SourceOne Furniture’s 300% Tariff: What’s Their Duty?

Jay Kemp, the controller of SourceOne Furniture, was brimming with excitement as he completed his passport application at a post office in Northern Wisconsin. He knew completing the application brought him one step closer to Shenyang, China. Except for a couple of fishing trips to Ontario, Canada with several college buddies, Jay had never left the country and was looking forward to experiencing the Chinese culture.

Jay’s boss, Karl Gengler, the owner of SourceOne Furniture invited Jay to join him and Bob Hamilton, SourceOne Furniture’s director of engineering, to meet two attorneys and auditors from the United States Department of Commerce (USDC) in Shenyang, China at the manufacturing plant of Shenyang Furniture Ltd. The meeting was supposed to be a two day review, an audit, of Shenyang Furniture Ltd.’s manufacturing cost data that Bob had submitted to the USDC to prove Shenyang Furniture Ltd. was earning a profit on the wooden bedroom furniture it was selling to SourceOne Furniture. The audit was part of a larger anti-dumping case filed by American furniture manufacturers claiming Chinese furniture manufacturers had been selling furniture at below cost to American furniture distributors and retailers in an effort to drive American furniture manufacturers out of business.

SourceOne Furniture Background

SourceOne Furniture is a relatively small, family owned manufacturing company located in Northern Wisconsin. Annual sales average around $20 million. Karl Gengler, the owner and founder of SourceOne Furniture, has a sales and marketing background. He held senior level sales positions with several publicly traded printing product organizations prior to founding SourceOne Furniture.
Karl built a culture at SourceOne Furniture that emphasized the sales process and minimized other organizational functions such as engineering, accounting, human resources, and quality control. Karl viewed both internal and external regulation as an impediment to sales growth. Due diligence and compliance were a distant afterthought with Karl and only necessary after a sales contract had been earned. When SourceOne Furniture was awarded the contract to provide all of the furniture for an upscale resort located in a popular tourist destination (The Wisconsin Dells), a contract worth $2 million of revenue, he never thought twice about compliance issues that might surround his plan of importing the furniture from a manufacturing plant in China.

**Importing to Boost Profits**

The contract to furnish the resort marked the first time that SourceOne Furniture would import product directly from a Chinese manufacturer. Importing products from foreign countries is common practice within the United States. However, most organizations that import products utilize brokers that vet manufacturers based on quality, price, and capability. Brokers also guide an importer through import laws relevant to the product they are importing. Karl decided to bypass the broker and import directly from Shenyang Furniture Ltd., a company he discovered through an industry acquaintance. Karl was sure that bypassing a broker would add at least five percent profit to the Wisconsin Dells contract and that Shenyang Furniture Ltd. was capable of delivering a quality product in a timeframe that would allow SourceOne Furniture to complete the sales contract with substantial profit.
Shrugging Off Internal Controls

Prior to his arrival at SourceOne Furniture Jay was the corporate controller for a contract manufacturing organization that specialized in plastic extrusion products. Jay had implemented several internal controls at that organization that tightened and improved the sales quotation process. These internal controls included having all price quotations for new products calculated by an individual independent from the selling process, verification of all product price quotations by the corporate controller prior to customer notification, and having raw material cost and lead time verification from at least two independent and reliable vendors. Jay suggested the sales process within SourceOne Furniture be tightened by implementing the internal controls listed above. However, his suggestions were ignored because Karl believed SourceOne Furniture would lose sales because of the extra time it would take to verify vendor pricing and double check internally generated price quotations.

