

CHAD CRAFT ENTERPRISES: A TROUBLED SUBSIDIARY

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Sarah Oakley, the comptroller for Chad Craft Enterprises (CCE) looked at her watch. "It is 9:30 p.m.," she thought, "and I need to review the financial statements one more time before e-mailing them to the rest of the management team." Oakley knew that the numbers were unfavorable again this month. She was concerned about the reaction of Bill Willhoite, CEO of CCE.

"I really dread the phone call that I will get first thing in the morning from Willhoite," Oakley said to herself as she recalled a management team meeting held earlier that day. She frowned as she remembered Willhoite's words in the management meeting. "We are all going to be out of a job soon if we break our bank covenants this month," Willhoite had said to the group. Oakley duly noted that Willhoite slammed his fist on the conference table as he had warned them about the bank covenants.

"But the most troubling aspect of the meeting was the comment that he specifically directed at me," Oakley said aloud. Oakley recounted how uncomfortable she felt when Willhoite stared at her and said, "Don't be too conservative, Sarah, because we cannot afford to miss the mark this month." Oakley acknowledged Willhoite's genuine concern for the company's financial well-being, but she disagreed with his proposed remedy. In her role as the company's comptroller, Oakley knew that GAAP allowed companies certain flexibility with accounting choices. She recognized that this flexibility also caused some accounting critics to question the quality of earnings reported by publicly traded companies. Oakley, however, was convinced that Willhoite wanted to engage in earnings management.

Turning her thoughts back to the review of the financial statements, Oakley debated several of the issues related to the financial statements. Oakley thought, "Maybe I've missed something or maybe I am being too conservative. I don't want Willhoite to think that I am defying him. How am I going to present these issues so that the other members of the management team understand my rationale and Willhoite does not explode?" With those thoughts, Sarah attached the files to her e-mail and hit the send button. Her muscles tensed as she turned off the office lights and closed the door behind her.

History of the Company

CCE was an automotive parts distributor founded in 1956 by Chad Craft, who wholly owned the company until it was sold to Auto Parts Limited (APL) in January of 1999. CCE's accounting records were kept on a cash basis. On average, CCE's inventory turned twice during a fiscal year. A large portion of CCE's business was high-volume distribution of low-margin auto parts to GM and Ford dealers. The low-margin portion of the business accounted for 30 to 40 percent of CCE's sales, with the gross profit margin on those sales being around 3 to 6 percent. The remainder of CCE's sales was wholesale distribution to the installers of the products such as garages and repair shops. A very small percentage of revenue was derived from retail sales.

Manufacturer rebates, special bulk pricing, seasonal pricing, and additional discounts also impacted CCE's profit margins. The issuance of free goods and volume discounts by vendors were accepted practices in the auto parts distribution industry. It was also a common industry practice for vendors to grant allowances to be used

exclusively for product promotions and to partially or fully offset certain other direct expenses.

Internal Changes

Before buying CCE, APL management had decided to take APL public within seven years. This decision mandated that APL eventually have audited financials that conformed to generally accepted accounting principles (GAAP). Conforming to GAAP required that CCE change from the cash basis of accounting to the accrual basis. APL management decided to make the transition to GAAP immediately rather than waiting, so the company engaged one of the Big Four accounting firms as its auditor and to help with its goal of becoming a publicly traded company.

At the time of the sale of CCE to APL, a new management team was put in place at CCE: Bill Willhoite was named CEO, Anthony Bullock, CFO, Marcus Harold, President, and Sarah Oakley, Comptroller. Previously, members of the Craft family had held the positions of CEO, CFO, and President. Oakley, who had been the assistant to the former comptroller of CCE prior to the sale, was the only member of management that was not new to the company or to the auto parts industry itself. Oakley was also the only female on the management team.

The sale of CCE to APL and the resulting internal management changes created turmoil in the company. The Craft family had employment contracts at the time of the sale; however, APL opted to release the Craft family members from their duties and buy out those contracts, which were for a five-year employment term. Several long-time employees were unhappy with their new reporting requirements, territories, and benefits. These employees had personal ties to the members of the ousted Craft family. The Craft family members let it be known that APL had unfairly relieved them of their management positions. These circumstances flamed the fires of discontent at CCE.

Financial Difficulties

As soon as the sale of CCE to APL was complete, APL lost the entire Ford dealer business due to the changes in ownership at CCE per the Ford contract. The Ford contract stipulated that a change in ownership at CCE allowed Ford to opt out of its contract with CCE. Competitors used the CCE's internal turmoil to their advantage. Several salespeople were courted away from the company and took key customers with them. Rumors regarding stability problems caused customer unease. The question of financial stability also caused vendors to tighten the company's credit limits. Sales by the original branches of CCE plummeted by 20% within the first six months after the sale of the company. By the end of the first year, CCE was in jeopardy of not meeting its bank covenants. A violation of the bank covenants would create major cash flow issues and liquidity concerns.

