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LETTER FROM THE EDITOR

Welcome to the *Journal of the International Academy for Case Studies*. The International Academy for Case Studies is an affiliate of the Allied Academies, Inc., a non-profit association of scholars whose purpose is to encourage and support the advancement and exchange of knowledge, understanding and teaching throughout the world. The purpose of the IACS is to encourage the development and use of cases and the case method of teaching throughout higher education. The *JIACS* is a principal vehicle for achieving the objectives of both organizations. The editorial mission of this journal is to publish cases in a wide variety of disciplines which are of educational, pedagogic, and practical value to educators.

The cases contained in this volume have been double blind refereed, and each was required to have a complete teaching note before consideration. The acceptance rate for manuscripts in this issue, 25%, conforms to our editorial policies.

If any reader is interested in obtaining a case, an instructor’s note, permission to publish, or any other information about a case, the reader must correspond directly with the author(s) of the case.

The Academy intends to foster a supportive, mentoring effort on the part of the referees which will result in encouraging and supporting writers. We welcome different viewpoints because in differences we find learning; in differences we develop understanding; in differences we gain knowledge and in differences we develop the discipline into a more comprehensive, less esoteric, and dynamic metier.

The Editorial Policy, background and history of the organization, and calls for conferences are published on our web site. In addition, we keep the web site updated with the latest activities of the organization. Please visit our site and know that we welcome hearing from you at any time.

JoAnn Carland
Western Carolina University
CASES
A DAY AT THE MOVIES

Carol Docan, California State University, Northridge
Leonard Rymsza, California State University, Northridge
Paul Baum, California State University, Northridge

CASE DESCRIPTION

The primary subject matter of this case concerns business law and statistical analysis. Secondary issues examine contract formation, terms of an agreement, breach of contract, misrepresentation and legal remedies, as well as ethical issues related to business conduct affecting consumers and statistical analysis involving hypothesis testing which may lead to alternate business decisions.

The case has a difficulty of level three, appropriate for junior level courses. The case is designed to be taught in three class hours, including a class presentation by student teams. The case is expected to require a minimum of three hours of outside preparation by student teams that present a report.

CASE SYNOPSIS

Draw your students into a scenario that they will identify with quickly. A busy college student rushes to get to the movie theater, on time, to see the latest big movie hit. The student unwittingly becomes part of a captive audience that must sit through twenty minutes of commercial advertisements before the movie actually begins. Instead of complaining about the cost of a movie ticket, the student is fuming because he had to sit through the commercials and wants his money back. When the manager refuses to return the price of the movie ticket, the student considers whether he has a good lawsuit against the theater on behalf of all moviegoers.

The theater receives a letter from the student expressing his dissatisfaction with the showing of the commercials and threatens a class action lawsuit. The theater learns that competitors have received similar complaints. The theater owners prepare to defend a potential lawsuit by forming a consortium.

Your students will embark on a search for answers to a variety of questions. In Case A, students are required to determine whether a contract exists, identify the terms of the agreement, determine whether a breach of contract occurred, and what remedies, if any, are available, and analyze whether the theater made an innocent misrepresentation or acted fraudulently. In addition,
students explore the ethical issues that arise from the theater owner's conduct of showing commercials to a captive audience.

In Case B, the consortium decides to conduct a survey to consider potential legal losses. The results of the survey are used to test the hypotheses regarding the percentage of all moviegoers who are unhappy with the commercials. The student must recognize the statistical issue as one of testing hypotheses about a population proportion, must be able to formulate the null and alternative hypothesis, compute the appropriate test statistic, and draw conclusions about whether the consortium should settle or defend the lawsuit.

The case study was developed after the authors became aware of a consumer fraud lawsuit that was filed against a national movie theatre chain on behalf of all moviegoers who sat through unannounced advertisements. The authors recognized a series of additional legal issues that were not presented in the original litigation, which lead to a discussion of the ethical issues presented in the scenario, and to a discussion of how the national chain might solve the threaten litigation through statistical analysis of a consumer survey.

LET'S GO TO THE MOVIES

The days had been extremely hot. It had been hotter than normal. In addition, the moisture coming up from the gulf had increased the humidity to almost unbearable levels. It was under these circumstances that Tommy decided to go see a movie. The theater would at least be air conditioned and would provide some welcome relief from the weather. Tommy looked in the movie section of the newspaper to see what movies were being screened in his area. He saw that the highly anticipated movie "The Governator" was being shown at the nearby Royal 16 Theater complex in the Eastfield Mall. The newspaper advertisement indicated that the movie was scheduled to begin in 30 minutes, at 1:00 pm. Tommy got his wallet and car keys, jumped into his car, and sped off to the mall. Since he always had difficulty finding a seat in the dark, one thing Tommy did not want was to be late for the beginning of the movie. Once the lights were out, he could barely see where he was going.

Tommy made it to the Royal Theater in 15 minutes. While at the ticket window to purchase his ticket, Tommy asked the cashier when the movie was scheduled to begin. The cashier told him that the movie would begin in 15 minutes, at 1:00 pm, the time posted on the marquee. Tommy asked what was the cost of an admission ticket to see "The Governator." The clerk replied, "nine dollars." Tommy exclaimed, "Nine dollars, why so expensive? Don't you give any discount for an early movie?" The cashier replied that because this was a long awaited "blockbuster movie" the theater owner was not reducing the price for early afternoon showings. Tommy reluctantly paid the nine dollars and was given a ticket of admission that stated the movie would begin at 1 pm. The ticket contained no other relevant statements.
Tommy was not a regular moviegoer. He had not been to the movies for several years because he was too busy. He was a business major at the local university and worked about 20 hours a week. Attending classes, studying and working left him very little time for entertainment.

Having already parted with nine hard earned dollars, Tommy reluctantly decided to stop at the refreshment counter. The line was long, but Tommy got in line anyway. After spending another nine dollars for a large tub of buttered popcorn, a large iced soda, and a super-sized candy bar, Tommy hurried off in the direction of the sixteen movie viewing rooms in search of the one showing "The Governator."

Tommy found the right Theater room at 12:58 p.m. He walked down the aisle, found a suitable row, and headed for a selected seat. Tommy softly exclaimed, "Pardon me, excuse me, pardon me," as he squeezed and climbed past other moviegoers to finally get to his seat. Tommy settled into his seat as best he could (with a little less popcorn and soda, but still clutching his candy bar). He let out a big sigh of relief. He was seated with 10 seconds to spare. The lights began to dim, and then Tommy uttered ". . . what the (expletive deleted) was this? A commercial!" Tommy was outraged. He had paid eighteen dollars to watch commercials? All that hurrying. All that worrying. All that anxiety to find his seat before the movie would begin. All that, just to see commercials!

As a matter of fact, twenty minutes of commercials were shown before the movie began. Tommy endured the commercials. After all the theater was air conditioned and comfortable. Finally the movie started. However, very early into the showing, it was clear to Tommy that this was the worst movie ever made. He decided to give the movie a chance to improve. Tommy watched the movie for another 30 minutes, but the movie did not get any better. Tommy stumbled and fumbled his way out of the viewing room and headed off to find the manager of the theater. Tommy was disgusted. Not only had he been forced to watch 20 minutes of commercials, the movie was, in his opinion, a bust. A waste of nine, hard earned dollars to see the movie. Tommy asked for his money back. The manager explained that it was the policy of the theater owner not to refund the admission fee.

THEATRE OFFERS NO SOLUTION - LET'S THREATEN TO SUIC

Tommy left the theater, vowing not to let this episode pass without some resolution. He was sure that the Theater had violated his legal rights as well as the rights of other moviegoers, particularly by showing all of those commercials. He returned home, found his Business Law textbook, and began to consider various legal actions he could pursue. There had to be some recourse.

Tommy, remembering a few things from a Business Law course he had taken, wrote a letter to Mr. Mull T. Plex, the owner of the Royal Theater. In the letter, Tommy expressed his
REACTION TO THE THREATENED LAWSUIT - CONSORTIUM FORMATION

After reading Tommy's letter and the possibility of a class action lawsuit being filed, Mr. Plex was livid. Not knowing how to proceed, he decided to contact other Theater owners in the area to see if they had also been notified as being potential defendants in Tommy's threatened class action lawsuit. After learning that all of his competitors had been contacted, Mr. Plex's initial reaction was "Good! With my untarnished reputation, I'll prevail in the lawsuit, but my competitors will go under. Then I'll be the only show in town." However, after realizing that he too could go belly up, Mr. Plex decided that it would be better if he and his competitors stuck together and prepared to defend any lawsuit by forming a consortium. Pleased with his "esprit de corps" strategy, Mr. Plex presented his idea to his competitors. The response was overwhelmingly positive and the consortium was formed.

After much debate, the consortium agreed that it would be useful to know the percentage of all theater goers who are unhappy with the practice of showing advertisements before the featured film begins. They reason that if the percentage is small, then Tommy is a "voice in the wilderness" and there is no basis for a class action lawsuit. However, on the other hand, if the percentage is substantial, then perhaps Tommy's response is not an aberration, in which case the more prudent course of action would be to proceed cautiously in the hope of avoiding the cost of defending a lawsuit. The consortium, while suspecting that the percentage is relatively low, probably less than 10%, decides to apply the following decision rule: if the percentage is actually 10% or more, the consortium will seriously consider negotiating a settlement of any lawsuit filed by Tommy. However, if the percentage is less than 10%, they will vigorously defend any lawsuit filed by Tommy.

The consortium is not sure how to go about surveying its patrons. In addition, the consortium is not sure what to do with the results of the survey if in fact it is conducted. Also, the consortium is concerned about the causes of action that Tommy may include in his lawsuit.

Your law firm handles business law matters, with a specialty in statistical analysis. Mr. Plex has hired your firm. Mr. Plex has indicated to you that he has several concerns and would like your firm to provide him some answers.
CASE A QUESTIONS - LEGAL AND ETHICAL

1. Does a contract exist between Tommy and Royal Theater? If a contract is present, what are the terms of the agreement and did Royal breach the agreement? If the contract was breached, what damages, if any, may Tommy recover?

2. What liabilities, if any, does Royal Theater have for innocent misrepresentation or fraud? In answering this question, incorporate the elements of law and reasoning of the court's opinion in the case of Lee P. Cao et al v. Huan Nguyen et al., 607 N.W. 2d 528 (2000).

3. What ethical issues might be involved in showing the commercials to a captive audience of moviegoers who have paid to see a movie? In answering this question, please read an article entitled, "Only the Ethical Survive," at: http://www.scu.edu/ethics/publications/iie/v10n2/ethical-surv.html. Also, search the Internet for other sources that will help you develop your answer.

CASE B QUESTIONS - STATISTICAL

You have reviewed Royal Theater's potential legal liability and the ethical issues raised by the theater showing twenty minutes of commercials to a captive audience. Royal Theater seeks additional guidance. With respect to surveying moviegoers, Mr. Plex wants advice on how to conduct a survey and how to analyze the data once it is collected. After pondering the survey design issue, your firm advised Mr. Plex and the consortium to randomly sample 100 patrons.

Upon taking your advice, the sample was selected. The sample revealed that 6 out of the 100 patrons surveyed agreed with Tommy and resented the ads.

4. In light of this result, should the consortium consider settling or contesting Tommy's lawsuit if it is filed?

5. When would the consortium make a Type I error? A Type II error?

6. Would your answer to Question 4 change if 300 patrons were randomly surveyed and 18 out of the 300 patrons agreed with Tommy and resented the ads?? Explain.
BUDGETING IN THE NOT-FOR-PROFIT AMBULATORY HEALTHCARE ENVIRONMENT

Clarence Coleman, Jr., Winthrop University
C. Angela Letourneau, Winthrop University

CASE DESCRIPTION

This case illustrates the crucial role third party insurer and patient mix plays in establishing the amount of federal grant funds a Community Health Center is eligible to receive. The federal grant financing of these centers is designed to provide the necessary funds to provide care for the indigent patient population. The case allows for the discussion of Medicare and Medicaid prospective payments systems as well as the traditional indemnity insurers such as Blue Cross Blue Shield. The case is targeted to senior level and MBA students and requires approximately two to three hours of outside class preparation. It may be covered in one or two class periods, depending upon the complexity of the issues introduced by the instructor.

CASE SYNOPSIS

The Healthcare delivery system has gone through major changes over the past ten years. While significant attention has been given to the plight of not-for-profit hospitals, little attention has been given to the financial issues of not-for-profit ambulatory Healthcare providers in general and Community Health Centers (CHC) in particular. The dilemma Health Centers face each year is budgeting and justifying the amount of federal support funds they should receive. This budgeting process is complicated by the potential loss of Medicaid patients to a state’s HMO plan, reduction in allowable charges by traditional indemnity plans, disallowance of non-Medicare cost in CHC cost reports and a host of other issues.

This case revolves around the financial debriefing between Marty (CEO) and the departing Rita (CFO) of the People’s Family Health Center. Lynn, the newly hired accountant, must provide Marty the necessary financial information he needs to negotiate the federal grant with the regional office of the Department of Health and Human Services. The issue to be decided is how much of a federal grant is required to balance the health center’s budget so they can continue providing the same level of medical care to the indigent population in the county.
CASE SUMMARY

The Healthcare delivery system has gone through major changes over the past ten years. Employers provided employees Health Maintenance Organizations (HMO) as an option to the traditional indemnity plans. Several states initiated Medicaid HMO’s as an alternative to their traditional Medicaid programs. Medical savings accounts have been incorporated in some employers’ cafeteria plans. All of these actions have been undertaken to arrest the spiraling cost of health care. While significant attention has been given to the plight of not-for-profit hospitals, little attention has been given to the financial issues of not-for-profit ambulatory Healthcare providers in general and Community Health Centers (CHC) in particular. The Community Health Center program is authorized under section 330 of the Public Health Service Act, Public Law 94-63. The objective of the program is to provide support for the care of medically underserved populations in rural and inner city areas. At the end of 2002, there were 3400 sites across the country, serving approximately 11 million patients. The centers are required to establish a fee schedule designed to cover the reasonable cost of providing care to all of its patients and are mandated to make reasonable collection efforts. Medicaid and Medicare reimburses the centers prospectively based upon a per visit capitation rate that encompasses all medical services provided. The amount reimbursed in any year is based upon the allowable cost as determined from the preceding year’s cost report. The dilemma Health Centers face each year is budgeting and justifying the amount of federal support funds they should receive. This budgeting process is complicated by the potential loss of Medicaid patients to a state’s HMO plan, reduction in allowable charges by traditional indemnity plans, disallowance of non-Medicare cost in CHC cost report and a host of other issues. The challenge to the student is to calculate the federal grant required to balance the Center’s budget given changes in patient mix, cost structure and reimbursed rates.

Glossary of Terms:

Capitation – Capitation, in the healthcare environment, refers to a fixed amount paid to a provider of health services for each patient visit. Capitation may also refer to the fixed payment per covered patient per month, made by an health maintenance organization to a provider of health services.

Community Health Center – Community Health Centers are not-for-profit healthcare providers. Because the Centers were developed to provide healthcare to individuals and families with meager economic means, they receive annual federal grants.

Health Care Provider - A healthcare provider is an individual, group, or other entity that make available certain health services to the public for a fee or monthly premium.
Health Maintenance Organization (HMO) – A Health Maintenance Organization may be a third party insurer, a health care provider or a combination of both. For a fixed monthly premium per group participant, Health Maintenance Organizations provide an array of services commensurate to the premium. In addition to other cost reduction strategies, health maintenance organizations have reduced their beneficiary payout costs by limiting access to healthcare specialists and reducing hospital inpatient days.

Medicaid – Medicaid is a third party insurer program administered by each individual state. Each state establishes its own Medicaid regulations. The program is jointly funded by the state taxes and federal matching funds.

Medicaid HMO – A Medicaid HMO is a state sponsored Health Maintenance Organization. A number of states established HMO’s to reap the cost savings experienced by the private sector of the economy.

Medicare – Medicare is a third party Insurer program administered by the Department of Health and Human Service of the United States Government. The program was enacted to provide for the Healthcare of the elderly. The program is jointly funded through an employer and employee payroll tax.

Third Party Insurer- A third party insurer is an entity that guarantees the payment of healthcare cost incurred by its plan beneficiaries. Insurance companies, labor unions and governmental agencies are examples of third party insurers.

CASE BACKGROUND INFORMATION

People’s Family Health Center has been in operation for more than twenty years. The CEO, Martin (Marty) Lambert has witnessed many changes in the health care industry. Marty had worked as a mid level manager in a hospital before assuming the leadership role at the Community Health Center; he was very excited about applying the financial management and other skills he had learned in the for profit environment to the local health center. Wellness Hospital, his former employer, had an $80 million budget and employed over 300 persons. He felt certain that a not-for profit health center with a two million dollar budget could not rival the latter in financial complexity. When Marty first joined People’s Family Health Center five years ago, Rita Martinez was the chief financial officer. Rita was very bright, having earned an accounting degree at Bastrop University and passed the CPA examination on her first sitting. In their very first meeting, Rita informed Marty that the family Health Center was a cross between a hospital and a physician’s private practice. The
Health Center like the Hospital, Rita explained, is reimbursed on a prospective payments system (PPS) for both Medicare and Medicaid patients. The reimbursed amounts for visits during the current year are based upon the previous years cost report. To simplify billing, Community Health Centers are permitted to lump together medical cost (e.g. physician charges, laboratory fees, radiology) into one composite rate per visit. The composite rate, often referred to as a per-visit capitation, includes all of the associated administrative cost of providing the medical services. Again like the hospitals, if the health center’s cost report revealed that it was reimbursed at an amount that exceeded its medical cost per visit, a liability to the government must be recorded.

Marty could hardly believe what he was hearing. Rita indicated that health centers are unlike physician practices because of the range of services offered and because they are required to be operated in a manner such that no person shall be denied services because of inability to pay (42CFR, Part 51c.303.) Health Centers are often located in remote rural and blighted urban areas. It is often the only source of healthcare for rural and urban patients; consequently, the government has encouraged these centers to become comprehensive in nature. Hence, they often offer dental and pharmaceutical services, environmental health analysis, transportation, nutrition counseling and a number of other disease mitigation and prevention services. Unfortunately, government agencies do not often coordinate policy. Medicare will only reimburse the centers for medical services. The direct cost of dental, pharmaceutical, nutrition counseling and other disease prevention and mitigation services as well as the pro rata administrative cost are not all allowable cost in the Medicare cost report. Disease prevention and mitigation services are approximately 15% of Peoples Health Center’s budget.

That brings us to third party insurers,” Rita began. “Like the private sector, the center has witnessed a steady reduction in the amount paid by insurance companies. As the Health Maintenance Organizations began to expand and the insurance industry consolidated, the insurance companies have substantially ignored the health center’s charges and pay according to their own fee schedule.” This was not a new revelation to Marty, since he was familiar with the financial stress Wellness hospital experienced when faced with similar unanticipated fee reductions. Rita remarked that when she started working with Peoples Family Health Center, twenty percent of their patients had some form of insurance. The number is down to ten percent, due in large measure to a decline in job opportunities because a local TV assembly plant moved its operations to China. The number of self-pay patients has correspondingly increased as the unemployment in the county has risen.

Marty recalls the first time he heard the term self-pay. He thought that pay category would be the major source of the Center’s revenue. He was mistaken. Rita explained that there were essentially three sub-categories of self-pay patients. Patients are assigned a pay category based upon their family income. Patients whose family income exceeds 200% of the Health and Human Services (HHS) poverty guidelines are required to pay 100% of their bill. Patients whose family income is less than or equal to 100% of the HHS poverty guidelines are asked to make a fixed nominal payment upon each visit. Patients whose family income is greater than 100% of the HHS poverty
guidelines but less than 200% are assigned a pay category 20%, 40% etc. based upon the relationship of their income to the poverty guideline. The personal liability charges to a patient increase per patient based on increases to family income.

CASE FINANCIAL OVERVIEW

Marty remembers very well his initial meeting with Rita and is saddened to see her leave. She has accepted a job to become the CEO of a very successful hospital management company. Prior to her departure, she has recruited Lyn Jones, a recent accounting graduate of Bastrop University. Marty has asked that he, Rita and Lyn meet to conduct a financial management exit conference. He has asked Rita to discuss both internal financial issues and emerging external risk faced by the People’s Health Center. Rita’s comments were not very encouraging. Recognizing the relative success of HMO’s in the private sector, the state started a Medicaid HMO two years ago. The Health Center may lose as much as 25% of its Medicaid visits. In addition, the state is experiencing a severe budgetary crisis and if it does not receive federal support soon, it has indicated that it will cap capitation reimbursements at $60 a visit. For as long as Rita can remember the health departments have given the center all the immunization and vaccines it needed. The Health Department has informed the center that it may not be able to continue the program. If the Health Department discontinues this program, the current variable cost per visit ($21.88) will rise to $25 per visit. Like most governmental agencies the county is not immune to the financial crisis currently being experience by the state. In search of re-election safe revenues, the county has proposed that not-for-profit organizations pay a fixed fee in lieu of taxes for fire, police and sanitation services. Such a fixed fee would add $25,000 to the Center’s current budget. Rita has prepared the preliminary revenue and expense budget which appears in Table 1 below.

<table>
<thead>
<tr>
<th>Table 1: Estimated Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries and Wages</td>
</tr>
<tr>
<td>Fringe Benefits</td>
</tr>
<tr>
<td>Purchased Services</td>
</tr>
<tr>
<td>Other Costs</td>
</tr>
<tr>
<td>Total Costs</td>
</tr>
</tbody>
</table>

Based upon the full and part-time physicians employed, under contract, and the support of the nurse practitioners, Rita estimates that the center will see approximately 27,674 patients in the
coming year. She indicated that the Center is approaching its physical capacity of 30,000 patients a year. The Center has experienced significant increase in migrant visits, particularly during the picking season. In order to increase physical capacity to 45,000 patient visits a year, the center would incur an additional $40,000 in annual fixed expenses. Variable costs comprise approximately 30% of the Center’s budget. A breakdown is provided in Table 2 below.

<table>
<thead>
<tr>
<th>Table 2: Budgeted Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cost Mix</strong></td>
</tr>
<tr>
<td>Variable</td>
</tr>
<tr>
<td>Fixed</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

The estimated revenue budget and reimbursement rates are presented below in Table 3.

<table>
<thead>
<tr>
<th>Table 3: Estimated Revenue Budget and Reimbursement Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Source</strong></td>
</tr>
<tr>
<td>Medicaid</td>
</tr>
<tr>
<td>Medicare</td>
</tr>
<tr>
<td>Third Party Insurance</td>
</tr>
<tr>
<td>Self-Pay</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

Medicaid will pay the Center slightly more than Medicare because it supports certain preventive healthcare programs. After presenting the proposed budget, Rita thanked Marty for all his support over the years. Before leaving to catch a plane, Rita assured Lyn that Marty would provide her with all of the necessary technology and consultation she needed to efficiently manage the CFO’s office. Marty has asked Lyn to study the information presented by Rita. He had an appointment at the Office of Health Grants Management within a week and needed to be prepared to answer all questions put forth by the grant management team.
REFERENCES


Title 42, Code of Federal Regulations, part 51c. Section 303.

Title 42, United States Code, 9902 (2).
VIRTUALLY THERE TECHNOLOGIES:  
A CASE STUDY OF EARNINGS MANAGEMENT  
AND FRAUD

Dean W. DiGregorio, Southeastern Louisiana University  
H. Lynn Stallworth, Southeastern Louisiana University  
Robert L. Braun, Southeastern Louisiana University

CASE DESCRIPTION

The primary subject matter of this case concerns recognizing and correcting earnings management and fraud. Secondary issues include helping students to develop professional judgment and to become aware of typical reporting problems experienced by growing companies. The case has a difficulty level of three and is appropriate for junior-level students in intermediate financial accounting courses. It could also be used at level four in a senior-level auditing class. The case is designed to be taught in 2.5 class hours and is expected to require 4 hours of outside preparation by students. Alternatively, the case can be assigned as a project that requires minimal classroom time.

CASE SYNOPSIS

Earnings management has received a great deal of publicity by the press and increased scrutiny by the SEC. However, many students do not understand how earnings management and frauds are perpetrated, the extent to which “gray” areas exist in accounting practice, and the role that professional judgment plays in determining the correct course of action. This instructional case is designed to help students learn to recognize earnings management and fraud, to develop professional judgment, and to become aware of typical reporting problems experienced by growing companies. Students are required to identify problem situations and differentiate between unintentional errors and omissions, aggressive accounting practices and fraud. They must also propose adjusting journal entries and determine the effect on income. The case is based on a fictional fast-growing high tech company, Virtually There Technologies, which manufactures and markets virtual reality game systems. In the wake of the abrupt departures of the CFO and controller, students assume the role of the new controller. Their job is to get the financial records in order before the annual audit of the company financial statements begins.
VIRTUALLY THERE TECHNOLOGIES: BACKGROUND INFORMATION

You have been hired as the controller for Virtually There Technologies (VTT), a small high tech company that has demonstrated steady growth since it introduced its first products in the mid-1990s. Your job is to get the financial records in order before the annual audit of the company financial statements. You are assuming the role of controller at an important and exciting time for the company. The previous CFO and controller resigned during the last month of the fiscal year citing “personal reasons” for their abrupt departures. There have also been quite a few contentious issues with the audit firm in recent years. To help manage the audit situation, the Interim CFO has asked that his office clear all information requested by the auditors before it is passed along to the auditors.

Virtually There Technologies develops, manufactures and markets virtual reality game systems. Its product line occupies a high-end niche by utilizing high definition video output technology and total sensory involvement. In addition, the company has created a line of software products for owners of the systems. VTT participates in B2B commerce through its efforts to place its hardware products in electronics retailing chains and B2C commerce through its on-line retail software enterprises.

The Board of Directors, consisting primarily of top management and members of their immediate families, appointed the Vice President of Marketing to serve as the Interim Chief Financial Officer (CFO). The assistant controller filled in until you were hired one month after the end of the fiscal year. As is common with many start-up companies, compensation comes mainly in the form of stock options and bonuses and varies significantly from year to year.

The President of VTT has an engineering background and recently completed an Executive Master of Business Administration degree at a local university. Although originally focused on technical innovation and research, his recent focus has been on the fiscal affairs of the business. He exercises strong control over all aspects of the company, and has been especially preoccupied with increasing quarterly earnings and entertaining the financial analysts who have become increasingly interested in the organization. This interest has been fueled by reports that the company will make an initial public offering of its stock this year. He has impressed the financial community with the depth of his knowledge of technical and financial affairs of the organization and his bold predictions for unprecedented growth with the development of new products.

A new major competitor entered the high-definition, integrated virtual reality market late in the third quarter of the last fiscal year. This competitor is very well established with the younger end of its demographic group. In fact, most of VTT’s younger customers grew up playing on game systems created by the competitor. Analysts are observing this issue closely. Failure to maintain market share in light of increased competition could be detrimental to VTT’s hopes of going public. As competition in the industry heats up, analysts expect to see increased consolidation through business failures and acquisitions.

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Central to its hopes of competing effectively in the increasingly competitive market is VTT’s new product line. Although it has not yet reached viability due to problems with the memory modules on the product, the company has scheduled a press conference to unveil the prototype in two months and is assembling products without the troublesome memory modules. In addition, they have developed software products to be used by the new hardware unit and are producing new titles in anticipation of demand for the product following its introduction.

**REQUIREMENTS**

Before beginning the assignment, you may want to review the Supplemental Instruction Materials included at the end of the case. These materials discuss specific accounting practices that can be used to manipulate earnings and perpetrate fraud.

A. For each item presented after this section, identify the problem and discuss how it should be handled. The descriptions should be written in the form of a memo to the president and numbered. Address only the adjustments for the year-ended December 31, 2001. For each item, state whether it appears to be the result of an unintentional error or omission, a potentially intentional misstatement, a fraudulent action (intentional), or an aggressive interpretation of generally accepted accounting principles.

B. Prepare any necessary adjusting journal entries and determine the effect of each entry on net income (record in a format similar to the following example). The company uses the perpetual inventory system. However, in cases where an adjusting journal entry would normally be made to the “inventory short/over” account, the “cost of goods sold” account should be used instead. After all required entries have been prepared, the effect on income column should be totaled and net income before taxes should be calculated. The net income before taxes for the year, before any required adjusting journal entries is $1,864,000.

<table>
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<tr>
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<th>Effect on net income</th>
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<td>1</td>
<td>Income per trial balance</td>
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**ADDITIONAL INFORMATION**

While reviewing the preliminary December 31, 2001 financial statements, several items caught your attention. Net income before taxes for the year was $1,864,000 compared to a net loss of $5,171,000 in the prior year. Both sales and the gross profit ratio have increased significantly.
compared to the prior year. The average collection period for accounts receivable has increased as a result of the increase in the average accounts receivable. The inventory turnover has decreased due to the increase in the average inventory. The asset turnover has increased because of the large increase in sales. As you continued to perform account analysis, you became aware of a number of accounting issues.

**SALES AND SALES RETURNS**

You were concerned whether the sales cut-off had been performed properly and that all sales returns received before year-end were properly recorded. During your investigations you discovered the following items:

1. While testing items in the December sales journal, you noted that shipping documents indicated that $800,000 worth of the goods (cost of $640,000) were not actually shipped until the second week of January in the new year. Upon further investigation, you determined that the inventory was included in the year-end physical inventory.

2. While reviewing the accounting procedures for sales made on the company’s website, you determined that when the order is placed, the customer’s credit card is charged and the sale is immediately recorded. Goods sold through the website are typically shipped once a week. When the goods are shipped, the inventory account is adjusted and cost of goods sold is charged. While reviewing the general ledger, you noted that there was no balance in the unearned revenue account. Upon further investigation, you determined that software sales of $250,000 were made through the website during the last week of the 2001 and shipped on January 2, 2002.

3. As part of performing the year-end sales cut-off procedures you identified a large sales return that was recorded early in the new year. Upon further investigation, you determined that the sales manager had asked a favorite customer to accept the delivery of game systems before year-end and had told the customer to “Just return them later, and I will take them off your bill.” The systems were invoiced for $600,000 and cost $480,000 to manufacture. You also learned that the sales manager was afraid of being fired because sales for the year were below the forecasted amount.

