EARNINGS MANAGEMENT AND ETHICAL CHALLENGES AT THE SUCCULENT COOKING INC. – A CASE STUDY

Charles Y. Tang, Pace University
Raymond J Elson, Valdosta State University
Susanne O'Callaghan, Pace University
John P. Walker, Queens College - CUNY
Leslee N. Higgins, Eastern Kentucky University

CASE DESCRIPTION

The primary subject matter of this case is earnings management that often takes place in financial reporting for business enterprise and ethical issues involved therein. It demonstrates to students that reported accounting earnings can be managed by seemly innocent actions such as increasing production and building up inventories. This case will expand students' understanding of the motivation of earnings management and raise their awareness of ethical issues involved in financial reporting for business enterprise. The case is appropriate for the second course in managerial accounting at the undergraduate level or similar courses at the graduate level. It can also be used in advanced level financial accounting courses or in auditing seminar on contemporary accounting issues. The case requires approximately three hours of outside preparation by students to arrive at reasonable solutions. The case could then be debriefed in class using calculations and discussions. This would require one class hour.

CASE SYNOPSIS

Earnings management occurs when firm management attempts to alter reported earnings for reasons other than objective reporting of firm performance. This opportunistic behavior is motivated by managers who seek job security and/or financial rewards. It is in direct violation of professional ethical standards and, in many cases, could be in violation of law. The purpose of the Succulent Cooking, Inc., ("the company") case is to demonstrate to students that earnings can be managed by seemly innocent actions such as increasing production and building up inventory levels. During the process of solving this case, students develop an understanding of the role of overhead and how overhead is allocated to determine reported accounting earnings. Students will be intellectually challenged as the case does require strong analytic skills and good understanding of accounting concepts related to product costing.

As described in the case, the company is about to miss the Wall Street earnings expectations which can adversely affect firm stock prices. The company is considering two alternative course of action to manage earnings by either reducing the commission rate paid to its sales force or increasing production level. Students are first required to apply analytic skills to provide a specific solution to the question. Then they will realize that all the proposed actions are forms of earnings management which are either illegal or unethical.

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INSTRUCTORS' NOTES

Recommendations for Teaching Approaches

The article, *The Earnings Game: Everyone Plays, Nobody Wins* (Collingwood, H. HBR 2001), can be used as a good background reading. This article provides vivid descriptions on earnings management, its motivation and consequences. It is important for students to understand the ethical issues imbedded in the case. Without the background knowledge, students might be too focused on the technical aspect of the case. This case is suitable for the second course in managerial accounting at the undergraduate level or the similar courses at the graduate level. It can also be used in advanced level financial accounting courses or in auditing seminars on contemporary accounting issues. Students should be given background information on the philosophical principles (theories) of ethics (or the Standards of Ethical Conduct by the Institute of Management Accountants, the alternate framework), and on the role of manufacturing overhead and its allocation mechanism in determining reported accounting income.

Students should be given time to prepare the case on their own. A minimum 3-4 hours would be fair to expect an average student to come up with some reasonable solution. The case could then be debriefed in class using calculations and discussion. This would require approximately one hour class time. The case can be completed as a whole or in parts with the time adjusted accordingly.

Learning Outcomes

The learning outcomes of the case are as follows:

1) To understand and analyze overhead costs and overhead allocation mechanism and their impact on reported earnings;
2) To understand and analyze behavior patterns of production costs. (Fixed manufacturing costs are considered as a part of the product costs by the current US GAAP and IFRS and are allocated to all production units, sold or unsold.)
3) To understand the motivation, consequences, and ethical dilemmas associated with earnings management.

Case Implementation and Effectiveness

The case was class tested at one university in summer 2013 in a graduate level class. Students had already completed their intermediate financial accounting and cost accounting courses. The case was used as an in-class project and students did not have prior preparation time. However, the course instructor led them through the class discussion and calculation process. Although the students found the case challenging they noted that it was an interesting assignment, and that it met the applicable learning outcomes.