Accounting Issues at APL

When CCE opened a new branch, certain vendors would either send out free goods to that location to help compensate CCE for the costs associated with the new branch, or they would issue a lump sum credit against the vendor payable. The free goods received were not consigned goods; the goods were shipped FOB to CCE. Within two months after becoming a subsidiary of APL, CCE opened two new branches, and vendors sent the two branches approximately \$250,000 in free goods. The CEO of CCE decided that

\$50,000 of the free goods should be returned to the vendors for credit in order to help alleviate some of the cash flow issues.

The company also received volume discounts for large orders, seasonal orders, and group orders. Based on the purchasing volume and incremental increases in purchases after initial orders, vendors would issue cash rebates to APL in the form of a check or credit memos applied directly against the vendor payable. The rebate was received in a lump sum with no detail except to note which period of time the rebate was earned. Some rebates were received quarterly, others annually. CCE also received certain vendor allowances to promote selected products or to reduce the direct expenses related to vendor sales events.

There was also the issue of price changes. The CCE warehouses contained more than one million active skus, up to one hundred and fifty product lines, and as many as four hundred sub categories. The total inventory was valued around eleven million dollars. Price changes could be anywhere from pennies to hundreds of dollars per sku. All inventories were carried on the books at replacement cost. There was a reserve set up to cover obsolescence issues, but the main issue was how to record the revenue or expense when the inventory increased or decreased in value. The company's computer system was not sophisticated enough to track the amounts by part number as they were sold. The company received a price change tape every month. This price change information was loaded into the computer system database in order to re-price the inventory at replacement cost. Exhibit One is an abbreviated example of the report that the comptroller received each month after the price change tapes were uploaded to CCE's database. The information provided in the price change tape gave the comptroller the date of the price change, the vendor totals, and the location where the inventory was physically located.

Conversation with the CEO

When Oakley arrived at work early Friday morning, she was hesitant to check her voice mail. She knew, however, that the confrontation was inevitable. The second voice mail message was from Willhoite, requesting the entire management team to attend a meeting as soon as everyone was in the office. He also requested that Oakley call him as soon as she arrived.

As soon as Willhoite was on the line, Oakley could hear the irritation in his voice. He said, "Sarah, did you actually expect me to accept these P & L's in their current form, showing these kinds of losses?"

Oakley replied, "Bill, I've looked them over several times and they are complete. There is nothing else I can book."

"What about all of those credits on the balance sheet?" he asked.

Before Oakley could respond, Willhoite added, "And, Sarah, I think you made a mistake with our vendor promotional allowances for January 2003. Those allowances should be booked as a reduction to our selling, general and administrative expenses in the month of the promotion. That was how we handled those allowances in 2002. Our 2002 annual report explained the allowance issue in a footnote."

"It is possible that I made a mistake. I will be happy to review them with the CFO to see if I am missing anything," Sarah replied.

Willhoite snapped back, "Oh, we are going to review them today in our meeting, so make sure that you are prepared to give a complete presentation on revenues,

inventory and cost of good sold. Sarah, I am not an accountant that is why I hired you. But, I have enough knowledge of accounting to know that GAAP gives management alternatives when accounting for certain issues. For example, CCE can use several approaches to inventory and be in conformance with GAAP. Am I correct in saying that some of these approaches result in recognizing more income?"

Oakley added, "Bill, you are correct when you say that GAAP recognizes several approaches to valuing inventories and that the valuation choice impacts income. But, I think..."

Before Oakley could finish her thoughts, Willhoite interrupted her by replying, "In my opinion, you are being too conservative with your approach to the issues that impact our inventory and costs of goods sold. Is there a written GAAP rule that a decision maker must follow with respect to conservatism?"

Oakley answered, "Bill, there is no written GAAP guidance related to conservatism. The concept is based on professional judgment."

Willhoite immediately retorted, "Well, in that case, my professional judgment says that we should book the free goods, discounts, rebates, and price changes as additional income. I am prepared to let heads start rolling if the covenants are not met. I look forward to your presentation this afternoon, Sarah."

Those words were still ringing in Oakley's head when she heard the phone click. Oakley steadied herself as she gathered her thoughts for the meeting. How would she comply with GAAP and allow Willhoite the flexibility of accounting choice provided by GAAP?

