Wallpaper Designs, Inc. : the cause of failure

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Abstract

This case involves a small retail business marketing wallpaper products, and eventually, paint products. Business failure was not the last chapter in this story. The epilogue to this story involved litigation and the debate concerning the contributing causes for the business failure. Accounting concepts are key factors to understanding a defensible answer. This case challenges students to evaluate the appropriate application of generally accepted accounting principles compared to accounting concepts that are outside the boundaries defined by GAAP.

Keywords: allocation of overhead, operating segments, GAAP, sustainability, personal guarantee, accounting period, direct cost, segment

Note: This case is based on actual events that brought the record of a failed wallpaper company, its former owners, the records of a paint company supplier, attorneys, accountants, and the court together. Arguments developed around accounting concepts, were critical to the non-accountant jurors' understanding and decision.

INTRODUCTION

Dave charged through the front doors of his law firm, Dewey, Heatum, and Chow and walked with long hurried strides into his office. There wasn't much time before he had to be back in court for the afternoon continuation of his client's trial, and he had to have some answers. In the morning session the defense had presented their case, including the predictable expert witness, and Dave's cross-examination of the expert witness had not gone well. Mercifully, the lunch recess had provided an opportunity to reassess his approach to challenging the testimony of the defendant's expert witness. Dave grabbed the phone, "Julie, could you get Phil Williams at the Williams CPA firm on the line form me?"

Moments later Phil is giving his usual cheery greeting, "Hey, Dave, what's up?

Dave begins, "Well, Phil, I need some help....some accounting help. I am in the midst of a cross examination and the expert witness, an accountant, is not confirming what I understand to be GAAP."

BACKGROUND

Dave is representing Wally and Wanda Martin, the owners of Wallpaper Designs Inc., a retail store that marketed wallpaper, and for a few years, paint. Wallpaper Designs discontinued business in March of 2007, after eighteen years of operations. Owning their own business had always been a dream that Wally and Wanda shared. About nine years ago the opportunity to buy Wallpaper Designs was presented to them. Wally took early retirement from his engineering position with the utility company and Wanda left a real estate company where she had been a real estate agent for fifteen years. They invested $100,000, a substantial portion of their retirement funds, to buy the business. When the Martin's discontinued the Wallpaper Designs operations, they intended to leave the failed business experience behind. They had lost all of their $ 100,000 investment, and they would have to find employment again. While the Martins were resigned to the idea that they would have to "leave it all behind," the Wallpaper Designs' paint supplier, Wilson Paint Company, was not willing to write off $40,000 of accounts receivable from Wallpaper Designs, Inc. Wilson Paint Company sued the Martins for the receivable, since the Martins had signed a personal guarantee on the paint purchases of Wallpaper Designs.

At this point, the Martins contacted Dave at the law firm of Dewey, Heatum, and Chow. In their interview with Dave, Wally and Wanda related how Bill Nichols, the area sales representative of the Wilson Paint Company, had called on them frequently over several years seeking to gain their business as distributors of the Wilson Paint product line. After about three years, Bill's persistence paid off and the Martins agreed to test the viability of adding the paint line by marketing several consigned shipments of standard paint products. The results showed promise, so they signed an agreement to distribute Wilson Paints in March of 2003. Bill Nichols spent the next two business weeks helping to set up a display area in the Wallpaper Designs store for the full line of Wilson Paint products. Bill also trained the Wallpaper Designs employees to mix paints to match the paint color pallet. In 2004, and the next few years, paint sales grew steadily, yet they never achieved the level of sales that Bill Nichols projected for Wallpaper Designs. Bill had at one point told the Martin's that he believed that the paint sales could equal their wallpaper sales within a year or two. In the first half of 2006, Wallpaper Designs became a slow pay on its payables with Wilson. In the last half of 2006, Wallpaper Designs' payables for paint purchases from Wilson Paints were not paid. The last order for $10,000 of paint was shipped only after the Martins signed a personal guarantee for the $30,000 of unpaid invoices and the new purchase of $10,000.

