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CASE 4.1

Rocky Mount Undergarment Company, Inc.

Employees involved in the accounting and control functions of organizations often face ethical dilemmas. Typically, at some point in each of these dilemmas an employee must decide whether he or she will "do the right thing." Consider the huge scandal involving Equity Funding Corporation of America in the early 1970s. In that scandal, dozens of the life insurance company's employees actively participated in a fraudulent scheme intended to grossly overstate Equity Funding's revenues and profits. These employees routinely prepared phony insurance applications, invoices, and other fake documents to conceal the fraud masterminded by the firm's top executives. When questioned by a reporter following the disclosure of the fraud, one of Equity Funding's employees meekly observed, "I simply lacked the courage to do what was right."[1]

In early 1986, several employees of Rocky Mount Undergarment Co., Inc. (RMUC), came face to face with an ethical dilemma. RMUC, a North Carolina-based company, manufactured undergarments and other apparel products. Approximately one-half of the company's annual sales were to three large merchandisers: K-Mart (29 percent), Wal-Mart (11 percent), and Sears (9 percent). RMUC employed nearly 1,300 workers in its production facilities and another forty individuals in its administrative functions. Between 1981 and 1984, RMUC realized steady growth in revenues and profits. In 1981, RMUC reported a net income of $378,000 on net sales of $17.9 million. Three years later, the company reported a net income of $1.5 million on net sales of $32 million.

Unfortunately, RMUC failed to sustain its impressive profit trend in 1985 as reflected by the financial data presented for the firm in Exhibit 1. Disproportionately high production costs cut sharply into the company's profit margin during that year. These high production costs resulted from cost overruns on several large customer orders and from significant training and other start-up costs linked to the opening of a new factory.

A subsequent investigation by the Securities and Exchange Commission (SEC) revealed that the company's senior executive and another high-ranking officer had refused to allow the firm to report its actual net income of $452,000 for 1985. To inflate the company's 1985 net income, these executives instructed three RMUC employees to overstate the firm's year-end inventory and thereby understate its cost of goods sold. Initially, the employees were reluctant to participate in the scheme. The two executives warned the employees that unless they cooperated, the company might "cease operations and dismiss its employees."[2] After much prodding, the three employees capitulated and began systematically overstating the firm's 1985 year-end inventory.

> *Following [the two executives'] specific instructions, the three RMUC employees inflated quantity figures on selected count sheets by adding numerals to the accurate quantity figures per item which had been previously recorded thereon during the*

1. H. Anderson, "12 More Ex-Equity Officials Get Jail, Fine or Probation," *Los Angeles Times*, 25 March 1975, Section 3, 9 & 11.

2. This and all subsequent quotes were taken from Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 212,* 9 January 1989.

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EXHIBIT 1

RMUC, INC., SELECTED FINANCIAL DATA, 1981–1985

RMUC, Inc.
Selected Financial Data, 1981–1985 (000s omitted)

	1985	1984	1983	1982	1981
Net Sales	$39,505	$32,167	$25,697	$21,063	$17,851
Cost of Sales	32,415	24,199	19,700	16,590	14,358
Selling, General & Administrative Expenses	5,791	4,523	3,405	2,694	2,454
Net Income	452	1,529	1,153	756	378
Total Assets	24,808	14,745	11,134	6,916	5,529
Stockholders' Equity	11,263	6,999	3,510	3,469	2,714
Current Assets	20,924	12,678	9,648	5,779	4,639
Accounts Receivable	7,115	4,725	3,734	2,608	1,290
Inventory	12,158	7,507	5,694	2,869	3,045
Current Liabilities	7,302	6,999	3,510	3,469	2,714

physical inventory count. The three RMUC employees then multiplied the inflated quantity figures per item on the count sheets by the actual unit cost per item and recorded the resulting false and inflated cost figures on the count sheets.

While the three employees were overstating RMUC's inventory, the two company executives who concocted the scheme periodically telephoned them to check on their progress. At one point, the employees indicated that they were unwilling to continue falsifying RMUC's year-end inventory quantities. Additional coaxing and cajoling by the two executives convinced the employees to resume their fraudulent activities. Eventually, the employees "manufactured" more than $900,000 of bogus inventory. After RMUC's senior executive reviewed and approved the falsified inventory count sheets, the count sheets were forwarded to the company's independent audit firm.

