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INSTRUCTORS' NOTES

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JOURNAL OF THE INTERNATIONAL ACADEMY FOR CASE STUDIES

SPECIAL INSTRUCTORS' EDITION

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LETTER FROM THE EDITOR

Welcome to the *Journal of the International Academy for Case Studies, Special Instructors' Edition.* 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 Instructors' Notes contained in this volume have been double blind refereed with their corresponding cases. Each case for which there is an Instructors' Note contained herein has been previously published in an issue of the *Journal of the International Academy for Case Studies*. Each case was required to have a complete teaching note before consideration. The acceptance rate for manuscripts in this issue, 25%, conforms to our editorial policies. This publication also conforms to the AACSB requirements to publish case notes which are considered by that body to be of more academic value than the case itself.

The Academy does not take copyrights on the cases and manuscripts it publishes. Accordingly, 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

CASE NOTES

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.

INSTRUCTORS' NOTES

Recommendations for Teaching Approaches

This case is designed to be used in an upper division business course. The purpose of the course is to enable students to utilize knowledge they have gained in their lower division core business courses. In addition, the course also aims to improve a student's communication, written and oral, and teamwork skills. Student teams prepare the answers to questions presented in the case with coaching from faculty. The faculty coaching is intended to provide answers to team questions. One team of students formally presents their case solution to the class. A second team of students acts as a "challenge team" by asking the presenting team for further explanation or clarification of its case solution. Following the challenge, the entire class is welcome to participate in an active question and answer session.

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?**

   Contract Formation

   The breach of contract claim appears to be straightforward. A simple contract was entered into between Tommy and Royal Theater, Tommy requesting a ticket and paying for it in cash. Who is the offeror and who is the offeree is really not critical to the case. Whether

Tommy offers to purchase the ticket by tendering the cash and Royal Theater accepts the tender, or Royal Theater offers to sell the ticket and Tommy accepts the offer by requesting a ticket and tendering the cash, makes little difference to the conclusion that a contract was entered into by the parties. The contract that results would have only a few very basic terms. Once Tommy's money is accepted, all that remains is Royal Theater's performance. Performance being Royal Theater's promise to begin showing the movie at 1 pm, the time indicated on the ticket. The ticket did not contain any express written statement authorizing the Royal Theater to show advertisements and promotions. Neither did the ticket contain any express written statement indicating that the movie would begin later than 1 pm on account of the showing of advertisements and promotions.

Contract Breach

The contract was breached, Tommy argues, by Royal Theater's failure to show the movie at the stated time. In addition, Tommy may also contend that the contract was breached by Royal Theater's unilateral decision to show unwanted advertisements and promotions despite the lack of an agreement regarding such showings. On the other side of this question of breach of contract, Royal Theater may simply state that time was not of the "essence." Specifically, that there was no agreement regarding showing the movie at precisely 1 pm. Consequently, Royal Theater would indicate that it would only be obligated to perform (show the movie) at 1 pm or within a reasonable amount of time after 1 pm. Royal Theater would indicate that the screening of the movie began at 1:20 pm, twenty minutes being a reasonable delay.

Contract Damages

If the contract is breached, there remains the issue of damages that Tommy has suffered. Tommy can argue that he suffered damages for wasted time, confusion and delay. How will Tommy translate these damages into a monetary amount. The complaint to the manager and a request for a refund would seem to be the easiest solution. Royal Theater would not only agree but might argue that refund of the cost of the ticket is the only solution for Tommy.

Although Tommy may recover very little in the form of monetary damages on the breach of contract claim, this does not mean that a class action suit is not worthwhile or that punitive damages or injunctive relief is unavailable in a fraud action against Royal Theater.

2. **What liabilities, if any, does Royal Theater have for innocent misrepresentation or fraud? In answering the question, consider reviewing the case of Lee P. Cao et al v. Huan Nguyen et al., 607 N.W. 2d 528 (2000) and incorporating in your report the analysis of the court.**

Misrepresentation vs. Fraud

The preliminary discussion by the students should distinguish between misrepresentation and fraud. A definition of each concept would be a good start. A misrepresentation is an assertion that is not in accord with the truth. Misrepresentations can be either, (1) "innocent" - where the representation is false but not intentionally deceptive, or (2) "fraudulent" - where the representation is made with knowledge of its falsity and with intent to deceive. In either instance, "innocent" or "fraudulent," the representation that is made is false. The distinction is that in a case of "innocent" misrepresentation the person making the representation is not aware that the representation is false (not in accord with the truth). Whereas, in the case of a "fraudulent" misrepresentation the person making the representation knows the representation is false and is making the representation with the specific intent to deceive another.

Students should recognize that the misrepresentation in this case was not innocent, but instead fraudulent. They should note that the statement, the movie would begin at 1 p.m., was false, that Royal was aware the statement was false, and that it was intended to deceive moviegoers. Students would point out that Royal made the statement to create a captive audience that would sit through twenty minutes of commercials before the movie began. This analysis eliminates any argument that Royal's statement was an innocent misrepresentation. Students then proceed to develop arguments to determine whether the elements of fraud exist.

Prima Facie Case for Fraud

The case Lee P. Cao et al v. Huan Nguyen et al., 607 N.W. 2d 528 (2000), provides the elements of fraud that must be established to prevail in a case. Students should recognize that Cao decision gives the prima facie case for fraud. The case states: In order to maintain an action for fraudulent misrepresentation, a plaintiff must allege and prove the following elements: (1) that a representation was made; (2) that the representation was false; (3) that when made, the representation was known to be false or made recklessly without knowledge of its truth and as a positive assertion; (4) that it was made with the intention that the plaintiff should rely upon it; (5) that the plaintiff reasonably did so rely; and (6) that the plaintiff suffered damage as a result.

Students should understand that in order for Tommy to prevail in a fraud claim against Royal Theater, he must allege and prove all six points stated in the Cao case. Students are expected to go through each point of the prima facie case and determine if the point is met or not met. Most importantly, the students should be able to explain the decision that they reach on each of the six points. Some of the points, as will be seen below, will require very little discussion. However, other points will be more complex, present contrary arguments, and require additional discussion.

Students should apply the elements of fraud in chronological order, as found in the Cao case. If Tommy and Royal Theater have conflicting arguments, each should be discussed. The following cites each element of fraud and applies the facts of the case to discuss the arguments and counter arguments that Tommy and Royal Theater might make.

(1) That a representation was made: Tommy would assert that Royal Theater made representations in newspaper advertisements, on the theater marquee and by the cashier at the ticket window that the movie would begin at 1 p.m.

Royal Theater has no counter argument.

(2) That the representation was false: Tommy would assert that the representations were false because the movie did not begin at 1 p.m. The movie began after twenty minutes of commercial advertisements were shown. To the contrary, Royal Theater may assert that the representation was not false because the posted time of 1 p.m. was the time when the theater lights would dim, thus advising customers to arrive on time while the theater was lighted.

Royal has the weaker argument.

(3) That when made, the representation was known to be false or made recklessly without knowledge of its truth and as a positive assertion: Tommy would assert that Royal Theater made a positive assertion, "The movie begins at 1 p.m.," and knew it was false because twenty minutes of commercial advertisements would be shown before the movie began.

Royal has no counter argument.

(4) That it was made with the intention that the plaintiff should rely upon it: Tommy may make the simple assertion that moviegoers rely on newspaper advertisements and theater marquees to determine which movies will be shown and at what specific times. Tommy would assert that Royal Theater intended to create a captive audience that would be seated at 1 p.m. only to be forced to sit through twenty-minutes of commercials He will also point out that Royal Theater receives revenues from it's advertisers at the expense of the captive audience that it deceives.

Royal Theater has no counter argument.

(5) That the plaintiff reasonably did so rely: The Cao case provides that a party is justified in relying upon a representation made to the party as a positive statement of fact when an investigation would be required to ascertain its falsity. The idea here is that a party's reliance on a positive statement of fact, under most circumstances, is reasonable in the absence of an attempt to verify the truth or falsity of the statement. If one were required to investigate to determine if every positive statement made to them was in fact true, the tort of fraud would be meaningless. What the students should indicate under this point is that the courts generally do not require a party to make an independent investigation as to the accuracy of the statement on which he relies. However, a person does not act justifiably if he relies on an assertion that is obviously false or not to be taken seriously.

Tommy will assert that he reasonably relied on the newspaper ad, the marquee, and the cashier's statement that the movie would begin at 1 p.m. Tommy would indicate that his reliance on the newspaper ad, the marquee, and the cashier's statement, was justified especially since the statements were not obviously false and were to be taken seriously. It was important that Tommy arrive before the lights in the theater dimmed because he could barely see what was happening when it was dark. He left his house and he arrived with fifteen minutes to spare, enough time to buy a drink and snacks. He entered the viewing room two minutes before the movie was to begin.

