



## **Policy and Judgment--The X Systems Group**

### **A Corporate Training Case Study**

The controller hears the plant manager say: “Ship a few unauthorized partials (untested and parts-missing machines) and keep the books open four extra shipping days.” What is the controller going to do?

#### ***Abstract***

*A controller enjoys the team spirit and success of a dynamic corporate division, until the numbers stop adding up. Examine the facts presented for X Systems Group and determine the course of action you believe should be taken.*

#### **Background**

Sitting in your office at corporate headquarters you remember the events during that fourth quarter quite vividly.

You were the new group plant controller for The X Systems Group. For the last 18 months your group had produced the hottest products in the company and the volume shipment budgets had been raised three times as everyone recognized their market potential. Spending levels were up 50% from the original budget and the “can do” reputation of the group was the source of many jokes around the company about how they used black magic to keep growing shipments so fast.

Because of its success and high visibility, everyone in the group felt like winners. There was a real esprit de corps, and 10-hour days were the rule, with 12- and 14-hour days not at all exceptional. Everyone felt like members of a winning team, and no one wanted to fail or let others down.

The plant manager really used the group spirit as a positive motivator. Bumper stickers had been printed touting the productive power of the X Group, and lots of people wore baseball caps with some of the same themes. Headquarters would approve just about any capital project and there were many regular visits by senior corporate managers and outsiders.

The word was that the X Group would provide 45% of the company’s profits over the next three years, so there was much attention given at the corporate level to group growth forecasts.

#### **The Problem**

Despite all the enthusiasm, for many months you had been concerned about the feasibility of the forecasts. After much discussion, the plant manager had agreed there was a high



probability the numbers could not be made. But he had been adamant that this should not be discussed in the plant or at the corporate level. He insisted that he wanted to use the pressure to make the numbers to keep people working hard and making personal sacrifices to do the impossible. He was an ex-Marine Captain and had the reputation as the best line manager in the company. He had interviewed seven people for the controller's job and had picked you. You admired and respected the man because he was dedicated, hard working and a natural leader, and most of all because you had seen him and his team do the impossible, bringing in the numbers quarter after quarter. Also, you considered your team members to be your friends and partners and didn't want to let them down.

As a result, you have consistently told corporate that you will make the forecasts, even though your people have developed analyses showing it probably can't be done, given available labor, space and materials limitations.

Looking back, you remember that some of the earlier performance had been achieved by dynamic and unusual management practices, such as hiring moonlighting workers from a competitor's plant, sending chartered jets to vendor sites to pick up parts, and, in a few cases, warehouse and slow truck shipments as well as paying a small vendor a bonus out of multiple petty cash vouchers to ship parts earmarked for another customer. You and the manager had even rented empty shopping centers without corporate approval or insurance coverage, paying the rent with weekly petty cash vouchers to stay within your disbursement authority and keep the buildings off the corporate books.

However, in the last 12 days of the quarter, the manager had run out of solutions and short-term fixes. There were plenty of orders; in fact, backlog had gone from 7 to 16 weeks. But the materials pipeline was dry, and testing problems had suddenly developed. The plant staff was also at the edge of sheer exhaustion. Tempers were short and morale was suddenly the lowest you had ever seen it in any organization. It was amazing how *everything* had changed in just a few short weeks.

According to your most optimistic estimates, you would miss the fourth quarter budget and forecast by at least \$75 million.

### **The Dilemma**

The manager's secretary had called saying he wanted to have lunch with you. Sitting in his truck in front of the sub shop, he told you in his usual confident way that two steps would solve all the problems. "Ship a few unauthorized partials (untested and parts-missing machines) and keep the books open four extra shipping days." The thing you remember most is how convinced he was that there were really no other choices. This was just another business problem for a dynamic manager to solve. It was a simple matter of bending a few minor red tape rules or jeopardizing the welfare of the plant and all of its people.

"Everyone has worked so hard," he told you. "We can't let them down over a few million bucks of shipments. It would take months, maybe even years to recover the morale from

that failure and disappointment. The company can't afford to let that happen; it needs this plant too much to lose the magic if everyone feels like a failure because we miss a few percent of the ship budget. There is no need to talk to corporate. They have their own problems to worry about. This is *our* job, and we have to do what's right."