Karl was notorious for securing sales contracts prior to receiving vendor pricing commitments and often based projected profit margins on calculations he conducted on a yellow legal pad while sitting in a recliner watching Green Bay Packer football games. Being the owner of SourceOne Furniture, Karl had the latitude to run the organization as he chose and often balked at controls his Controller, Jay, suggested. These controls may have slowed the sales process but would have provided important safeguards against inaccurate sales quoting and erroneous lead time commitments made to customers. Jay did the best job he could within the confines of the controller role as defined by the owner.
Jay worked hard to provide SourceOne Furniture’s lending institution with accurate interim financial statements, reasonable pro-forma financial statements, and complete borrowing base certificates so that debt covenants were met and short term borrowing needs could be planned and modified on a regular basis. Jay asked Karl for a detailed projected margin analysis of the Wisconsin Dells contract so that pro-forma financial statements could be updated accordingly and included in the monthly reporting package distributed to the lending institution, the advisory board, as well as the executive management team. Jay was not surprised when Karl handed him several pages of notes written in pencil on yellow legal pad paper. Jay could barely make sense of the figures that were sprawled across the paper both horizontally and vertically. After several hours of analysis and consultation with Karl, Jay constructed a margin analysis report for the Wisconsin Dells job based on the assumptions provided by Karl. (See figure 1 for Wisconsin Dells margin analysis)

Jay was skeptical of the expected profit but found comfort in the fact that Karl showed an anticipated contribution margin of approximately $670,000 or 39% on the entire Wisconsin Dells job, which exceeded SourceOne’s typical margin on domestically sourced sales by nearly 10%. Jay expected costs to surface that Karl had not anticipated and he therefore included an additional $250,000 in his analysis for unanticipated import related costs. Jay’s instincts told him that even Karl’s worst guessing and estimating shouldn’t consume more than 15% of the expected revenue from the Wisconsin Dells job. So he was comfortable providing these figures to the bank and other stakeholders.
Karl worked closely with Shenyang Furniture Ltd. and provided them with engineered drawings of the furniture, packaging instructions, and a non-negotiable delivery schedule. Karl made several trips to China before the first container of furniture was sent to ensure the furniture was constructed to a quality level consistent with customer specifications and that the manufacturer was making sufficient progress on the furniture so that delivery dates would be honored. Karl commented on several occasions to Jay that the importing process seemed relatively easy and he was pleased with his decision to bypass a broker. He clearly displayed confidence in his ability to satisfy the sales contract without any major hindrances.

The 300% Anti-Dumping Tariff

Karl was dumbfounded when he opened a letter addressed to SourceOne Furniture from the USDC. The letter stated that there was a 300% antidumping duty for new shippers of wooden bedroom furniture from the People’s Republic of China. It went on to say that because Shenyang Furniture Ltd. was considered a first time shipper, all the furniture would be held at the port of entry, in Los Angeles, California, until the 300% tariff was paid in full. Karl told Jay the bad news and asked Jay to secure funding to pay the tariff so that the furniture could be released and sent to the customer in fulfillment of the contract.

Jay became nauseous as he began to work with the bank to secure funding for the tariff and was disgusted that an anticipated $670,000 margin had instantly turned into more than a $1.8 million deficit (See figure 2 for Wisconsin Dells analysis). Jay knew the costs associated with the tariff would place SourceOne Furniture in violation of several debt covenants and severely restrict the company’s cash flow well into the foreseeable future. Jay was concerned the bank might throw their existing loans into default.
Karl, however, was certain there had to be a way around the tariff and was motivated to do whatever he could to avoid the tariff on all remaining furniture that had yet to be imported. Karl asked Shenyang Furniture Ltd. to ship the remaining furniture unassembled and labeled as “wood parts” as opposed to TV stand, dresser, headboard, nightstand, and end table. Karl believed his tactic would disguise the shipment as wood instead of furniture and he could therefore avoid the tariff because he would not be importing wooden bedroom furniture.

**Working Around the 300% Tariff**

In addition to masking the rest of the material being shipped from China, Karl contacted several staff members at the USDC and asked them for an exemption from the tariff for Shenyang Furniture Ltd. because the amount of wooden bedroom furniture being imported was immaterial and posed no threat to the domestic furniture manufacturing industry. Karl was told the USDC was willing to review the financial records of all new shippers in order to establish a factory specific tariff for the manufacturer based on the costs of the shipper relative to a predetermined standard. Karl knew an audit of manufactured costs was his best course of action in obtaining a refund of the tariff.