4. While working in your office, you received a call from an irate customer. The customer complained that she was still being billed for systems that had been previously returned. After speaking with the warehouse supervisor you determined that the systems were returned during the week before year-end. The sales manager had told the warehouse manager not to worry about preparing a return slip until the new year. The warehouse manager also asked you whether it was OK to prepare the return slip now. You further determined that the
systems were counted during the year-end inventory and valued at $250,000. The original sale was recorded at $310,000.

RECEIVABLES

Your main concerns regarding accounts receivable were that the balances recorded on the books were correct and that the allowance for doubtful accounts was reasonable. In addition to the sales cut-off procedures previously performed, you also reviewed the accounts receivable aging at December 31, 2001 and the subsequent cash receipts received in January and February of 2002. During your investigations you discovered the following items:

5. While reviewing accounts receivable, you learned that several vendors have complained about charges listed on their statements. Upon further investigation, you determined that no documentation was available for the sales in question and that there were no entries made for the related cost of goods sold. The sales in question total $350,000. The employee that posted the entries said that they were told to do it by the sales manager.

6. While reviewing the accounts receivable aging you noticed several large 180 day outstanding balances for accounts that were otherwise current. Upon questioning the accounts receivable supervisor you were told that there had been a problem with the orders. The systems shipped were defective and had been returned. The production manager said “New systems would be shipped out so don’t worry about adjusting the books.” Unfortunately, the customers canceled the orders and bought similar systems from a competitor. You also learned that the defective systems could not be economically repaired but were still counted and included in the ending inventory. The inventory was valued at $320,000. The original sales were recorded at $400,000.

7. The company uses the allowance method to record bad debts. The accounts receivable aging is reviewed and a reasonable percentage, based on experience, is applied to each of the various age categories. The allowance for doubtful accounts per the general ledger is then adjusted to its estimated balance. After reviewing the accounts receivable aging and subsequent collections, you estimated that problem accounts receivable totaled $540,000. The allowance for doubtful accounts per the general ledger had a balance of $320,000.

8. While reviewing the accounts receivable system you realized that certain high volume customers were eligible for rebates based on the total annual purchases over a specific dollar amount. You calculated that $300,000 of unrecorded rebates were due at year-end. The rebates were paid in January 2002 and recorded as an expense at that time.
INVENTORY

The introduction of new products and improved versions of existing products occurs frequently in high tech industries. You were concerned that obsolete inventory was properly written off and that a proper classification was made between work-in-process inventory and research and development costs. During your investigations you discovered the following items:

9. While reviewing the perpetual inventory records you noted that several game systems and software products had very little or no activity. The inventory in question had a recorded value of $210,000. Upon discussions with sales and warehouse personnel, you learned that the items were prior versions of current systems and software, and were no longer offered for sale in the product catalog. You were also told that they will probably be thrown out rather than be sold through alternative distribution channels.

10. The newest version of the game system is being produced without memory modules because the “bugs” have not yet been worked out of that part of the system. After inquiring where the costs incurred for the partially completed units were recorded, you were told that they were included in the work-in-process inventory (WIP). Upon further analysis you determined that WIP includes $1,200,000 of costs related to the newest version of the game system. This amount includes components with a cost of $800,000 that can be used in other VTT products. The remaining components of the partially completed units are not compatible with any other game systems produced by the company. In addition, the software that is to be used exclusively by this game system is capitalized as finished goods inventory. The costs associated with the software are $280,000.

11. In your discussions with the marketing department, you found out that they just rolled out a new campaign in which they made shipments of game systems to several major electronics retailers under terms that they could take, display, and sell the systems for three months. Any systems that were not sold in the three-month “trial period” could be returned. Payment for the systems sold (or additional systems that they wanted to keep on hand) would need to be paid for during the fourth month of the special promotion. The shipments were made on December 1. Sales were recorded in the amount of $750,000 and the related cost of goods sold were recorded in the amount of $600,000.

FIXED ASSETS AND INTANGIBLES

You were concerned that fixed assets and intangibles were properly recorded, that related period costs were properly expensed, and that the capitalized costs were properly allocated over the economic useful life of the assets. During your investigations you discovered the following items:
12. While reviewing the depreciation schedules you noted that all of the estimated useful lives and salvage values had been increased during the year to unrealistic levels. After correcting and updating the depreciation schedules, you determined that depreciation expense for the year was $2,100,000. While reviewing the general ledger, you noted that a standard journal entry in the amount of $100,000 had been posted to depreciation expense each month during the year.

13. While reviewing intangible assets you noted an account labeled “customer acquisition costs” with a balance of $250,000. Upon further investigation you determined that the costs were related to creating and mailing a CD containing several of the company’s lesser-known games to individuals who had registered with the company when they joined the users group. The software automatically expires 30 days after it is accessed for the first time. None of the costs had been amortized during the year.

14. While reviewing the patents account you noted that $200,000 had been capitalized in connection with the purchase of a patent that related solely to the memory modules for the new game systems. At year-end, the memory module still did not function properly.

15. While reviewing computer software costs which had been capitalized, you noted that outside programmers had been paid $700,000 to develop new software programs for the virtual reality game systems. Upon further investigation you determined that $500,000 had been incurred before working versions were created.

16. While reviewing the accounts payable cutoff, you were informed that all invoices received in January 2002 for purchases of component parts and other materials were recorded as January purchases. After spot checking the large invoices you determined that $250,000 of purchases were delivered in December, but were recorded as January payables.

17. While inquiring if there were any vendor invoices that had not been entered into the system, a nervous employee mentioned that you might want to look in the former controller's file cabinet. When you investigated you found a thick folder containing invoices for that never been given to the accounts payable department. The invoices were for purchases of electronic components to be used in manufacturing a variety of the company’s successful products and totaled $350,000. They all related to the year just ended.

ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

You were concerned that all December 31, 2001 liabilities were recorded in the proper period. As such you reviewed the January and February 2002 purchase journals and cash disbursement journals for a proper accounts payable cut-off. You also searched for unre corded liabilities. During your investigations you discovered the following items:

16. While reviewing the accounts payable cutoff, you were informed that all invoices received in January 2002 for purchases of component parts and other materials were recorded as January purchases. After spot checking the large invoices you determined that $250,000 of purchases were delivered in December, but were recorded as January payables.

17. While inquiring if there were any vendor invoices that had not been entered into the system, a nervous employee mentioned that you might want to look in the former controller's file cabinet. When you investigated you found a thick folder containing invoices for that never been given to the accounts payable department. The invoices were for purchases of electronic components to be used in manufacturing a variety of the company's successful products and totaled $350,000. They all related to the year just ended.
18. The company uses commissioned salespeople to handle all sales to electronics retail chain stores. While inquiring about the existence of accrued commissions, you were told that salespeople are not paid until the accounts receivable are collected. At year-end, the relevant accounts receivable totaled $3,200,000 and the commission rate was 5%. You also noticed that commission payments of $150,000 were paid and expensed during the first week of the new year. They were based on December collections. At year-end, there was no liability recorded on the books for accrued commissions.

19. While reviewing the January 2002 payroll journal you noticed that payroll of $80,000, for the week ending December 31, 2001, was actually paid and expensed on January 4th, 2002. There was no other unpaid payroll. At December 31, 2001, there was a $20,000 CR balance in the accrued payroll account.

SUPPLEMENTAL INSTRUCTIONAL MATERIALS

The goal of earnings management and fraudulent financial reporting, or financial statement fraud, is usually to materially overstate reported net income in order to make a business look stronger than it actually is. To overstate net income, net revenues can be overstated, and expenses can be understated. Some of the usual methods used do each are described in detail in the paragraphs below.

It should be noted that not all material misstatements and omissions are a result of fraud or inappropriate earnings management. Care should be taken to differentiate between aggressive accounting practices, alternative interpretations in “gray” areas, errors, omissions, and fraud. There may be aggressive but legitimate accounting practices which increase reported net income. There are also honest differences in opinion regarding how certain types of transactions should be reported. Mistakes are unintentional and should be in both directions. That is, they may increase or decrease reported income. If all the mistakes are in the same direction and increase net income, then there is a question of whether they were unintentional or intentional. Fraud is the result of intentional misstatement or omission, and the effect on income is usually only in one direction.

Earnings management and fraudulent reporting may be done in order to benefit a particular individual, or the company as a whole. For example, executives or employees who are afraid of losing their jobs, or whose level of compensation (for example, bonuses or the value of stock options) is contingent on operating results, may be tempted to overstate the company’s reported earnings. Similarly, a business owner that desires to sell the company or obtain additional financing may face the same temptation. Likewise, if the company is close to violating debt covenants, management may feel pressured to inflate net income.

The following sections review various means by which a company can manage earnings or perpetrate fraud.
OVERSTATEMENT OF NET REVENUES

Some of the methods used to overstate net revenues for a period include performing an improper sales cutoff, recognizing income too early, recording fictitious sales, not recording actual sales returns, and misclassifying the proceeds from the sale of assets, debt or equity.

The purpose of the sales cutoff is to ensure that all sales are recorded in the period in which the revenue was earned. This is generally, the period in which the goods were shipped or the services provided. By performing an improper sales cut-off, actual sales from the following period can be recorded in the current period. This is done by keeping the sales journal for the current period, open into the next period. In addition, goods can be billed before they are actually shipped. Services can be billed before they are actually performed. Customer deposits received can be classified as sales, even though the goods or services have not yet been provided. Many desperate people have justified these types of actions by believing that it is just a timing difference and that the problem will reverse itself out in the following period. In fact, they usually start a vicious cycle that requires even larger misstatements in the following periods. The income overstatements created by the above actions are compounded when a periodic inventory system is used because both, the sales are overstated, and the related cost of goods sold are understated.

When revenues can not be increased sufficiently by performing an improper sales cutoff, the next step often taken is to record fictitious sales to either actual customers, or customers which do not exist. For example, legitimate invoices can be recorded more than once, actual orders can be over billed by overstating the quantity shipped and/or the price per unit, or totally fictitious sales can be recorded.

When sales returns are not recorded, net sales are overstated. The problem is further compounded by the effect of the returned goods on ending inventory and cost of goods sold. Excuses for not recording sales returns may range from the potentially legitimate "The return was not approved" or "We were going to reship the correct goods within the same period without charge," to the more severe problem "Joe told me not to do anything until next year." It should also be noted that even if sales returns were not approved before being accepted, there is a high likelihood that the customer will not pay the invoice and the valuation of the accounts receivable will become an issue. Also, a high level of sales returns may also indicate a problem with the quality of the inventory and require a valuation adjustment.

When proceeds from the sale of fixed assets are reported as sales, many problems can arise. First, sales are overstated and the gain/loss is understated. Second, the net book value of the assets (cost - accumulated depreciation) is often not removed from the books and this results in an overstatement of the net fixed assets and an understatement in the cost related to the sale of the asset. Third, depreciation expense may be calculated on assets that are no longer owned. And fourth, profit margins may become misleading since revenues are misclassified between operating and non-operating items.
If the issuance of debt is misclassified as a normal sale, net revenues and retained earnings will be overstated, and liabilities will be understated. If the issuance of equity is misclassified as a sale, net revenues and retained earnings will be overstated and common stock will be understated.

**UNDERSTATEMENT OF EXPENSES**

Some of the methods used to understate expenses include overstating inventory, failing to properly adjust the carrying value of assets, capitalizing items which should be expensed, and understating normal liabilities. In addition, if losses are expected as a result of litigation, claims, and assessments, and they are not recorded, then expenses may be materially understated.

When inventory is overstated, the related cost of goods sold is understated. Inventory can be overstated by overstating the counts, costs, or extensions on the inventory listing for actual and fictitious inventory. It can also be overstated by treating inventory held on consignment as being owned by the consignee.

By failing to properly adjust the carrying value of assets such as accounts receivable, inventory, and investments, then expenses such as bad debts, inventory holding losses, unrealized losses, and other impairment losses can be understated.

When transactions are capitalized, they are recorded as assets, instead of expenses. If done inappropriately, assets will be overstated, and expenses will be understated. For example, transactions that should be recorded as repairs and maintenance may be capitalized as fixed assets.

When liabilities are not recorded, or are not properly adjusted, then usually expenses will be understated. Some of the ways that liabilities can be understated include performing an improper accounts payable cutoff, intentionally not recording all legitimate bills received, and not adjusting accrued liabilities to their proper balances.

The purpose of the accounts payable cutoff is to ensure that liabilities are recorded in the period in which they were incurred. This is generally the period in which the goods or services were received. By performing an improper accounts payable cutoff, purchases in the current period can be recorded in the following period. This is done by either closing the current purchase journal before all the bills for the period are received or by choosing to record current invoices in the purchase journal for the following period.

When performing an accounts payable cutoff, usually, the purchase journals and cash disbursements journals for the one or two months after year-end are reviewed to determine if any material items have been recorded in the wrong period. If a client is familiar with this audit technique, and wants to intentionally understate liabilities, he or she may hold invoices and not give them to the accounts payable clerk to enter into the system. If legitimate bills are not entered into the system in the proper period, then expenses and liabilities will be understated.

When accrued liabilities are not adjusted to their proper balances, usually both the liabilities and the related expenses are understated. Frequently, the unrecorded accrued liabilities will be
recorded as direct distributions (i.e. expenses) in the cash disbursements journal, in the period when actually paid.

As part of an audit, the auditor sends legal letters to the client’s legal representation. The attorneys are expected to disclose matters related to current and pending litigation, claims, and assessments. For example, the attorneys should address the client’s expected response (settle, contest), the expected results (win, lose), and the range of expected losses. Examples of litigation, claims, and assessments include: lawsuits related to the nonperformance of contracts, product liability lawsuits, product warranty liabilities, workman’s compensation claims, personal injury claims, construction contract disputes, and environmental cleanup cost assessments. The expected damages can be material. To conceal the problem, clients may either not disclose potential problems to their auditor or attorneys, or may pay attorneys off the books so that auditors do not know about the related litigation.
FUTURETECH AND LOGOISTICS: AN AFFAIR TO REMEMBER*

David Kapuvari, Long Island University
Barry Armandi, SUNY-Old Westbury

CASE DESCRIPTION

The primary subject matter of this case concerns office romance and covert employee companies. Secondary issues examined include group cohesiveness, management controls, fraud, and conflict of interest. The case has a difficulty level of three, appropriate for the junior level. The case is designed to be taught in one and a half class hours and is expected to require 3 hours of outside preparation by students.

CASE SYNOPSIS

Logoistics, a high tech manufacturer in the Northeast, is a global leader in wireless security and surveillance equipment. In the Test Engineering Department of the Printed Circuits Board Division, three engineers and one technician started a secret company, called FutureTech. FutureTech member's were using Logoistics' resources and were even performing services for some of Logoistics' competitors. At the same time, an affair was occurring between one member of FutureTech (Harry) and another associate in the Test Engineering Department of Logoistics (Donna). This latter non-member of FutureTech was secretly conducting a second affair with another member of FutureTech (Matt). A violent outburst occurs between Harry and Donna resulting in Harry's arrest. Logoistics' management discovers both the affairs and the covert Company and is considering what to do. The reader is left with the decisions that upper management must make regarding the individuals in the affairs and those within FutureTech.

INTRODUCTION

"What a bunch of idiots," commented Fred Black, Logoistics' Senior Vice President of Human Resources. "Don't they realize they could ruin their careers, not just here but in the entire industry," he continued. "And the personal lawsuits..." responded Robert Stein, Logoistics' Director of Printed Circuit Boards (PCB). "But remember Fred, we have two problems here...", Stein nervously stressed. Thinking aloud, Black stated, "what should we do?"
BACKGROUND ON LOGOISTICS

Logoistics, a high tech manufacturer in the Northeast, was a global leader in wireless security and surveillance equipment. Logoistics produced wireless audio and video surveillance recording devices. Logoistics wireless large-scale products were installed at more than 600,000 customer locations and its miniaturized ones (more commonly known as "bugs") in more than 10 million locations worldwide. Logoistics' global network of business partners provided products and services to both manufacturing and service type organizations, including retailers, transportation, banks, healthcare, and education.

Logoistics Inc. was co-founded in 1970 by Joseph Sergi who was its CEO and President. After obtaining his doctorate in optical physics and with financial support from family and friends, he was able to develop a miniature camera and audio recorder. In 1975, the Company introduced the "LaserTron", a laser security device capable of invisibly detecting intruders. In 1984, Logoistics launched the "LaserBase" which not only identified intruders, but also stored the information in a database for future analysis. In 1992, Logoistics introduced the first commercially available wireless miniature detection devices, making surveillance portability and information storage complete. Since 1992, other products emerged to continue Logistics dominance in the field.

All of Logoistics products required extensive use of highly complex and sophisticated technology supplied from a large pool of vendors. These supply companies were carefully screened for component reliability and quality, adhering to all Logoistics specifications. Some of these components were microchips, printed circuit boards, lenses, and various microelectronics. Logoistics' financial information for 1999 and 2000 is contained in Appendix A.

THE TEST ENGINEERING DEPARTMENT

The following incidents happened in the Test Engineering Department of the Printed Circuit Boards Division (PCB) of Logoistics during 1999-2000. Appendix B shows the Organization Chart for the Department.

THE BIRTH OF FUTURETECH

Dynamo Inc., a vendor company of Logoistics, was having difficulty keeping up with the demand for writing test programs for some of its products. Dynamo's sales representative asked Michael Strong and Harry Fried, test engineers for Logoistics, if they could help by writing an In-circuit test program for a third party company. He explained that Dynamo was a little short handed and could use some temporary help. Strong and Fried agreed and wrote the test program. They were paid by Dynamo for their efforts ($10,000) and, seeing how lucrative this type of work could be, they requested more work. To get more work, however, they needed to be on a preferred
vendor list, which included only companies. They decided to form a company and included two more associates, Matt Scott and Sam Kim. They incorporated under the name FutureTech and asked the Dynamo sales representative for more programs to write and test fixtures to build.

FUTURETECH'S OPERATIONS

Using Logoistics licensed In-Circuit test development software, the members of FutureTech started writing programs for Dynamo. Most of the time they found it was easier to write the programs at Logoistics during work hours. They ordered the Test Fixtures from CyberText, a company they frequently used at Logoistics to aid in building test fixtures. They also made a deal with CyberText to give it all the Logoistics test fixture business if CyberText would defer payment on all FutureTech test fixtures. Cybertext agreed to the deal.

The next problem was finding a way to debug the test program with the test fixture. This feat required the use of a Dynamo In-Circuit Test Station, which cost $300,000. Every time they received a job from Dynamo, they would fly to Massachusetts to use their In-Circuit Test Stations. Frequently, two of them would call in sick to their supervisor at Logoistics on a Friday or a Monday. This travel was costly, however, and seriously cut into FutureTech's profits. Therefore, they would concoct reasons for Logoistics to pay for the trip to Dynamo in Massachusetts. They would convince their manager Pat Guarino to authorize a trip because getting sufficient time on Dynamo development stations was frequently a bottleneck. Fried and Strong would make a request to Pat Guarino,

"Pat, we have a lot of hot projects in house and the test engineers won't finish on time unless they can get more time on the Dynamo development stations. Dynamo said we can use one of their machines in Massachusetts for a few days".

Other excuses involved requesting Dynamo training courses for new or specialized applications. Since the department was swamped with work and Pat was himself busy with other projects, he gave his approval without delving into the specifics. Pat had always believed that if you work with professionals, you should be able to trust them to their jobs.

The work from Dynamo only trickled in, so the members of FutureTech pressed the Dynamo Sales Representative for more work. He explained to Strong and Fried that Dynamo annually published a "Third Party Preferred Vendor List" booklet to their clients, which would be an excellent advertising method for FutureTech to acquire more business. FutureTech and the Dynamo representative entered into another deal. The deal was that the sales representative would make a formal recommendation to Dynamo that FutureTech become a "Preferred Vendor", and in return, Logoistics Technologies would buy two new Dynamo In-Circuit Test Stations for $300,000 each. Fried and Strong eventually convinced their manager and director to purchase the two Dynamo In-Circuit Test Stations for $600,000. After the purchase, the stations sat idle at Logoistics for 6 months, since they really were not needed.
THE AFFAIR

During all these deals between FutureTech, Dynamo and CyberText, engineer Harry Fried started an in company affair with technician Donna Gold (both Harry and Donna reported to Pat Guarino. See Exhibit 1). Since Donna worked the night shift, Harry frequently stayed late working with Donna. According to other night shift technicians in the Department, Donna and Harry disappeared for hours. One evening a technician was returning to Logoistics from his dinner break, when to his surprise he spotted Fried's oversized SUV in the Logoistics' parking lot. He thought to himself "This is very late for Harry to still be at work. Maybe he's having car trouble again". As he approached the truck, he saw Harry sitting alone in the front seat. He waved, Harry waved back, and then he suddenly saw Donna in the SUV. In his embarrassment, the technician stopped waving and walked away from the truck.

In another episode, Both Donna and Harry were working late one night in the lab, when a technician came in. Harry jumped up from behind the equipment tables in the back, adjusting his pants. He asked what the technician wanted and told him to leave and come back later. The technician left and as he was walking down the hall, turned to see Donna slipping out the rear door. He quickly realized why Harry was so abrupt with him.

Everyone in the PCB Test department was aware of the affair. They knew that Donna had affairs with other people in the company before, but it was usually just temporary. They were also amazed that she was able to continue this way of life without her husband finding out. Her husband was very jealous and often prevented her from attending any of the Departmental social outings. Both Donna and her husband were members of a motorcycle gang, and her husband was prone to violence. If he ever found out about the affair, he probably would cause a great deal of bodily harm to Harry. His jealousy was justified since Donna's past and her current actions were very risqué. She liked the attention from men, and frequently wore tight cotton blouses with one too many buttons open in the front.

THE TRIP TO MASSACHUSETTS

Harry and Donna, wanting to spend more time with each other, arranged a one-week "FutureTech" trip to Dynamo in Massachusetts to work on a test program for the new Dynamo In-Circuit Test Station the department purchased. Donna went as Harry's aide to help on the program. Pat Guarino was informed that the trip was necessary because the program needed to be ready before the new station arrived at Logoistics. Michael Strong and Matt Scott were going to Massachusetts the following week to complete the program. The week passed and Donna came into work, but Harry never returned. Everyone in the Department asked Donna if Harry was okay, because he had not shown up for work and did not call in. She replied that Harry got very sick in Massachusetts. The second week passed, and still there was no sign of Harry. Mike and Matt
returned from Massachusetts, and Donna immediately had a private meeting with them. When some of the engineers and technicians inquired about the nature of this meeting, they were informed that the Dynamo test program did not get finished because Harry got sick. The group did not buy the excuse and suspicions began to mount.

THE UNRAVELING

Upon returning from Massachusetts, Michael Strong, Matt Scott, and Donna Gold decided to let Pat Guarino and Robert Stein know what happened. Stein called Fred Black of Human Resources immediately and Black suggested getting everyone together for a meeting. Harry finally came into work a week later. He immediately met with Robert Stein who informed him of the meeting to be held the next day. Stein told Harry that Michael, Matt, and Donna presented their side of what happened in Massachusetts. Stein also let Harry know that he, Pat, and Fred knew about the affair with Donna. They wanted to hear Harry's side of the story.

After meeting with Stein, Harry briefly got together with engineer Jerry Kane, who had only started with Logoistics two weeks earlier. Jerry and Harry had worked together at another company for several years and Jerry was hired mainly because of Harry's recommendations. Harry was quite distraught over what had happened in Massachusetts.

Since he considered Jerry a friend and he knew that rumors would be circulating, Harry decided to let Jerry know what had happened. Late one night, Harry and Donna were in their separate hotel rooms preparing for bed. Harry was actually thinking about leaving his wife for Donna, because he thought he was in love. Harry picked up his hotel room phone and called Donna's room. The line was busy. "Who could she be talking to this late" Harry wondered. He then called her house in New York. The phone rang and he hung up. "If she's not talking to her husband, whom is she talking to?" Harry again wondered. In recent weeks, he had been getting suspicious of Donna and Matt Scott, so he called Matt's house. His line was busy. "Aha," Harry thinks, "she's talking to Matt Scott". He stormed out of his room and pounded on Donna's door. She let him in and he accused her of having an affair behind his back with Matt. Donna confessed to the affair with Matt, and Harry went ballistic. He picked up a water glass and threw it at the wall only a few feet away from Donna. The glass broke and Donna threatened to call security. Harry picked up the phone and dared her to do it. She called and the hotel manager showed up at Donna's room with a security guard. Donna explained what happened. They saw the broken glass on the floor, and arrested Harry for intentional destruction of private property.

THE MEETING

Mike Strong, Matt Scott, Harry Fried, and Donna Gold met with Robert Stein and Fred Black. Donna gave her side of the story but omitted a lot of information about her affair with Harry.
She indicated it was a short-lived fling and as far as she was concerned, it was over. Donna failed to mention about the numerous emails she and Harry had sent each over the last year. She also failed to disclose that she deleted all the email files from Harry's computer concerning her. Harry waited patiently until she finished. Fred then asked Harry for his version. Harry basically repeated what he had earlier told Jerry Kane. He stated that the affair was going on for over a year. He thought he was in love with Donna until he found out about Matt. He was still visibly upset and screamed at Donna, "How could you betray me?" After composing himself, Harry took out of his briefcase a folder. He placed it before Fred Black and said, "This is how much you can trust what she is telling you." Harry had been copying his and Donna's "love emails" to floppy disk, just in case he ever needed them, and printed them out for the meeting. The truth about Harry's arrest, Donna deleting of company emails, and the fact that the two of them were sneaking out of the building during working hours finally surfaced. Donna was flabbergasted and embarrassed.

Fred then turned to Matt and said, "It's not just Donna and Harry. There are others who are involved. I think we need to look further into this." Matt decided to come to her rescue.

"Look Fred, these things happen. We can all tell you of other affairs, incidents, etc. that we have heard throughout the Company, but you probably are aware of them. We made a mistake. However, it was a personal matter, not one involving the Company. We would never do anything to hurt the Company."

Harry was seeing red, and became increasingly upset with every word Matt spoke. Finally, he could take no more and jumped up, pulled another folder from his briefcase, gave it to Fred and yelled, "Here's proof you can't believe anything Mr. Boy Scout is saying to you. Go ahead! Read it! Oh, by the way Matt, here's my resignation letter from FutureTech."

THE DEMISE OF FUTURETECH

Before the Massachusetts incident, FutureTech activities within Logoistics seemed to come to a screeching halt, as the members appeared fearful of losing their jobs. As time passed and no firings occurred, they seemed to regain confidence and an aura of immunity came about them. The members were close and worked well together on FutureTech activities.

When the incidents occurred in Massachusetts, the secret of FutureTech's existence had been maintained, and kept from Logoistics management. However, all the engineers and technicians in the PCB department and several technicians on the production floor were now aware it. For months Harry had been suspicious about Donna and Matt, so he started compiling information about FutureTech's questionable activities within Logoistics. Among this information were the "Dynamo Preferred Vendor List Booklet" and some FutureTech corporate papers. Some documents revealed that FutureTech was conducting business with Logoistics competitors.

With all that was occurring, members of FutureTech became sloppy and someone once left FutureTech documents by the copy machine. In the papers, it explained that a FutureTech associate connected an external modem to a computer in the PCB lab to email prospective clients and connect
to risqué web sites. This enabled them to by-pass Logoistics' Internet security. All this information was in the folder Harry gave Fred and Robert.

THE WALLS COME TUMBLING DOWN

Fred picked up the phone immediately and spoke quickly. He informed the person on the other end what to do and hung up. Within the next five minutes, associates from Logoistics' Information Systems Department and Security showed up in the PCB lab and confiscated the hard drive and external modem from the illicit computer. They also copied the hard drives of Michael Strong, Matt Scott and Sam Kim to the Logoistics network.

Fred addressed the group and said, "There is a lot for us to consider and I must let Joe Sergi and our legal counsel look at this information. This is a very serious matter. I will get back to you by the end of the day. Until such time, don't discuss this matter with anyone."

Mike, Matt, Harry, and Donna left. Fred looked out the window and stared. Robert began to speak but the phone rang, interrupting him. Fred picked it up and listened.

He slammed the phone down. "That was security," he said. "It seems Matt and Harry got into a fight with each other. Security broke it up and escorted them off the grounds… What a bunch of idiots…"

Fred thought out loud "What should we do about Harry and Donna's affair? What should we do about FutureTech and what consequences should there be for those involved?"

NOTE

* All events are true. The organization, individuals, products, and dates were changed to provide confidentiality.
### Appendix A: Financial Data for Logoistics Incorporated

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Revenues</td>
<td>$977.9 Million</td>
<td>$1.139 Billion</td>
</tr>
<tr>
<td>Cost of Goods Sold</td>
<td>547.6 Million</td>
<td>635.7 Million</td>
</tr>
<tr>
<td>Development Costs</td>
<td>1.459 Million</td>
<td>1.847 Million</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>424.11 Million</td>
<td>484.20 Million</td>
</tr>
<tr>
<td>Operating Expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Engineering Costs</td>
<td>71.1 Million</td>
<td>81.9 Million</td>
</tr>
<tr>
<td>Selling and Admin.</td>
<td>194.8 Million</td>
<td>220.7 Million</td>
</tr>
<tr>
<td>Earnings from Oper.</td>
<td>141.8 Million</td>
<td>176.6 Million</td>
</tr>
<tr>
<td>Net Interest Expense</td>
<td>3.5 Million</td>
<td>5.8 Million</td>
</tr>
<tr>
<td>Earnings Before Taxes</td>
<td>138.9 Million</td>
<td>170.9 Million</td>
</tr>
<tr>
<td>Net Earnings</td>
<td>92.9 Million</td>
<td>116.2 Million</td>
</tr>
</tbody>
</table>

### Appendix B

Logoistics Organization Chart
for the Printed Circuit Division's Test Engineering Department
2000

- **Joseph Sergi**  
  Chairman and CEO
- **Richard Conti**  
  Sr. VP Operations
- **Fred Black**  
  Sr. VP Human Resources
- **Robert Stein**  
  Director PCB
- **Pat Guarino**  
  Manager Test Engineering

- Don Luba  
  Test Engineer
- Michael Strong  
  Test Engineer
- Matthew Scott  
  Test Engineer
- Harry Fried  
  Test Engineer
- Jerry Kane  
  Test Engineer
- Sam Kim  
  Technician
- Donna Gold  
  Technician
EAST WEST COMPANY

Henry Elrod, University of the Incarnate Word

CASE DESCRIPTION

The names in this case have been changed and some facts simplified to facilitate classroom analysis and discussion. There may be no correct answers to the issues presented in the case. The case is intended to stimulate classroom discussion, and is not intended to criticize or question the accounting treatment selected by the company or its auditors. The issues involved should help students develop professional judgment in the selection of accounting principles, and emphasize the purposes of financial reporting.