### ***Comments on "Policy and Judgment--The X Systems Group"***

**Martin S. Fridson, CFA, is Chief High Yield Strategist and Managing Director at Merrill Lynch.**

*Mr. Fridson is author of several books on Financial Statement Analysis.*

Note: Martin's comments are based on a fictitious case, any resemblance to person living or dead is coincidental.



*"Companies never "make it up" once they begin booking a little extra revenue in the current quarter. Instead, they dig themselves into a deeper and deeper hole as time passes."*

Contrary to the group plant controller's perception, everything has *not* changed in just a few short weeks at The X Systems Group. The system has been corrupt for a long time, making the present crisis inevitable. As is usually the case with financial fraud, borrowing profits from the future has created pressure to do more and more of the same. Companies never "make it up" once they begin booking a little extra revenue in the current quarter by using the classic gimmicks described in this case. Instead, they dig themselves into a deeper and deeper hole as time passes.

The progressive nature of dishonest practices is illustrated by the outright bribe (euphemistically labeled a "bonus") paid to a vendor to divert a parts shipment from the rightful recipient. Now is the time for the group plant controller to pull the plug, despite having to face dismissal and perhaps even criminal charges. The personal consequences will only get worse if the fraud continues. Under no circumstances should the controller agree to abet the plant manager's newest planned deceptions.

In the X Systems affair, we see the mask ripped off the "can-do" approach. Enthusiasm, motivation and tenacity all sound great, but they ring hollow when managers ignore legitimate rules and regulations. Setting targets is a powerful technique, yet a destructive one when they become objectives unto themselves, rather than reflections of actual

economic performance. It is particularly insidious when managers use peer pressure (“Don’t let the team down”) to enforce participation in the unethical scheme.

The predictable conclusion of this story, sadly, is that senior management will escape all responsibility for the false financial reporting. Previous earnings will be restated and the accompanying press release will blame a “rogue manager.” Such a claim is preposterous in view of senior managers’ frequent visits to the plant and ultimate responsibility for operations. The top executives will not be forced to rescind the performance-related bonuses they received with the help of financial reporting gimmicks, which they will later deny knowing about. Regrettably, the demonstrated success of chief executive officers and chief financial officers in maintaining deniability ensures the regular recurrence of this sort of situation in the corporate world.

**Maureen F. McNichols, Ph.D., CPA, is Marriner S. Eccles Professor of Public and Private Management, Stanford University.**

*She is the author of “Does Meeting Expectations Matter: Evidence from Analysts’ Forecast Revisions and Share Prices,”(with R. Kasznik), Stanford University Graduate School of Business working paper, 2001.*



*“The earnings targets appear to come from corporate management with little input from X Systems about what is feasible.”*

This case presents the controller of X Systems with a very difficult choice: He can ship incomplete products and keep the books open four extra days or report in accordance with generally accepted accounting principles and fail to meet internal targets.

The controller’s immediate concern is to determine what steps are acceptable to meet a target, but the case raises broader questions as well. In particular, the earnings targets appear to come from corporate management with little input from X Systems about what is feasible. Furthermore, spending levels increased 50% from the original budget. This suggests targets for production have been increased substantially relative to expectations held at the start of the budget year. If X Systems repeatedly resorts to heroic measures to meet these targets, corporate management may well have a false impression of what production is achievable and what level of sales growth is sustainable. Thus X Systems may face rising targets over time and declining prospects for meeting those targets using appropriate management practices. Overall, this raises the concern that manipulating information hinders corporate and division level planning and resource allocation decisions. An open question is the business’ control environment and corporate management’s role in its condition. Is X Systems a renegade division or is the group’s

manager responding to incentives designed by corporate management? Do existing controls motivate managers to act in the best interests of shareholders?<sup>5</sup>