After obtaining and studying the accounting records for Wallpaper Design, Dave had another meeting with the Martins. Dave presented a strategy for dealing with the claims represented in Wilson's suit. Since the paint product required a display area in the store, space for storing inventory, space for mixing equipment, in-store training of employees, and the work of sales staff, the paint segment of the store operation should absorb a proportionate amount of the overhead (rent, utilities, insurance, salaries, etc.). When a proportionate allocation of overhead is made to the paint segment (based on sales revenues), the result is that the direct costs of the paint segment and the allocated costs of the store operation are greater that the paint sales. The paint segment is shown to be unprofitable. In addition, considering the fact that Bill Nichol's persistence practically "coerced" the Martins into taking on the Wilson Paint products, and that Nichols' forecasted paint sales turned out to be exaggerated, it can be argued that Wilson Paints contributed to the demise of Wallpaper Design. Indeed, after Dave shared this argument with Wally, Wally responded that he had not had enough understanding of accounting to document the impact of the paint line the way Dave had presented it, but he had always felt that the paint line had not only contributed, it had caused the failure of their business. At this point, it was clear to Dave and the Martins that their response to Wilson's suit would be a counter suit. The counter suit would claim $200,000 in actual business and personal damages and $800,000 in punitive damages. Dave suspected that a favorable settlement would be a probable outcome, since Wilson's legal costs could quickly exceed their $40,000 receivable, and Wilson could lose a lot more if the jury is sympathetic to the Martins and apathetic or even hostile to the Wilson Paint Company.

When the counter suit was presented to the Wilson Paint Company, the response was not what Dave expected. Wilson's attorney communicated to Dave that there would be no settlement and Wilson Paints was prepared to "go the distance".

REVIEW OF THE TESTIMONY

After several months of discovery, the case finally came to trial in March of 2008.

Wilson Paint’s Claim

The documentation of $40,000 of delivered and invoiced product to Wallpaper Designs was not disputed. The failure to pay Wilson Paint Company $40,000 for the delivered product also was not disputed. The Martin's did argue that the personal guarantee was provided under duress, and should, therefore, be invalidated. They further argued that if the personal guarantee is not invalidated, it should only be applicable to purchases that occurred after the agreement was signed and not the full $40,000. These facts were presented to the judge and his decision was deferred pending the outcome of the counter suit.

Martins' Counter Claim

Dave drew testimony from the Martins that presented the history of the relationship that had developed between the Martins at Wallpaper Designs and the Wilson Paint Company, including the coercive nature of the recruitment of Wallpaper Designs to distribute paint products. The Martins also testified about the exaggerated sales performance numbers that Bill Nichols had caused the Martins to believe would result when they became distributors of his product. Finally, Dave led Wally through a discussion of the accounting records of Wallpaper Designs to show how the paint segment of the business had never been profitable when direct costs and appropriately allocated overhead is deducted from the sales revenue for paint products. An eight year comparative income statement, Exhibit 1 (Appendix), was presented to make this point. (Dave felt that he had enough undergraduate accounting to effectively make the accounting arguments, without adding a costly accountant as an expert witness).

Wilson Paint's Response

Jay Drew, Wilson's attorney, had many of the expected questions in cross-examining the Martins. His questions brought out the fact that Wallpaper Designs' sales had been declining in the years leading up to the addition of the Wilson Paint product line. Jay Drew also pointed out that the comparative income statement that Dave presented as Exhibit 1, shows a decline in sales of wallpaper products that persisted to the end of operations. Also, the Martins confirmed that they were the decision makers in their company, and had added and deleted product suppliers (usually wallpaper manufacturers) over their years of managing the Wallpaper Designs business. None of those decisions was considered coerced regardless of the persistence of the sales representative. Furthermore, with declining sales, the amount of wallpaper products inventoried and displayed had been reduced by 2004, although the wallpaper products were displayed throughout the store. Store employees testified that when the paint products were added they did not have to reduce the amount of wallpaper products that were being displayed; they simply stored and displayed the wallpaper products in less space. Finally, there were no additional employees hired to accommodate the work related to the new product line. All employees did testify that their work days were busier after the paint products were added.

Jay Drew also examined his own expert witness, Gary Ballard, a CPA with a local accounting firm. The CPA testified that he had examined the financial statements of Wallpaper Designs, Inc., for the past eight years. The financial statements showed that sales of the wallpaper products declined in every year from 1999 through 2006. The sales of paint, on the other hand, increased in each successive year, 2003 through 2006. Jay asked his witness to comment on the reasoning that forecasted sales of a complimentary product like paint in a wallpaper store might not meet expectations if the sales of the primary product are declining. Dave objected that the witness was not qualified to answer a marketing question, and any answer would require speculation. Of course, Dave's objection was sustained, as Jay expected, but he succeeded in planting the idea in the jurist's minds.

