



Chapter 1

Management accounting in context

Assignment material

Questions

- 1.1 Explain the way in which cost accounting, management accounting, activity management and financial reporting are inter-related.

Solution:

Management accounting measures, analyses and reports financial and non-financial information that helps managers make decisions to achieve an organisation's goals. It focuses on internal reporting and is not restricted by Australian generally accepted accounting practice (GAAP).

Financial accounting focuses on reporting to external parties such as investors, government agencies and banks. It measures and records business transactions and provides financial statements that are GAAP-based.

Other differences include (1) management accounting emphasises the future (not the past) and (2) management accounting influences the behaviour of managers and other employees (rather than primarily reporting economic events).

- 1.2 'Management accounting should not fit the straitjacket of financial reporting.' Explain your response to this statement and give an example.

Solution:

While financial accounting is constrained by GAAP, management accounting is not. The result is that:

- management accounting allows managers to charge interest on owners' capital to help judge a division's performance, even though such a charge is not allowed under GAAP
- management accounting can include assets or liabilities (such as 'brand names' developed internally) that are not recognised under GAAP
- management accounting can use asset or liability measurement rules (such as present values or resale prices) that are not permitted under GAAP.

- 1.3 Explain the way in which a management accountant is able to help to form strategy.

Solution:

Management accountants can help to formulate strategy by providing information about the sources of competitive advantage—for example, the cost, productivity or efficiency advantage of their company relative to competitors or the premium that a company can charge when it adds features that differentiate its products or services.

1.4 Describe the business functions in the value chain.

Solution:

The business functions in the value chain are:

- **Research and development**—generating and experimenting with ideas related to new products, services or processes.
- **Design of products, services and processes**—the detailed planning and engineering of products, services or processes.
- **Production**—acquiring, coordinating and assembling resources to produce a product or deliver a service.
- **Marketing (including sales)**—promoting and selling products or services to customers or prospective customers.
- **Distribution**—delivering products or services to customers.
- **Customer service**—providing after-sales support to customers.

1.5 Explain the term ‘supply chain’ and its importance to the management of activities.

Solution:

Supply chain describes the flow of goods, services and information from the initial sources of materials and services to the delivery of products to consumers, regardless of whether those activities occur in the same organisation or in other organisations.

Cost management focuses on the most effective and efficient use of resources, in order to make benefit-cost trade-offs. Companies are most effective when they integrate and coordinate activities across (1) all companies in the supply chain and (2) all business functions within their own value chain.

1.6 ‘Management accounting deals only with costs.’ Do you agree? Explain your answer.

Solution:

‘Management accounting deals only with costs.’ This statement is misleading at best and wrong at worst. Management accounting measures, analyses and reports financial *and non-financial* information that helps managers define the organisation’s goals and make decisions to fulfil them. Management accounting also analyses revenues from products and customers in order to assess product and customer profitability. Therefore, while management accounting does use cost information, it is only a part of the organisation’s information recorded and analysed by management accountants.

1.7 Explain the way in which management accountants help to improve quality and to ensure that products are delivered on time.

Solution:

Management accountants can help improve quality and achieve timely product deliveries by recording and reporting an organisation's current quality and timeliness and by analysing and evaluating the costs and benefits—both financial and non-financial—of new quality initiatives such as TQM, relieving bottleneck constraints or providing faster customer service.

1.8 Describe the five-step guide to making decisions.

Solution:

The five-step guide to making decisions is (1) identify the problem; (2) gather relevant information; (3) identify and evaluate potential courses of action, (4) make and implement a decision, and (5) evaluate performance and learn.

1.9 Distinguish between planning decisions and control decisions.

Solution:

Planning decisions focus on (a) selecting organisation goals, predicting results under various alternative ways of achieving those goals, deciding how to attain the goals, and (b) communicating the goals and how to attain them to the entire organisation.

Control decisions focus on (a) taking actions that implement the planning decisions, and (b) deciding how to evaluate performance and providing feedback and learning to help future decision making.

1.10 Describe the three guidelines that help management accountants provide the most value to managers.

Solution:

The three guidelines for management accountants are:

1. Analyse benefits and costs,
2. Give full recognition to behavioural and technical considerations, and
3. Use different costs for different purposes.

1.11 'Knowledge of technical issues such as computer technology is a necessary but not a sufficient condition to becoming a successful management accountant.' Do you agree? Explain your answer.

Solution:

Agree. A successful management accountant requires general business skills (such as understanding the strategy of an organisation) and people skills (such as motivating other team members) as well as technical skills (such as computer knowledge, calculating costs of products, and supporting planning and control decisions).

1.12 As a new management accountant, reply to this comment by a production manager: 'No bean counter knows enough about my responsibilities to be of any use to me. As I see it, our accountants may be needed to keep records for shareholders and the Australian Tax Office, but I don't want them sticking their noses in my day-to-day operations.'

Solution:

The new management accountant could reply in one or more of the following ways:

- a. Demonstrate to the plant manager how he or she could make better decisions if the management accountant were viewed as a resource rather than deadweight. In a related way, the plant manager could show how his/her time and resources could be saved by viewing the new management accountant as a team member.
- b. Demonstrate to the plant manager a good knowledge of the technical aspects of the plant. This approach may involve doing background reading. It certainly will involve spending much time on the plant floor speaking to plant personnel.
- c. Show the plant manager examples of the new management accountant's past successes in working with line managers in other plants. Examples could include:
 - assistance in preparing the budget
 - assistance in analysing problem situations and evaluating financial and non-financial aspects of different courses of action
 - assistance in submitting capital budget requests.
- d. Seek assistance from the chief financial officer to highlight to the plant manager the importance of many tasks undertaken by the new management accountant. This approach is a last resort but may be necessary in some cases.

1.13 Describe the professional occupation of members of CPA Australia, Chartered Accountants of Australia and New Zealand (CAANZ) and the Chartered Institute of Management Accountants (CIMA).

Solution:

CPA Australia (Certified Practising Accountant Australia) and ICAA (Institute of Chartered Accountants Australia) are the two largest professional accounting organisations in Australia, the third being IPA (Institute of Public Accountants). CPA and ICAA members are finance, accounting and business professionals who have undergone training to obtain a recognised qualification, and whose membership requires continued professional development and adherence to an ethical code. Chartered Institute of Management Accountants (CIMA) has its headquarters in London and is an international body of management accountants.

1.14 Name the five areas in which there are standards of ethical conduct for management accountants in Australia. Name the organisations that set these standards.

Solution:

The Chartered Institute of Management Accountants (CIMA) sets standards of ethical conduct for management accountants in the following areas: competence, confidentiality, integrity and credibility. As per CIMA's code of ethics, a CIMA member must act in the public interest AND comply with FIVE fundamental principles:

- Integrity
- Objectivity
- Professional competence and due care
- Confidentiality
- Professional behaviour.

(Note that this code, as with many professional accounting bodies, is based on the IFAC Code of Ethics.)

1.15 If a management accountant is faced with an ethical conflict, state and explain the steps that s/he should take if established written policies provide insufficient guidance on how to handle it.

Solution:

If a member cannot resolve an ethical issue by following The Chartered Institute of Management Accountants (CIMA) code of ethics the CIMA's code of ethics for professional management accountants which can be found at:

www.cimaglobal.com/Documents/code%20FINAL.pdf, or by consulting the ethics information on CIMA's website, he or she should seek legal advice as to both his or her legal rights and any obligations he or she may have. The CIMA Charter, By-laws and Regulations give definitive rules on many matters.