Jay’s presence at the audit seemed appropriate given his position as corporate controller of SourceOne Furniture. However, Karl delegated responsibilities of the audit to Bob. Although Bob was familiar with the furniture manufacturing process and understood standard costs, Jay believed an accountant familiar with overhead cost allocation schemes and material and labor rate calculations should coordinate and correspond with auditors, not an engineer. Bob completed cost schedules and corresponded directly
with both Shenyang Furniture Ltd. and the USDC without consulting with Jay. Therefore, Jay did not know what data had been exchanged between the parties involved in the audit. Jay shared his concerns of being excluded from the audit planning with Karl and was told not to worry about it, that he (the owner) had everything under control.

**The Pre-Audit Meeting**

After 36 hours of travel, Jay, Karl, and Bob arrived at the international airport in Shenyang, China. They arrived on a Friday and the audit, which was to last two days, was scheduled to start the following Monday. Their plans to site see, visit local shops and markets, and spend time with the owners of Shenyang Furniture Ltd. over the weekend were scrapped when the auditors and attorneys from the USDC arrived on Friday asking for a pre-audit meeting.

Karl asked the auditors and attorneys to meet privately before the start of the pre-audit meeting. Karl believed the relationship building skills he had perfected as a sales professional could be used to win over the audit team and that he could convince them to grant a favorable tariff rate to Shenyang Furniture Ltd. if they understood the adverse impact the 300% tariff was having on his business. The auditors wanted nothing to do with relationship building and warned Karl that any attempt to influence the audit was illegal and would not be tolerated. The auditors presented a lengthy list of data they needed to have available Monday morning because the data Bob had supplied to the auditors in the prior months was incomplete, inconsistent, and often conflicted previously submitted data.
Salvaging the Audit

Karl quickly realized the mistake he had made when he gave Bob the responsibility to correspond with the auditors. With a look of despair Karl asked Jay to work with the accounting group at Shenyang Furniture Ltd. over the weekend to collect and compile the data the auditors requested for the audit on Monday.

Jay worked diligently over the next two days logging more than 18 hours each day as he tried to overcome a difficult language barrier to create the detailed cost analysis the auditors were interested in. The auditors were mostly interested in schedules outlining how much each piece of furniture actually cost the factory to produce. Jay had created many manufacturing bills of material and manufacturing routings with standard and actual costs for products over the years. However, he previously had access to detailed computerized records written in his native language to do this.

Unfortunately, the records of Shenyang Furniture Ltd. were all handwritten in volumes of bound ledgers. Jay spent most of his time asking for translated copies of production related records that would display the number of pieces manufactured and source documents indicating prices paid for raw material. Jay toured the manufacturing facility, reviewed payroll records, and weighed component parts such as screws and dowels in an effort to establish a verifiable manufactured cost per completed piece of furniture.
The Flawed Bill of Material

Jay had access to engineered drawings, raw material, labor, and overhead input costs from SourceOne Furniture’s database for a prototype of the headboard SourceOne had manufactured during the contract negotiation process. He therefore created a comparative cost analysis of the headboard produced in China with the actual cost to manufacture a headboard in the United States in an effort to establish some relative reference for the calculations he would be providing the auditors (See figure 3 for comparative cost analysis). The analysis frustrated Jay. He knew he had correctly calculated both the Chinese and American costs, however, the Chinese costs were well above the American costs to manufacture the headboard.