To further overstate RMUC's December 31, 1985, inventory, the company's senior executive instructed another RMUC employee to obtain a false confirmation letter from Stretchlon Industries, Inc. Stretchlon supplied RMUC with most of the elastic needed in its manufacturing processes. At the time, RMUC had an agreement to purchase 50 percent of Stretchlon's common stock at net book value. On December 31, 1985, Stretchlon had in its possession only a nominal amount of RMUC inventory. Nevertheless, a Stretchlon executive agreed to supply a confirmation letter to RMUC's independent auditors indicating that his firm held approximately $165,000 of RMUC inventory at the end of 1985. As a condition for providing the confirmation, the Stretchlon executive insisted that RMUC prepare and forward to him a false shipping document to corroborate the existence of the fictitious inventory. After receiving this shipping document, the Stretchlon executive signed the false confirmation and mailed it to RMUC's independent audit firm.

The fraudulent schemes engineered by RMUC's executives overstated the firm's December 31, 1985, inventory by approximately $1,076,000. Instead of reporting inventory of $12,158,000, in its original December 31, 1985, balance sheet, RMUC reported

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EXHIBIT 2

FOOTNOTE DISCLOSURE OF RMUC'S INVENTORY FRAUD

> Subsequent to the issuance of its financial statements for the year ended December 31, 1985, the Company determined that inventory as reported was misstated. The accompanying financial statements have been restated to reflect correction of such misstatement. The significant effects of restatement were to reduce inventories $1,076,000, increase cost of sales $1,140,000, increase selling, general and administrative expenses $40,000, and reduce net income $607,000 from the amounts previously reported.

inventory of $13,234,000. The overstatement of inventory boosted RMUC's reported net income for 1985 to $1,059,000, which was more than $600,000 higher than the actual figure.

Near the completion of the 1985 audit, RMUC's auditors asked the company's senior executive to sign a letter of representations. Among other items, this letter indicated that the executive was not aware of any irregularities [fraud] involving the company's financial statements. The letter also stated that RMUC's financial statements fairly reflected its financial condition as of the end of 1985 and its operating results for that year. Shortly after receiving the signed letter of representations, RMUC's audit firm issued an unqualified opinion on the firm's 1985 financial statements.

Following the SEC's discovery of the fraudulent misrepresentations in RMUC's 1985 financial statements, the federal agency filed civil charges against the firm's two executives involved in the fraud. The SEC eventually settled these charges by obtaining a court order that prohibited the executives from engaging in any further violations of federal securities laws. RMUC also issued corrected financial statements for 1985. Exhibit 2 presents a footnote included in those financial statements. That footnote describes the inventory-related misstatements in the company's original 1985 financial statements.

Questions

1. Did the overstatement of RMUC's inventory at the end of 1985 materially affect the company's reported financial data for that year? Defend your answer.
2. What audit procedures might have prevented or detected the overstatements of RMUC's inventory quantities at the end of 1985?
3. How did RMUC's buyout option for Stretchlon affect the quality of the evidence provided by the inventory confirmation letter, if at all? Explain.
4. Refer to Exhibit 2. In your view, did the footnote included in that exhibit adequately describe the misrepresentations in RMUC's original financial statements for 1985? Why or why not?
5. How would you have reacted if you had been one of the employees pressured by RMUC's executives to misrepresent the company's 1985 year-end inventory? Before responding, identify the alternative courses of action that would have been available to you.