Mr. Ballard was also asked to evaluate the claim made by the plaintiff that the paint segment had never been profitable, showing losses each year for Wallpaper Designs. Mr. Ballard stated that this assertion was not correct, because the impact of the paint product line on the profitability of Wallpaper Designs should be based on segment margin. The allocation of common fixed overhead based on the relative sales dollars of the wallpaper and paint products is not appropriate.

In Dave's cross-examination, he challenged Mr. Ballard's representation of GAAP. Dave argued the point that GAAP requires that overhead should be allocated to segments. Each operating segment must carry the overhead burden that it creates, which is both variable and appropriately allocated fixed cost. This indeed, Dave pressed, was the finding of a judge in American Drug, et.al. versus Wal-Mart, in a Conway, Arkansas case. Ballard responded that Dave's argument might have greater credibility if Wallpaper Designs had started business with two product lines, wallpaper and paint, and a store facility was acquired to accommodate the space needs of both products. Then it would be apparent that both products were responsible in the initial business plan for the overhead costs. “The facts are different here, Ballard argued. The wallpaper segment existed first, and the paint segment was added as a ‘rescue’ attempt by the Martins. The GAAP of allocated overhead, as Mr. Dewey has proposed, does not apply here, added Ballard.”

It was not a concept Dave had not heard of in his accounting education and it was not an argument raised in the Conway case. Dave was not prepared to respond to this argument. The best he could do was object to the characterization of the Martin's decision to add the paint line as a rescue attempt.

"Your honor, the witness cannot presume to know what motivated the Martin's in this business decision or any other decision for that matter. It is only his speculation." The judge sustained Dave's objection and declared a lunch recess.

DAVE AND PHIL WILLIAMS’ PHONE CONVERSATION CONTINUES

Dave reviewed with Phil the testimony that had taken place that morning, particularly the accounting related testimony.

"So now you know the accounting issues I am debating with the expert witness. What points can I make to win this argument?"

Phil couldn't resist, "So you decided to be your own expert witness. How does that saying go, 'the attorney that chooses to represent himself has a fool for a client.' If we adapt that in this situation it would be, the attorney that chooses to be his own expert accounting witness..."

“Alright, alright,” Dave interrupted, “you made your point, but I don’t have time to review Mark Twain-isms. In fact, speaking of time, your time right now is pro bono, as we say in our trade, so don’t send me a bill, since my client can’t pay it.”

“Well, in that case, Dave, I am going to give you the short answer to your question. Your original argument is the right one to make here. The allocation of overhead to operating segments is the conventional standard applied in financial reporting. It is the method that professional bodies like the FASB have studied, debated, and resolved to be the proper presentation in financial statements. It is called GAAP, ’generally accepted accounting principles’. I think you need to make this point more forcefully, and don’t leave any room for creative accounting.

Regarding the argument that the paint product was added long after the company was started and should not have existing fixed costs allocated to it because the paint products were added to rescue the company, I would respond as follows: Even if that argument is supportable initially, how long can that position be justified, a year, two years, three, indefinitely? I think it is obvious that the ‘no allocation’ argument breaks down because the product has to be managed, personnel have to order and handle and invoice for the product, it has to have space that is financed in some way, then there is insurance and taxes. Do you see my point, Dave?

If the witness comes up with a certain number of years, challenge that by asking why it isn't more years or fewer years. Basically, you want to make the witness appear to be making it up as he goes through the testimony. The jury will see that it is just creative and self-serving accounting. Also, ask the witness what reference could one go to in the generally accepted accounting literature to read about this accounting concept he is proposing."

"Yeah, that's good, Phil. I'm trying to write it all down. I wish I had these points come to mind this morning, but, fortunately, it's not too late."

"One more point, Dave, regarding when to start allocating, just state that the Martin's decided to make the allocation from the beginning to see if, indeed, this product was going to be able to carry its weight. Also, since you said earlier that the allocation was based on sales, explain that this criteria was the fairest allocation criteria to avoid assigning an unfair burden to the paint product line."

