**Case 1-9 Cleveland Custom Cabinets**

**This case is treated as GVV in the Test Bank IM in Chapter 2. Faculty can assign the case in Chapter 1 or delay it until Chapter 2, if they plan to use it for GVV testing purposes in Chapter 2.**

Cleveland Custom Cabinets is a specialty cabinet manufacturer for high-end homes in the Cleveland Heights and Shaker Heights areas. The company manufactures cabinets built to the specifications of homeowners and employs 125 custom cabinetmakers and installers. There are 30 administrative and sales staff members working for the company.

James Leroy owns Cleveland Custom Cabinets. His accounting manager is Marcus Sims, who reports to the director of finance. Sims manages 15 accountants. The staff is responsible for keeping track of manufacturing costs by job and preparing internal and external financial reports. The internal reports are used by management for decision making. The external reports are used to support bank loan applications.

The company applies overhead to jobs based on direct labor hours. For 2016, it estimated total overhead to be $4.8 million and 80,000 direct labor hours. The cost of direct materials used during the first quarter of the year is $600,000, and direct labor cost is $400,000 (based on 20,000 hours worked). The company’s accounting system is old and does not provide actual overhead information until about four weeks after the close of a quarter. As a result, the applied overhead amount is used for quarterly reports.

On April 10, 2016, Leroy came into Sims’s office to pick up the quarterly report. He looked at it aghast. Leroy had planned to take the statements to the bank the next day and meet with the vice president to discuss a $1 million working capital loan. He knew the bank would be reluctant to grant the loan based on the income numbers in [Exhibit 1](file:///C:\Users\smintz\Downloads\142135d66cbf466c93cb8d772622e8cd). Without the money, Cleveland could have problems financing everyday operations.

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| Exhibit 1  Cleveland Custom Cabinets | |
| **Net Income for the Quarter Ended March 31, 2016** | |
| Sales | $6,400,000 |
| Cost of goods sold | 4,800,000 |
| Gross margin | $1,600,000 |
| Selling and administrative expenses | 1,510,000 |
| Net income | $     90,000 |
|  | |

Leroy asked Sims to explain how net income could have gone from 14.2 percent of sales for the year ended December 31, 2015, to 1.4 percent for March 31, 2016. Sims pointed out that the estimated overhead cost had doubled for 2016 compared to the actual cost for 2015. He explained to Leroy that rent had doubled and the cost of utilities skyrocketed. In addition, the custom-making machinery was wearing out more rapidly, so the company’s repair and maintenance costs also doubled from 2015.

Leroy wouldn’t accept Sims’s explanation. Instead, he told Sims that the quarterly income had to be at least the same percentage of sales as at December 31, 2015. Sims looked confused and reminded Leroy that the external auditors would wrap up their audit on April 30. Leroy told Sims not to worry about the auditors. He would take care of them. Furthermore, “as the sole owner of the company, there is no reason not to 'tweak’ the numbers on a one-time basis. I own the board of directors, so no worries there.” He went on to say, “Do it this one time and I won’t ask you to do it again.” He then reminded Sims of his obligation to remain loyal to the company and its interests. Sims started to soften and asked Leroy just how he expected the tweaking to happen. Leroy flinched, held up his hands, and said, “I’ll leave the creative accounting to you.”

**Ethical Overview**

The stakeholders of the firm have a right to financial statements that follow GAAP and have adequate disclosures. From a deontology perspective, Marcus Sims should follow the rules of the profession; i.e., GAAP and no subordination of judgment. From a utilitarian perspective all the stakeholders should benefit, not just Leroy the owner. In adjusting the numbers in order to obtain a bank loan, the bank could be greatly harmed in order to benefit one stakeholder, Leroy. If Sims should give into Leroy, then it could be easier to subordinate judgment in the future and may give Leroy the means to blackmail subordination easily.

From a rights perspective the stakeholders, other than Leroy, have a right to truthful dealings (including financial statements) with the firm. From a deontology perspective, the firm has a duty to be truthful. From a utilitarian perspective, all stakeholders should be considered in determining the greatest good. From a virtue perspective the firm owes trustworthiness, respect, responsibility and fairness to its stakeholders. The firm also has a citizenship responsibility to pay taxes based upon truthful reporting of operations. The board has an obligation to corporate governance that means oversight of Sims, and providing an audit committee to ensure that truthful financial statements are provided to stakeholders and to serve as a check on management behavior.

The board of directors are there to provide governance, ask questions, and to represent all the shareholders and fulfill duties to outside stakeholders of the firm. The board should not just rubber stamp Leroy’s decisions but act independently of management and in the best interests of the shareholders.

The external auditors have a responsibility to the public interest, and have a duty to be independent of clients, maintain objectivity and integrity, and exercise due care including professional skepticism.

**Questions**

1. **Do you agree with Leroy’s statement that it doesn’t matter what the numbers look like because he is the sole owner? Even if it is true that Sims “owns” the board of directors, what should be their role in this matter? What about the external auditors? Should Sims simply accept Leroy’s statement that he would handle them?**

No, Leroy is not the sole stakeholder to the firm. The firm has creditors (including the bank), customers, employees, suppliers, and the government, who are all stakeholders. Leroy possibly has a spouse and dependents who would share in gains and losses.