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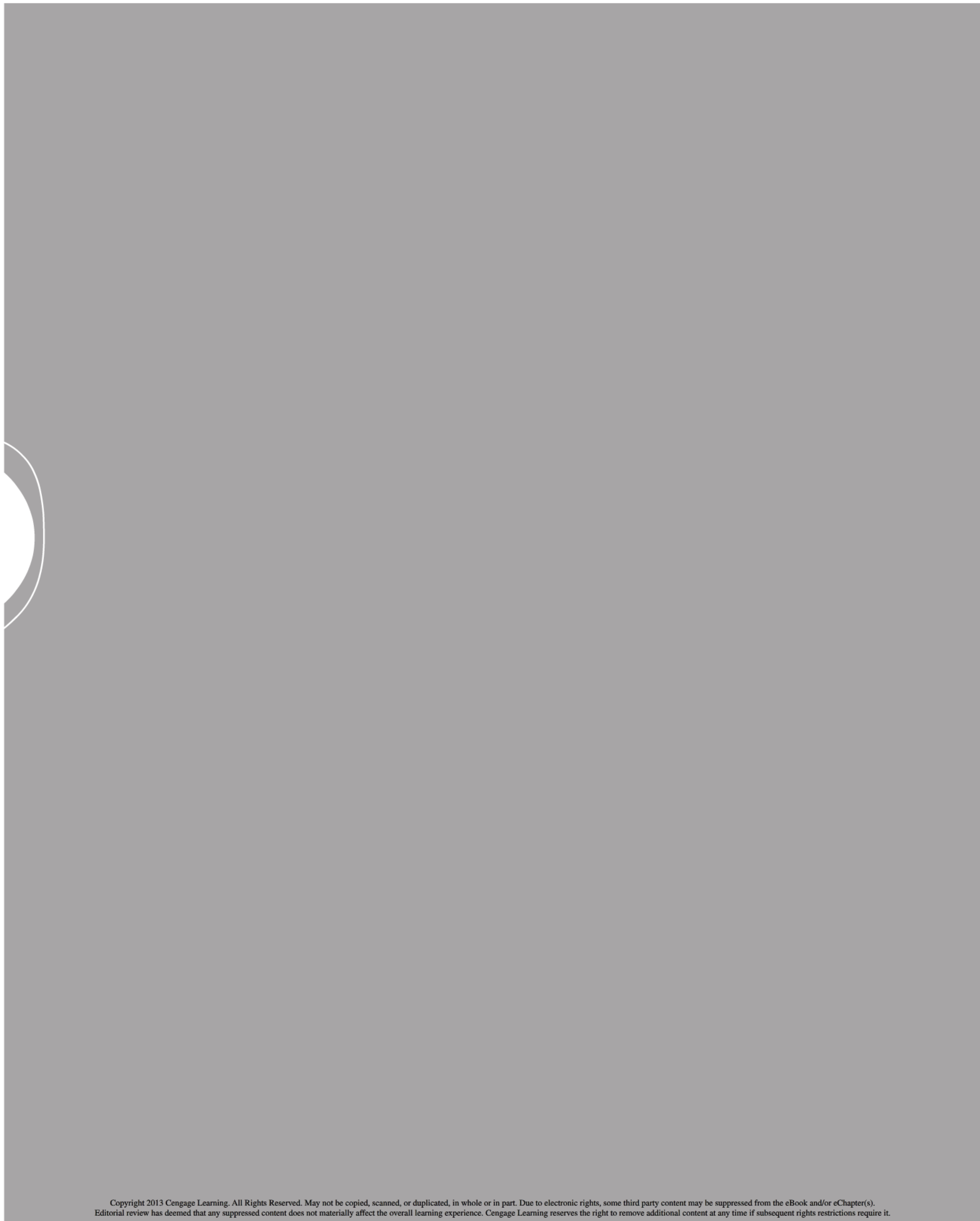

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CASE 4.2

Suzette Washington, Accounting Major

Suzette Washington financed her college education by working as an inventory clerk for Bertolini's, a clothing store chain located in the southeastern United States.[1] Bertolini's caters primarily to fashion-conscious young men and women. The company's stores carry a wide range of clothing, including casual wear, business suits, and accessories. The Bertolini's store for which Suzette worked is located a few blocks from the campus of the large state university that she attended. Except for management personnel, most of Bertolini's employees are college students. Suzette's best friend and roommate, Paula Kaye, worked for Bertolini's as a sales clerk. Paula majored in marketing, while Suzette was an accounting major.

During Suzette's senior year in college, Bertolini's began experiencing abnormally high inventory shrinkage in the store's three departments that stocked men's apparel. Suzette's supervisor, an assistant store manager, confided in her that he believed one or more of the sales clerks were stealing merchandise. Over lunch one day in the student union, Suzette casually mentioned the inventory problem to Paula. Paula quickly changed the subject by asking Suzette about her plans for the weekend.

"Paula, rewind for just a second. Do you know something that I don't?"

"Huh? What do you mean?"

"Missing inventory . . . shrinkage . . . theft?"

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After a few awkward moments, Paula stopped eating and looked squarely into her friend's eyes. "Suzette, I don't know if it's true, but I've heard a rumor that Alex and Matt are stealing a few things each week. Polo shirts, silk ties, jeans. Occasionally, they take something expensive, like a hand-knit sweater or sports jacket."

"How are they doing it?"