CASE SYNOPSIS

This case is based on events and financial statements reported by SanDisk, audited by Ernst & Young, LLP. The case involves the application of the rules of GAAP, regarding the treatment of realized and unrealized gains and losses on securities held for resale and held to maturity securities, the application of GAAP regarding subsequent events, and impairment of the fair value of assets. Students are asked to choose among conflicting principles, and to decide when the strict application of GAAP may produce misleading results.

EVENTS OF THE YEAR 2000

East West is a manufacturer whose products require a part, the availability of which is constrained by market forces. In some years, there is not enough of the part to go around, while in other years there is a glut of the critical part. This has an adverse effect on East West's operating results, making the year-to-year financial performance erratic. In 2000, East West addressed this problem by buying a ten percent share of a foreign manufacturer of the critical part, Taekwon Corporation, for $150 million. The investment does not provide sufficient voting strength to elect an East West representative to Taekwon Corporation's Board of Directors. While East West operating management asserts that the ten percent interest does not give them significant influence over Taekwon, they have been able to obtain a contractual right to purchase 15 percent of Taekwon's annual output, thus smoothing the supply of the critical part, and East West's operating results. East West earned $1.29 per common share in 2000.
FIRST QUARTER, 2001

Early in 2001, about a year after the original investment, Taekwon was merged into its parent, Hapkido Holding, Inc., in an exchange of stock. The fair value of the new shares East West received for its stock in Taekwon was $600 million. The stock was "lettered," meaning that East West agreed that their current intention was to hold the stock for investment, not to sell the Hapkido shares. Additionally, the Hapkido stock was subject to a shareholder covenant, restricting East West's ability to sell the Hapkido stock for five years. The resale restrictions expire ratably over the five-year period, with 20 percent of the restricted stock becoming available for sale each December, beginning with December 2001.

Management believes the merger transaction is not subject to the accounting rules governing like-kind exchanges of productive assets. The items exchanged are non-monetary securities, not productive assets. Neither Hapkido nor East West are dealers in Taekwon stock, nor in Hapkido stock. Hapkido stock is traded on the New York Stock Exchange, so its market price is readily determinable. East West's share of ownership in Hapkido is significantly less than the ten percent of Taekwon given up. Management believes the correct accounting for the transaction is to record the Hapkido shares at their fair value of $600 million, and recognize a gain, as a component of ordinary income, of $600 million, less the carrying value of the Taekwon stock given up.

THIRD QUARTER, 2001

Early in the third quarter of 2001, Hapkido declared and paid a 15 percent stock dividend to shareholders of record at July 31. While this had no impact on the overall value of East West's interest in Hapkido, the dividend shares were not encumbered by the restrictive covenants. Shortly after learning of the stock dividend, management announced its intention to sell the unrestricted shares.

FOURTH QUARTER, 2001

At December 31, 2001, the restrictions related to 20% of the Hapkido stock expired. Since the intention was to sell the shares as they became unrestricted, management believes the value of the unrestricted shares should be reclassified as "Securities held for resale".

Due to the impact on the stock market of the events of September 11, 2001, the fair value of the total shares of Hapkido that East West owns (restricted, dividend, and unrestricted shares) declined to $200 million, from the earlier $600 million value. Management believes this decline is temporary in nature.
FIRST QUARTER, 2002

After the date of the auditor's report on the financial statement for December 31, 2001, but before the final printing and mailing to shareholders, due to the events in the stock market related to Enron and other accounting scandals, and due to business reverses suffered by Hapkido, the total fair value of the Hapkido shares owned declined to $50 million, from the $200 million year end figure. While the decline at year-end was considered temporary in nature, management believes the current decline should be considered "other than temporary".

REQUIRED

ALTERNATIVE A. (see your instructor).

You are East West's Controller. A summary trial balance for the year ended December 31, 2001, is set out below. None of the transactions related to Hapkido or Taekwon have been recorded, and income tax provisions have not been made. Assume that East West's tax rate is 30 percent. The initial purchase of Taekwon stock, in 1999, has been recorded, at cost.

1. Prepare any/all necessary or appropriate journal entries to record the transactions described:
   a. The exchange of Taekwon stock for Hapkido stock, in the merger.
   b. Receipt of the unrestricted stock-dividend shares.
   c. The expiration of the restrictive covenants on the first 20 percent of the Hapkido restricted shares.
   d. The decline in value at year-end 2001.
   e. The decline in value at the end of the first quarter, 2002.
   f. Any other transactions or events that may require recordation.

2. Prepare an income statement and classified balance sheet, in good form; including appropriate earnings per share amounts, for the year ended December 2001.

3. Prepare notes to financial statements or additional disclosures needed, if any, related specifically to the Hapkido/Taekwon investment, its value, and/or its impact on reported earnings.

ALTERNATIVE B

You are the Chief Financial Officer of East West. Prior to Sarbanes-Oxley East West has purchased significant consulting services and advice from your auditors, and the company expects to continue to do so. Accordingly, you intend to hire new auditors.
1. Prepare a memorandum, to document your file for the new auditors, identifying the accounting issues and significant estimates made by management with regard to the Taekwon/Hapkido investment.
   a. Show the disposition of each item.
   b. For each issue identified, cite the specific authoritative GAAP you are applying by number (FASB 52, APB 5, SOP 96-1, etc., for instance) and paraphrase the applicable principle, rule, convention, or practice.

2. The document you prepare is intended to explain and dispose of the accounting issues, and recap their effect on net income and total assets, so the new auditors can easily follow the complex trail of transactions over the last three years. Prepare a schedule to recap the effect on net income, and earnings per share, of the transactions being summarized, over the various calendar quarters.

**ALTERNATIVE C**

You are a staff auditor, assigned for the first time to the East West audit during the second quarter of 2000, after the fieldwork is substantially complete and the report has been prepared but not published. The audit partner in charge of the job gives you a large file labeled "Taekwon/Hapkido," and explains that there has been a big decline in the value of the investment, prompting some discussion of the propriety of the accounting with regard to the investment, and whether a subsequent event has occurred. He asks you to review the file (which reveals the fact situation substantially as set out in the text of the case above) and to prepare an audit memorandum that will evaluate the significant audit issues, accounting issues, significant estimates, and related effects on the financial reports, and a recommendation as to what, if anything, your firm should do.
### Working trial balance

**December 31, 2000 and 2001**

<table>
<thead>
<tr>
<th>Amounts in $000s.</th>
<th>2001 Preliminary</th>
<th>Dr.</th>
<th>Cr.</th>
<th>Final 2001</th>
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<tr>
<td>Cash and near cash</td>
<td>297,274</td>
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<td></td>
<td></td>
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<tr>
<td>Short term investments (trading securities)</td>
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<td></td>
<td></td>
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<tr>
<td>Investment in Hapkido, unrestricted, held for sale</td>
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<td></td>
<td></td>
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<tr>
<td>Accounts receivable, net</td>
<td>65,573</td>
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<tr>
<td>Inventory</td>
<td>337,548</td>
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<tr>
<td>Prepaid expense and other current assets</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property and equipment</td>
<td>48,909</td>
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<tr>
<td>Investment in Taekwon</td>
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<td></td>
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<tr>
<td>Investment in Hapkido, restricted, held to maturity</td>
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<td></td>
<td></td>
<td></td>
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<tr>
<td>Deposits and other assets</td>
<td>264,133</td>
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<tr>
<td>Accounts payable</td>
<td>(63,722)</td>
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<td>Accrued payroll</td>
<td>(7,655)</td>
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<tr>
<td>Income tax payable</td>
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<tr>
<td>Deferred income tax</td>
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<td></td>
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<tr>
<td>Other accrued liabilities</td>
<td>(85,541)</td>
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<tr>
<td>Notes payable</td>
<td>(188,367)</td>
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<tr>
<td>Common stock</td>
<td>(841,625)</td>
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<tr>
<td>Retained earnings, prior years</td>
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<tr>
<td>Accumulated other comprehensive income (loss)</td>
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<td></td>
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<tr>
<td>Sales, basic products</td>
<td>(459,457)</td>
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<tr>
<td>Other income</td>
<td>(71,679)</td>
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<tr>
<td>Cost of goods sold</td>
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<tr>
<td>Research &amp; development expense</td>
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<td>Selling expense</td>
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<tr>
<td>General &amp; administrative expense</td>
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<tr>
<td>Other expense</td>
<td>25,658</td>
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<tr>
<td>Gains &amp; losses on investment in Taekwon (Hapkido)</td>
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<tr>
<td>Provision for income taxes--current portion</td>
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<td></td>
</tr>
<tr>
<td></td>
<td>-</td>
<td>-</td>
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</tr>
</tbody>
</table>
THE BRIEF CAREER OF CARLY HENNESSEY:
A LOOK AT THE ECONOMICS OF POP MUSIC

Richard H. Fern, Eastern Kentucky University

CASE DESCRIPTION

The two primary topics in this case study are the matching concept which underlies accrual accounting and types of cost behavior patterns for management decision making. The case is appropriate for upper-level accounting majors. With two sets of discussion questions, it could be used in either the first intermediate accounting course or the upper-level managerial course. Either the financial or managerial approaches to the case can be taught in two class hours. Both approaches will require about three to four hours of outside preparation by students.

CASE SYNOPSIS

In this case, students examine financial and managerial accounting concepts in an identifiable setting, the pop music industry. As background to the accounting issues, students get an introduction to the pop music industry through a brief look at two years in the recording life of a sixteen-year old newcomer artist. The industry is revealed through a look at the terms of recording contracts, production and promotion costs and pressures, and the music distribution system. Students can listen to several songs and see the artist's promotional video on the Web as part of the background material.

The primary financial accounting issue is how recording studios account for production and promotion costs for albums of new and untested recording artists. Students decide whether such costs should be treated as revenue expenditures and expensed as incurred or capital expenditures to be deferred to future periods. Students will discover that most new releases never approach even a break-even volume of sales which makes the likelihood of future revenues extremely unlikely. Ultimately, a recommendation is required as to when advances to the artist and the sizeable recording and promotional costs for her album should be recognized. Student activities include accessing the corporate Web site, locating corporate accounting policies regarding music promotion and production costs, researching some GAAP rules for the music industry and discovering a practical application of some basic financial accounting theory.

The managerial accounting issues revolve around cost behavior patterns and break-even analysis. The issues of fixed, variable, mixed, and discretionary fixed costs are introduced. Using
the industry's average break-even level of sales, students are asked to approximate the variable costs for CDs and project what happens to variable costs and record company revenues as sales exceed the break-even level.

CASE

*Billboard Magazine* (April 7, 2001): Carly Hennessy, "I'm Gonna Blow Your Mind": "Fresh from his work on Rod Stewart's latest album, producer/one-time New Radical Gregg Alexander lends his songwriting/production skills to the other side of the demographic spectrum with teen newcomer Carly Hennessy. … this track is infused with such rapturous spirit; "I'm Gonna Blow Your Mind (Really Want to Kiss You) is a playful, affection-filled romp; … accentuated by a rollicking up-tempo beat, organic instrumentation and the impressive, playful vocals of Dublin native Hennessy; … the most promising debut track we've heard this year". CT (*Billboard*, April 2001). These were the initial review comments in early 2001 for the song "I'm Gonna Blow Your Mind" by newcomer Carly Hennessy. To promote her first release, MCA Records spent $250,000 on a promotional video, $200,000 for independent promoters, and $100,000 on "imaging" costs for Ms. Hennessy and $150,000 for a four-week promotional tour. [To hear "I'm Gonna Blow Your Mind" and watch the video, go to: http://www.mcarecords.com/ .]

In 1999, Ms. Hennessy signed a recording contract with MCA (a subsidiary of the French company Vivendi Universal). In her native Ireland she had enjoyed success as a child singer (releasing a Christmas album at age 10) and actress (performing all over Europe in "Les Miserables" at age 13). At age 16, Ms. Hennessy dropped out of high school and came to Los Angeles with her father. Her demo disc caught the ear of an executive at MCA Records who was looking to capitalize on the then current trend toward younger pop artists such as Britney Spears and 'N Sync. MCA originally planned to start Ms. Hennessy in the pop market and then develop her into a more adult sound along the lines of Celine Dion.

Carly signed a six-album contract with MCA. Up front she received a $100,000 cash advance against the first album, $5,000 per month in living expenses and the use of a car. The label would own the music and advance all of the promotion and recording costs. For Ms. Hennessy to earn more, the studio would first have to recover the advances and living expenses, all recording costs and one-half of any video production costs (See Appendix A for more information on contract terms for recording artists).

Record companies argue that such terms are needed since they are taking most of the risk with new, and even, veteran artists. Since sales of 500,000 and 700,000 copies are needed to break even, statistics show that only about 5 percent of albums ever reach profitability. For example, in 2001, of the 6,455 new titles released by the top five music labels, only 112 titles sold over 500,000 copies; only 60 titles sold over 1 million copies [Source: SoundScan]. Record labels depend on a few very
big hits to absorb the costs of all releases. Therefore, labels feel justified in tying new and unproven artists to a minimum number of releases and recouping their development costs from artist royalties.

The first album was completed by the end of 1999. However, neither Carly nor the company was happy with the results. Everyone felt that it was too adult sounding and too serious for the teen market. However, MCA still believed in her ultimate success as a recording artist. In early 2000, MCA hired new producers and writers to rerecord the album from the beginning. By the end of the year, however, the new album was still not completed.

At this point, feeling the pressure of having already committed a lot of time and money to the effort, MCA decided to release her first single. In early 2001, the song "I'm Gonna Blow Your Mind" was released. Despite some limited, positive reactions from the press and the radio industry, the song didn't get much air time. Typical industry impressions were along the lines of "too mature for pop radio", "too pop-sounding for adult top 40" and "... it just didn't have that sound that seemed like it would kick in" (Ordoñez, 2002). The promotional video was dropped after a lacklustre test run on Nickelodeon. Sales of the title were very disappointing.

With the production schedule for the first album falling ever further behind, a new, more veteran manager was hired in early 2001. A release date of November 2001 was set for the album with both spending and production speeded up to meet the deadline. Additional production costs of $650,000 brought MCA's total investment in the album to about $1 million which is considered high for a first effort. However, everyone involved thought that the upcoming album, "Ultimate High", had the makings of a hit.

To overcome Ms. Hennessy's limited name recognition with the public, MCA committed additional resources in a hurried-up promotional campaign for the album. As part of the promotion, a single from the album, "Beautiful You" was released mid-2001

*Billboard Magazine* (October, 29, 2001): Carly Hennessy, "Beautiful You": "Carly Hennessy got off to a promising start with her launch single "I'm Gonna Blow Your Mind". Unfortunately, she got lost in radio's marked turn away from youthful pop, and the song went largely unnoticed. ...this equally compelling follow-up … 'Beautiful You' is a buoyant outing, spirited and optimistic with an adhesive chorus fully capable of locking itself tightly in the memory. A spray of guitars and some "nah, nah, nahs" throughout give it added gusto. These guys have done their jobs; now, MCA, it's up to you to make sure radio gets the message." CT (*Billboard*, October, 29, 2001). ...Despite some favorable reviews like Billboard's and MCA's spending of almost $500,000 on promotion for "Beautiful You", it got even less air time than "Mind". Hopes for a concert tour by Ms. Hennessy were abandoned. Not counting advances and living costs, MCA's investment in Ms. Hennessy was over $2 million.

For a variety of reasons, this was not a very favorable climate for new pop artists to be attempting a breakthrough. In the pop music industry (unlike rock, classical and soul music) successful songs need to be instant hits since they are given little time to "grow" into a success.

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*Journal of the International Academy for Case Studies, Volume 10, Number 3, 2004*
"Early and often" exposure is crucial. This puts tremendous pressure on pre-release and early promotional efforts for the title and the artist.

For songs to be successful, they need a lot of radio air time. But, deregulation of radio station ownership had left the industry dominated by a few big players with a focus on profits. Local stations are under pressure to only play those songs that seemed like immediate hits leaving little time for new songs to "catch on". Air time for new artists is at a premium or restricted to smaller stations.

Large discount retailers (e.g. Wal-Mart) are the fastest growing segment of retail music sales. Unlike traditional music stores, discounters stock a large volume of only a limited number of titles. They stock huge inventories of successful, proven artists but aren't willing to take a chance on new, unproven artists. In this environment, record companies have a harder time getting new and untested titles on the shelves.

World-wide music sales (the U. S. accounts for two-thirds) had been in decline since 1996 and continued dropping another five percent in 2001. The movement from vinyl records to CDs sparked a sales boom that had all but ended by the mid-1990s and no similar sales-generating trend had taken its place. But, perhaps most importantly, pop music had been unable to find new, hugely-popular artists who could continually sell multi-millions of albums. In 2001, for the first time since 1966, no album sold over five million copies (Goldsmith & Ordonez, 2002). Even Britney Spears' latest album only sold one-third as many copies as her first album three years earlier (Nielsen SoundScan!)

Into this market, MCA released Carly Hennessy's single "Beautiful You". Together, her first two singles ("Mind" and "Beautiful You") only sold about 17,000 copies.

*Billboard Magazine* (August 3, 2001): Hennessy's High: With a successful career as a child actor/ model already under her belt, Irish teenager Carly Hennessy now turns her attention to music. Her MCA debut, "Ultimate High", features the A-list songwriting and production talents of the New Radicals' Gregg Alexander and Danielle Brisebois. The lead single is "I'm Gonna Blow Your Mind". Nick Kelly (Kelly, 2002).

At last, the album "Ultimate High" was released in late 2001. Billboard's review pointedly talks more about the production and writing team and the artist's earlier successes rather than her success or promise as a singer. As it turned out, this review was accurately prophetic of the market's reaction to the album. [To hear "Ultimate High", go to: www.mcarecords.com .]

Following the failure of her first two singles, limited air time and lukewarm press, retailers stayed away from the album. Only about 10,000 copies were even ordered. The album generated sales of less than $5,000 (about 400 copies) in its first three months (MusicReviewer.com). To some production executives at MCA, it appeared that Ms. Hennessy's music wasn't rejected by the public; it just never "made it to the public".

After almost three years, MCA had invested well over $2 million in developing and promoting Carly Hennessy. As a last effort, MCA released "I'm Gonna Blow Your Mind" in Europe
in early 2002. In hopes of promoting her in a more favorable market, the album, "Ultimate High", would be released there later.

Meanwhile, Ms. Hennessy vacated her apartment in Los Angeles, turned in her car and moved back to Ireland where she is currently getting ready for the European promotional tour for the album. She is still hopeful that it takes more than one album for artists to find a place in popular music.

<table>
<thead>
<tr>
<th>Table 1: FINANCIAL ACCOUNTING DISCUSSION QUESTIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Based on the trends in the popular music industry over the past few years, briefly discuss the likelihood of any new artist generating at least a &quot;break-even&quot; level of sales for a debut album.</td>
</tr>
<tr>
<td>2 In your opinion, at what point during the first two-year period of her contract (1999-2001) could MCA executives reliably predict the success or failure of Ms. Hennessy's recording career? Justify your answer.</td>
</tr>
<tr>
<td>3 MCA Records is a subsidiary of Vivendi Universal SA (a French company). At Vivendi's Web site, locate the most recent set of financial statements (Form 20-F filed with the SEC). Scan Footnote No. 1 for a description of their revenue and expense recognition policies related to their music holdings (look for: Revenues and Costs - Music).</td>
</tr>
<tr>
<td>4 Put yourself in the role of the controller for MCA. Prepare a brief report recommending the proper accounting for the costs related to the Carly Hennessy project over the years 1999 - 2001. In your report, be specific as to when you think the costs should be recognized as expenses. Make any reasonable assumptions necessary to make your recommendations complete but please identify any assumptions that you make.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Table 2: MANAGERIAL ACCOUNTING DISCUSSION QUESTIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 What does the term &quot;break even&quot; mean? How does a company compute its break-even sales level? On average, about how many copies of a new release have to be sold before the record company breaks even?</td>
</tr>
<tr>
<td>2 In general, what determines whether a business' costs follow either fixed or variable cost patterns? Identify the main costs in the Case (see Appendices A and B) as primarily either a fixed or variable costs for the recording industry. Give reasons for your choices.</td>
</tr>
<tr>
<td>3 What are some other possible cost behaviors other than pure fixed and pure variable costs? Give examples of each related to the recording industry.</td>
</tr>
<tr>
<td>4 Based on your response to question 1 and 2, compute the approximate variable cost for MCA records related to the CD &quot;Ultimate High&quot;. Assume that all costs are either pure fixed or pure variable costs. Does this variable cost per CD seem reasonable? Why or why not? What costs do you think would be included in the variable cost amount? (In this analysis, consider all costs incurred by MCA up to the album's release date as costs related to the CD.)</td>
</tr>
<tr>
<td>5 After a CD reaches the break-even level of sales, what happens to the record company's costs? Is this a change in the fixed costs or variable costs? Explain. Using the data for the album &quot;Ultimate High&quot;, discuss MCA's potential profit on the next 100,000 copies sold above the BE level of sales. How might various provisions in the artist's contract affect this profit? Explain.</td>
</tr>
</tbody>
</table>
Standard terms for a new artist's first recording contract lock them into a minimum number of albums or a number of years (usually one year is guaranteed; company has option for "pick-ups" of other years). This prevents the artist from signing with any other label regardless of their success. However, it doesn't prevent the label from "dropping" the artist at any time by ceasing to produce or promote the artist's music (Ordoñez, 2002). Only after proving themselves in the marketplace can artists dictate better terms. In fact, after some successful releases, it's customary for artists to renegotiate their contracts to more favorable terms.

In the recording industry, record companies must sell between 500,000 and 700,000 albums in order to break even. Recording artists typically earn royalties at the industry standard of 15 percent of sales. Out of that 15 percent however, the artist must absorb additional costs for various promoters, managers and other company fees. At best, artists "net" only about 75 percent of the "gross" royalty. Under the best of circumstances, new artists could expect to make no more than $.80 to $1.00 per album.

Typically the record company "fronts" the sizeable recording, producing, packaging, manufacturing, promotion, and royalties for other writers and artists. These costs are then recouped from the recording artist's royalties. For example, quality producers can sign for a royalty of 3 percent of retail sales. This is paid initially by the record company but ultimately it goes against the artist's 15 percent royalty. The same policy controls many other promotional and touring costs.

There are various other reasons why artists get only a portion of the agreed on 15 percent of retail price for CDs sold. In some contracts, companies charge a "packaging deduction" against retail sales before computing artist royalties. For example, with a 25 percent packaging deduction, the artist only earns their 15 percent royalty on 75 percent of retail. Record companies usually don't pay artist royalties on "free" copies sent with press kits and other promotional giveaways. And, occasionally, artist royalties are only paid on 90 percent of CD sales to cover breakage, returns, etc. (Lathrop & Pettigrew, 1999). Some artist contracts provide for "cross-collateralization" where any costs not recovered on one record are charged against subsequent releases until all costs are recovered (Wassman, 1997).
### Table 3: APPENDIX B - CD PRICING and RECORDING & PROMOTION COSTS

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pricing</td>
<td>Revenue to the recording company is the distributors' wholesale price which ranges from 45% - 60% of retail. New CDs sell at full retail for around $17.99 each. Discounted prices might be $11.99 or on the low end, about $9.99 or lower.</td>
</tr>
<tr>
<td>Recording - Studio Time</td>
<td>The largest record companies have their own recording studios and these costs are included as part of corporate overhead. Other artists rent studio time for the recording, overdubbing, mixing, etc. Hourly rental rates run from $35 to $300. A ten-track CD might require 15 hours per song or 150 hours of studio time.</td>
</tr>
<tr>
<td>Recording - Musicians</td>
<td>Nonunion musicians may cost $25 per hour; union scale is $100 per hour; &quot;name&quot; artists may get as much as $300 per hour. A ten-track CD might require as much as 250 hours of musician time.</td>
</tr>
<tr>
<td>Recording - Producer</td>
<td>The producer oversees and directs all aspects of the recording process. Costs range from $200 to $1000 per track or a royalty up to 3 percent. High-end producers might cost $50,000 or more for a CD.</td>
</tr>
<tr>
<td>Recording - Engineer</td>
<td>The engineer handles the technical recording aspects. Costs $25 to $50 per hour.</td>
</tr>
<tr>
<td>Recording - Media</td>
<td>Costs range from $200 to $500 per CD.</td>
</tr>
<tr>
<td>Recording - Mastering</td>
<td>Final polishing of the recorded tracks necessary for the finished &quot;master&quot; copy. Includes evening out the audio levels and tone. Ranges from $600 to $2400 per CD.</td>
</tr>
<tr>
<td>Packaging</td>
<td>Costs will depend on the colors, graphic designs, size of enclosures, printing, image reproductions, etc.; perhaps $.15 to $.90 per CD.</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>Reproduction of master recording costs around $1 per CD.</td>
</tr>
<tr>
<td>Promotion</td>
<td>This is the most unpredictable of the total costs since most of these expenditures are discretionary. Costs include press kits (from $.50 to $3.00 each), collateral (posters, bumper stickers, post cards, etc.), mailing lists, mailing costs, publicity campaign, advertising, tour support. Total costs might run from $2,000 on the low end to well over $50,000 per release.</td>
</tr>
<tr>
<td>Royalties</td>
<td>These are percentages paid to certain participants in the project. Depending on the terms, amounts are based on sales or distribution. Royalties to the primary artist run from 10 to 15 percent of retail selling price for CDs sold. Up front advances to the artist are deducted from future royalties earned but unrecovered advances do not have to be repaid. Mechanical royalties are paid for use of material written by others. Payments are $.071 per song or $1.35 per minute of playing time per CD made and distributed.</td>
</tr>
</tbody>
</table>
REFERENCES


WORLDCOM INC.: SURVIVAL AT STAKE

Kamala Gollakota, University of South Dakota
Vipin Gupta, Grand Valley State University

CASE DESCRIPTION

The primary subject matter of this case concerns management of mergers and acquisitions in a turbulent environment. Secondary issues examined include strategic, organizational, and competitive issues that push the companies to the brink of destruction, and that may induce them to breach the boundaries of ethics and accountability for remaining afloat. The case has a difficulty level appropriate for first year graduate level. The case is designed to be taught in 1.5 class hours and is expected to require 2 hours of outside preparation by students.

CASE SYNOPSIS

Accounting fraud issues have taken the center stage whenever there is a discussion about the bankruptcy of WorldCom. However, the fraud issues were just an outcome of a deep-rooted deterioration in the performance fundamentals of WorldCom. In this case, we discuss some of the strategic, organizational and environmental issues that led to the survival challenges, and hence precipitated ethical irregularities and downfall of the company.

INTRODUCTION

Considerable attention has been focused on WorldCom in recent months. WorldCom has the dubious distinction of being the company responsible for the biggest accounting fraud and bankruptcy in the US till date. It may be tempting to view WorldCom mostly as an example of how unethical behavior leads to bankruptcy. However, to do that would miss out on a major lesson in management. An analysis of the company's performance shows that the company was having severe problems even before the accounting fraud issue surfaced. Had the company stayed on that trajectory, it might be speculated that it would have moved into bankruptcy sooner or later. WorldCom suffered from strategic and organizational dilemmas and was in an industry facing tremendous turbulence. The aim of this case is to identify the strategic, organizational and environmental issues that led to the decline of WorldCom.
The foremost characteristic of the telecommunications industry is one of change. The twin drivers of change have been technology and regulation/deregulation. Traditionally telecommunications meant communicating by telephone and historically one company provided the service: AT&T. AT&T was considered a natural monopoly and controlled all aspects of telephony: local, interstate and international long distance. However, in 1963, MCI filed with the FCC to be allowed to provide communication services. In 1969, MCI was granted permission to do so, and started voice transmission over microwave links between St. Louis and Chicago. Other companies followed suit but competition was hampered because of AT&T's control over the local exchanges. In 1984, AT&T was ordered to breakup. The long distance business was created as a separate company and retained the AT&T name. Long distance telephone services were opened up to competition while the local exchanges were still monopolies. The local exchanges (connections to millions of individual homes) - RBOC's (Regional Bell Operating Companies) were created into 22 separate holding companies. Each RBOC served between 12 and 20 million customers and reported assets in excess of $20 billion. These local exchanges were required to give access to the long distance companies to reach individual homes through their network (for an "access fee": fees paid by long distance providers to local exchanges to transmit the long distance call to the homes of the customers). Numerous companies jumped in to offer long distance services - WorldCom was one of these.

WORLDCOM ENTERS THE MARKET

In 1983, WorldCom was launched under the name LDDS - Long Distance Discount Service by Mississippi businessmen Murray Waldron and William Rector. Its business was to resell long distance phone service. The company ran into difficulties by 1985, and Bernie Ebbers, who had invested in the company became its CEO. Ebbers would lead the company through its meteoric rise and even faster fall. The company expanded beyond its base in Mississippi and went public in 1989. In May, 1995, LDDS changed its name to WorldCom.

Ebbers, originally a high school basketball coach who moved to Mississippi from Canada was managing a chain of motels. When he took over LDDS, he had no background in telecom. Wearing faded jeans, cowboy boots and turquoise jewelry he described his organization as "Our personality is to be very loose. We aren't stuffed- shirt people" ("Bernie's Deal," 1997). However, he was an aggressive businessman, and a compulsive deal maker. His vision of growth was by acquisition. Major acquisitions included Advanced Telecommunications Corporation (a long distance reseller which gave it access to its business customers), Metromedia Communications Corporation and Resurgens Communications group (both full service long distance providers), IDB Communications
group (which in addition to a having domestic and long distance telephone network, had facsimile and data connections, television and radio transmission services and mobile satellite communications capabilities) and Williams Telecommunications group (WilTel), (which came with 10,000 miles of fiber and 1000 miles of microwave technology). One of WorldCom's most significant acquisitions was of MFS Communications. MFS came with local network access facilities via digital fiber optic cable network and most important, owned UUNET technologies. UUNET was a leading internet provider that catered primarily to business customers.