The major difference between the Chinese and American costs was the amount of lacquer required to seal the headboards. According to the records provided by Shenyang Furniture, Ltd. each headboard required three gallons (384 ounces) of lacquer (the most expensive material input in the process). Jay knew it was physically impossible to apply three gallons of lacquer to each headboard because the lacquer would need to be applied at a thickness greater than three inches. Jay argued his point with the lead manufacturing engineer, production manager, and cost accountant at Shenyang Furniture, Ltd. and demanded accurate figures to provide the auditors. The response from Shenyang Furniture, Ltd. was that their actual production records indicate three gallons of lacquer was applied to each headboard and if the auditors required source documents tracking actual costs they would need to manufacture records for Jay to provide the auditors.
Jay’s patience was running thin as the sun began to set on Sunday evening. He had to make a decision on what data he would provide the auditors Monday morning. If Jay presented the flawed data exactly as he had received it from Shenyang Furniture, Ltd., the auditors could increase the 300% tariff to reflect the actual costs of Shenyang Furniture, Ltd., possibly resulting in additional tariffs on the imported furniture. However, if Jay were to present what he thought was more accurate cost data, SourceOne Furniture could receive hundreds of thousands of dollars in refunds from the USDC for previously paid tariffs. Jay knew Karl would want him to manufacture cost data to appease the auditors and provide the greatest likelihood a refund would be issued. Jay’s conservative nature told him source documents should not be altered and he should provide the facts as he best understood them. There did not appear to be any clear cut answer on how best to proceed. Yet, his gut told him manufacturing documents to support his beliefs did not feel right. He was not sure what to do, but as a member of the Institute of Management Accountants, he knew his actions should be guided by the IMA Statement of Ethical Professional Practice.

**Initial Questions for Discussion:**

1. If you were the controller in this case, what would you have done, and why?
2. Is there anything the controller could have done to prevent the dilemma from happening in the first place? Be specific as to what and how he could have gone about it.
3. What obligations does the controller have, if any, regarding the owners’ decision to mask future shipments as wood instead of furniture? What would you have done?
## Figure 1: Margin Analysis Report Wisconsin Dells Contract

<table>
<thead>
<tr>
<th>Item</th>
<th>Quantity</th>
<th>Sales Price</th>
<th>Extended Revenue</th>
<th>Chinese Supplier Quote</th>
<th>Estimated Ocean Freight</th>
<th>Total Estimated Unit Cost</th>
<th>Total Extended Unit Cost</th>
<th>Expected Contribution Margin</th>
<th>% of Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>TV Stand</td>
<td>1,000</td>
<td>$300</td>
<td>$300,000</td>
<td>$150</td>
<td>$35</td>
<td>$185</td>
<td>$185,000</td>
<td>$115,000</td>
<td>38%</td>
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<tr>
<td>Dresser</td>
<td>1,000</td>
<td>400</td>
<td>400,000</td>
<td>225</td>
<td>55</td>
<td>280</td>
<td>280,000</td>
<td>120,000</td>
<td>30%</td>
</tr>
<tr>
<td>Headboard</td>
<td>2,000</td>
<td>200</td>
<td>400,000</td>
<td>75</td>
<td>20</td>
<td>95</td>
<td>190,000</td>
<td>210,000</td>
<td>53%</td>
</tr>
<tr>
<td>Nightstand</td>
<td>2,000</td>
<td>75</td>
<td>150,000</td>
<td>35</td>
<td>10</td>
<td>45</td>
<td>90,000</td>
<td>60,000</td>
<td>40%</td>
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<tr>
<td>End Table</td>
<td>3,000</td>
<td>150</td>
<td>450,000</td>
<td>80</td>
<td>15</td>
<td>95</td>
<td>285,000</td>
<td>165,000</td>
<td>37%</td>
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<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td><strong>$1,700,000</strong></td>
<td></td>
<td></td>
<td></td>
<td><strong>$1,280,000</strong></td>
<td><strong>$420,000</strong></td>
<td><strong>25%</strong></td>
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</table>