Royal Theater may assert that Tommy's reliance was not reasonable. To support this argument, Royal would point out that Tommy had not been to the movie for many years. Additionally, if Tommy had asked others moviegoers he could have easily learned that several minutes of commercial announcements are shown before the movie begins. If Tommy had made this simple inquiry, he would have understood that it was only important for him, personally, to arrive by 1 p.m. because the lights would dim and he would have had difficulty finding a seat in the dark. Once he was comfortably in his seat, the movie would begin after the showing of some commercials.

The decision on element (5) could conceivably be in favor of Tommy or Royal.

(6) That the plaintiff suffered damage as a result: Tommy may assert that he lost twenty minutes of his time and lost $9.00 by paying for a movie that was a bust. Some students might also include the cost of the snacks, in his losses. Tommy will

have difficulty determining the value of his time since we do not know what he would have done if he had known the movie started twenty minutes later.

Royal Theater may assert that since the value of Tommy's time cannot be calculated, he is not entitled to recover damages for that loss. Regarding the cost of the movie ticket, Royal Theater might assert that Theaters do not guarantee that consumers will enjoy the movies they pay to view. Moviegoers assume the risk that they will not enjoy the movie, yet they have the opportunity to make that judgment when they pay to see the movie. Royal may also assert that Tommy enjoyed the benefits of consuming the snacks, thereby not suffering a loss.

Royal Theater has the better argument on element (6).

Students who find in favor of Tommy on this point may also raise the issue of whether punitive damages should also be awarded. The issue could be raised because the class of plaintiffs is quite large. Students should be able to point out that the awarding of punitive damages generally requires a showing of conduct that is reprehensible or egregious. On this point, it is left up to the students to determine whether Royal Theater's conduct is to be identified as reprehensible or egregious.

In conclusion, students should conclude that while Tommy will probably be able to establish fraud elements 1-4, he might have some difficulty in establishing elements 5 and 6. If Tommy cannot establish all six elements, he will not prevail in a fraud case against Royal.

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." For a copy of the article see: 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.

Students are referred to an article entitled, "Only the Ethical Survive" found at http://www.scu.edu/ethics/publications/iie/v10n2/ethical-surv.html. The basic premise of the article is that, in the long run, it is "good business" to act ethically. Students are encouraged to do some independent research on the question of ethics in business. A search of the Internet, using Google for example and searching "ethics in business" or "business ethics," will produce a considerable volume of material. It is up to each instructor to decide what they would like their class to do in answering this question.

Cost - Benefit Analysis

Here are some possible topics that students can raise. One theory discussed in the literature is a Cost-Benefit analysis. With this ethical theory, a company weighs the costs and benefits of a business decision. If the costs to the company would outweigh the benefits that the company would receive from the decision, one might conclude that the decision is unethical.

Students should identify the "benefits" to Royal Theater from showing advertisements. The obvious benefit to Royal Theater would be revenues received from advertisers for showing the commercials.

On the other hand, what are the "costs" to Royal Theater? Here students might want to look at Royal Theater stakeholders. Stakeholders are entities that are affected by Royal Theater or that have an affect on Royal Theater. Who are the stakeholders in this case - shareholders (in a corporation), employees, suppliers, customers, media, and the local community? The students should be able to identify the stakeholders and explain how the stakeholders might be affected by Royal Theater's decision to show the advertisements in the theater and what affect the stakeholders might have on Royal Theater because of the showing of advertisements.

Justice or Fairness

Another ethical theory is one of "fairness" or "justice." The idea here would be that a decision is ethical if everyone, who is affected by the decision, is treated fairly. In this circumstance the question that students might address would revolve around the question of is it fair to moviegoers to become a "captive audience" with Royal Theater reaping the benefits of commercial revenues.

CASE B QUESTIONS - STATISTICAL

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

The answer to this question involves testing a hypothesis regarding a population proportion. This is a standard statistical test that is covered in an elementary statistics course. The consortium suspects that the proportion of moviegoers who resent the showing of the ads is small, less than 10%. This is the belief or opinion to be tested. This belief or opinion is stated as the alternative hypothesis. The null hypothesis represents all other possibilities regarding the (unknown) population proportion (or percentage), 10% or more in our case.

To conduct the test, let

P = (unknown) proportion of all movie patrons who resent ads.

We then formulate the null (H_0) and the alternative (H_1) hypotheses, as shown below.

Hypotheses

$H_O: P \geq 0.10$ (Null hypothesis - Avoid lawsuit and negotiate settlement.)

$H_1: P < 0.10$ (Alternative hypothesis- Go to trial and fight the lawsuit.)

Students generally find formulating the hypotheses to be one of the most difficult parts of the problem. They tend to forget that the belief, opinion, suspicion or claim to be tested is stated as the alternative hypothesis while the null hypothesis represents all other possibilities. Additionally, students may also incorrectly formulate the hypotheses as a two-tailed test. In our problem, the correct test is a one-tail test, using the left tail as the rejection region because we would be inclined to reject the null hypothesis only for relatively small values of the sample proportion (much smaller than 10%).

The following examples might be presented in class and discussed prior to assigning this case. They would help clarify these issues and guide the student to the correct formulation of the hypotheses for this case. A test is either a one-tail or two-tail test, depending on the values of the sample result (usually, the sample proportion or sample mean) for which we reject the null hypothesis. If we reject the null hypothesis for both very large and very small values of the sample result, the test is a two-tailed test. For example, in testing the effectiveness of a new insulin pump, we would reject the null hypothesis (the pump is effective in that it produces the desired amount of insulin on average) for both very large or very small values of the average amount of insulin released-that is, if the average amount of insulin released is too high or too small. The correct hypotheses would be:

H_0: Average level of insulin= Desired level of insulin

H_1: Average level of insulin $\neq$ Desired level of insulin

On the other hand, if we reject the null hypothesis for only very large values or only very small values of the sample result, the test is a one-tail test. The rejection region (region where the null hypothesis is rejected) of a one-tail test can either be in the right tail or in the left tail. For example, if we are testing the breaking strength of a paper bag, the appropriate test is a one-tail test, using the lower or left tail as the rejection region because we would reject the null hypothesis (that the breaking strength of the bag is equal to or greater than the desired level) for very small values of the test statistic. These values would provide evidence that the breaking strength of the bag is far below the desired level.

H_0: Average breaking strength of the bag = Desired breaking strength of the bag

H_1: Average breaking strength of the bag < Desired breaking strength of the bag

Lastly, the rejection region of a one-tail test could be in the right or upper tail. This would be the case if we rejected the null hypothesis for very large values of the test statistic. To illustrate, suppose we are testing the noise level of a new lawn mower. We don't care if the noise level is very low; our concern is that it is not too high. Therefore, the appropriate test is a one-tail test, using the right or upper tail as the rejection region. In this case,

H_0: Average noise level = Desired noise level

H_1: Average noise level > Desired noise level

If the test statistic does not fall in the rejection region, students will often incorrectly conclude that the null hypothesis is true and therefore should be accepted. Instructors should remind their students that no statistical test will prove that the null hypothesis is true. The test can only provide evidence that it is false and hence should be rejected. To get this point across, the best analogy to present to students is from our criminal system. In a criminal trail, the null hypothesis is that "the defendant is innocent." (In our legal system this is the presumption - "innocent until proven guilty.") The alternative hypothesis is that the defendant is "guilty." (The alternative is what the prosecution [the state] believes; otherwise the state would not be prosecuting the defendant.) The jury, after reviewing the evidence, may render a verdict of "not guilty." We therefore would state that the null hypothesis should not be rejected. Not rejecting the null hypothesis means that there was not sufficient evidence to reach a guilty verdict. A "not guilty" verdict does not imply that we accept the null hypothesis and conclude that the defendant is innocent. Thus, we can never prove that a defendant is innocent, but we can, with enough evidence, prove that the defendant is guilty.

The next step is to test the hypotheses. We begin by assuming that the null hypothesis is true and then determine if the evidence (sample data) supports or conflicts with this assumption. We use the sample evidence and the value of the population proportion to compute a value called z, or the test statistic, by applying the following formula:

Test Statistic, z

$$z = \frac{\bar{p} - p_o}{\sqrt{\frac{p(1-p)}{n}}},$$

where

n = sample size = 100

X = number of patrons in the sample who resent the ads = 6

$\bar{p}$ = X/n = proportion of patrons in the sample who resent the ads = 6/100 = 0.06

p_0 = proportion of patrons under the null hypothesis (hypothesized value of p) = 0.10. The decision to reject or not reject the null hypothesis depends on how large the computed z value is relative to the critical z value. The critical z value is a percentile of the standard normal distribution and is obtained from a standard normal table. The percentile depends on the risk we are willing to take of incorrectly rejecting the null hypothesis-that is, rejecting the null hypothesis when it is true. This risk is called the Type I error and is specified prior to conducting the test. For example, if we set the Type error at 5%, then, if we repeated the test a very large number of times, 5% of the time we would incorrectly reject the null hypothesis. With a Type I error of 5%, we state that the test is conducted at the 5% level of significance. The level of significance is often denoted as ". (Thus, " = 0.05 means that the test is conducted at the 5% level of significance.)