Research shows that companies that consistently meet analysts' expectations are valued more highly by investors.<sup>6</sup> However, this research also finds that businesses that meet expectations in only one or two years are valued based on their actual earnings, not their earnings relative to expectation. In other words, a company that reports earnings per share of \$1.20 when investors expect \$1.30 is valued similarly in the short run to one that reports EPS of \$1.20 when investors expect \$1.10.<sup>7</sup> This finding suggests that the market rewards companies that consistently establish achievable expectations and meet them, but not those that manipulate expectations or earnings to meet a specific earnings target. Consistently meeting expectations requires the ability to properly set expectations and then motivate employees to meet them. X Systems will find this increasingly difficult because expectations are unlikely to be set properly without valid information. Also, by borrowing ahead to meet this period's revenue goal, it is likely to face greater pressure to perform. Although the manager of X Systems might believe that he is helping corporate management by achieving targets at any price, he is depriving them of the information they need to manage their business, allocate resources and communicate with investors.

With this as background, I recommend that the controller have a serious talk with the manager of X Systems. The manager needs to understand that as the manipulations escalate, they make future targets less attainable and set the stage for their ultimate disclosure. In other words, the manager has to think beyond the current quarter's numbers. For this reason, X Systems must tell corporate management that the current forecasts are unattainable. While the short-term consequences may seem very negative, the long-term fallout is surely worse. Corporate management should work with X Systems to develop better communication, budgeting and control procedures. Without them, the company risks a major control failure that would be very damaging to the business, its employees and investors. Academic research shows that investors do respond to lower earnings in valuing a company. However, the reaction is far more negative if investors perceive that the earnings numbers they have used to value the business are a product of creative accounting.

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<sup>5</sup> For further discussion of related issues, see *Accounting for Decision Making and Control* by Jerrold Zimmerman (1995), *Management Accounting* by Atkinson, Banker, Kaplan and Young (1995) and *Divisional Performance Measurement and Control* by Solomons (1965). See also "Speech by SEC Chairman: Remarks Before the Conference on the Rise and Effectiveness of New Corporate Governance Standards" by SEC Chairman Arthur Levitt, December 12, 2000.

<sup>6</sup> See "Does Meeting Expectations Matter: Evidence from Analysts' Forecast Revisions and Share Prices," April 2001, Stanford University Graduate School of Business working paper, by Ron Kasznik and Maureen McNichols.

<sup>7</sup> Of course, the price reaction to the announcement is positive for the first company and negative for the second, but the value of these two companies is the same. Only by consistently meeting expectations do businesses appear to earn a market reward; that is, a value greater than that expected given their earnings.



**Nita Clyde, Ph.D., CPA, is a partner at Clyde Associates.**

*Clyde Associates is a boutique consulting firm located in Dallas, TX where Nita specializes in accounting education with a particular emphasis on issues of professional ethics. She chairs the AICPA/NASBA Joint Committee on Continuing Professional Education Standards, as well as a Special Committee on Ethics in the CPA Profession. She is a past member of the AICPA Board of Directors, and is currently a member of its governing Council. Nita was a university professor for almost 20 years.*

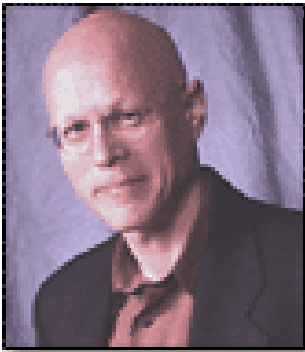
*“The controller should inform the plant manager that he or she will no longer be a party to any attempts to hide true operating status.”*

The group plant controller for The X Systems Group has allowed professional judgment to be influenced by misguided admiration and respect for the plant manager. While loyalty to a superior or fellow employee may be admirable, the controller’s participation in the variety of schemes to improve group performance measures ignores the impact of these dubious actions on the company as a whole. Both the company and its owners have been placed at risk through the acquisition of surreptitiously rented facilities lacking proper insurance. By consistently assuring the corporate office that forecasts will be made, the controller has ignored the analyses of his or her immediate subordinates and become a participant in what can only be labeled a whitewash of the real plant operating results. Many would call the behavior fraudulent. It is troubling that the controller—while “concerned about the feasibility of the forecasts”—has done nothing to refute or modify the plant manager’s problem-solving suggestions.

