

Caveat emptor: are super normal profits acceptable?

Professor Alan Lovell, Head of Department of Finance and Accounting, Nottingham Business School, The Nottingham Trent University
Email: alan.lovell@ntu.ac.uk

Summary

The case study puts you in the position of someone who has worked for many years in companies in the defence industry that delivers products to the government in the shape of the Ministry of Defence. You become aware that a company you are a director of has overcharged the Ministry on a contract. The case study takes a longitudinal approach and takes you through your response to the issue in stages. At each stage you are asked what you would do. At each subsequent stage the pressure to keep quiet about the super normal profits increase and your response to these pressures is sought.

Key words

Ethics of business negotiations, super normal profits, duties of directors, corporate governance

The case

Background

You are currently employed as the finance director of a company which is a manufacturer and supplier of naval surveillance equipment to the Ministry of Defence (MoD). However, before we consider the problem with which you are currently faced, it will be helpful to reflect upon your career to-date.

Your career began 30 years ago when you secured the post of a trainee accountant within a large electronics company. During your early years with the company you were not only successful in passing your professional examinations, you also gained the confidence of many senior people within the company and progressed up the management hierarchy with some alacrity. Some time later a major problem arose between your employers and the MoD. This was at a time when you were working closely with a number of the main board directors, and although you had not been associated with the project in question, you were asked to act on behalf of your company during sensitive negotiations with the MoD.

The negotiations with the MoD were ultimately concluded and during this period you established a reputation with the MoD officials as a trustworthy and effective operator which was to stand you in good stead in later years. You stayed with the electronics company for a few more years before leaving to join an American company which was also involved in the defence field. Once again you were closely involved with the MOD in negotiations of a more normal nature concerning design and specification changes and their implications for cost, and hence price.

Ultimately you left the American company and set up business on your own as a management consultant. Your experience and expertise had clearly been gained in

the defence field and it is not surprising that most of your clients were involved in defence work. Indeed many clients came to you as a result of the MoD advising these companies to contact yourself so that their difficulties, which had often arisen out of problems associated with specification and price changes, could be resolved.

Your fortunes prospered and one of the companies for which you acted in negotiations with the MoD was the main subsidiary of a group of companies whose managing director was one of your former colleagues and directors at your first employer, the large electronics company. He had engaged your consultancy company to resolve a contractual problem the naval electronics subsidiary company was having with the MoD.

Not only were you successful in resolving this initial problem, you were then retained to assist the subsidiary's management in developing a corporate business plan and to improve the quality of the corporate decision making. You were successful in 'turning the company around' and your involvement with the company is now a considerable part of your personal business life.

The group managing director made a number of offers to you to become a full-time director of the subsidiary, but, initially, you resisted these overtures. However, his persistence finally paid off and you agreed to become a director of the subsidiary, responsible for accounting and finance matters, but also general business development issues. One of the conditions of the appointment was that you be allowed to continue with your consultancy practice. Effectively this meant that four days per week you worked as a director of the subsidiary company and one day per week you administered your consultancy practice. However, you ceased to play an active part as a consultant within the practice, due to the demands of the your roles with the naval electronics subsidiary. You left the actual consultancy work to the consultants you employed.

One of your early actions, upon becoming a director of the subsidiary, was to appoint an assistant to yourself (who was also a professionally qualified accountant) to be responsible for the day to day operation of the accounts department, whilst you concentrated upon strategic issues. The early period was both successful and profitable. One particular decision which did concern you, however, was the appointment of a new salesman, who you understood to 'enjoy' a dubious reputation. Your contacts in the industry had indicated that his record in securing contracts with the MoD was impressive, but your contacts had let you know that that there was some concern, within the industry, about his methods and ethics. You were a member of the panel which interviewed and recruited the salesman and you did register your objections to his appointment, but you were overruled.

The Initial Problem

The above represents a review of past events up to the present time.

The first suggestion that your earlier concern about the appointment of the salesman was to be justified came some 2 years after his appointment when you overheard a conversation during a senior management meeting at which the salesman in

question was bragging about how he had hoodwinked the MoD and obtained super normal profits for the company on a group of contracts. The boasts of the salesman indicated that the super profits were considerable.