Critical z value

What is the critical z value? The answer depends on whether a one-tail or a two-tail test is being conducted. If the test is a one-tail test using the lower or left tail, the critical z value is the 5th percentile of the standard normal distribution, -1.645. (This value is obtained from the [cumulative] standard normal distribution table.) If the computed z value is less than this value, we reject the null hypothesis. That is, we reject the null hypothesis if the computed z value is more than 1.645 standard deviations below the hypothesized value of the proportion. Conversely, if the computed z value is greater than -1.645, we do not reject the null hypothesis. If the test is a one-tail test using the left or lower tail, the critical z value is the same, expect that we drop the minus sign and use 1.645. (Lastly, if the test is a two-tailed test, we split the risk of a Type I error among the lower and upper tails, with 2.5% in each tail as opposed to 5% in one tail. From the standard normal table, we get two critical z values, namely, -1.96 and 1.96.)

Students often find it difficult to interpret the meaning of the z value. The following explanation should help. The z value is simply the number of standard deviations (or, more precisely, standard errors) the sample proportion is away from the hypothesized value of the proportion. The numerator of the z value is the difference between the sample proportion and the hypothesized value of the proportion. The denominator is the standard error of the sample proportion, or more simply, the sampling error. The sampling error depends on the sample size, n, and the hypothesized value of p. The larger the sample size, the smaller the sampling error and the bigger the z value. The larger the z value, the more likely it is that the null hypothesis will be rejected. Conversely, the smaller the sample size, the larger the sampling error and the smaller the value of z. Small z values tend to support the null hypothesis; consequently, the less likely it is that the null hypothesis will be rejected.

Decision Rule (at 5% level of significance)

$Z_{0.05}$ = critical z value at the 5% level of significance (5th percentile of standard normal distribution)

= -1.645

We would reject the null hypothesis for z values that are less than the critical value. Thus, we may state the decision rule as:

If $z < -1.645$, reject the null hypothesis at the 5% level of significance; otherwise, do not reject.

Test Result

Since

$\bar{p}$ = X/n = 6/100 = .06

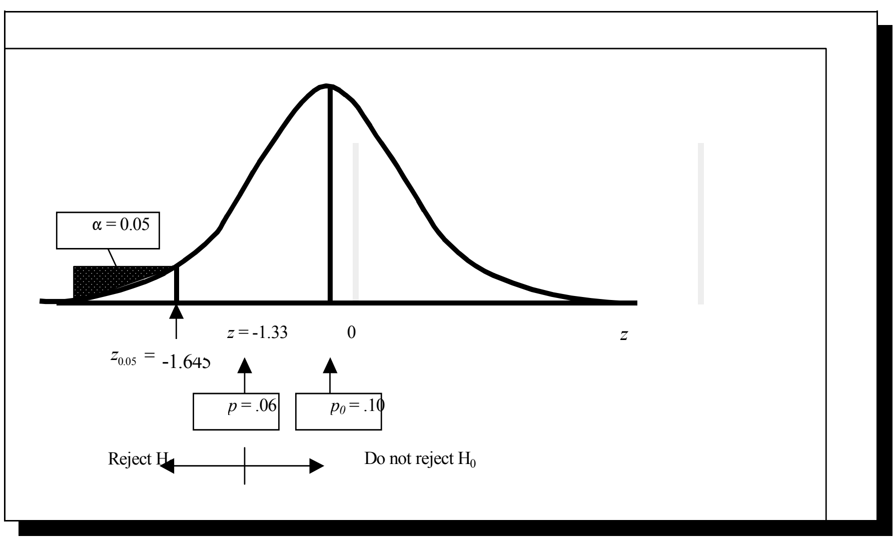
$$z = \frac{\bar{p} - p}{\sqrt{\frac{p(1-p)}{n}}} = \frac{.06 - .10}{\sqrt{\frac{(.10)(.90)}{100}}} = -1.33$$

Students often find it difficult to interpret the meaning of this result. It simply states that the sample proportion (0.06) is 1.33 standard deviations below the hypothesized value of the proportion (0.10). Since the computed z value (-1.33) is greater than the critical z value (-1.645) we cannot reject the null hypothesis. Thus, the difference between sample proportion and the hypothesized value of the proportion is due to sampling error.

Students tend to also have difficulty interpreting the magnitude of negative numbers. They should be reminded that -3, for example, is bigger than -5, but -3 is smaller than -2.

Since z = -1.33 > -1.645, we do not reject the null hypothesis. Thus, there is not sufficient evidence, at the 5% level of significance, to conclude that the proportion of patrons who resent the showing of the ads is less than 0.10 (10%). Thus, there is insufficient evidence to justify going to trail. The consortium should, therefore, negotiate a settlement.

These results are illustrated below in the form of a graph.



The graph is the standard normal distribution. This is a graph of all possible z values. Recall that the z values are the number of standard deviations the sample proportion is away from the hypothesized value of the (unknown) population proportion, $p_0 = 0.10$. The mean of the z distribution is 0 because the hypothesized value of the population proportion is zero standard deviations away from itself. The computed z value for the sample proportion, p =

0.06, is -1.33, meaning that the sample proportion is 1.33 standard deviations below the hypothesized value of the population proportion.

The critical value of z corresponding to the 5% level of significance is -1.645. The critical value of z is the value of z that cuts off 5% of the area in the lower tail of the distribution. (More precisely, it is the 5th percentile of the standard normal distribution.) We reject the null hypothesis H0 if the computed z value is less than the critical z value. (A computed value of z that is less than the critical value of z, -1.645, represents the "rejection" region of the test.) On the other hand, we do not reject the null hypothesis if the computed z value is greater than the critical z value. (A computed value of z that is greater than the critical value of z represents the "do not reject" region of the test.)

Students will also have difficulty in interpreting the results of the test. They should first state whether the null hypothesis is rejected or not rejected. If it is rejected, they should conclude that there is sufficient evidence to support the alternative hypothesis. If it is not rejected, the correct conclusion is that there is insufficient evidence to support the alternative hypothesis.

Students may also wonder why we have to perform a statistical test in the first place. After all, they might reason that since the sample revealed that 6 out of 100 moviegoers, or 6%, resent the ads and that 6% is less than 10%, they can conclude, without going through all the effort of conducting a statistical test, that the consortium should fight the case. What is the underlying flaw in this argument? It ignores the sampling error and looks only at how far away the sample proportion is from the hypothesized value. While each of these results is important, neither is sufficient by itself. The formula for the z value allows us to account for both results. The numerator of z is the difference between the sample proportion and the hypothesized value. The denominator is the sampling error. The larger the sample size, the smaller the sampling error. If, for example, the difference between the sample proportion and the hypothesized value is very large, it would be tempting to argue that the null hypothesis should be rejected. However, if the sampling size is very small, the sampling error (the denominator) will be quite large. If it is very large relative to the difference between the sample proportion and the hypothesized value of the proportion (the numerator), the z value will be very small and, consequently, the null hypothesis would not be rejected. (Small z values tend to support the null hypothesis while large z values provide evidence that the null hypothesis should be rejected.) At the other extreme, if the difference between the sample proportion and the hypothesized value of the proportion is very small, students might be inclined to not reject the null hypothesis. But if the sampling error, due, for example, to a large sample size, is very small, a large z value could be obtained, thereby rejecting the null hypothesis.

The point is that any result that is based on sample data is subject to sampling error. The sampling error must be accounted for when judging the difference between the sample result and the result expected if the null hypothesis were true. For example, if a coin is claimed to be fair is tossed a very large number of times, it would be expected that heads would come up 50% of the time. If, however, the coin is tossed 100 times, but heads come up 48 times, could it be argued that the coin is biased in favor of getting more tails? Probably not, since the difference between the sample result (48 heads) and the expected result (50 heads) would be attributed to random variation or sampling error. The larger the sample size, the smaller the sampling error and the more statistically reliable is the sample outcome. The computed z value allows us to account for both the difference between the sample result and the expected result (if the null hypothesis were true) as well as the sampling error.

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

Solution

A Type I error is made if we reject the null hypothesis if it is true. This would mean going to trial when the consortium should try to settle the case.

