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GPE: A Slippery Slope into a Tangled Web

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Abstract

This is a case study regarding an international manufacturing company (GPE in the united states) based out of Europe that produces machinery used to generate electricity. The European Corporate organization is comprised of several subsidiary organizations and incorporated subsidiaries. GPE has created separate companies for the equipment manufacturing, as well as for the sale of parts and services outside of the Americas. Further, GPE Corp also consists of the US Corporate organization, which is comprised of four business units including the US Financing Division focuses on finding other corporations to provide funds as outside investors. Credit financing is obtained from the World Bank and private banks for these power plant projects. Bob Smith has been assigned to a new position working for Joe Daboss, the VP of Plant Management division of the US operations. In this case we have covered several different scenarios involving revenue recognition, consolidation, transfer pricing, forecasting and ethics. Bob's problems which are presented in the case begin with the billing that he is asked to process based on a "handshake deal", or verbal commitment, which is not confirmed by the subsidiaries. Bob is embarrassed by these scenarios, but discovers that his boss; Joe Dabossis getting bonus payments for meeting the profit budget. In our opinion, this is a multidimensional case that would be appropriate for courses in Advanced Accounting, Advanced Managerial Cost Accounting, Auditing, Accounting Ethics and a Business Strategy course for Accounting majors. Points of emphasis for Advanced Accounting and Auditing would be consolidation, revenue recognition, internal controls and ethics. In a Managerial Accounting or a Business Strategy course, the instructor should place emphasis on transfer pricing, forecasting and performance evaluation and Ethics.

Keywords: Intercompany transaction, revenue recognition, transfer pricing, international business, forecasting and ethics

I. Introduction

On the day before the year-end holiday period, Bob Smith's boss, the VP of US Parts and Service called Bob into his office and told him that the company has been reorganized, and that Bob's position has been relocated to another city. Knowing that Bob really doesn't want to relocate, the company had decided to transfer him to an exciting new opportunity located in the same office, working for Joe Daboss, the VP of Plant Management.

Plant Management is a new business unit within the US Corp subsidiary of GPE, tasked with global responsibilities for starting up and managing the operations of new power plants that GPE has constructed. Bob met with his new VP, Joe Daboss, who expressed his enthusiasm about bringing Bob into his small team of experts, telling Bob he really values having a financial expert to help guide the ***rapid growth that is planned***.

At the conclusion of the meeting, Joe asked Bob to make a couple of billings to reflect a deal that he has made to provide startup services a new plant in Asia. This power plant is outside the normal US market area, but since Plant Management has global responsibilities, another GPE parts and service organization outside the US group called Parts/Service Asia 1 has contracted with Plant Management to provide management of the startup. The GPS intra-company revenue and accounts receivable to Parts/Service Asia 1 needs to be billed today, before the end of the year to get the financials right for the current year. The work had already been done by the Plant Management team, Joe said, so there are no additional costs to the job. Joe has just been waiting for Bob to join the team. When Bob asked Joe to see the contracts so he can be sure to get the documentation, Joe says that this is a handshake deal within the company, arranged personally by him, so there is no need for that formality. Bob entered the billing of intra-company revenue and accounts receivable from Parts/Service Asia 1 and heads home for the holidays.

