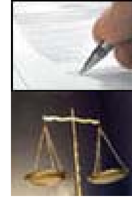
CASE: Ethics and the Manager; Rigging Standards



Jenny Cummins, the newly hired controller at Merced Home Products, was disturbed by what she had discovered about the standard costs at the Home Security Division. In looking over the past several years of quarterly earnings reports at the Home Security Division, she noticed that the first-quarter earnings were always poor, the second-quarter earnings were slightly better, the third-quarter earnings were again slightly better, and the fourth quarter always ended with a spectacular performance in which the Home Security Division managed to meet or exceed its target profit for the year. She also was concerned to find letters from the company's external auditors to top management warning about an unusual use of standard costs at the Home Security Division.

When Ms. Cummins ran across these letters, she asked the assistant controller, Gary Farber, if he knew what was going on at the Home Security Division. Gary said that it was common knowledge in the company that the vice president in charge of the Home Security Division, Derek Lansing, had rigged the standards at his division in order to produce the same quarterly earnings pattern every year. According to company policy, variances are taken directly to the income statement as an adjustment to cost of goods sold.

Favourable variances have the effect of increasing net operating income, and unfavorable variances have the effect of decreasing net operating income. Lansing had rigged the standards so that there were always large favorable variances. Company policy was a little vague about when these variances have to be reported on the divisional income statements. While the intent was clearly to recognise variances on the income statement in the period in which they arise, nothing in the company's accounting manuals actually explicitly required this. So for many years Lansing had followed a practice of saving up the favourable variances and using them to create a nice smooth pattern of earnings growth in the first three quarters, followed by a big 'Christmas present' of an extremely good fourth quarter. (Financial reporting regulations forbid carrying variances forward from one year to the next on the annual audited financial statements, so all of the variances must appear on the divisional income statement by the end of the year.)

Ms. Cummins was concerned about these revelations and attempted to bring up the subject with the president of Merced Home Products but was told that "we all know what Lansing's doing, but as long as he continues to turn in such good reports, don't bother him." When Ms. Cummins asked if the board of directors was aware of the situation, the president somewhat testily replied, "Of course they are aware."

Required:

1. How did Derek Lansing probably 'rig' the standard costs—are the standards set too high or too low? Explain.
2. Should Derek Lansing be permitted to continue his practice of managing reported earnings?
3. What should Jenny Cummins do in this situation?