Exercises

1.16 Value chain and classification of costs

Johnson & Johnson, a health-care company, incurs the following costs:

- a. Payment of booth registration fee at a medical conference to promote new products to physicians
- b. Cost of redesigning an artificial knee to make it easier to implant in patients
- c. Cost of a toll-free telephone line used for customer inquiries about drug usage, side effects of drugs and so on
- d. Equipment purchased to develop drugs yet to be approved by the government
- e. Sponsorship of a professional golfer
- f. Labour costs of workers in the tableting area of a production facility
- g. Bonus paid to a salesperson for exceeding a monthly sales quota
- h. Cost of FedEx courier service to deliver drugs to hospitals

Required

Classify each of the cost items (a–h) as one of the business functions of the value chain shown in Figure 1.5 (p. 9).

Solution: (15 min.)

Value chain and classification of costs

<u>Cost Item</u>	<u>Value Chain Business Function</u>
a.	Marketing (including sales)
b.	Design of products, services or processes
c.	Customer service
d.	Research and Development
e.	Marketing (including sales)
f.	Production
g.	Marketing (including sales)
h.	Distribution

1.17 Key success factors

Dominion Consulting has issued a report recommending changes for its newest manufacturing client, Gibson Engine Works. Gibson currently manufactures a single product, which is sold and distributed nationally. The report contains the following suggestions for enhancing business performance:

- a. Develop a rechargeable electric engine to stay ahead of competitors
- b. Adopt a TQM philosophy to reduce waste and defects to near zero

- c. Reduce lead times (time from customer order of product to customer receipt of product) by 20% in order to increase customer retention
- d. Negotiate faster response times with direct material suppliers to allow for lower material inventory levels
- e. Benchmark the company's gross margin percentages against its major competitors

Required

Link each of these changes to the key success factors that are important to managers.

Solution:(10–15 min.)

Key success factors

**Change in Operations/
Management Accounting**

Key Success Factor

- | | |
|----|---------------------------------|
| a. | Innovation |
| b. | Cost and efficiency and quality |
| c. | Time |
| d. | Time and cost and efficiency |
| e. | Cost and efficiency |

1.18 Key success factors

Vargas Construction Ltd provides construction services for major projects. Managers at the company believe that construction is a people-management business, and they list the following as factors critical to their success:

- a. Increase spending on employee development to streamline processes
- b. Foster cooperative relationships with suppliers that allow for more frequent deliveries as and when products are needed
- c. Integrate tools and techniques that reduce errors in construction projects
- d. Train employees in green construction techniques to appeal to companies seeking certification
- e. Benchmark the company's gross margin percentages against its major competitors

Required

Match each of the above factors to the key success factors that are important to managers.

Solution:(10–15 min.)

Key success factors

**Change in Operations/
Management Accounting**

Key Success Factor

- | | |
|----|---------------------------------------|
| a. | Time and cost and efficiency |
| b. | Time, quality and cost and efficiency |
| c. | Quality and cost and efficiency |
| d. | Innovation and quality |
| e. | Cost and efficiency |

1.19 Planning and control decisions

Gregor Ltd makes and sells brooms and mops. It takes the following actions, not necessarily in the order given. For each action (a–e), state whether it is a planning decision or a control decision.

- a. Gregor asks its advertising team to develop fresh advertisements to market its newest product.
- b. Gregor calculates customer satisfaction scores after introducing its newest product.
- c. Gregor compares the costs it actually incurred with the costs it expected to incur for the production of the new product.
- d. Gregor’s design team proposes a new product to compete directly with the Swiffer.
- e. Gregor estimates the costs it will incur to distribute 30 000 units of the new product in the first quarter of next financial year.

Solution:(10–15 min.)

Planning and control decisions

<u>Action</u>	<u>Decision</u>
a.	Planning
b.	Control
c.	Control
d.	Planning
e.	Planning

1.20 Planning and control decisions

Gavin Adams is the CEO of Trusted Pool Service. He takes the following actions, not necessarily in the order given. For each action (**a–e**), state whether it is a planning decision or a control decision.

- a. Adams decides to expand service offerings into an adjacent market.
- b. Adams calculates material costs of a project that was recently completed.
- c. Adams weighs the purchase of an expensive new excavation machine proposed by field managers.
- d. Adams estimates the weekly cost of providing maintenance services next year to the city recreation department.
- e. Adams compares payroll costs of the past quarter to budgeted costs.

Solution:(10–15 min.)

Planning and control decisions

<u>Action</u>	<u>Decision</u>
a.	Planning
b.	Control
c.	Planning
d.	Planning
e.	Control

1.21 Planning and control decisions

Leisure Hotels (LH) is a hotel chain in Australia that provides superior accommodation. It takes the following actions, not necessarily in the order given below. For each action (**a–e**), state whether it is a planning decision or a control decision.

- a. LH compares the cost of food ingredients in its top restaurants with the expected costs.
- b. LH calculates its share of the accommodation market after introducing its off-season special offers.
- c. LH asks its marketing and management accounting teams to conduct a feasibility study of offering special rates in the off-season.

- d. LH estimates the costs it will incur to sell 500 additional room-nights in the off-season next year.
- e. LH compares the sales of room-nights in the first off-season of offering reduced rates with the estimate in the feasibility study.

Solution: (10–15 min.)

Planning and control decisions

<u>Action</u>	<u>Decision</u>
a.	Control
b.	Control
c.	Planning
d.	Planning
e.	Control

1.22 Five-step guide to decisions, service firm

Dewhirst Painters is a firm that provides house-painting services. Harry Dewhirst, the owner, is trying to find new ways to increase revenues. Dewhirst performs the following actions, not in the order listed.

- a. Dewhirst calls Johnson’s Hardware to ask the price of paint sprayers.
- b. Dewhirst discusses with his employees the possibility of growing the revenues of the firm.
- c. One of Dewhirst’s project managers suggests that using paint sprayers instead of hand painting will increase productivity and thus revenues.
- d. The workers who are not familiar with paint sprayers take more time to finish a job than they did when painting by hand.
- e. Dewhirst compares the expected cost of buying sprayers to the expected cost of hiring more workers who paint by hand, and estimates profits from both alternatives.
- f. The project scheduling manager confirms that demand for house painting services has increased.
- g. Dewhirst decides to buy the paint sprayers rather than hire additional painters.

Required

Classify each action (a–g) according to its step in the five-step guide to decisions (identify the problem and uncertainties; obtain relevant information; make predictions about the future; make decisions by choosing among alternatives; implement the decision, evaluate performance, and learn).

Solution: (15 min.)

Five-step guide to decisions, service firm

<u>Action</u>	<u>Step in Decision-making Process</u>
a.	Gather relevant information
b.	Identify and evaluate potential courses of action
c.	Make and implement a decision
d.	Implement a decision, evaluate performance, and learn
e.	Gather relevant information and identify and evaluate potential courses of action
f.	Evaluate performance and learn
g.	Make and implement a decision

1.23 Five-step guide to decisions

Sizemore Landscaping is a firm that provides commercial landscaping and grounds maintenance services. Derek Sizemore, the owner, is trying to find new ways to increase revenues. Mr Sizemore performs the following actions, not in the order listed.

- a. Mr Sizemore decides to buy power tilling equipment rather than hire additional landscape workers.
- b. Mr Sizemore discusses with his employees the possibility of using power equipment instead of manual processes to increase productivity and thus profits.
- c. Mr Sizemore learns of a large potential job that is about to go out for bids.
- d. Mr Sizemore compares the expected cost of buying power equipment to the expected cost of hiring more workers and estimates profits from both alternatives.
- e. Mr Sizemore estimates that using power equipment will reduce tilling time by 20%.
- f. Mr Sizemore researches the price of power tillers online.

Required

Classify each of the actions (a–f) according to its step in the five-step decision-making process (identify the problem and uncertainties; obtain relevant information; make predictions about the future; make decisions by choosing among alternatives; implement the decision, evaluate performance, and learn).

Solution: (15 min.)