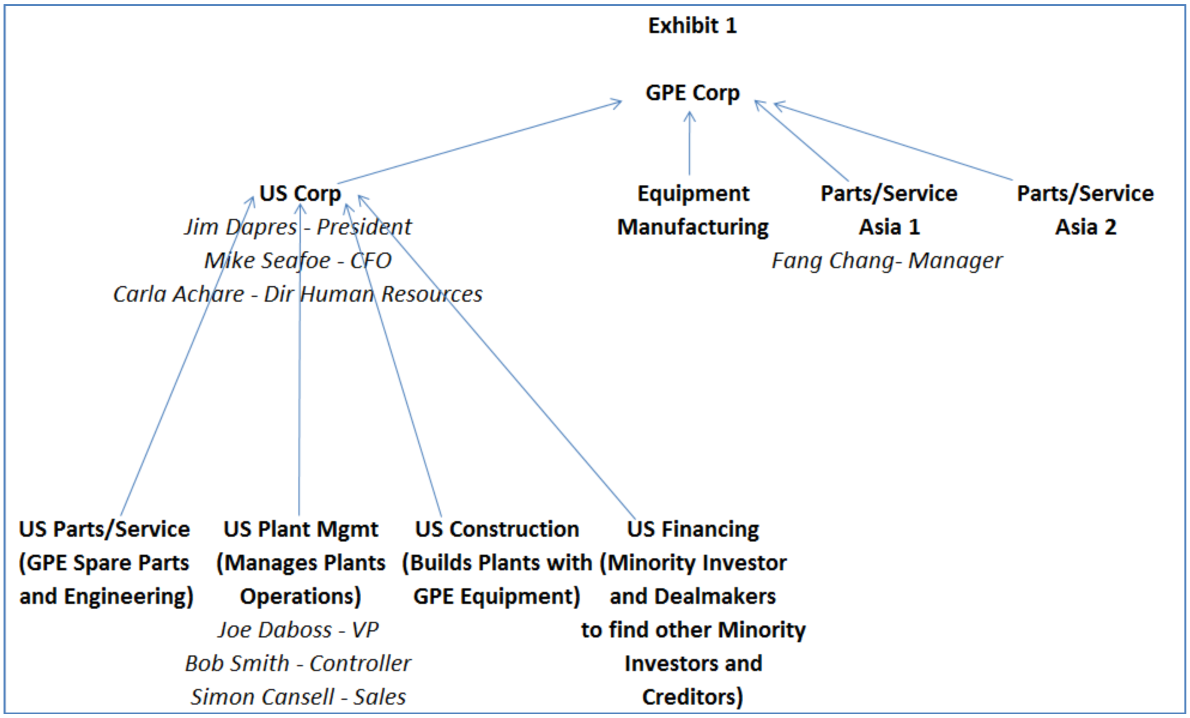
GPE is organized to construct the power plant and help to operate them. In order to build the power plant, GPE requires a great deal of funding which they get through their own financing as well as outside investors and the World Bank. The company first will organize a division to oversee the building of the power plant and then assist in operating the plant. The cost of the original investment and the operating cost of the plant, will determine the rate of the electricity that the local government regulated utility will charge the customer.

II. Background

A simplified organization chart of Global Power Equipment (GPE) is shown below in Exhibit I. Financial reporting relationships are shown with arrows and the names and titles of the GPE employees from this case are entered under their organizational unit.

Global Power Equipment (GPE) is an international, European based manufacturer of machinery that is used to generate electricity. The business units of GPE Corp. provide all of the equipment and services required build a new power plant and operate it to generate electricity. In order to build the power plant, GPE requires a great at deal of funding. While GPE provides some of the equity financing, most of the equity funds come from outside investors. Because these power plants are for less developed countries, major credit financing is obtained through from the World Bank. The US Financing unit creates a new investor corporation for each power plant (not shown below). GPE and each outside investor take a minority share ownership in the new power plant. The US Corp of GPE buys power generating equipment and spare parts from GPE Equipment Manufacturing for use in the construction, startup and operation of the power plant that is owned by the new investor corporation. The new Plant Owner corporation negotiates the rates for electricity with local government regulated utilities (not shown below) which then distribute and sell electricity end consumers (not shown below). The rates are partially based on the cost of the original investment and the operating cost of the plant.

Bob Smith has just completed his assignment as the business area controller for the US Parts and Service business unit at Global Power Equipment (GPE). GPE is an international, European based manufacturer of machinery that is used to generate electricity. The US subsidiary company that Bob works for has had a great year, and Bob has shared in the success as his business unit has met and exceeded their revenue and operating profit goals. US Parts and Service provides GPE branded spare parts and expert technical engineering services to their customer base of power plants located throughout the Americas. This has been a particularly good year, as the US subsidiary has had several new plants in less developed countries that have recently started operations.



GPE: The organization chart

The GPE financial systems are not integrated, and GPE relies on a series of manual consolidations to prepare their corporate reporting. The European corporate organization is comprised of subsidiary organizations and incorporated subsidiaries. Separate companies have been established for the equipment manufacturing and the sale of parts and service outside the Americas, (Asia 1) & (Asia 2). The US Corporate organization is comprised of four business units, Bob's old parts and service unit, Bob's new plant management business unit, a unit to construct new power plants with GPE equipment purchased from the European equipment manufacturing unit and a unit that provides financing for new power plants, called US Financing.