Stage 1: Discussion topic

What action, if any, would (not should) you take in this situation and what would be your justification for your decision?

The action you actually take

You instruct the chief accountant to look into the contracts in question and to establish the validity of the salesman's claims. The feedback from the accountant confirms the salesman's boasts. It appears that the salesman has managed to get the MOD to pay for the same group of costs on a variety of contracts, as well as some of the cost estimates for specification changes being considerably above what the MoD should have been expected to pay.

The accountant's estimate for the excess profits was £3M, or 75% of last year's profits.

Stage 2: Discussion topic

What action, if any, would (not should) you take in this situation and what would be the justification for your decision?

The action you actually take

You actually take the information to your colleague, the managing director of the group company, and place it before him. The group has its own finance director, but your relationship with this person, whilst not difficult, has never been close. Your dealings have always been with the group managing director (he is the principal reason you are with the company and he is happy to maintain this relationship).

You inform him that it is your intention to create a provision in the current year account's for the repayment of a sum equivalent to the super-profits, and that you are seeking his support for this action. You argue that, notwithstanding your own personal objections to the making of dishonest profits and the fact that it is ultimately the public who will have to 'foot the bill' for these excess charges, it is not in the long term interests of the company to retain these funds. If, and when, the MoD became aware of the deceit, the company could lose its status as a supplier to the MoD. How the managing director wishes to handle the position of the salesman you leave with him.

The managing director agrees with you and at the next group board meeting obtains the unanimous backing of the board. This is despite the fact that the repayment is significant for the group as a whole and that the market conditions generally have 'turned down' of late, making the repayment even more of a burden.

You return to the subsidiary and set in train the accounting entries necessary to create the provision.

Shortly after this your colleague, the group managing director, is taken seriously ill and is absent from work for three months. During this period you detect a change of emphasis at group level, particularly towards the MoD repayment. At the end of the three months you learn of the death of the group managing director. This is not only a personal loss, but the situation at group level with regard to the repayment to the MoD takes a turn, for you, for the worse. The new managing director is a relative of the family which has a dominant position on the subsidiary board. At the next meeting of your own subsidiary's board of directors you receive an instruction to withdraw the provision for the MoD repayment from the accounts. You are informed that the final accounts, which are due for submission within the next few weeks, should not include any reference to, or allowance for the MoD repayment..

Stage 3: Discussion topic

How do you (not should you) respond to this instruction and why?

The action you actually take

You inform the board that you are not prepared to remove the provision from the accounts. You acknowledge that with the existing capital commitments of the company (a new head office has been planned and agreed at board level) and the disappointing market conditions causing a strain on cash flow, the repayment of the sum will exacerbate a difficult situation. The deteriorating market conditions had very recently forced the company into a small redundancy exercise, the financial necessity of this having been identified by yourself. However, you stress that the company has no option but to provide for the repayment of the excess profits. You point out that the company's current intention to purchase new head office accommodation is itself built upon the assumption that corporate profits are a good deal higher than is actually the case.

You leave a somewhat acrimonious meeting defiant that the provision will remain in the accounts and that the board will have to consider how it was going to cope with the significant repayment. During the 'debate' you had stressed that you considered it likely that the MOD would agree to a phased repayment of the excess profits. You had successfully negotiated such staged repayments for clients of your consultancy practice.

Two weeks later you attend a board meeting of the subsidiary company, called to consider the annual accounts. The accounts are tabled (not by yourself but by the chairman) and as the director responsible for accounting and finance matters, you are asked to sign the accounts along with the managing director. In the preceding two weeks you had personally supervised the preparation of the final accounts and had ensured that a provision for the MoD repayment was made. It is immediately clear to you that this provision is not in the final accounts which you are now being asked to 'sign-off'. The provision has been removed and there is no recognition of a liability to the MoD.

Stage 4: Discussion topic

The managing director has signed the accounts and in the full view of the rest of the board you are asked to add your signature.

What do think the consequences might be if you refuse to sign the accounts?