A Type II error is made if we do not reject the null hypothesis if it is false. This would mean avoiding going to trail by trying to negotiating a settlement when the consortium should actually fight the case in court.

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.

Solution

Let

n = sample size = 300,

X = number of patrons in the sample who resent the ads = 18,

$\bar{p}$ = X/n = proportion of patrons in the sample who resent the ads = 18/100 = 0.06,

p_0 = hypothesized proportion of patrons who resent the ads = 0.10.

We now compute z as before, but inserting the new values above:

$$z = \frac{\bar{p} - p}{\sqrt{\frac{p(1-p)}{n}}} = \frac{.06 - .10}{\sqrt{\frac{(.10)(.90)}{300}}} = -2.31$$

Since z =-2.31 < -1.645, we reject the null hypothesis. Thus, there is sufficient evidence, at the 5% level of significance, to conclude that the proportion of patron who resent the ads is less than 0.10. Hence, there the consortium would be justified in going to trial.

Students might wonder why the null hypothesis is rejected with a sample size of 300, but is not rejected with a sample size of 100, particularly in view of the fact that the sample proportion (0.06) is the same in both cases? The answer is straightforward: with the sample size is this question (300) being three times as large as the sample size in the previous question (100), the sampling error is smaller, resulting in a larger z value. As we stated earlier, larger z values provide weaker evidence in support of the null hypothesis and, consequently, lead us to reject the null hypothesis.

It is also helpful to point out that if, for example, the sample size is quadrupled, the resulting sampling error would not be one-forth as large as is was before; rather it would be one-half as large. This is just another way of saying that, as the sample size continues to increase, the reduction in the sampling error gets smaller and smaller-that is, the sampling error decreases as the sample size increases, but at a decreasing rate. In the extreme case, if you sampled the entire population, the sampling error would, of course, be zero, the z value would be infinitely large and any difference that exists, whether large or small, would be significant and, hence, lead to the rejection of the null hypothesis.

BUDGETING IN THE NOT-FOR-PROFIT AMBULATORY HEALTHCARE ENVIRONMENT

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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.

INSTRUCTORS' NOTES

Discussion Questions and Answers

1. What is meant by a prospective payment system (PPS) form of reimbursement? What is potential risk associated with this form of reimbursement?

Prospective payment systems defines a form of reimbursement where providers are paid a fee for services based upon the previous year's Medicare or Medicaid cost report. Hospitals are paid a fixed fee per Diagnosis Related Group (DRG) illness. Community Health Centers are paid a fixed fee per patient visit. Hospitals and CHC's are also required to file annual cost reports. The risk associated with this system from a provider prospective is the potential liability for excess reimbursements. Medicare rules are very complex and often require healthcare accounting specialists to prepare cost reports.

2. What is the Contribution Margin (CM) and Weighted Contribution Margin per visit for each patient category?

	Contribution Margin	Patient Mix	Weighted Contribution Margin
Medicaid	$43.12	40%	$17.25
Medicare	40.12	20%	8.05
Third Party Insurance	23.12	10%	2.31
Self Payers	13.12	30%	3.94
Weighted CM		100%	31.52

In order to arrive at the various contribution margins, the student deducts the fixed variable cost per visit (21.88) from the reimbursement rates established by Medicare and Medicaid. Students will often asked how a Health Center can calculate a single rate for the thirds party insurers and self pays. The answer is that the Center calculates a weighted average rate. Students now understand that the third party insurers' mix as well as the self-pay patient mix must be held constant over the budget year in question. Unless there are serious economic dislocations in the county, these numbers are relatively constant. In addition, we can use sensitivity analysis to model different mix outcomes.

3 Assume that the Center's current cost and reimbursement structure remain constant over the upcoming year. How many patient visits would the clinic need in order to break even in the absence of a Federal Grant? Comment on the feasibility of your answer.

	Fixed Costs	Weighted CM	BE Visits	Over (under BE)
Breakeven (BE)	$1,364,085	$31.52		43,277(16,553)

This question will probably cause the student to re-read the case. By dividing the weighted contribution margin into the fixed cost, the break even visits can be found. The Health Center currently has a physical capacity of 30,000 patient visits annually; consequently, it cannot break-even without grant funds given current capacity constraints. Capacity is a function of the number of physicians, midlevel practitioners, examination rooms and the center hours. Asking the student to consider the effect of the additional fixed cost due to expanded capacity to 45,000 patients annually can extend this question.

4. Assume that the Center's current cost and reimbursement structure remain constant over the upcoming year. What is the amount of the Federal Grant required to balance the Center's budget (breakeven).

Source	Rate	Patient Mix	Weighted
Medicaid	$65	40%	$26.00
Medicare	$62	20%	$12.40
Third party insurance	$45	10%	$4.50
Self-Pay	$35	30%	$10.50
Joint Contribution Margin			$53.40
Total Patient Visits			26,724
Total projected Revenues			$1,427,062
Estimated Expenses	($1,948,692)		
Required Federal Grant	($521,630)		

5. If the Health Department discontinues providing the Center immunizations, vaccines and flu shot, what will be the required Federal Grant to balance the budget?

Recall that the current variable cost per visit is $21.88. If the Health Department discontinues providing immunizations, vaccinations and flu shots, variable cost per patient will increase by $3.1243, rising to $25 per visit. This action does not affect total revenues, but increases total variable cost by $83,379 (26,724 * $3.1243). The additional $83,493 is added to the original grant requirement ($521,631) to get the new grant requirement of $605,123. Another approach is to calculate a new joint contribution margin.

Source	Rate	Patient Mix	Weighted
Medicaid	$65-$25=$40	40%	$16.00
Medicare	$62-$25=$37	20%	$7.40
Third party insurance	$45-$25=$20	10%	$2.00
Self-Pay	$35-$25=$10	30%	$3.00
Joint Contribution Margin			$28.40
Total Patient Visits			26,724
Total Projected Contribution Margin			$758,962
Fixed Costs	($1,364,085)		
Required Federal Grant	($605,123)		

6. Assume that the Center's current cost and reimbursement structure remain constant over the upcoming year with the following exceptions. The state capped Medicaid reimbursements at $60 per visit and the county's Health Department did indeed discontinue providing the center immunization, various pediatrics vaccines and flu shots. What is the Federal Grant required to balance the budget?

Source	Rate	Patient Mix	Weighted
Medicaid	$60-$25=$35	40%	$14.00
Medicare	$62-$25=$37	20%	$7.40
Third party insurance	$45-$25=$20	10%	$2.00
Self-Pay	$35-$25=$10	30%	$3.00

Joint Contribution Margin			$26.40
Total Patient Visits			26,724
Total Projected Contribution Margin			$705,514
Fixed Costs	($1,364,085)		
Required Federal Grant	($658,571)		

The combination of the cap on Medicaid reimbursement and the action by the Health Department increases the Federal Grant requirement by $136,941, ($658,571- 521,630).

ADVANCED (For Graduate or Cost Managerial Class)

7. Using Excel, prepare a one-way sensitivity table. The table will assume that the current Medicaid reimbursement ($65) will remain constant, but the percentage of Medicaid patients will decline from 40% by one percent per decrement to a floor of 30%. Show the effect on Medicaid Revenues, Medicare Revenues, Total Revenues, Total Cost and the required Federal Grant

Md%	Medicaid	Medicare	Revenues	Cost	Grant Needed
	$694,824	$331,378	$1,427,062	$1,948,691	$521,630
1.00%	$687,876	$331,378	$1,420,113	$1,946,353	$526,239
2.00%	$680,928	$331,378	$1,413,165	$1,944,014	$530,849
3.00%	$673,979	$331,378	$1,406,217	$1,941,676	$535,459
4.00%	$667,031	$331,378	$1,399,269	$1,939,338	$540,069
5.00%	$660,083	$331,378	$1,392,320	$1,936,999	$544,679
5.00%	$660,083	$331,378	$1,392,320	$1,936,999	$544,679
7.00%	$646,186	$331,378	$1,378,424	$1,932,322	$553,898
8.00%	$639,238	$331,378	$1,371,476	$1,929,984	$558,508
9.00%	$632,290	$331,378	$1,364,527	$1,927,645	$563,118
10.00%	$625,342	$331,378	$1,357,579	$1,925,307	$567,728

This is the one-way sensitivity table.