Five-step guide to decisions

<u>Action</u>	<u>Step in Decision-making Process</u>
a.	Make and implement a decision
b.	Identify and evaluate potential courses of action
c.	Gather relevant information and identify and evaluate potential courses of action
d.	Gather relevant information and identify and evaluate potential courses of action
e.	Make and implement a decision
f.	Gather relevant information

1.24 Professional ethics

Heather Scott is division management accountant and Martin Andrews is division manager of the Walk Smart Shoe Company. Scott has line responsibility to Andrews, but she also has staff responsibility to the company management accountant.

Andrews is under severe pressure to achieve the budgeted division profit for the year. He has asked Scott to book \$200 000 of revenues on 30 June. The customers' orders are firm but the shoes are still in the production process. They will be shipped on or around 4 July. Andrews says to Scott: 'The key event is getting the sales order, not shipping the shoes. You should support me, not obstruct me in reaching my division goals.'

Required

1. Describe Scott's ethical responsibilities.
2. What should Scott do if Andrews gives her a direct order to book the sales?

Solution: (10–15 min.)

Professional ethics

1. Scott's ethical responsibilities are well summarised in the CIMA's code of ethics for professional management accountants which can be found at: www.cimaglobal.com/Documents/code%20FINAL.pdf. Areas of ethical responsibility include the following:
 - Integrity
 - Objectivity
 - Professional competence and due care
 - Confidentiality
 - Professional behaviour.

The ethical standards related to Scott's current dilemma are Integrity, Objectivity, Professional competence and due care, Confidentiality and Professional behaviour. Using the integrity standard, Scott should carry out duties ethically and communicate unfavourable as well as favourable information and professional judgements or opinions. Competence and due care, and professional behaviour, demand that Scott perform her professional duties in accordance with relevant laws, regulations and technical standards. Objectivity requires that Scott report information fairly and objectively. Scott should refuse to book the A\$200 000 of sales until the goods are shipped. Both financial accounting and management accounting principles maintain that sales are not complete until the title is transferred to the buyer.

2. Scott should refuse to follow Andrews' orders. If Andrews persists, the incident should be reported to the Company Management Accountant. Support for line management should be wholehearted, but it should not require unethical conduct.

1.25 Professional ethics

Hannah Gilpin is the management accountant of Blakemore Auto Glass, a division of Eastern Glass and Window. Blakemore replaces and installs broken windshields. Her division has been under pressure to improve its divisional operating income. Currently, divisions of Eastern Glass are allocated corporate overhead based on cost of goods sold. Jake Myers, the president of the division, has asked Gilpin to reclassify \$50 000 of installation labour, which is included in cost of goods sold, as administrative labour, which is not. Doing so will save the division \$20 000 in allocated corporate overhead. The labour costs in question involve installation labour provided by trainee employees. Myers argues, 'The trainees are not as efficient as regular employees, so this is unfairly inflating our cost of goods sold. This is really a cost of training (administrative labour) not part of cost of goods sold.' Gilpin does not see a reason for reclassification of the costs, other than to avoid overhead allocation costs.

Required

1. Describe Gilpin's ethical dilemma.
2. What should Gilpin do if Myers gives her a direct order to reclassify the costs?

Solution: (10–15 min.)

Professional ethics

1. Gilpin's ethical responsibilities are well summarised in the IMA's 'Standards of Ethical Behaviour for Practitioners of Management Accounting and Financial Management' (Exhibit 1.7 of text). Areas of ethical responsibility include the following:
 - Competence
 - Confidentiality

- Integrity
- Credibility.

The ethical standards related to Gilpin’s current dilemma are integrity, competence, and credibility. Using the integrity standard, Gilpin should carry out duties ethically and communicate unfavourable as well as favourable information and professional judgements or opinions. Competence demands that Gilpin perform her professional duties in accordance with relevant laws, regulations, and technical standards and provide decision support information that is accurate. Credibility requires that Gilpin report information fairly and objectively and disclose deficiencies in internal controls in conformance with organisational policy and/or applicable law. Gilpin should use her professional judgement to decide if reclassifying labour costs from cost of goods sold to administrative labour is appropriate. This cost should be classified as cost of goods sold and she should refuse to classify the \$50 000 of costs as administrative costs only to avoid allocation of overhead costs.

2. Gilpin should refuse to follow Myers’ orders but should discuss her concerns with Myers. If Myers persists, the incident should be reported to the corporate controller of Blakemore Auto Glass. Gilpin may also want to consider consulting the IMA for ethical guidance. Support for line management should be wholehearted, but it should not require unethical conduct.

1.26 Planning and control decisions

Intheknow.com.au offers its subscribers several services, such as an annotated television guide and local area information on weather, restaurants and movie theatres, music festivals and art workshops. Its main revenue sources are fees for banner advertisements and fees from subscribers. Recent data are:

Month/year	Advertising revenues	Actual number of subscribers	Monthly fee per subscriber
June 2017	\$4 000 988	28 642	\$14.95
December 2017	833 158	54 813	19.95
June 2018	861 034	58 178	19.95
December 2018	1 478 072	86 437	19.95
June 2019	2 916 962	146 581	19.95

The following decisions were made from June to October 2019:

- a. June 2019: Raised subscription fee to \$24.95 per month from July 2019 onwards. The budgeted number of subscribers for this monthly fee is shown in the following table.
- b. June 2019: Informed existing subscribers that from July onwards the monthly fee would be \$24.95.
- c. July 2019: Offered email service to subscribers and upgraded other online services.
- d. October 2019: Dismissed the director of marketing after significant slowdown in subscribers and subscription revenues, based on July to September 2019 data in the table below.
- e. October 2019: Reduced subscription fee to \$21.95 per month from November 2019 onwards.

Results for July–September 2019 are:

Month/year	Budgeted number of subscribers	Actual number of subscribers	Monthly fee per subscriber
July 2019	140 000	128 933	\$24.95
August 2019	150 000	139 419	24.95
September 2019	160 000	143 131	24.95

Required

1. Classify each of the decisions (a–e) as a planning or a control decision.
2. Give two examples of other planning decisions and two examples of other control decisions that may be made at Intheknow.com.au.

Solution: (15 min.)

Planning and control decisions

1. Planning decisions

- a. Decision to raise monthly subscription fee
- c. Decision to upgrade content of online services (later decision to inform subscribers and upgrade online services is an implementation part of control)
- e. Decision to decrease monthly subscription fee

Control decisions

- b. Decision to inform existing subscribers about the rate of increase—an implementation part of control decisions
 - d. Dismissal of Director of Marketing—performance evaluation and feedback aspect of control decisions
2. Other planning decisions that may be made at Intheknow.com.au: to raise or lower advertising fees; or to charge a fee from on-line retailers when customers click-through from WebNews.com.au to the retailers' websites.

Other control decisions that may be made at Intheknow.com.au: to evaluate how customers like the new format for the weather information, working with an outside vendor to redesign the website or to evaluate whether the waiting time for customers to access the website has been reduced.

1.27 Strategic decisions and management accounting

A series of independent situations in which a firm is about to make a strategic decision follow.

Decisions

- a. Prestige Computers is trying to decide whether to produce and sell a new home computer software package that includes the ability to interface with a thermostat and a refrigerator. There is no such software currently on the market.
- b. Mayberry Pharmaceuticals has been asked to provide a 'store brand' facial cream that will be sold at discount retail stores.
- c. Hellophones is about to decide whether to launch the production and sale of a mobile phone with standard features.
- d. Georges Delicatessen is entertaining the idea of developing a special line of gourmet pasta sauce made with sun-dried tomatoes, mushrooms and truffle oil.

Required

1. For each decision, state whether the company is following a cost-leadership or a differentiated-product strategy.
2. For each decision, discuss what information the management accountant can provide about the source of competitive advantage for these firms.

Solution: (20 min.)

