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Startup, Inc.: Linking Financial Accounting, Managerial Accounting and Strategic Management

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ABSTRACT: This case introduces students to Porter's (1980) three basic types of competitive advantage—cost leadership, differentiation and focus—and integrates these concepts with concepts taken from management and financial accounting. At the center of the case is CPA Terry Merton, who first identifies a target market segment, and then selects and implements one of these strategies for her business. The competitive strategy selected has implications for cost calculations (including opportunity costs) and financial reporting.

In addition to introducing students to Porter's (1980) notions of competitive advantage, the case supports the achievement of three other specific educational goals. First, students acquire a basic knowledge of the economic consequences of accounting choice. Second, students achieve a greater appreciation of the ambiguities surrounding the calculation of product cost. Third, students will come to understand how conflicts can sometimes arise between income measurement concepts and liability measurement concepts.

This case can be used in a senior-level accounting theory course. It requires students to move beyond a rule-based approach to solving accounting problems. Specifically, the case illustrates the fact that decisions about the amount of a liability are sometimes not clear cut. Lacking clear-cut guidelines for making such judgments, reasonable decision makers can arrive at widely different estimates of the amount of the liability. Students must integrate concepts from financial accounting, management accounting and strategic management. In doing this, they become a total business advisor to Terry.

The Startup, Inc. case also illustrates the interrelationship between strategic management and external financial reporting. When managers select a strategic plan, they must take into account the financial reporting implications of the strategic plan. The Startup, Inc. case illustrates a situation in which the selection of a strategic plan will impact current financial results, which, in turn, may affect Startup's relationship with a lending institution.

Students can assume the roles of different decision makers in completing the case which leads to more student interest and discussion. For instance, students can assume the role of Terry Merton, the owner of Startup, Inc., as she selects a strategy, or they can assume the role of Bill Andersen, the loan officer at the local bank which has granted Terry a business loan.

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STARTUP, INC.

Terry Merton, CPA, hardly noticed the bright sunshine as she drove down the freeway in late October, 19X0 on her way to her job as controller for a small manufacturing company in her hometown of Brightside, California. She was contemplating the prospect of starting one of two types of businesses, either her own (1) tax practice, or (2) tax and accounting practice. Although quite satisfied with her present employment, she was very excited about the possibility of owning her own business. Prior to assuming the controllership, Terry had worked for four years in the small business division of a Big 6 public accounting firm's Brightside office and had dreamed of opening her own practice. Terry has decided that 19X1 is the year her dream will become a reality.

Arriving at her office early, Terry began to think about the possible market segments she might serve and the types of tax and accounting problems these potential clients might have. For instance, Terry might simply establish a tax practice which would focus on serving individuals who typically require only simple return preparation. Serving this target market segment would mean preparing simple tax returns, such as form 1040 and other schedules commonly completed for individuals along with the 1040.

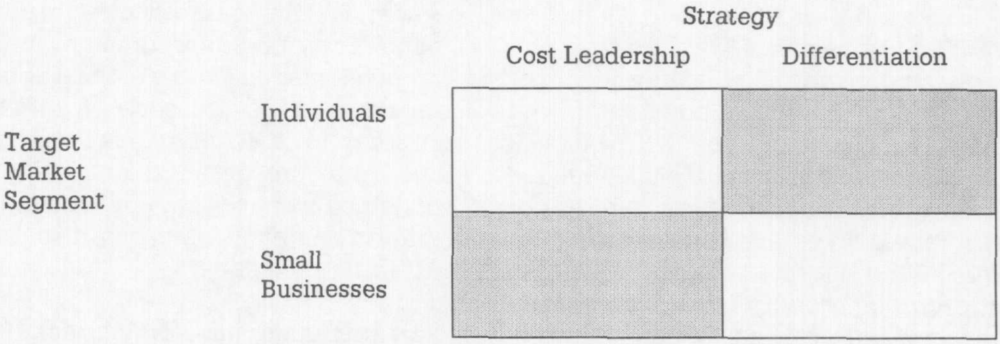
On the other hand, Terry could establish both a tax and accounting practice. This would mean she would serve both individuals and small businesses, although her primary target market would be small businesses. Pursuing this alternative would mean that she would render tax services for individuals, small businesses, estates, trusts and pension plans. Further, she would provide compilation, review and audit services for small businesses, as well as advice on designing accounting information systems. Terry knew that her first step would be to identify the market segment she wished to serve. To be successful, she would have to serve the selected target market very well.

Once she identified her target market segment, Terry could then make a decision about the three competitive strategies she might implement. These strategies are: (1) cost leadership, (2) differentiation and (3) focus. Terry decided to pursue a focus strategy, which meant that she would focus on a particular buyer group, segment of the product line, or geographic market. Regardless of the target market served, Terry would serve only the geographic area surrounding Brightside; thus, she was sure she would implement a focus strategy. Therefore, the decisions which remained related to (1) the target market to be served, and (2) whether to implement a cost leadership or differentiation strategy. Terry's decision matrix is shown in exhibit 1, which shows the combinations of market segments and strategies available to Terry.

Pursuing a cost leadership strategy meant that she would attract clients by keeping her prices (and her costs) low. At the same time, Terry would still be attentive to providing quality service on a timely basis. She would compete on the basis of price and monitor costs to be sure they were kept low.

Pursuing the differentiation strategy meant providing services which are considered to be unique. Differentiating her product probably meant that Terry would provide above-average service and develop a more personal relationship with clients. With the differentiation strategy, Terry would be able to charge above-average prices for the services provided to clients and would not have to be as attentive to cost control as she would under the cost leadership strategy.

EXHIBIT 1
Startup, Inc.
Competitive Strategy Considerations



This exhibit shows the possible strategies that Terry Merton might pursue as well as the target market segments she could serve. She could implement a cost leadership strategy focusing on individuals requiring help with simple tax return preparation. Terry's other alternative is to serve small businesses by providing a differentiated product consisting of a variety of tax return and accounting services. Note that the darkened cells represent strategy-target market segment combinations that Terry will not consider, since competitors are already serving these segments employing the indicated strategies.

Terry looked at the sketch she had drawn (exhibit 1). She noted that theoretically she would be able to implement either the cost leadership or differentiation strategy with either of the two market segments. Thus, she had a total of four alternatives available. However, she immediately eliminated two of the four alternatives: cost leadership-small business and differentiation-individual since there were already other competitors in the Brightside area pursuing these alternatives. Therefore, from a practical standpoint, Terry was left with either selecting the cost leadership-individual tax return combination (hereafter referred to as cost leadership) or the differentiation-small business combination (hereafter referred to as differentiation).

