports are due to the bank, which reviews them carefully on a monthly basis. These projected losses will cause Frame Tec to be in violation of its financial covenant requirements. Sarah wonders, "Since the work-in-process schedules are quite subjective, would anyone question my disclosure of this problem in a few months? Would the bank ever realize that I knew it was a problem? Will future projects be profitable?"

As Sarah contemplates the ramifications of this decision, she has conflicting thoughts and is confused. If the bank decides to eliminate the credit line funding, Frame Tec will most likely default on its contracts and could be forced out of business. She knows that the owners don't have significant sources of outside funds that can be used to bail out the company. On the other hand, it's the holiday season. Frame Tec has 300 families who don't need bad news. Winters are tough enough for carpenters. The company has had a great year, but the situation could deteriorate very quickly.

Yet Sarah also is proud of her professional accomplishments and reputation. Not only is she the CFO, but she is a Certified Management Accountant (CMA®) and Certified Public Accountant (CPA) as well. The bank has relied on her to prepare accurate financial statements for 10 years. She is known for her trustworthiness, and she knows that there will need to be full disclosure for these projects eventually. There is no way for the projects currently in process to generate profit.

She faces a difficult choice. Does she hope for the best and keep the work-in-process schedules based on the initial estimates, or does she disclose the projected losses on this month's report to the bank? Would it hurt anyone to wait awhile?

NOTES FOR THE WRITE-UP

Please answer the case using your best ethical judgment and knowledge of accounting standards for revenue recognition. Structured questions for the case write-up include:

1. Does Sarah have all of the facts? What accounting standards and ethical guidelines are available to her?
2. Why does she feel pressured? How do the virtues compete to make this decision difficult?
3. What are her alternatives and the consequences?
4. What do the rules say? Specifically research and address IMA's Statement of Ethical Professional Practice as a guide to your answer.
5. Which overarching virtues are most important in this decision?
6. What are the possible steps to resolve the problem?

Teaching notes are available by contacting Jodi Ryan, manager of Student and Academic Relations, at jryan@imanet.org.

Elizabeth Dunn, CPA, is a licensed general contractor, accountant, and co-owner of Trilogy Construction, Inc., in Oroville, Calif. She is a member of the IMA Sacramento Chapter.