Unanticipated Import Costs: $250,000
### SourceOne Furniture

**Margin Analysis Report (With 300% Tariff)**

**Wisconsin Dells Resort Contract**

<table>
<thead>
<tr>
<th>Item</th>
<th>Quantity</th>
<th>Sales Price</th>
<th>Extended Revenue</th>
<th>Chinese Supplier Quote</th>
<th>300% Tariff</th>
<th>Estimated Ocean Freight</th>
<th>Total Estimated Unit Cost</th>
<th>Total Extended Unit Cost</th>
<th>Expected Contribution Margin</th>
<th>% of Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>TV Stand</td>
<td>1,000</td>
<td>$300</td>
<td>$300,000</td>
<td>$150</td>
<td>$450</td>
<td>$35</td>
<td>$635</td>
<td>$635,000</td>
<td>($335,000)</td>
<td>(112%)</td>
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<tr>
<td>Dresser</td>
<td>1,000</td>
<td>400</td>
<td>400,000</td>
<td>225</td>
<td>675</td>
<td>55</td>
<td>955</td>
<td>955,000</td>
<td>(555,000)</td>
<td>(139%)</td>
</tr>
<tr>
<td>Headboard</td>
<td>2,000</td>
<td>200</td>
<td>400,000</td>
<td>75</td>
<td>225</td>
<td>20</td>
<td>320</td>
<td>640,000</td>
<td>(240,000)</td>
<td>(60%)</td>
</tr>
<tr>
<td>Nightstand</td>
<td>2,000</td>
<td>75</td>
<td>150,000</td>
<td>35</td>
<td>105</td>
<td>10</td>
<td>150</td>
<td>300,000</td>
<td>(150,000)</td>
<td>(100%)</td>
</tr>
<tr>
<td>End Table</td>
<td>3,000</td>
<td>150</td>
<td>450,000</td>
<td>80</td>
<td>240</td>
<td>15</td>
<td>335</td>
<td>1,005,000</td>
<td>(555,000)</td>
<td>(123%)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td><strong>$1,700,000</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td><strong>$3,535,000</strong></td>
<td>($1,835,000)</td>
<td>(108%)</td>
</tr>
</tbody>
</table>
Figure 3: Headboard Costed Bill of Material Domestic vs. Chinese Cost

<table>
<thead>
<tr>
<th></th>
<th>SourceOne Furniture</th>
<th></th>
<th>Shenyang Furniture Ltd</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Costed Bill of Material (Domestic Manufacturing)</td>
<td>Headboard</td>
<td>Costed Bill of Material (Chinese Manufacturing)</td>
<td>Headboard</td>
</tr>
<tr>
<td><strong>Direct Material</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Item</td>
<td>Quantity</td>
<td>Cost</td>
<td>Extended Cost</td>
<td>Item</td>
</tr>
<tr>
<td>Oak</td>
<td>15 bd. Ft.</td>
<td>$4.25 bd. Ft.</td>
<td>$63.75</td>
<td>Oak</td>
</tr>
<tr>
<td>Hardware</td>
<td>1</td>
<td>$2.25</td>
<td>$2.25</td>
<td>Hardware</td>
</tr>
<tr>
<td>Lacquer</td>
<td>6oz</td>
<td>$.45</td>
<td>$2.70</td>
<td>Lacquer</td>
</tr>
<tr>
<td>Packaging</td>
<td>1</td>
<td>$7.50</td>
<td>$7.50</td>
<td>Packaging</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td><strong>$77.70</strong></td>
<td><strong>Total</strong></td>
</tr>
<tr>
<td><strong>Direct Labor</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Process</td>
<td>Hours</td>
<td>Hourly Cost</td>
<td>Extended Cost</td>
<td>Process</td>
</tr>
<tr>
<td>Rip Saw</td>
<td>.05</td>
<td>$35.00</td>
<td>$1.75</td>
<td>Rip Saw</td>
</tr>
<tr>
<td>Chop Saw</td>
<td>.05</td>
<td>$40.00</td>
<td>$2.00</td>
<td>Chop Saw</td>
</tr>
<tr>
<td>Glue Station</td>
<td>.15</td>
<td>$35.00</td>
<td>$5.25</td>
<td>Glue Station</td>
</tr>
<tr>
<td>CNC Router</td>
<td>.10</td>
<td>$150.00</td>
<td>$15.00</td>
<td>Hand Router</td>
</tr>
<tr>
<td>Finishing</td>
<td>.15</td>
<td>$50.00</td>
<td>$7.50</td>
<td>Finishing</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td><strong>$31.50</strong></td>
<td><strong>Total</strong></td>
</tr>
<tr>
<td><strong>Overhead</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Applied as percent of Labor (200%)</td>
<td></td>
<td>$63.00</td>
<td></td>
<td>Applied as percent of Labor (200%)</td>
</tr>
<tr>
<td><strong>Total Cost</strong></td>
<td></td>
<td></td>
<td><strong>$172.20</strong></td>
<td><strong>Total Cost</strong></td>
</tr>
</tbody>
</table>
TEACHING NOTES