8. Using Excel, prepare a two-way sensitivity table. Table two should show the impact of a decrease in the Medicaid reimbursement from $65 to $60 in decrements of $1 and a decline in the number of Medicaid visits from 40% to 30% in 1% decrements. The body of the table will show the required Federal Grant needed to balance the budget in the sixty-six scenarios

M'caid % drop	Rate 1	Rate 2	Rate 3	Rate 4	Rate 5	Rate 6
521,629.61	65	64	63	62	61	60
0.00	$521,630	$532,319	$543,009	$553,698	$564,388	$575,078
0.01	$526,239	$536,822	$547,405	$557,988	$568,570	$579,153
0.02	$530,849	$541,325	$551,801	$562,277	$572,752	$583,228
0.03	$535,459	$545,828	$556,197	$566,566	$576,935	$587,304
0.04	$540,069	$550,331	$560,593	$570,855	$581,117	$591,379
0.05	$544,679	$554,834	$564,989	$575,144	$585,299	$595,454
0.06	$549,288	$559,337	$569,385	$579,433	$589,481	$599,530
0.07	$553,898	$563,840	$573,781	$583,722	$593,664	$603,605
0.08	$558,508	$568,343	$578,177	$588,011	$597,846	$607,680
0.09	$563,118	$572,845	$582,573	$592,301	$602,028	$611,756
0.10	$567,728	$577,348	$586,969	$596,590	$606,210	$615,831

This is the two-way sensitivity table.

The amount of Federal Grant required if Medicaid caps its reimbursement rate and the center loses Medicaid patients to the Medicaid HMO ranges from $521,630 to $615,831.

A worse case scenario table could be developed that would also include the effects of the increase in variable cost because of the loss of the Health Department support and the potential fee in lieu of taxes that might be assessed by the county.

Additional instructor notes one and two way sensitivity tables

One way sensitivity Proof

Medicaid % Loss	Medicaid Revenues	Total Revenues	Total Costs
0.00%	$694,824	$1,427,062	$1,948,691
10.00%	$625,342	$1,357,579	$1,925,307
Difference	$69,482	$69,482	$23,384
Patients			
0.00%	10,690	$65	$694,850
10.00%	9,621	$65	$625,365
Difference			$69,485
Variable cost per patient			$21.88
Patient loss = 10690 x 10%			1,069
Total Variable Cost			$23,385

Two way sensitivity table proof

Sensitivity Rate Factor	A		$65.00	$62.00	$60.00
Fee reduction	B		$0	$3	$5
Sensitivity Medicaid loss %	C		2.00%	10.00%	5.00%
Medicaid patients	D		10,690	10,690	10,690
Variable per patient	E		$21.8757	$21.8757	$21.8757
Medicaid patient lost	F	C X D	213.8	1069	534.5
Original federal grant required	G		($521,630)	($521,630)	($521,630)
Variable Cost savings:					
Medicaid Patients loss x Variable cost	H	F X E	$4,677	$23,385	$11,693
Lost Revenues:					
Medicaid patients lost x $65	I	F X $65	($13,897)	($69,485)	($34,743)
Remaining Medicaid patients x fee reduction	J	F X B	$0	($28,863)	($50,778)
	K	G+H+I+J	($530,850)	($596,593)	($595,457)

FUTURETECH AND LOGOISTICS: AN AFFAIR TO REMEMBER*

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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.

INSTRUCTORS' NOTES

Intended Instructional Audience and Placement in Course Instruction

This case was based on original field research and written for several different audiences and uses. The case was developed at a company in which one author was employed and the other was a consultant. It was primarily developed for undergraduates enrolled in an Organizational Behavior course, although it could also be used in a Principles of Management course. For the Organizational

Behavior course, the case should be introduced after the students have read the chapters on values and group dynamics (in Robbins, 1998; Chapters 4, 7, 8,11, and 12). An extension of the case also could be used at a macro level covering human resources policies and organization culture (Robbins; Chapters 15 and 16). In the Principles course, the case should be used after a discussion on leadership and /or controlling.

Second, the case also has value for students taking a course in Business Ethics or Management and Society. Specifically, the case could be employed in conjunction with a discussion on moral judgment and personal ethics (Carroll and Buchholtz; Chapters 4 and 5).

Lastly, the case can be useful in management training and development programs. In such programs, two topics can benefit from using the case. First, the subject of office romance and how to handle such matters while maintaining team performance can be examined. Second, deviant behavior by stealing company resources for personal gain would likewise be an appropriate use.

Learning Objectives

The overall purpose of this case was to introduce students to the concepts of group dynamics and ethics in a high tech company. Students can obtain a realistic perspective for the temptations imposed upon employees from both internal and external forces. The concepts of character and integrity also should receive ample importance in the students' learning. Students should also realize the importance of management controls through the use of policies, procedures, and training in warding off such an unethical practice of using company resources for personal gain.
Specific learning objectives are as follows:

1. To understand the problems office romances and hidden companies can cause for employers.
2. To develop a formal system of management controls, such as policies, procedures, and a viable code of ethics, for preventing such problems from arising in the future.
3. To understand the concepts of group cohesiveness, conflict of interest (ethics), and fraud in the workplace.

TEACHING STRATEGIES

Preparing the Student Prior to Case Analysis

The instructor may decide to use various approaches when employing this case. It is recommended, however, that regardless of the method used, students prepare by reading material on ethics, especially on conflict of interest, and/or material on values and group behavior. Likewise, the student should become familiar with the information on management control, especially the creation and application of policies and procedures for dealing with deviant behavior in organizations. The instructor may also wish to have the students read other references on the subject, such as in conflict management The instructor may then decide to use one or a combination of the following method prior to the case being assigned:

1.	A brief lecture and discussion on the topics of ethics values and group dynamics.
2.	A student presentation on each topic.
3.	A guest lecture on one or more of the topics.
4.	A video on one of the topics.

Students should also be prepared to discuss the case by having read before class the article "Managing Attraction and Intimacy at Work" by Marcy Crary (1987). In this article Crary distinguishes between "Attraction", which may be beneficial and functional to managers and organizations, and "Intimacy" which can, and usually does, have the opposite impact. Yet attraction may have a down side as well. Crary, through her interviews, reports that some people, who were attracted to others at work, had at times feelings of uncertainty, confusion, frustration, fear, resentment, and anger.

Elsewhere, she relates how "some people seek the aid of a close but neutral party to help them sort out their feelings and gain some perspective on their attraction - particularly when the costs of directly expressing that attraction to the person seem too high." (p. 31) This may be what Harry did with his friend, Jerry, when he returned from Massachusetts.

Students should be aware of Crary's recommendations for organizations and managers in dealing with employee attraction and intimacy (p. 40). First, organizations should develop "constructive standards" about these relationships. Second, managers should not create rules that prohibit these relationships, since "such formal rules and sanctions only drive emotions underground, thus preventing people from dealing more constructively with the issue involved." Third, the establishment of training programs would raise the consciousness of employees regarding these relationships and the tensions that would ensue. Fourth, skill building can help employees to manage these issues by developing effective strategies. Lastly, "role models of close, effective male-female relationships in management can have an obvious impact on people's hopes and fears concerning attraction and intimacy at work." These recommendations should be kept in mind when discussing the solutions.

Role Playing

Role-playing is a device that permits the student to empathize with the participants in the case. The student plays the part of a character in this drama (or sometimes comedy). In this case, the following roles should be assigned to students:

Fred Black, Sr. VP Human Resources	Robert Stein, Director Printed Circuit Boards Division
Michael Strong, Test Engineer	Matthew Scott, Test Engineer
Harry Fried, Test Engineer	Sam Kim, Technician
Donna Gold, Technician	

The instructor also may include Pat Guarino, Manager Test Engineering Department but remember he was a silent participant. The remainder of the class can be observers or consultants. A number of scenarios can be played:

First, the startup of Future Tech (5 minutes);
Second, the Massachusetts trip (10 minutes);
Third, the meeting with Fred Black (15 minutes);
Fourth, an imagined outcome indicating what the students think will happen (10 minutes);

The remaining time can be spent for debriefing or presenting the consultants' or observers' perspective. Allot sufficient time at the end to tie the case to theory. Invariably, students will want to know what really happened. The epilogue at the beginning of this teaching note can accomplish that for the instructor.

Before the role playing, students should be aware of the characters they will be playing including the characters' motivation and viewpoint, prepare for their parts, create any dialogue, and practice with each other. This role-playing should be assigned at least one week in advance to give students ample time to prepare. The instructor may wish to meet with the "cast" to discuss their roles and what will enfold. They also should be told the amount of time they have, which should not be the entire class since the instructor would want a debriefing and discussion to ensue.

POSSIBLE ASSIGNMENT QUESTIONS AND ANSWERS

1. What are the problems and causes in this case?

There are two immediate problems confronting management. First, is the affair between Harry and Donna. Although it was a personal matter, it still has implications for the Company. Work time was used for carrying on the affair, which means that the employees were not fulfilling their obligations to the employer. This behavior may result in poor performance or sabotage if and when the affair is discontinued. For example, the erasing of computer files. It also establishes questionable organizational values that may be misinterpreted by other employees as acceptable behavior. Lying and cheating, or overall dishonesty, are not values that organizations wish to condone.

