Management Accounting Case Book

Cases from the IMA Educational Case Journal

Raef A. Lawson
About IMA®

IMA, the association of accountants and financial professionals in business, is one of the largest and most respected associations focused exclusively on advancing the management accounting profession. Globally, IMA supports the profession through research, the CMA® (Certified Management Accountant) program, continuing education, networking, and advocacy of the highest ethical business practices. IMA has a global network of more than 80,000 members in 140 countries and 300 professional and student chapters. Headquartered in Montvale, N.J., USA, IMA provides localized services through its four global regions: The Americas, Asia/Pacific, Europe, and Middle East/Africa. For more information about IMA, please visit www.imanet.org.

About the CMA®

IMA’s globally recognized CMA (Certified Management Accountant) is the leading certification for management accountants and financial professionals in business. Earning the CMA requires a mastery of advanced-level knowledge in four critical areas: financial planning, analysis, control, and decision support. For more information about the CMA certification program, please visit www.imanet.org/certification.
Preface

As the field of management accounting evolves, management accountants are required to have a mastery over an ever-widening body of knowledge, including such areas as risk management, strategic cost management, process management, and more. They must also be able to apply that knowledge in an integrated manner to situations often involving uncertainty.

A useful way to develop such competency is through the use of case studies. Besides making mastery of important concepts more interesting, case studies can enhance one’s grasp of management theory by facilitating broad discussion designed to challenge one’s thinking and helping to foster critical thinking skills.

Management Accounting Case Book: Cases from the IMA Educational Case Journal (MACB) offers many cases that have been through a rigorous review process to ensure high quality of both case and teaching notes and have been used at dozens of schools. Some cases are intended for a certain academic level (e.g., principles, undergraduate, graduate, MBA), but most are usable for multiple audiences and can be adapted to the objectives of the instructor. MACB can be used to supplement a textbook or as a standalone text for using the case method.

The cases in this book were chosen from cases published in the IMA Educational Case Journal (IECJ*). The IECJ is a high-quality online journal with the mission to publish teaching cases for management accounting and related fields. The IECJ aims to provide an educational resource rich in detail to reflect current business problems. Through publication of these case studies, IMA (Institute of Management Accountants) is pursuing its goal of enhancing the teaching of management accounting worldwide to help develop the global management accounting profession.

The Management Accounting Case Book is organized into five sections, each dealing with a specific area of management accounting:

- Business Leadership and Ethics (including the role of the management accountant, ethical situations, IMA Guidelines, whistleblowing, organizational culture, and employee engagement)
- Operations, Process Management, and Innovation (including flexible budgeting, standard costs, variance analysis, nonfinancial performance indicators, quality control, lean, and innovation governance)
- Planning and Decision Making (including cost estimation, CVP analysis, budgeting, decision making, capital investments, target costing, and TOC)
- Risk Management and Internal Controls (including sustainability, performance evaluation and indicators, responsibility centers, balanced scorecard, transfer pricing, compensation, and incentives)
- Strategic Cost Management (including product and service costing, cost allocation, and strategy implementation)

I want to thank the Associate Editors of the IECJ, the members of the IECJ Advisory & Review Board, and the authors of the cases included in this volume for their many years of support of our journal. Their efforts have been instrumental to the development of this great resource.

I wish you success and hope you enjoy these cases!

Rae Lawrence, Ph.D., CMA, CPA, CFA
Editor, IMA Educational Case Journal
Professor-in-Residence and Vice President of Research & Policy
Institute of Management Accountants
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I. Business Leadership and Ethics

**Trust May Breed Trouble: Fraud Opportunities and Ethics at Saintly Church**
Cecily Raiborn, Janet B. Butler, Nathan H. Cannon, and Randall F. Young, Texas State University

SAINTLY CHURCH IS EXPERIENCING DECLINING REVENUES AND increasing expenses, and several fraud risk factors are present. Do these fraud risk factors indicate fraudulent activity by one or more of the key persons in the case, or could there be reasonable and legitimate explanations? The purpose of this case is to allow students to explore the IMA Statement of Ethical Professional Practice within the context of a nonprofit institution by examining the role of Sandy Withers, CMA, as she attempts to help the church address these issues. By completing the case, students will identify potential underlying causes (both fraudulent and legitimate) of the declining revenues and increasing expenses, highlight weaknesses in internal controls, and discuss Withers’s responsibilities and approaches to communication under the IMA Statement of Ethical Professional Practice.

This case is an ideal assignment for an undergraduate or graduate accounting course that discusses internal controls, the fraud triangle, and potential organizational fraud. It is also a good assignment to integrate toward the end of a fraud prevention class that employs a case-based teaching methodology since most fraud cases have a primary objective of identifying the fraud or the fraud risk factors.

**Keywords:** ethical standards, church fraud, not-for-profit fraud, fraud triangle, internal controls.
Trust May Breed Trouble: Fraud Opportunities and Ethics at Saintly Church

Cecily Raiborn, Ph.D., CMA, CPA, CFE
McCoy Endowed Chair in Accounting
Texas State University

Nathan H. Cannon, Ph.D., CPA
Assistant Professor of Accounting
Texas State University

Janet B. Butler, Ph.D., CGMA, CITP
Professor of Accounting
Texas State University

Randall F. Young, Ph.D.
Assistant Professor of Accounting
Texas State University

INTRODUCTION

Light twinkled through the stained glass windows as Pastor Peter Lang walked through Saintly Church. He had just met with Sandy Withers, a CMA® (Certified Management Accountant) and two-year member of the church’s governing board. Lang and Withers had been discussing the fact that the church was perennially short of funds—although what church wasn’t these days?—and the possibility of instituting some new internal controls for oversight.

As a board member, Withers was part of the group responsible for managing Saintly Church’s overall business and nonbusiness affairs. Such responsibility included implementing policies regarding church administrative policies and procedures. Although the church had grown significantly over the past 20 years, board members had made few of the administrative policy changes suggested by advisers and the church’s denomination headquarters.1 The church was primarily operating under a system of trust. The following passage illustrates the majority viewpoint of the board: “Trust is the emotional glue that binds a team together and produces confidence.... High-achieving churches have a high level of trust among the staff. It means the lead pastor trusts the staff, the staff trusts the pastor, and the staff trusts one another.”