US Financing business unit specializes in finding other corporations to provide funds as outside investors, where typically each of the GPE US Financing and three other investors each provide 25% of the equity. Credit financing is also obtained from the World Bank and private commercial and investment banks for these power plant projects, which can stretch into the hundreds of million dollars. US Financing and the other Outside Investors each provide a minority share, and the ownership is established as a new Plant Corporation. A nice feature of this arrangement is that the debt incurred by the plant is not shown on the four owner's corporate financial statements. This "off-balance sheet item", is reported only as an asset investment in an unconsolidated subsidiary.

The new Plant Corporations are managed by GPE US Plant Management and generate the electrical power, sell it to a local utility, subject to local government regulation. The electrical power is then resold by the local utility to the end user customers within the local country. US Plant Management orders GPE factory spare parts and service exclusively from US Parts and Service at GPE list prices according to maintenance schedules prepared by GPE.

III. Chorology of events and transactions:
After the holiday, in January Bob Smith was excited to return to his new position with US Plant Management. Bob met with Mike Seafoe, CFO of US Corp. Mike has recently promoted and transferred in Bob's office location as a result of a reorganization. In their brief meeting, Bob assured Mike that the books for the year will be closed quickly so that Mike and his staff can begin their consolidations for GPE Corp.

Bob faxed an intra-company accounts receivable confirmation form to Fang Chang, the manager of Parts/Service-Asia 1, for the billing he did before the holiday. When Bob realized that he has not received a reply a few days later, so he sent an email to Fang Chang asking about the status. A week later, still hearing nothing, from Fang Chang, Bob sent another email and another confirmation fax, but again received no reply. Since Parts/Service Asia-1 half way around the world and twelve time zones away, the time difference makes calling pretty impractical. The following week, Bob stayed very late one evening, and placed a telephone call to Fang Chang, but had to leave a message since Fang is out of the office on a business trip.

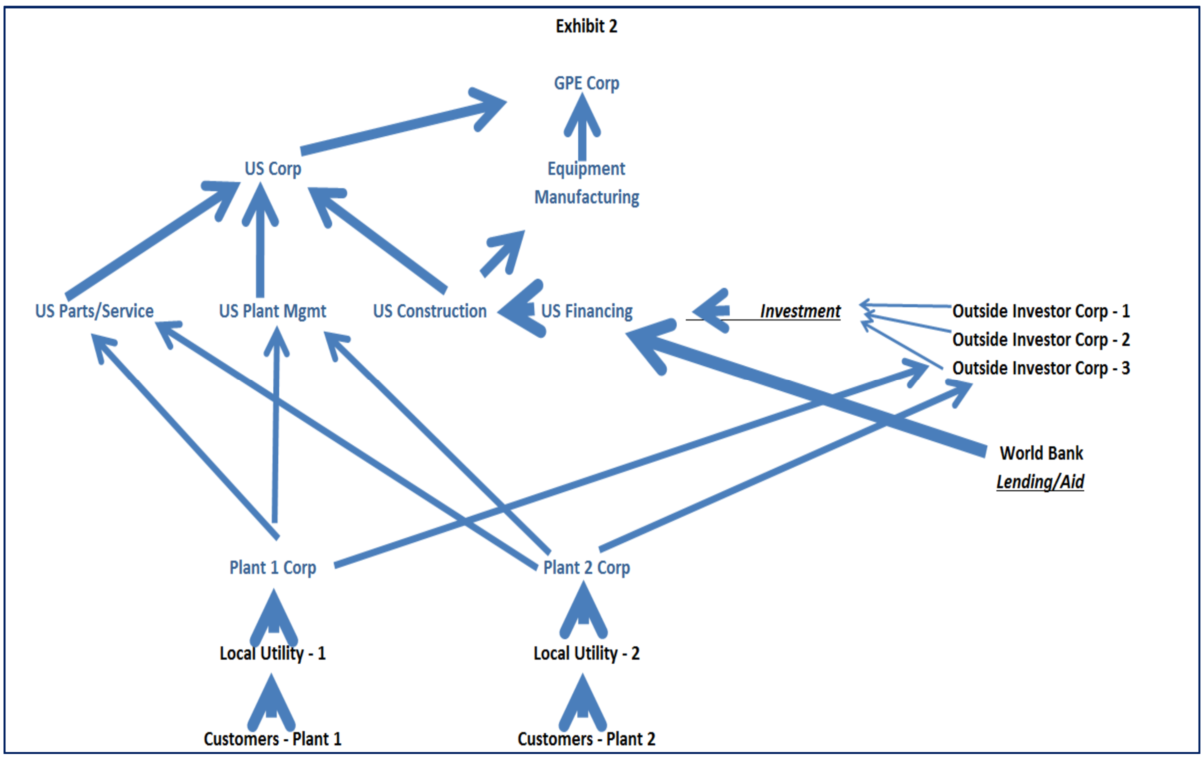
The deadline to close the books arrived the next day. Unconfirmed intra-company accounts receivable must be cleared out from the books so based on Joe Daboss's assurances that the billings were valid Bob decided to 'park' the amount in a other asset account by crediting the intra-company accounts receivable and debiting other assets. Bob assumed that this reclassification would allow the necessary time for the issue to be resolved after Fang Chang returned from his business trip.