Further subordination of the controller’s judgment to that of the plant manager carries such peril that “letting the team down” becomes an attractive alternative by contrast. The controller should inform the plant manager that he or she will no longer be a party to any attempts to hide true operating status and alert corporate management to the problems. Admission of his or her role in the various schemes may (and probably will) force the controller to seek other employment, but, to paraphrase the words of the plant manager: “This is [my] job, and [I] have to do what’s right.”

**Steven Wallman, J.D., is founder and CEO of FOLIOfn founded in 1998.**

*Using the FOLIOfn system, investors can purchase customized portfolios. He is a former commissioner of the U.S. Securities and Exchange Commission and a former partner, Covington and Burling. He is a non-resident senior fellow of economic study at Brookings.*



*“Being part of a hot team is extremely energizing. Who wants to be the skunk at the garden party when the reality of slow sales and high expenses sets in?”*

It’s a shame. The situation described in this case study is a symptom of the pressures that the current system of static, “snapshot-style” quarterly accounting places on ordinary people trying to do their jobs. And it richly foreshadows the disastrous consequences that can follow.

It’s easy to imagine being in the shoes of the group plant controller for The X Systems Group. Being part of a hot team is extremely energizing. Who wants to be the skunk at the garden party when the reality of slow sales and high expenses sets in? Under the current system, no one has to be, as long as there are a few more weeks or days in the quarter (whether the days are real or borrowed from the next quarter). The controller and his colleagues gave in to the temptation to double the bet and press on, hoping that the future would be better. It is easy to see in retrospect how they succumbed. But one has to have sympathy for the plant manager and the controller. The slowly unfolding disaster is one of those things that is hard to recognize as it is happening without the proper distance, objectivity and controls. It is always easy to think that the solution is just around the corner, especially if you have actually pulled together a solution quarter after quarter before.

Ironically, the incentives of the current reporting system exacerbated the problem from the perspective of the shareholders. Since the managers were free to try to “fix” the problem right up until the end of the quarter, they had plenty of time to make it worse, which is what they did. Their desire to hide the bad news from subordinates, superiors and shareholders was aided by the snapshot quarterly system. What might have been a soft landing is going to be a hard crash.

Imagine a radically different system in which a company’s progress toward goals that affect shareholder equity is truly an open book, reported in real-time. Eventually there will be no reason, given financial systems software and the ubiquity of the Internet, for shareholders not to be given much more frequent, even daily, information about shipped units and other measures of performance. Even if shareholders were not given this information, at least senior management should have it. Had corporate headquarters seen the dry materials pipeline they would have known there could be trouble. But they were apparently clueless because they were relying on a quarterly number without knowing what was behind it. They were also caught relying on a plant manager who, at the end of this quarter, unfortunately thought the world would bend to his version of the rules. And now the controller is in the tough spot of having to explain that the rules here are unyielding, even though the controller abetted the previous cover-up with headquarters.



Now there is only one course, and there should be some measure of relief in the transparency. For people like X Systems Group's controller, the pressure of concealment and the ethical dilemma it creates must be removed from his daily concerns. There is a job to do and pretending will not solve the problem. The plant is sound, the backlog is growing, profits are there to be had--just not entirely in this quarter. The workers do not benefit from the current concealment, by the way, no matter how valuable their team spirit may be. The news cannot be hidden forever, and when it breaks, the concealment will only compound employees' bitterness and shock about the company's shortfall.

Transparency going forward will also counterbalance X Systems Group's grave lack of meaningful controls. It's hard to imagine an excuse for headquarters' laissez faire attitude toward capital expenditures and production planning, and even harder to explain an approach to expenditures so lax that it would condone chartering of jets and renting real estate, with headquarters none the wiser. A somewhat more real time and granular reporting requirement, at least internally, could have smartened everyone up. But until it is here, full disclosure of the real end-of-quarter numbers--using a real end of quarter, not one with some extra days in it--is the only permissible course of action.