While Withers agrees with the basic sentiment, she also believes that too much trust could create problems. She explained to Pastor Lang that trust is simply not a valid internal control. She referenced a recently-read article stating that the environments of not-for-profit organizations (including churches) often make them more vulnerable to fraud and abuse than for-profit businesses because of the reasons listed in Figure 1. Pastor Lang can see the point Withers was trying to make, but he could also see that putting in internal controls would likely mean additional work for him and other church workers. He asked Withers to please discuss with him any recommendations she is considering before taking those recommendations to the board.
Figure 1: Susceptibility for Fraud and Abuse in Not-for-Profit Organizations

Not-for-profit organizations often:

- Place excessive control in their founder, executive director, or substantial contributor;
- Allocate limited resources to accounting, internal controls, and financial oversight;
- Have many volunteers working in the organization who are privy to confidential information;
- Have boards of directors comprising only volunteers, with little or no financial oversight expertise;
- Have nonreciprocal transactions, such as charitable contributions, that are easier to steal than other sources of revenue where there is consideration exchanged; and
- Are highly susceptible to the effects of negative publicity and, therefore, are reluctant to report, or even discuss, fraud when it occurs.


THE CHURCH

Saintly Church was formed about 20 years ago in a small suburb of a metropolitan area. As the city grew, so did the suburb and the church. A large proportion, but definitely not all, of the members would be classified as having middle-to-high income. To meet the needs of its membership and others in the community, the church operates Little Saints Daycare five days a week. Church operating funds are raised from the Little Saints Daycare tuition, collection plate donations, online donations through Secure Spirits (the church denomination’s giving website), and a monthly bingo game. The church also has two large community rooms that may be rented out for nonchurch events. The community rooms are constantly under renovation to make them more attractive for rental activities.

In addition to a small petty cash fund in the church secretary’s desk drawer, a larger cash “benevolent fund” is available to pay for food for the occasional homeless person or to provide less-affluent church members with financial assistance for small emergencies. If there is insufficient cash in the benevolent fund to help someone in need, the pastor can ask the governing board for additional money.

THE PEOPLE

Pastor Lang has been with the church for three years, having moved halfway across the country just prior to taking the position. He showed up at the right time. The previous pastor retired and moved to Florida a year previously, and the church had just finished its discernment and transition process, which generated recommendations for interview candidates and sought to preserve continuity between the leaving and incoming pastors. After vowing the governing board in his interview, Lang (with an undergraduate degree in accounting and graduate degree in theology) passed his background check and was hired. In addition to his salary and a credit card to be used for church business, Lang is provided with a housing and car allowance. He was slightly disappointed by the salary offered, but stated that he could manage on that amount since he is single and his accounting major made him good at budgeting. His background has also made him a favorite with some of the elderly parishioners because he is able to help them with their finances.

Sabrina Louis, the church secretary, had been hired eight years ago by the previous pastor. That pastor, being concerned about privacy issues related to congregants’ contributions, made Louis solely responsible for counting collection plate offerings rather than the more typical approach of having rotating teams of congregation members perform that task. Over the years, Louis has been given more and more responsibilities. Today she is in charge of much of the bookkeeping, including recording contributions and pledges, preparing financial statements, and making purchases authorized by Lang or, in the case of purchases more than $2,000, by the board. Because of her multiple job duties and her dedication to the church, Louis tends to work long hours and takes few vacation days. She says that vacations aren’t really important to her since she is not married and few family members live close by.

GENERAL FINANCIAL PROCESSES

The church has a checking and savings account at a local bank. Two tellers and one manager from the bank are church members. Bank statements are sent to the church address and are reconciled monthly by Lang. In addition to Lang, one member of the governing board has authority to sign checks for the church; only one signature is required on a check. Lang typically makes bank deposits on Monday. Cash and checks from the Sunday collection plate are stored in a small safe that Lang, Louis, and one member of the governing board have the combination for. Cash offerings
have decreased significantly over the past few years since many church members prefer to contribute by check or online on a monthly basis.

Daycare tuition can be paid on a daily, weekly, or monthly basis depending on how regularly a child attends. Daily and weekly tuitions are generally paid by check, but some people do pay in cash. Monthly tuition is billed by Louis and remitted to her by check. The number of people working at Little Saints Daycare varies based on the number of children. Lang interviews and hires daycare workers. There are three “regular” workers, and substitutes are available to fill in when needed. One of the regular workers provides Lang with information about the daily number of children attending (and those who paid in cash) as well as who worked and for how long. Lang reviews the attendance records and forwards the attendance records and any tuition payments to Louis. Louis records the tuition payments received then sends the checks or cash to Lang to deposit into the bank. Daycare employees’ timesheets are also reviewed, and the information is given to Louis. She writes the payroll checks, and Lang signs them. One of the other regular workers is in charge of purchasing snack and meal items for the daycare center and turns the receipts over to Lang, who approves them and submits them to Louis to provide payment.

Although Louis is in charge of checking the calendar for availability of community rooms, Lang meets with individuals wanting to rent the room. There is no set fee for room rental. The amount Lang charges depends on whether the person who wants to rent is a church member or nonmember, what the purpose of the rental is, how long the rental will be, and what (if any) church furniture or fixtures will be used. Lang collects a deposit and tells Louis the remaining amount to bill.

The monthly bingo game is scheduled on a Saturday night and is a cash-only event. Both Lang and Louis sell the bingo cards, and Lang pays out the winnings from the proceeds. Volunteers call the games and help with the event. Lang uses bingo proceeds to pay for the volunteers’ drinks and snacks as a thank you for donating their time. The net cash is then deposited into the bank on Monday along with the Sunday offerings. Bingo proceeds have been declining substantially although most church members still attend and socialize.

### The Circumstances

Three days after her discussion with Pastor Lang, Withers gathered with the rest of the church’s governing board for the monthly meeting. A major focal point of the meeting was the financial statements provided by Louis.1 (Tables 1 and 2 present portions of the 2014 budget and excerpts from the three-year Statement of Activities prepared for the Board.) While they may not have been considered dismal, the financials did not provide good news compared to the budget. Offerings were lower than expected, as were tuition, rental, and bingo revenue. Expenditures for benevolences, daycare worker wages, daycare snacks and meals, and community room improvements were higher than budgeted. The situation has been getting worse over the last 18 months, and the board members were concerned. One board member who had recently become the victim of employee fraud at his business remarked that things had financially gone downhill since Lang had become pastor. The board member then mused aloud that Lang could easily be stealing from the church. After all, had the other board members seen Lang’s new car?