For the first proposal, average students are expected to be able to determine that commission needs to be cut by about 2% in order for income to meet the earnings target. They are also expected to point out that cutting commission might hurt the moral in the marketing department which can compromise future sales. They might also be able to point out that cutting commission might inflict labor dispute and lawsuits by employees.

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Students with stronger analytic skills are expected to provide a reasonable solution as to the level of production that is needed to meet the earnings target. However, their answers won't be accurate. They may be able to determine the inventory level in units, but usually unable to determine the costs of inventory that will appear on the balance sheet once production is increased.

More importantly, students may recognize that increasing production in this context is a form of earnings management. Management would be acting unethically as they are motivated to artificially alter reported earnings which will mislead investors and other financial statement users in general. This could be in violation of integrity and objectivity which are important building blocks of the standard of ethical conduct for accountants.

Students might be able to point out that increasing production would result in increased inventory which can compromise future earnings.

DISCUSSION QUESTIONS AND ANSWERS

1. *How much will the sales commissions have to be cut in order to meet the earnings target (in dollars and percentage)?*

Income Statements For fiscal quarter ending June 30 20X5 In USD 1,000		
Sales ($350 x 95000)	33,250	**33,250**
- Cost of Goods Sold ($250 x 95000)	23,750	23,750
Gross Profit	**9,500**	**9,500**
- Sales Commission (5% of sales)	1,663	X=1028
- Executive Salary	1,900	1900
- Rent and Depreciation	460	460
Profit of Operation	**5,478**	6,112
-Interest Expense	220	220
Net Income Before Taxes	**5,258**	5,892
-Income tax (31%)	1,630	1,827
Net Income	**3,628**	4,066
-Minority Interest	36	41 (.01)
Income Available to Stockholders	**3,591**	4,025 (.99)
Basic Earnings Per share Excluding Extraordinary Items (cents)	**0.1026**	***0.115***

$9500 - X - 1900 - 460 = 6112$; **X=$1,028,000 or 3.0917% of Sales**

Column 1 represents the original income statement information as provided in the case. Column 2 represents the calculation used to solve for the unknown value, the new sales commission or X. X is approximately 3% as noted above; therefore the sales commission would be reduced by 2% in order to meet the earnings target. The details are outlined below:

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In order for the earnings per share to reach $0.115 per common share, total income available to common stockholder: $0.115 x 35mil shares = $4.025 mil. (Note the number of common shares is implicitly given in the case: $0.115 EPS x 35 mil. Shares = Total net income $4.025 mil.)
Total net income before minority interest: $4.025mil. / 0.99 = $4.0656566 mil.
Total net income before income tax: $4,065,657 /0.69 = $5,892,256
Operating income before interest & tax: $5,892,256 + $220,000 =$6,112,256
The commission rate, X, can be determined as follows (000): $33,250 – $23,750 – $33,250 X – 1900 – 460 = $6,112.256. Solve, X=3.0917%. This means commission needs to be cut by about 1.91% from the current 5% level.

2. *How many units need to be produced and sold for the quarter in order to meet the earnings target if the sales commission is left unchanged at 5%?*

Income Statements For fiscal quarter ending June 30 20X5 In USD 1,000		
Sales ($350 x 95000)	33,250	**33,250**
- Cost of Goods Sold ($250 x 95000)	23,750	X=23,115
Gross Profit	**9,500**	**10,135**
- Sales Commission (5% of sales)	1,663	1,663
- Executive Salary	1,900	1900
- Rent and Depreciation	460	460
Profit of Operation	**5,478**	6,112
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Net Income Before Taxes	**5,258**	5,892
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UC x SUnit = $23115; UC = $243.32; U.FMO = $108.32

U.FMO = $10925000 / Punits = $108.32; Punit = 100.859 Units

Operating income before interest & tax must be $6,112,256 (=$5,892,256 + $220,000) in order for earnings to meet the earnings target. Thus, cost of goods sold, CGS, must be:

$33,250 – CGS – $33250 x 5% – 1900 – 460 = $6,112.256, so CGS = $23,115.244
Because CGS = Unit Costs x Unit Sold, $23,115,244= UC x 95000, therefore, UC=$243.3184.
Unit Variable Manufacturing Costs = $135 (+)
Unit Fixed Manufacturing Costs = U.FMC
Unit Costs =$243.3184
Therefore, U.FMC = $108.3184 = Total FMC / Unit Produced.
Since Total FMC = $10,925,000 [=95,000 units x ($23,750,000/95,000 – 135)], we have
UFC = $10,925,000 / Production Units = $108.3184, Solve, Production Units = 100,859 units.
Produced goods not sold but added to inventory = 100,859 – 95,000 = 5,859 units.

Total production for the quarter has to be 100,859 units which is 5,859 units more than what can be sold. These remaining units will be added to the warehouse as inventory items.

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3. *If the production is to be increased, estimate the value of the Finished Goods Inventory that will appear on the balance sheet?*

Reconcile Units and Costs

	Units	Variable Mfg. Costs	Fixed Mfg. Overhead	Total Costs
Unit Costs		$135.00	$108.32	$243.32
Units Produced	100,859	$13,615,965	$10,925,000	$24,540,965
Cost of Goods Sold	95,000	$12,825,000	$10,290,356	$23,115,356
Ending Finished Goods	5,859	$790,965	$634,644	$1,425,609

4. *What are the ethical issues of cutting sales commissions retroactively? Frame your answer using the Philosophical Principles (Imperative, Utilitarianism, and Generalization) in Ethics.*

The first principle, Imperative, directs a decision maker to act according to the requirements of an ethical rule. According to its leading proponent Kant, reason and the strict duty to be consistent should govern our actions. Therefore, individuals should act only as they think everyone should act all of the time.\

From the Imperative principle it would be inappropriate to retroactively cut the sales commission since the marketing and sales teams worked diligently to generate the sales and should be compensated accordingly. There is a clear expectation for the company to pay the commission that was agreed to by both parties at the beginning of the transaction.
The second principle, Utilitarianism, examines the consequences of the action rather than following specific rules.

Clearly, the marketing and sales team would suffer if their commissions were retroactively reduced. However, the company would receive a benefit from this action. If looking at it from the company's perspective, the action would be beneficial to the company and should be done. However, from the sales team perspective, the company is reneging on its promise

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and they would be hurt by the action. Therefore, the commissions should not be retroactively reduced.

The third principle, Generalization, considers the consequences of the decision made by similar persons acting under similar circumstances.

The decision to retroactively reduce the commission would be a benefit to the company but would hurt the sales team. However, this action would be for the 'greater good' and so the company should reduce the commissions in order to achieve its desired goals.

5. *Which proposal would you recommend and why?*

Under current GAAP, it is possible for a company to increase reported net income by increasing its production level. This is because increasing production without achieving a corresponding increase in sales allows the company to put units into finished goods inventory and thereby defer some of the fixed manufacturing costs to a future period rather than expensing all fixed manufacturing costs in the current income statements, resulting in an increase in net income for the current period.

Although increasing production is legal and Succulent is not violating any accounting standards, the purpose of this increase is to alter reported net income and thus it is a form of earnings management. By doing this, the company artificially increases its net income making its performance look better than it really is. It is misleading to investors and other financial statement users. The use of this approach is unethical since it contradicts the IMA standards of ethical conduct that requires accountants to be objective in reporting firm performance (IMA Statement of Ethical Professional Practice).

DISCLAIMER

This case and teaching note was prepared by Charles Tang, Raymond Elson, Susanne O'Callaghan, John Walker and Leslee Higgins and is intended to be used for class discussion rather than either effective or ineffective handling of the situation.

REFERENCES

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