Strategic decisions and management accounting

1. The strategies that the companies are following in each case are:
 - a. Differentiated product strategy
 - b. Low price strategy
 - c. Differentiated product strategy
 - d. Low price strategy

2. The following are examples of information the management accountant can provide for each strategic decision.
 - a. Cost to develop, produce and sell new software
 Premium price that customers would be willing to pay due to product uniqueness
 Price of basic software
 Price of closest competitive software
 Cash needed to develop, produce and sell new software

 - b. Cost of producing the 'store-brand' facial cream
 Productivity, efficiency and cost advantages relative to competition
 Prices of competitive products
 Sensitivity of target customers to price and quality
 How the market for facial cream is growing

 - c. Cost to manufacture and sell the cell phone
 Productivity, efficiency and cost advantages relative to competition
 Prices of competitive cell phones
 Sensitivity of target customers to price and quality
 The production capacity of Hellophones and its competitors

 - d. Cost to produce and sell new line of gourmet pasta sauce
 Premium price that customers would be willing to pay due to product uniqueness
 Price of basic ingredients
 Price of closest competitive product

1.28 Management accounting guidelines

For each of the following items, identify which of the management accounting guidelines applies: benefit-cost approach, behavioural and technical considerations, or different costs for different purposes.

1. Analysing whether to keep the billing function within an organisation or outsource it
2. Deciding to give bonuses for superior performance to the employees in an Indian subsidiary and extra holiday time to the employees in a New Zealand subsidiary
3. Including costs of all the value-chain functions before deciding to launch a new product, but including only its manufacturing costs in determining its inventory valuation

4. Considering the desirability of hiring one more salesperson
5. Giving each salesperson the compensation option of choosing either a low salary and a high-percentage sales commission or a high salary and a low-percentage sales commission
6. Selecting the more costly computer system after considering two systems
7. Installing a participatory budgeting system in which managers set their own performance targets, instead of top management imposing performance targets on managers
8. Recording research costs as an expense for financial reporting purposes (as required by Australian Accounting Standards) but capitalising and expensing them over a longer period for management performance evaluation purposes
9. Introducing a profit-sharing plan for employees

Solution: (15 min.)

Management accounting guidelines

1. Benefit-cost analysis
2. Behavioural and technical considerations
3. Different costs for different purposes
4. Benefit-cost analysis
5. Behavioural and technical considerations
6. Benefit-cost analysis
7. Behavioural and technical considerations
8. Different costs for different purposes
9. Behavioural and technical considerations

1.29 Management accounting guidelines

For each of the following items, identify which of the management accounting guidelines applies: benefit-cost approach, behavioural and technical considerations, or different costs for different purposes.

1. Analysing whether to produce a component needed for an end product or to outsource it
2. Deciding whether to compensate the sales force by straight commission or by salary
3. Adding the cost of store operations to merchandise cost when deciding on product pricing, but only including the cost of freight and the merchandise itself when calculating cost of goods sold on the income statement
4. Considering the desirability of purchasing new technology
5. Weighing the cost of increased inspection against the costs associated with customer returns of defective goods
6. Deciding whether to buy or lease an existing production facility to increase capacity
7. Estimating the loss of future business resulting from bad publicity related to an environmental disaster caused by a company's factory in the Philippines, but estimating clean-up costs for calculating the liability on the balance sheet

Solution: (15 min.)

Management accounting guidelines

1. Benefit-cost analysis
2. Behavioural and technical considerations and benefit-cost analysis
3. Different costs for different purposes
4. Benefit-cost analysis or behavioural and technical considerations, for example, how employees will react to the new technology

5. Benefit-cost analysis
6. Benefit-cost analysis
7. Different costs for different purposes

1.30 Role of management accountant, role of chief financial officer

Martin Saunders is the management accountant at Future Ltd, a manufacturer of devices for the computer industry. He is being considered for a promotion to chief financial officer.

Required

1. In this table, indicate which executive is primarily responsible for each activity.

Activity	Management accountant	CFO
Managing accounts payable		
Communicating with investors		
Strategic review of different lines of businesses		
Budgeting funds for a plant upgrade		
Managing the company's short-term investments		
Negotiating fees with auditors		
Assessing profitability of various products		
Evaluating the costs and benefits of a new product design		

2. Based on this table and your understanding of the two roles, what types of training or experiences will Saunders find most useful for the CFO position?

Solution: (15 min.)

Role of management accountant, role of chief financial officer

- 1.

Activity	Management accountant	CFO
Managing accounts payable	X	
Communicating with investors		X
Strategic review of different lines of businesses		X
Budgeting funds for a plant upgrade	X	
Managing the company's short-term investments		X
Negotiating fees with auditors		X
Assessing profitability of various products	X	
Evaluating the costs and benefits of a new product design	X	

2. As CFO, Saunders will be interacting much more with the senior management of the company, the board of directors and the external financial community. Any experience he can get with these aspects will help him in his new role as CFO. Martin Saunders can be better positioned for his new role as CFO by participating in strategy discussions with senior management, by preparing the external investor communications and press releases under the guidance of the current CFO, by attending courses that focus on the interaction and negotiations between the various business functions and, either formally or on the job, getting training in issues related to investments and corporate finance.

1.31 Role of management accountant, role of chief financial officer

George Jimenez is the management accountant at Balkin Electronics, a manufacturer of devices for the computer industry. The company may promote him to chief financial officer (CFO).

Required

1. In this table, indicate which executive is primarily responsible for each activity.

Activity	Management accountant	CFO
Managing the company's long-term investments		
Presenting the financial statements to the board of directors		
Strategic review of different lines of businesses		
Budgeting funds for a plant upgrade		
Managing accounts receivable		
Negotiating fees with auditors		
Assessing profitability of various products		
Evaluating the costs and benefits of a new product design		

2. Based on this table and your understanding of the two roles, what types of training or experience will George find most useful for the CFO position?

Solution: (15 min.)

Role of management accountant, role of chief financial officer

- 1.

Activity	Management accountant	CFO
Managing the company's long-term investments		X
Presenting the financial statements to the board of directors		X
Strategic review of different lines of businesses		X
Budgeting funds for a plant upgrade	X	
Managing accounts receivable	X	
Negotiating fees with auditors		X
Assessing profitability of various products	X	
Evaluating the costs and benefits of a new product design	X	

2. As CFO, Jimenez will be interacting much more with the senior management of the company, the board of directors, auditors, and the external financial community. Any experience he can get with these aspects will help him in his new role as CFO. George Jimenez can be better positioned for his new role as CFO by participating in strategy discussions with senior management, by preparing the external investor communications and press releases under the guidance of the current CFO, by attending courses that focus on the interaction and negotiations between the various business functions and outside parties such as auditors and, either formally or on the job, getting training in issues related to investments and corporate finance.

1.32 Ethics

Jocinta Marks is the Melbourne-based management accountant of Prakash & Sons, a rapidly growing manufacturer and marketer of Indian food products. Marks is currently considering

the purchase of a new cost management package for use by each of the company's six manufacturing plants and its many marketing personnel. Four major competing products are being considered by Marks.

Pinnacle is an aggressive software developer. It views Prakash & Sons as a target of opportunity. Every six months, Pinnacle has a three-day users' conference in a Chinese location. Each conference has substantial time allowed for 'rest and recreation'. Pinnacle offers Marks an all-expenses-paid visit to the upcoming conference in Hong Kong. Marks accepts the offer, believing it will be very useful to talk to other users of Pinnacle software. She is especially looking forward to the visit because she has friends living in Hong Kong. Prior to leaving, Marks receives a visit from the chief executive of Prakash & Sons. Marks shows him an anonymous letter sent to her. It argues that Pinnacle is receiving unfair favourable treatment in Prakash & Sons' software decision-making process. The letter specifically mentions Marks's upcoming 'all-expensespaid package to Hong Kong'. Marks is deeply offended. She says she has made no decision, and she believes she is very capable of making a software choice on the merits of each product. Prakash & Sons currently does not have a formal, written code of ethics.