#### Table 1: 2014 Budget Excerpt

<table>
<thead>
<tr>
<th>Unrestricted Revenues:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Contributions/Offerings</td>
<td>$200,000</td>
</tr>
<tr>
<td>Daycare Tuition</td>
<td>155,000</td>
</tr>
<tr>
<td>Bingo Revenue</td>
<td>18,000</td>
</tr>
<tr>
<td>Building Use</td>
<td>5,500</td>
</tr>
<tr>
<td>Total Unrestricted Revenues</td>
<td>$378,500</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenses:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Pastor Compensation</td>
<td>$ 80,000</td>
</tr>
<tr>
<td>Church Employees Compensation</td>
<td>75,500</td>
</tr>
<tr>
<td>Daycare:</td>
<td></td>
</tr>
<tr>
<td>Employee Wages</td>
<td>130,000</td>
</tr>
<tr>
<td>Snacks and Meals</td>
<td>13,000</td>
</tr>
<tr>
<td>Utilities and Miscellaneous</td>
<td>8,200</td>
</tr>
<tr>
<td>151,200</td>
<td></td>
</tr>
<tr>
<td>Maintenance &amp; Utilities</td>
<td>30,000</td>
</tr>
<tr>
<td>(incl. Community Room)</td>
<td></td>
</tr>
<tr>
<td>Benevolences</td>
<td>18,500</td>
</tr>
<tr>
<td>Church Council</td>
<td>4,800</td>
</tr>
<tr>
<td>Youth Ministry</td>
<td>5,100</td>
</tr>
<tr>
<td>Worship and Music</td>
<td>4,300</td>
</tr>
<tr>
<td>Outreach and Advertising</td>
<td>1,000</td>
</tr>
<tr>
<td>Total Expenses</td>
<td>$369,600</td>
</tr>
<tr>
<td>Excess of Revenues over Expenses</td>
<td>$ 8,900</td>
</tr>
</tbody>
</table>
The board members turned to Withers. Surely her knowledge of accounting and budgeting could help them understand what might be happening. Withers thought carefully about everything that was going on. On one hand, logical explanations could be given for all of the unfavorable variances between the budget and actual amounts. On the other hand, internal controls were weak, and the potential for fraud is high.

Given the IMA Statement of Ethical Professional Practice, Withers knows that she has a responsibility to be honest, fair, and objective in addressing the church’s financial issues with the rest of the board members. A CMA has a competence responsibility to “provide decision support information and recommendations that are accurate, clear, concise, and timely.” Additionally, a CMA has a credibility responsibility to “communicate information fairly and objectively” and to “disclose all relevant information that could reasonably be expected to influence [a] user’s understanding of...analyses or recommendations.” Finally, even though the church had no stated internal control policies, Withers knew that she had a responsibility to disclose the control problems that could lead to inappropriate behaviors.

**CASE QUESTIONS**

1. Who are the stakeholders of Saintly Church?
2. A system of internal controls should be designed to protect assets and ensure compliance with organizational policies and procedures. Do you believe that the church has a reasonable system of internal controls? Explain why or why not.
3. Prepare a flowchart of the sources and uses of the church funds. Indicate within the flowchart where documentation is being prepared and by whom. Use this flowchart to identify points of weakness in the current system of internal controls for question 4.
4. Fraud, waste, and/or abuse may occur when an organization has no, or ineffective, internal controls.
   a. In what ways might Pastor Lang commit fraud in the church? If the pastor is stealing from the church, what rationalizations might he use for his actions?
   b. In what ways might Sabrina Louis commit fraud in the church?
   c. What types of waste and abuse could be occurring in the church by persons other than Pastor Lang or Sabrina Louis?
   d. What recommendations should Withers supply to the board about the church’s internal controls?
5. Assuming that no theft is occurring at the church, discuss the human resource issues that the lack of internal controls places on church employees.
6. Organizational governance reflects the manner in which management (in this case, the church’s board and pastor) is directed, administered, and controlled toward the achievement of mission and vision. It appears that the appropriate level of governance is not being provided by the board at Saintly Church. What legal and ethical issues might arise related to the various stakeholders given the lack of good organizational governance?
7. What rational and legitimate explanations could be given for each of the line item budget variances?
8. Review the standards of competence, confidentiality, integrity, and credibility within the IMA Statement of Ethical Professional Practice.
   a. How should Withers proceed relative to (1) the situation and (2) her communications with the board and others?
   b. Given the responsibility of confidentiality, how should Withers broach the subject (if at all) of the potential for Louis committing fraud?

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**ENDNOTES**


3. Churches are not-for-profit organizations. Not-for-profit entities typically use fund accounting rules and principles and prepare financial statements in accordance with FASB Statement of Financial Accounting Standards (SFAS) Nos. 116 and 117. At the time this case was written, SFAS 117 was under review. See [http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=1176159286112](http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=1176159286112) for an update of the current status of this standard and the review process.
**Diamond Foods, Inc.**  
Jomo Sankara and Deborah L. Lindberg, Illinois State University

THIS CASE EXAMINES A REAL-LIFE OCCURRENCE OF ALLEGED financial statement fraud by Diamond Foods, Inc. Specifically, the company purportedly understated walnut costs in order to falsify earnings to meet estimates by stock analysts. The facts of this case are drawn from Securities & Exchange Commission (SEC) accounting and auditing enforcement releases and administrative proceedings releases. Learning objectives specific to this case include increased awareness of real-life ethical dilemmas, understanding the reasons for earnings management, understanding the costs of earnings management, and greater awareness of appropriate auditing responses to potential earnings management fraud.

The case is within the grasp of introductory undergraduate students and is also appropriate for graduate students. The case can be used in either an auditing course or a managerial course. You can pick relevant questions from the case to assign to students as deemed appropriate based on the class.

**Keywords:** Diamond Foods, Inc., managed earnings, analyst expectations, ethics, auditors, budgetary control.
Diamond Foods, Inc.