What action do you take?

The action you actually take

You refuse to sign the accounts.

You are immediately man-handled by the chairman and another director (a relative of the chairman) and frogmarched into an adjoining room. You are informed that you have been made redundant as part of the redundancy exercise and that you are to leave the premises immediately and not to return. You express a wish to address your fellow directors, but this request is denied to you. You are evicted from the premises without having had the opportunity of speaking to anyone else or even returning to your office. Your coat and briefcase were handed to you by the chairman.

Stage 5: Discussion topic

What courses of action and lines of enquiry would you now pursue?

Tutors' notes

Introduction

The simulation is based upon an actual case, developed from a variety of interviews with the different parties involved, including a Member of Parliament who had raised the case in the House of Commons, various members of the accountant's professional accounting body, including the secretary of the at the time of the affair and documentary evidence from solicitors and transcripts from a television programme that featured the case.

Far more detail could be provided, and the actual case proceeds far beyond the point where this simulation finishes. The case is one with many worrying features about the integrity of senior civil servants of a government department and the role of the professional accountancy body of which the subject of the simulation was a member. However, to allow the case to be employed as an introductory case on ethical issues, the simulation has been constrained in the way that it has.

Decision 1

Without even entering the ethical realm, the commonsense response is likely to be, 'undertake an investigation and establish the facts'. The salesman might be lying; exaggerating; or telling the truth, but until the facts of the case are established, any response would be premature. However, a different response was given to the author when he employed the simulation with members of two of the leading professional accountancy bodies in the UK. Approximately thirty five accountants were seated at various tables in groups of five or six in a large room. The meeting was a joint branch meeting of the two professional bodies concerned and the author had been invited to lead a discussion on ethical issues that can face accountants.

The author was employing the simulation as part of a research project he was undertaking. Each group was required to debate each stage of the simulation and tape recorders had been placed on each of the tables (with everyone's agreement) so that the discussions could be captured on tape and studied at a later date by the author. The author circulated amongst the groups and twice during the evening was called to separate tables to switch the respective tape recorders off, thus allowing individual participants to make statements that they did not wish to be captured on tape. One of these instances related to an accountant who was a member of the Council (effectively the governing body) of his professional institute and who had worked for a number of years for a company whose major customer was the MoD. His response was,

“In my experience the case would end here [decision 1]. This sort of situation went on all the time. As a senior member of the contracts’ team it was my job to pack as many costs into contracts as possible. When the MoD auditors came round it was our job to hoodwink them. It went on all the time. Everybody did it. The MoD’s auditors were easy meat. It was the way the game was played. We padded out the contracts – they had to find the padding. Most times we won.”

This statement might well be an interesting perspective to discuss with your students. Notwithstanding the ethicality of the statement, it is also worth reminding the students that he was a senior member of his profession and well respected as a man of integrity.

When asked what happened when the MoD did identify ‘non-relevant costs’, he replied that an attempt would always be made to explain how the unusual nature of the contract in question meant that the ‘doubtful’ costs were in fact legitimate costs (maybe because of a particular need to absorb overheads in specific and ‘unusual’ way), and sometimes this worked. On very rare occasions’ the ‘added’ costs were accepted as “possibly debatable in terms of their ‘attachability’ to the contract in question”, and would be withdrawn from the contract’s costing. At no time did the MoD ever raise the prospect that there had been an attempt to hoodwink them and the matter was never taken up as an issue that could threaten the supplier’s status as a ‘preferred supplier’ to the MoD.

Decision 2

Clearly there are a variety of possible ways of responding to the news of the scale of the deceit, e.g.

- i) Judge that it is not worth the hassle to raise the issue and to ‘brush the information under the carpet’. However, at a practical level to do so, after having requested the investigation, seems tantamount to shutting the proverbial stable door after the horse has bolted.
- ii) Believing that this is a serious issue that threatens the company’s reputation and relationship with the MoD (i.e. making the business case rather than the moral case), to call a meeting of the subsidiary’s board of directors to discuss the possible ramifications of the deceit.
- iii) The same as (ii), but rather than raising the issue with the subsidiary’s board, to go straight to the group finance director, and possibly the group board. This might be a tactic if the group board might be more sympathetic to your feelings of concern than the subsidiary company’s board. However, in this case, family domination meant that both subsidiary and group boards’ would be likely to respond in a similar vein.