In considering which strategy to pursue, Terry thought about a nationally-known provider of tax preparation services which had offices located throughout the U.S. This national firm used television, radio and billboard advertising to present 17 reasons why taxpayers should do business with their firm. Terry was certain that the national firm had a costly centralized administrative structure. The firm's tax preparers were typically not CPAs, but were graduates of a training program conducted by the firm. Terry felt that this nationally-known firm was pursuing a differentiation-individual tax return strategy, since it emphasized the 17 reasons but did not emphasize low price.

If Terry selected the cost leadership strategy, the limited tax expertise required would allow Terry to remain at her present employment. She would hire Jim Wallace, an experienced semi-retired preparer of noncomplicated tax returns. Terry would locate her tax practice in a storefront in a nearby shopping mall. Rent was very low there, and there was a high volume of pedestrian traffic past the location. Given this heavy pedestrian traffic, Terry reasoned that she would incur little advertising cost. Terry expected that her costs could be kept low compared with the nationally-known firm for two reasons: (1) she would provide minimal training for Jim and (2) she would have minimal administrative and advertising costs.

As already indicated, if she pursued a differentiation strategy, her target market would be small businesses. With the differentiation strategy, the services she would provide would be significantly different from the services provided by competitors. Terry would differentiate herself along a number of dimensions, many of which related to her extensive experience with the Brightside business community. First, from her experience working in a Big 6 firm's small business division, Terry is acquainted with all the bankers in town. She knows how to prepare financial presentations for clients seeking loans in such a way that the loan applications are almost always approved. She also is familiar with virtually all the small business rental property in town, and can direct clients to the most reasonably priced locations. Finally, she is thoroughly familiar with the operation of a small business and can provide extremely useful insights to small business owners. Therefore, like the nationally-known firm, Terry would provide small businesses with many reasons to patronize her new firm. If the differentiation-small business strategy is pursued, Terry will leave her $40,000/year controller position to become the principal employee of Startup, Inc.

Terry would like to finance her new business start-up costs entirely from her personal savings. This is not possible, however, since she just recently purchased a new automobile for cash, which left her with a savings account balance of only $2,400. She will need a business loan to cover start-up costs including the purchase of a computer and software. Prior to contacting Bill Andersen, the loan officer at a nearby bank, Terry prepares some preliminary profit estimates. Terry's estimates of the revenues and costs associated with each strategy for the first year of operation, 19X1, are presented in exhibit 2. The projected balance sheet of Startup, Inc., prior to any bank loans, is presented in exhibit 3.

Part I: Startup, Inc.—November 19X0

Terry projects revenues of $67,500 (450 clients at $150/client) and $91,350 (203 clients at $450/client) under the cost leadership and differentiation strategies, respectively (see exhibit 2). Supplies average $10 per client and constitute the only variable costs for Startup, Inc. The fixed expenses vary between the strategies in several respects:

1. If she pursues the differentiation strategy, Terry will incur significantly higher liability insurance costs each year than she would under the cost leadership strategy. This is due to the fact that she has much more liability exposure since she will be doing attest work (reviews and audits).
2. Annual computer software costs will be greater under the differentiation strategy. This is because each year Terry will purchase specialized CD-ROM tax preparation disks needed to properly prepare the estate and trust returns. Additional software is also needed if she wishes to advise clients with regard to pensions.
3. If she pursues the differentiation strategy, Terry will incur additional expense for club membership dues and entertainment expenses compared with the cost leadership strategy. This is due to the fact that

EXHIBIT 2
Startup, Inc.
Projected Income Statements Under Two Competitive Strategies
For the Twelve Months Ended December 31, 19X1

		Strategies for Practice	
		Cost Leadership	Differentiation
Revenues	(450 clients at $150)	$67,500	
	(203 clients at $450)		$91,350
Variable Expenses:			
Supplies ($10 per client)		4,500	2,030
Contribution Margin		63,000	89,320
Fixed Expenses:			
Depreciation—Computer		1,600	1,600
Software		500	4,000
Liability Insurance		2,400	11,680
Rental—Furniture		5,660	5,660
Club Membership and Entertainment		—	1,200
Preparer Salary		26,000	31,200
Secretarial Salary		16,000	16,000
Advertising		200	1,180
Rent—office		8,400	—
Training		—	8,000
Total Fixed Expenses		60,760	80,520
Operating Income*		$ 2,240	$ 8,800

* Assuming that Startup, Inc., is organized as a Subchapter S corporation, operating income and net income are identical. Operating income equals net income because income tax equals zero since Terry Merton, not Startup, Inc., is the taxable entity.

EXHIBIT 3
Startup, Inc.
Balance Sheet
October 31, 19X0

Cash	$2,400
Total Assets	$2,400
Common Stock, $1 par	$1,000
Additional Paid-in Capital	1,400
Total Liabilities and Shareholders' Equity	$2,400

Terry knows that she can develop the estate and trust work through social contacts with bankers and attorneys.

4. Under the cost leadership provider strategy, Terry will continue in her present employment position. She will hire Jim Wallace for $500/week. Although not a CPA, Jim is approaching retirement at the public accounting firm where Terry had been employed. Jim would be happy

to work part-time at Startup, Inc. Terry is impressed with Jim's qualifications and is confident he could prepare uncomplicated tax returns. The differentiation strategy, however, will entail more complicated tax return preparations, which are beyond Jim's capabilities. Under the differentiation strategy, Terry would resign from her controller position and work full-time for Startup, Inc., drawing a salary of $600 per week.

5. Terry's home has a very large attached apartment which she presently leases to two college students at a rent of $500 per month. The students' lease expires on December 31, 19X0. Under the differentiation strategy, she will not renew the lease. Instead, she will set up the offices of Startup, Inc. in the apartment. Under the cost leadership provider strategy, the students would continue to occupy the apartment, since space in a nearby strip mall will be leased for Startup's offices. The strip mall space would provide needed pedestrian traffic and high visibility for Startup, Inc., and avoid traffic congestion in Terry's residential neighborhood.
6. Anticipating the complexity of clients under the differentiation strategy and considering the fact that she has been out of public accounting for three years, Terry estimates $8,000 in annual training costs. Minimal training costs are projected with the cost leadership preparer strategy since Jim Wallace already possesses the necessary experience, and the level of tax expertise required is minimal.