Possible causes of such behavior are the temptations that people will have as they work together for long periods. Likewise, personal problems, such as a dysfunctional family life, poor morals, or personal history are other causes. Office romance continues to be an increasing problem for organizations.

The second problem, the existence of FutureTech represents a "conflict of interest", a "misuse of power" and theft. The members of FutureTech were utilizing company resources for personal profit and made decisions that may not have been in the best interests of Logoistics. The use of Logoistics leased software, seeking authorization for unnecessary business trips, dealing with Logoistics competitors and conducting FutureTech work during Logoistics company time are some of the behaviors one would frown upon. FutureTech members also used Logoistics business as leverage to get a deferred payment deal with the test fixture vendor, CyberText.

This second problem can have several different causes. The most obvious is personal greed for more money, however this is not usually the initial cause since there first must be opportunity. Dynamo provided this opportunity by approaching the engineers. Secondly, the extra income was easy and lucrative. Thirdly, there had to exist a lack of supervision on the part of Logoistics. This allowed them to convince their managers to authorize many of their requests. This also raises a question as to the organization's culture. The company's desire to have a high entrepreneurial spirit, as seen in the company's founder, may have been misinterpreted and misapplied by employees. Finally, the lack of a sufficient workload enabled them to have spare time to perform FutureTech activities during company time.

2. What alternatives should be considered?

For the affair, the Company can dismiss both Harry and Donna for the theft of time and work. The Company, however, should consider counseling both of them and Matt for his behavior with Donna, although it is not clear if any use of Company time and facilities was involved in the affair with Matt and Donna. If the affairs were to continue or violence, sabotage, or lower morale persists, then the Company would need to dismiss the parties.

For the second problem, the existence of FutureTech, two possible courses of action are as follows:

Option 1: hey could have been given written warnings, requested to dissolve FutureTech, and put on probation, which Logoistics management did.

Option 2: They could have been fired the three associates for misconduct and temporarily outsource the workload to test fixture contractors, until new employees could replace them. The remaining associates would be requested to absorb some of the increased workload as well.

3. What solutions should be recommended?

Counseling is a viable option and within the Company's human resource benefits. The Company should not want to lose productive and valuable employees (prior to the affairs) without giving them a chance to regain their performance and composure. Management should try to salvage these workers by offering them counseling and training. However, all participants should be placed on probation for a six-month period with regular reporting of their activities and time to both their manager, director, and the Human Resource department.

Having a freelance business on the side is not necessary illegal as long as Company resources, customers, and time are not used. (See also Question #7) The means in which FutureTech conducted business therefore was questionable. Thus, written warnings seem appropriate. More practically, given the climate of scarce supply of test engineers and technicians, the Company should seek to retain these individuals, placing them on the aforementioned six-month probation. Apparently, the timing of the consequences could work in favor of the FutureTech members. Two engineers had just transferred to another department with in Logoistics before Harry's venture. Logoistics should be concerned that firing 75% of their PCB engineers would have dire consequences on production.

4. How should Logistics' management go about implementing these solutions?

Concerning the affair, both Harry and Donna would be referred to a counselor within the existing network of the Employee Assistance program. Their progress and performance would need to be carefully monitored by their manager. Donna should be transferred to another department and if at all possible Harry too. This would separate him from Matt and help to defuse the situation.

Next, management should consider starting Company-wide training programs to indoctrinate employees of the potential work and personal hazards of workplace romances and intimacy.

For the FutureTech situation, first, Logoistics management would have had to delay the transfers of the two engineers to the other department. Secondly, they would need to begin a search for two engineers and a technician. The technician position could have been filled immediately from within the company. The engineering positions would have taken longer. Thirdly, management could have requested that the remaining engineer absorb as much work as possible and outsource the rest to contract programmers.

5. If Fred Black, HRM Vice President called you in as a consultant, what advice would you give him to prevent such incidents from occurring in the future?

Overall, what are noticeably absent are ethical guidelines and a process to confront quickly unethical conduct. A published code of ethics should, therefore, be created and given high priority. Although the Company does have a "Code of Conduct", it merely describes core values and contains more generalities about relationships with customers and vendors. A strong clear and explicit document needs to be produced. Likewise, explicit policies need to be developed and disseminated to all employees on engaging in outside activities for remuneration using unapproved company resources. Also, procedures need to be created for managers to deal with these issues.

The manner in which this code of ethics can be accomplished should take the following form: First, gain approval from upper management. Second, construct a committee from all levels of management and from employee ranks to draft the code. Upper management and especially the legal officer should examine and approve the document. Fourth, the code should be communicated to all employees and made part of an orientation program for new employees. The Company newsletter may publish portions of the code with explanations or examples. Fifth, Human Resources should establish mandatory education programs explaining the code and presenting examples of dilemmas and their resolution. Lastly, top management must realize that they serve as role models and must therefore be models of ethical conduct.

Another suggestion is to appoint a person to serve as a liaison or ombudsmen to mediate and hopefully resolve ethical conflicts. This person needs to be well respected and can serve part time. (See Hughes, Ginnett, and Curphy, 1996; Chapter 8; and Leap and Crino, 1993; Chapter 17)

6. Explain how Group Cohesiveness and Conflict of Interest are demonstrated in the case.

Group Cohesiveness is the degree to which group members are attracted to each other and willing to work together. The size of the group and its importance are two factors that contribute to cohesiveness. In the Test Engineering Department we see a relatively small group (seven associates and one manager). The group seemed to be cohesive until two situations emerged. First, the start of FutureTech caused an imbalance in the department with two subgroups forming- FutureTech members and nonmembers. The split caused one group to constantly be on guard that the others would not report FutureTech's activities. Likewise, possible pangs of jealously by nonmembers not being included could have caused someone to anonymously report the covert actions to management or at least communicate the actions to the grapevine. The group's importance seemed to give them an attitude of invincibility. The test engineers were important to the operation and especially to the final quality of the product. Thus, we see the reluctance to fire all of them. However, Matt underestimates

FutureTech's cohesiveness and is surprised when Harry blows the whistle on the entire operation. (See Robbins, Chapter 7)

Conflict of Interest is a conflict that exists when the self-interest of a person interferes with his obligation to act in another person's or group's interests. Accordingly, FutureTech's members had an actual, personal, and individual conflict of interest. In their operations, their interests were first with FutureTech rather than Logoistics. They repeatedly used Company resources for their own personal gain. Use of the telephone, copiers, computers, fax, customers, and test stations were blatant and in only FutureTech's interests. In essence, the members used biased judgment, misused their positions, violated confidentiality, and were in some instances in direct competition with their employer. (See Boatright, Chapter 6) Likewise, it is important to note that employees have fiduciary responsibility to the shareholders (owners) of the Company. Actions, while in the employ of the Company and on Company time and premises, for personal gain constitute a conflict of interest. A distinction needs to be drawn, however, between a conflict of interest and conflicting interests. In the former, one of the interests is not legitimate and thus, morally condemnable. In conflicting interests, all interests are legal. In the latter, these may be considered as unfortunate, but not condemned. Thus, in the FutureTech situation, we see that the deviant behavior was illegal because of the unauthorized use of Company resources, and constituted a conflict of interest. (See Beauchamp and Bowie, Chapter 5)

7. Discuss the fraudulent aspects of this case.1

This is an employer-employee relationship. Pursuant to an agreement, whether expressed or implied, the employee undertakes to perform services or to do work under the direction and control of another (i.e. the employer or the manager acting for the employer) for compensation. The employer-employee relationship is created with the consent of both parties, which is generally a contract and thus subject to the principles of contract law. In many instances the duration of the contract is not stated. It is thus considered employment-at-will and may be terminated at anytime by either party for any reason at all as long as it is not for discriminatory reasons.

The duties of an employee are determined either expressly or implied by the contract with the employer. The law also implies certain obligations on the part of the employee. Employees are under a duty to perform such services as may be required by the contract of employment. For example, an employee may be given confidential trade secrets and has been instructed not to disclose them to others. Failure on the part of the employee to live up to the stipulation of the directive and thus his or her contract, may force the employer to enjoin the use of the information by the employee and by any person to whom it has been disclosed by the employee. An employee who works for a company owes his or her allegiance to that company. Conduct that comprises that loyalty is a conflict of interest. There is generally no fiduciary duty (special relationship of trust) between an employee and employer. Such fiduciary responsibilities exist solely for officers of corporations and members of the Board of Directors. Thus, an employee does not have to put the interests of his or her employer ahead of themselves. Since there is no fiduciary duty, an employee is probably not responsible for any damages as a result of a breach of his or her

a) duty of loyalty
b) duty of diligence
c) usurp of a business opportunity
d) duty not to compete
e) duty of care

But as previously mentioned their actions would be considered a breach of their employment contract and may result in an injunction and termination of employment as this behavior by an employee is clearly unethical. It is also arguable as to whether they should forfeit compensation that they would have received, since they are in breach of their employment contract and have been doing "other business" on company time.