The pattern underlying these acquisitions and mergers seems to be an attempt to obtain end to end ownership of the networks. Many of these companies were similar to WorldCom in that they were entrepreneurial start ups. Majority were in markets with high growth, and WorldCom often paid top dollar to own them. With these acquisitions WorldCom transformed itself from a patchwork of regional long-distance resellers into a network of facilities-based service providers, competitive local exchange carriers and backbone network operators. By 1996, it had revenues of $5.4 billion and was the fourth largest provider of long distance services in the US with a strong internet presence. Its competitors in the long-distance telephony arena included AT&T, the largest, with $47 billion in annual revenue, followed by MCI with $15 billion annual revenue, and Sprint with $14 billion in annual revenue. The top four telephony companies (AT&T, GTE, BellSouth, and NYNEX) accounted for 60 percent of all telephony - local and long distance - revenue dollars.

Although WorldCom was growing rapidly with its acquisitions, problems were emerging in the telecommunications industry. At the cost end, the RBOC's who provided local service ("the last mile" - providers of service between the home/office and the long distance company's switches), continued to have monopolies. Although local access was mandated by the FCC, access charges (charges paid by the long distance telephone company to the local telephone company) were high. Long-distance carriers typically paid 30 to 40 percent of gross revenues for local origination and termination of long-distance calls. High access fees and allegations of non-cooperation from local exchange companies in getting access to the local networks, were common complaints from long distance providers. Price pressures were felt because of increasing competition, low switching costs and the increasing commoditization of long distance service. The price of long distance calls dropped sharply, while the price of local calls rose. These developments prompted the Telecommunication Act of 1996.

**THE TELECOMMUNICATION ACT OF 1996, CONVERGENCE AND UNPARALLELED DEMAND**

The Telecom Act of 1996 resulted in further deregulation of the industry. Under this Act, long distance carriers were allowed to provide local phone service (including by setting their own facilities and thereby avoid paying high access charges). Further, local carriers were required to
make individual components of their networks available at wholesale prices to the resellers. Local carriers who opened their networks to competition were allowed to offer long distance services. This Act cleared the way for a whole range of competitors. There were two business models: operate as a facilities-based provider or operate as a reseller. Facility based providers invested in laying the communications lines and networks. Resellers, however, did not need to expend capital on laying lines, but could lease the networks of the provider and resell these to consumers. While resellers had been around even before the Telecom Act of 1996, the Act of 1996 required the facility-based carriers to provide access to the resellers at wholesale prices (Oliver, 1997).

In 1993, the FCC had cleared the way for telephone companies to enter the information services business, including computer data services, financial services, stock quotes, and news reporting. They were also permitted to deliver video services, although like the cable companies, they could not own the program content. Even though the telephony market structure shifted from a monopoly to an oligopoly, on the eve of the 1996 Act, there was little product differentiation. Differentiation was usually an illusion created by varying small, nonessential aspects of a product or service. The Act of 1996, however changed this and created the possibility for telecom companies to fully control the new value added services from end to end, by entering both local as well as long-distance markets, and thus gain an effective capability for product and service differentiation. Two significant technological advances fuelled this optimism in the industry: digital transmission with the increased performance of fiber optic cable (that allows large amounts of data to be transmitted - making video transmission possible) and the boom in internet. Rapid internet growth rates of the order of 750 to 1000% annually had been projected and endorsed by WorldCom ("Too many debts; too few calls - The telecoms crisis," 2002). This concept of convergence - the possibility that data, voice and video could all be offered by a single provider to a household, and the surge in demand with new entertainment possibilities was the dream of many telecommunication. Telecommunication firms scrambled to build the groundwork to be the provider of choice. Investors viewed telecom as the wave of the future, and the backbone for the 21st century world economy that could sustain accelerated growth in revenues and profits. With the stock market boom, and easy money available, telecom companies seemed poised to take off. Telecom was deemed the hottest industry on the eve of the MCI-WorldCom acquisition.

It was in this atmosphere, that WorldCom made an offer to purchase MCI.

ACQUISITION OF MCI

MCI was a company with a longer history and had pioneered in opening up the telephone market to competition by filing an anti-trust suit against AT&T in 1974. After entering the long distance business, MCI started constructing a coast-to-coast fiber optic network. Unlike WorldCom, that started as a reseller and grew by acquisitions, MCI grew from within and gained market share
by various marketing innovations such as "Friends and Family". By 1997, MCI was the second largest long-distance carrier in the US. Although it had experienced good growth, the pressures of the long distance business, had started affecting its performance.

British Telecom was looking for ways to enter the US market and was planning to acquire MCI. Since 1993, British Telecom had 20% stake in MCI and was in the process of acquiring the balance 80% of MCI. However, BT reduced its initial offer of $23 billion to $17.9 billion in August 1997, based on revised information. US telecom industry's long distance revenue growth was expected to slow down considerably. MCI performance had also dropped. Most importantly, losses in local-market business were running at $800 million in 1997 - twice what MCI had expected ("WorldCom tucks in - again," 1997). This drop in BT's offer opened the door for other bidders. Both WorldCom and GTE wanted to buy MCI and were bidding for MCI. WorldCom's offer of $37 billion beat the $28 billion all cash offer of GTE, and valued MCI at twice the BT's offer.

WorldCom's acquisition of MCI in 1997 was incredible in many ways. At that time, WorldCom was a little known company and MCI was the second largest long distance carrier - a company many times the size of WorldCom. This acquisition was the largest merger in US history till that point. There was great euphoria and this deal was commended by the media with phrases like "Why WorldCom + MCI adds up. At Last! A "Deal Of The Century" That's Smart" (Kupfer, 1997: 35).

WorldCom justified its doubling of BT's bid because it expected twice the synergies compared to BT. First, the combined company will have all the pieces of the modern telecom network - local, wireless, long-distance and internet access, and a broad market coverage nationally and internationally, and for business and residential customers. WorldCom (through its subsidiary UUNet) was the world's biggest carrier of Internet traffic, which was growing very rapidly. Further, WorldCom was the number 4 long distance provider and MCI was the number 2 long distance provider, which jointly provided 25% share in the US long distance market - compared to 54% of AT&T, down from 62% in 1992 (Elstrom, Barret, & Yang, 1997: 26). WorldCom had local fiber optic assets in 96 US cities, which would save MCI the 45% fee it had to pay the Baby Bells for using their networks. MCI had special strengths in the residential market, while WorldCom had been focused almost exclusively on the business customers. WORLDCOM also had a mass of undersea fiber that would help MCI long distance business to offer better global connections. The merging of the systems was expected to cut the firms costs by $2.5 billion in the first year, and by $5 billion in the 5 years following. Half these savings were to come from using each other's networks to route their customers internet and phone traffic saving on leasing costs (Yang & Elstrom, 1999). Mr. Sidgmore, WorldCom's CFO, stated that underlying similarities in design made merging the networks easy (Yang & Elstrom, 1999).

The rest of the synergies were foreseen to come from the decrease in overhead from 30% of revenues to 23% (Yang & Elstrom, 1999). The acquisition would allow both firms to benefit from using MCI's large sales force. WorldCom, which had a reputation for running a tight ship could
rejuvenate MCI which had become rather stodgy (a shift from its days of challenging the system under McGowan) and help it transition to a long distance business design, that was becoming increasingly commodity type and price based. On the other hand, MCI had a reputation for marketing innovations and WorldCom could leverage its brand name and the marketing savvy of MCI's executives. At the same time, WorldCom also expected that it could fix MCI's "management problems" by providing strategic direction to MCI. Strategic mistakes by MCI included its aborted purchase of Nextel Communications, a wireless firm, on-off alliance with Rupert Murdoch's News Corp in 1995 and not investing in networks. Moreover MCI had been pumping money into the video-on-demand market that has been a tech blind alley. On the whole, acquisition was expected to benefit shareholders - in the '90's MCI's shares returned an average annual return of 4.3%, while WorldCom had a return of 55.8% ("WorldCom tucks in - again," 1997). Post-acquisition, the combination of WorldCom's local business assets with MCI's long distance assets was predicted to result into a cost savings of $20 billion over five years (Business Week, 1998).

A comparison of the combined companies vis a vis their competitors is given in Table 1.

<table>
<thead>
<tr>
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<th>AT&amp;T</th>
<th>MCI WorldCom</th>
<th>Sprint</th>
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</thead>
<tbody>
<tr>
<td>Total Customers</td>
<td>80 million</td>
<td>22 million</td>
<td>20 million</td>
</tr>
<tr>
<td>Consumer Voice</td>
<td>$21.7 billion</td>
<td>$6.9 billion</td>
<td>$2.8 billion</td>
</tr>
<tr>
<td>Business Voice</td>
<td>$16.4 billion</td>
<td>$14.1 billion</td>
<td>$5.6 billion</td>
</tr>
<tr>
<td>Total Voice</td>
<td>$38 billion</td>
<td>$20.9 billion</td>
<td>$14 billion</td>
</tr>
<tr>
<td>Data/Internet</td>
<td>$7.7 billion</td>
<td>$11.0 billion</td>
<td>$2.8 billion</td>
</tr>
<tr>
<td>Wireless</td>
<td>$6.7 billion</td>
<td>N/A</td>
<td>$2.9 billion</td>
</tr>
<tr>
<td>International</td>
<td>$1.1 billion</td>
<td>$1.8 billion</td>
<td>N/A</td>
</tr>
<tr>
<td>Other</td>
<td>$8.3 billion</td>
<td>$378.0 million</td>
<td>$287 million</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$61.9 billion</td>
<td>$34.1 billion</td>
<td>$20.1 billion</td>
</tr>
</tbody>
</table>


The acquisition was completed on September 14th 1998 and the new company was called MCIWorldCom. During 1999 and 2000, MCIWorldCom acquired about a dozen companies related to a variety of web-based services. Most prominent of these were Skytel Communications, a provider of one way messaging services, acquired in 1999; and Intermedia Comm acquired in September 2000 for $6 billion (Elstrom & Mandel, 2000).
STRATEGIC CHALLENGES

Though the scale and scope of business opportunities presented by the acquisition were unprecedented, realization of the anticipated synergies was also an unparalleled challenge. There were two major concerns. First, WorldCom had grown through 50-odd acquisitions since 1992, and was still in the process of integrating several of its acquisitions: Brooks Fiber Properties that gave it local phone assets, MFS that turned it into the nation's largest Internet-backbone operator, and CompuServe's high-speed networking division CNS. Its core competency lay in deal making, focused on buying companies, largely for their sales force and customer base, and growing profits by cutting overhead and transferring the customers and their traffic onto WorldCom's network (Mehta, 2001). It was not known for developing new products and services or for customer care and service, and had followed a strategy of follower, not an early mover. Its primary stated mission was to make the company appealing to a potential acquirer, such as an overseas carrier looking for a presence in the US or to a regional telephone company striving to grow beyond its local territory, and materialize an ultimate deal yielding huge returns to WorldCom's shareholders (Mehta, 2001). MCI, on the other hand, took pride in product innovation, and had grown essentially through internal development. The anticipated synergies from the acquisition were based on the premise that MCI's product innovation capability could be transferred to WorldCom's high growth businesses, while WorldCom's cost control capability would fit MCI's maturing long distance market. Thus while the acquisition gave WorldCom a large scale of broad scoped telecom assets unparalleled in the industry and there were potential synergies, the two companies needed to be integrated to realize these synergies.

Second, at a strategic level, despite its numerous acquisitions, WorldCom's portfolio had numerous weaknesses. The combined company was more dependent on the long distance business, and therefore faced stronger risks from the regional Bells' anticipated moves into the long distance business (Upbin, 1998). Further, while WorldCom had resale rights to wireless, it avoided taking ownership of wireless assets - instead adopting a wait and watch approach until the customer ownership of cell phones becomes huge (Mehta, 2001). In contrast, its smaller rival Sprint already had a healthy blend of local, long distance and wireless assets, with strong global alliances. The fast-growing wireless business was at the core of Sprint's growth strategy, and a critical part of AT&T's plans.

Finally, the company had to make the largest non-treasury bond issue in US history, valued at $6.1 billion to pay cash to British Telecommunications for its 20% stake in MCI. It also had to establish short-term bank debt and commercial paper of $15 billion to finance the post-acquisition integration and investments in August 1998 (Garrity, 1998). Consequently, its balance sheet was under pressure, looking less healthy compared to its major rivals - Sprint and AT&T.
ORGANIZATIONAL CHALLENGES

Following the acquisition, Ebbers, started to "shape up" the culture of MCI. To bring about the necessary efficiencies, three of MCI's corporate jets were sold. Company cars were eliminated for everyone except Ebbers and Bert Roberts, MCI's former Chairman. In July 1988, Ebbers called MCI's top executives for a powwow in Florida. Here Ebbers announced new austerity measures. Instead of corporate jets and first class comfort, that MCI executives were used to, they had to fly discount airfares and rent cars instead of limos. Hotel room limits were reduced from $200 per night to $59.00 per night and executives were encouraged to share rooms. Business lunches over $5.00 would need receipts (in the past it was $25.00) and these executives were to submit monthly revenue statements that would be personally reviewed by Ebbers. In the strangest move of all, water coolers disappeared from MCI's corporate office in December 1998. Such cost control measures were felt throughout MCI. By March 1999, 2,215 people were laid off. In terms of marketing, a major policy shift was instituted. MCI had a culture of expensive sales promotions and gaining accounts big-name accounts for brand building. Now the policy was to change to based on whether these projects brought in money (Yang & Elstrom, 1999). As these austerity measure were being put into place many MCI executives left or were replaced, including the marketing executives credited with MCI's prior marketing successes (Hoover, 1998). The Wall Street Journal reports that as many as 70% of MCI executives left the firm following the austerity measures after the acquisition (Pelliam, 2002). As in some other telecom mergers, combining the two networks was more difficult than anticipated and the quest to add value was elusive.

ENVIRONMENTAL TURBULENCE

These strategic and organizational problems were exacerbated by changes in the industry environment. Between the time when the Telecommunications Act of 1996 was passed, and 1999, 147 resellers entered the market. Although reselling typically has razor thin margins, and is not a very profitable business, the existence of resellers greatly constrained the power of facilities based long distance providers (like MCIWorldCom) to increase prices. Competition was intensely price based and prices per minute fell rapidly, on average by 10%, between 1997 and 2000 (Elstrom & Mandel, 2000). In 2000, there were more than 500 long-distance providers, with prices as low as 3 cents a minute for big corporate customers (Haddad, 2000). MCIWorldCom's share of long distance business stood at 25% in 2000 (Haddad, 2000). With 43% of its total revenues coming from the long distance business in 2000, MCIWorldCom was squeezed at the revenue end.

At the cost end, the Baby Bell companies who provided local service has relatively high access charges (charges paid by the long distance telephone company to the local telephone company). The deregulation of this sector started later, but proceeded very slowly, putting cost
pressures on the long distance providers. In 2002, WorldCom estimated that it pays hundreds of Local Exchange Carriers a total of $750 million a month for local access, interconnection, billing, and other services. On the other hand, Local Exchange Carriers purchased services from WorldCom worth only $455 million per month, for offering long distance services to their customers ("Local Carriers Battle WorldCom in Court For Payment, Right To Terminate Service," 2002). Consequently, the fundamentals of voice communication business deteriorated faster than expected.

The euphoria in terms of increasing bandwidth continued. Between 1998 and 2001 the amount of fiber in the ground increased five-fold. Technological advances in the capacity of fiber increased the transmission capacity of fiber 100-fold. So actually total transmission capacity increased 500-fold. However, the entertainment boom and other applications of this technology did not keep up as expected. During the same period demand increased only 4-fold ("Too many debts; too few calls - The telecoms crisis," 2002). This created massive imbalance between supply and demand. The high debt coupled with high marketing expenditures in expectation of the projected revenues squeezed the industry operating margins. With 20% of its 1999 revenues, or $7.5 billion, coming from carrying data on internet backbone, and another 10% of its revenues ($3.5 billion) coming from providing Internet access to the corporate customers, MCIWorldCom had to drastically cut down its overall growth and profit projections as a result. Compared to MCIWorldCom, AT&T derived only 12% of its revenues from Internet/data and Sprint derived 16% from this segment. They, as well as other major rivals, had stronger focus on wireless business and web-based services.

There was not much better news in the internet business which did not grow as fast as expected. As wireless technology improved and wireless services became more widely used, consumers increasingly switched from wired to wireless services. The trend accelerated in the year 2000 as mergers & acquisitions contributed to formation of strong wireless players, resulting in cost savings and attractive promotions such as free handsets with 12 to 24 months of wireless service contracts. In July 2000, the merger of GTE and Bell Atlantic created the largest US wireline and wireless operations, named Verizon Telecommunications. SBC Communications acquired Bell South to take 2nd position in wireless. AT&T wireless dropped from the dominant position in early 1999 to No. 3 by mid-2000. Sprint took the 4th position in wireless business, backed by a marketing alliance with Radio Shack that gave its wireless products instant national distribution.

The earlier uncertainty about wireless was getting resolved with the technological strides made in wireless technology. Wireless service was increasingly used as a marketing tool by bundling it with other services like long-distance telephone and Internet under discount one stop packages (Advertising Age, 2000). Also, value-based wireless services, such as wireless-based internet access or wireless-long distance telephone call transfer, gave an additional edge to the telecom firms that had strong wireless positions. Therefore, firms like MCIWorldCom that did not have a strong wireless segment began losing customers in all their businesses to the wireless majors.
ATTEMPTS TO ENTER WIRELESS AND THE FAILED ACQUISITION OF SPRINT

MCIWorldCom sought to fill the major hole in its portfolio of businesses - that of not having a strong base in wireless - by proposing to acquire Sprint, whose wireless unit had a national coverage and a good depth in several major cities. Sprint's wireless assets would allow MCIWorldCom to offer high-speed wireless connection directly to the local customers. MCIWorldCom offered $129 billion for Sprint's combined wired and wireless operations, a 50% premium over Sprint's then stock valuation (Titch, 2001). However, regulatory agencies in Europe and in the US joined forces against the proposed merger. Although the combined company would be smaller than AT&T in the long distance business, it was expected that in some long distance markets there would be a duopoly (Krapf, 1999). Further, with MCIWorldCom being focused primarily on very high density business accounts in urban areas, the merger with Sprint would further deter development of voice services in rural and residential properties. More importantly, the combined operations would create an unhealthy concentration of internet operations. MCIWorldCom was the dominant player in the Internet backbone business, and given the immense significance of internet to the current US economy, its acquisition of Sprint, which held 8% share in the Internet-backbone business, would deter competition. Sprint offered to spin off its internet-backbone business into a separate business unit to facilitate its merger with MCIWorldCom. MCI had to earlier sell its Internet assets for $1.75 billion to UK-based Cable & Wireless to gain regulatory approval for merger with WorldCom. The difficulties of separating voice backbone from the Internet backbone meant that MCI failed to separate and share the business customer list and to transfer most employees in the Internet backbone business to Cable & Wireless. In March 2000, MCI was ordered to pay $200 million in damages to Cable & Wireless (Jones, 2000). However, with the Cable & Wireless experience on record, the US Department of Justice rejected the merger. The market reacted strongly to this setback and WorldCom's stock price fell sharply. The stock was no longer a viable currency for big acquisitions, and the debt levels reached unsustainable proportions (Titch, 2001). Its balance sheet looked distinctively unhealthy: by the end of 2000, the long-term debt of WorldCom had grown to $20.7 billion, from $13.1 billion a year earlier. Revenues, on the other hand, had grown from $37.1 billion in 1999 to just $39.1 billion in 2000 (Titch, 2001).

With failure of the bid to acquire Sprint, WorldCom, now MCIWorldCom, reasoned that most of the growth would have to come through internal development, and that web-based services offered the best prospect for such growth.

STRATEGIC REFOCUS?

By late 2000, MCIWorldCom realized its post-merger strategy of combining disparate businesses: consumer and corporate oriented businesses, long distance and Internet business,
price-sensitive business and service oriented business would not be effective for entering the higher value-added web-services business. To allow a proper focus in November 2000, MCIWorldCom was partitioned into two groups: WorldCom and MCI. Although both of these are not separate legal entities and are still owned by WorldCom Inc., they would be tracked separately. The WorldCom group would focus on high-end data services, Internet, Web-hosting, providing total solutions, international and commercial voice businesses; and MCI group would consist of the consumer, small business, wholesale long distance, wireless messaging and dial-up Internet access businesses. In general the business and commercial customers were assigned to WorldCom while the retail (consumer) and small business was assigned to MCI. The MCI group was allocated an expense and the WorldCom group was allocated a corresponding decrease in costs for the use by the MCI group of the fiber optic systems and buildings, furniture, fixtures and equipment attributed to the WorldCom group. The businesses attributed to the MCI group accounted for 41.8% of revenues, 38.0% of net income and 14.8% of assets for the year ended December 31, 2000 (Worldcom, 2001). The company also expressed its intention to spin-off MCI group to a suitable buyer, should it receive an attractive offer, and identified the WorldCom group as the focus of its future growth. Though the company recognized that the internet backbone and data business growth is falling sharply below previous expectations, it still rejected the concern the data business is becoming a commodity like voice long distance. In November 2000, Ebbers reasoned that "offering data is much more complex than providing voice" (Barron's, 2000). This split would also serve to provide investment funds which were becoming increasingly hard to come by and was in line with other companies in the industry spinning off high-growth operations in 2000, and additional $60 billion was expected to be mobilized in 2001 (Elstrom & Mandel, 2000).

WorldCom identified two major assets that would support rapid growth in web services (Haddad, 2000). First, its vast, global network of 300,000 miles of fiber optics, that carried 50% of the world's Internet traffic. This network could deliver faster, digital Internet access and other web services, such as the industrial-strength web site design and management, to corporate customers with whom it had good relationships. Instead of just carrying data on its internet backbone, the thrust would be to offer premium services such as storing, enhancing, and manipulating data, the market for which stood at $37 billion in 2000. Second, its 40 million long distance phone customers could be encouraged to pay for the breakthrough value-added services, such as browsing the Web by speaking into their phone. MCIWorldCom earmarked $100 billion, including $9 billion in 2000, for developing its Internet backbone into a mega internet computer, to break into and rapidly grow the web services market. It believed that the mega internet computer concept would allow it to attack wide range of web service opportunities all at once, and would give it a dominant advantage despite the presence of strong early mover competitors in various sub-segments of web services. The critics, however, remained skeptical of MCIWorldCom's ability to grow into a full-service Internet provider, given its penny-pinching culture, lack of innovative spirit, and poor record of customer service,
holding that "delivering service on Internet time" is alien to WorldCom's culture (Haddad, 2000). Although this would later be restated, in 2001, WorldCom group showed a revenue increase of 11% from 2000. MCI group however experienced a decline of 16% in revenues - primarily on account of the substitution by wireless (Worldcom, 2002). Consumer revenues declined 9 percent to $1.7 billion. Wholesale revenues declined 19 percent to $591 million. Alternative channels and small business revenues declined by 29 percent to $531 million. Dial-up Internet revenues declined by 15 percent to $344 million.

TOWARDS BANKRUPTCY: 2002

By the end of 2001, telecommunications companies in the US had added massive capacity in networks, backed by $400 billion of debt over 1997-2001, based on an idea that the world was about to experience a huge wave of demand for data traffic, and that their brand new networks would be needed to carry that data. Ironically, however, those predictions sowed the seeds for their own downfall, prompting a further wave of investment which left the telecom industry facing chronic overcapacity and unrealized revenues - a problem accentuated by the general economic downturn (Mehta, 2002). New revenue generated per investment dollar was expected to be 26 cents, down from 42 cents in 1998 and 34 cents in 2000 (Elstrom & Mandel, 2000). Compared to capital spending surge of 25.5% annually since 1996, telecommunications revenues grew only 10.5% per year - much below the persistent projections of 15% growth annually. Return on assets dropped from 12.5% in 1996 to 8.5% in 2000 (Elstrom & Mandel, 2000). Competition got worse when a whole new set of competitors stepped in - powerful firms with deep pockets: Cable and Utility companies.

The intensely competitive nature of the industry is evident when we consider the numerous bankruptcy protections that were being filed. Teligent, McLeod USA, Metromedia Fiber Networks, and Nextlink filed for Bankruptcy protection. Global Crossing, a fiber-optic network company under federal investigation for accounting fraud, was also under bankruptcy with debts of $12.4 billion. Similarly, $26 billion debt-ridden Qwest Communications, a phone and Internet carrier, was also under federal investigation for accounting fraud, and was feared to be on the verge of bankruptcy (Bergstein, 2002).

The stock price of WorldCom continued the downward slide that started with its failed acquisition of Sprint and was its lowest in seven years - down 88% from its April 1999 peak (Mehta, 2002). Adding to the bleak industry situation, and slowing growth of WorldCom were rumors about financial impropriety. Pressures inside the company had been mounting and it was reported that three star employees were suspended and at least 12 others had their commissions frozen over an order-booking scandal (Smith & Solomon, 2002). In March 2002, SEC started investigating the accounting practices of WorldCom including personal financial benefits extended to the CEO -
Ebbers received $408.2 million in low 2.32% interest loans from WorldCom to cover margin calls he made on company stock (Black, 2002).

Events moved very rapidly after this. Continuing pressures in its business led to massive layoffs when 10% of its employees were laid off and the firm slashed its revenue projections for 2002 by a billion dollars. Ebbers resigned as CEO following this. Moody's dropped WorldCom's debt status to "junk". In the hope of saving dividends associated with the MCI stock, WorldCom eliminated its MCI tracking stock (Smith & Solomon, 2002).

On 25th June 2002, WorldCom admitted that it needed to restate its accounts for 2001 because of some accounting irregularities. WorldCom had booked $3.8 billion of expenses (charges paid to local telephone networks to complete calls) as capital expenses. By moving these ordinary expenses to the capital account, it could show lower expenses, greater profits and amortize the capital expenses over a period of time in the future. This transformed WorldCom's bottom line from a loss for all of 2001 and the first quarter of 2002 into a profit (Sandberg, Solomon, & Blumenstein). This disclosure led a complete collapse in the share price which was already very low. Trading in WorldCom's stock was halted on 26th June and the SEC filed civil fraud charges against the company. Less than a month later, WorldCom, squeezed by suppliers who demanded upfront payments, was forced to file the biggest bankruptcy in corporate history on July 21st. Further problems came up - in early August, 2002, the ongoing internal review of accounts unearthed additional inflated profits of $3.3 billion starting in 1999. Restatement of accounts would then wipe out profits for year 2000. The company warned that more irregularities might surface. The company might also need to take a write off of goodwill to the order of $50 billion. In mid-September, additional accounting improprieties of $2 billion surfaced, involving accounting issues that in the past were open for interpretation - such as merger and acquisition accounting and asset write downs (Thal Larsen, 2003). Eventually, with nearly $11 billion of irregularities, there were serious concerns as to the whether the company's performance during the tech boom was really just based on accounting gimmicks. During the ongoing investigation of WorldCom's accounting practices, it emerged that some employees in the company were concerned about these accounting misstatements and had taken it up with their superiors, but were pressured not to pursue the matter (Dreazen & Solomon). In late September 2002, some high-ranking executives pleaded guilty to falsifying accounting data on instructions from senior management (Cohon & Solomon, 2002).

SURVIVING IN THE FUTURE

While some analysts are skeptical about ability of WorldCom to recover from the loss of its credibility and goodwill, WorldCom still has some very valuable assets. The communication fiber owned by WorldCom is 95,000 miles long, covers 65 countries and carries much of the world's internet traffic including 29% of the traffic in USA. WorldCom has long term contracts it has signed
with many large multinational companies and governments. Through MCI, WorldCom has access to 20 million telephone customers. Finally, the numerous small acquisitions it has made along the way that were never really integrated into its operations would be useful assets (Kessler, 2002).

WorldCom expected to continue its operations, and emerge revitalized from bankruptcy as a "vital counterbalance" to the Bells' dominance of local telephone markets. It planned to have 3 million local customers by the end of 2002, and offer its "The Neighborhood" all-distance calling plan in all of the Lower 48 states by the first quarter of 2003 ("WorldCom Bankruptcy's Effect on Telecom Market Debated," 2002).