Jomo Sankara  Deborah L. Lindberg
Illinois State University  Illinois State University

INTRODUCTION

This case examines an interesting real-life occurrence of alleged financial statement fraud by Diamond Foods, Inc. Specifically, the company purportedly understated walnut costs in two fiscal years in order to falsify earnings to meet estimates by stock analysts. The facts of this case are drawn from Securities & Exchange Commission (SEC) accounting and auditing enforcement releases and administrative proceedings releases.

OVERVIEW

The SEC filed separate actions in January 2014 against Diamond Foods, Inc., its former Chief Executive Officer Michael Mendes, and its former Chief Financial Officer Steven Neil for their roles in a scheme to understate walnut costs in order to falsify earnings to meet estimates by stock analysts. The SEC contends that Diamond materially falsified its financial statements in fiscal years 2010 and 2011. Diamond has since restated its financial results for those periods. The company’s reported earnings decreased by $10.5 million for its 2010 fiscal year and by $23.6 million for its 2011 fiscal year. Additional specific information is provided in the following sections of the case.

DIAMOND FOODS: MORE THAN NUTS

Diamond Foods, Inc., based in San Francisco, Calif., has a significant line of business that involves buying walnuts from growers and then selling the walnuts to retailers. The company diversified into potato chip and microwave popcorn product lines, introducing these lines after Diamond became a publicly traded company in 2005. Diamond first entered the microwave popcorn business when it acquired the Pop Secret popcorn brand from General Mills in 2008. Two years later, Diamond Foods expanded into potato chips by acquiring the Kettle Foods potato chip company. The potato chips are sold under the Kettle Brand label in the United States and Kettle Chips brand in the United Kingdom. As of August 31, 2011, Diamond had issued 22,011,196 shares of common stock.

Although Diamond Foods diversified into other product lines, walnuts remained its primary product. In 2010, a significant increase in the cost of walnuts threatened Diamond’s financial results, and, as described in the following paragraphs, two of Diamond’s top officers allegedly manipulated financial information.

THE ACCOUNTING SCHEMES

In fiscal year 2010, there were significant increases in the average prices demanded by walnut growers. Accordingly, Diamond needed to pay significantly more to its growers in 2010, compared to prior years. Yet an increase in the cost of walnuts would decrease net income at a time when Neil,
Diamond’s then-CFO, was facing pressure to meet or exceed the earnings estimates of Wall Street analysts.6 Neil gave “extra” payments to Diamond’s walnut growers but allegedly improperly excluded portions of these payments from the cost of walnuts by instructing his finance team to consider the payments as advances on crops that had not yet been delivered. Mendes, Diamond’s then-CEO, was not only involved in the decision to make special payments to growers but also was aware of the way these payments were recorded in the financial statements.7 By allegedly falsifying the financial statements for fiscal years 2010 and 2011, Diamond was able to hit quarterly earnings per share (EPS) targets and exceed analysts’ estimates.8 The SEC also alleges that both Neil and Mendes personally benefitted from the alleged fraud by receiving cash bonuses and other compensation based on reported EPS in both fiscal years 2010 and 2011.9

**FISCAL YEAR 2010: “CONTINUITY” PAYMENTS**

Diamond began manipulating the financial statements by understating its walnut cost in the second quarter of fiscal year 2010. In accordance with Diamond’s accounting policy, the cost of the 2009 walnut crop is reported in the 2010 financial statements. Diamond had previously recorded an estimated average walnut cost of $0.82 per pound in the first quarter of fiscal year 2010 based on the 2009 crop. But in order to beat the analysts’ consensus second quarter EPS forecast, Neil reduced the walnut cost estimate to $0.72 per pound.10 The resultant increase in stock price from beating analysts’ forecasts supported Diamond’s expansion into potato chips and the imminent acquisition of the Kettle Foods potato chip company.

Diamond subsequently paid a final minimum price to the walnut growers of $0.71 per pound, which was significantly lower than market price for the 2009 crop. Therefore, Neil created a scheme to “close the gap” between the final minimum price and the market price, which was to pay the walnut growers extraordinary payments of approximately $0.10 per pound, termed as a “continuity” payment. Only the final minimum price of $0.71 per pound was included in the 2010 financial statements. To avoid including the continuity payment in the 2010 financial statements, Neil instructed his finance team that the payment was an advance for the 2010 walnut crop. But the growers were paid the continuity payment and final 2009 crop payment in one check, the continuity payment went to growers not under contract to deliver the 2010 crop, and continuity payments were made to growers who ultimately did not deliver a 2010 crop. Mendes reviewed and approved correspondence sent to the growers related to this matter. Excluding the continuity payments from the 2010 financial statements resulted in Diamond beating its EPS forecasts and reporting a 52% growth in earnings.11

**FISCAL YEAR 2011: “MOMENTUM” PAYMENTS**

Neil also allegedly manipulated walnut costs in the 2011 fiscal year, resulting in the continuation of the trend of beating analysts’ earnings estimates. A competitive price for the 2010 walnut crop was approximately $1 per pound. Diamond paid the walnut growers an average first installment payment of $0.57 per pound and agreed to pay a final payment of $0.08 per pound. Diamond subsequently recorded the final 2010 crop walnut cost as $0.74 per pound. The cost of the 2010 walnut crop is recorded in 2011 fiscal year’s financial statements.

Neil knew that Diamond’s “final” price for the 2010 crop of walnuts, not including the “momentum” payment, was about $0.40 per pound below prices being paid by Diamond’s competitors. This gap was considered unusual and unprecedented.12 To close the gap in payments to the walnut growers, Neil issued an extraordinary and unusual payment to growers of $0.30 per pound, termed the “momentum” payment. This payment was treated by the finance team as an advance for the 2011 crop and therefore was excluded from 2011 fiscal year’s reported earnings. The payment, however, was paid to all growers who delivered the 2010 walnut crop to Diamond, including those not under contract to deliver a 2011 crop and those who ultimately did not deliver a 2011 crop.

The fiscal year 2010 “continuity” payments and the fiscal year 2011 “momentum” payments could be termed “earnings management” activities. As noted in this case, the SEC took exception to the earnings management methods used by Diamond. But not all methods used to increase net income are unethical.