Required

1. Do you think Marks faces an ethical problem in regard to her forthcoming visit to the Pinnacle users' group meeting? Refer to the CGMA Code of Ethics (<<http://www.cgma.org/AboutCGMA/DownloadableDocuments/CGMA-code-of-ethics.v2.pdf>>). Explain.
2. Should Prakash & Sons allow executives to attend user meetings while negotiating with other vendors about a purchase decision? Explain. If yes, what conditions on attending should apply?
3. Would you recommend that Prakash & Sons develop its own code of ethics to handle situations such as this? What are the pros and cons of having such a written code?

Solution: (30 min.)

Ethics

1. Marks face an ethical problem. The trip appears to be a gift which could influence her purchase decision. The ethical standard of integrity requires Marks to refuse the gift. Companies with 'codes of conduct' frequently have a 'supplier clause' that prohibits their employees from accepting 'material' (in some cases, any) gifts from suppliers. The motivations include:
 - a. Integrity/conflict of interest. Suppose Marks recommends that a Pinnacle product should subsequently be purchased by Parkas & Sons. She could make this recommendation because she felt obligated to them as her trip to the Hong Kong conference was fully paid by Pinnacle.
 - b. The appearance of a conflict of interest. Even if the Pinnacle product is the superior one at that time, other suppliers likely will have a different opinion. They may believe that the way to sell products to Parkas & Sons is via 'all-expenses-paid package to Hong Kong.' Those not wanting to do business this way may downplay future business activities with Parkas & Sons even though they could gain much from such activities.

Some executives view the meeting as 'suspect' from the start given the Hong Kong location and its 'rest and recreation' tone.

2. Parkas & Sons should not allow executives to attend user meetings while negotiating with other vendors about a purchase decision. The payment of expenses for the trip constitutes a gift that could appear to influence their purchase decision.

Pros of attending user meeting

- a. Opportunity to learn more about Pinnacle's software products.
- b. Opportunity to interact with other possible purchasers and get their opinions.
- c. Opportunity to influence the future product development plans of Pinnacle in a way that will benefit Parkas & Sons. An example is Pinnacle subsequently developing software modules tailored to food product companies.
- d. Saves Parkas & Sons' money. Visiting suppliers and their customers typically cost money, whereas Pinnacle is paying for the Hong Kong conference.

Cons of attending

- a. The ethical issues raised in requirement 1.
- b. Negative morale effects on other Parkas & Sons employees who do not get to attend the Hong Kong conference. These employees may reduce their trust and respect for Marks' judgement, arguing she has been on a 'supplier-paid vacation'.

Conditions on attending that Parkas & Sons might impose

- a. Sizable part of that time in Hong Kong has to be devoted to business rather than recreation.
 - b. Decision on which Parkas & Sons executive attends is not made by the person who attends (this reduces the appearance of a conflict of interest).
 - c. Person attending (Marks) does not have final say on purchase decision (this reduces the appearance of a conflict of interest).
 - d. Parkas & Sons executives go only when a new major purchase is being contemplated (to avoid the conference becoming a regular 'vacation').
3. The company does not need its own code of ethics. They can use the code of ethics developed by the CIMA the CIMA's code of ethics for professional management accountants which can be found at:
www.cimaglobal.com/Documents/code%20FINAL.pdf.

Pros of having a written code

The Conference Board outlines the following reasons why companies adopt codes of ethics:

- a. Signals commitment of senior management to ethics.
- b. Promotes public trust in the credibility of the company and its employees.
- c. Signals the managerial professionalism of its employees.
- d. Provides guidance to employees as to how difficult problems are to be handled. If adhered to, employees will avoid many actions that are unethical or appear to be unethical.
- e. Drafting of the policy (and its redrafting in the light of ambiguities) can assist management in anticipating and preparing for ethical issues not yet encountered.

1.33 Budgeting, ethics, pharmaceutical company

Chris Jackson was recently promoted to management accountant of Research and Development (R&D) for BrisCor, a Fortune 500 pharmaceutical company that manufactures prescription drugs and nutritional supplements. The company's total R&D cost for 2018 was expected (budgeted) to be \$5 billion. During the company's mid-year budget review, Chris realised that current R&D expenditures were already at \$3.5 billion, nearly 40% above the mid-year target. At this current rate of expenditure, the R&D division was on track to exceed its total year-end budget by \$2 billion!

In a meeting with CFO Ronald Meece later that day, Jackson delivered the bad news. Meece was both shocked and outraged that the R&D spending had got out of control. Meece wasn't any more understanding when Jackson revealed that the excess cost was entirely related to research and development of a new drug, Vyacon, which was expected to go to market next year. The new drug would result in large profits for BrisCor, if the product could be approved by year-end.

Meece had already announced his expectations of third-quarter earnings to Wall Street analysts. If the R&D expenditures weren't reduced by the end of the third quarter, Meece was certain that the targets he had announced publicly would be missed and the company's stock price would tumble. Meece instructed Jackson to make up the budget shortfall by the end of the third quarter using 'whatever means necessary'.

Jackson was new to the controller's position and wanted to make sure that Meece's orders were followed. Jackson came up with the following ideas for making the third-quarter budgeted targets:

- a. Stop all research and development efforts on the drug Vyacon until after year-end. This change would delay the drug going to market by at least six months. It is possible that in the meantime a BrisCor competitor could make it to market with a similar drug.
- b. Sell off rights to the drug Martek. The company had not planned on doing this because, under current market conditions, it would get less than fair value. It would, however, result in a one-time gain that could offset the budget shortfall. Of course, all future profits from Martek would be lost.
- c. Capitalise some of the company's R&D expenditures, reducing R&D expense on the income statement. This transaction would not be in accordance with accounting standards, but Jackson thought it was justifiable because the Vyacon drug was going to market early next year. Jackson would argue that capitalising R&D costs this year and treating them as expenses next year would better match revenues and expenses.

Required

1. Referring to ethical principles, comment on the acceptability of items a–c above.
2. Recommend an appropriate course of action to Jackson .

Solution: (30 min.)

Budgeting, ethics, pharmaceutical company

1. The overarching principles of the IMA Statement of Ethical Professional Practice are Honesty, Fairness, Objectivity and Responsibility. The statement's corresponding 'Standards for Ethical Behaviour...' require management accountants to:
 - Perform professional duties in accordance with relevant laws, regulations, and technical standards.
 - Refrain from engaging in any conduct that would prejudice carrying out duties ethically.

- Communicate information fairly and objectively.
- Disclose all relevant information that could reasonably be expected to influence an intended user's understanding of the reports, analyses, or recommendations.

The idea of capitalising some of the company's R&D expenditures is a direct violation of the IMA's ethical standards above. This transaction would not be 'in accordance with relevant laws, regulations, and technical standards'. GAAP requires research and development costs to be expensed as incurred. Even if Jackson believes his transaction is justifiable, it violates the profession's technical standards and would be unethical.

The other 'year-end' actions occur in many organisations and fall into the 'grey' to 'acceptable' area. Much depends on the circumstances surrounding each one, however, such as the following:

- Stop all research and development efforts on the drug Vyacon until after year-end. This change would delay the drug going to market by at least six months. It is also possible that in the meantime a BrisCor competitor could make it to market with a similar drug.* While this solution may solve the budget shortfall in this year, it could result in a significant loss of future profits for BrisCor in the long run, especially if a competitor is able to obtain a patent on a similar drug before BrisCor.
 - Sell off rights to the drug, Martek. The company had not planned on doing this because, under current market conditions, it would get less than fair value. It would, however, result in a onetime gain that could offset the budget shortfall. Of course, all future profits from Martek would be lost.* Again, this solution may solve the company's short-term budget crisis, but could result in the loss of future profits for BrisCor in the long run.
2. While it is not uncommon for companies to sacrifice long-term profits for short-term gains, it may not be in the best interest of the company's shareholders. In the case of BrisCor, the CFO is primarily concerned with 'maximising shareholder wealth' in the immediate future (third quarter only) but not in the long term. Because this executive's incentive pay and even employment may be based on his ability to meet short-term targets, he may not be acting in the best interest of the shareholders in the long run.