Several analysts began asking if it is fair for the companies like WorldCom to be allowed to revive. They worried that as the unethical, debt-burdened companies are allowed to reorganize under bankruptcy and shed their debt obligations, they would gain an unfair competitive advantage over still solvent and ethically managed companies, and force the latter to follow the suit. Ivan Seidenberg, chief executive of Verizon, was "on fire - fire-engine-red mad" that his company, with $59 billions in debt, might have to compete with some companies that use bankruptcy to clear their huge debt obligations. Verizon spokesman Eric Rabe held, "Fundamentally, what you have is companies using bankruptcy arbitrage to fund their business model". "For those of us who pay our debts, that's grotesquely unfair." (Bergstein, 2002)

In addition, though it was felt that the $10 trillion gross domestic product US economy will be able to weather the WorldCom bankruptcy, concerns remained about the effects on those who do business with telecoms. Nearly 60 public telecom companies filed for bankruptcy court protection in the 19 months from 2001 to July 2002 (Swartz, 2002). Fallout from the telecom implosion was on pace to be the USA's biggest financial debacle. Several leading banks were among the WorldCom's top creditors: JP Morgan was owed $27 billion; Citibank, $3.3 billion; Bear Sterns, $2.7; Morgan Stanley, $1.9 (Swartz, 2002). After the banks, WorldCom's biggest creditors were regional telephone companies that sell WorldCom access on their networks so that WorldCom can complete customer phone calls and data transmissions. WorldCom owed hundreds of local exchange carriers $750 million in monthly billings. SBC, Verizon and BellSouth were asking the Federal Communications Commission to protect them from future telecom bankruptcies by requiring bigger upfront deposits from carriers such as WorldCom. However, in view of the dire state of the telecom companies, FCC was reluctant to accept the demand for upfront deposits. Most of the USA's 1,200 small phone companies had a business relationship with WorldCom, accounting for 5% to 10% of revenue (average monthly payment: $12,500), because the small carriers charged WorldCom's MCI to start and finish calls in their territories. The survival of several of these companies was now also on stake. Further, with WorldCom operating in 65 nations, foreign telecom outfits were also being squeezed. Videsh Sanchar Nigam, India's main international long-distance and Internet provider, wasn't been paid access fees by WorldCom for last several months, accumulating arrears of more than $100 million (Swartz, 2002).
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**CASE DESCRIPTION**

Ever wished you had a full-length case (lots of issues, lots of data) about a large under-performing company in the developing world? This case challenges students to use the information provided to develop a plan to dramatically increase profitability and to double the number of tons of products sold by Nigerian Packaged Goods Ltd. within a four-year period. The case is based on field research conducted by the author in Nigeria. At first glance, students may believe the central issue in the case is "marketing strategy." As they will discover in the epilogue, however, the solution developed by the company's Managing Director involves initiatives on a very wide range of factors with the potential to impact corporate performance. Those factors include not only marketing strategy-related issues (that is, target market and the four marketing mix variables) but also company, competitor, and customer characteristics; industry considerations; and the macro-economic environment in Nigeria. The case is appropriate for senior-level undergraduates as well as students in MBA and Executive Development programs. It is designed to be taught in a "one hour and a half" class session, and is likely to require at least a couple hours of preparation by students.

**CASE SYNOPSIS**

Brian Keith is the newly-appointed Managing Director of Nigerian Packaged Goods Ltd., a large subsidiary of Global Packaged Goods Ltd. and a major manufacturer and marketer of consumer packaged goods (foods, cosmetics, soaps, detergents, toothpastes, etc.) in Nigeria. The company has just reported a massive loss, and the former managing director together with most of the senior management team have retired. To ensure continued support for the company from worldwide headquarters in Belgium, Keith believes that he will need to dramatically improve profitability and to double sales volumes within the next four years. Data and information in the case include:

1. Description of the challenge the company faces.
2. For Nigeria: Historical overview, a sample of recent statistics from the World Bank, and (for benchmarking purposes), some comparable statistics on the United States.
3. On the company: Historical overview, current performance, and numerous factors impacting that performance.
4. *Characteristics of the marketing strategy, including descriptive information on the product line, characteristics of the distribution system, and information on the promotion and pricing strategies the company is currently using.*

5. *Characteristics of the competitive situation.*

**THE SITUATION**

Boarding his flight to Lagos, Brian Keith wondered again whether his decision four months ago to accept his old friend Johnson Ojo's offer to become Managing Director of Nigerian Packaged Goods, Ltd. would make or break his career at the multinational parent company, Global Packaged Goods, Ltd. As former Managing Director of a major Nigerian Packaged Goods Ltd. subsidiary, Keith had hands-on senior management-level knowledge and experience of the Nigerian business environment. Thus, while he knew very well the tremendous opportunities and successes which can be achieved in Nigeria, Keith also knew how problematic the Nigerian business environment can be. Difficulties Nigerian Packaged Goods had faced recently and/or was currently facing included:

1. The company had been losing small amounts of money for the last three years. For the most recent year, however, Nigerian Packaged Goods, Ltd. had written off more than $1.5 billion naira (approximately US$15,000,000) of very old accounts receivable and inventory. As a result, the company would be posting a large annual loss.

2. As the magnitude of the problems Nigerian Packaged Goods, Ltd. was facing had become more clear, Keith had requested a three-month suspension of the company's listing on the Nigerian Stock Market. When its stock resumed trading at the end of that three month suspension, the price of a Nigerian Packaged Goods, Ltd. share fell from around 13 naira to 5 naira. Clearly, the public image of the company had been badly damaged.

3. The former Managing Director and most of his senior management team had retired, and both staff morale and motivation were currently very low.

Putting his career-related concerns behind him, Keith began thinking again about the performance objectives which he and Ojo had discussed earlier in the day. The two of them had agreed that to ensure continued support for Nigerian Packaged Goods, Ltd. from Global Packaged Goods, Ltd. headquarters in Belgium, it would be necessary both to double Nigerian Packaged Goods, Ltd. sales volumes within the next four years and to dramatically increase profitability as well. The challenge of course would be to actually achieve those objectives.

**THE COUNTRY**

The Federal Republic of Nigeria is a large (one-tenth the land mass of the United States) tropical country in West Africa. It is composed of 36 states plus Abuja, the Federal Capital Territory.
These states differ in many ways, one of which is that the terrain ranges from beaches and swamps in the south to desert conditions in the north. Levels of education and income tend to be higher in the south than in the north. The dominant religion in the north is Islam, while the south is predominantly Christian. Hausa is the dominant ethnic group in the north; in the east, the dominant group is the Igbo, while the west is predominantly Yoruba. Nationwide, the median age is 15. For a small sample of World Bank statistics on Nigeria, together with comparative data for the United States, see Appendix 1.

Nigeria is a major oil-producing country, and its Gross National Product (GNP) of approximately 33 billion dollars makes it the third largest economy in Africa. In sub-Saharan Africa only South Africa (GNP exceeds 100 billion dollars) has a larger economy. However, and as indicated in Appendix 1, with Africa's largest population (approximately 120 million people), Nigerian GDP per capita is very low (less than US$300.00 per year). The World Bank reports that approximately half the population lives on US$1.00 per day or less. In short, while the overall market is large, the purchasing power of most individuals in Nigeria is very low. For some background on Nigeria since it became an independent country, see Appendix 2.

Nigeria's low income levels plus additional problems discussed in Appendix 2 (that is, the scams, the infrastructure deterioration together with the attendant increase in the costs of doing business, the inability of private sector firms to procure the foreign exchange needed to fund their ongoing operations and maintenance, the corruption, and so on) led numerous multinational investors and companies to stay away from Nigeria. Over time, many of the multinational investors and/or corporations which had come to Nigeria during the oil boom of the 1970s decided to withdraw. For most firms in the petroleum sector, however, and for a few non-oil firms as well, leaving the country was not viewed as a feasible alternative. One non-oil firm finding itself in this category was Nigerian Packaged Goods, Ltd.

**THE COMPANY**

Global Packaged Goods, Ltd. (hence, GLOPAG) the parent Belgium-based consumer products company of Nigerian Packaged Goods, Ltd. (hence, NIPAG) has been exporting products to Africa for more than 100 years. At the beginning of the 20th century, the company opened its first manufacturing plant in Africa, a soap factory in South Africa. Over the years, the company greatly expanded its operations in Africa. Currently, GLOPAG has operating subsidiaries not only in Nigeria but also in Ivory Coast, the Democratic Republic of the Congo, Ghana, Kenya, Malawi, Namibia, Niger, South Africa, Tanzania, Uganda, Zambia, and Zimbabwe.

Most GLOPAG activities in the above countries including Nigeria involve food and non-food consumable consumer items. Products in the foods category include bouillon cubes, cooking oils, ice cream, and margarines. Non-foods products include baby care lotions and powders, detergents,
petroleum jellies, soaps, toothpastes, and other personal care products. Across all countries, laundry detergents is the largest and strongest GLOPAG category.

Over the years, GLOPAG and its predecessor companies have had a huge presence in Nigeria. For additional background on GLOPAG's activities in Nigeria over the years, see Appendix 3. In 1993, then-Chairman Erasmus Adepo announced that NIPAG's annual revenues had, for the first time, exceeded one billion naira. As indicated below, each year till 1996 NIPAG reported very impressive increases in turnovers:

<table>
<thead>
<tr>
<th>YEAR</th>
<th>TURNOVER (000 naira)</th>
<th>PRE-TAX PROFIT (000 naira)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>617,500</td>
<td>12,480</td>
</tr>
<tr>
<td>1992</td>
<td>891,000</td>
<td>18,600</td>
</tr>
<tr>
<td>1993</td>
<td>1,538,559</td>
<td>29,561</td>
</tr>
<tr>
<td>1994</td>
<td>2,758,971</td>
<td>(302)</td>
</tr>
<tr>
<td>1995</td>
<td>4,186,993</td>
<td>(827)</td>
</tr>
<tr>
<td>1996</td>
<td>4,284,072</td>
<td>(919)</td>
</tr>
<tr>
<td>1997</td>
<td>3,406,224</td>
<td>(46,111)</td>
</tr>
</tbody>
</table>

At the end of 1997, NIPAG announced that CEO Adepo and most of his senior management team had retired, and that Mr. Johnson Ojo, one of the most distinguished businesspersons in Nigeria, had been appointed NIPAG's non-executive Chairman. It was at this time that the head of GLOPAG's business group for Africa offered the Vice Chairman/CEO post to Brian Keith. For additional information on Keith's background, see Appendix 4. After spending a few days wondering whether this assignment represented a huge opportunity or a kiss of death, Keith had accepted GLOPAG's offer to become NIPAG Chairman and CEO.

**Characteristics of the Nigerian Market.**

As the economic environment in Nigeria deteriorated (see Appendix 2), receiving high "value for money" became very important to many consumers. Offering well-known brands had at one time been sufficient for success, but by the 1990s performance and "value for money" had become far more important for most consumers. For a substantial portion of the market, low prices are very important as well.
Price and Product-related Information.

In the face of the deteriorating economic environment, NIPAG moved to protect profits by increasing prices and reducing costs. One approach NIPAG used was to reduce the active ingredients of many of the international brands it manufactured and sold in Nigeria. In the process, NIPAG substantially lowered the "value for money" for consumers and debased the brand equity of these products. For an overview of NIPAG's product range at the time of the case, see Appendix 5.

One implication of the above "debasing" is that world-class brands smuggled into Nigeria began to represent better "value for money" for consumers than the NIPAG products manufactured locally. Furthermore, and in contrast to packaging innovators (milk-products companies, some detergents companies) who began offering single-use packs or sachets which were more affordable for Nigerian consumers, NIPAG continued to use traditional (that is, large developed-world-sized) packaging. Thus, over the years, NIPAG not only moved away from its original promise of "superior value for money," but also failed to deliver on the explicit promise of GLOPAG's Corporate Purpose (see Appendix 6), that is, "to anticipate consumer aspirations and to respond creatively and competitively with branded products and services which raise the quality of life for our customers."

Promotion-related Information.

Over the years, NIPAG's competitors in Nigeria (both formal and informal sector) have massively increased their marketing spending. The percentage of revenues spent by NIPAG on advertising, however, is almost the same now as it was many years ago when sales were nearly twice as high. For this reason, NIPAG's "share of voice" (that is, total promotional funds spent by NIPAG, divided by total promotional funds spent by all sellers of consumer packaged goods in Nigeria) is far lower today than during NIPAG's glory days.

Distribution-related Information.

NIPAG has 28 depots serving 850 wholesalers and large retailers. Nearly all of these direct customers are located in major urban areas (i.e., rural coverage is very weak), and many compete against each other. For example, the company has 20 distributors in the Northeast: Six in Jos, four in Maidugari, and so on. Very few of these direct customers are making any money. For a list of the locations of NIPAG's leading distributors in Nigeria, see Appendix 7.

NIPAG salespeople are of course calling regularly on the direct customers, trying to persuade these distributors and large retailers to buy additional products and to maintain inventories. However, NIPAG does not use its leverage with banks in Nigeria to assist its direct customers with their financial arrangements. In other words, the direct customers are responsible for developing their own
lines of credit from banks. Typically, NIPAG's direct customers end up paying 4 or 5 points more for their credit facilities than the rate paid by NIPAG for similar facilities.

**Additional Considerations.**

As Keith reviewed the situation, he noted the following points:

1. While the business environment in Nigeria had deteriorated enormously since the glory days of the 1970s oil boom, NIPAG had done little to update its business model or its strategy. NIPAG had always been a dominant "second-to-none" company, and the members of the Board of Directors still embraced and reflected this attitude, even though various measures of NIPAG's performance (for example, turnover and profits) no longer justified such a conclusion. For example, while NIPAG's product turnover in 1989 had been 46,000 tons, the corresponding figure for 1997 was only 24,000 tons. Of this huge decrease, some had been lost to other companies in Nigeria which manufacture products similar to those produced by NIPAG (foods, cosmetics, soaps, detergents, toothpastes, and so on). However, as noted earlier, the most serious competition was coming from products manufactured at world-scale plants elsewhere in the world and then smuggled duty-free by traders into the Nigerian market. Reasons NIPAG is "at risk" from this sort of approach include the following points:

   A. Because Nigerian firms like NIPAG must invest heavily in infrastructure (i.e., generate their own electric power, drill and pump their own water, etc.), costs of building a manufacturing plant in Nigeria are high (20% higher, according to a World Bank estimate) compared to places elsewhere in the world where public water and power infrastructures are provided.

   B. The productivity of the workers in Nigerian factories tends to be approximately 25-50% of the level achieved in world-scale factories elsewhere in the world. Reasons for these low levels of productivity include the following:

      1. Many manufacturers in Nigeria including NIPAG have adopted a "dumbed-down" approach to their jobs and workers. In other words, instead of providing workers on the production line training to identify and quickly fix themselves production and/or quality-related problems, NIPAG and other manufacturers using the "dumbed-down" approach place untrained people on the line and rely on supervisors to catch production-related problems. Because it can take a long time for supervisors to realize something has gone wrong, levels of waste and inefficiency in companies using the "dumbed-down" approach tend to be very high.
2. Very few manufacturers in Nigeria have incentive programs to motivate workers on the line to be concerned about efficiency, productivity, and product quality. NIPAG does not have such programs. The result is that labor-related costs of products manufactured in Nigeria are quite high, even though hourly labor rates (compared to elsewhere in the world) are low. Furthermore, at NIPAG (as at many other manufacturing companies in Nigeria), rewards and promotions are often awarded based not on merit but on factors such as ethnic bias and/or bribes. In NIPAG and many other manufacturing companies in Nigeria, managerial systems are not at all transparent. Abuse of authority and violation of approved procedures, regulations, and rules are common. In such environments, the primary managerial response to low levels of performance is often excuses and/or invocation of "the Nigerian factor," that is, the idea that difficulties in the Nigerian environment and/or psyche make it impossible to achieve levels of performance achieved elsewhere. Elements of "the Nigeria factor" argument include the following points:

a. The idea (there is some truth to it, unfortunately) that employee attitudes are more "how can I use my position in the company to enrich myself and my family and friends," instead of "how can I contribute to the growth and profitability and success of the company."

b. There is very little team orientation. This is not helped by the fact that while many companies around the world have implemented share ownership programs to stimulate and motive their employees, NIPAG has no such program.

c. While many worldclass factories elsewhere in the world use "5S" sorts of programs (see Appendix 8), NIPAG has no such initiative.

3. Levels of planning and coordination tend to be very low. NIPAG has not formed strategic alliances with key suppliers, and procurement is not well organized. It is quite common for NIPAG to be in a situation where there is demand for its products but needed raw materials and/or packaging are not available. When raw materials and packaging are available, NIPAG can find itself using huge amounts of overtime to get products manufactured and out in the marketplace. This approach substantially increases costs.
C. An important implication of points #1-#3 (above) is that world-class products smuggled in duty-free from elsewhere in the world can cost less than products manufactured locally in Nigeria. Thus, competition from the informal sector (that is, from smugglers) is a very critical issue for formal sector manufacturers in Nigeria like NIPAG who pay duties on imported goods; taxes to local, state, and federal governments; and fund retirement schemes for Nigerian staff.

2. Regarding profitability, NIPAG found itself in a "Catch 22" situation. On the one hand, NIPAG's existing system (5 old factories full of old equipment) was very expensive to run and generated very little profit. On the other, because there was very little profit being generated, senior overseas managers were unwilling to spend money updating factories and/or equipment. NIPAG's plants are dirty and antiquated. This led to various sorts of odd situations. For example, although NIPAG's headquarters were located on a very impressive harbor-side compound with a private jetty capable of handling ocean-going vessels, and although these facilities were conservatively estimated to be worth at least one billion naira, a substantial portion of the communications and office equipment in the complex dated back to the early 1980s. Furthermore, the office did not possess central airconditioning. Given the age of the headquarters communications infrastructure, readers will not be surprised to learn that only a few of the most senior NIPAG executives had e-mail access in their offices. Furthermore, there is no automated sales processing, no on-line communications links to depots and/or major distributors, and so on.

3. While NIPAG continued to provide a full range of expensive services and benefits for employees (food from company-owned and operated canteen, car purchase schemes for senior managers, medical scheme, security scheme, etc.), none of these schemes had been updated recently and none of them are competitive with benefit plans offered by other major firms in Nigeria. For example, while some companies offer house purchase schemes to senior managers (the company co-signs the note and the manager receives a subsidized interest rate), NIPAG had never provided this sort of benefit to its staff. Furthermore, the quality of these non-essential services which NIPAG provides to its employees (canteen, medical care, etc.) tends to be quite low.

4. As indicated earlier, the economic environment in Nigeria had changed dramatically over the last several years. Nonetheless, NIPAG had made no major revisions or adjustments to its compensation schemes for managers.

5. As indicated earlier, NIPAG provided no incentives for junior staff (supervisors, people working on a production line, etc.) to strive to improve throughput, productivity, and/or quality. Furthermore, NIPAG exhibited no particular interest in safety, worker health (important to productivity), working conditions (important to
morale), etc. There was no emphasis on and little interest in cross-functional teams and other newer approaches to doing business. Furthermore, there was no emphasis on establishing and then promoting to everyone a mission/vision as to who NIPAG is, what NIPAG seeks to achieve, and so on. In other words, there was no attempt to capture workers' hearts and heads, and to get them to be entrepreneurial/proactive in improving the company and its operations. NIPAG provided no rewards for staff interested in any of the above attitudes or performance, even though it was clear that at first-class plants elsewhere in the world, junior (i.e., production) staff can double their salary if they take responsibility for and then deliver high levels of product quality, productivity, safety, throughput, and so on. NIPAG provided no recognition or any other rewards for employees adopting such attitudes.

6. Traditionally, NIPAG has been a very hierarchical company. Directors of NIPAG's various functions (marketing, finance, human resources, etc.) are clustered together in a directors wing at headquarters, rather than being located near the mid-level managers who report to them.

7. With its "glory days" history of being able to sell everything it could manufacture, NIPAG has never devoted much time or energy to customer service. The company does have customer service representatives, but both the leader of the customer service organization and the individuals in the customer service roles are low-level employees.

THE CHALLENGE

Assume you are Brian Keith, the new Vice Chairman/CEO of NIPAG. How will you go about achieving the performance objective which you and your chairman (Johnson Ojo) have identified, that is, to double NIPAG's sales in the next four years?
## Appendix 1
Sample of World Bank Statistics: Nigeria Versus the United States in 1999

<table>
<thead>
<tr>
<th></th>
<th>Nigeria</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP per capita (current US$)</td>
<td>260</td>
<td>30,730</td>
</tr>
<tr>
<td>GDP growth(annual)</td>
<td>1.8%</td>
<td>4.4%</td>
</tr>
<tr>
<td>Adult illiteracy rate (age 15+)</td>
<td>38.9%</td>
<td>no data</td>
</tr>
<tr>
<td>Urban population (% of total)</td>
<td>42.2%</td>
<td>76.8%</td>
</tr>
<tr>
<td>Malnutrition (% of children under 5 years old)</td>
<td>39.1%</td>
<td>no data</td>
</tr>
<tr>
<td>Life expectancy at birth (years)</td>
<td>47</td>
<td>77</td>
</tr>
<tr>
<td>Infant mortality rate (per 1000 live births)</td>
<td>83</td>
<td>7</td>
</tr>
<tr>
<td>Under 5 mortality rate (per 1000 live births)</td>
<td>151</td>
<td>8</td>
</tr>
<tr>
<td>Male mortality rate (per 1000 adults)</td>
<td>444</td>
<td>143</td>
</tr>
<tr>
<td>Female mortality rate (per 1000 adults)</td>
<td>390</td>
<td>78</td>
</tr>
<tr>
<td>Prevalence of anemia among pregnant women</td>
<td>55%</td>
<td>no data</td>
</tr>
<tr>
<td>Population</td>
<td>120,817,300</td>
<td>274,894,000</td>
</tr>
<tr>
<td>Annual population growth</td>
<td>3%</td>
<td>1%</td>
</tr>
<tr>
<td>Population aged 0-14 years</td>
<td>22.2%</td>
<td>10.5%</td>
</tr>
<tr>
<td>Population aged 60+years</td>
<td>4.1%</td>
<td>15.9%</td>
</tr>
<tr>
<td>Fertility rate (# of births per woman)</td>
<td>5.2</td>
<td>2.1</td>
</tr>
<tr>
<td>Total health expenditures (% of GDP)</td>
<td>2.8%</td>
<td>13%</td>
</tr>
<tr>
<td>Public health expenditures (% of GDP)</td>
<td>0.8%</td>
<td>5.8%</td>
</tr>
<tr>
<td>Health expenditures per capita (in US dollars)</td>
<td>29.90</td>
<td>4107.80</td>
</tr>
<tr>
<td>Health expenditures per capita, PPP</td>
<td>23.00</td>
<td>3950.00</td>
</tr>
<tr>
<td>Physicians (per 1000 people)</td>
<td>0.2</td>
<td>2.7</td>
</tr>
<tr>
<td>Measles immunization (% of children under 12)</td>
<td>26%</td>
<td>92%</td>
</tr>
<tr>
<td>DPT immunization (% of children under 12)</td>
<td>21%</td>
<td>96%</td>
</tr>
<tr>
<td>TB incidence</td>
<td>214</td>
<td>7</td>
</tr>
<tr>
<td>Male smoking (% of adults)</td>
<td>15%</td>
<td>28%</td>
</tr>
<tr>
<td>Female smoking (% of adults)</td>
<td>2%</td>
<td>22%</td>
</tr>
<tr>
<td>Adult population HIV-1 seroprevalence (age 15-49)</td>
<td>5.1%</td>
<td>0.6%</td>
</tr>
</tbody>
</table>
APPENDIX 2
NIGERIA: ADDITIONAL COUNTRY BACKGROUND

At independence in 1960, Nigeria's economy was primarily agricultural. The largest export was groundnuts (peanuts), grown in the northern part of the country. The annual groundnut harvests were bagged, stacked in huge piles or pyramids at rail depots throughout Northern Nigeria, and then shipped to ports in Southern Nigeria for export. Other important agricultural exports included cocoa beans from Western Nigeria and palm products (palm kernels and the results of pressing them, that is, palm oil and palm by-products) from Eastern Nigeria. At this time, Nigeria's millions of small farmers grew both the export products listed above and enough food (maize, rice, and yams) to feed the entire country.

In the early 1950's, oil was discovered in Nigeria. By the late 1970's, oil sold for $40.00 per barrel was generating massive amounts of money. The Federal Government of Nigeria made huge investments in roads, bridges, and buildings for the public sector (administrative buildings, housing estates and apartments, etc.). The government also invested huge amounts of money in a large number of "showcase" projects including steel mills, paper plants, expensive hotels, and a new Federal Capital City called Abuja. Many people moved to the oil areas, the project areas, and/or the large cities, hoping to find jobs in the oil sector, work on the private/public projects financed by petrodollars, etc.

As a consequence of the massive cash inflows and the changing opportunities available in Nigeria, agriculture and agricultural production were badly neglected. By the early 1980's, agricultural exports had nearly disappeared, and Nigeria no longer produced enough food to feed itself. The shortfall in food production was made up by importing numerous food products, including both traditional staples and alternative foodstuffs such as wheat.

In the early 1980's, the price of oil collapsed. Over the next ten years, the price was often in the range of $10.00/barrel to $20.00/barrel. The annual impact of this price collapse depended on the level of production. However, it is probably correct to say that each decrease of $1.00 in the price of a barrel of oil reduced Nigeria's export earnings by at least $700 million dollars per year. Over the decade of the 1980s, the total revenue loss for Nigeria from oil price decreases undoubtedly exceeded $70 billion.

It took years for the impact on the Nigerian economy of the drying up of the oil revenues to fully manifest itself. The first economic consequences, caused by the shortage of foreign exchange, were the scaling back of the importation of big-ticket consumer items. Subsequently, manufacturing activities relying exclusively on imported equipment, raw materials, and supplies began to suffer. For companies in these industries, the cost of imported equipment, spares, raw materials, and supplies escalated sharply, as large amounts of local currency chased an ever-shrinking pool of hard currencies including dollars. These increased costs of overseas inputs led many industries to substitute local materials for imported ones (for example, brewers substituted sorghum for malt). Companies not able to find local substitutes increased prices, downsized their operations, or dropped out of business entirely.

The drying up of oil revenues had additional negative effects on the quality of life and economic activity in Nigeria. Over time, basic services like roads, electricity, water supply, and tele-communications began to deteriorate. By the late 1980s, neither industrial nor residential customers relied exclusively on public service providers for electricity or water. Instead, both groups had invested vast amounts of money in back-up generating equipment for electricity and private boreholes and/or trucking for water. In addition, because Nigeria's "hard-wire" phone equipment barely functioned due to service overloads and lack of maintenance, numerous businesspersons invested large amounts of money first in dedicated radio/microwave links and later, cellular telephone equipment. The need to make such investments increased the cost of doing business in Nigeria, and reduced dramatically the international competitiveness of Nigerian products and industry.

Another effect of the tremendous decrease in oil revenues was a very substantial increase in corruption. Due to the revenue decreases, federal, state, and local governments in Nigeria were unable to pay public sector employees. As prices of goods and services containing imported materials increased (most goods did include some overseas parts or components), and as public sector salaries fell or went unpaid, many civil service and public sector employees searched for alternative sources of funds to maintain their standards of living. Ultimately, many public sector employees started...
demanding bribes before they would act on requests for service by individual and/or corporate customers. By the late
1980s, Nigeria and especially its international airport in Lagos, Murtala Muhammed Airport, had a very ugly (and
unfortunately, well-deserved) reputation as an uncontrolled and uncontrollable den of thieves and crooks.

As the economic pressure on individuals increased, signs of the intense nature of their struggle to survive began
to manifest themselves in the private sector as well. A small number of well-organized Nigerians became involved in a
series of scams known as "419". In a typical "419" scam, a wealthy individual in a developed world nation receives a letter
on the letterhead of a major Nigerian para-statal like the Nigerian National Petroleum Corporation (NNPC) indicating that
the sender needs access to an offshore account so as to be able to "park" some petrodollars for a few weeks or months.
The letter invites the wealthy overseas individual to provide such an account, and promises that at the end of the "parking
period," this individual will be allowed to keep a percentage of the parked funds. Perpetrators of the scheme hope the
overseas "target" will provide them names and numbers for an existing bank account with real money in it. Immediately
on receipt of the names and numbers for real accounts, the Nigerian perpetrators utilize electronic funds transfer
mechanisms to steal the target's funds and move them into their own accounts.

APPENDIX 3
GLOPAG/NIPAG: ADDITIONAL CORPORATE BACKGROUND

GLOPAG's operations in West Africa began in early in the 20th century, when its founder created a West Africa
Department. The original purpose of this department was to secure the palm oil needed to support GLOPAG's growing
soap business. Over the next several years, however, GLOPAG purchased a number of other companies involved in
trading along the West African coast. In 1919, as part of his continuing efforts to source tropical oils from West Africa,
GLOPAG's founder purchased a huge trading company in Nigeria which at one time had been engaged not only in
commercial activities but also in providing police services throughout the country.

In the early 1920's, GLOPAG (West Africa) Ltd. was established. After a year or two, the company started
making and marketing soap in Nigeria. While the founder himself died soon afterwards, his company (including its
operations in Nigeria) continued to prosper. By 1930, GLOPAG (West Africa) was supplying 50% of the
factory-manufactured soap purchased in Nigeria, and was exporting its brands throughout West Africa as well.
Meanwhile, the large Nigerian trading company acquired earlier became both the primary supplier of palm products (oil,
etc.) for GLOPAG's soap manufacturing operations and a major distribution outlet for the company's soap products as
well.

In the early 1930s, GLOPAG (West Africa) began to experience intense competition from other soap
manufacturers, especially a British manufacturer in Liverpool called Bibbys. Compared to GLOPAG, Bibbys "Bear" brand
offered higher fatty acid (that is, active ingredients) content, lower prices, and a scent which appealed strongly to certain
markets in Nigeria. In response, GLOPAG (West Africa) introduced different brands (various colors and perfumes) for
different markets in Nigeria:

<table>
<thead>
<tr>
<th>Location</th>
<th>Soap Brand</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lagos</td>
<td>Carnaba brand brown soap.</td>
</tr>
<tr>
<td>Port Harcourt</td>
<td>Parasol brand pink soap.</td>
</tr>
<tr>
<td>Calabar</td>
<td>Parasol brand pink soap; also, Manatee brand.</td>
</tr>
<tr>
<td>Kano &amp; Zaria</td>
<td>Signet brand pink soap.</td>
</tr>
<tr>
<td>Jos</td>
<td>Signet brand red soap.</td>
</tr>
</tbody>
</table>

In addition to tailoring products to local preferences, GLOPAG (West Africa) also launched at this time
aggressive promotional efforts for the above soaps and the "Sparkle" laundry tablet it imported from Belgium.

During the Second World War, many European governments banned the export of various items including soap
to West Africa. This eliminated Bibbys and other European competitors and gave GLOPAG (West Africa) a monopoly.
not only in Nigeria but throughout much of West Africa. In response, the company raised prices and began manufacturing additional brands in Nigeria, including Sparkle. After the war, GLOPAG (West Africa) expanded its existing factory outside of Lagos and began manufacturing additional soap brands in Nigeria. In addition, GLOPAG (West Africa) began considering the manufacture of other products. A proposal to create a milk factory was approved in the 1950s, and the plant began producing milk early in 1954. In 1958, due partly to increased volumes and partly to political considerations (i.e., a desire to have factories located not just in Lagos but in other areas as well), GLOPAG (West Africa) opened a new factory in Eastern Nigeria.