"I've heard---and don't repeat any of this now--I've heard that a couple of times per week, Alex stashes one or two items at the bottom of the trash container beneath the number two cash register. Then Matt, you know he empties the trash every night in the dumpster out in the alley, takes the items out and puts them in his car."

"Paula, we can't let them get away with this. We have to tell someone."

"No 'we' don't. Remember, this is just a rumor. I don't know that it's true. If you tell a manager, there will be questions. And more questions. Maybe the police will be brought in. You know that eventually someone's going to find out who told. And then . . . slashed tires . . . phone calls in the middle of the night."

"So, don't get involved? Don't do anything? Just let those guys keep stealing?"

"Suze, you work in inventory. You know the markup they put on those clothes. They expect to lose a few things here and there to employees."

"Maybe the markup wouldn't be so high if theft wasn't such a problem."

Now, there was no doubt in Paula's mind that Suzette was going to report the alleged theft scheme to management. "Two months, Suze. Two months till we graduate.

---

1. This case was developed from information provided by a former college student who is now a CPA. The names, location, and certain other background facts have been changed.

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Can you wait till then to spill the beans? Then we can move out of state before our cars are spray-painted."

One week following Suzette and Paula's conversation, a Bertolini's store manager received an anonymous typed message that revealed the two-person theft ring rumored to be operating within the store. Bertolini's immediately retained a private detective. Over a four-week period, the detective documented $500 of merchandise thefts by Alex and Matt. After Bertolini's notified the police, the local district attorney filed criminal charges against the two young men. A plea bargain agreement arranged by their attorneys resulted in suspended prison sentences for Alex and Matt. The terms of that agreement included making restitution to Bertolini's, completing several hundred hours of community service, and a lengthy period of probation.

Questions

1. What would you do if you found yourself in a situation similar to that faced by Suzette in this case?
2. Do you believe that it was appropriate for Suzette to report the alleged theft ring to a store manager? Would it have been unethical for Suzette *not* to report the rumored theft ring?
3. Accounting majors are preparing to enter a profession recognized as having one of the strongest and most rigorously enforced ethical codes. Given this fact, do you believe that accounting majors have a greater responsibility than other business majors to behave ethically?
4. Briefly discuss internal control activities that might have prevented the theft losses suffered by Bertolini's.

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CASE 4.3

Oak Industries, Inc.

Oak Industries began operations in the early 1930s as a manufacturer of car radio components. The California-based company struggled financially through its first few years but managed to emerge from the Depression, unlike many of its competitors. In the late 1960s, Oak expanded into the cable television industry. Technological innovations developed by the company contributed to the tremendous growth of that industry during the past few decades. In 1977, Oak began marketing subscription television services. Within four years, Oak ranked as the largest operator of subscription television systems in the United States. Oak's subscription television subsidiary also generated the majority of the company's annual revenues by the early 1980s.

Rainy Day Reserves

Exhibit 1 presents selected financial data for Oak Industries for the period 1978–1981. Oak established new sales and profit records each successive year during this period. In fact, in both 1980 and 1981 the company's *actual* net income eclipsed the figure reported by the company. In 1980, Oak's top executives became concerned that the company could not indefinitely sustain its impressive growth rate in annual profits. To help the company maintain this trend, the executives began creating reserves that could be used to boost Oak's reported profits in later years.

> *To report a smooth upward earnings trend and to provide a "cushion" of profits to be used in periods of lower actual earnings, Oak implemented a policy during 1980 and 1981 of establishing unneeded reserves to be released (reversed) in later periods, if needed.*[1]

These "rainy day reserves" included overstatements of the company's allowances for inventory obsolescence and uncollectible receivables.

Unfortunately, Oak needed to "dip" into its rainy day reserves much sooner than expected. In 1981, Oak established subscription television operations in the Dallas-Fort Worth and Phoenix metropolitan areas. Almost immediately, the company began encountering major financial problems in these new operations due principally to unexpectedly low sales. Based upon its sales forecasts for these two new market areas, Oak had stockpiled a large quantity of television decoder boxes. Because of the significant shortfall in subscribers, much of this inventory was not needed. To make matters worse, rapid technological changes soon rendered the excess inventory obsolete. Oak also had an unusually high rate of sales returns for a new model of a decoder box that it sold to new subscribers. Quality control problems in Oak's manufacturing processes caused this model to be unreliable. Finally, Oak experienced a higher than normal rate of uncollectible receivables in the Dallas-Fort Worth and Phoenix market areas.

