

## **Creative Accounting?**

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The Buenas Cosas Corporation has had an average yearly increase in Gross Profit Margin (GPM) of 10% over the last 5 years. This year's quarterly report shows a 2% GMP increase, and management expects a decrease in GMP for the last quarter of the year.

Concerned about these reports, the general manager decides to hold a meeting with the operations managers and the comptroller to discuss the third quarter report and find ways of stopping the current downward GMP path.

The operations manager recommends obtaining better control over product costs by using ABC Costing and Total Quality Management. He argues that controlling product costs is of paramount importance since an increase in selling price would lose substantial market share given the current highly competitive market.

The comptroller has a different suggestion: to change the inventory method to one that can decrease the reported Cost of Goods Sold.

After these suggestions were laid out, the three begin to debate the options available:

**Operations Manager:** We have been using the same inventory method for many years and have received good results from it. Why fix something that isn't broken?"

**Comptroller:** There is nothing wrong with the present inventory method. However, a change in the accounting method for inventory can increase profits or at least appear to do so.

**General Manager:** The external auditor will notice the change in inventory method. We have gotten clean reports from them in the past. Do we really want to

place our good reputation in jeopardy?

**Comptroller:** Professional accounting standards allow us to change accounting methods, although they tend to encourage overall consistency. We only need to show that the new method is preferable in some way. Then we must disclose the effects of the change in the financial statements.

**Operations Manager:** From what I remember of my accounting courses in college, we need to disclose the effect of the change on the previous years also. This could have a negative impact on the amounts reported in these years.

**Comptroller:** We can choose a method that will have a positive impact in profits of the previous years and in the current year. The accounting team can then justify the change and make the necessary calculations.

**General Manager:** It sounds good to me. The accounting change in the inventory method will solve our immediate problem. In addition, we will have enough time to find alternatives to improve operations for next year. So go ahead and make all the necessary calculations. We need to improve the GMP by the end of the year.

*Questions:*

1. Evaluate the final decision of the general manager in terms of the following two questions:
  - a. A change in accounting method should result in financial statements that provide more useful information to users. Does this change satisfy this demand? Does this change deceive the users in any way?
  - b. A change in accounting method should not be used to improve artificially the reported performance and financial position of an organization. Does this change represent merely an artificial improvement in the reported performance and financial position of the organization?

2. Suppose you were participating in this meeting. How would you respond to the arguments of the operations manager and the controller? What alternatives would you propose? How would you defend them?
3. Clarify the ethical problems (if any) facing the general manager. How would you classify them?
4. Put yourself in this meeting. Then continue the dialogue. What alternatives would you put forth? How do you think the general manager, the controller, and the operations manager would react to your proposals? How would you defend them?