As its product line and volumes expanded, GLOPAG (West Africa) found itself hurt by the fact that the big trading companies distributing its products (UAC, John Holt, SCOA, and so on) had no reason to favor GLOPAG (West Africa) products over products provided by other manufacturers. In 1959, the company created its own chain of 33 depots all around Nigeria. Perceived advantages of the new depot system included:

1. A complete range of products should be continuously available in each depot. "Out of stock" situations should fall, as should the amount of inventory merchants need to carry and the amount of unsold merchandize which becomes old or stale.

2. The reduction in distributor margins (because GLOPAG (West Africa) is now providing its products to distributors in their own markets) should reduce the movement of products from one town to another.

3. With depots in each major market, it should be easier to track competitive developments and to know when pricing adjustments or special promotional efforts are needed in a particular market.

After independence on 1 October 1960, GLOPAG (West Africa) continued to broaden the range of products manufactured in Nigeria. In the early 1960s, the company began producing laundry detergent plus toothpastes, and later it added shampoo, face cream, liquid detergents, and toilet soap flakes.

In 1972, the Nigerian Government introduced the Nigeria Enterprises Promotion Decree. The decree categorized most business enterprises into two groups. Industries in Schedule 1 (haulage, newspaper printing and publishing, etc.) were reserved for Nigerians. In the case of Schedule 2 enterprises (including GLOPAG) the decree required that 40% of equity be available to Nigerians. As a result of this decree, GLOPAG (West Africa) became a public company and changed its name to Nigerian Packaged Goods, Ltd. (i.e., NIPAG). Another impact of the decree was to hasten the extent to which local (that is, Nigerian) managers replaced expatriates. Of NIPAG's 170 management staff in 1974, 155 were Nigerians. In 1975, NIPAG's first Nigerian chairman was named.

Over the years, the Indigenization Decree of 1972 was amended several times. By 1977, enterprises were divided into three schedules. As in 1972, Schedule 1 industries were reserved for Nigerians. Schedule 2 industries (NIPAG still fell in this category) were required to make 60% of their equity available to Nigerians, and Schedule 3 industries were required to make 40% of their equity available to Nigerians. An important implication of the 1977 decree was that NIPAG ceased to be a subsidiary of GLOPAG. However, one technical and one engineering assistance agreement ensured that NIPAG continued to enjoy world-class information/support from GLOPAG.

In the late 1970s, the high oil prices associated with the global energy crisis created a boom economy in Nigeria. Suddenly, NIPAG found itself accounting for up to 25% of GLOPAG’s global profits. During this period, NIPAG continued to introduce new products and services (for example, products and services for bakers), expanded its existing factories, and commissioned a third factory as well. By the early 1980s, however, oil prices had begun falling. As they fell, both Nigeria's revenues and its economy collapsed. To conserve scarce foreign exchange, the government implemented an import licensing scheme which created huge problems for companies like NIPAG which rely not only on imported equipment but also on specialized imported raw materials (for example, perfumes for its soaps). The last quarter of 1986, the shortage of foreign exchanged forced NIPAG to close its soap manufacturing plant.

During the decade of the 1980s, NIPAG re-launched several key products and introduced several new products including a detergent bar and a local-bean ground coffee. Another major initiative during this period was substitution of imported materials (for example, packaging) by materials produced in Nigeria. NIPAG estimated that import substitution
helped the company survive the recession of the 1980s, and that the program led to an enormous reduction in NIPAG's foreign exchange requirements.

In 1987 Erasmus Adepo became Chairman of NIPAG. Under Adepo, a number of NIPAG products were re-launched, including soaps, detergents, and toothpastes. As for new products, successful launches included a food seasoning product, a detergent for colored and delicate clothes, a laundry soap for lower-income consumers, and two new face creams. As a result of GLOPAG's acquisition of a global cosmetic company, that company's Nigerian affiliate was merged into NIPAG in 1989. At CEO Adepo's urging, NIPAG also invested heavily in a large plantation in Northern Nigeria.

APPENDIX 4
BRIAN KEITH

Brian Keith is 45. He started his GLOPAG career about 20 years ago as sales manager with a GLOPAG group trading company in the Middle East. From 1982-1985, he served as marketing manager for a Division of NIPAG's trading company subsidiary in Nigeria. Keith left Nigeria to become sales director at a U.K. company between 1985-1987. From 1988-1991, he was Chairman of GLOPAG's heavy equipment dealerships in East Africa. He returned to Nigeria in 1992 as Managing Director of GLOPAG's heavy equipment operations there, and served in that role till 1996 when he was appointed Chairman of GLOPAG's operations in Zambia.

APPENDIX 5
NIPAG'S PRODUCT RANGE

Creams and Lotions Products

Our strong and viable skin care brands are regularly updated to cater for the needs of consumers. Citrus and Aloe are effective skin moisturizers that cleanse and rejuvenate the skin, leaving it soft and smooth. Our PetroJel brand soothes and conditions dry skin, while our OdorFree brand offers an effective, long-lasting and affordable line of deodorant products to keep users fresh and confident all day long.

Baby Care Products

Bear is a leading baby care brand in Nigeria. Constantly innovating with consumer-relevant ideas, Bear has introduced new oil and lotion products to make babies' skins even softer, smoother, and better-protected.

Hair Care Products

Svelte, our leading haircare brand, has now been improved and relaunched to better satisfy the expressed needs of the Nigerian market. The brand is now in aesthetically appealing packaging which allows for ease of identification of the different products in the line. A test-market carried out in Nigeria proves the products are effective in imparting the desired benefits of giving consumers' hair lots of body and bounce.

Oral Care Products

SoWhite is a leading oral care brand, and the toothpaste is now packaged in worldclass laminate tubes. A 13gm sachet has also been deployed to provide affordability and convenience. The line includes toothbrushes in three sizes and
with soft, medium, and hard tufts. NoCav is our second toothpaste brand, and offers consumers a high quality brand at a very affordable price.

**Toilet Soap Products**

NIPAG has an excellent understanding of skin types/needs, backed with the latest technology in soap making, to provide a wide variety of worldclass toilet soaps to meet the specific needs of various consumer groups. Among the brand offerings are Carnaba, the “value for money” Parasol brand, and the Lemon Signet brand for active healthy people. These products are all made with high quality ingredients, bearing in mind the needs of our esteemed customers.

**Fabrics Washing/home Cleaning Products**

In order to satisfy the everyday needs of people everywhere in the country, we ensure that the quality of our fabrics wash brands (Lion, Tiger, and Bull) stand out significantly from competition and serve as the benchmarks for quality in the marketplace. Shine is the first choice for kitchen and bathroom cleaning chores for housewives all across Nigeria.

**Food Components Products**

NIPAG’s food components are a delight to housewives who greatly prize good cooking. Our BestCook product line includes seasoning cubes, vegetable oil, and margarines. The margarines are fortified with vitamins which tend to be lacking in the diets of children in Nigeria and elsewhere in the developing world. Our vegetable oils are odorless, non-foamy, and spatterless.

**Beverages/drinks Products**

NIPAG offers the finest beverages and drinks in Nigeria. TigerSupreme Tea, our flagship brand, is made from a rich blend of carefully-selected tea leaves sources from the best tea growing countries of the world. MandillaBest, our value for money brand, meets the needs of consumers requiring an economy-priced product. Our VitaC orange and blackcurrant drinks are made from natural juices rich in vitamin C.

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**APPENDIX 6**

**GLOPAG'S CORPORATE PURPOSE**

GLOPAG exists to meet everyday needs of people everywhere- to anticipate consumer aspirations and to respond creatively and competitively with branded products and services which raise the quality of life for our customers. Our deep roots in local cultures and markets around the world will be the foundation for our future growth. We bring our wealth of knowledge and international expertise to the service of local consumers and customers.

To achieve long term success, the following will be required:

1. A total commitment to exceptional standards of performance and productivity.
2. An ability to work together effectively.
3. A willingness to embrace new ideas and learn continuously.

Finally, GLOPAG believes that success will require a commitment to high standards of corporate behavior toward our employees, our customers, and the societies and worlds in which we live.
## APPENDIX 7
### LOCATIONS OF NIPAG'S LEADING DISTRIBUTORS IN NIGERIA

<table>
<thead>
<tr>
<th>CITY</th>
<th>NUMBER OF DISTRIBUTORS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aba</td>
<td>9</td>
</tr>
<tr>
<td>Abeokuta</td>
<td>3</td>
</tr>
<tr>
<td>Abuja</td>
<td>1</td>
</tr>
<tr>
<td>Bauchi</td>
<td>1</td>
</tr>
<tr>
<td>Benin</td>
<td>5</td>
</tr>
<tr>
<td>Calabar</td>
<td>2</td>
</tr>
<tr>
<td>Enugu</td>
<td>1</td>
</tr>
<tr>
<td>Gombe</td>
<td>4</td>
</tr>
<tr>
<td>Gusau</td>
<td>1</td>
</tr>
<tr>
<td>Ibadan</td>
<td>3</td>
</tr>
<tr>
<td>Ijebu-Ode</td>
<td>2</td>
</tr>
<tr>
<td>Jos</td>
<td>6</td>
</tr>
<tr>
<td>Kaduna</td>
<td>6</td>
</tr>
<tr>
<td>Kanu</td>
<td>6</td>
</tr>
<tr>
<td>Lagos</td>
<td>10</td>
</tr>
<tr>
<td>Lokoja</td>
<td>1</td>
</tr>
<tr>
<td>Maiduguri</td>
<td>4</td>
</tr>
<tr>
<td>Makurdi</td>
<td>1</td>
</tr>
<tr>
<td>Minna</td>
<td>1</td>
</tr>
<tr>
<td>Ondo</td>
<td>2</td>
</tr>
<tr>
<td>Onitsha</td>
<td>4</td>
</tr>
<tr>
<td>Oshogbo</td>
<td>2</td>
</tr>
<tr>
<td>Owerri</td>
<td>1</td>
</tr>
<tr>
<td>Port Harcourt</td>
<td>2</td>
</tr>
<tr>
<td>Sokoto</td>
<td>5</td>
</tr>
<tr>
<td>Umuahia</td>
<td>1</td>
</tr>
<tr>
<td>Warri</td>
<td>2</td>
</tr>
<tr>
<td>Yola</td>
<td>2</td>
</tr>
<tr>
<td>Zaria</td>
<td>1</td>
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</tbody>
</table>
APPENDIX 8
"5S" MODEL FOR IMPROVING FACTORY OPERATIONS

<table>
<thead>
<tr>
<th>THE TERM</th>
<th>MEANING OF THE TERM</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Seiri</td>
<td>Keep only what we need (materials, supplies).</td>
</tr>
<tr>
<td>2. Seiton</td>
<td>Everything must be in its place.</td>
</tr>
<tr>
<td>3. Seiso</td>
<td>Everything must be clean and spotless.</td>
</tr>
<tr>
<td>4. Seiketsus</td>
<td>No backsliding on #1–#3 (above).</td>
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<tr>
<td>5. Shitsuke</td>
<td>Follow procedures to sustain achievements.</td>
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THE OVERPAID STUDENT

Robert C. Schwab, Andrews University

CASE DESCRIPTION

This short case focuses on the motivational and equity problems created by a student wage scale which is based on class standing rather than job demands or work performance. Fairness issues related to motivation, compensation, performance recognition and exception procedures are highlighted. The case has a difficulty level of three, and is best-suited for use in junior or senior-level courses in human resource management, organizational behavior or compensation. The case can be presented and discussed in about one class hour, and is expected to require about two hours of outside preparation by students.

CASE SYNOPSIS

This case chronicles the experience of Cindy, a student employee in a mid-western university. She is an excellent worker and receives a generous wage increase which seems to violate the school's student wage scale. Her supervisor followed the appropriate exception procedures, but several supervisors and students suspect favoritism or political muscle has been at work. They are upset because their requests for wage increases for excellent student workers have been denied. Friction develops between best friends when one receives a large wage increase while the other does not. Is the organization equitably compensating its students, or is the system inherently flawed and unfair? Student interest in this case should be high because the wage scale under scrutiny (which focuses more on class standing than work performance) is commonly used in many schools.

THE OVERPAID STUDENT

Cindy, a freshman biology major, has worked in the payroll department of Peoria University as a student employee for the past year. Her supervisor, Susan Wong, quickly discovered that Cindy was a very efficient and competent worker. Because of her initiative and demonstrated skills, she was assigned several special projects during the year. Cindy was also the student chosen to substitute for other workers who were absent due to illness, vacations or unexpected emergencies. Mrs. Wong
greatly appreciated Cindy's reliability and commitment to work all year long (including breaks and holidays) without complaint. Every task Cindy was assigned was performed extremely well, and Mrs. Wong quickly advanced her pay to the top rate allowed for freshmen.

Many years ago, the university established a single wage scale for all student workers. The student scale is not linked to the pay system established for full-time employees. There are no written job descriptions or formal performance appraisal procedures in place for student workers. The appropriate pay range is determined by the student's class standing. Advancement within the range is for merit or experience. If a supervisor feels a student wage adjustment is needed, a justification and recommendation are submitted to the Student Labor Manager for approval. If a requested wage adjustment exceeds the guidelines (this should be quite rare), it must be approved by the University Business Manager. The current student wage scale used at Peoria University is displayed in Table 1.

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<thead>
<tr>
<th></th>
<th>Freshman</th>
<th>Sophomore</th>
<th>Junior</th>
<th>Senior</th>
<th>Graduate</th>
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<td>Starting</td>
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<td>Midpoint</td>
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<td>Top Rate</td>
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While the wage scale is easy to understand and administer, most students at Peoria University don't feel it is a fair pay system. Entry-level seniors with no previous experience or skills are paid at least $7.00 per hour, while hard-working, productive workers like Cindy can't possibly earn similar wages until they are at least sophomores or juniors.

During the month of April, the payroll department was disrupted when a very good graduate student became seriously ill and had to resign immediately. Mrs. Wong reassigned Cindy to the graduate student's job because she knew Cindy would do her best to get things caught up. It was a complicated job, but in a short time Cindy had mastered it and things were running smoothly. There is no question that Cindy was one of Susan's most valuable and versatile student workers.

On June 1, Cindy was scheduled to receive a pay adjustment because she was now officially classified as a sophomore. Mrs. Wong wanted to reward Cindy for her outstanding work performance, but the pay scale would only allow a 50 cent raise to $7.00 per hour. Susan thought about the irony of the new senior who had just been hired in the office and was being oriented by Cindy. The inexperienced student was paid $7.00 per hour, while Cindy was paid $6.50 per hour to train and orient him. Mrs. Wong remembered that the graduate student had been paid $8.50 per hour, and yet there was Cindy, competently administering the most difficult student job in the office for just $6.50 an hour. It just wasn't fair to exploit Cindy this way! Cindy was the ideal student.
worker...she was knowledgeable, trustworthy, flexible, never asked for time off and never complained about anything.

Mrs. Wong determined that she would try to reward Cindy for her outstanding performance. She wrote a wage exception letter to the University Business Manager and requested that Cindy receive $8.50 per hour. She justified this request with several specific examples of Cindy's accomplishments and competence, pointed out that Cindy was doing the very difficult job held previously by the graduate student who had been paid $8.50 per hour, noted that she was working through the entire summer, and concluded by showing that the departmental budget was sufficient to cover this wage increase. Apparently, Mrs. Wong's justification was convincing, because the wage exception was approved by the Business Manager.

When Mrs. Wong told Cindy about her new pay rate, Cindy was very pleased. She thanked Susan profusely and told her the raise would be a big help in covering her educational expenses. Cindy appeared to be energized and very motivated by this positive recognition.

A few weeks later, Cindy was troubled when she overheard what some of the students and staff were saying about her "unfair" wage and her supervisor, Mrs. Wong. A few supervisors were unhappy because their requests for variances from the student wage scale had been rejected by the Business Manager. When they found out that Mrs. Wong's wage exception for Cindy had been approved, they were very upset. From their perspective, it appeared that a few department heads with "clout" were able to adjust student wages at will, while most supervisors were never allowed to deviate from policy. This unhappiness had leaked out into the student ranks, and a few jealous students were overheard saying that "Cindy must have gotten her big wage increase because Mrs. Wong is in charge of payroll and can get away with ignoring the school policies."

Cindy knew that roughly 15% of the student employees at the university were paid significantly above the regular student wage scale, and that this was done to recognize outstanding performance or to encourage good student workers to stay during the summer months. Several undergraduates were earning over $8.00 per hour, but Cindy didn't feel she could divulge these facts because most payroll information at the university was considered confidential.

The biggest personal problem that Cindy faced as a result of her wage exception was the loss of one of her closest friends, Wendy. Wendy and Cindy had been good friends all through high school and both started their programs at Peoria University last fall. Wendy was majoring in accounting and worked in the accounting office at the university. Although her job responsibilities were not the same as Cindy's, great accuracy and precision were expected, and Wendy distinguished herself as one of the best workers in the accounting department. Wendy's supervisor was extremely pleased with her performance and requested that Wendy's wage be increased to $8.00 per hour. The request was based on Wendy's excellent work performance and her willingness to work during the summer, but the request was denied. Wendy's wage was increased from $6.50 to $7.00 per hour, but she was very disappointed and didn't try to hide her unhappiness. Wendy knew all about Cindy's raise to $8.50 an hour because Cindy had told her on the day it happened. When Wendy learned her
wage would only be $7.00 per hour, she became resentful and announced to Cindy that she wasn't going to fuss the details at work anymore because good workers weren't appreciated in the accounting department. Over the next week, Wendy reminded Cindy how unfair it was that they were both sophomores, but that her boss didn't have enough clout to get her the wage she deserved. Wendy quit her accounting job a few weeks later, and went to work at the local Wal-Mart store. She continued to grumble about how unfairly she had been treated, and generally made Cindy uncomfortable whenever the two were together. Cindy feels bad, but avoiding Wendy is less stressful than facing her, and the two have drifted apart as a result.

Cindy doesn't know what to do. She doesn't like the jealously and pressure that she feels from some of her friends, but she loves her job in payroll and her supervisor, Mrs. Wong. It's not her fault that some wage exceptions were granted while others were denied. She worked very hard last year and feels she deserves the raise she got. Why is everyone unhappy with her? Maybe she should quit her job too, and go to work at Wal-Mart or Burger King. At least no one would be mad at her, and maybe Wendy would still be her friend!

NOTE

The names of individuals and the organization have been disguised.
AU REVOIR, MRS. WILLIAMSON

Charles A. Rarick, Barry University

CASE DESCRIPTION

The primary subject matter of this case concerns cross-cultural management problems. Secondary issues include expatriate selection and training. The case has a difficulty level of five. The case is designed to be taught in one class hour and is expected to require six hours of outside preparation by students.

CASE SYNOPSIS

Margaret Williamson, a British expatriate had been assigned to Paris as a marketing manager for a British-French joint venture called EUROi. While Margaret had been a successful manager in London, she did not continue that success in Paris and experienced many difficulties in her new assignment. Margaret was unable to work effectively with her French counterpart, Georges DuPont which was the result of personality differences, and differences in country and corporate culture. The inability to adjust to these challenges resulted in Margaret failing in her expatriate assignment and returning to London with an uncertain future in her company.

INTRODUCTION

Margaret Williamson, age 50 has just returned to London from Paris, where she worked for the past six months as a marketing specialist for a British and French joint venture called EUROi. British computer manufacturer RoyalPC formed the joint venture with a French ISP called Internet du France (IDF). The two companies hope to capitalize on their particular strengths and grow a Pan-European Internet service. EUROi competes in Europe on the basis of price, and has positioned itself as an alternative ISP in an already crowded market. EUROi targets the 16 to 24 year-old market by offering programming that appeals to a more youthful market. The company also offers subscribers sizable discounts on Royal personal computers.

Margaret began her career at Royal fifteen years ago as a secretary. As a recently divorced mother of two, Margaret entered the work force for the first time and displayed a strong work ethic. Although she did not attend college, Margaret is a very intelligent individual and a quick learner. These traits did not go unnoticed at Royal, and she was promoted out of the secretary pool and placed
into the Marketing Department. Margaret advanced in the department, gaining a reputation for handling difficult assignments. With a strong devotion to her children and her work, she chose not to remarry. With her children now grown she became interested in an international assignment.

Her colleagues viewed Margaret as an effective manager. She was seen as fair to all, conscientious, a good decision maker, and very loyal to the company. Because of her abilities, she was selected to act as marketing liaison between her company and the French partner in the newly formed joint venture.

Mrs. Williamson, as she prefers to be called, is a refined British lady. She possesses excellent manners and prides herself on her personal composure. Her ability to remain calm and level-headed in tense situations would be challenged when she moved to Paris for her new assignment.

Georges DuPont, age 35 is director of marketing for EUROi. DuPont, a graduate of the prestigious Ecole Nationale d' Administration, comes from an elite French family. Somewhat of a renegade, Georges refused to work in the family business after college. He instead, found employment in a number of computer-related businesses. DuPont became fascinated with the creative side of the computer and Internet business. He had been at IDF for four years, and was highly regarded as an effective manager and creative promoter. As marketing director of the joint venture, DuPont was given the responsibility of working with Williamson to find a way to increase revenue for EUROi. DuPont prides himself on his literary and artistic skills and enjoys engaging others in verbal debate.

From the start of their working relationship, problems surfaced between Margaret and Georges. At first, small personal habits of the two seemed to cause friction. Margaret often remarked that Georges never smiled at her, and Georges called Margaret's personality as "interesting as a bottle of cheap California wine." Over the early weeks of the relationship, the situation deteriorated further. Margaret was convinced that Georges was an incompetent and lazy manager. She felt that Georges was too autocratic and did not delegate enough responsibility to lower levels in the organization.

Margaret further complained to her superiors back in London that Georges frequently broke company policy, canceled meetings with little notice, took two-hour lunch breaks, and never admitted his mistakes. She felt that he did not respect her as an equal partner; in fact, she felt that he actually resented her help in promoting the joint venture.

To add more tension to the already strained relationship, Margaret learned that Georges (a married man) was having an affair with his secretary, Giselle. This fact came to light when Margaret found out that the two of them were going to a resort in the south of France for three weeks of vacation. Margaret was offended by Georges's lack of morality, which included his affair with Giselle as well as his advances to other women in the company.

Georges was equally unimpressed with Margaret. He felt that she was uneducated, insensitive, and too concerned with money and company regulations. Georges frequently joked to others about the way in which Margaret dressed. He felt that she had no taste in fashion, and that this alone made her abilities in the company suspect. Georges was unhappy that Margaret forced everyone to
communicate with her in English. Although she spoke little French and Georges and most others spoke fluent English, he resented this, nevertheless. When Margaret requested that she be referred to as "Mrs. Williamson," Georges just rolled his eyes and muttered something in French that Margaret did not understand. He seldom used either her first or last name in conversations with her.

The workplace tensions continued for some time, with Georges and Margaret frequently disagreeing and complaining about each other. It was known throughout EUROi that the two did not get along, and their strained interactions were often the butt of jokes around the company. Georges tried to avoid Margaret as much as possible, which put her in the awkward position of having to go through Giselle to communicate with him. Margaret did not like to deal with Giselle because of her "illicit" behavior with her boss.

The situation finally came to a head when a creative team was to be assembled to design a large advertising campaign for EUROi. Margaret had already developed a plan to assemble the team and empower them with the responsibility of creating a more youth-oriented advertising theme. Margaret had identified five people whom she felt would be best suited for the project. Her plan was to allow these people to work independent of management in creating a new series of advertisements. Margaret felt that a more creative approach to promotion was needed, and she wanted this team to develop a breakthrough design for the promotional strategy.

When Margaret approached Georges with her idea, he refused to accept it. He told Margaret that he felt the current campaign was effective, but admitted that he could see a need for some improvement. Georges recommended that he solicit the advice of a few key people and that he create the new ad design. After all, he was the director of marketing for the new company. Margaret tried to explain to Georges why her plan was better, and that a similar approach had been successful with RoyalPC. Georges just stared at the ceiling, smoking his cigarette. Margaret wasn't even sure if he was listening to her.

After a few weeks of attempting to convince Georges that her plan was better, Margaret decided that she needed help from London. She arranged for a video conference call to be held between London and Paris, in which she and some senior managers at Royal would discuss the issue further with Georges. Margaret sent an e-mail message to Georges, informing him of the conference but received no response. After two days, she asked Giselle if her boss knew of the proposed meeting and if he could attend. Giselle just smiled and responded that he could attend the meeting, if he desired to do so. Margaret sent a memo to Georges indicating the date and time of the conference call and emphasizing the importance of his presence at the meeting.

On the day of the meeting, Margaret searched for Georges. Even though the meeting wasn't for a few hours, she wanted to make sure he would attend, and she thought that perhaps she could even get him to change his mind before the call took place. Giselle told Margaret that he would be in the office soon and that she would remind him of the meeting.

As the 1:00 PM hour for the meeting approached, Margaret was frantic. She phoned Giselle and demanded to know where Georges was and when he would be in the conference room. Giselle
responded that she didn't know where he was and that she really didn't care. When Giselle rudely hung up the phone, Margaret was convinced that Georges would not show up for the meeting. She decided, however, that she might be able to use this to her advantage.

The call from London came precisely at 1:00 PM, with just Margaret sitting in the Paris office. She explained to the people in London that Georges was not present and that she had no idea why he was not there. She went on to tell the London managers that she was not surprised by Georges's behavior; he continually expressed contempt for her, and he had an apparent disregard for the welfare of EUROi. Margaret went on for over 30 minutes detailing Georges's shortcomings, when suddenly he entered the room with three other EUROi employees. Georges apologized for his tardiness but explained that he and the others had been across town working with marketing personnel from a very popular magazine targeted toward the 16 to 24 age group in Europe. Georges was very excited about what this "team" had accomplished, and he wanted the London managers to know the details.

The video call went on for another hour with the three EUROi employees explaining with charts and figures how the association with the youth magazine would be beneficial to the company. They proposed new creative advertising designs and an association with the popular magazine. The team appeared to have been well prepared for the meeting. Georges, who spoke with great confidence and enthusiasm, directed the entire presentation. From the questions asked by the London managers, it was clear that they felt Georges's plan was superior to the one proposed by Margaret. When the presentation was completed they thanked Georges and his team and quickly approved the plan.

At that point Margaret rose from her chair, red-faced and very angry. She appeared at first barely able to speak, but when she began, she angrily accused Georges of undermining her authority. Margaret called Georges a "sneaky bastard," and for the next five minutes vented her frustration at Georges, who sat quietly staring at the ceiling, smoking his cigarette.

Finally the most senior London manager interrupted Margaret and politely asked if Georges and his team could leave the room for a moment. Georges got up and began to leave, but before he left he stopped, smiled at Margaret, and said, "au revoir, Mrs. Williamson."

REFERENCES


COLLEGE RECRUITING AT ORGSERVICES CORPORATION

Woody D. Richardson, Ball State University
Brien N. Smith, Ball State University

CASE DESCRIPTION

The case presents a good springboard for discussing the recruitment process in general and to illustrate the level of students' interest in less well-known organizations. The case also demonstrates the common practice of sending employees to their alma maters to recruit. The case presents a good opportunity to explore student's expectations regarding the job market in general and their specific desires regarding a suitable employer by evaluating the presentation of OrgServices. You may ask students to visit your own career center or one of the many websites providing salary information to obtain salary ranges for jobs of interest to each of the majors represented in your class. This may serve as a "reality check" for many of the students who have not been collecting this information. This case is intended for use in an Employee Selection class in a discussion of recruitment practices; therefore its difficulty level is a three (junior-level). The case is short enough to be easily covered in one class period or as a part of class period if using a recruitment lecture. Alternatively, the case can be used early in the Business Policy or General Management course to stimulate discussion of job-related topics. In either case the case should require less than 1 hour of outside preparation by students.

CASE SYNOPSIS

The case follows, Jason and Patrick, two service area managers for OrgServices Corporation as they return to their alma mater to recruit for the company's Management Training Program. A senior-level Business Policy class constitutes their audience for the presentation. OrgServices is the largest uniform provider in the United States with sales of over $2 billion in 2001. Jason and Patrick briefly present a description of OrgServices and its outstanding achievements (e.g. over 20 consecutive years of growth in revenues and profits, making Fortune's list of Most Admired Companies, etc.). They project that the company will expand its workforce from its current level of 20,000 to 39,000 in 10 years. They also describe the 2-year Management Training Program open to all business majors where trainees rotate through all aspects of the business.
At the close of the presentation only 3 students pick up information on the company leaving Jason and Patrick to wonder what went wrong. Patrick and another alumnus of the University were scheduled to visit a junior-level class in one month. As the case closes the two are in a quandary over what if anything should be done differently for their next visit to campus.

RETURNING TO CAMPUS

As Patrick Kantner pulled onto the campus on a bright spring day in 2002, the new bell tower immediately caught his eye. The alumni publication he received from his alma mater had featured the carillon bells and tower that now anchored the north end of Ball State University. The sudden jolt from a huge pothole redirected Patrick's eyes to the street ahead. As he gazed at the potholes and tar patches he thought that the poor condition of the campus streets had changed little in the four years since his graduation. He parked his car and quickly strode past the "Frog Baby" fountain to the entrance of the College of Business where Jason Truell, a former classmate, was waiting.

Patrick extended his hand to Jason, a fellow service manager at OrgServices Corporation. "How have you been?" "Oh, I can't complain," Jason replied as he firmly returned Patrick's hand shake. "I'm looking forward to making the presentation and to seeing some of our old professors." "Ahh, but it's going to be a little weird standing in front of the class rather than sitting behind a desk," Patrick said. "Yeah, but I'm sure that the students will be receptive to the OrgServices story which should make it a little easier. After all, we're not presenting for a grade today," said Jason. "I'm not so sure," Patrick interjected. "Fred seemed pretty intent on us recruiting some Ball State grads for our Management Training Program." "I guess as General Manager, Fred can't have too much of a good thing," Jason chuckled. "Let's see, besides the two of us there is Tara in your plant and Ann in HR in my office also graduated from here. The professor said he'd meet us in room 140 just before class, so we'd better get inside," Patrick said as he opened the door for Jason, who was carrying a box of promotional materials on OrgServices.