**EARNINGS MANAGEMENT METHODS**

Earnings management is the purposeful intervention in the external financial reporting process with the intent of obtaining some private gain.13 Several methods may be used to manage earnings. Accruals management (AM) is the manipulation of accounting accruals (or prepayments) in order to manage earnings. AM is relatively common and relatively easy to justify since it is based on accounting estimates and assumptions. Real transaction management (RTM) involves the timing and structuring of actual business activities in order to achieve a desired financial reporting result.14 Non-GAAP earnings management is another type...
of earnings management where GAAP (Generally Accepted Accounting Principles) is violated in order to manipulate the reported earnings number. Although both AM and RTM do not generally violate GAAP, there may be instances when AM does violate GAAP.15

In his article “Overvaluation and the Choice of Alternative Earnings Management Mechanisms,” Brad Badertscher argues that there is a pecking order to managing earnings. He argues that firms are likely to first use AM because it does not affect business operations and therefore is the least costly form of earnings management. But use of AM is limited because of the reversing nature of accruals. RTM generally follows AM but is more costly than AM because it impacts the company’s long-term performance. In addition, companies will eventually run out of RTM opportunities and either stop managing earnings or transition to the most costly form of earnings management.16 Companies use non-GAAP earnings management because it is difficult to detect and enables large-scale changes to reported earnings. Yet Badertscher argues that non-GAAP earnings management is the most costly form of managing earnings because of legal fees and capital market costs once the GAAP violation has been revealed. Therefore, non-GAAP earnings management is generally the last method used to manage earnings.

Auditors have the responsibility to conduct their audit to provide reasonable assurance that there are no material misstatements in the financial statements. This responsibility includes ascertaining that any “earnings management” techniques do not violate GAAP.

THE AUDITORS

Neil approved the walnut cost and determined the accounting for walnut payments. He supervised Diamond’s finance and accounting team (“finance team”) and the team that managed relationships with growers (“grower relations team”). As the CFO, Neil directly interacted with Diamond’s external auditors. Neil prepared an internal memorandum each quarter that justified the quarterly estimated cost of walnuts and a memorandum to the external auditors that justified the final walnut costs. The SEC notes that the auditors relied on the memos when issuing their opinions about Diamond’s financial statements.17

FISCAL YEAR 2010

During the audit of the 2010 financial statements, the auditors asked Neil for information to justify his decision to account for the “continuity” payment as an advance on the next year’s crop of walnuts. The SEC contends that Neil made material misrepresentations to the auditors and withheld material information from them. Specifically, he falsely stated that walnut growers had asked for an advance payment for next year’s crop and omitted the fact that he and other Diamond representatives had assured growers a competitive price for the current year.18 Further, the auditors relied on a “management representation letter” that Neil signed, which stated that the “continuity” payment was for the 2010 crop and did not represent a payment for 2009 walnut costs. Mendes was cognizant of representations made to the external auditors and signed the related management representation letter related to the 2010 financial statements audit.19

FISCAL YEAR 2011

Neil continued to manipulate walnut costs during fiscal year 2011. In e-mails, Neil referred to the walnut costs as a “lever” to manage earnings in Diamond’s quarterly financial statements. As a result of the cost manipulations, Diamond reported EPS that met or exceeded analysts’ expectations for every quarter in 2011. It should be noted that Diamond’s stock price was central to a proposed acquisition of a major potato chip business unit in spring 2011.20 The company’s stock price reached approximately $92.50 per share in September 2011.

EPILOGUE

DIAMOND FOODS

As a result of media speculation of accounting irregularities and an internal investigation, Diamond Foods issued restatements on November 14, 2012. Around the time of the announcement, the price of Diamond’s stock declined to approximately $15.40 per share.

Diamond Foods, Inc., without admitting or denying the allegations, agreed to pay $5 million to settle the charges filed against it by the SEC.21 Diamond also consented to the entry of a permanent injunction against future violations of the relevant securities laws.22
MICHAEL MENDES
Michael Mendes, Diamond’s former CEO, agreed to settle charges against him by paying a civil money payment of $125,000 to the SEC and agreeing to “cease and desist” from committing or causing any future violations of Sections 17(a) (2) and (a)(3) of the Securities Act as well as other Sections and Rules of the Exchange Act. In addition, Mendes returned or forfeited more than $4 million in bonuses and other benefits he received as a result of Diamond’s allegedly fraudulent financial reporting.

STEVEN NEIL
The SEC’s litigation against Steven Neil, Diamond’s former CFO, continues and, at the time of this writing, is still pending. The SEC is seeking several things from Neil, including:

- Permanently enjoining Neil from directly or indirectly violating certain rules of federal securities laws;
- Prohibiting Neil from serving as an officer or director of any entity having securities registered with the SEC pursuant to the Exchange Act;
- Surrendering any wrongfully obtained benefits (Neil received $1.18 million in bonuses, including $687,043 tied to meeting EPS goals);
- Reimbursing Diamond for all compensation received or obtained during the relevant statutory time period established by Section 304 of the Sarbanes-Oxley Act (SOX); and
- Paying civil penalties.

GENERAL QUESTIONS:

1. In this case, Diamond Foods was accused of “managing earnings” in an unethical manner. Provide two specific examples of how a company could ethically improve net income.

2a. Why do you think accounting personnel (the “finance team”) seemed to “go along” with the schemes to understate the cost of walnuts in both fiscal year 2010 and fiscal year 2011? Provide as many possible reasons you can think of.

2b. Instead of agreeing to record the extra payments to growers as “advances” and, in effect, helping the company falsify the financial statements, what other alternative actions were available to the finance team? Consider professional standards, such as the IMA® (Institute of Management Accountants) Statement of Ethical Professional Practice or the AICPA (American Institute of Certified Public Accountants) Code of Professional Conduct, when answering this question.

3. At the time of this writing, charges against Steven Neil, the former CFO of Diamond Foods, were still pending. Conduct research to determine the status of these charges. In your opinion, why do you think Michael Mendes, the former CEO of Diamond Foods, chose to settle charges with the SEC, whereas Neil is disputing the charges?

AUDITING QUESTIONS:

4. Describe the “fraud triangle.” Discuss the components of the fraud triangle in the context of this case.

5a. The auditors were misled by both Michael Mendes and Steven Neil. Neil even signed a “management representation letter.” Describe what a “management representation letter” is. Do you believe that it, and other representations by management, constituted sufficient appropriate audit evidence in this case? Defend your answer. (Hint: Review the requirements of Statement on Auditing Standards (SAS) No. 99, paying particular attention to the concept of fraud risk factors (“red flags”) in an auditing context.)

