through either cable, satellite, or the Internet. Someday the concept of walking into a video store to rent a movie in the form of a tape will seem arcane, as will the present state of Magnetic's business model. Today, however, Magnetic brings tremendous impact to Artisan's business, adding an entirely new distribution channel and a premier global name. Magnetic not only fits strategically, but also generates significant free cash flow. This situation puts management in an ethical quandary.

In light of this trend, how should those assets be valued today? Are historical figures based on the pooling method appropriate? Under pooling, Artisan would neither write down the hard assets of limited future value, nor would it amortize the significant premium to book in the form of goodwill. This would be both legal and beneficial to shareholders, at least in the short term; the company would avoid an immediate hit to earnings (and stock valuation). Prospective and long-term investors in the company, however, would bear the true cost of these decisions in the form of decelerating earnings, a reduced return on equity, and write-downs. These concerns may be misplaced, however, if the acquisition achieves management's strategic goals. Many analysts and investors view this as prudent financial management. What ethical issues do the CEO and the CFO face? What ethical dilemmas must be resolved before the firm can move forward with business? How would you address this situation in good conscience, knowing that you could account for (get away with) a transaction using pooling accounting? What management issues do you face if you take the unexpected hit to earnings?

Required

1. **Identify stakeholders** List the parties involved. First list those parties directly affected by the various results of these accounting transactions and the way they are reported. List the size and scope of each party (e.g. an individual, a population). Then list those parties indirectly affected in the same manner. Next to that list, note the extent to which they stand to benefit or be harmed under the various transactions and their various interpretations.
2. **Identify ethical issues** From an ethical context, what are the moral issues involved? Here, the student should take a step away from the accounting and focus on the argument from a greater perspective of right versus wrong. Although ideally each proposed solution could be classified as good or bad, rarely will this be the case; resolutions are usually characterized by various shades of gray. Some may have both a good and bad connotation depending upon the viewpoint of the treatment.
3. **Identify alternative solutions** In a cost/benefit analysis, the materiality and the impact of the various treatments should be closely examined. Here, common sense and prudence should be your overriding thought process. In those seemingly all-too-frequent cases where the treatment could go either way and the impact be equal on both sides, clearly the accountant should choose the method that he or she feels will provide the clearest picture of a given transaction or organization.
4. **Make a decision: select a preferred solution** The hardest part requires the least explanation. That's what you will be paid (and evaluated) for.

C10–55 MONOLITH FINANCIAL

Credit Analysis: The Pressure to Agree

As a traditionally trained accountant working in the risk management group for Monolith Financial, you have for years been performing credit analysis on behalf of the firm and its clients in the merchant banking and syndicated loan group. Recently promoted to a high profile senior risk management position, you now meet regularly with senior management and the new investment-banking group, conducting credit analysis on the firm's larger counterparts and clients, both old and new. In this role, you determine the creditworthiness of various firms applying for loans. If granted, these loans may either be held by the firm for its own account, be placed in trust accounts managed by Monolith Financial, sold to other banks, or securitized (packaged) and sold on the open market, usually at an attractive profit. As such, you serve as a fiduciary to clients and shareholders.

After doing extensive work on Mechanized Medical, a large client new to the firm, you have severe reservations about their financials and the quality of their balance sheet. Specifically, they compete in the highly competitive medical devices industry. Their products are extremely complex and difficult to perfect because of their interaction with the human body. In spite of tremendous regulatory scrutiny, they are continually subject to lawsuit due to flaws and imperfections, even though significant time and money is spent at the R & D stage. Furthermore, the technology in this arena is rapidly evolving and frequently renders marquee products obsolete. Although Mechanized currently enjoys a dominant position in this industry, it relies on older products for the majority of its revenues. These products have a large installed base, and therefore may be subject to liability claims. These material facts introduce volatility, and therefore risk, into the earnings stream. With the exception of two speculative technologies early in the development stage, Mechanized has few promising products in the pipeline, and therefore relies on its preexisting patents. For these reasons, you have concerns about the firm's potential to generate revenues and meet its debt service requirements. On the balance sheet side, the firm's assets consist primarily of intangible assets in the form of patents. As a credit analyst, you are concerned about the quality of those assets. As they are intangible, they tend to be illiquid. Their valuation is highly subjective and not guaranteed to generate revenues. Of greatest concern to you, however, are the technological threats to each patent: when a new and improved technology emerges with FDA approval, the market abandons older products in favor of the newer technology. This rapid erosion in earnings power can decimate the value of these assets, many of which may be backing outstanding loans. In light of these facts and concerns, you recommend in a research report that Monolith pass on Mechanized, and not extend credit to the firm.

Less than an hour after issuing the research report, the managing director storms into your new office (the one overlooking the ocean), demanding to know why you are "severing one of the firm's best (most lucrative) business relationships." Monolith, he explains, will not only be extending credit to Mechanized, but also advises the firm through the investment banking side, and plans to bring them public next spring. This one relationship will be worth tens of millions of dollars over the next year, and will continue to be lucrative thereafter. "How can we deny the firm's loan application, and then turn around and sell the firm to the public as an attractive investment opportunity?" he asks "With a smile." The investment banking side of the firm would also weigh in on your career prospects. The managing director asks you to take another look at the credit. The firm does enjoy a dominant position within the industry. With a growing installed base, doctors throughout the country are increasingly familiar with the product and are comfortable with its design and benefits to the patient. In this respect, he argues, Mechanized owns the industry standard. He cites their sharp growth in revenues and declining expenses. Furthermore, the risk to the firm will be minimal, as this loan can be placed in trust accounts, put out for the bid on Wall Street, or sold to one of the firm's mutual funds. He senses your unease, and presses you to go back to work and reconsider your stance.

As a newly promoted executive living in the real world, happy to be promoted to a senior position within the firm, you face a serious dilemma. Relying upon the education and credit analysis skills that have brought you so far, you have determined that this company presents far too great a risk of default and, therefore, have decided against lending to it. Despite the tremendous growth, its earnings are volatile and certainly not assured. Even more important to a creditor, the balance sheet offers little assurance; the assets are intangible and highly illiquid. Subject to intense competition and technologic innovation, their future value can never be certain. Your managing director, however, sees the credit differently. He sees the "bigger picture" and wants you to change your professional opinion. He cites strong revenue growth, a dominant position in a growing market, and experienced management. He also cites the other business units that are dependent on you. They want to extend the loan to Mechanized and secure more business in the process. These are coworkers and colleagues, most of whom have for years rated Mechanized very favorably in their credit work. Their business and their bonus will be affected by your work. The risk to the firm may be minimal due to the potential resale of the loans to other clients and mutual funds. In this respect, you may be able to extend credit and not leave the firm exposed. In a highly visible position, you are the only one leaning against the wind. What do you do, and how do you resolve these issues?

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