After introducing themselves to the senior class of business policy students, Patrick asked, "How many of you have heard of OrgServices?" Only 2 of the 30-plus students raised their hands. "We're not surprised," Patrick continued. "When Jason and I were sitting where you were four years ago, we hadn't heard of OrgServices either. First, I'll give you a little background on the company and what it does and then Jason will tell you about our management training program. Please feel free to ask us questions at any point in the presentation and remember we'll be at the Career Fair over in the coliseum all afternoon."
Patrick began his overview of the company.

OrgServices is a leader in the uniform rental and corporate identity apparel industry. Approximately 75% of company sales come from the rental business. In addition to uniform rental and sales, OrgServices also provides facility services (e.g. mats, soaps, etc.), first-aid supplies, and cleanroom services. Under the direction of Tom T. Harris, who was listed on Forbes 400 Richest Americans in 2001, OrgServices has recorded over 20 years of consecutive growth in sales and profits.

In 2001, OrgServices recorded over $2 billion in sales and over 4 million people went to work in an OrgServices uniform. The company's profits were in excess of $220 million in 2001, a compound growth rate of 25% from 1998-2001. OrgServices was listed on NASDAQ in 1983. An investment of $1,000 in OrgServices stock in 1983 would be worth $50,000 in 2001. Fortune magazine ranked OrgServices as the No. 1 outsourcing services business in its 2001 list of "America's Most Admired Companies.

Uniform Rental and Sales.

The company designs and manufactures corporate identity programs that it rents or sells throughout the United States and Canada. Over 400,000 companies use OrgServices and its client list includes Honda, Pfizer, Coca-Cola, Wal-Mart, TruGreen, NASCAR, Marriott, Delta Airlines, NAPA, DHL Worldwide Express, Firestone and many others. Its services include advice on the proper fabric, color, style and type of uniform for the type of job. Then OrgServices measures each employee and issues a set of uniforms for each individual. These uniforms would include the company name or logo and the individual wearer's name, if desired. Rental customers receive regular deliveries each week to pick up soiled uniforms and drop-off professionally cleaned uniforms. Rental service also includes exchanges for worn garments or garments that no longer fit properly due to weight loss or gain. Since the terrorist attacks of September 11, uniform sales customers including hotels, airlines, and entertainment businesses have delayed uniform purchases due to slowdowns in their businesses. However, company executives' feel this would result in pent-up demand that would benefit OrgServices as the economy recovers.

Facility Services.

This service area provided by OrgServices includes entrance mats, soaps, air fresheners, and other cleaning supplies. The mat service is aimed at reducing dust entering the workplace and improving employee and customer safety while the hygiene services are aimed at improving
sanitation and appearance of restrooms, and eliminating the need for on-site inventories. The hygiene services include hand care and air freshener stocking and maintenance.

Through the years these services and others have been added to the uniform rental trucks that visit clients on a weekly basis. As customers develop a relationship with OrgServices, the addition of these services became a natural outgrowth of our business.

First Aid and Safety.

The fourth service area provided by OrgServices is first aid and safety. OrgServices services its clients' first aid needs through its OrgServices's first aid line of products. These include bandages, gauze, ointments, sprays, tablets, eyewashes, burn care, and the cabinetry to house the supplies. This service area also provides training and industry updates on OSHA and other government agency workplace requirements.

Cleanroom Resources.

The final service area offered by OrgServices is its cleanroom operations. OrgServices seeks to provide equipment, supplies, training, apparel rental, and precision laundering service to microelectronics, pharmaceuticals, biotechnology, medical device and other manufacturing industries. OrgServices was the first apparel service company to receive ISO-9002 registration.

MANAGEMENT TRAINING PROGRAM

Now that you've heard a little about what OrgServices does, I'll let Jason fill you in on the Management Training Program at OrgServices, Patrick said. Patrick and I both went through the Management Training Program right out of school, and I'd like to tell you a little about it, now Jason continued. It is a 2-year program designed to develop future managers and executives who are committed to the OrgServices principles and values. Management trainees rotate through all aspects of the business from sales, office operations, plant, and delivery. Trainees also attend seminars at the headquarters in Indianapolis. Selection into the program is competitive with salaries starting in the mid-30's. Management's goal for every trainee is to prepare him or her to be a General Manager in 10 years.

I recall thinking as I folded uniforms, loaded and unloaded trucks - I went to college for this? Jason grinned. But I remember what my mentor at OrgServices told me, it's easier to manage people if you have first-hand experience of what they are doing. Now, I believe that Patrick and I are more effective service area managers for having that breadth of experience in our training. This experience is critical to effectively manage a diverse workforce. Over 40% of the customer service
representatives (route drivers) that Patrick and I manage as Service Area Managers have college degrees while the workers in the laundry plants may not have completed high school." Jason flipped on the overhead projector and said, another benefit to the breadth of the training is that we are not limited to any one business major in our recruiting.

OPPORTUNITIES AT ORGSERVICES

As Jason placed a transparency on the overhead projector he continued, before we take your questions we'd like to give you some idea of the opportunities at OrgServices. As you can see we project the potential uniform rental market alone to be $12 billion! As he put up the next slide he continued, in 2001, we were the largest player with only 8% of the uniform rental market share, but our nearest competitor only has about 2% with most of the market made up of small, single location suppliers. By 2005 we project OrgServices will capture 13% of this market. We have 3% of uniform sales and 5% of the entrance mat and first aid markets this year. We expect to double our positions in these markets by 2005.

Patrick placed a map of the U.S. on the overhead. OrgServices is in 280+ of the top 325 U.S. markets and has a location practically anywhere you might like to live and work, continued Jason. As the company expands the number of employees needed is expected to reach 39,000 in the next 10 years nearly double the 2001 level of 20,000. Patrick and I obviously feel that the growth opportunities are exciting at OrgServices and we'd be more than happy to discuss the career opportunities at OrgServices, Jason concluded.

THE REACTION

Patrick handed an OrgServices coffee mug to both students who asked a question. The questions seemed to be obligatory aimed at pleasing the professor rather than ones based on a genuine interest in the company. After the last question, Jason reminded the students of the Career Fair and suggested that the students pick up a business card and a brochure on the Management Training Program as they left the class. The professor thanked Jason and Patrick then dismissed the class. As the students filed out only 3 picked up any information. Jason and Patrick headed to Patrick's car to get some lunch before they manned the booth at the career fair that afternoon.

As the car door shut Patrick began, "Can you believe that they only picked up three of our cards?" "No, I thought the soft job market and the fact that we were willing to talk to seniors of any major that we'd have gotten more of a response," replied Jason. "Do you think my mention of folding clothes turned them off?" asked Jason. "Probably, but it is a fact and besides what is wrong with folding clothes, anyway? Patrick pulled into the restaurant parking lot and continued, "OrgServices
is a great company with exceptional opportunities for those willing to work, and if they can't see that then I'm not sure what to do. I guess uniform rental, mats, and soap just isn't as exciting as some of the other companies recruiting on campus. The professor asked Ann Baxter from HR and me to speak to his Principles of Management class next month. I wonder what students are looking for these days? Do you think we should alter our approach or was this just a strange class?"

NOTE

While based on real events the company and individual names have been disguised at the company's request.
SCHOOL OF BUSINESS REVISES ITS MISSION STATEMENT

Bobby Medlin, Henderson State University
Ken Green, Jr., Henderson State University
Carl Stark, Henderson State University

CASE DESCRIPTION

The primary subject matter of this case concerns implementation of a process designed to improve an existing mission statement in terms of completeness and quality. Students use a mission statement evaluation scale to identify deficiencies in an existing mission statement and adopt a TQM based brain storming, multi-voting approach to rectifying the deficiencies. The case depicts a university business school in the process of reviewing and improving an existing mission statement for purposes of satisfying accreditation requirements and improving program and service delivery processes. The case is designed to be taught in approximately three class hours.

CASE SYNOPSIS

Students are provided with a management scenario in which the dean of a university school of business has determined that the school's mission statement must be revised and improved in terms of completeness and quality for purposes of meeting accreditation requirements and reestablishing a strong sense of unity of direction on the part of the school's faculty and staff. One of the faculty members has been assigned the task of facilitating the mission statement improvement process which incorporates 1) assessment of the completeness of the existing statement by faculty and students of the school of business, 2) participation in a brainstorming, multi-voting process designed to rectify noted deficiencies in the statement, 3) a revision of the statement and finally 4) a reassessment of the new statement. Students are asked to apply this mission statement improvement process to the current mission statement for their university.

THE CASE

The dean of a small university business school wants to improve the school's mission statement to meet AACSB accrediting requirements and to improve the business program. She wants
to refocus the school's faculty and staff on the school's purpose and vision. She has assembled the school's faculty and staff in the meeting room of one of the local community banks. She begins the activities with some opening comments. "Before I turn the proceedings over to Dr. Alexander, let me thank everyone for coming. I know we could have done this at our building, but I thought everyone might enjoy getting away for the day. As you can see, there are refreshments in the back--help yourself. We'll break for lunch around 11:30, be back at 1:00, finish up around 5:00, dinner at my house at 6:00. Does anyone have any questions or announcements before we get started? Well, in that case, I will turn the show over to your esteemed colleague, Dr. Alexander."

**BACKGROUND**

The School of Business is part of a small liberal arts university that, in addition to traditional liberal arts programs, also offers excellent programs in a number of professional areas including business. The School of Business offers undergraduate degree programs in Accounting and Business Administration as well as a Master's Degree in Business Administration. Five years ago, the School received full, 10-year accreditation by AACSB, the oldest and most prestigious external accrediting body for collegiate business programs. The process was extremely challenging, requiring great commitment on the part of the entire faculty, administration, and staff of the School. Everyone within the School took great pride in accomplishing this goal-not only because the School received the accreditation, but also because this intense effort resulted in dramatic improvements in the quality of the programs. The challenge now was to maintain the accreditation that they had worked so hard to achieve.

AACSB accreditation standards are built around the mission of each specific business program. Five years ago, the School completely revised its mission statement to accurately reflect what really existed within the School as well as what the School wanted to become. At first, it was done simply to satisfy a requirement for accreditation; however, it proved to be very beneficial in modifying and developing mission-supportive activities and programs that significantly enhanced the quality of the programs and services provided by the School.

**THE PROCESS**

Dr. Alexander and a colleague had developed the Mission Statement Evaluation Scale (Appendix A) designed to measure the completeness of an organization's mission statement. The scale includes items related to nine areas that their research indicated should be discussed in a complete mission statement. Items 1 through 4 generally relate to the organization's purpose or reason for existence; the remaining five items relate to the organization's vision of the future.
Phase one of the process required members of the faculty and staff to use the nine-item scale to measure the extent to which the primary concepts that should be incorporated into a mission statement are actually included. The scale was developed and assessed for reliability and validity by Green, Medlin and Medlin (2001). A score is determined for each of the nine items as well as an overall score for the completeness of the mission statement. Results are determined and communicated to the group. Low scores (with averages below 5.00) for individual items indicate the area(s) that require greater scrutiny. These results lead to phase two of the process.

The faculty and staff meet for intense discussions about specific ideas addressing the weak areas as determined in the first phase of the process. Each area of deficiency is addressed using a brainstorming, multi-voting technique designed to build consensus related to how the deficient area should be corrected. The brainstorming portion of the technique involves all participants in generation of a maximum number of ideas related to improvement. The multi-voting portion results in a shortened prioritized list of improvements and a general agreement that inclusion of the short list in the mission statement will in fact make the statement more complete. While the scale allows assessment of completeness, it's this brainstorming, multi-voting exercise that results in improve quality of the statement.

Following this meeting, the mission statement is re-written to reflect these modifications, distributed to the group again for reevaluation using the nine-item scale, re-scored with the results communicated to the group. At that point, the decision can be made to accept the changes and a new mission statement is adopted—the final phase of the process.

THE MEETING

Phase one of the process had been completed by the 23 members of the Business faculty and staff. Phase two was about to begin.

"Thank you, Dean," said Dr. Alexander. "I know you guys won't believe this, but I'm going to skip my opening story—even though it was going to be my funniest yet—and get right to work. We've got a lot to do today." Dr. Alexander recognized that mission discussions tend to create a great deal of debate, sometimes veering away from the true objective, and he was determined to keep the group focused and moving in the right direction. He was confident this would happen because of the process that he was using.

"Just to review for a second, you all have evaluated our old mission statement (Appendix B). I gave you the results last week (Appendix C), but I've also brought copies of that memo if anyone needs one. Our overall score of 61% indicates that we've got some significant work to do. Keep in mind that changing mission statements is an incremental thing. We aren't trying to totally revamp what we have, just to tweak it a little and make it better. Recall that the areas of competitive advantage, vision, scope and the factors (technology, creativity and innovation) had significantly
lower scores than the other areas. So, that's where we need to focus today. If we can enhance those four areas, that would represent a major accomplishment in improving the completeness and quality of our mission statement."

Dr. Alexander explained the way today's meeting would take place. The group would completely address each area before moving to the next one. For each area, he would go around the room and every faculty and staff member would specify what he or she thought should be included in the mission statement to improve the deficient area. (Note: The faculty had been asked to bring this information after considering it since the initial results were distributed). These would be recorded on the board at the front of the room. Once everyone's suggestion was recorded, he would ask each person to vote on their top three from the list on the board. Results would be tabulated, and those three items would ultimately be injected into the mission statement.

As Dr. Alexander expected, his challenge was to keep everyone focused on the task at hand. Everyone was dedicated to improving the mission statement, but discussions often did stray off course. Though the comments led to some very interesting and valuable discourse, it occasionally was not pointed in the direction that Dr. Alexander wanted to go. But by noon, the group had completed the process for the competitive advantage and vision deficiencies. As the group chatted over lunch, everyone seemed to agree that the results did indeed represent quality improvement.

After lunch, things began to progress much smoother. The group, wanting to avoid being told "that's nice but off the subject," tended to be much more focused. By the end of the afternoon, the remaining areas of scope and factors had been discussed, and suggestions for improvement had been made.

**FOLLOW-UP**

Phase two of the process was not complete. Suggestions had to be written into the mission statement, the statement reevaluated, and the results tabulated to determine if the suggestions had indeed improved the mission statement.

The next morning, Dr. Alexander modified the mission statement for the School of Business by incorporating the changes suggested at the prior meeting and sent it via e-mail attachment to his colleagues (See Appendix D). The email asked everyone to reevaluate the new statement and get the results back to him by the end of the week. He was very pleased with both the quantity and quality of the input at the retreat and was confident that the results would show significant improvement in the quality of the mission statement.

The new evaluations trickled in slowly, but by the end of the week everyone had submitted their reevaluation. As Dr. Alexander studied the results (See Appendix E), he began to smile. "All right, the process worked. Yes!" The overall score had risen from 61% to 92%. He also noted that the average scores for the four deficient areas had risen significantly. In fact all of the area scores
had risen. This confused him until he realized that the process of improving the four deficient areas had overlapped with all of the areas. Such across the board improvement should have been expected. He would show the results to the Dean this afternoon and recommend that the School adopt the revised mission statement.

**INSTRUCTIONS**

1. Discuss the value of the mission revision process used in the case in terms of:
   a. The improvement in completeness of the mission statement.
   b. The improvement in quality of the mission statement.
   c. Increased familiarity with the organization's purpose and vision on the part of the process participants.
   d. Increased internalization of the organization's purpose and vision on the part of the process participants.
   e. Implications of internalization on the organization's long-term performance.

2. Using the Mission Statement Evaluation Scale,
   a. Assess the completeness of your university's mission statement.
   b. Summarize the results of the evaluation and compute item averages and an overall completeness score.
   c. Rank the areas from low to high according to area means. Note the areas with scores of less than 5.00.

3. Apply the brainstorming, multi-voting process to improve top two areas of deficiency. Revise the mission statement to reflect the results of the brainstorming, multi-voting process.

   ◆ Reevaluate the revised mission statement using the Mission Statement Evaluation Scale. Compare the results of the initial evaluation and the reevaluation noting any improvements.

**REFERENCES**

APPENDIX A
MISSION STATEMENT EVALUATION SCALE
(Green, Medlin & Medlin, 2001)

Based on a thorough review of the organization's mission statement, circle the number that best represents your agreement with each of the following statements.

<table>
<thead>
<tr>
<th>Statement</th>
<th>Strongly Disagree</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>Strongly Agree</th>
</tr>
</thead>
<tbody>
<tr>
<td>The purpose or reason for the organization's existence is clearly identified.</td>
<td>Strongly Disagree</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>Strongly Agree</td>
</tr>
<tr>
<td>The services and/or products provided society is clearly identified.</td>
<td>Strongly Disagree</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>Strongly Agree</td>
</tr>
<tr>
<td>The fundamental, unique competitive advantage that sets the company apart from other firms of its type is clearly identified.</td>
<td>Strongly Disagree</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>Strongly Agree</td>
</tr>
<tr>
<td>The scope of the company's operations in terms of products and services offered and markets served is clearly identified.</td>
<td>Strongly Disagree</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>Strongly Agree</td>
</tr>
<tr>
<td>There is a clear description of the firm's philosophy about how it does business and treats its customers.</td>
<td>Strongly Disagree</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>Strongly Agree</td>
</tr>
<tr>
<td>There is a clear description of what the organization wants to become.</td>
<td>Strongly Disagree</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>Strongly Agree</td>
</tr>
<tr>
<td>The statement promotes a sense of shared expectations in employees.</td>
<td>Strongly Disagree</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>Strongly Agree</td>
</tr>
<tr>
<td>The statement communicates a positive public image to important stakeholder groups.</td>
<td>Strongly Disagree</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>Strongly Agree</td>
</tr>
<tr>
<td>The importance of factors such as technology, creativity and innovation is emphasized.</td>
<td>Strongly Disagree</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>Strongly Agree</td>
</tr>
</tbody>
</table>

Total the scores on each question and divide by 9 to compute an overall score for the organization's mission statement. Then, divide the overall score by 7 and multiply it by 100 to compute the overall percentage score.

Overall Score = ____________   Overall percentage = ____________
APPENDIX B
ORIGINAL MISSION STATEMENT

We are dedicated to providing our students with the highest quality educational experiences in business concepts and skills that are needed to meet the challenges of today's complex and changing environment, to compete effectively in the global marketplace, and to make positive contributions to their chosen professions. The School focuses on the development of leaders with capacity to effectively initiate, manage and implement change in a dynamic business environment. In consonance with Henderson's liberal arts mission, we seek to promote our students' growth through the attainment of knowledge and the acquisition of necessary skills in a manner that will develop in each student the capability to think logically and critically, communicate effectively, and appreciate the complexity and diversity of world cultures.

Our unique challenges are the following:

- To provide an educational environment where the teaching and preparation of students is top priority;
- To develop in our students positive attitudes toward quality work, self discipline, personal motivation, ethical behavior, effective leadership, and teamwork;
- To serve as a resource for the business community in the areas of counseling, training, and economic development;
- To maintain a faculty actively involved in their respective professions and who actively produce intellectual contributions on a continuing basis;
- To model effective organizational performance that is based on commitment, individual competence, integrity, self-management, and pride.
## APPENDIX C
### RESULTS OF INITIAL EVALUATION

<table>
<thead>
<tr>
<th>SCALE ITEM</th>
<th>Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>COMP ADVANT</td>
<td>2.8889</td>
</tr>
<tr>
<td>VISION</td>
<td>2.9444</td>
</tr>
<tr>
<td>SCOPE</td>
<td>3.5000</td>
</tr>
<tr>
<td>FACTORS</td>
<td>3.8333</td>
</tr>
<tr>
<td>PHILOSOPHY</td>
<td>4.5000</td>
</tr>
<tr>
<td>EXPECTATIONS</td>
<td>4.6667</td>
</tr>
<tr>
<td>SERVICES</td>
<td>5.0556</td>
</tr>
<tr>
<td>IMAGE</td>
<td>5.1667</td>
</tr>
<tr>
<td>PURPOSE</td>
<td>5.7778</td>
</tr>
<tr>
<td>Average</td>
<td>4.2592</td>
</tr>
<tr>
<td>Score</td>
<td>60.85%</td>
</tr>
</tbody>
</table>
APPENDIX D
REVISED/PROPOSED MISSION STATEMENT

We are dedicated to providing our students with the highest quality educational experiences in business concepts and skills that are needed to meet the challenges of today's complex and changing environment, to compete effectively in the global marketplace, and to make positive contributions to their chosen professions. We believe that our unique competitive advantage is an open, collegial atmosphere that fosters a "personal education" experience for our students.

The School focuses on the development of leaders with capacity to effectively initiate, manage and implement change in a dynamic business environment. In consonance with the University's liberal arts mission, we seek to promote our students' growth through the attainment of knowledge and the acquisition of necessary skills in a manner that will develop in each student the capability to think logically and critically, communicate effectively, and appreciate the complexity and diversity of world cultures.

We strive to develop a School that is highly connected with regional businesses and institutions and that is recognized locally and regionally for the provision of cutting edge, relevant educational services. More precisely, we strive to build a School that produces the best business graduates in the State.

Our unique challenges are the following:

- To provide an educational environment where the teaching and preparation of students is top priority;
- To develop in our students positive attitudes toward quality work, self-discipline, personal motivation, ethical behavior, effective leadership, and teamwork;
- To serve as a resource for the business community in the areas of counseling, training, and economic development;
- To maintain a faculty actively involved in their respective professions and who actively produce intellectual contributions on a continuing basis;
- To model effective organizational performance that is based on commitment, individual competence, integrity, self-management, and pride.
## APPENDIX E

### RESULTS OF REEVALUATION

<table>
<thead>
<tr>
<th>SCALE ITEM</th>
<th>Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>COMP ADVANT</td>
<td>6.54</td>
</tr>
<tr>
<td>VISION</td>
<td>6.52</td>
</tr>
<tr>
<td>PHILOSOPHY</td>
<td>6.24</td>
</tr>
<tr>
<td>FACTORS</td>
<td>6.22</td>
</tr>
<tr>
<td>EXPECTATIONS</td>
<td>6.24</td>
</tr>
<tr>
<td>SCOPE</td>
<td>6.42</td>
</tr>
<tr>
<td>SERVICES</td>
<td>6.76</td>
</tr>
<tr>
<td>IMAGE</td>
<td>6.50</td>
</tr>
<tr>
<td>PURPOSE</td>
<td>6.80</td>
</tr>
<tr>
<td>Overall Mean*</td>
<td>6.47</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>.44</td>
</tr>
<tr>
<td>Overall Score</td>
<td>92.43%</td>
</tr>
</tbody>
</table>
BIG FLICKS STUDIO: A CASE ANALYSIS OF EQUITY STRUCTURING POLICY AND EARNINGS MANAGEMENT

Richard Mason, University of Nevada, Reno
John Mills, University of Nevada, Reno
Lynn Bible, University of Nevada, Reno

CASE DESCRIPTION

The primary subject matter of this case is an evaluation of the impact on earnings that can result from forming a separate subsidiary joint venture and the use of the equity accounting method. The main objective is to help students realize that there are various ways that management can adjust earnings to provide different outcomes with the same underlying business performance. Secondary objectives include helping students understand the nature and complexity of the structured finance decision and the various conflicting managerial motivations involved in such a decision. Students are also given an understanding of the market effects that may drive earnings management. The case provides a good example of the effects of the equity method of accounting and is suitable for use when presenting the equity method. This case is appropriate for an upper-division undergraduate financial accounting course, an accounting MBA or MAcc course or even a finance course. Level of difficulty would be four or five on a ten scale. The case is designed to be discussed in one and a half hours and should take students no more than two hours of outside preparation.

CASE SYNOPSIS

Corporate structuring has provided management with many opportunities to shape earnings. This case involves the evaluation of a joint venture for funding motion picture production and provides a means for students to see the impact of such a creation on earnings, while staying within the bounds of existing accounting rules. It also provides the instructor with the opportunity to discuss the market and ethical considerations involved in earnings management for a publicly traded firm. Actual situations and accepted practices used in the entertainment industry were used in the case design. Alternative financing choices are demonstrated that impact on the corporate bottom line. Specifically, at issue is whether to set up a joint venture as a basis for improving short-term
CASE INTRODUCTION

The case of the Enron Corporation will most likely be associated with the downfall of Arthur Anderson, the shredding of audit papers, and the wrong doings of corporate officers. What may not be remembered is that the initial enquiries into the Enron problems revolved around the structuring of a series of partnerships, which allowed Enron to hide much of its corporate debt as well as to keep losses out of the parent company financial statements. Essentially, these schemes were designed to manage the reported accounting earnings. Revelations of the debt carried by these so-called special-purpose entities (SPE) would later help sink the company. Enron executives or affiliates controlled many of the SPEs Enron set up. The failure to consolidate these related-party controlled entities has led to criminal charges against those involved. Unlike the Enron situation, it is far more common for SPEs to be formed without the control aspects needed to make the SPE a related-party entity.

What many investors, creditors, analysts, and students fail to realize, is that the structuring of subsidiary partnerships and corporations is a common practice used by many corporations listed on the major stock exchanges. Both the FASB and the SEC have had many meeting and discussions on defining what is appropriate for disclosure or inclusion in consolidated financial statements. The FASB currently has two exposure drafts that address consolidation issues Consolidation of Certain Special-Purpose Entities—an interpretation of ARB No. 51; and, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Guarantees of Indebtedness of Others—an interpretation of FASB Statements No. 5, 57, and 107.

There are several definitions of earnings management. The National Association of Certified Fraud Examiners define it as "the intentional, deliberate, misstatement or omission of material facts, or accounting data, which is misleading and, when considered with all the information made available, would cause the reader to change or alter his or her judgment or decision." (1993, 12) Former SEC Chairman Arthur Levitt defines earnings management as earnings reports that "reflect the desires of management rather than the underlying financial performance of a company." (1998) Katherine Schipper, now a FASB board member, stated that earnings management is a form of "'disclosure management' in the sense of a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain (as opposed to, say merely facilitating the neutral operations of the process)." (1989) Finally, Healy & Whalen claim that "earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying
economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers." (1999)

The current headlines scream about accounting fraud at Enron and Waste Management, and now WorldCom. Yet, on a day-to-day basis, hundreds of corporations are making decisions cognizant that these decisions may improve their bottom line, and who is to say that they are wrong? One could argue that the real problem is the lack of a true understanding of the complexities of accounting rules and regulations by many securities analysts.

THE CASE

`The film industry is a hit driven business. Most films are not financial successes, while a few become blockbusters. The high-risk nature of the industry coupled with the accounting rules relating to films, provides an environment that is ripe for the use of financing structures that allow for the management, or smoothing, of earnings over time. Some major film studios employed off-balance sheet joint-venture financing structures in the 1980's and 1990's. Successful films that were financed by Columbia Pictures through these type of ventures included Ghostbusters, Tootsie, The Big Chill, and Annie. It is also important to realize that many films such as Ishtar, Spacehunter: Adventures in the Forbidden Zone, and other unsuccessful films that are not well known were also financed through these structures.

The president of Big Flicks Studios has recently learned about the possible use of a financing structure promising to boost short-term earnings, but does not understand how it works. He asks you, the CFO of Big Flicks Studios, to investigate this possibility, suggest any relevant transaction structures and prepare a spreadsheet explaining the earnings impact of the financing structure.

Big Flicks Studio is registered as a corporation, currently traded in the over-the-counter market. The corporation also complies with generally accepted accounting principles as provided by AICPA Statement of Position SOP 00-2, Accounting by Producers or Distributors of Films. It currently has 10 million shares of common stock outstanding.

Big Flicks Studio produced and released two films in the current year (2002), each with a production cost of $50 million. Therefore, Big Flicks spent a total of $100 million on the two films. The revenues from movie, video, and television sales for these two films will be generated over a five-year time period. The first film is a martial arts action picture, The Tax Master. After its initial release, The Tax Master was projected to take in $80 million of revenue in excess of distribution expenses over its life, resulting in a gross profit of $30 million ($80-$50 production cost= $30). Distribution expenses for films include such items as the cost of prints sent to theaters and all the advertising and promotion costs.
The second film is a romantic comedy entitled The Houston Story. Unfortunately, after its release, it has been projected to take in only $30 million above expenses, or to lose $20 million ($30-$50 production cost= $(20)).

Big Flicks also has ongoing net income from its film library of $30 million per year. For simplicity, assume that each film has only a five-year life and the profits are earned ratably over the five years. We will also assume away general and administrative expenses so our gross profit or loss will be our income before taxes. Taxes are assumed at a flat 35% of income.

**Requirement #1**

How does SOP 00-2 require film producers and distributors to treat "loss" films? How does SOP 00-2 require film producers and distributors to treat "profitable" films? Prepare an income statement in accordance with SOP 00-2 for the five years of anticipated revenues (years 2002-2007) for Big Flicks. This should include earnings per share (EPS) data.

You, the CFO, suggests that an alternative for Big Flicks Studio is to enter into a 50/50 partnership, or joint venture. This would be a separate entity called Picture Partners created with 50% of the equity provided by Big Flicks Studio and 50% of the equity provided by Filmvest, an entity unaffiliated with Big Flicks. Each of these two contributing companies would receive 50% of the profits. The management of Picture Partners is established in a way that Picture Partners and Big Flicks are not related parties and the management of the joint venture is independent of either Big Flicks Studio and Filmvest, i.e. no consolidation of Picture Partners is required.

Joint ventures are frequently found in the business world. They represent separate investments by two or more entities. They offer various advantages such as allowing companies to share technological, operating, and financial risk. Joint Ventures are typically set up as separate legal entities and as such, prepare their own financial statements. Provided neither partner has more than 50% ownership, the joint venture partners account for the investment using the equity method of accounting. Use of the equity method means that for the balance sheet, the gross assets and liabilities are excluded from the financial statements of the partners and they only include the proportional net asset (investment) value of the venture is shown. Likewise, for the income statement the revenues and expenses of the joint venture are also excluded and only the proportional net income or loss from the venture is shown in the partners income statement.

