

Focus on Ethics

DID BOEING EXPLOIT ACCOUNTING RULES TO CONCEAL COST OVERRUNS AND PRODUCTION SNAFUS?

Aircraft manufacturers use job-order costing to determine the cost of an airplane. As this chapter discusses, supply chain management and production controls are also important tools used by manufacturers to manage production costs. As *BusinessWeek* reports, however, things don't always go according to plan.

For three years, Boeing's top management had been seeking a merger with McDonnell-Douglas Corporation, whose board of directors was reluctant to approve the deal. Finally, the deal went through, and the world's largest aerospace company was born—"the first manufacturer ever with the ability to build everything that flies, from helicopters and fighter jets to space stations."

Unfortunately, "a disaster was quietly unfolding inside Boeing's sprawling factories—one that would ultimately wind up costing billions of dollars, cause several executives to lose their jobs, and lead to claims of accounting fraud. Facing an unprecedented surge in orders because of a booming economy, workers were toiling around the clock, pushing the assembly line to the breaking point. At the same time, the company was struggling to overhaul outdated production methods. These pressures were building up to what was, in essence, a manufacturing nervous breakdown. In the weeks after the merger announcement, parts shortages and overtime approached all-time highs. As costs went through the roof, the profitability of airliners such as the 777 swooned. A special team formed to study the crisis issued a report with a blunt conclusion: 'Our production system is broken.'"

Had investors "understood the scope of the problems, the stock would probably have tumbled and the McDonnell deal—a stock swap that hinged on Boeing's ability to maintain a lofty share price—would have been jeopardized."

In May of 2002, *BusinessWeek* reported the results of its three-month investigation, which "reconstructed this hidden chapter in the company's history—and analyzed its current implications." The *BusinessWeek* article alleges that "new details supplied by several inside witnesses indicate that Boeing did more than simply fail to tell investors about its production disaster. It also engaged in a wide variety of aggressive accounting techniques that papered over the mess. Critics say the company should have taken charges for the assembly-line disaster in the first half of 1997, even if it meant jeopardizing the McDonnell merger. They also claim that Boeing took advantage of the unusual flexibility provided by *program accounting*—a system that allows the huge upfront expense of building a plane to be spread out over several years—to cover up cost overruns and to book savings from efficiency initiatives that never panned out. 'Boeing managed its earnings to the point where it got caught,' says Debra A. Smith, a partner at Constraints Management, a Seattle-area manufacturing consultancy, and a former senior auditor at Deloitte & Touche who worked on the company's account during the early 1980s. 'Boeing basically decided in the short run that [managing earnings] was a lesser evil than losing the merger,' adds Smith. At a time when investors are asking themselves how far Corporate America can be trusted, the Boeing saga provides rich new evidence that companies have much greater leeway to manipulate their numbers than most people suspect."⁵

Boeing allegedly used a system they called *program accounting* to spread their huge cost overruns across several years, thereby propping up earnings and the company's share price. After the merger with McDonnell-Douglas, however, the truth came out in the form of much lower earnings.

What is your view of how Boeing handled its cost overruns, its production problems, and the merger with McDonnell-Douglas? Did the company's top executives act ethically? How about their accountants?

⁵Stanley Holmes and Mike France, "Boeing's Secret: Did the Aircraft Giant Exploit Accounting Rules to Conceal a Huge Factory Snafu?" *Businessweek*, May 20, 2002, pp. 110–120. Also see Andy Pasztor and Anne Soueo, "Boeing Could Pay Large Penalty to Settle Probes, Avoid Prosecution," *The Wall Street Journal*, September 17, 2005, pp. A1, A8. Unrelated to the ethical issues described above, Boeing has experienced more recent setbacks relating to the grounding of its 787 Dreamliner, due to problems with the aircraft's lithium-ion batteries. As this book goes to press, the problem had apparently been solved, and several airlines had resumed their flights of the Dreamliner. See Christopher Drew, "United Joins in Grounded Dreamliners' Return to the Skies," *The New York Times* (on line), May 20, 2013, p. 1.