5b. Describe what the terms “analytical procedures” and “professional skepticism” mean in an auditing context. Do you think the auditors should have discovered the alleged fraud perpetrated in the financial statements in fiscal year 2010 and fiscal year 2011? Defend your answer.

5c. Conduct research as to (1) who the auditors were during the timeframe of this case and (2) the current status of any litigation against the auditors. Discuss any allegations against the auditors, including your opinion as to the merits of the allegations.

6. If the auditors had discovered the alleged fraud, what is the appropriate action, or series of actions, for an audit firm of a publicly traded company (such as Diamond) that becomes aware of illegal acts by the client’s management?

COST/MANAGERIAL ACCOUNTING QUESTIONS:

7. How could management accounting tools, such as variance analysis, benchmarking, and Cost-Volume-Profit analysis, have been used to highlight Diamond’s profitability challenges?

8. How could the budgeting process have been used to help Diamond achieve its targets without resorting to the alleged financial statement irregularities?

9. Reconcile the 2010 walnut cost payments with the final walnut cost of $0.74 per pound recorded in the 2011 financial statements.
10. Why was the 2010 “momentum” payment larger than the 2009 “continuity” payment? If the earnings management was not exposed, do you believe the earnings management could have continued? If the earnings management did continue, how would it likely have been done?

11. Describe the different reasons for managing earnings.

12. What are the disincentives for managing earnings?

13. Which IMA ethical guideline(s) was violated by Diamond’s CFO?

ENDNOTES

1The material presented in this case was drawn from several SEC accounting and auditing enforcement releases, litigation releases, and administrative proceedings. Since some of the information from these sources is overlapping, endnotes include the primary sources where the information is located.
4Learn more about Diamond Foods at www.diamondfoods.com/about.
7SEC, Administrative Proceeding File No. 3-15674.
8 Fiscal year 2011 ended July 31, 2011.
9SEC, Litigation Release No. 22902, and SEC; Administrative Proceeding File No. 3-15674.
11 Ibid.
18 Ibid.
19 SEC, Administrative Proceeding File No. 3-15674.
23 SEC, Administrative Proceeding File No. 3-15674.
25 Ibid.
Sunk Costs: What Costs Do You Sea?
Marty Stuebs and Cari Edison, Baylor University; Katy Hurt, Independent External Auditor

COMPANIES’ RESPONSIBILITIES FOR SAFETY ARE IMPORTANT SOCIAL AND ENVIRONMENTAL CONCERNS. This fictional case—inspired by recent actual events—presents a capital investment intended to improve cruise ship safety. Both managerial accounting investment analyses and ethical recognition of responsibilities play necessary roles in the safety investment decisions. The case also refers to and encourages use of the IMA Statement of Ethical Professional Practice.

The case blends managerial accounting and ethics, so it is suitable for a number of managerial accounting and accounting ethics courses. It was written for students in an undergraduate, advanced undergraduate, or graduate managerial or cost accounting course. It should be used after students have practiced NPV and payback period capital investment techniques. Since the case integrates capital investment analyses within a larger analysis and considers professional responsibilities (in particular, the IMA Statement of Ethical Professional Practice) in the presence of incentives, it can be used in an accounting ethics course as well. The case can also be simplified and adapted for use in lower-level managerial accounting classes.

Keywords: capital budgeting, capital investments, safety investments, ethics, responsibility, managerial and cost accounting analysis, decision making.
Sunk Costs: What Costs Do You Sea?

Marty Stuebs
Baylor University

Cari Edison
Baylor University

Katy Hurt
Independent External Auditor

BACKGROUND

Festival Cruise Lines (FCL), a publicly traded company on both the New York Stock Exchange (NYSE) and London Stock Exchange, is the largest cruise company in the world. FCL serves as the parent company for four primary subsidiaries—a broad spectrum of cruise line brands that cater to a variety of cruise vacationers. At the low end, the first FCL subsidiary, Festival, offers an affordable cruise experience to a wide variety of cost-conscious customers. Other FCL subsidiaries, like Goddess Cruise Lines, American Swiss Cruise Lines, and Dranuc Cruise Lines, offer progressively higher-quality cruise experiences for correspondingly higher price premiums. FCL is domiciled internationally and has two headquarters located in Doral, Fla., an industrial area of Miami, and Southampton, England.

FCL’s Festival subsidiary began entertaining passengers on its Happy Boats in 1972. Today, it employs upwards of 90,000 crew members who serve more than 3.5 million cruise passengers annually on a fleet of 24 ships. Cruises generally range from three to 18 days in duration, and the one-week cruise is the most common. Ships venture to a wide variety of world-wide destinations, including New Zealand, Tahiti, New England, Alaska, the Mexican Riviera, Caribbean, Mediterranean, and many more.

Festival finds itself in an industry that has evolved over the last century. The cruise ship industry was born in 1844. Focus shifted from carrying cargo to pleasing customers, and superliners were being developed by the early 20th Century. These ships provided an abundance of fine dining and leisure activities to affluent passengers and generally were not designed to cater to the general population. In the 1960s, cruise ship companies began shifting operations to attract a broader spectrum of middle-income clientele. While premium ships were still available, the days of the affluent Titanic-style voyages were becoming a thing of the past. Price competition began to slowly enter the market and dramatically increased in recent years. Call it the “Walmart-ization” of the cruise ship industry. The recent downturn in the economy put real pressure on potential passengers’ discretionary income and, as a result, cruise ship prices. Containing and controlling costs in this environment is critical to a cruise ship company’s success.

The cruise industry is also a high-fixed-cost industry. A typical cruise ship can cost $500 million, and larger and larger ships are being built. Given the enormous fixed costs, one of the greatest challenges facing the cruise ship industry today is utilizing capacity—filling ships with passengers and generating revenue. Festival’s bottom line is extremely dependent on cruise ship passengers and ship occupancy levels. Projecting a healthy reputation to attract customers and maintain occupancy levels is important.

Festival generally has an impeccable history of safety. But increased competition and economic pressures in the industry recently created an additional bottom-line focus on cost control. Many safety repairs and investments had been tabled and delayed to increase ship turnaround, time at sea, revenue utilization, and ultimately profits. In 1998, Festival ran into its first instance of trouble with a passenger-filled ship. Since that time, more than five ships have encountered...
disconcerting incidences—four incidences attributable to fires in engine rooms, laundry rooms, and a generator room.