As January turns into February, after another series of faxes and emails to Fang Chang, Bob began to really worry, however, Bob was swamped by a backload of work and learning his new job. Joe Daboss has been out of the office building in business for the whole year. While the amount that was reclassified as an "Other Asset" was pretty big for US Plant Management business unit's results, having made the difference between an operating loss for the year and reaching the budgeted operating profit, it was pretty small and immaterial for US Corp as a whole. The auditors came and left. Bob answered truthfully that he had no unconfirmed intra-company accounts receivable. The auditors never asked Bob about the immaterial amount of other assets where he had parked the bill to Parts/Service Asia 1.

In early March, Bob finally reached Fang Chang by telephone. Fang Chang asked "Why do you keep sending me these faxes, I have no idea what you are talking about!" "We don't need your help starting up this new plant", Fang continued. The following week, Joe Daboss returned to the office from his business trips. Bob explained that he has no option but to reverse the billing of intra-company revenue and eliminate the other asset. Because the prior year had been closed, the net impact will reduce profit for the current year. This reversal would really put US Plant Management behind the budget. Bob was pretty embarrassed, and didn't mention it to Mike Seafoe. Since at the end of the first quarter, when a lot of adjustments are occurring, Mike never noticed the charge to Parts Management Revenue and Profit. It is just the first quarter, so no forecast for the year is due. Soon after, Bob investigated a new expense in Plant management and discovered that it is Joe Deboss's bonus payment for meeting the profit budget in the prior year.

In April, Simon Cansell, the Sales Engineer for US Plant Management returned to the office from an extended period of travel throughout the GPE global operations. Bob has heard a lot of good things about Simon, especially about how well he builds spreadsheet financial models and his ability to close deals by estimating plant startup and operating costs. These estimates were then given to US Financing who used them in contract negotiations with outside equity investors and the World Bank.

Bob is also wizard in spreadsheet based financial forecasting, having done many budgets, strategic plans and financial analysis projects in the course of his career. Bob met with Simon to discuss upcoming contracts, seeking to learn more about the business and was hoping to assist him any way he could. Simon was ecstatic. He has so many deals close to signing which were big not only for Plant Management, but for the entire GPE US Corp. As they were talking, Bob and Simon sketched the Exhibit 2, shown below, to show the flow of money into GPE.



GPE: The relationship between subsidiaries

Referring to Exhibit 2, Bob noticed that there were two major funding paths. On the right side, the initial funding for power plant construction from outside investors and the World Bank came through US Financing to buy equipment and construction costs. The second flow of funds started at the bottom of Exhibit 2 when end customers in less developed countries purchased electricity from their local utilities. The local utilities then paid for the electricity purchased to the investor owned Plant 1 and 2 Corps. These funds were used to purchase parts from GPE US Parts and Service, for management fees to US Plant Management and for other operating expenses of the power plants. Profits of the plant went back to the investors and profits of US Corp went to GPE Corp. Noting the direction of the arrows, Bob and Simon agreed that this was a "sweet" series of arrangements. The profit from both paths then flowed to the GPE Corp parent.

