

## Pacific Health Care: What should the Controller do?

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### Abstract

The protagonist in this case was recently hired by a non-profit organization that provides needed health care services. They are in the midst of a financial crisis which may only be temporary. He is asked to alter the accounting records for a short period of time to avoid bankruptcy. The situation presented in the case is intended to get students to think about the ethical trade-offs in an environment where the “greater good” may actually be achieved by complying with the CFO’s request to alter the records since the health, and even the lives, of some clients may be at risk if the organization were to fail. This case was designed specifically to encourage students to consult the AICPA Code of Conduct and the IMA Statement of Ethical Professional Practice and integrate these standards into their analysis of the case.

### The Context

Tim Brighton is married with two children, ages 3 and 5. His wife was recently laid off from a large national bank. At this time her job prospects look bleak since her career was oriented toward the financial services industry which has been negatively impacted by the current recession.

Tim is a licensed CPA who recently accepted a position as the controller of Pacific Health Care, a medium sized non-profit organization specializing in providing healthcare services to low income residents. Until recently, Tim was working for a large regional CPA firm where he had a variety of audit clients including non-profit organizations. Tim was tired of the long hours and the pressure of public accounting and believed that working in the non-profit sector would be relatively free of stress and that the hours would be more predictable. When he accepted the position of controller at Pacific Health Care Tim received an increase in compensation. Since he came to work for Pacific, Tim has heard that the prior controller was terminated and that it was a messy termination and that a wrongful termination lawsuit is pending.

Pacific derives about eighty percent of its revenue from contracts with the city and the state. The remaining twenty percent comes from institutional and individual giving. Pacific has a great reputation in the community because of the high quality of the services they provide.

The current recession has materially diminished the sources of funding available to both state and local governments. Consequently, contracts between Pacific and the municipalities that were once “automatic renewals” have become less certain. Contracts that are renewed often times have provisions reducing the reimbursed amounts for service units (health care services provided to clients). The nonrenewal of some contracts and the lower reimbursement amounts on new contracts is beginning to reduce working capital to dangerously low levels.

Pacific has a line of credit with a regional bank in the amount of \$500,000. The current economic circumstances have resulted in Pacific needing to utilize the entire \$500,000 line of credit with little hope of being able to pay down the debt in the next year. Pacific is using the line of credit as a source of permanent financing and Tim realizes that if the line is not renewed an immediate liquidity crisis would result. The bank requires that the line be reviewed twice yearly which entails providing them with the most recent financial statements. The six month review is next week.

Tim reports to the CFO of Pacific, Amanda Mathews. Tim has quickly learned that Amanda is a hard driving, focused executive and has aspirations to become the CEO sometime in the future. She tolerates no dissention and views discussing issues as a waste of time because of her certainty of being correct.

Ms. Mathews is concerned that the current financial statements will not be satisfactory to the bank. The statements reflect a fast deterioration of working capital approaching a 1:1 ratio with current liabilities needing to be paid in the next thirty days but amounts due from city and state agencies expected to be received in the next 60-120 days. The operating statement is currently showing an operating loss. Ms. Mathews is concerned that the statements could cause the bank to increase the interest rate on the line of credit or cause the line of credit to be cancelled. The cancellation of the line of credit would bring on such a liquidity crisis that it is doubtful that Pacific could remain a going concern.

The CFO has approached Tim to discuss the current financial situation and current financial statements. She indicates to Tim that she believes that certain modifications could be made to the statements which would show Pacific in a more favorable financial and operating position. She tells Tim that it is almost certain that Pacific will receive a \$750,000 grant in the next 4-5 months from a national health care organization. Ms. Mathews believes that this will eliminate the organization's liquidity problem.

Tim knows that he and the CFO must sign a cover letter accompanying the financial statements going to the bank. The letter, in essence, states that the accompanying financial statements, to the best of their knowledge and belief, present fairly Pacific's financial position and the operating results in accordance with generally accepted accounting principles. Tim questions the CFO about the implication of "modifying the statements" and signing such a letter. She emphatically states that this type of "earnings management" is very common in both the profit and non-profit sectors of the economy. When survival of an entity is at stake such financial statement modification is the only thing an entity can do. "After all, where is your loyalty, to the bank or to our clients who depend on the healthcare services we provide? Any adjustments you make to the books will be reversed once we receive the \$750,000 grant and no one will know about the "modified" financial statements but you and me. Also, our audit is over six months away."

Tim knows the dire consequences of his telling the CFO he will not modify the financial statements or sign a letter accompanying the financial statements. Tim decides to postpone consideration of the long-term structural cost issues and he begins to think about how he could modify the accrual based financial statements. His ideas are beginning to evolve:

1. Accrue revenues not yet due from the city and state. His rationalization is these items are under a contract and they will be due once Pacific provides the services.
2. Exclude certain accrued expenses using the rationalization that these items do not need to be paid at this time.
3. Reclassify certain noncurrent assets as current and classify certain current liabilities as noncurrent. Tim believes that many times such classification is somewhat subjective and he is merely using his judgment.

Tim is pleased with his ideas because these modifications will improve both the working capital picture as well as improve the operating results of Pacific. Yet, he is troubled that he has been asked by the CFO to change the financial statements so that Pacific looks favorable to the bank. He is equally concerned that he will need to provide his signature to the letter accompanying the statements. Tim decides to leave the office and head home to discuss these issues with his wife Maria.

Tim and Maria prepare the children's dinner and ready them for bed. Once Maria and Tim have time alone Tim describes the events of his day. He describes the conversation with Amanda. He outlines Pacific's financial problems and the liquidity and going concern crisis that will be faced if the bank does not renew the line of credit. He tells Maria that he must modify the statements in order for the organization to have a reasonable chance of a renewed credit line. He discusses his professional and ethical responsibilities to the profession as well as his responsibility to the general public. He asks for Maria's perspective on the dilemma he faces.

Maria does not hesitate to offer her opinion. "Shouldn't you consider the clients of Pacific first? Many of those people would receive no health care without Pacific and some of them could even die. It seems to me that temporarily adjusting the financial statements is a small price to pay to keep the services of Pacific available to your clients. Face it Tim, professional ethics always sounds somewhat attractive in the classroom but what about the real world?"

After a pause, Maria continues. "I think that you also have to consider your family. You know, if you refuse to change the financial statements Amanda will probably fire you immediately and Pacific will not pay severance. Where will you find a job? We have had a hard time financially since I have been out of work. How would we manage if you lost your job? Are you prepared to risk your family's well-being?"

Tim ponders the events of the day. "Ethical issues are much more difficult in reality than in the classroom-I never dreamed I would be placed in such a difficult position."

### Questions for Discussion

1. Students should consult the Institute of Managerial Accountant's (IMA) Statement of Ethical Professional Practice and the American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct. Is Tim still bound by the AICPA code even though he is no longer working in public accounting? Which sections of the IMA statement apply to this case? Pacific may or may not have established policies on resolving an ethical conflict.
2. Does anyone benefit personally if Amanda's request is met? Does this matter?
3. In considering the broad ethical issues, who is harmed by Amanda's plan?
4. Does it matter that this organization would both be in a better position to provide services to clients with Amanda's plan?
5. What should Tim do? What are his obligations to Pacific? To Pacific's clients? To the accounting profession?