Of course all of these problems would be better addressed had there been an expressed written contract between the employer and the employee stipulating these issues (duties, responsibilities, trade secrets, customer lists, non-compete during and/or after employment). Yet the absence of such a written contract does invalidate their obligations to their employer.

Concerning fraud, which is defined as "…the misrepresentation by a person of a material fact, known by that person to be untrue or made with reckless indifference as to whether the fact is true, with intent to deceive and with the result that another party is injured" (Whittington and Pany, p. 53) there is no question that the participants did misrepresent fact, especially the reason for their trip to Massachusetts. However, it is not clear whether the Company was injured in that regard. Thus on the surface it appears that their deception was fraud but only if the Company can show that the loss of employee productivity and reduction in profits were directly related to the deception.

In essence therefore, there is a breach of an employment contact, theft of services and company resources, possibly fraud, but no violation of fiduciary responsibility.

EPILOGUE

Harry and Donna were both fired.

Mike, Matt and Sam were separately called into Human Resources and met several times with Logoistics management. They all received a harsh slap on the wrists and written warnings for alleged misconduct. No one else was fired. They also were requested to immediately dissolve FutureTech and warned that any continued activity of this manner would result in instant termination.

All are still employed at Logoistics in the PCB Department. The latest developments indicate that they did indeed dissolve FutureTech. According to an outside vendor they are now operating under a new name…MSM Enterprises.

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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.

INSTRUCTORS' NOTE

This case takes the student through the accounting rules for realized and unrealized gains and losses on investments and securities. The case is intended for students in any of Intermediate Accounting, Auditing, or Accounting Ethics. In the requirements, Alternative A is intended to give practical experience in recognizing the need for entries, adjustments, and disclosures, in the preparation of entries and preparation of simple financial statements. The inclusion of a simple capital structure (with only one class of stock and no change in shares outstanding) earnings per share calculation is intended to emphasize the material impact of the transactions. Alternative A is best used in Intermediate Accounting. Alternative B calls for a rhetorical rather than computational solution. Under Alternative B requirements, students must recognize the transactions generating accounting activity, and be able to identify and discuss the appropriate GAAP. Alternatives A and B ask students to assume the role of either Controller or Chief Financial Officer. Alternative C asks students to evaluate the events, estimates, and accounting treatments and presentation selected by management, from the point of view of the auditor. Alternatives B and C are intended for use in Auditing and Ethics classes. Under any of the alternatives, students should be troubled by the conflicting treatments of realized and unrealized gains and losses on securities and investments, depending on the expressed intent of management, and should be troubled by the specific results obtained by the strict application of GAAP to the facts presented. Deferred tax issues arising from recording unrealized gains and losses are ignored. Teachers of Intermediate Accounting may find the case useful for taking students through the current GAAP for investments, but may find the Intermediate students so intent on learning the FASB's rules that they do not readily see the larger issues of overall presentation and transparency that will be the focus of the discussions in Auditing and Ethics.

The initial investment is not a marketable security investment, and should be simply recorded at cost. Unrealized temporary changes in market value should be ignored. Likewise, the restricted stock received in the merger should be classified as a held to maturity investment, and since neither the stock given up nor the stock received are productive assets, and since there is no intent to sell either asset, the gain on the exchange should be recognized, as a component of ordinary income.

Students may believe the realized gain is extraordinary. However, mergers by exchange of stock are neither unusual, nor infrequent, so the gain is not extraordinary.

Students are asked to recognize the accounting effect of the change in intent by management, regarding the stock dividend shares (never restricted) and as to the shares for which the restrictive covenant expires. When management expresses its intent to sell, and sale is no longer restricted, FASB 115 asks that the value of shares be reclassified to securities held for resale. This presents opportunities to discuss how to calculate the amounts to reclassify. Both the stock dividend shares, and the shares for which the restrictions expire, must be assigned values. The approach used in the sample solution is similar to the standard methods used to determine the relative values to record, say, a stock with detachable warrants offering, when the amount received from the offering, and the market value of both the warrants and the stock without warrants, immediately after the offering, are known.

With the dramatic decline in fair value reached by year end, students are asked to account for a temporary impairment in an asset accounted for at cost, not held for resale, and not held as marketable securities. FASB 115 indicates this decline in value is to be ignored unless realized, or unless the impairment is other than temporary. Additionally, the student is asked to account for the unrealized decline in fair value of the securities held for resale, which FASB 115 would recognize, but record and disclose in other accumulated comprehensive income, rather than as a component of ordinary income or loss. As a matter of presentation, students must decide whether the display of other accumulated comprehensive income should be on the income statement, the balance sheet, or elsewhere.

Finally, students must deal with the subsequent event rules, and a change in management's determination that the decline in value of the stock is other than temporary. The case clearly asserts that management believes the decline is temporary in nature at year-end. Because the change to other than temporary, from temporary, occurs after year-end, all of the facts and conditions creating subsequent event treatment are not in place at year-end. Accordingly, the student will need to decide how to disclose the amount of the loss to be recognized, as well as how to calculate the loss amount, related to the other than temporary impairment, in 2002.

Most accounting students encounter the concepts of extra-ordinary items, subsequent events, realized and unrealized gains and losses in investments, etc., for the first time, in Intermediate Accounting. This case can be used to discuss these matters.

Some students may notice the timing of the change to other than temporary in 2002 will allow subsequent event treatment, or other disclosure, but is after the date of the audit opinion. This allows discussion of the possibility of an unaudited footnote in an audited financial statement, the practical reasons management may not want to pay for the extra audit work to re-date the opinion, whether a dually dated opinion is possible, etc. Other than as a window for possible subsequent event treatment, these dating problems can be ignored for students without any background in audit.

The sample solution for Alternative A records the transactions, in accordance with the intent of management, in a perfunctory manner, following the guidance of FASB 115. The case provides a beginning trial balance for each of the two years, reflecting usual transactions for the year, but without any transactions related to the Taekwon/Hapkido investment, for either year. The initial purchase has been recorded. Journal entries are provided to record the investment transactions, and changes in fair value, described in the case. These are posted to the trial balances, and summary balance sheets and income statements are produced for each of the two years. This is the solution to the problem obtained in the real world version of this case. East west's rationale was simply to follow the steps in FASB 115 for accounting for investments held to maturity and investments held for sale, in the apparently firm belief that following the letter of the rules would lead to an appropriate result in every case.

The real world solution included an unaudited additional footnote to describe the change in value of the investment after year-end and the accounting treatment accorded the transactions. These have been omitted to simplify the case. Instructors may present the case without the sample solutions, depending on the level of the class, and the intent of the instructor. This can be accomplished by using the Alternative B requirements.

The solution from the real world occurrence produces an unsatisfactory result. Within a single set of financial statements and disclosures (for 2001), related to a single investment of $150 million in a parts factory, the case presents the following conflicted results:

1. An after tax gain of $315 million, reported on the income statement.
2. An after tax loss of $89.6 million, in other accumulated comprehensive income.
3. A note to financial statements disclosure indicating the remaining investment, with a book value of $472 million, is worth only $200 million at year-end 2001.
4. An unaudited note that the same investment, with an initial cost of $150, million has a fair value of only $50 million at the end of the first quarter of the next year.
5. In a year when gross margins drop and total sales decline sharply, and the fair value of the $150 million investment drops below cost, year 2000 earnings per share increase to $3.49, from $1.29 reported for 1999.

These results assail transparency. While everything described can be found in the financial statements and notes, the story is convoluted and difficult to follow. Worse, this result is disingenuous. It flies in the face of economic reality. The company has invested $150 million in an asset that is worth only $50 million by the time the financial statement is printed. The presentation of the $3.49 earnings per share, an increase of 171 percent, is based on a huge gain that has disappeared. Income from continuing operations, excluding transactions related to the investment, actually decreased by 94 percent.

What happened? Students may duplicate these results, wending their way by rote, through some fairly complex accounting principles. What have been lost sight of are the objectives of financial reporting, of transparency, and the idea that the financial statements should not be misleading.