Obtaining a Business Loan

Terry faxed the financial projections in exhibits 2 and 3 to Bill Andersen in early November 19X0. As a loan officer, Bill must follow a set of specific guidelines in making his loan approval decisions. If Bill approves too many loans which ultimately are "bad," he will be dismissed from his job. For all loan applications, he must be able to justify after-the-fact his decision to the bank's board of directors, based largely on the loan applicant's financial statements. In assessing the credit worthiness of Terry's loan application, Bill plans to use operating income before depreciation and working capital as surrogates for cash-paying ability. Terry will offer her nearly new automobile as collateral for the loan. The bank's policy is to approve loans only if the annual payments are less than the beginning working capital balance and the projected before depreciation operating income for the next 12 months. The bank has also instituted a policy to have all loans due and payable on demand at the end of any calendar year if the payee is not in compliance with the original loan requirements.

Bill's bank has a maximum loan period for startup companies of five years. At an interest rate of ten percent per annum, Startup, Inc. qualifies for an $8,000 maximum loan requiring a $2,110 annual payment. Consequently, Startup's December 31 working capital balance and annual operating income (before depreciation expense) must not fall below $2,110, or the bank loan becomes due and payable.

Part II: Startup, Inc.—November 19X1

By November 19X1, Startup had completed its first 11 months of operation, and has paid its first annual bank loan payment of $2,110. Startup did not perform up to expectations in 19X1. Operating income and depreciation expense for the year ended December 31, 19X1 are estimated at $1,000 and $1,600 respectively. The average billings and variable costs per return for 19X1 equaled the expected amounts, but client volume was down exactly two percent from the projected volume levels. The *pro forma* balance sheet at December 31, 19X1 is presented in exhibit 4. Although somewhat disappointed with the level of operating profit, Terry is grateful that Startup's projected December 31, 19X1 working capital balance and operating income before depreciation exceed the $2,110 minimum loan requirements.

Terry is thinking about how to make Startup more successful in the future. She is contemplating pursuing one of three options to increase the volume of tax preparations. Terry believes that she must select one of these three options by December 31, 19X1. After that date, potential clients may already have scheduled appointments with their present accountant. Increased volume of preparations seems appropriate to Terry since, as exhibit 2 indicates, most of Startup's costs are fixed.

Terry believes that the average revenues and costs per client in 19X2 will be the same as experienced in 19X1. That is, the billings and cost of supplies

EXHIBIT 4
Startup, Inc.
***Pro forma* Balance Sheet**
December 31, 19X1

Assets		
Current Assets:		
Cash	$3,390	
Accounts Receivable	400	
Supplies	100	
Total Current Assets		$ 3,890
Property, Plant and Equipment:		
Computer	8,000	
Less: Accumulated Depreciation	(1,600)	6,400
Total Assets		$10,290
Liabilities and Shareholders' Equity		
Current Liabilities:		
Accounts Payable	$ 200	
Bank Loan—Current Portion	1,441	
Total Current Liabilities		$ 1,641
Long-Term Liabilities:		
Bank Loan (8,000 – 1,310)	6,690	
Less: Current Portion	(1,441)	5,249
Total Liabilities		6,890
Shareholders' Equity:		
Common Stock, $1 par	1,000	
Additional Paid-in Capital	1,400	
Subchapter S Earnings	1,000	
Total Shareholders' Equity		3,400
Total Liabilities and Shareholders' Equity		$10,290

per client in 19X2 is expected to be the same as predicted for and experienced in 19X1. A breakdown of the fees charged clients in 19X1 is presented in exhibit 5. Fifty percent of clients were charged the average billing fee, while 30 percent were charged less than and 20 percent greater than the projected average billing fee per return.

Terry would like to pursue one of the following growth options:

Option One

As part of the marketing strategy, Terry would give a coupon to each of the 54 people who had just moved to Brightside. Each coupon would entitle the holder to a free 1040 EZ tax return preparation. Any additional tax schedules required will be billed at the standard billing rate of $75 per hour. The coupons would expire on April 15, 19X2.

Option Two

In Option Two, Terry would present a coupon to a select group of 40 clients for whom Terry provided services in 19X1. The coupons would entitle the holder to a 60 percent discount off the normal billing rate on services provided during 19X2. The coupons will expire on December 31, 19X2. The only stipulation is that the user of the coupon must be a new client. That is, 40 individuals who were existing clients of Startup must present the coupons to another 40 individuals. Since Terry believes these 40 first-year clients were pleased with the services provided by Startup, and the coupons would make great stocking stuffers, she fully expects that all 40 coupons will be used by new clients.

Option Three

If Terry pursued Option Three, she would present all clients with an option to currently pay the average 19X1 billing per client to purchase a coupon entitling them to an amount of service which they were provided in 19X1. That is, if Startup provides a client with the same level of service in 19X2

EXHIBIT 5
Startup, Inc.
Breakdown of Fees Charged
For the Twelve Months Ended December 31, 19X1

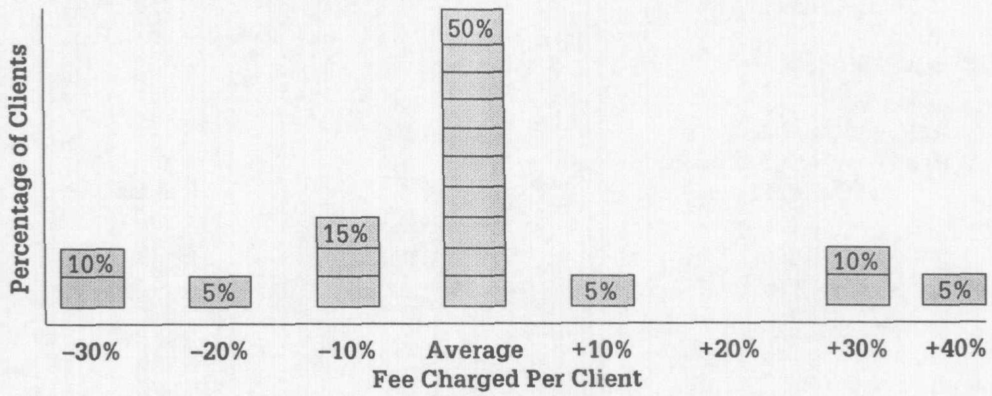


Exhibit 5 provides a breakdown of the fees charged to clients of Startup, Inc. during the 12 months ended December 31, 19X1. Ten percent of the clients were charged 30 percent below the average billing fee per client, five percent were charged 20 percent below the average per client fee, and so forth. The average fee charged to clients was the same as projected in exhibit 2.

as in 19X1, the client would not be billed for the 19X2 services since they have already paid the 19X1 average billing per client, which was $150 under the cost leadership strategy and $450 with the differentiation strategy. Clients would only be billed for additional services provided by Startup. The coupons would expire on December 31, 19X2.