**INTRODUCTION**

The office was quiet. The sunny spring weather in Miami, Fla., had lured many Festival Cruise Line (FCL) personnel to take an enjoyable Friday afternoon off. But Linda Wright, a senior accountant at FCL, and some of her accounting staff were still busy at work. It was late Friday afternoon; Linda took a brief pause to reflect on her career at FCL.

Linda Wright’s name suited her perfectly. She did not like being wrong—carried herself with integrity and seldom made bad decisions. She had been attracted to Festival’s culture and mission—to the happiness, joy, laughter, and entertainment FCL generated and brought to passengers on its Happy Boats. Miami also provided Linda and her family a picturesque destination to call home. FCL had been a great career choice for Linda. When she joined Festival, she was the sole female in the accounting department. Over the years, she had become a skilled accountant and excelled within the company.

Linda and her staff were busy putting together capital budgeting analyses for investment proposals and projects that had been submitted to the corporate office. Among the submitted proposals, Linda and a few of her colleagues—Matt Dennison and Evan Trueitt—were analyzing a capital investment proposal to improve the safety of the cruise ship fleet for FCL’s Festival subsidiary. This capital investment analysis posed a real challenge to delicately balance bottom-line income considerations of controlling costs with adequate safety investment considerations for protecting cruise ship personnel and passengers and minimizing safety risks.

Linda recognized a few challenges with the safety investment proposal, and two were prominent. First, the developing analysis was based on many—often slippery—estimates. Although accounting can be perceived as black-and-white and relatively straightforward, Linda found herself in murky waters, collecting data and performing analyses that were largely based on educated estimates. What was the cost of an accident? What value should be placed on human injury? The team’s estimates could influence analysis of the safety investment’s viability and eventually influence FCL passenger and crew safety.

Second, Linda wondered how receptive executive management would be to a significant capital outlay designed to generate safety improvements but potentially offer little bottom-line benefit. Would the proposal be passed over for projects promising larger potential boosts to profits?

Bottom-line considerations were becoming a primary focus in executive decisions because of increasing price competition in the cruise industry and the increasingly tight economy.

Linda pondered her concerns: “How can I handle the uncertain estimates included in my analysis? What are my responsibilities to passenger and crew safety? How do I balance these responsibilities with controlling costs and profitability?” Linda Wright could not get this one wrong.

**THE TURBULENCE**

“What are you having for lunch today?” David asked with a jovial smile.

“Dave! Do you even have to ask? A spinach salad with smoked salmon and veggies,” Linda replied.

“A creature of habit! You’re a typical accountant,” David nodded. “You need to live a little; try something different—even delicious. They’re serving filet mignon today and look at these desserts!” David exclaimed as he took a bite of tiramisu.

Linda was having lunch in Festival’s corporate cafeteria with David Santana, the head of Corporate Risk Management at Festival. David was a colleague and friend who Linda had known and respected for years—even if their dietary preferences were strikingly different. David was a bright, hard-working Peruvian immigrant who had worked his way up through the Festival ranks over the years. The capital investments in safety improvements were his brain child, and now he was audaciously championing the latest proposal.

In fact, the capital proposal for safety improvements had been a main topic of conversation during several lunches Linda and David shared over the last couple of months. David’s concern for these safety improvements went beyond the professional; it was also personal. A few years earlier, an engine fire on the Festival ship Victory had created serious safety concerns. Mario Venasquez, one of David’s Peruvian childhood friends, was a Festival employee on the ship. In fact, David was able to get Mario the job on the Victory so that he could help his family in Peru. Mario valiantly took action to fight the fire, and his responsive and courageous actions contained it, resulting in limited damage and minimal interruptions. The engine fire incident went virtually unnoticed to passengers. But Mario sacrificed his life to contain the engine fire—a tragic blow for David. This incident became the “canary in the coal mine” for David—a signal that Festival needed to change course and take corrective action to improve ship safety.

So conversation quickly returned to the safety investment topic as Linda and David started lunch. “Did you get our actuarial estimates on the probabilities and magnitudes of cruise ship safety accidents?” David queried.
“Yes, we did. Thank you, Matt and Evan added them into our capital investment analyses. In fact, we also finished extensive conversations with Festival's legal counsel,” Linda replied.

“Oh? Great! Let me know if you have any questions or need any more data. What did legal have to say?” asked David.

“Well, according to the lawyers, Festival is currently meeting all international maritime safety standards. The safety improvements would go well beyond current international legal standards and requirements but would protect Festival in the future if laws change and safety requirements become more rigorous,” Linda said.

“Well, that isn’t all that surprising. The cruise ship industry has consistently lobbied lawmakers for years to keep safety regulation to a minimum,” David revealed, “but Festival needs to be different.” David’s face reflected the passion resulting from the loss of his friend and his recent experiences.

“You’re right. This is important for Festival,” Linda affirmed.

“Our crew members, valued passengers, and shareholders need to be protected and reassured that we care about the safety of our people. I’m concerned that the Board of Directors is favoring cost control and financial considerations a little too much. Their minds are wrapped up in the current year’s bottom line. I have championed safety investments for several years now and have been repeatedly turned down due to limited financial resources. Corporate needs to extend its vision beyond a myopic focus on the bottom line. This is about more than just profits; it’s about people,” David concluded.

Linda nodded empathetically. David was right. Festival executives selected capital investments primarily on the basis of a project’s contribution to economic return and bottom-line impact. The lunch conversation continued and slowly meandered into casual chit-chat. Linda appreciated David as a Festival employee.

THE NUMBERS

“I just got an e-mail from John. Corporate is now breathing down our necks for the capital investment analysis information. We really need to wrap this up soon,” Linda relayed as she rallied Matt and Evan during a brief powwow in her office. John Cary was Festival’s current hard-charging CEO. Projects including the safety investment proposal had made it through the initial screening phase. Now executives wanted analysis information to rank proposals for possible selection and funding during the preference phase of analysis.

Linda’s team had begun putting together the capital investment analyses for the safety investment proposal. Linda decided to develop three estimates: one for what she viewed as the minimum investment required by adding emergency generators to each ship; one for installing the emergency generators and high-pressure water mist systems (an intermediate-level proposal); and one to fully fund all the recommended changes, including upgrading the engine rooms. Using these three alternatives, Evan and Matt began calculating the total number of annual cruise line passengers Festival can carry.