Jackson definitely faces an ethical dilemma. It is not unethical on Jackson's part to want to please his new boss, nor is it unethical that Jackson wants to make a good impression on his first days at his new job; however, Jackson must still act within the ethical standards required by his profession. Taking illegal or unethical action by capitalising R&D to satisfy the demands of his new supervisor, Ronald Meece, is unacceptable. Although not strictly unethical, I would recommend that Jackson not agree to slow down the R&D efforts on Vyacon or sell off the rights to Martek. Each of these appears to sacrifice the overall economic interests of BrisCor for short-run gain. Jackson should argue against doing this but not resign if Meece insists that these actions be taken. If, however, Meece asks Jackson to capitalise R&D, he should raise this issue with the chair of the audit committee after informing Meece that he is doing so. If the CFO still insists on Jackson capitalising R&D, he should resign rather than engage in unethical behaviour.

1.34 Professional ethics

Marie Sommers is the new division management accountant of the snack foods division of Superior Foods. Superior Foods has reported a minimum 15% growth in annual earnings for each of the past five years. The snack foods division has reported annual earnings growth of more than 20% each year in this same period. During the current year, the economy went into a recession. The corporate management accountant estimates a 10% annual earnings growth rate for Superior Foods this year. One month before the 30 June financial year-end of the current year, Sommers estimates that the snack foods division will report an annual earnings growth of only 8%. Zac Haast, the snack foods division manager, is not happy, but he notes that 'the end-of-financial-year actions' still need to be taken.

Sommers makes some enquiries and is able to compile the following list of end-of-financial-year actions that were more or less accepted by the previous division management accountant:

- a. deferring June's routine monthly maintenance on packaging equipment by an independent contractor to July
- b. extending the close of the current financial year beyond 30 June so that some sales of next year are included in the current year
- c. altering dates of shipping documents of next July's sales to record them as sales in June of the current financial year
- d. giving salespeople a double bonus to exceed June sales targets
- e. deferring the current period's advertising by reducing the number of television spots run in June and running more than planned in July
- f. deferring the current period's reported advertising costs by having Superior Foods' outside advertising agency delay the billing of June advertisements until July or by having the agency alter invoices to conceal the June date
- g. persuading carriers to accept merchandise for shipment in June of the current financial year although they normally would not have done so

Required

1. Why might the snack foods division director want to take these end-of-financial-year actions?
2. The division management accountant is deeply troubled and reads the CIMA Code of Ethics for Professional Accountants. Classify each of the end-of-financial-year actions (a–g) as acceptable or unacceptable according to that document.
3. What should Sommers do if Haast suggests that these end-of-financial-year actions are taken in every division of Superior Foods and that she will greatly harm the snack foods division if she does not cooperate and paint the rosiest picture possible of the division's results?

Solution: (30–40 min.)

Professional ethics

1. The possible motivations for the snack foods division director wanting to take end-of-financial-year actions include:
 - a. Management incentives. Superior Foods may have a division bonus scheme based on one-year reported division earnings. Efforts to front-end revenue into the current year or transfer costs into the next year can increase this bonus.
 - b. Promotion opportunities and job security. Top management of Superior Foods likely will view those division managers that deliver high reported earnings growth rates as being the best prospects for promotion. Division managers who deliver 'unwelcome surprises' may be viewed as less capable.

- c. Retain division autonomy. If top management of Superior Foods adopts a 'management by exception' approach, divisions that report sharp reductions in their earnings growth rates may attract a sizable increase in top management supervision.
2. The 'CIMA Code of Ethics for Professional Accountants' requires management accountants to:
 - Perform professional duties in accordance with relevant laws, regulations and technical standards.
 - Refrain from engaging in any conduct that would prejudice carrying out duties ethically.
 - Communicate information fairly and objectively.

Several of the 'end-of-financial-year actions' clearly are in conflict with these requirements and should be viewed as unacceptable by Sommers.

- b. The financial year-end should be closed on midnight of 30 June. 'Extending' the close falsely reports next year's sales as this year's sales.
- c. Altering shipping dates is falsification of the accounting reports.
- f. Advertisements run in June should be charged to the current year. The advertising agency is facilitating falsification of the accounting records.

The other 'end-of-financial-year actions' occur in many organisations and fall into the 'grey' to 'acceptable' area. However, much depends on the circumstances surrounding each one, such as the following:

- a. If the independent contractor does not do maintenance work in June, there is no transaction regarding maintenance to record. The responsibility for ensuring that packaging equipment is well maintained is that of the plant manager. The division controller probably can do little more than observe the absence of a June maintenance charge.
- d. In many organisations, sales are heavily concentrated in the final weeks of the fiscal year-end. If the double bonus is approved by the division marketing manager, the division controller can do little more than observe the extra bonus paid in June.
- e. If TV spots are reduced in June, the advertising cost in June will be reduced. There is no record falsification here.
- g. Much depends on the means of 'persuading' carriers to accept the merchandise. For example, if an under-the-table payment is involved, or if carriers are pressured to accept merchandise, it is clearly unethical. If, however, the carrier receives no extra consideration and willingly agrees to accept the assignment because it sees potential sales opportunities in June, the transaction appears ethical.

Each of the (a), (d), (e), and (g) 'end-of-financial-year actions' may well disadvantage Superior Foods in the long run. For example, lack of routine maintenance may lead to subsequent equipment failure. The divisional controller is well advised to raise such issues in meetings with the division president. However, if Superior Foods has a rigid set of line/staff distinctions, the division president is the one who bears primary responsibility for justifying division actions to senior corporate officers.

3. If Sommers believes that Haast wants her to engage in unethical behaviour, she should first directly raise her concerns with Haast. If Haast is unwilling to change his request, Sommers should discuss her concerns with the Corporate Controller of Superior Foods. She could also initiate a confidential discussion with a CPA Australia (ICAA or CIMA) Counsellor, other impartial adviser or her own attorney. Sommers may also ask for a transfer from the snack foods division if she perceives that Haast is unwilling to listen to pressure brought by the CFO or President of Superior Foods. In the extreme, she may want to resign if the corporate culture of Superior Foods is to reward division managers who take 'end-of-financial-year actions' that Sommers views as unethical and possibly illegal.

1.35 Professional ethics

Trade Issue Pty Ltd is a publishing company that produces trade magazines. The company's shareholders are awaiting the announcement of Trade Issue's earnings for the financial year, which ends on 30 June. Market analysts have predicted earnings to be around \$1.34 per share. The CEO of Trade Issue expects earnings to be only \$1.20 per share, and knows this will cause the price of the shares to drop. The CEO suggests the following ideas to various managers to try to increase reported earnings by the end of the financial year:

- a. delaying the recording of cancelled subscriptions for June until July
- b. waiting until the new financial year to update the software on office computers
- c. recognising unearned subscription revenue (cash received in advance for magazines that will be sent in the future) as revenue when received in the current month (just before financial year-end) instead of booking it as a liability
- d. delaying the recording of purchases of office supplies on account until after financial year-end
- e. recording advertising revenues that relate to July in June
- f. waiting until after financial year-end to do building repairs
- g. switching from declining-balance to straight-line depreciation to reduce depreciation expenses in the current year

Required

1. Why would Trade Issue's CEO want to 'manage' earnings?
2. From the point of view of the CIMA Code of Ethics for Professional Accountants, which of items **a–g** above are acceptable to Trade Issue's management accountant? Which are unacceptable?
3. What should the management accountant do about the CEO's suggestions? What should the management accountant do if the CEO refuses to change the suggestions?