The Strategic Plan and Financial Reporting

Terry realizes that, depending on which option she pursues, a liability and perhaps an expense or an asset will have to be recorded in Startup's accounting records for the year ended December 31, 19X1. Terry especially does not want to implement an option that would adversely effect the projected 19X1 income of $1,000 and December 31, 19X1 working capital balance of $2,249. If anything, Terry would like to shift income into 19X1, since the projected 19X1 operating income was below expectations. Terry is very concerned about how each option would be reflected in her financial statements for the calendar year ended December 31, 19X1. She is concerned because she realizes that those financial reports will be monitored by banker Bill Andersen to determine whether she is complying with the loan agreement terms. Consequently, Terry and Bill are very concerned about how the selected option is reflected in the financial reports. Above all, Terry knows that Bill wants her to use fair and honest accounting. The option selected must not interfere with the loan continuation approval. For without the continuing loan, Terry will not realize her dreams for Startup. Therefore, she must carefully consider the financial reporting implications of each of the three potential growth options. That is, how will each option affect the projected 19X1 operating income and working capital balance on December 31, 19X1?

QUESTIONS

1. Terry must select one of two practice strategies: cost leadership or differentiation. Using the profit estimate in exhibit 2, compute for each strategy the number of clients that must be served to break-even. At the projected level of volume, what is the margin of safety for each strategy?
2. From Bill Andersen's perspective, which practice strategy is better? Why?
3. From a managerial and strategic planning perspective, which practice strategy should Terry pursue? Why? (Show computations.)
4. How does the Financial Accounting Standards Board define a liability?

For Questions 5–9, you must select the practice strategy (cost leadership or differentiation) you believe Terry should pursue and answer the questions accordingly.

5. What is a cost? What was Startup's cost of serving one client during the calendar year ended December 31, 19X1?
6. Assume that Terry decides to pursue Growth Option One. She telephoned all 54 new Brightside residents to welcome them to the city and to encourage them to have a free tax return prepared in 19X2. From these conversations, 35 new residents indicated positively that they would take advantage of this free offer. The other 19 remained uncommitted. What is the amount of liability to be recorded by Startup related to the coupon offer to the new residents? What is the impact on Startup's projected 19X1 operating income and the December 19X1 working capital balance?
7. Assume that Terry decides to pursue Growth Option Two. What is the amount of liability to be recorded by Startup as of December 31, 19X1 for

these discount coupons? What would be the effect on Startup's projected 19X1 operating income and December 31, 19X1 working capital balance?

8. Assume that Terry decided to pursue Growth Option Three. Suppose that several clients took advantage of the offer by paying $9,000 cash. What is the amount of the liability to be recorded by Startup from these advance payments? What is the effect on the projected 19X1 operating income and the December 31, 19X1 working capital balance?

9. Refer to your answers to questions 6–8. Does the amount of the liability recognized by Terry have any economic consequences? That is, will Terry refrain from pursuing certain options because those options result in an unfavorable accounting treatment?

TEACHING NOTES

Introduction

This case introduces students to concepts from the strategic management literature and integrates those concepts with financial accounting and management accounting concepts. While other teaching cases have integrated accounting with other topics such as auditing, legal concepts, organizational goals and operating decisions (e.g., Arnold et al. 1994; Ruhl and Hartman 1994; Whittred 1994), our case is the first to link accounting with strategic management concepts. Along with other authors (Shank 1989; Shank and Govindarajan 1989, 1993) we contend that the connection between strategic management and accounting is an important one. Our case shows the interrelationships between strategic management and (1) management accounting and (2) financial accounting.

This approach illustrates an holistic approach to financial and managerial accounting. By an holistic approach, we mean viewing the client or firm not simply as an audit client or consulting client, but as an entire business entity. We believe that a teaching case which views the client from this broad perspective represents an advance over currently available teaching materials. In real life, the client or firm faces a variety of challenges in the business environment; the CPA must help address these business challenges simultaneously. It would make little sense for the CPA or the client to attempt to address the disclosure issues without thinking about the cost of the various options being considered. Further, this approach is consistent with the notion of the CPA as a total business advisor to clients. This notion has been embraced by several of the major public accounting firms.[1] As a total business advisor, the CPA must be knowledgeable in areas as diverse as financial accounting, management accounting and strategic management. Further, the CPA must be able to integrate his or her knowledge in these areas in order to provide the best possible service to the client. Knowledge in just one specialized area is not enough. Borrowing concepts from Boyer (1992), our approach is to view the accountant as one who must be able to integrate knowledge.[2]

This case also illustrates the fact that when there is ambiguity in financial accounting pronouncements, an opportunity arises for interested parties to lobby for preferential treatment. Just as Terry would lobby for the accounting treatment which would show her to be in compliance with the loan agreement, so too would special interests lobby the Financial Accounting Standards Board (FASB) for certain preferential treatment. Given the ambiguous reporting decision, Terry may argue for a certain accounting treatment in spite of the fact that the pertinent FASB pronouncement is well known. The case can serve as a rudimentary introduction to the topic of

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[1] In an in-house magazine, KPMG Peat Marwick Chairman Jon Madonna quoted two anonymous clients regarding the need for the CPA to thoroughly understand the client's business. One client remarked, "My public accounting firm must understand the nature of my business and the basics of what drives my business decisions." A second client noted, "You must be able to provide me with valuable feedback based on an analysis of my business" (*KPMG* 1994). Phillip Laskaway, chairman of Ernst & Young, implied a similar client need when he said, "So we give the client good advice on how they can be more efficient or better at what they're doing. That's not an additional consulting service. That's part of the audit." (Greene and Barrett 1994, 32)

[2] The notion of knowledge integration appears to be a concept whose time has come. Ernest Boyer (1992, 89), in "Scholarship Reconsidered: Priorities of the Professoriate," writes: "We need creative people who go beyond the isolated facts, who help shape a more coherent view of knowledge, and a more integrated, more authentic view of life."

the accounting standard-setting process by illustrating the fact that the determination of the proper financial accounting disclosure is not an exact science. This case advances the teaching literature by showing how financial statements may not reflect the economic reality of a situation. Startup, Inc., is written so that the option which results in the highest operating income (Option 3) is actually the poorest option from a strategic management perspective. Thus, Terry is confronted with two choices: she can either show adequate financial performance (pursue Option 3) or she can build true economic value (reject Option 3). She cannot do both.

