**Case 1-6 Capitalization versus Expensing**

Gloria Hernandez is the controller of a public company. She just completed a meeting with her superior, John Harrison, who is the CFO of the company. Harrison tried to convince Hernandez to go along with his proposal to combine 12 expenditures for repair and maintenance of a plant asset into one amount ($1 million). Each of the expenditures is less than $100,000, the cutoff point for capitalizing expenditures as an asset and depreciating it over the useful life. Hernandez asked for time to think about the matter. As the controller and chief accounting officer of the company, Hernandez knows it’s her responsibility to decide how to record the expenditures. She knows that the $1 million amount is material to earnings and the rules in accounting require expensing of each individual item, not capitalization. However, she is under a great deal of pressure to go along with capitalization to boost earnings and meet financial analysts’ earnings expectations, and provide for a bonus to top management including herself. Her job may be at stake, and she doesn’t want to disappoint her boss.

**Questions**

Assume both Hernandez and Harrison hold the CPA and CMA designations.

1. **What are the loyalty obligations of both parties in this case?**

Capitalizing the expense would overstate assets and understate expenses which would overstate net income. This would cause misleading and false financial statements. As CPAs, Hernandez and Harrison should have loyalty to the public interest. As employees at a public company, they have a loyalty obligation to prepare truthful and non-misleading financial statements that are in conformity with generally accepted accounting principles. As CMAs, Hernandez and Harrison are expected to perform professional duties in accordance with relevant laws, regulations, and technical standards, which include GAAP that dictate expensing of each item. Their responsibilities also require that they follow the policies of the firm and not manipulate the financial statements. They are to act in the best interest of the firm. Harrison may be trying to improve the short-term financial position of the firm but it may cause a longer-term problem to the firm’s reputation.

1. **Assume that you were in Gloria Hernandez’s position. What would motivate you to speak up and act or to stay silent? Would it make a difference if Harrison promised this was a one-time request?**

Gloria needs the courage to speak up about how it is wrong to capitalize $1 million that should be expensed. She needs to think of the long term results of what doing this would do to the company’s and her reputation versus the short term result of greater net income or a larger bonus. If the items are capitalized and it is later revealed that expensing was appropriate, then Gloria could be sanctioned by a state board of accountancy for her actions. She may even be blamed for going along and be convicted of crime, as was Betty Vinson in the WorldCom case.

Gloria is being asked to capitalize essentially one item costing $1 million rather than expense the 12 items totaling $1 million. The difference in accounting treatment has an immediate effect of increasing net income for the year, which will lead to bigger bonuses for the executives. It might seem tempting to go along with the plan since her job may be at stake and she does not want to disappoint her boss. However, under the objectivity and due care provisions of the AICPA Code, and the competence and credibility provisions in the IMA Statement of Ethical and Professional Practice, Gloria should expense the items.

Gloria should be prepared to speak to the CEO and the audit committee of the Board of Directors. She should explain that the company’s and industry’s accounting principles require the items to be expensed. If the items are capitalized to manipulate earnings and increase bonuses, trust earned will be compromised and the financial statements are false. Even if Gloria’s job survives the refusing to capitalize the items, Gloria may need to look for another position at a company with a corporate culture more in line with her values.

Gloria should not go along with the capitalization request even if Harrison promised that it was a one-time request. If Harrison tries manipulate accounting again in the future, and Gloria went along the first time, she places herself in a “gotcha” situation. Betty Vinson saw, the one-time request became a habitual occurrence. Gloria should look to identify enablers in the organization, such as a trusted advisor, to counteract the disablers or those who want her to go along with the capitalization.

1. **What would you do and why?**

Hopefully, the students would not go along with the request. However, it is easy to say that one should not go along with such requests when one is sitting in classroom and not feeling the actual pressure. Gloria has to consider not only will she lose her job, but new challenges would exist for her to cover bills, student loans, mortgage payment, car payment, family health, and all the other pressures of real life and being an adult. A worthwhile perspective is to ask the students how they would feel if their decision to go along made it to the front page of the local newspaper. Would they be proud to defend it?

The key in this kind of situation is to empower Gloria to give voice to her values and do the right thing. The Giving Voice to Values methodology will be discussed in Chapter 2.