As they begin to review Simon's forecasts, Bob became concerned some of Simon's financial assumptions. Large increases in price and volume each year are forecasted in the projections; however, there are practically no increases in inflationary cost per unit assumptions. Bob was also curious why there were no costs forecasted for central US Plant Management office support in Simon's forecasts. Simon explained to Bob that he has assumed that these central support costs were all non-incremental fixed costs, and not therefore relevant to new plants.

The length of the contracts that Simon was proposing covered a span of five or more years of plant management. When Bob asked Simon about how he allowed for contingencies and unplanned problems, Simon Cansell stated that this is marketing, and to do that would be like telling the outside investors and the World Bank that we plan on running the power plants inefficiently.

Bob expressed his concerns to Simon Cansell, and later discussed them with his VP, Joe Daboss. Bob was really concerned that while these contracts might make money in the first couple of years, the lack of inflation in costs, the lack of allowance for central office support and the lack of any allowances that something might go wrong or an unexpected change occur makes it likely that, in Bob's opinion, these contracts might become unprofitable in a very few years. Joe Daboss responded to Bob that he is an accountant and should stick to accounting. Bob was told that he should concentrate on his job and leave marketing to people who have the knowledge of engineering and the process of making deals, like Simon and himself.

In May, Joe came into Bob's office. He was really angry. "Why haven't you billed Plant-1 Corp for management consulting fees in addition to our regular plant management fees?" Joe demanded. Bob responded that he is not aware that anyone had been to or even called Plant-1 all year, so he had no reason to bill. Joe explained to Bob that Plant-1 was wholly owned by GPE US-Financing. Consistent with the past, Plant-1 had been making a lot of profit this year. If it were not billed for consulting fees, the local government would lower the rates that the plant could charge to the local utility for the electricity it generates. Joe was livid that Bob, as an accountant, did not understand this simple principle of business. "This is just the kind of thing I was talking about last month", Joe say's to Bob, "when you were wasting your time with Simon instead of doing your accounting work". Joe then made it clear to Bob that US Plant Management needed a qualified accountant to continue on the path to growth, and that if Bob didn't get with it he would find a qualified accountant to do the job.

When Bob prepared the bill in the US Plant Management accounting system and showed it to Joe Deboss, Joe explained that the government regulators will question this big bill, so it should be broken up for the previous months. Bob explained that he cannot prepare bills in the US Plant Management system for any other date than today. Bob then got an idea, and prepared duplicate back dated bills in Excel for the previous months that can be forwarded to Plant-1. Joe Daboss complemented Bob on his ingenuity in resolving the problem, and reminded him to keep up with the billings in the future before they fall behind and have this problem again.

In June, Joe scheduled a US Plant Management staff meeting to share the Strategic Plan for the business. The five year forecast showed that the number of plants to manage was going to double each of the next five years. Each plant will make a tidy profit for US Plant Management, and the number of central office staff was projected to stay the same throughout the whole five years as they become ever more efficient. Bob wondered how the staff can do this, as there are only a few of them working on the staff now, and they are all really busy. Not wanting to aggravate Joe Daboss, however, Bob said nothing.

In August Joe called Bob into his office and told him that he was going on a critical week long trip to Plant-2, which is owned by US Financing and three outside investors. There had been some major operational issues at Plant-2, and most of the Plant Management staff has been there already this year.

Financially, Plant-2 revenue is much lower than expected because the local utility had not been purchasing nearly as much power as originally planned. Expenses are out of control, especially those for spare parts purchased from Bob's old business unit, US Parts and Service. Bob is very aware that the technical US Plant Management staff from his office have been spending a lot of time and travel expense at Plant-2, resolving many operational issues and determining whether the replacement spare parts used should be considered as a warranty expense and changed to US Construction, or whether these additional spare parts should be considered as normal use, and charged to Plant-2.

Joe Daboss explained that the owner group is losing money due to the revenue shortfall, and has not paying their bills to the US Corp business. It had become a real mess and the Plant's accounts payable did not match the accounts receivables from GRE US Parts and Service and GRE US Plant Management. Bob's task was simple on this trip; Joe explained; figure out the bill and come home with a check.