The case employs strategic management concepts taken from Michael Porter's research regarding how competitive advantage is achieved: through cost leadership, differentiation or focus. A firm pursuing a cost leadership strategy often provides a standard, no frills product and tries to achieve cost advantages from all sources (Porter 1985). An example of this strategy would be the less expensive models of Toyota automobiles (Shank and Govindarajan 1993). In a differentiation strategy, a firm tries to be unique in its industry along some dimensions that are valued by buyers. Because of this uniqueness, the differentiating firm commands a premium price for its product. An example of this is the BMW automobile (Shank and Govindarajan 1993). Porter (1985) argues that while a firm may have strengths or weaknesses when compared with competitors, the significance of any strength or weakness that a firm has is ultimately a function of its impact on the ability to achieve cost leadership or differentiation.

Management and financial accounting systems are central to achieving competitive advantage. Porter (1980) points out that while the need to understand and control costs is important for firms pursuing a cost leadership strategy, such knowledge is also important for firms pursuing a differentiation strategy. While it is expected that higher costs are associated with differentiation, those costs cannot be allowed to consume the additional price charged by the differentiating firm. Thus, cost accounting concepts are central to the successful implementation of either type of competitive strategy.

In the Startup case, competitive strategy enters the case in two points, when Terry must select a particular practice strategy and when she must decide which of the three options to pursue. Our case is not just about strategic cost management, but also about how different strategies are reflected in the financial statements, a topic of interest to accounting students.

Specific Educational Goals

1. To introduce students to the linkage between Porter's (1980) three basic types of competitive advantage: cost leadership, differentiation, and focus and management and financial accounting.
2. To introduce students to the concept of the economic consequences of accounting choice.
3. To help students achieve a better understanding of the ambiguities surrounding the calculation of cost.
4. To show students that conflicts can occur between income measurement and liability measures, and suggest ways that these conflicts may be resolved.

SPECIFIC ISSUES

Economic Consequences of Accounting Choice

A major issue in this case is the economic consequences of accounting choice, a research topic which has been treated extensively in the accounting literature (see, for example, Holthausen and Leftwich 1983; Watts and Zimmerman 1986). Zeff (1988) argues that undergraduates should be introduced to the concept of the economic consequences of accounting choice, and we agree. As an illustration of the economic consequences of accounting choice, one may recall the controversy surrounding the treatment of the investment tax credit (ITC) in 1962–63, 1967 and 1971. The controversy centered on whether firms could immediately recognize the effects of the ITC, or whether they had to defer these effects over a number of years. The argument was made that if firms were required to defer the effects of the ITC, they would be less likely to invest in fixed assets, investments which were needed at that time to boost a sagging national economy. Note that regardless of the accounting treatment of the ITC, the underlying economic event was the same. The point was that the accounting treatment would affect the behavior of business owners. The same concern is present in the Startup case.

In the Startup case, the owner of the firm must select one option which will allow her to increase the revenues from her business. The option selected affects her financial statements, and the financial statement presentation affects her ability to remain in compliance with a debt covenant. Our goal is to show students that managers trying to achieve short-run goals may jeopardize the longer term viability of their firms. In the short term, Terry may be able to remain in compliance with the loan agreement. Over the long run, however, her positive cash flows will be significantly decreased by pursuing Option 3 rather than Options 1 or 2.

What is a Cost?

The case requires students to carefully consider the meaning of product cost. "Cost" has many meanings: variable cost, fixed cost, product cost, period cost and so on (Zimmerman 1995). We suspect that most cost and managerial accounting textbooks do an adequate or better job explaining different types of cost, with the exception of opportunity cost. Opportunity cost is defined as, "The benefit that is foregone as a result of choosing one course of action rather than another" (Zimmerman 1995, 24).

Textbook authors typically place the topic of opportunity cost in the chapter on short-run decision making. Thus, students may see opportunity costs as relevant only in this rather narrow context. However, economists see opportunity costs as central to an understanding of what cost is all about. The opportunity cost of a particular decision depends on the other alternatives available. The alternative actions comprise the opportunity set, and before one can calculate opportunity cost, one must know the opportunity set (Zimmerman 1995). Students completing this case will recognize that they must know the opportunity set before one can measure cost. The opportunity set consists of the strategies and options available to Terry.

Opportunity cost may play a minor role in cost and managerial accounting textbooks because opportunity costs are not reliable in the sense that they cannot usually be verified. Reliability (and relevance) are important concepts which must be considered by those preparing financial reports for external users. If opportunity costs are not reliable, then Terry cannot include them on the *pro forma* statements prepared for Bill Andersen. This does not mean that opportunity costs are unimportant. Financial reporting and strategic planning are related but distinct activities. Costs which are developed for financial reporting purposes must be adjusted to include opportunity costs if they are to serve the needs of strategic planners.

Students must carefully consider the meaning of product cost for financial reporting purposes as they attempt to determine the amount of liability (if any) to be recognized in 19X1. Our case goes beyond previous teaching materials in this regard by requiring students to determine not only the accounts which are affected, but also the amount to be used for the journal entry. This better reflects the demands placed on the manager responsible for external financial reporting.

Conflicts Between Revenue Recognition Concepts and Liability Measurements

Revenue recognition concepts may not be consistent with liability measurements and valuations. In fact, as Samuelson (1993) recently indicated, income measurement and financial statement measurement can be conflicting concepts. For example, cash collections for future magazine subscriptions are commonly considered to be liabilities, and measured at the cash amount received. Revenue is recognized as the magazines are delivered. This accounting seems proper for the revenue side of the equation, but not when one considers the liability measurement. Before delivery of the magazines, the liability is stated at the sales price, rather than the production costs for the magazines. Since liabilities are "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events" (FASB 1985), the amount of cash received exceeds the future economic sacrifices required to satisfy those obligations. From a liability standpoint, those unearned revenues may be more properly measured at the publisher's probable future sacrifice.

