

## **Case 2-7**

### **Milton Manufacturing Company**

Milton Manufacturing Company produces a variety of textiles for distribution to wholesale manufacturers of clothing products. The company's primary operations are located in Long Island City, New York, with branch factories and warehouses in several surrounding cities. Milton Manufacturing is a closely-held company. Irv Milton is the president of the company. He started the business in 1999 and it grew in revenue from \$500,000 to \$5.0 million in ten years. However, the revenues declined to \$4.5 million in 2010. Net cash flows from all activities also were declining. The company was concerned because it planned to borrow \$20 million from the credit markets in the fourth quarter of 2011.

Irv Milton met with Ann Plotkin, the chief accounting officer (CAO), on January 15, 2011, to discuss a proposal by Plotkin to control cash outflows. She was not overly concerned about the recent decline in net cash flows from operating activities because these amounts were expected to increase in 2011, as a result of projected higher levels of revenue and cash collections.

Plotkin knew that if overall capital expenditures continued to increase at the rate of 26 percent per year, Milton Manufacturing probably would not be able to borrow the \$20 million. Therefore, she suggested establishing a new policy to be instituted on a temporary basis. Each plant's capital expenditures for 2011 would be limited to the level of capital expenditures in 2009. Irv Milton pointedly asked Plotkin about the possible negative effects of such a policy, but in the end Milton was convinced it was necessary to initiate the policy immediately to stem the tide of increases in capital expenditures. A summary of cash flows appears in Exhibit 1.

Sammie Markowicz is the plant manager at the headquarters location in Long Island City. He was informed of the new capital expenditure policy by Ira Sugofsky, the vice president for operations. Markowicz told Sugofsky that the new policy could negatively affect plant operations because certain machinery and equipment, essential to the production process, had been breaking down more frequently during the past two years. The problem was primarily with the motors. New and better models with more efficient motors had been developed by an overseas supplier. These were expected to be available by April 2011. Markowicz planned to order 1000 of these new motors for the Long Island City operation, and he expected that other plant managers would do the same. Sugofsky told Markowicz to delay the acquisition of new motors for one year after which time the restrictive capital expenditure policy would be lifted. Markowicz reluctantly agreed.

Milton Manufacturing operated profitably during the first six months of 2011. Net cash inflows from investing activities exceeded outflows by \$250,000 during this time period. It was the first time in three years there was a positive cash flow from investing activities. Production operations accelerated during the third quarter as a result of increased demand for Milton's textiles. An aggressive advertising campaign initiated in late 2010 seemed to bear fruit for the company. Unfortunately, the increased level of production put pressure on the machines and the degree of breakdown was increasing. A big problem was that the motors wore out prematurely.

Markowicz was concerned about the machine breakdown and increasing delays in meeting customer demands for the shipment of the textile products. He met with the other branch plant managers who complained bitterly to him about not being able to

spend the money to acquire new motors. Markowicz was very sensitive to their needs. He informed them that the company's regular supplier had recently announced a 25 percent price increase for the motors. Other suppliers followed suit and Markowicz saw no choice but to buy the motors from the overseas supplier. That supplier's price was lower, and the quality of the motors would significantly enhance the machines' operating efficiency. However, the company's restrictions on capital expenditures stood in the way of making the purchase.

Markowicz approached Sugofsky and told him about the machine breakdowns and concerns of other plant managers. Sugofsky seemed indifferent. He reminded Markowicz of the capital expenditure restrictions in place and that the Long Island City plant was committed to make expenditures at the same level as it had made in 2009. Markowicz argued that he was faced with an unusual situation and he had to act now. Sugofsky hurriedly left but not before he said to Markowicz: "A policy is a policy."

Markowicz reflected on the comment and his obligations to Milton Manufacturing. He was conflicted because he viewed his primary responsibility, and that of the other plant managers, as ensuring that the production process operated smoothly. The last thing the workers needed right now was a stoppage of production because of machine failure.

At this time, Markowicz learned of a 30-day promotional price offered by the overseas supplier to gain new customers by lowering the price for all motors by 25 percent. Coupled with the 25 percent increase in price by the company's supplier, Markowicz knew he could save the company \$1,500, or 50 percent of cost, on each motor purchased from the overseas supplier.

After carefully considering the implications of his intended action, Markowicz contacted the other plant managers and informed them that while they were not obligated to follow his lead because of the capital expenditure policy, he planned to purchase 1,000 motors from the overseas supplier for the headquarters plant in Long Island City.

Markowicz made the purchase in the fourth quarter of 2011 without informing Sugofsky. He convinced the plant accountant to record the \$1.5 million expenditure as an operating (not capital) expenditure because he knew the higher level of operating cash inflows would mask the effect of his expenditure. In fact, Markowicz was proud that he had “saved” the company \$1.5 million and he did what was necessary to ensure that the Long Island City plant continued to operate.

The acquisitions by Markowicz and the other plant managers enabled the company to keep up with the growing demand for textiles and the company finished the year with record high levels of net cash inflows from all activities. Markowicz was lauded by his team for his leadership. The company successfully executed a loan agreement with Second Bankers Hours & Trust Co. The \$20 million borrowed was received on January 3, 2012.

During the course of an internal audit on January 21, 2012, Beverly Wald, the chief internal auditor, discovered that there was an unusually high level of motors in the inventory. A complete check of inventory determined that \$1.0 million of motors remained on hand.