- iv) Circumvent the two boards' of directors and approach the group managing director directly, on the basis that with his backing, the two boards would be likely to support your line of thinking and recommendations.

Options (ii), (iii) and (iv) are behaviours that each draws their rationale from making the 'business case' for opening a line of communication with the MoD. The same behaviours are also possible, (thus creating a further three possibilities, but this time with the ethical case being the justification, rather than the business case. Both a consequentialist perspective could be used to justify revealing the 'error' to the MoD (with the exception of the salesman, it is in everyone's interest that the MoD is contacted about the 'error'). Without this resolution, everyone, bar the salesman, stands to lose in one way or another. Alternatively a non-consequentialist (principled-based) argument could be cited along the lines that 'we are not the sort of company that acts in this way, and we are not going to be. We will return the money on principle'.

Although the same behaviours can be justified using a 'business-case-logic', as well as ethically based rationale (and different ethical rationales at that), it is important to tease out the differences that the varying rationales represent. For example, if the consequentialist position had shown that there would be more 'losers' than 'winners' from the 'revelation-option', would that justify concealment?

Decision 3

The situation is now serious for you personally. Although the instruction has come from the subsidiary board, you are aware that this statement could only have been made with group board approval. You are isolated. You have a number of options before you, namely:

- a) agree to the stipulation, buying yourself some time to either work on individual board members with a view to achieving acceptance of your position over the next, say, 12 months, or alternatively, agreeing to the stipulation, in order to buy time to develop an 'exit strategy' from the company at a time that is convenient to yourself. This is a pragmatic, self-interested option, which might not appear to possess much in the way of ethical content, although if the accountant had dependents, e.g. partner, children, parents, etc, then their well-being has to an ethical concern.
- b) Refuse to agree to the demand, handing in your notice at once.
- c) Refuse to agree to the demand, contacting the external auditors, requesting an inspection of the subsidiary company's books of account.
- d) Refuse to agree to the demand and contacting your professional accountancy body to see what help they could provide.

Option (b), (c) and (d) are not mutually exclusive and any or all of the options could even be pursued, employing option (a).

Again both consequentialist and non-consequentialist perspectives could be employed to justify each option. However, once again it is important to underscore that whilst the basis of the ethical justification might lead to the same action/behaviour, this will not always be the case and these circumstances need to be explored.

Decision 4

To sign the accounts would place you in the position of knowingly defrauding a government ministry and if uncovered you could be facing a jail sentence and the withdrawal of your membership of your professional accountancy body. Your consultancy company would be likely to experience a very large reduction in its earnings' capacity because of its heavy reliance on MoD work.

Having reached this stage, for either pragmatic or ethical reasons, to sign the accounts now would not only undermine all your previous actions, you would be likely to be seen by the group and subsidiary boards as a *potential* whistleblower¹ – a dangerous employee to have on your staff if those implicated in the deceit are all board members.

To agree to sign the accounts now would seem either, or both, irrational and unethical / immoral. You have been painted into, or painted yourself into a corner from which you are unlikely to be able to extract yourself neatly and without cost, both emotional and literal.

Where to from here?

- Legal advisors to explore the possibilities for taking a case to an Employment Tribunal for unfair dismissal?
- Approach your accountancy body for assistance?
- Approach the media to media to 'blow the whistle'?
- Approach the MoD to enlist their assistance and support?

Again these options are not mutually exclusive, although your discussions with any or all of these groups is likely to project your concerns as ones based upon 'principle-based' reasons, not consequentialist arguments. In such circumstances principled-based justifications carry more integrity and appeal.

¹ See Lovell, A. (2003), 'The Enduring Phenomenon of Moral Muteness: Suppressed Whistleblowing', *Public Integrity*, Vol.5, No.3, pp.187-204, for a consideration of suppressed whistleblowing.