Financial accounting standard setters have not consistently indicated a preference for either revenue recognition or financial position measurement when a conflict occurs. The Financial Accounting Standards Board's Conceptual Framework definition of elements tends to emphasize the balance sheet (i.e., the asset/liability viewpoint). Comprehensive income is defined as "the change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources" (FASB 1985). Net income becomes the residual when the net change in assets (from nonowner sources) is computed. The FASB (1975), nevertheless, seems to stress revenue recognition by requiring that the recognition of revenues be limited to those that meet a realization and an earnings test. Inventories, for example, cannot be valued at net realizable values, since that would recognize revenue before it is realized, thus violating the revenue recognition concept. Consequently, the restrictive conditions for revenue recognition place limits on the measurement of assets and liabilities (Samuelson 1993).

The multipart Startup, Inc. case is an excellent way to illustrate how revenue recognition conventions and financial position measurements can conflict. The fact that liability measurements are frequently of less concern than revenue recognition in standard-setting policies is illustrated. Students must make judgments as to whether revenue recognition or asset/liability measurement should prevail.

The case illustrates the fact that reasonable decision makers can disagree regarding the proper recording of economic events in the accounting records. Such insight may not be obtained in many accounting courses which follow a rule-intensive pedagogical approach. The rule-intensive approach implies that accountants simply apply well-defined rules to varying situations. The Startup case is not about the simple application of rules; rather, the case requires students to exercise conceptually oriented reasoning in addressing ambiguous situations, as suggested by Courtis (1987) and Subotnik (1987).

A second feature of the case is that it underscores the fact that different stakeholders may hold widely differing points of view about the substance of an economic event. These points of view may be linked to the vested interests of the stakeholders. For instance, Terry Merton has a vested interest in the financial success of Startup. Thus, she will probably advocate an accounting treatment which enables her to comply with the terms of the loan agreement. On the other hand, loan officer Bill Andersen may be hesitant to accept an earnings enhancing treatment proposed by Terry, because if Terry defaults on the business loan, Bill's career may suffer. As indicated in the case, Bill's superiors may demand that he justify his decision and question the accounting treatment of whatever strategy Terry selects. Thus, Bill Andersen's job is on the line.

The case also points out that the strategy selected and its subsequent accounting treatment are not a matter of abstract importance. Rather, the accounting treatment affects Terry Merton's ability to continue the business loan, which in turn affects the future financial performance of Startup, Inc.

Finally, the case illustrates conflicts that can arise between financial and managerial accounting. Terry may be tempted to choose the differentiation strategy due to its higher projected operating income. The loan continuation would be less in doubt. However, when opportunity costs (salary and rent foregone) are considered, the cost leadership provider strategy is better.

Guidelines for Classroom Use

The case has been classroom tested, with excellent results, in an accounting theory course. The case may also be appropriate at the intermediate accounting level, although students may have difficulty with the various portions of the case. There are several ways of presenting the case so as to generate maximum student interest and discussion. We assign the case as an individual assignment to be initially completed outside of class and subsequently used as a starting point for an overall class discussion. This approach has worked very well.

Another approach is to divide the class into two groups with about half the students assuming the role of Terry Merton and the other half assuming the role of Bill Andersen. It should become clear that if the projected 19X1 operating income or the December 31, 19X1 working capital balance is adversely affected by the growth option selected, Terry is out of compliance with the loan agreement. Therefore, Terry favors enhancing 19X1 operating income if possible.

At least one student will probably indicate that Bill Andersen wants fair and honest accounting. This provides an opportunity for a discussion of how difficult it is to define what "fair and honest" means. Fair and honest does not necessarily mean the treatment which results in the lowest net income. That is, fair and honest accounting is not the same as conservative accounting.

A third option is to assign students to small groups (containing students assuming both roles) for discussion of major points and possible solutions. Each small group could then present its possible solution(s) to the entire class. Finally, an overall class discussion can ensue. Instructors should act as facilitators to the overall class discussion to keep students on track and to assure that all significant points are sufficiently presented. Most important, instructors should resist the temptation to give "the answer"; a major point of the case is that it is not clear which accounting treatment is more appropriate.

Role playing is very important in this case. As we argued earlier, depending on their vested interest, different people will argue for different amounts to be recorded in the accounting records. By reflecting on the role-playing, students will realize that they argue differently depending on their point of view and vested interest.

Case Discussion

The proposed answers to the eight questions, along with instructional notes, are presented below:

1. **Cost Leadership**

Break-Even Point = $\frac{\text{Fixed Costs}}{\text{Contribution Margin per Client}}$

= $\frac{\$60{,}760}{\$140}$ = 434 returns or $65,100 (434 at $150)

Margin of Safety = Projected Sales – Break-Even Sales
= $67,500 – $65,100
= $2,400 or 3.6%

Differentiation

Break-Even Point = $\frac{\$80{,}520}{\$440}$ = 183 returns or $82,350 (183 at $450)

Margin of Safety = $91,350 – $82,350
= $9,000 or 9.9%

2. Bill Andersen is concerned with the ability of Startup, Inc. to make timely loan payments. Another concern is Startup, Inc.'s ability to stay in compliance with the loan agreement. According to the loan agreement, Startup, Inc. must maintain sufficient before depreciation operating incomes and working capital balances. Therefore, Bill would favor the alternative that is associated with the greatest possibility for meeting the loan requirements.

   The differentiation strategy appears to be the "safest" from Bill's perspective. Its projected operating income before depreciation for 19X1 of $10,400 ($8,800 + $1,600) exceeds by 270.8% the corresponding $3,840 ($2,240 + $1,600) amount for the cost leadership strategy. Moreover, the differentiation strategy's margin of safety is better (9.9% compared to 3.6%). Finally, Terry would become a full-time employee with the differentiation strategy. That level of commitment and involvement may be perceived by Bill favorably, especially compared to the absentee ownership arrangement of the cost leadership strategy.