Wald reported her findings to Ann Plotkin and together they went to see Irv Milton. After being informed of the situation, Milton called in Ira Sugofsky. When Wald told him about her findings, Sugofsky’s face turned beet red. He paced the floor,

poured a glass of water, drank it quickly, and then began his explanation. Sugofsky told them about his encounter with Sammie Markowicz. Sugofsky stated in no uncertain terms that he had told Markowicz not to increase plant expenditures beyond the 2009 level. "I left the meeting believing that he understood the company's policy. I knew nothing about the purchase," he stated.

At this point Wald joined in and explained to Sugofsky that the \$1 million is accounted for as inventory and not an operating cash outflow. "What we do in this case is transfer the motors out of inventory and into the machinery account once they are placed into operation because, according to the documentation, the motors added significant value to the asset." Sugofsky had a perplexed look on his face. Finally, Irv Milton took control of the accounting lesson by asking: "What's the difference? Isn't the main issue that Markowicz did not follow company policy?" The three officers in the room shook their head simultaneously, perhaps in gratitude for being saved the additional lecturing. Milton then said he wanted the three of them to brainstorm some alternatives on how best to deal with the Sammie Markowicz situation and present the alternatives to him in one week.

This case deals with a company's efforts to manage its short-term earnings and cash outflows by restricting capital expenditures.

### **Ethical Issues**

Top management's decision to restrict capital expenditures created a conflict for Sammie Markowicz, the plant manager at the headquarters location in Long Island City. On the one hand, Markowicz knows that the company expects him to follow company policy. On the other hand, he is very conscious of his primary responsibility to keep the production process operating as efficiently as possible. Markowicz was placed in a difficult position because of the capital expenditure restrictions, especially in light of the previously experienced machine breakdowns. The conflict comes to a head for Markowicz when he learns about the 25% price increase that is announced by the plant's primary supplier for motors used in the production process.

Markowicz' decision to order \$150,000 of the motors for the Long Island City plant influences other plant managers to take similar actions. He acted in a way that he thought would be in the best interest of the company even though it violated company policy. He failed to consider the consequences of his action on the stakeholders. At a minimum, Markowicz could have contacted top management with his dilemma and sought a reversal of the policy by emphasizing the more frequent machine break downs and pending price increase. Markowicz was wrong to hide the acquisition of an asset by charging it to expense. This action violates the rights of the stockholders who rely on accurate financial information. Markowicz's action were primarily motivated by self-interest (reasoning at stage 2) and not out of concern for the interests of the stakeholders. An issue that should be dealt with by the company is how and why Markowicz was able to circumvent the interest controls and override the policy.

### **Question**

**Use the ten step decision-making model explained in the chapter and develop the alternatives to be presented to Milton. Be sure to select the optimum alternative.**

**1. Frame the ethical issue.**

Markowicz defied company policy and used accounting fraud to hide decision.

**2. Gather all the facts.**

Markowicz was concerned about the machine breakdowns, increasing delays in meeting customer demand for the products. The workers were facing safety concerns and stoppage of productions due to machine failures and price increase from supplier.

**3. Identify the stakeholders and obligations.**

The stakeholders include the owners, Milton Manufacturing, officers, workers, suppliers, and customers. Markowicz has an obligation to follow company policies, to ensure accurate financial reporting, and to protect workers' safety.

**4. List the relevant core values involved in the situation.**

The core values include trustworthiness, respect, and fairness.

**5. Identify the operational issues.**

The operating issues are the machine breakdowns and increasing delays in meeting customers' demands for shipment of products.

**6. Identify the accounting issues.**

The accounting issues are how did Markowicz circumvent internal controls and how did he get the capital assets recorded as an operating expense.

**7. List all the possible alternatives of what you can or cannot do.**

The company can pretend that management did not know or notice the violation of the policy. The company could counsel Markowicz to not do it again.

The company could decide to publicly punish Markowicz to temper any future insubordination. The company could fire Sugofsky, who did not listen or negotiate on issue, in addition to Markowicz.

**8. Make an ethical analysis of the alternatives.**

**9. Decide on a course of action.**

**10. Reflect on your decision.**

Have the students use the teleology, deontology, fairness, justice or Kohlberg theories to defend their choice of option.

**Exhibit 1**  
**Milton Manufacturing Company**  
**Summary of Cash Flows**  
**For the Years Ended December 31, 2009 and 2010**  
**(000 omitted)**

	<b>December 31, 2010</b>	<b>December 31, 2009</b>
<b>Cash Flows from Operating Activities</b>		
Net income	\$372	\$542
Adjustments to reconcile net income to net cash provided by operating activities	1,350	1,383
Net cash provided by operating activities	\$1,722	\$1,925
<b>Cash Flows from Investing Activities</b>		
Capital expenditures	\$(2,420)	\$(1,918)
Other investing inflows (outflows)	176	84
Net cash used in investing activities	\$(2,244)	\$(1,834)
<b>Cash Flows from Financing Activities</b>		
Net cash provided (used in) financing activities	\$ 168	\$ (376)
<b>Increase (decrease) in cash and cash equivalents</b>	<b>\$ (354)</b>	<b>\$ (285)</b>
<b>Cash and cash equivalents – beginning of the year</b>	<b>\$ 506</b>	<b>\$ 791</b>
<b>Cash and cash equivalents – end of the year</b>	<b>\$ 152</b>	<b>\$ 506</b>