If Festival chooses not to invest in the expenditures, each ship has an available passenger capacity of 3,500. But under Festival’s current operations, the ships are only at 90% capacity. Additionally, Festival’s fleet of 24 ships cruise an average of 48 weeks out of the year. In order to make the minimal changes, the cruise schedule must remain the same to minimize the effect on capacity. The emergency generators will be installed during each of the ships’ four weeks of dock time (52 weeks in a year – 48 weeks), so total passenger capacity will remain unchanged for this alternative.

If the midrange alternative is selected, substantial effects will be seen. Average available passenger capacity will remain unchanged at 3,500, but the utilization rate will be 90% for year one, 91% for year two, and 92% for years beyond year two. In order to install the generators and sprinkler systems, the ships will need to be docked for the repairs. Therefore, only 36 cruises can be operated in year one, 40 in year two, and 49 in years beyond year two.

If all repairs and upgrades are performed, the utilization rate will be 90% for year one, 93% for year two, and 96% for years beyond year two. On average, 30 one-week-long cruises will operate in years one and two, and 50 one-week-long cruises will operate each year after year two. Evan and Matt’s findings and calculations are shown in Table 1.

Without any expenditures, Festival’s cruise ships can carry approximately 3.629 million passengers per year on its fleet of 24 ships. Each passenger will generate $1,700 of revenue (sales price plus onboard spending). The variable costs are approximately $300 per passenger, and the fixed costs are around $3.6 billion per year. Linda’s team also collected the information on the actuarial estimates, probabilities, and costs of possible expected accidents from David Santana. This information can be used to calculate an estimated expected value of the cost of accidents. The operating costs, total passenger capacity, and potential accident costs depend on which parts of Linda’s recommendations are funded. In all three cases, Linda decided to leave the $1,700 selling price and onboard spending and $300 variable cost estimates in place. None of
Table 1: Festival Cruise Lines, Inc.: Annual Passenger Factors

<table>
<thead>
<tr>
<th></th>
<th>Current Operations</th>
<th>Minimum Funding</th>
<th>Midrange Funding</th>
<th>Complete Funding</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(All Years)</td>
<td>(All Years)</td>
<td>Year 1</td>
<td>Year 2</td>
</tr>
<tr>
<td>1. Capacity Utilization Factor:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average available passenger capacity/cruise</td>
<td>3,500</td>
<td>3,500</td>
<td>3,500</td>
<td>3,500</td>
</tr>
<tr>
<td>Capacity utilization rate (average actual capacity/available capacity)</td>
<td>90.00%</td>
<td>90.00%</td>
<td>90.00%</td>
<td>92.00%</td>
</tr>
<tr>
<td>Capacity utilization factor (Number of passengers/1 week cruise)</td>
<td>3,150</td>
<td>3,150</td>
<td>3,150</td>
<td>3,185</td>
</tr>
<tr>
<td>2. Turnover Factor (Number of 1 week cruises/year)</td>
<td>48</td>
<td>48</td>
<td>36</td>
<td>40</td>
</tr>
<tr>
<td>3. Fleet Factor (Number of Cruise Ships/year)</td>
<td>24</td>
<td>24</td>
<td>24</td>
<td>24</td>
</tr>
<tr>
<td>Total Annual Festival Cruise Line Passengers</td>
<td>3,628,800</td>
<td>3,628,800</td>
<td>2,721,600</td>
<td>3,057,600</td>
</tr>
</tbody>
</table>

The changes were likely to impact those two figures. Total passenger capacity, investment costs, and fixed operating costs, however, are another story.

Making the minimum required changes would cost $100 million. Such minimal changes will have little impact on continuing capacity or efficiency, and during and after the repair process, total passenger capacity would remain unchanged. The investment would, however, somewhat reduce the probability of an accident. Linda and her team collected data on the likelihood and costs of accidents based on historical data in the industry. This information is included in Table 2.

Adding the emergency generators and installing high-pressure water mist systems on all ships will cost approximately $250 million. Linda expects these changes to improve efficiency enough to increase post-project annual passenger capacity to 2,722 million in year one, 3,058 million in year two, and 3,787 million in years following year two. Once the upgrades are made, the net annual fixed costs will decrease slightly to approximately $3.384 billion. The investments will also reduce the probability and projected costs of expected accidents.

If the Board of Directors will allow upgrades to the engine room as well, Linda estimates the upfront cost will be $300 million. Post-implementation annual passenger capacity will be approximately 2,268 million in year one, 2,344 million in year two, and 4,032 million in all years following year two. In addition, annual fixed costs will drop to around $3.240 billion, and the projected probabilities and costs of expected accidents will decrease as well.

Matt and Evan estimate that all of the capital investments will have a useful life of 15 years with no salvage value. Additionally, they conservatively assume that all capital investment outlays occur and begin to depreciate at the same time (i.e., time 0) even though complete installation of some considered alternatives will occur after the start of capital investment outlays (i.e., time 0).

Linda, with the help of Matt and Evan, input the information into a spreadsheet (see Table 2) in order to calculate the net present value (NPV) and payback period of the different funding options. For tax purposes, it is Festival’s policy to depreciate capital investments using the straight-line method, and Festival’s marginal tax rate (combined federal, state, and local) is about 40%. The hurdle (discount) rate is 10% after tax for all capital expenditures.

Festival’s policy states that the company will only consider investing in capital projects with a positive NPV within five years to satisfy certain profitability thresholds. Also, it will only invest in capital projects with an unadjusted payback period of five years or less. Linda and her team used these standards to evaluate the different alternatives.

**LINDA’S SITUATION**

The analysis was coming together, but Linda began to replay executives’ potential responses over and over in her head. Because of Festival’s large size in the market, the public’s eye is always on its stock price. CEO John Cary was well aware of this and never let anyone forget the importance of the bottom line. Even though Festival seeks to please its passengers, John and the rest of the top executives put pleasing shareholders as their first priority.

These thoughts left Linda somewhat anxious. Her analysis affected a significant number of people. What were her responsibilities to the executives and the Board of Directors, shareholders, Festival employees, Festival cruise ship personnel and passengers, and David? How could she balance and meet all of these responsibilities?