3. From a managerial and strategic planning perspective, the cost leadership strategy is preferable for several reasons. The most important reason is financial. Although the operating income in exhibit 2 is greater with differentiation, the cost leadership strategy is preferred when opportunity costs are considered. To determine the opportunity costs, one must know the opportunity set: cost leadership or differentiation. The profit figures for differentiation fail to indicate the $14,800 opportunity costs, namely the foregone $8,800 salary ($40,000 – $31,200) and $6,000 rental income. When opportunity costs are considered the projected operating income for differentiation becomes a negative $6,000 ($8,800 operating

income less $14,800 in opportunity costs). Consequently, the cost leadership strategy is more profitable by $8,240 ($2,240 compared to a negative $6,000).

If Terry desires to become a full-time employee of Startup, Inc., some psychic income will be lost. However, Terry would have to receive $8,240 of annual psychic income from pursuing differentiation as opposed to becoming a cost leadership tax return provider.

Finally, the question of absentee ownership could be addressed. Is the likelihood of substantial growth in sales and profits as great with absentee ownership (the cost leadership strategy) as it is with full-time involvement by the owner (with differentiation)? One thing is certain; Terry must continually be involved with Startup, Inc. regardless of the strategy chosen.

4. Liabilities are "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events" (FASB 1985).
5. As indicated above, the concept of opportunity cost is central to an understanding of the meaning of cost. To measure the cost of a particular strategy, one must know the opportunity set. The opportunity set consists of the strategies and options available to Terry.

Students will probably not begin the discussion of cost with a discussion of opportunity cost. Rather, they will focus on other definitions of cost that are found in many managerial and cost accounting textbooks. As Horngren et al. (1994) point out, there are different costs for different purposes. One can calculate the full cost or the incremental cost of serving a client. Of course, the full cost per client depends on how many clients are served and the strategy chosen.

Cost Leadership Strategy

An operating income of $1,000 for 19X1 for cost leadership can be computed as follows:

Revenues [441 clients (450 × 98%) at $150]	$66,150
Variable Costs (441 clients at $10)	4,410
Contribution Margin	61,740
Fixed Costs (derived)	60,740
Operating Income	$ 1,000

The full cost per client is computed by dividing the $65,150 full cost by 441 clients for $147.73 per client. Students must calculate the actual fixed costs, given the information that the number of returns was two percent less than the number of budgeted returns.

Differentiation Strategy

Fixed costs under the differentiation strategy are $86,560, computed as follows:

Revenues [199 clients (203 × 98%) at $450]	$89,550
Variable Costs (199 at $10)	1,990
Contribution Margin	87,560
Fixed Costs (derived)	86,560
Operating Income	$ 1,000

The full cost per client is $444.97 ($88,550 ÷ 199 returns) for the differentiation strategy. When one considers the $14,800 opportunity costs, however, the full cost per client equals $519.35 [($88,550 + $14,800) ÷ 199 clients].

Under both practice strategies, the incremental cost of serving a single client is $10, the cost of supplies. This incremental cost is constant at all levels of activity.

Students may ask which cost (full cost or incremental cost) is "right?" An appropriate response is to ask which costs are relevant? The only relevant costs are those which differ among alternatives. It is reasonable to assume that whether Terry pursues either cost leadership or differentiation, she will still incur the fixed costs in 19X2. This being the case, then the fixed costs of $60,740 with cost leadership and $86,560 for differentiation are not relevant to the strategic planning decision to choose among growth options. In the short run at least, the relevant costs are those that will change, which amounts to $10 per client.

6. This represents a contingent liability for future services. With FASB (1975), "Accounting for Contingencies." a loss should be accrued by a charge to expense and a liability recorded if it is probable that a liability has been incurred and the amount of loss can be reasonably estimated. For the 35 new residents who indicated positively that they would have a free tax return prepared, it appears that the probable condition has been met. Therefore, a determination of the amount of the liability needs to be assessed. Students will be prone to say that a liability should be recognized in the amount of $5,250 (35 × $150 average billing) for the cost leadership strategy and $15,750 (35 × $450 average billing) for the differentiation strategy. That would measure the opportunity cost of the free tax return if Startup, Inc. had to forgo revenue from other clients. However, since Startup, Inc. has not attained its projected volume at this point, the possibility of Startup, Inc. turning away clients due to time constraints appears remote. Therefore, the $5,250 and $15,750 amounts really are not appropriate. So then, what amount is appropriate?

   Given that a liability is the probable future economic sacrifice of economic benefits, the amount of the liability should be measured at the incremental cost of preparing the 35 tax returns for the new residents of Brightside. The only incremental costs Startup, Inc. will incur would be $10 per return. It appears then that Startup, Inc. has a probable liability for free tax return coupons outstanding in the amount of $350 (35 returns at $10 per return). The liability established by the other 19 new residents is not probable. A liability, however, could be reasonably possible, which would indicate that footnote disclosure would be appropriate.

   The impact on 19X1 operating income must also be determined. That is, should the proposed $350 tax return preparation cost be expensed in 19X1 or 19X2? Students may argue that 19X2 would result in better matching since the return will be prepared in that time period. However, the cost really does not result in a cause-and-effect relationship with revenues. In fact, no revenues are associated with these returns except for the additional charges for required tax schedules. The tax return preparation cost perhaps more closely resembles an advertising cost and fits the immediate write-off approach to matching. The $350 cost would then be expensed in 19X1. Terry certainly would not favor this matching approach, however, because her operating income would be reduced from $1,000 to $650, a 35 percent decline. Moreover, her working capital would be reduced from $2,249 to $1,899, which is below the minimum amount required.

7. The possibility of Startup, Inc. providing 40 discounted accounting services for the relatives and friends of this year's clients appears likely. Students may well argue that some of these coupons may be misplaced, lost or ignored.

However, considering that where there is a free lunch one observes a lack of seating, it appears probable that most of the coupons will be redeemed for discounted accounting services. Therefore, one could assume that a probable obligation has been established. We could again assume that the likelihood of having any revenue foregone due to these discounted services appears remote.

Unlike Option One which limited the returns to 1040 EZ tax return, these coupons entitle the holder to a discounted accounting services, regardless of the level of complication involved. To be consistent, students who advocated recognizing a liability of $5,250 (low cost) or $15,750 (product differentiation) in Part 1, may now advocate recognizing a liability of $3,600 [40 at ($150 × 60% discount)] for cost leadership and $10,800 [40 at ($450 × 60% discount)] for differentiation.