This case places the corporate controller square in the middle of several ethical decisions and forces him to reevaluate his decision to work for SourceOne Furniture. The case provides students and faculty an opportunity to apply ethical decision making to a complicated scenario with significant cash flow and legal consequences for a small corporation with somewhat limited financial resources.

HOW THE AUDIT ENDED

The corporate controller believed the potential liabilities (legal, ethical, financial) were too great to create a fictitious bill of material that would more accurately communicate the costs of the Chinese manufacturer. Instead, he presented all of the data he collected from the Chinese Manufacturer to the auditors. He explained to the auditors the flaw with the bill of materials in an effort to receive guidance and approval from them to change the cost figures to reflect what would be a more accurate cost to manufacture the furniture in China.

The auditors agreed the data the corporate controller presented was not accurate because of the source documents provided by the Chinese manufacturer. However, they were unsympathetic to his request and plea to change the bill of materials to something more reasonable. The auditors had the legal responsibility to accept data presented during the audit and verify the data as authentic. Had they allowed alternative figures they would be violating their responsibilities and jeopardizing the authenticity of the audit.

Not only did the auditors deny the request to accept alternative figures, they reprimanded SourceOne Furniture for the manner with which they approached the audit. They were critical of the fact that data was collected and submitted less than 24 hours prior to the start of the official audit. Additionally, the auditors were vocal in letting the owner of SourceOne Furniture know he had made a critical error in assigning audit responsibilities to the director of engineering. Fittingly, the auditors calculated a new tariff rate for the Chinese importer based on the figures they received during the audit. The new rate marked the first time in the history of the United States Department of Commerce that the calculated rate from a new shipper review exceeded the pre-assigned rate of 300%. The new rate assigned was 429%, a near fatal blow to SourceOne Furniture. SourceOne Furniture ended up paying tariffs in excess of $2.5 million.

To add insult to injury (or perhaps it was karma), the resort owners in Wisconsin Dells filed for bankruptcy prior to completion of the project. SourceOne Furniture only recovered approximately 25% of the agreed upon contracted sales price for the furniture delivered. In all, SourceOne Furniture lost more than $4 million on this one contract. The lending institution forced the owner of SourceOne Furniture to contribute $3 million of additional capital into the business in order to avoid foreclosure. The entire senior management team learned very valuable lessons about the importance of internal controls and the necessity to have a strong control environment.
LEARNING OBJECTIVES

An overarching goal of this case is to provide the reader with a greater appreciation for the role management accountants play in privately held corporations. As such this case can be used in a wide range of courses and contexts. The primary learning objectives of this case include:

1. To learn about corporate governance and the need for internal controls, a strong control environment, and an ethical and responsible tone at the top of the organization.
2. To study standard versus actual costing and the impact both costing methods have on reporting cost data to internal and external stakeholders.
3. To examine how a costed bill of materials is constructed and the importance of relationships between the accounting function and other functional areas within a manufacturing organization (such as engineering, production, and purchasing).
4. To determine how the Institute of Management Accountants’ (IMA) Statement of Ethical Professional Practice can be used to guide accountants through the decision making process.
5. To provide insight into the role of various audits, auditors, and the effectiveness of GAAS.
6. To evaluate the benefits and detriments of importing products from foreign countries (including the role of various governmental units and how they rely on sound accounting information and practices).
7. Explore financial reporting concepts related to contingent liabilities (FASB ASC 450) and how SourceOne Furniture should report the tariff and all related transactions

CASE APPLICATION

The learning objectives listed above can be applied to this case in many ways using various lenses (audit, ethics, cost accounting, financial reporting). The case has been broken down into three focal areas based on the actual events of the audit. The three focal areas are the absence of adequate internal controls, masking shipments from China to avoid the tariff, and the events of the audit. The focal points can be modified to shift emphasis toward various accounting concepts relevant to a wide range of accounting courses.