Exhibit 1
Chad Craft Enterprises: A Troubled Subsidiary
Replacement Cost Data for January 2003

| Date | Line | LOC1 | LOC2 | LOC3 | LOC4 | LOC5 | LOC6 | LOC7 | LOC11 | LOC12 | Total |
|------------|------|-----------|----------|----------|----------|----------|----------|----------|----------|----------|-----------|
| 01/02/2003 | GDY | 3,628.38 | 503.67 | 429.67 | 588.22 | 473.45 | 482.69 | 592.73 | 494.21 | 467.63 | 7660.65 |
| 01/06/2003 | AIM | 1,134.94 | 252.01 | 220.12 | 457.61 | 398.60 | 359.66 | 439.10 | 229.48 | 251.61 | 3,743.13 |
| 01/06/2003 | BCA | 2.88 | - | - | - | - | - | - | - | - | 2.88 |
| 01/06/2003 | BEN | 11,092.16 | 1,559.33 | 1,166.25 | 1,504.00 | 1,438.69 | 1,512.36 | 1,628.55 | 1,134.30 | 1,315.24 | 22,350.88 |
| 01/06/2003 | BEN | 1,012.63 | 197.48 | 196.26 | 180.21 | 186.63 | 193.42 | 204.35 | 160.86 | 184.00 | 2,515.84 |
| 01/06/2003 | BEN | 6,653.88 | 1,593.99 | 1,666.02 | 1,804.58 | 1,535.81 | 1,877.18 | 1,709.21 | 1,597.47 | 1,372.18 | 19,810.32 |
| 01/06/2003 | D42 | (2.62) | (2.24) | (1.70) | (1.70) | (1.70) | (1.88) | (1.70) | (1.52) | (1.88) | (16.94) |
| 01/06/2003 | FEL | 533.59 | 62.18 | 59.57 | 128.18 | 87.36 | 82.55 | 116.27 | 133.27 | 22.44 | 1,225.41 |
| 01/06/2003 | FME | 212.92 | 33.39 | 34.89 | 59.76 | 71.76 | 65.86 | 80.28 | 45.30 | 48.97 | 653.13 |
| 01/07/2003 | BER | 8.69 | 2.74 | 2.20 | 2.31 | 4.01 | 3.90 | 7.68 | 3.38 | 1.12 | 36.03 |
| 01/07/2003 | BUS | 3.85 | 1.63 | 1.46 | 22.66 | 2.10 | 1.29 | 4.37 | 1.14 | 0.94 | 39.44 |
| 01/07/2003 | CRC | 16.06 | 12.09 | 15.06 | 10.88 | 11.77 | 10.89 | 19.65 | 6.52 | 10.55 | 113.47 |
| 01/07/2003 | IDL | (147.99) | (46.25) | (26.08) | (81.12) | (27.30) | (29.64) | (34.03) | (34.19) | (21.68) | (448.28) |
| 01/07/2003 | LEV | 34.34 | 11.63 | 14.40 | 14.51 | 11.82 | 29.74 | 35.62 | 13.22 | 11.312 | 176.59 |
| 01/07/2003 | RAD | 3.12 | .95 | (0.06) | (0.14) | 0.68 | 1.27 | 0.50 | (0.43) | 0.02 | 5.91 |
| 01/07/2003 | SEC | - | - | (12.18) | - | - | - | - | - | - | (12.18) |
| 01/07/2003 | SYL | 15.74 | 9.25 | 6.91 | 9.33 | 8.27 | 8.65 | 14.58 | 6.56 | 8.16 | 87.45 |
| 01/07/2003 | TEC | (4.41) | (5.71) | (4.55) | (5.33) | (2.55) | (1.76) | (6.45) | (0.76) | (3.74) | (35.46) |
| 01/08/2003 | DOR | - | - | - | - | - | - | - | - | (36.87) | (36.87) |
| 01/08/2003 | IDL | 129.60 | 39.15 | 25.65 | 71.55 | 21.60 | 25.65 | 27.00 | 35.10 | 16.20 | 391.50 |
| 01/17/2003 | ARI | - | - | - | - | - | - | - | - | - | - |
| 01/23/2003 | STD | (6.16) | - | - | - | - | - | - | - | - | (6.16) |
| 01/27/2003 | BNA | 5,673.87 | 1,392.10 | 915.40 | 1,089.08 | 1,083.18 | 1,027.65 | 1,267.45 | 961.76 | 1,180.76 | 14,591.25 |
| Total | | 29,995.47 | 5,617.39 | 4,709.29 | 5,854.39 | 5,304.18 | 5,649.48 | 6,105.16 | 4,785.67 | 4,826.96 | 72,847.99 |

Legend: Line - Auto Part (abbreviation rather than full name)

LOC - Store Identification Number

Column Total - equals replacement value for specific store (Columns 3 through 9)

Row Total - equals replacement value for specific auto part as per stated date

The total of the last column is the total replacement value of all the auto parts