Alternatively, students could argue that the amount of the obligation cannot be reasonably estimated because of the unknown service difficulty and corresponding standard billing rate, so no obligation can be recognized currently. However, there appears to be a range of possible discounts for each practice strategy.

The cost leadership strategy, using the information in exhibit 6, has billings ranging from $105 ($150 × .70) to $210 ($150 × 1.40) in 19X1. Consequently, the discounts granted these 40 individuals could range from $2,520 [(40)($105 × .60)] up to $5,040 [(40)($210 × .60)]. From a conservative standpoint, an estimate of the probable discounts to be granted would be at least $2,520. So then should a liability and an expense be established for $2,520 as of December 31, 19X1? The

EXHIBIT 6
Startup, Inc.
Breakdown of Fees Charged
For the Twelve Months Ended December 31, 19X1

Fee	Number of Clients	Total Revenue
Cost Leadership:		
$105 (150 × .70)	44 (441 × .10)	$ 4,620
120 (150 × .80)	22 (441 × .05)	2,640
135 (150 × .90)	66 (441 × .15)	8,910
150 (150)	221 (441 × .50)	33,150
165 (150 × 1.10)	22 (441 × .05)	3,630
195 (150 × 1.30)	44 (441 × .10)	8,580
210 (150 × 1.40)	22 (441 × .05)	4,620
Totals	441 (450 × .98)	$66,150
Differentiation:		
$315 (450 × .70)	20 (199 × .10)	$ 6,300
360 (450 × .80)	10 (199 × .05)	3,600
405 (450 × .90)	30 (199 × .15)	12,150
450 (450)	99 (199 × .50)	44,550
495 (450 × 1.10)	10 (199 × .05)	4,950
585 (450 × 1.30)	20 (199 × .10)	11,700
630 (150 × 1.40)	10 (199 × .05)	6,300
Totals	199 (203 × .98)	$89,550

answer is no, since these discounts do not represent a potential cash outflow. They represent an opportunity cost (a benefit foregone).

No liability should be established since the cash required to satisfy these 40 discounted tax returns should approximate $400 (40 at $10 supply cost per return). The minimum expected revenues from these returns, $1,680 [(40 returns)($105 × .40)], exceeds the cash required, so no liability recognition is warranted.

The analysis for the differentiation strategy is similar. Billings per client in 19X1 ranged from a low of $315 ($450 × .70) to a high of $630 ($450 × 1.40). The discount allowed could possibly then range from $189 ($315 × .60) up to $378 ($630 × .60). However, Startup, Inc., at the minimum, should receive cash of at least $126 ($315 × .40) per client served, which would more than cover the $10 supply cost.

Unlike Growth Option One, the discount fee coupons do not create a liability nor cause Startup, Inc. to recognize an expense. Consequently, the 19X1 operating income and December 31, 19X1 working capital balance amounts would be unaffected. This option appears to be viable, since the marginal revenue provided by these discounted coupons should exceed the associated incremental costs.

8. If Terry pursues Growth Option Three, the revenue recognition concept may be more appropriate. That is, should Startup, Inc. be able to currently recognize the $9,000 received in advance for the 19X2 accounting services? Most students would probably answer no. So if no revenue is recognized currently, how do we treat the $9,000 advanced payments? Most students will immediately indicate that it is unearned revenue to be presented as a current liability on the balance sheet, since it will be earned within the next twelve months or normal operating cycle, whichever is longer. If that were true, then Startup, Inc. would establish a current liability for $9,000 for these advance payments, even though we had previously argued in Growth Option One no liability be established unless there are incremental costs. And if there are incremental costs, the liability is limited to those costs. Nevertheless, from a revenue recognition perspective, one should establish a liability in the amount of $9,000. The liability perspective advocated in Growth Option One would not recognize a liability for the $9,000, but for the incremental costs associated with those future 19X2 returns, of $600 for cost leadership and $200 for differentiation.[3]

   It is fairly clear that Growth Option Three may not be economically sound. By offering the coupons, Startup, Inc. is actually reducing the amount of cash that would otherwise be available to pay the bank loan. If Startup, Inc. offers all clients the opportunity to prepay their 19X2 accounting services at the 19X1 average billing amount per client, probably only those clients who had paid more than the average billing amount in 19X1 will purchase the coupons, assuming that the complexity of their 19X2 services is similar to that of their 19X1 services.

   Exhibit 6 was created using the information provided in exhibit 5. We see that 88 clients with the cost leadership strategy and 40 clients with the product

[3] Cost Leadership: $9,000 ÷ $150 average billing per return = 60 taxpayers who purchased discount coupon at a $10 incremental cost per return = $600. Differentiation: $9,000 ÷ $450 per return = 20 taxpayers at a $10 cost = $200.

differentiation strategy paid more than the average billing amount per client. A *conservative* estimate of the opportunity cost of Growth Option Three can be calculated by assuming the 60 cost leadership clients and the 20 product differentiation clients who prepaid their 19X2 accounting services paid an amount slightly above the 19X1 average billing per client. Exhibit 7 shows a conservative calculation of the opportunity cost of lost fees associated with Growth Option Three to be $2,040 for low cost leadership and $1,800 for product differentiation.

Of course, opportunity costs generally are not entered in the accounting records. Therefore, Terry may be willing to pursue Growth Option Three because this option, like Option Two, does not reduce either 19X1 operating income or the December 31, 19X1 working capital balance. However, Growth Option Two, will increase cash flows from new clients, while Growth Option Three can only reduce total cash flows to Startup, Inc.

9. Terry will certainly be aware of the economic consequence of pursuing Option 1. The consequence will be that Startup, Inc. will be out of compliance with the loan agreement. Therefore, she may reject Option 1 immediately. The important point is this: financial accounting standards alone may encourage managers to pursue economically unsound strategies. When this is pointed out to students, they become aware that accounting reports may not include all relevant information for stakeholders' decision making.

EXHIBIT 7
Startup, Inc.
Calculation of Opportunity Cost Associated with Growth Option Three

Fee	Opportunity Cost Per Client	Number of Clients	Total Opportunity Cost
Cost Leadership:			
$165	$165 – $150 = $15	22	$ 300
$195	$195 – $150 = $45	38	1,710
	Totals	60	$2,040
Differentiation:			
$495	$495 – $450 = $45	10	$ 450
$585	$585 – $450 = $135	10	1,350
	Totals	20	$1,800

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