When Bob arrived at Plant-2, his meetings with the owner representatives, led by Outside Investor Corp-1's Dick Naster, were highly charged and contentious. Dick stated that all the problems at Plant-2 were due to poor <u>plant management and the "incestuous" relationship</u> that GPE had created. Bob compared the budget to the actual expenses and found disturbing cost overruns versus the budget. The budget had been based on Simon Cansell's original marketing projections. After a week, Bob has figured out the accounting, but had to fly home without a check.

On the plane and over the weekend, Bob prepared a report that concluded that the Plant-2 operations would continue to lose money due to the many operational issues that were not foreseen in Simon Cansell's original marketing forecast. The report also concluded that the US Plant Management unit had little chance of ever succeeding at Plant-2 under the current contract, especially given Dick Naster's unwillingness to work cooperatively, and will probably never get fully paid for the significant amount of work already done. Bob's report recommended activating the termination clause of the plant management contract for Plant-2, and cutting the losses for US Plant Management. Bob gave a copy of his report to Joe Daboss. Bob also gave a copy to the President of US Corp, Jim Depres. Bob didn't really know much about Jim, since he had recently been transferred into US Corp from another part of GPE. Shortly afterwards, Bob learned that Jim Depres worked on the Plant 2 deal.

In September, Joe Deboss scheduled a meeting with Carla Achare, Director of Human Resources for US Corp and with Bob Smith. Carla explained to Bob that he had been placed on a formal performance improvement plan and would have regularly scheduled meetings with Carla until his job performance improved. Joe Deboss was particularly concerned that Bob was not being a "team player". After Joe left, Bob explained what had been going on from his perspective to Carla, who expressed her deep concern.

In October and November, it became increasingly clear to Bob that US Plant Management would not meet their financial objectives for the current year. The impact of the reversal of last year's intra-company billings to Parts and Service Asia 1, and cost overruns in the central office for marketing and Plant-2 travel are the primary unbudgeted causes. Bob reviewed the forecasts with Joe Daboss and Mike Seafoe, CFO of US Corp.

In late December, Joe Daboss came into Bob Smith's office and said "I have some billings that I would like entered before you leave for the holidays." These intra-company billings are handshake deals just arranged with Parts and Service Asia-2, in different countries and with a different manager than Fang Chang of Asia-1. There is no additional cost since the work has already been done. The additional revenue with no cost would generate just enough to profit for US Plant Management reach the budgeted profit for the current year.

Bob summarized what Joe had told him and met with Mike Seafoe. Mike agreed with Bob that, without contracts, these billings did not meet the criteria billing based on the revenue recognition principle of accounting. Bob explained to Joe why the billings could not be made.

Consequences

Bob was relieved that the second year's financial statements were clean, but knew that Joe Daboss was not pleased with the loss that had occurred. Bob knew that this would mean that Joe Daboss would not get his bonus for the year and that he would suffer a loss of reputation among his fellow executives. Soon after, Bob arrived to work to find Joe waiting at his desk with a box for him to pack his personal belongings. It was Bob's last day with GPE.

IV. Required Case Questions

1) What was the financial statement impact of:
   a) Bob's original billing to Parts/Service Asia 1 after the initial meeting with Joe Daboss (assume $300,000)?
   b) Bob's 'parking' of the Parts/Service Asia 1 billing in January?
   c) Bob's reversal of the billing to Parts/Service Asia?
2) Why was Joe Daboss so upset that Bob did not bill Plant 1 for management fees? Were these fees appropriate?
3) Are there ethical issues with Simon Cansell's marketing forecasts?
4) Was Bob Smith on a Slippery Slope? Compare his actions at the beginning, during and end of the case. Was Bob personally profiting from his actions?

5) How should Bob Smith respond to Joe Deboss's request to bill Parts and Service Asia 2? How does the revenue recognition principle apply? What are Bob's potential options, and potential consequences of each option?
6) Refer to Exhibit 2. What did Dick Naster mean (August) about the 'incestuous' relationship within GPE in regards to Plant-2? What ethical issues can you identify with transfer pricing, warranty and other management issues?
7) In general what is the perception of the "role of the accountant" in the case? What are the implications of how Bob's role was defined by Joe Deboss? What other professional issues might have existed.

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