Leroy’s statements of owning the board and taking care of the auditors should not be relied upon by Sims. If Sims is the one doing the creative accounting, he will be the one suffering the consequences, when the fraud is uncovered. Leroy may not want to know how the creative accounting will be done so he can feign ignorance (like in WorldCom and Health South scandals).

The case is silent whether Marcus Sims holds the CPA or CMA. Either way, those standards provide guidance in deciding what to do. Sims reports to the director of finance. Sims manages 15 accountants. The staff is responsible for keeping track of manufacturing costs by job and preparing internal and external financial reports. The internal reports are used by management for decision making. The external reports are used to support bank loan applications. Sims has a variety of ethical obligations that dictate honest, objective, careful, and thorough deliberation in making choices including what the right thing to do is in this case.

* + 1. **Assume that Sims is a CPA and holds the CMA. Put yourself in Sims’s position. What are your ethical considerations in deciding whether to tweak the numbers?**

Now we know Sims is a CPA and CMA. He has an obligation to follow GAAP and not subordinate his judgment. Sims must be prepared to act out of integrity even if it means a loss of job. He has a responsibility to the public interest above all else. Sims has to decide between subordinating his judgment and leaving his present job, either due to firing or quitting. If Sims leaves his present job, then he will face a confidentiality issue as to whether it frees him to disclose the information to others.

Sims would be dishonest to “tweak” the numbers. He might be able to get away with it one time, but eventually his failings would be discovered. At that time the consequences would be much more severe because of the cover-up. When the situation is made public, Sims could be civilly and criminally prosecuted; lose his CPA license; and be unable to find a job in a financial sensitive area again.

Sims should not “tweak” the numbers. The chances are high that Leroy may fire him on the spot for not following the orders to change the numbers. However, Sims can more easily explain why he is looking for a new job because he acted on principle than why he spent time in jail for his actions.

Should Sims decide to go along with something he knows is wrong, Leroy has something to hold over his head in the future if Sims decides, all of a sudden, to take the ethical high road.

Loyalty is a key issue in this case. Sims should understand that his loyalty obligation is not to Leroy and the company but to the public that relies on accurate and reliable financial information.

* + 1. **Assume you do a utilitarian analysis to help decide what to do. Evaluate the harms and benefits of alternative courses of action. What would you do? Would your analysis change if you use a rights theory approach?**

Using an act utilitarian analysis, Sims may consider doing as requested by Leroy. This alternative may seem to provide the greatest good for all concerned as Cleveland Cabinets can continue in business; Leroy is happy that the bank will lend more money; the employees and Sims will continue employment with the firm; creditors will be paid; and the board and shareholders will continue to believe that all is well with the firm. However, from a rule utilitarian basis, GAAP rules should never be violated regardless of utilitarian benefits. The ends do not justify the means of manipulating the data.

From a rights approach, the investors, creditors, and the bank have right to truthful and non-misleading financial statements following GAAP. The employees and Sims have the right to earn fair wages for work done, and to be treated fairly, honestly, and professionally by management. Leroy does not have the right to run the company as his personal entity but has obligations to a broad group of stakeholders. He has a duty to provide oversight in an honest, open, professional manner. He has an obligation to make sure that financial statements are non-misleading and follow GAAP.

Sims may consider doing minor “tweaks” to the numbers, not as much as requested by Leroy. Sims may hope that the minor “tweak” will be enough to satisfy the bank but be realistic to show liquidity for the amount of loans needed. In this alternative, Cleveland Cabinets and Leroy might have to start tightening expenses and strategic planning for a tighter future of the firm. Some employees may be laid off to conserve costs. Sims may receive an angry scolding from Leroy but keep his position. Sims will need to work with Leroy to develop a realistic budget while addressing the need to cut costs.

Sims could refuse to “tweak” the numbers. It is highly probably that Leroy will fire him on the spot. The firm may have a rough time financially with reduced bank financing, possible bankruptcy, lay-offs, and investors losing money. However, this might provide a wakeup call to Leroy and the firm to control costs and to strategically plan and budget the firm to sounder financial well-being.

1. **Think about how you would actually implement your chosen action. What barriers could you face? How would you overcome them? Is it worth jeopardizing your job in this case? Why or why not?**

Sims may want to consult with the external auditors to see if he may have made a mistake on the applied overhead for the current year. Getting a second opinion should help to bring into focus what are his ethical responsibilities.

Sims faces push back from Leroy and his position may be at stake. If he discloses his concerns to outsiders his fellow employees may treat him as a whistleblower; he may be blamed for not being a team player; he may be retaliated against.

The shareholders, creditors, and the bank may be shocked that the company had its financial position go south so quickly; they may resent the loss of their investment.

Is this worth Sims losing his job over? Only Sims can say. But would Sims want to stay working for a company that has made its financial statements a house of cards? Would he be asked to continually cover his tracks of the creative accounting? Can Cleveland Cabinets regain profitability without changing the business model (and possibly, some of the players)? Would Sims be willing to go to jail for Leroy? How would he feel if his decision became front page news? Would he be proud to defend it?