Solution: (30 min.)

Professional ethics

1. The possible motivations for Trade Issue Pty Ltd's CEO to 'manage' earnings include:
 - a. Manage the stock price. The CEO of Trade Issue wants to meet the forecast earnings number of A\$1.34 per share because the CEO believes that the share price will drop if actual earnings fall short of the forecast.
 - b. Job security. The CEO may be concerned that the Board of Directors may have a poor view of him if he delivers 'unwelcome surprises'. Depending on how much the share price falls, they may even consider dismissing him.
 - c. Management incentives. The bonuses of top management and the CEO may be based on earnings. If earnings decrease, either smaller or no bonuses may

be paid. If top management and the CEO have share options, the value of these options will be adversely affected if the share price falls.

2. The 'CIMA Code of Ethics for Professional Accountants' requires management accountants to:
 - Perform professional duties in accordance with relevant laws, regulations and technical standards.
 - Refrain from engaging in any conduct that would prejudice carrying out duties ethically.
 - Communicate information fairly and objectively.

Several of the 'end-of-financial-year actions' are clearly in conflict with these requirements and should be viewed as unacceptable.

- a. Subscriptions cancelled in June should be recorded in June itself and not delayed until July.
- c. Subscription revenue received in June in advance for magazines that will be sent out in July is a liability. Showing it as revenue falsely reports next year's revenue as this year's revenue.
- d. Office supplies purchased in June should be recorded as an expense of the current year and not as an expense of the next year.
- e. Recording advertising revenues that relate to July in June falsely reports next year's revenue as this year's revenue.

The other 'end-of-financial-year actions' occur in many organisations and fall into the 'grey' to 'acceptable' area. Much depends on the circumstances surrounding each one, however, such as the following:

- b. If the software on office computers is not updated until the next financial year, there is no transaction or expense to record in June. The responsibility for ensuring that the software is updated is that of the chief information technology officer. The management accountant can do little more than observe the absence of June software update and question whether this will have an adverse long-term impact on Harvest Day.
- f. If building repairs are not done in June, there is no transaction to record in June. There is no record falsification here. The decision regarding when to do building repairs is made by the operations manager.
- g. Many companies switch their depreciation policy from one method to another. Trade Issue could argue that straight-line depreciation better represents the decrease in the economic value of the asset compared to the declining balance method. Straight-line depreciation may also be more in line with what its competitors do. If, however, Trade Issue changes to straight-line depreciation with the sole purpose of reducing expenses to meet its earnings goal, such behaviour would be unacceptable. The CIMA Code of Ethics for Professional Accountants requires management accountants to communicate information fairly and objectively and to carry out duties ethically.

3. Trade Issue's management accountant should raise his/her concerns directly with the CEO. If the CEO refuses to change his request, the Management accountant should raise these issues with the Audit Committee and the Board of Directors. The Management accountant could also initiate a confidential discussion with a CIMA

Ethics Counsellor, other impartial adviser or his/her own attorney. In the extreme, the Management accountant may want to resign if the corporate culture of Trade Issue is to reward executives who take 'end-of-financial-year actions' that the Management accountant views as unethical and possibly illegal.

Collaborative learning problems

1.36 Ethical challenges

In June 2017, the government of Sandos invited bids for the construction of a mobile telephone network. Pure Tone, an experienced communications company, was eager to enter the growing field of mobile telephone networks in countries with poor infrastructure for land-lines. If Pure Tone won a few of these early contracts, it would be sought after for its field experience and expertise. After careful analysis, the company prepared a detailed bid for the Communications Ministry of Sandos, building in only half of its usual profit margin and providing a contractual guarantee that the project would be completed in two years or less. The multimillion-dollar bid was submitted before the deadline, and Pure Tone received notification that it had reached the Sandos government. Then, despite repeated faxes, emails and telephone calls to the ministry, there was no news on the bids or the project from the Sandos government.

Richard Burns, Director of Global Operations for Pure Tone, contacted the Australian commercial attaché in Sandos, who told him that his best chance was to go to Sandos and try to meet the deputy minister of communications in person. Burns prepared thoroughly for the trip, rereading the proposal and making sure that he understood the details.

At the commercial attaché's office in Sandos's capital, Burns waited nervously for the deputy minister and his assistant. Burns had come to Sandos with a clear negotiating strategy to try to win the bid. Soon the deputy minister and his staff arrived, introductions were made and pleasantries exchanged. The deputy minister asked a few questions about Pure Tone and the bid and then excused himself, leaving his assistant to talk to Burns. After clearly indicating that many other compelling bids had been made by firms from around the world, the assistant said: 'Mr Burns, I guarantee that Pure Tone's bid will be accepted if you pay a \$1 million commission. Of course, your excellent proposal doesn't have to be altered in any way.' It was clear to Burns that the 'commission' was, in fact, a bribe. Tactfully, he pointed out that Australian laws and Pure Tone's corporate policy prohibited such a payment. The assistant wished him a good day and a pleasant flight home and left.

Required

1. As a shareholder in Pure Tone, would you prefer that Pure Tone executives agree to the payment of the 'commission'?
2. When Burns described his experience to his friend Anthony Corder, who managed international business development for another company, Corder said that his own 'personal philosophy' was to make such payments if they were typical in the local culture. Do you agree with Corder's point of view? Explain.
3. Why would Pure Tone have a corporate policy against such payments?
4. What should Richard Burns do next?

Solution: (40 min.)

Ethical challenges

1. It is clear that bribes are illegal according to Australian laws. It is not clear from the case whether bribes are illegal in Sandos. However, knowledgeable people in global

business would attest to the fact that it is virtually impossible to find any country in the world that specifically sanctions bribery. The major point, however, that deserves discussion is: Should Pure Tone engage in any unethical activities even if they are not illegal? It is difficult to make a generalisation about all shareholders of the company. It is, however, safe to assume that not all shareholders would want to keep their investment in a company that is engaged in unethical and/or illegal activities. There is historical evidence to substantiate this point: When apartheid laws were in effect in South Africa, many investors divested shares of companies doing business in South Africa.

2. Apparently Corder thinks that local culture and common practice are one and the same. This, in fact, is not the case. There are many common practices in developing countries, which are against the native culture.

Specifically, bribery often leads to decisions that are not made on the basis of the merits of the alternative selected. This results in misallocation of meagre resources of the developing country. Misallocation of resources has adverse effects on the economy of a country and the living standard of its population. The negative impact is intensified in developing countries because they can least afford the misallocation of resources.

As it applies to local common practice, multinational companies may make some small allowances but draw a hard line against paying the A\$1 million 'commission'.

3. Pure Tone might have an articulated corporate policy against such payments to get the message across that regardless of laws, the top management would not tolerate any bribery payments made by its employees. A strong and consistent message from the top often has a noticeable effect on the corporate culture and employee behaviour.

Australian laws specifically prohibit bribery payments. Such payments can result in heavy penalties to the company making the payments.

4. If this contract is of great importance to the global strategy of Pure Tone, it is likely that this kind of issue will come up again as Pure Tone expands into very diverse cultures and the company should tackle it head on and make a policy decision against offering bribes. Richard Burns should discuss the situation with the top management at Pure Tone and re-affirm his goal to get the Sandos contract by legal means. He could seek the help of the Australian representative in Sandos to continue a dialogue with Sandos' deputy minister of communications. He could propose other creative, legal changes to the Pure Tone's bid, even at the cost of reducing the profitability of the current project. Concessions such as training programs, schools and other public works projects may be legal. Get the attention of the Sandos government and raise Pure Tone's profile both at home and abroad. In the worst case, if the Sandos government does not agree to any of the creative, legal 'extras' that Pure Tone can provide in order to win the contract; Burns should report this to Pure Tone's management and be willing to walk away from the Sandos project.