This case could easily be applied to any of the following courses (undergraduate or graduate):

1. Cost Accounting or Advanced Cost Accounting
2. Auditing or Advanced Auditing
3. Intermediate Accounting
4. Accounting or Business Ethics
5. Strategic Management
6. Fraud, Advanced Fraud or Forensic Accounting  
7. International Accounting  
8. Accounting Research Courses  
9. Continuing Education Classes and Seminars

**THREE AREAS OF FOCUS**

As mentioned above, the case has three focal points relative to the role of a management accountant. Questions have been developed relative to each focal point. However, the user could generate questions that extend each focal point or explore additional aspects of the case relative to the course and class setting. Each focal point is briefly summarized below.

**INADAQUATE INTERNAL CONTROLS**

First, the organization lacked obvious internal controls. The owner of the organization was somewhat rebellious, stubborn, and arrogant in his leadership approach. The owner of the organization set a tone within the organization that controls were an impediment and unnecessary. The case describes an attempt the controller made to implement internal controls such as a quotation verification process prior to releasing price quotes to customers. There are many additional internal controls that could have prevented the more than $4 million loss sustained by the organization. Understanding the role of the controller in establishing a strong control environment and adequate internal controls is integral in preventing results experienced by SourceOne Furniture.

**MASKING SHIPMENTS FROM CHINA (Secondary Dilemma)**

Second, the controller had to decide how to react to the decision by the owner to mask additional shipments from China. This is a secondary dilemma in the case which the class can explore. Marking product as wooden parts as opposed to wooden furniture has an errant tone. Additional information you might choose to share or not with the class as you use the case: The import rules and laws at the time the case unfolded were vague and did not determine what constituted a completed piece of furniture. Furthermore, the Controller was not directly involved in this decision, so a question of responsibility arises. This additional information could be shared after an initial discussion to see if this change in context might also change someone’s opinion about what to do.
THE AUDIT

Third, the events surrounding and leading up to the audit should be of no surprise given the haphazard approach illustrated by SourceOne Furniture throughout the case. The controller was excluded from the entire audit planning process. Additional information you might choose to share or not with the class as you use the case: The Controller was overworked and stretched thin within the organization at the time the owner decided to begin importing product from China. He was preoccupied with all financial functions related to the manufacturing process (payroll, account collections, cash disbursements, financial statement preparation, product costing, budgeting, software implementation, and management of the human resources function in addition to the purchasing function). Therefore, he did not push to be more involved in the audit.

Assigning the pre-audit correspondence and data compilation to the director of engineering was a grave mistake made by the owner. As a result, the controller was forced to minimize the damage of the audit once in China. How the controller interacted with the Chinese manufacturer and auditors was pivotal and could have had different results if the controller had reacted differently and provided the auditors with slightly modified cost data.

Suggested Questions for Discussion

IMA’s Statement of Ethical Professional Practice:

1. What are the four overarching ethical principles that express IMA members’ values and standards that guide their conduct?
2. Describe what options Jay (controller) has in preparing and presenting data for the auditors when they return Monday morning. How does the IMA Statement of Ethical Professional Practice address each of the options you have described?
3. What resources are available through the IMA that can assist Jay in his immediate decision on what information to provide the auditors?
4. Are the actions taken by Karl (owner of SourceOne Furniture) to mask shipments from China as wood parts as opposed to wood furniture covered by the IMA statement of Ethical Professional Practice? What is Jay’s (controller) responsibility relative to Karl’s action?
5. Describe the ethical resolution process outlined by the IMA’s Statement of Ethical Professional Practice. How could Jay have applied the resolution process to his decision on what information to provide the auditors?
Corporate Governance, Internal Controls, Tone at the Top:

1. What is Corporate Governance? Describe how poor corporate governance contributed to the events surrounding the tariff.
2. What is a Control environment? What are the major elements of a control environment? Describe the strengths and weaknesses of the control environment at SourceOne Furniture.
3. What are internal controls? What makes an internal control effective?
4. What could Jay have done differently that may have prevented the events that unfolded during the pre-audit? Provide examples of internal controls Jay could have developed to help mitigate risk for SourceOne Furniture during the sales bidding and contract process.
5. Define what is meant by the ethical and responsible tone at the top. How does the ethical and responsible tone at the top impact the development and implementation of an effective internal control system?

Cost Accounting and Advanced Cost Accounting:

1. What is a costed bill of material? Describe how a bill of material can become part of an effective internal control.
2. What is a costed routing? Describe how a routing can become part of an effective internal control.
3. Describe actual costing. Do you believe it was appropriate the auditors asked for cost data based on actual costs? Explain.
4. Describe standard costing. Describe how standard costing could have been used and verified by the auditors during the audit.

Audits, Auditors and the Application of GAAS:

1. What is a Certified Audit according to Generally Accepted Auditing Standards (GAAS)? How does a Certified Audit differ from the audit performed in this case by the United States Department of Commerce?
2. What is the Internal Audit Standards Board (IASB)? Does the scope of the IASB cover the events that unfolded within the case? Explain.
3. What are the different types of internal audits? Who are internal auditors? What are the responsibilities of internal auditors? How could an internal audit of internal controls have helped SourceOne Furniture avoid the tariff?
4. What is an operational audit? How could SourceOne Furniture benefit from an operational audit?
Financial Accounting, US GAAP, and the FASB Codification:

1. What is the FASB Codification?
2. Describe how SourceOne Furniture should have reported the potential tariff cost in both its balance sheet and income statement under US GAAP.
3. What section of the FASB Codification provides direction on how to account for the tariff?
4. What is a contingent liability? Does the tariff qualify according to the FASB Codification as a contingent liability? If no, why not? If yes, what portion of the tariff would be considered a current liability as opposed to a long-term liability?
5. In what ways do you think the IMA’s Statement of Ethical Professional Practice applies to the financial reporting of the tariff?

Sarbanes Oxley Act:

1. What is the Sarbanes Oxley Act? Describe the act in general terms and the reasons behind its passage.
2. Does the Sarbanes Oxley Act apply to SourceOne Furniture? If no, why not? If yes, describe the provisions of the act you believe were breached by SourceOne Furniture, if any?
3. In what ways do you think the provisions of SOX are complimented by the IMA’s Statement of Ethical Professional Practice?

SUMMARY

The users can choose which objectives and questions to include based upon the course materials they are using. The questions provide a great starting point for an in-depth and meaningful discussion of the material. This case works well in both undergraduate and graduate level accounting and finance courses. The case presented lends itself to multiple teaching formats: written, oral, or a combination thereof in individual or group format. Whether an individual or group written case analysis, having an in class discussion of the case greatly enhances the potential learning gained from this case. The in-class discussion can also take a variety of formats, small or large group, or individual question and answer or combination thereof.

If you choose to only do an in-class discussion of the case (or doing the whole analysis within one class session) you will want to have had the students read the case prior to coming to class. In addition, you may want them to come up with a list of what they see as the five most important concepts they got out of reading the case, or having prepared answers to selected discussion questions. This can provide a good jumping off point for group or individual discussions.

Regardless of the particular course being taught, the inclusion of ethics and professional codes of conduct is highly encouraged. This case provides an easy way to integrate the coverage of specific concepts within accounting and the professions ethical responsibility to society. The Institute of Management Accountants statement of ethical professional practice is a wonderful tool to incorporate into the teaching of this case.