"Thanks, Phil. That is just the information I needed. In the future I think we should do all our business this way. The price is certainly right."

"Well, remember how this works when I need some legal help. Talk to you later."

BACK IN COURT

Dave continued his cross examination and laid out all of the arguments he had gotten from Phil as forcefully as he could. He held back on the challenge regarding how long Mr. Ballard would go without allocating overhead. When he finished, Dave felt his presentation had been effective, and would challenge Ballard's credibility. He hoped that Mr. Ballard would feel a little shaken and give an ineffective response.

Mr. Ballard carefully and deliberately began his response, "Your points are valid in the right context, in the right circumstance, but not in this situation. The financial data clearly shows that wallpaper sales were on the decline. Something had to be done to forestall and hopefully prevent business failure. A reasonable action would be to add a product that is complimentary and has demand. The Martin's apparently determined that Wilson Paints was a good choice that fit the criteria. So, once it was added, how should they determine whether it is helping to slow or change the direction that the business was taking? It is simple; compare added revenue and added costs. If the added revenue is greater, it is helping, and that is what the financial data shows."

"What about the notion that this subsidizing of the paint product line cannot go on indefinitely?" Dave's voice revealed some frustration. "If you don't charge the paint product line with the overhead that helps sustain it, then the rest of the business' products have to carry it. That's not fair. When does that arrangement come to an end? Is it a year, two, three, five, or is there no end in your judgment?"

"If I had to choose from the options you just gave me, there is no end. That would be my answer. Let me explain that choice," Ballard continued, "a business is created for an indefinite period, yet at some point, and for any number of reasons it may cease to function. That is the life of a business. In accounting, we divide a business' life into accounting periods. Your reference is a year. Whatever the length of the accounting period, it is chosen to service the information needs of management or satisfy reporting requirements in the context of a going concern. In this case, whether the business is a going concern is the question. Once it is put on life support, what is the relevance of choosing a particular number of accounting periods for termination. Let's continue the effort as long as it is helping and there is hope. Once it is clear that the business is no longer sustainable, let's not end it and then blame the life support system."

"I have no more questions your honor." Dave returned to his chair, feeling a little frustrated and perturbed. Accounting was supposed to be a little more straight-forward than this. Two accounting experts, and they can't agree on something so basic. And "life support system," I didn't see that one coming. Probably another accounting concept I missed in my intro class.

REQUIREMENTS:

1. The accounting arguments centered on how to measure segment performance. In particular, how should overhead costs be allocated to the wallpaper and paint product segments? Explain the reasons for your answer.
2. Based on your answer to requirement 1., what arguments were compelling, informative, useful, and/or effective, and what arguments were distracting and ineffective? Would you make any additional arguments that you think have merit for evaluating this case?
3. How would you rule on the counter suit, Wallpaper Designs claim for actual damages of $200,000 and a punitive judgment of $800,000? Give the reasons that support your decision.
4. How would you rule on the original claim in this lawsuit, Wilson Paints' demand for collection from Wally and Wanda of the $40,000 account balance for paint products sold to Wallpaper Designs, Inc.

REFERENCES

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APPENDIX

Exhibit 1

Wallpaper World, Inc.
Comparative Income Statement
For the Five Years Ended December 31, 2003
(Thousands of dollars)

	1999	2000	2001	2002	2003	
	Wallpaper	Wallpaper	Wallpaper	Wallpaper	Wallpaper	Paint
Sales	$500	$450	$400	$350	$300	$50
Variable Cost	200	180	160	140	120	25
Contribution Margin	300	270	240	210	180	25
Fixed Cost	210	210	210	210	180	30
Net Income	$ 90	$ 60	$ 30	$ 0	$ 0	($ 5)

Wallpaper World, Inc.
Comparative Income Statement
For the Three Years Ended December 31, 2006
(Thousands of dollars)

	2004		2005		2006	
	Wallpaper	Paint	Wallpaper	Paint	Wallpaper	Paint
Sales	$250	$50	$200	$100	$150	$150
Variable Cost	100	25	80	50	60	75
Contribution Margin	150	25	120	50	90	75
Fixed Cost	175	35	140	70	105	105
Net Loss	($ 25)	($ 10)	($20)	($ 20)	($ 15)	($ 30)