1.37 Ethical challenges, environmental concerns

Furniquil Ltd produces high-quality furniture in Australia for sale to top Australian retailers. In 1995, Furniquil purchased a timber operation in Indonesia, and shifted from using

Australian hardwoods to using Indonesian ramin in its products. The ramin proved to be a cheaper alternative, and it was widely accepted by Furniquial's customers. Furniquial's management credits the early adoption of Indonesian wood for its ability to keep its Australian factory open when so many competitors had closed their doors. Recently, however, consumers have become increasingly concerned about the sustainability of tropical woods, including ramin. Furniquial has seen sales begin to fall, and the company was even singled out by an environmental group for boycott. It appears that a shift to more sustainable woods before year-end will be necessary, and more costly.

In response to the looming increase in material costs, CEO Stuart Fisher calls a meeting of senior management. The group generates the following ideas to address customer concerns and/or salvage company profits for the current year:

- a. Pay local officials in Indonesia to 'certify' that the ramin used by Furniquial is sustainable. It is not certain whether the ramin would indeed be sustainable. Put highly visible tags on each piece of furniture to inform consumers of the change.
- b. Make deep cuts in pricing through the end of the year to generate additional revenue.
- c. Record executive year-end bonus compensation accrued for the current year when it is paid in the next year, after the December fiscal year-end.
- d. Reject the change in materials. Counter the bad publicity with an aggressive ad campaign showing the consumer products as 'made in Australia', since production takes place in Australia.
- e. Redesign upholstered furniture to replace ramin contained inside with less expensive recycled plastic. The change in materials would not affect the appearance or durability of the furniture. The company would market the furniture as 'sustainable'.
- f. Pressure current customers to take early delivery of goods before the end of the year so that more revenue can be reported in this year's financial statements.
- g. Begin purchasing sustainable Australian hardwoods and sell the Indonesian subsidiary. Initiate a 'plant a tree' marketing program, in which the company would plant a tree for every piece of furniture sold. Material costs would increase 25%, and prices would be passed along to customers.
- h. Sell off production equipment before year-end. The sale would result in one-time gains that could offset the company's lagging profits. The owned equipment could be replaced with leased equipment at a lower cost in the current year.
- i. Recognise sales revenues on orders received but not shipped as of year-end.

Required

1. As the management accountant for Furniquial, prepare a report to the CEO in which you evaluate each of the preceding items (a-i) in the context of the professional accountants' code of ethics.
2. Prepare a formal written note as to the action you would take with regard to those items that are in violation of the ethical standards for management accountants.

Solution: (40 min.)

Ethical challenges, environmental concerns.

1. The overarching principles of the IMA Statement of Ethical Professional Practice are Honesty, Fairness, Objectivity, and Responsibility. The statement's corresponding 'Standards for Ethical Conduct...' require management accountants to:
 - Perform professional duties in accordance with relevant laws, regulations, and technical standards.

- Refrain from engaging in any conduct that would prejudice carrying out duties ethically.
- Communicate information fairly and objectively.
- Disclose all relevant information that could reasonably be expected to influence an intended user's understanding of the reports, analyses, or recommendations.

Several of the suggestions made by Fisher's staff are clearly in conflict with the statement's principles and required standards and should be viewed as unacceptable.

- a. *Pay local officials to 'certify' the ramin used by Furniquel as sustainable. It is not certain whether the ramin would indeed be sustainable or not.* If the payment could be considered a bribe, the company would be in violation of the *Foreign Corrupt Practices Act*. Knowledge of such a violation of law would be considered a violation of professional ethics.
- c. *Record executive year-end bonus compensation accrued for the current year when it is paid in the next year after the December fiscal year-end.* GAAP requires expenses to be recorded (accrued) when incurred, not when paid (cash basis accounting). Therefore, failure to record the executives' year-end bonus would violate the IMA's standards of credibility and integrity.
- f. *Pressure current customers to take early delivery of goods before the end of the year so that more revenue can be reported in this year's financial statements.* This tactic, commonly known as channel stuffing, merely results in shifting future period revenues into the current period. The overstatement of revenue in the current period may mislead investor's to believe that the company's financial well-being is better than the actual results achieved. This practice would violate the IMA's standards of credibility and integrity. Channel stuffing is frequently considered a fraudulent practice.
- i. *Recognise sales revenues on orders received but not shipped as of year-end.* GAAP requires income to be recorded (accrued) when the four criteria of revenue recognition have been met:
 - i. The company has completed a significant portion of the production and sales effort.
 - ii. The amount of revenue can be objectively measured.
 - iii. The major portion of the costs has been incurred, and the remaining costs can be reasonably estimated.
 - iv. The eventual collection of the cash is reasonably assured.

Because criteria 1 and 3 have not been met at the time the order is placed, the revenue should not be recognised until after year-end. Therefore, recording next year's revenue in the current year would be a violation of GAAP and would be falsifying revenue. This would be a violation of the IMA's standards of credibility and integrity and may be considered fraudulent.

Three of the suggestions appear to be acceptable:

- d. *Reject the change in materials. Counter the bad publicity with an aggressive ad campaign showing the consumer products as 'made in Australia', since manufacturing takes place in North Carolina.* This is an acceptable strategy. Consumers could then weigh the employment benefits against the negative

environmental effects of the company's actions.

- e. *Redesign upholstered furniture to replace ramin contained inside with less expensive recycled plastic.* Creative changes in product design using recycled materials will allow Furniqual to address sustainability concerns as well as protect company profits.
- g. *Begin purchasing sustainable North American hardwoods and sell the Indonesian lumber subsidiary. Initiate a 'plant a tree' marketing program, by which the company will plant a tree for every piece of furniture sold.* While this solution would increase cost of materials and the price Furniqual must charge for its product, sales and profits may not decline if consumers perceive the value of sustainability and corporate social responsibility.

The other 'year-end' actions occur in many organisations and fall into the 'grey' to 'acceptable' area. Much depends on the circumstances surrounding each one, however, such as the following:

- b. *Make deep cuts in pricing through the end of the year to generate additional revenue.* Again, this is only a short-term tactic to improve this year's financial results. Investors may be content in the short run, but in the long run, the new shipping company will see reduced margins from these actions.
 - h. *Sell-off production equipment prior to year-end. The sale would result in one-time gains that could offset the company's lagging profits. The owned equipment could be replaced with leased equipment at a lower cost in the current year.* While this course of action does not necessarily violate the IMA's code of ethical standards, it may be only a short-term tactic to improve this year's financial results. Fisher will need to weigh his options in the long term to make the most cost effective decision for his company.
2. It is possible that any of the 'year-end' actions that fall into the 'grey' area may be good for investors, depending on the credible evidence that supports the management decision. For example, replacing owned equipment with leased equipment may result in both short-term gains for the company and long-term cost reduction. If so, this decision would be in the best interest of the investors. If the decision only results in short-term gains, but higher costs in the long-run, then the decision may not be in the best long-term interest of the company's investors and should not be implemented solely to prop up short-term earnings.

Those decisions that clearly violate the IMA code of ethical standards (a, c, f, and i) would never be in the best interest of the investor. These options would result in misleading financial statements and could result in the demise of the company or even in criminal charges, as was the case with companies such as Enron and WorldCom. If Fisher asks the management accountant to take any of the actions that are clearly unethical, he should raise this issue with the chair of the Audit Committee after informing Fisher that he is doing so. If Fisher still insists on the management accountant taking these actions, he should resign rather than engage in unethical behaviour.