The ownership of the scripts and other rights to The Tax Master and The Houston Story is transferred to the Picture Partners before production begins, so Picture Partners will own and produce the films. Picture Partners licenses the distribution rights back to Big Flicks. To keep this example more tractable, Big Flicks is assumed to be distributing the films without a fee. In reality a distribution fee arrangement for each of the distribution markets ranging from 20-40% was not uncommon. Both Big Flicks and Filmvest contribute 50% of the cost of the films as they are actually
produced. Filmvest is itself a private entity funded by wealthy individuals interested in cash flow and tax benefits, but unconcerned with reported accounting earnings.

**Requirement #2**

Prepare an income statement in accordance with SOP 00-2 for the five years of anticipated revenues (years 2002-2007) for Picture Partners. Keep in mind that the Picture Partners is not a taxed entity and that profits flow through to the parent companies. Then prepare an income statement for the five years of anticipated revenues (years 2002-2007) for Big Flicks. The equity method is used to record transactions from its participation in Picture Partners. This should include earnings per share (EPS) for each year.

**Requirement #3**

The normal price earnings ratio for the film industry is 15 times annual EPS. Prepare a chart of the potential stock price and overall market capitalization of Big Flicks for the five-year period under both Alternative #1 and #2.

**Requirement #4**

As the CFO of Big Flicks, you know that film production and distribution can result in potentially volatile earnings. Provide arguments for maintaining the current corporate structuring versus creating Picture Partners. What are the financial concerns of each alternative?

**Requirement #5**

Would the provisions of the current FASB exposure drafts: Consolidation of Certain Special-Purpose Entities-an interpretation of ARB No. 51; and, Guarantor's Accounting and Disclosure Requirements for Guarantees and Including Guarantees of Indebtedness of Others-an interpretation of FASB Statements No. 5, 57, and 107, impact Big Flick's ability to derive the short-term earnings benefit of the Picture Partners transaction structure?
MISSOURI SOLVENTS: 
THE CAPITAL INVESTMENT DECISION

David A. Kunz, Southeast Missouri State University
Kenneth Heischmidt, Southeast Missouri State University

CASE DESCRIPTION

The primary subject matter of this case concerns the fine line between ethical and unethical behavior and the capital budgeting process. Case examines the challenges of identifying unethical behavior and resolving ethical conflicts. Students are expected to apply a predetermined process to the ethical analysis of a realistic business situation. The situation is one that young business professionals may encounter early in their careers. The case requires students to have an introductory knowledge of general business issues thus the case has a difficulty level of three (junior level) or higher. The case is designed to be taught in one class session of approximately 1.25 hours and is expected to require 1-2 hours of preparation time from the students.

CASE SYNOPSIS

Missouri Solvents is a regional distributor of liquid and dry chemicals. Allen David, a recent college graduate and financial analyst for Missouri Solvents, has completed the net present value (NPV) calculation for new drum filling equipment. The project is championed by Stewart Scott, vice president of sales for Missouri Solvents, who provided most of the supporting assumptions for new drum filling equipment. The initial analysis indicated the project did not meet company investment criteria. Scott was not satisfied with the analysis and increased the sales assumptions. David thought the revised sales numbers were aggressive. When David expressed his concern, Scott assured him that he was the sales expert and knew the packaged goods market. David felt that one way or another Scott was going to insure that the project would achieve a positive NPV and meet company investment criteria.
THE CAPITAL INVESTMENT DECISION

The Situation

Missouri Solvents is a regional distributor of liquid and dry chemicals, headquartered in St. Louis. The company has been serving the St. Louis marketplace for over twenty-five years and has a reputation as a reliable supplier of industrial chemicals. Growth has been steady but over the last five years sales and profits have grown at double-digit rates due to the addition of new product lines. Stewart Scott, vice president of sales, has been the main force behind the product line expansion and he continues to aggressively seek growth opportunities.

One of Missouri Solvents' competitors recently announced that due to a change in its long-term direction it intended to close its packaged goods operations. Scott views this announcement as a growth opportunity but recognizes that Missouri Solvent will need to increase its current packaging capacity to fill the void created by the withdrawal of its competitor.

Chemical Distribution

A chemical distributor is a wholesaler. Operations may vary but a typical distributor purchases chemicals in large quantities (bulk - barge, rail or truckloads) from a number of manufacturers. Bulk chemicals are stored in "tank farms", a number of tanks located in an area surrounded by dikes. Tanks can receive and ship materials from all modes of transportation. Packaged chemicals are stored in a warehouse. Other distributor activities include blending, repackaging, and shipping in smaller quantities (less than truckload, tote tanks, 55-gallon drums, and other smaller package sizes) to meet the needs of a variety of industrial users. In addition to the tank farm and warehouse, a distributor needs access to specialized delivery equipment (specialized truck transports, and tank rail cars) to meet the handling requirements of different chemicals. A distributor adds value by supplying its customers with the chemicals they need, in the quantities they desire, when they need them. This requires maintaining a sizable inventory and operating efficiently. Distributors usually operate on very thin profit margins.

Capital Investment Analysis

The Net Present Value (NPV) method is used by Missouri Solvents to rank projects and to decide whether or not to include the project in the capital budget. Calculating NPV requires estimating the project' expected benefits (future cash flows) and finding the present value of the future cash flows (discounting) using a discount rate which reflects the risk level of the project. The
company uses the firm's cost of capital (13%) as the discount rate for most projects. If the present value of the future cash flows exceeds the project's cost, the investment has a positive NPV and is considered acceptable. The dollar value of the investment determines the approval level required. A higher dollar investment requires a higher approval level, Scott can approve projects up to $500,000 but projects over $500,000 require the approval of Missouri's CEO, Bill Davis and projects over $1,000,000 require board approval.

THE ANALYSIS

New drum filling equipment needed to meet the demand of the new customers would cost $860,000 to acquire and install. Scott estimated the packaged goods sales resulting from the new drum filling equipment and projected selling prices to support the acquisition. As usual, Scott was conservative in his initial estimates. Scott never wanted to provide a larger than needed estimate to justify a project.

Allen David, a recent college graduate and financial analyst, was assigned the task of conducting the NPV analysis. David estimated the cost to operate the new drum filling equipment and used the sales and selling price assumptions provided by Scott, to develop projected cash flows and determined the project's NPV. No matter how he ran the numbers, the project failed to generate a positive NPV.

David knew Scott would not be satisfied with his analysis. Scott has wanted this equipment for a number of months and saw the competitor's withdrawal as an opportunity to justify the acquisition of the equipment.

Meeting with Vice President of Sales

David discussed the analysis with Scott and reviewed the assumptions he made to develop the projected cash flows. The estimated incremental drum sales did not generate sufficient cash flow to justify the cost of the new equipment. David explained that the project had a negative NPV of ($79,657), thus failed to meet company investment requirements. As David expected, Scott was not pleased that the project failed to meet company investment requirements.

Scott explained how the new equipment would not only allow the company to increase its drum filling capacity to meet increased demand resulting from the withdrawal of a competitor but would also improve the efficiency of the company's drum filling operation. The increased efficiency would translate into lower operating costs, which would allow the company to attract new customers with lower prices or increase the company's profitability on current drum sales. The new equipment will also provide the capacity to add a new product line of packaged goods.
Scott then asked the question David knew was coming. "What can we do to make this project meet company criteria?" Scott proceeded to revise upward his drum selling price assumptions. He told David his initial estimates were conservative and to run the analysis again. David thought the revised selling price estimates were aggressive, substantially higher than the company's current average pricing. When David expressed his concern, Scott indicated a new product line that would have a substantially higher price than the company's current packaged goods line. He also told David that this was his project and tactfully, but firmly, communicated to David that he probably knew the packaged goods market better than David. As the meeting ended, Scott told David to increase the projected sales by another ten percent if the project's still generated a negative NPV. David left the meeting feeling that one way or another Scott was going to insure the project achieved a positive NPV and met company investment criteria.

Meeting with Controller

After the meeting with Scott, David met with his boss, Ann Nye, Controller, and described the meeting with Scott. In particular, he expressed his reservations about the revised assumptions provided by Scott. Ann told him that it was his job to verify the reasonableness of the assumptions and "run the analysis." She asked if he was certain the assumptions were not reasonable. He replied no, but indicated that based on historic information they seem very aggressive. She said that Scott had over 20 years in the chemical distribution business and knew the market. She told him to use Scott's new assumptions and run the analysis again.

David's Dilemma

After David made the assumption changes suggested by Scott, the project still yielded a slightly negative NPV of ($14,072). Following Scott's instructions, he increased projected sales volume by another ten percent. The higher sales volume resulted in a positive NPV of $44,212. The positive NPV indicated the project met the acceptance standards and would be included in the company's capital budget.

Despite the positive NPV and the instructions from Ann Nye, David was uncomfortable with the analysis. He did not feel the projected sales and selling price assumptions provided by Scott, which were necessary to generate the positive NPV, could be achieved.
THE TASK

Use the Seven Step Model, developed by Velasquez, to recommend a course of action for Allen David. A description of the model is provided in appendix 1.

SUGGESTED REFERENCES


Appendix 1
Seven Step Model
Manuel Velasquez

The seven step model is a basic procedure for evaluating and resolving an ethical business problem. The seven steps and a brief explanation follow:

1) What are the relevant facts? Identify the primary factors that impact the business event and provide an ethical issue. Make sure the discussions focus on the facts while fully discussing the case as a whole.

2) What are the ethical issues? There may be many business related issues that are separate from the identified ethical issues. After discussion of the multiple issues in the case, focus on the one most relevant for this case discussion. Keep focused on the ethical issues.

3) Who are the primary stakeholders? Identify the parties being impacted by this situation. Possible stakeholders include the company, investors in the company, departments, work groups, current customers, future customers, competitors, shareholders, future investors, and others. Also consider individuals involved in the case including spouses, children, relatives, work cohorts, other employees, and future employees.

4) What are the possible alternatives? Develop alternatives to resolve the identified ethical issue and discuss the pros and cons of the actions.

5) Discuss the ethics of the alternatives. Use common acceptable moral philosophies as a basis for their discussion. These moral philosophies may include the perspectives of Teleology (both egoism and utilitarianism), Deontology, and Relativist.
   a) Teleology suggests actions may be judged correct or acceptable if they provide desired results. Thus, consequences of decisions are of primary importance.
   b) Deontology suggests actions should be guided by certain rights of individuals. The focus is on the intentions associated with a behavior, not the consequences. This philosophy suggests individuals have certain absolute rights. Among these include freedom of conscience, freedom of consent, and freedom of speech. In contrast with teleological philosophies that look at the ends associated with an action, the deontology philosophies look most closely at the means associated with a particular action.
   c) The Relativist looks at what others do in this situation, and direct their action accordingly. What has been observed behavior of others (supervisors, coworkers, peers in the same business position) in the same or similar business situations? They derive their perspective subjectively from the experiences of other individuals.

6) What are the practical constraints? Identify the realistic factors that restrict the participant's ability to implement any suggested alternative. These factors may include, but would not be limited to, personal or family security, personnel evaluation concerns, legal concerns, financial concerns, and willingness of others to go along with the solution. There are many possible constraints.

7) What actions should be taken and why?
SILVER BREAD BAKERY: A SMALL BUSINESS CASE FROM THE SULTANATE OF OMAN

Kermit W. Kuehn, American University of Sharjah
Yousef Al-Busaidi, Sultan Qaboos University

CASE DESCRIPTION

If you are looking for an international small business/entrepreneurship case that allows you to introduce multiple issues in entrepreneurship, this case does so simply, yet in a relatively thorough manner. The case allows you to contrast typical Western entrepreneurial environments with a decidedly different economic, legal, and social context. There is enough information presented to permit discussion of a wide range of topics including generic advantages and disadvantages of buying an existing business over starting a new one, market analysis, cultural idiosyncracies that affect how the business operates, and simple financial analysis.

The events in the case take place between 1991 and 2001 in the Sultanate of Oman. The student follows Hamad, an Omani entrepreneur, as he considers the purchase of an existing, troubled bakery from his acquaintance, Sadeq. The case proceeds from the purchase to review the actions taken by Hamad to turn the business around as he responds to the changing marketplace. Extensive footnotes describe the social, legal and business factors that influence the way the business operates in this environment.

CASE SYNOPSIS

The primary subject matter of this case concerns the purchase of a troubled existing small business in an international context and the issues confronted and actions taken to turn the business around. Specific issues relate to general management in this non-Western context, with considerable attention given to the changing environment the business was operating in during the period. Secondary issues included in the case relate to human resources, organizational structure and financial analysis. The case has a difficulty level of 2 (sophomores or higher), depending on what you expect the student to be able to do. Depending on the depth of analysis pursued, the case would fit into a 50 minute or 75 minute class period.
INTRODUCTION

The Hussain and Abdulla Bakery was started in the mid-to-late 1980s by Abdulla, a manager in one of the government ministries, and Dr. Hussain, an eye consultant in a local hospital in Muscat, Oman. Neither of the partners had any experience in running a business. The business was located in Al Khodh, a small community located about 40km northwest of Muscat, where the government had built subsidized housing for low-income Omani. The reason for selecting this location was unclear, but the motives of the founders were apparently to enhance their personal incomes over and above their modest government salaries. The catalyst for the decision came when the government offered low cost loans to Omani who would start small businesses in the Sultanate.

Hussain and Abdulla concluded that a low-tech bakery was most appropriate for the location. They were able to obtain a $52,000 loan through the government program to launch the business. The business would sell directly to retail customers from a retail front counter, as well as wholesale to restaurants and other businesses that sell foodstuffs. They hired eight workers from the subcontinent (e.g. India, Pakistan, and Bangladesh) and a foreman from Egypt to run the business. They purchased two delivery vans and a modest amount of equipment for the bakery.

Almost from the very start, problems were faced in operating the business. The foreman was not as knowledgeable about operating a bakery as was first thought, plus his style of dealing with employees was very authoritarian and aggressive. While workers from the subcontinent were used to not being treated particularly well, they did not like the Egyptian's way of dealing with them. They reacted to his aggressive style by hindering production output and producing poor quality products. Not only were they in conflict with the foreman, they were in constant verbal conflict amongst themselves, often escalating into physical brawls.

The owners were largely hands off, coming by daily to collect receipts. As time went on, it became clear to the owners that they were not making any money in the business. As they kept no formal accounting records of the business, it was hard to tell what was actually happening in the business. In any case, the owners were not happy. The Egyptian foreman persuaded another Omani, Sadeq, an acquaintance of his, to purchase the bakery.

The foreman convinced Sadeq that with a modest investment in upgrading the equipment of the bakery, the business could make a handsome profit. Sadeq, an intermediate school graduate, was a governor (a wali) in one of the states in the Sultanate. He purchased the business in 1990 for $60,000. Sadeq had no prior business experience. He invested an additional $16,000 in equipment and facility upgrades in order to make the business more productive.

As a governor, Sadeq was a busy man. Further, he lived some 300km from Al Khodh where the business was located. He was clearly an absentee owner and was forced to put the foreman in full charge of running the business day to day. Sadeq was not comfortable with this arrangement as he did not really trust the foreman. He suspected that he was being cheated, not an untypical suspicion. Aside from this, there were certain issues in which Sadeq had to be involved. His inability to be
readily accessible to address these needs hurt the business. At one point, the business was shut down for 20 days because a machine part, unavailable in Oman, needed to be purchased in Dubai (U.A.E., a neighboring country). The Egyptian foreman could not cross the border to get the part because of a visa restriction. Thus, when Sadeq could finally address the issue, nearly three weeks had passed. The impact on customers and the business was all too evident.

The above example was reflective of ongoing equipment failures. This was only one aspect of the problems facing the business. There were also problems with worker motivation and poor work attitudes and behavior, as well as problems with product distribution, the business's poor reputation in the market, all requiring skills and commitment that Sadeq simply lacked or was unable to provide.

By late 1991, Sadeq had had enough. He asked Hamad to get involved in some way in hopes of saving the business. Sadeq had known Hamad for years and knew of his considerable business background. Hamad asked for a month to study the situation, insisting on full access to the business to investigate what the issues were and to determine the turnaround potential of the business.

**BUSINESS IN THE PERSIAN (ARAB) GULF**

**Working in the region.**

Rapid development starting in the late 1960s and early 1970s resulted in the need to import expertise and labor to support this development. Governments in the region sought to protect their societies and borders by restricting movement of expatriates. Policies were formulated specifically to control the movement of the vast, poor populations of the region who were looking to better their personal situations. For example, a Pakistani laborer would not be able to cross neighboring borders, while a Pakistani professional had greater ease of mobility. In general, Westerners could acquire visas more easily. Hence, nationality and social/labor status affected mobility.

**Owning and Operating a Business.**

As is the case in many of the countries in the Persian Gulf region, Omani law requires that a national must own at least 51% of the business. Hence, expatriates seeking to start their own businesses in Oman must find a national to sponsor the expatriate's visa and get the business license. The national is willing to do in exchange for a sponsorship "fee", which can run up to several thousand dollars annually for large enterprises. While the national is liable for the debts of the business and any legal entanglements the expatriate employees get in to, there are many Omanis willing to take the risk. Thus, most Omani owners do not try to learn how the business actually operates, opting for a "fee" for putting their signature on legal documents. Such fictitious ownership is illegal in Oman, but little enforcement is actually carried out.
Owner-Sponsor Relationship.

There is a tenuous symbiotic relationship between the "real" owner of the business, the expatriate, and the "fictitious" owner, the Omani. In the ideal situation, as far as the expat and the Omani are concerned, the expatriate operates the business as they like and cause as little trouble as possible for the Omani. The Omani gets his money and the expat runs his business. Each is aware of the risks. To the expatriate, he is at the whim of the sponsor, who has legal control of his visa and passport, thus his right to stay in the country. As majority owner of the business, the Omani can do what he likes with the business. The expat is in this sense dependent on the good will of the national sponsor.

The Omani recognizes that the expat has the knowledge to actually run the business, and knowledge is power to a certain extent. Further, the expat could easily mislead the Omani as to what is actually going on in the business. Many expats in this position are quite shrewd and have been known to exploit every opportunity to make money, including cheating the owner. Finally, the Omani signs for labor cards, loans, business licenses, and is legally liable for anything going on in the business that is illegal. Again, if the expat doesn't produce money through the business to pay these costs, the Omani must.

The bottom line is that the Omani is not particularly motivated to learn the businesses he legally owns. Hamad, the Omani in this particular case, is unusual in this regard as he does seek to know how the businesses he owns actually work. This isn't true in all of his businesses, but certainly for the bakery. In some of his businesses he is more passive, but in most, he is/was an active owner/operator. That is not to say, he was the prime day-to-day operator of these businesses, just active in their oversight.

HAMAD'S WORK HISTORY

Hamad had finished elementary school. He had worked a number of years in neighboring U.A.E. as a clerk (3 years), a driver (3 years) and in the U.A.E. military (9 years). His business background had started back in 1982, where he owned and operated a chicken farm. He was still involved in the operations of this business. In 1990, he got involved in a small grocery store as owner and operator. He started a small construction company in 1991, with his brother, in which he was still actively involved. He also owned a small auto repair garage, which he got involved with in 1988.

HAMAD'S OBSERVATIONS ON THE BAKERY

Hamad observed that there was only one other bakery operating in Al Khodh and it wasn't all that good. He also noted that social trends were changing, particularly with regard to local buying...
habits. He knew that Omanis were increasingly more willing to buy certain things rather than make them themselves. He suspected that this trend would likely continue. So from this perspective, there seemed to be some market potential.

Hamad visited the bakery often, observing the operation and talking with employees. He studied carefully the production processes involved in the business. At the end of the month, he noted the following problems:

**Poor product quality.** The quality and consistency of the bread produced was a real problem for the business from Hamad's perspective. He felt that consistent quality bread at a modest price was essential for business success. It clearly was not present here.

**Poorly trained workforce.** The workers were inadequately trained to handle the various aspects of bread production. There was limited cross-training of employees. Certain key tasks were understood by only one employee.

**Poor attitudes and performance behaviors among a number of employees.** Employee motivation was very poor, evidenced by low productivity and lack of willingness to work by many of the employees. Cooperation among employees was non-existent and conflicts were common.

**Poor market development.** The business had a poor reputation in the marketplace. Quality of product and reliability as a supplier was poor. The distribution network was in need of serious expansion in order to develop the business volumes necessary to cover the perceived costs of doing business.

**Low quality/reliability of equipment.** The equipment installed was of poor quality and had not been well-maintained. Hence, equipment failures were frequent, further hurting the reputation of the business as a bread supplier. No spare parts were available, thus requiring frequent and costly trips to neighboring U.A.E.

**No accounting system in place.** There was no sure way to know what was going on in the business as proper accounting records did not exist.

**Unattractive retail space.** As a good portion of the business was from walk-in customers, Hamad concluded that the unattractive décor and lack of cleanliness of the business was a real hindrance to building the quality image Hamad envisioned.
Problems with the municipality. The municipality is the dominant government influence for local business. It controls the various licenses a business needs to operate, as well as conducts numerous inspections to insure compliance on a host of issues ranging from health to labor cards of workers. The more problems a business location had, historically, the more inspections it will get in the future. Hence, more harassment. This was seen as a general issue for business in the market, and for this one in particular.

From a practical standpoint, Hamad felt that any one of these issues was solvable; some easier than others. However, collectively they presented a real challenge, a challenge he was not sure he should take on. He had other businesses and other options he could pursue. Yet, despite all the negatives, Hamad sensed there was something good that could happen with this little bread producer in Al Khodh, Oman.

TAKING OVER THE BUSINESS

Armed with a commitment from an acquaintance from the U.A.E. to partner with him in the business, Hamad agreed to buy the business, licenses, equipment, business name, inventory, vehicles and labor permits for $83,000. The business was purchased with $44,000 cash, equally from Hamad and Saeed, and the $39,000 balance was financed through a loan from the government development bank. Hamad was the managing partner in the business.

Soon after the purchase, Hamad changed the business name to Silver Bread Bakery, a change made to communicate to the market a new business with new management. Hamad focused on learning the bread baking business. He convinced a friend who owned a bakery in another town to allow him to learn how to mix the dough from one of his employees. He determined to learn not only how to properly mix the ingredients for the different bread doughs he needed, but all aspects of bread making.

HUMAN RESOURCES

In 1992, when Hamad took over the business, there were eight employees. Typically, labor for the bakery would come from the subcontinent and would primarily be made up of Indians, Pakistanis, Sri Lankans or Bangladeshis, though at times non-Gulf Arabs might be employed to a lesser extent. This labor was plentiful, skilled and inexpensive. It was becoming more difficult as time went on to get the necessary labor permits to bring in expatriate labor as the government became increasingly more insistent that Omanis be employed for these types of jobs. Omanis are not as easy to manage, are viewed by most as not as willing to work and typically get paid more for the same job, making them a less attractive workforce.
For the bakery at this time, employee salaries ranged from $170 to $250 per month - paid at the end of each month. Very modest housing was included and amounted to rather crude barracks-type sleeping quarters and a common bath area. Healthcare was provided for all employees and full-time employees are eligible for free round-trip airfares to their home country once every two years. Hamad provided interest-free loans of up to $780, with payroll deductions at $65 per month for repayment.

Drivers were compensated under a different arrangement, where a base salary was paid plus whatever they sold above the cost of the bread they bought at discount from the bakery. Each day the driver was "sold" an inventory of bread and was permitted to sell it to customers for whatever price they were able to negotiate. Hamad collected from them weekly. No inventory was returnable.

Initially, Hamad focused on mixing dough as a specific task he personally wanted to learn as it allowed him to deal with a particular employee problem. He was aware that the eight employees he had inherited with the business were not all working with the business interest in mind. There had been numerous conflicts between workers, escalating even to the level of fist fights among employees. One particular problem involved the flour mixer - the one who mixed all the dough. This employee used his exclusive knowledge of how to make the various bread doughs to control other employees, including the previous manager. His was the one job no one else could do. He refused to teach anyone how to do his job, hence insuring his power and job security. After learning how to mix bread dough, Hamad taught two other employees how to do so. He then fired the flour mixer, cancelled his visa and sent him back to India. Two other employees were terminated as well due to attitude and performance problems.

PRODUCT

The business produced and sold traditional Arabic flat bread, sliced bread loaves and selected Arabic sweets. Most revenue came from the traditional breads. While the product line had been relatively stable, the quality of the product had improved dramatically since Hamad bought the business. This was seen as crucial for continuing success of the business.

OPERATIONS

Silver Bread Bakery operated both a single retail outlet and a wholesale business to other retailers from this single location. Approximately 30-35% of the revenue was from the retail counter.

Operationally speaking, the business was structured along product type; that is, the type of bread actually made. One department focused on the production of traditional Arabic bread while the other produced loaf bread. Each department employed around six people. One person handled the retail counter and substituted as a driver when necessary.
Hamad focused on trying to enhance the reliability of the people, process and technology of the business as he felt these were critical to building the business. Supplier unreliability in the country was typical, thus building and maintaining a good reputation for producing a quality, reasonably priced product that was reliably delivered everyday was Hamad's goal.

Starting with eight employees in 1992, the number of employees had increased to fifteen by 1998. Two employees worked in external sales and delivery to wholesale customers. Working hours were long and the work day was made up of a split shift. The shop closed in the afternoon for a couple of hours. Those who worked with production of loaves of bread worked longer hours than those who worked in the traditional Arabic bread, due to the extra time required to prepare the bread for baking and shipping. No additional pay was given for the additional hours.

In 1998, Hamad purchased a simple, reliable conveyor system for moving bread from the oven to final processing areas. He opted for a system from India, though more sophisticated systems were available from Europe. The cost and simplicity was viewed as an important attribute due to the lack of support locally for such technology, not to mention that the equipment from India was much cheaper and easier to maintain.

By the end of the decade, the factory was operating pretty smoothly. With most of the equipment having been upgraded since the purchase in 1992, further growth would have to come through expansion of physical space. The single location was doing brisk business and was estimated to be operating 75-85% of capacity. While more people could be hired, the physical capacity of the current facility had obvious limitations.

THE MARKET

Prior to the 1990s, Al Khodh was a town primarily made up of Omanis living in government-built low-income housing. Thus, the community was comprised of households with large families and low average household incomes. The town was estimated to have a population of less than 3,000 residents at that time. There were no paved streets and shops lined dusty roads with people driving and parking nearly anywhere they chose. Goats wandered freely in herds, scavenging for food. The market bustled everyday with people going about their daily business of getting provisions for the day's meals. It was still a quite traditional Omani setting. Much of the shopping was conducted by the men, or women accompanied by male relatives, all dressed in traditional Omani attire. Children were numerous, often barefoot, enjoying the daily games of the street.

Traditional flat breads were a stable part of every Omani diet and were historically baked fresh every day in the home. By the late 1980s however, Omanis were finding the convenience of simply buying fresh bread daily from the bakeries preferable to making their own. The bread sold in bakeries was inexpensive and was fresh. As it was typical that people would go to the markets daily for fresh meat, vegetables and fruit, picking up bread as well required no real change in daily habit. Hence, Hamad saw this trend as an opportunity for the bakery.
There was one other bakery in Al Khodh and it was not seen as a serious competitor, assuming that the successful turnaround in service quality of Silver Bread could be made. Because of the nature of the market, new bakeries opening up in Al Khodh didn't seem likely at this time. There were formidable competitors who had delivery networks in Al Khodh, particularly to grocery stores or restaurants, but not direct producer-retail outlets. While the competition was quite intense from these other outlets, Hamad felt he could take better advantage of his physical presence on the main road of Al Khodh to attract considerable retail business.

Hamad found that suppliers for the bakery were in abundance and that they were very anxious to get his business. The supplies he needed were mostly common items such as flour, cooking oils, and such and could be found readily from several outlets. He continuously monitored pricing in the market.

One development that was having a large impact on the town was the establishment of the government university, Sultan Qaboos University, which opened in 1986. The university was located less than 5km from Al Khodh and brought increased traffic from students and their families on their way to the university. The university itself was a sizable market with a number of food outlets located there.

MARKET CHANGES THROUGH THE 1990S

Starting in 1992, a massive development plan was devised and implemented in Al Khodh, which included paving streets, creating new roads, building a hospital and schools. With these improvements and several others, and the continued growth of the university, the demographics of the community were changing. With increased demand for goods and services and increased development, the cost of property steadily increased through the 90s. Poorer families sold property and moved to less expensive locations and wealthier residents began to build in the area. The modest low-income dwellings were being dwarfed by increasing numbers of moderate to high-priced villas. Additionally, in 1999, the university put in place a policy that required all male students to find housing off-campus. This decision further increased property prices as investors were rapidly adding housing to rent to this immediate need. All this increased the amount of traffic and business activity in the town. These two fast-growing groups, higher income households and students, were likely buyers of bread as opposed to making their own. The population grew steadily through the decade and the trend was expected to continue.

These changes were positive for the Silver Bread Bakery, with sales growing early, plateauing in the latter half of the decade (See Table 1 & 2 for financial information on the business). The changes have not gone unnoticed by competitors, however, with two new bakeries opening, one in 1998 and another in 1999. While these stores have not opened factories here, they have full retail outlets. These two companies have strong reputations in the broader Omani market, certainly better known than Silver Bread.
Thus far, market growth has absorbed the increased supply. Hamad's store sales, after a modest decline in 1997 and 1998, were relatively flat for much of the latter half of the 1990s. Hamad wondered what all these changes will mean in the coming years for Silver Bread Bakery. While sales are holding up reasonably well, growth had slowed and competition was increasing. He was pleased with the level of competence of his workers and the quality of his product, but whether he was doing the right things to insure future growth was anything but clear.

| Table 1: Income Statement (Cash Basis - US Dollars) - 1995-2000 |
|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|
| Sales              | 250,046             | 251,226             | 244,397             | 241,903             | 253,248             | 253,603             |
| Total Expenses     | 216,209             | 214,767             | 212,290             | 209,345             | 213,869             | 211,307             |
| Profit             | 33,837              | 36,459              | 32,107              | 32,558              | 39,379              | 42,296              |

<table>
<thead>
<tr>
<th>Table 2: Typical Annual Expenses (US Dollars)</th>
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<tr>
<td>Gas (Ovens)</td>
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<td>Raw Materials</td>
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<tr>
<td>Air Tickets</td>
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<td>Labor Card Fees</td>
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Note: Expense details were unavailable for 1997-1999; hence, an average of the available years was used to calculate the expenses in Table 2.
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