Reversal of the Rainy Day Reserves

In the first quarter of fiscal 1982, Oak's senior executives instructed the company's accountants to "release" several million dollars of the reserves established during

1. Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 63,* 25 June 1985.

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EXHIBIT 1

OAK INDUSTRIES, INC., SELECTED FINANCIAL DATA, 1978–1981

Oak Industries, Inc.
Selected Financial Data, 1978–1981

	1981	1980	1979	1978
Net Sales*	$507,119	$385,586	$281,348	$192,181
Gross Profit	168,437	125,163	86,060	51,402
Net Income	30,350	20,082	11,170	4,850
Earnings Per Share	2.23	1.85	1.36	.72

*Net sales, gross profit, and net income are expressed in thousands of dollars
Source: Oak Industries, Inc., 1982 Form 10-K filed with the Securities and Exchange Commission.

1980 and 1981. The reversal of these reserves significantly reduced Oak's reported expenses and allowed the company to sustain its smooth upward earnings trend by reporting a record quarterly profit. If the reserves had not been reversed, the company's net income for the first quarter of 1982 would have been nearly 50 percent lower than the reported figure of $7.5 million. Oak's top executives boasted in the company's financial report for the first three months of 1982 that "First quarter sales and net income were greater than in any first quarter in the Company's history."

As fiscal 1982 progressed, Oak's financial problems worsened. At year-end, the management of Oak's subscription television subsidiary notified corporate headquarters of $40 million of asset write-offs and increases in loss reserves needed for that subsidiary. Oak's senior executives realized that if they booked the $40 million of additional expenses, the company's consolidated income statement for 1982 would reflect a large loss. Instead of reporting that loss, the executives decided to report earnings per share of $.25 for 1982, which translated to a net income of approximately $4.1 million.

To "manufacture" the desired net income for fiscal 1982, Oak's senior executives turned to the company's chief financial officer (CFO), who oversaw the company's accounting department. The senior executives instructed the CFO to take the necessary steps to produce the target earnings figure. In response to that directive, the CFO instructed the firm's controller to determine how much of the $40 million of unrecorded expenses could be booked if the company were to report earnings per share of $.25 for 1982. After the controller arrived at that figure, the CFO instructed him to arbitrarily allocate that amount between the company's reserves for bad debts and inventory obsolescence. The controller complied, resulting in Oak reporting the management-mandated $.25 earnings per share for 1982.

SEC Investigation Focuses on Oak's Controller

The SEC investigation that uncovered the illicit accounting methods used by Oak Industries in the early 1980s focused on the firm's controller. Particularly disturbing to the SEC were the controller's impressive credentials. In addition to being a CPA, the controller had an extensive accounting background, including several years of experience with Arthur Andersen & Co., Oak's independent audit firm.

The SEC discovered that Oak's controller often questioned his superiors' judgment, at least initially, when they instructed him to misrepresent the company's financial data. For example, the controller recommended disclosing in Oak's financial statements for the first quarter of 1982 that the company had reversed several million dollars of the illicit rainy day reserves. When the firm's senior executives rejected the controller's recommendation, he relented and subsequently helped prepare the misleading financial statements for the first quarter of 1982.

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Later in 1982, Oak's controller received a series of memos from the CFO of the firm's subscription television subsidiary. Among other financial problems being experienced by that unit, these memos notified the controller that the subsidiary's inventory obsolescence reserve was significantly understated. At the end of the fourth quarter of 1982, the subsidiary's CFO reported that his unit's inventory should be written down by nearly $10 million. Nevertheless, according to the SEC, the controller "accepted senior management's judgment and failed to take steps necessary to cause Oak to record the necessary reserves."[2]

The SEC also reported that Oak's controller knew that key accounting documents were being withheld from the company's independent auditors, Arthur Andersen & Co. Oak often prepared two sets of loss exposure analyses: one set to be used for internal decision-making purposes and another set to be forwarded to Arthur Andersen. The loss exposure analyses given to the independent auditors understated the severity of Oak's inventory obsolescence and bad debt problems. During Oak's 1982 audit, the firm's controller received a memorandum written by one of the company's internal auditors. This memorandum suggested that the independent auditors be given an "edited version" of an earlier memo that analyzed the status of Oak's reserve for uncollectible receivables. This edited version of the earlier memo significantly understated Oak's estimated uncollectible receivables at the end of 1982.

> *We [the internal audit staff] would like to issue the edited version of the . . . memo to Arthur Andersen to avoid any additional suspicions on their part as to the content. We believe the revised memo has been toned down sufficiently to be issued to them.*

The controller apparently did not prevent the internal audit staff from forwarding the misleading memo to the independent auditors. As a result, Oak's independent auditors received an inaccurate analysis of the year-end status of the client's uncollectible receivables.

Near the end of Arthur Andersen's 1982 audit of Oak Industries, the company's controller signed a letter of representations addressed to the audit firm. Among other assertions, this letter indicated that company officials had provided all of Oak's financial records and related information to Arthur Andersen. The letter of representations also stated that Oak's financial statements had been prepared in accordance with GAAP.

EPILOGUE

In June 1985 and March 1986, the SEC issued enforcement releases documenting Oak Industries' abusive accounting and financial reporting practices. These releases also reported the sanctions imposed on the company and its executives involved in the fraudulent scheme. The SEC permanently banned Oak's chief executive officer from serving as an officer or director of a publicly owned firm. Four other Oak officers, including its CFO and controller, settled charges filed against them by agreeing not to violate federal securities laws in the future. The terms of the agreement also required Oak to establish an audit committee that would assume an active role in the company's accounting and financial reporting function. In early 1985, Oak voluntarily reissued its financial statements for 1982 and 1983. Collectively, these financial statements reduced Oak's previously reported net income for those years by approximately $44 million, or $2.70 per share. The company also disclosed in early 1985 that it would

2. This and subsequent quotations, unless indicated otherwise, are taken from Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 93*, 26 March 1986.

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be discontinuing its subscription television operations.

One of the SEC's enforcement releases in the Oak Industries case focused exclusively on the firm's controller. In this release, the SEC noted that the controller clearly was not a "primary decision-maker" within the firm or a member of its senior management. As a result, the controller was not directly responsible for the company's earnings manipulation scheme. Nevertheless, the SEC maintained that the controller neglected his professional responsibilities when he became aware of that scheme. This was true despite the controller often challenging his superiors' questionable decisions.

> *Although [the controller] may have made the appropriate recommendations to his corporate supervisors, when those recommendations were rejected, [he] acted as the "good soldier," implementing their directions which he knew or should have known were improper.*

The SEC's refusal to recognize the "good soldier" defense as a valid justification for questionable conduct by mid-level corporate executives was debated by the business press following the public disclosure of the Oak Industries fraud. Most parties who commented on this issue supported the SEC's position. However, one individual warned, "It's unrealistic to place a burden on mid-level [corporate] managers to discharge obligations that they're not in a position to discharge."[3]

Often complicating the role of a corporate controller is the fact that his or her immediate superior lacks an accounting background. This was true in the Oak Industries case. Oak's controller was a CPA, but his immediate superior, the company's CFO, was not. The chief accountant of the SEC's enforcement division at the time, Robert Sack, observed that "added pressure" is often placed on a controller when his or her superior is not a CPA.[4] Sack recommended that in such cases a controller develop a relationship with the firm's board of directors, legal counsel, and independent auditors. These parties can serve as useful allies for the controller if his or her superior makes unreasonable demands at some point regarding accounting or financial reporting issues.

Questions

1. Is it unethical for a company to intentionally understate its earnings? Why or why not?
2. Should auditors be equally concerned with potential understatements and potential overstatements of a client's revenues and expenses? Identify audit techniques that may be particularly helpful in uncovering understatements of revenues and overstatements of expenses.
3. Place yourself in the position of Oak's controller when the company's senior executives rejected his recommendation to disclose the reversal of the rainy day reserves. What would you have done at that point?
4. What responsibilities does a company's controller and other accounting employees have when interacting with the firm's independent auditors? Do these responsibilities conflict with other job-related responsibilities of a company's accounting employees? Explain.
5. Should the SEC and other regulatory bodies hold corporate accountants who are CPAs to a higher standard of conduct than corporate accountants who are not CPAs? Defend your answer.

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3. K. Victor, "Tough-Minded SEC Takes Aim At Corporate 'Good Soldiers'," *Legal Times*, 7 April 1986, 1.

4. *Securities Regulation and Law Reports*, "Internationalization Raising Questions on SEC Disclosure System, Peters Says," 12 December 1986, 1773.

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