There is no proposed solution to alternative C. In auditing class, discussions of the ethics involved are appropriate. Investigation of the debate over principles versus rules based auditing may be in order. Is it possible the mandate of Rule 501, Rules of Professional Conduct, with regard to the exercise of professional judgment, have been obscured by the desire of the FASB to give us clear direction? Have the pressures of daily life, inflicted by management on an accounting staff wishing to please, eroded professional judgment in the preparation of meaningful financial statements? Do auditors now believe that the exact application of generally accepted accounting principles automatically results in financial statements that are fairly stated and not misleading?

Finally, teachers of accounting and auditing may wish to consider whether this case, with its three alternative uses, presents a clear and appropriate point of departure or recognizable decision point to the students. While the requirements of each of the three alternatives are clear and specific, they intentionally do not ask the students leading questions to guide them to the intended observation or solutions. The chemistry of every class is different. The level of knowledge and experience in the rules and principles of accounting varies from class to class and course to course, with the maturity and experience of the students. In the audit and accounting workplaces, the points at which critical decisions should be made are not often obvious. The development of the critical judgment that is required of the professional accountant must come from that hard experience as from the kind, mentoring hand of the classroom teacher.

DISCLAIMER

This critical incident and teaching note was prepared by the author and is intended to be used as a basis for class discussion rather than to illustrate either effective or ineffective handling of the situation. The names of the organizations, and their financial information, have been changed, and the transactions simplified, to facilitate classroom use.

SUGGESTED SOLUTION FOR ALTERNATIVE A

East West Company

Journal entries, year 2001	Dr.	Cr.
Investment in Hapkido	600,000	
Gain (loss) on disposition of Taekwon investment		600,000
Gain (loss) on disposition of Taekwon investment	150,000	
Investment in Taekwon		150,000
To record exchange of stock at fair value of shares received.		
Investment in Hapkido, unrestricted	90,000	
Investment in Hapkido		90,000
To reclassify 15% of Hapkido stock to unrestricted, available for sale, re: stock dividend		
Investment in Hapkido, unrestricted	102,000	
Investment in Hapkido		102,000
To reclassify 20% of Hapkido stock to unrestricted, available for sale, re: expired restrictions.		
Provision for income taxes	137,670	
Income tax payable		137,670
To record income tax provision		
Accumulated other comprehensive income (loss)	128,000	
Investment in Hapkido, unrestricted		128,000
Deferred tax asset	38,400	
Accumulated other comprehensive income (loss)		38,400
To record unrealized loss, net of tax effect, in held for sale securities		

East West Company
Working trial balance Amounts in $000s.
December 31, 2000 and 2001

	2001 Prelim.	Dr.	Cr.	Final 2001
Cash and near cash	297,274			297,274
Short term investments (trading securities)	248,601			248,601
Investment in Hapkido, unrestricted, held for sale	-	192,000	128,000	64,000
Accounts receivable, net	65,573			65,573
Inventory	337,548			337,548
Prepaid expense and other current assets	58,873			58,873
Deferred tax asset		38,400		38,400
Property and equipment	48,909			48,909
Investment in Taekwon	150,000		150,000	-
Investment in Hapkido, restricted, held to maturity	-	600,000	192,000	408,000
Deposits and other assets	264,133			264,133
Accounts payable	(63,722)			(63,722)
Accrued payroll	(7,655)			(7,655)
Income tax payable	-		137,670	(137,670)
Deferred income tax	-			-
Other accrued liabilities	(85,541)			(85,541)
Notes payable	(188,367)			(188,367)
Common stock	(841,625)			(841,625)
Retained earnings, prior years	(275,101)			(275,101)
Accumulated other comprehensive income (loss)	-	128,000	38,400	89,600
Sales, basic products	(459,457)			(459,457)
Other income	(71,679)			(71,679)
Cost of goods sold	312,431			312,431
Research & development expense	85,450			85,450
Selling expense	61,735			61,735
General & administrative expense	36,962			36,962
Other expense	25,658			25,658
Gains & losses on investment in Taekwon (Hapkido)	-	150,000	600,000	(450,000)
Provision for income taxes--current portion	-	137,670		137,670
	-	1,246,070	1,246,070	-

East-West Company

Income statement	Amounts in $000s, except EPS	Year ended December 31, 2001
Revenue		
Sales, basic products		459,457
Other income		71,679
		531,136
Less cost of goods sold		312,431
Gross profit		218,705
Expenses		
Research & development expense		85,450
Selling expense		61,735
General & administrative expense		36,962
Other income and expense		25,658
		209,805
Income (loss) before gain on investment		8,900
Gains on investment in Taekwon (Hapkido)		450,000
Income before tax		458,900
Income tax expense		137,670
Net income		321,230
Common shares issued & outstanding		92,000
Earnings per share	(92,043,000 common shares issued & outstanding)	3.49

East-West company

Balance sheet In $000s, except per :	December 31, 2001	
Assets		
Current assets		
Cash and near cash	297,274	
Short term investments (trading securities)	248,601	
Investment in Hapkido, unrestricted	64,000	
Accounts receivable, net	65,573	
Inventory	337,548	
Prepaid expense and other current assets	58,873	
Deferred tax asset	38,400	
		1,110,269
Fixed assets and other assets		
Property and equipment, net of accumulated depreciat	48,909	
Investment in Hapkido, restricted	408,000	
Deposits and other assets	264,133	
		721,042
		1,831,311
Liabilities		
Current liabilities		
Accounts payable	63,722	
Accrued payroll	7,655	
Income tax payable	137,670	
Other accrued liabilities	85,541	
		294,588
Term liabilities		
Notes payable		188,367
		482,955
Stockholder's equity		
Common stock	841,625	
Retained earnings, beginning balance	275,101	
Current year earnings	321,230	
Accumulated other comprehensive income (loss)	(89,600)	
		1,348,356
		1,831,311
		-

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.*

INSTRUCTORS' NOTES

FINANCIAL ACCOUNTING ISSUES

Financial Accounting Question 1

Question: **In light of trends in popular music industry over the past few years, briefly discuss the likelihood of any new artist generating at least a break even level of sales for a debut album.**

Students should conclude from the background material in the case that it is extremely unlikely that any one new artist will be a "success". In fact, based on the sales figures for new titles in 2001, it is considerably unlikely that new releases would even make a profit. Less than 2 percent (112 / 6455) even reached break-even.

The focus here is to get students to think about the concept of materiality (as a prelude to Question 4) as it relates to expected future recoverability of deferred costs. It really isn't necessary that students assign an exact probability to this question as long as they realize that in this industry, profitability only comes to a very few big-name artists. Most albums never even recover the upfront promotion and production costs or cash advances to the artists.

Financial Accounting Question 2

Question: **In your opinion, at what point during the three-year period of her contract (1999-2002) could MCA executives reliably predict the success or failure of Ms. Hennessy's recording career? Justify your answer.**

This question is intended to get students to concentrate on the timing of events and when, perhaps, the future viability of a project becomes doubtful. This is a warm-up exercise to Question 4 where students will be asked to make the same judgment in applying GAAP.

To properly discuss this issue, students will need to sort out the chronology of events. Perhaps the class as a group can draw a timeline to put all important events in context. Here is a brief summary: Mid 1999 - Carly signs six-album contract; December 1999 - First album completed; results aren't very encouraging; Early 2000 - New producer and writers hired to rerecord the entire album; December 2000 - Rerecorded album not completed; Early 2001 - The single "I'm Gonna Blow Your Mind" (from the upcoming album) released in U. S.; New production manager hired for the album; Mid 2001 - The single "Beautiful You" (from the album) released in U. S.; November 2001 - The album "Ultimate High" released in U.S; Early 2002 - The single "I'm Gonna Blow Your Mind" released in Europe.

Based on the case discussion, it seems clear that both the artist and the label still considered Carly Hennessy a potential success at end of 1999. Even though everyone was disappointed in the first album, at that point it was still considered a production and positioning problem, not an artist problem.

By the end of 2000, the seeds of doubt should have been emerging. Although Carly had still not been tested in the market, the long recording and production problems suggested that perhaps she didn't really fit into any of the potential markets. However, absent any market results, the studio optimists at MCA still considered her a viable artist and worth the continued investment of MCA's resources.

In mid 2001, it was becoming obvious that Carly Hennessy was perhaps not going to be a success in U. S. pop music. Extremely slow sales of the first single in the spring were followed by equally slow sales of the second single in the fall. Even though the rerecorded album was finally completed in November, it was all but ignored by both retailers and radio stations. All doubts about future success were put to rest by the end of 2001.

Financial Accounting Question 3

Question: **MCA Records is a subsidiary of Vivendi Universal SA. At their website, locate the most recent set of financial statements. Scan Footnote No. 1 to locate their accounting policies for revenue and expense recognition related to their music holdings.**

Instructors might give the Vivendi Universal URL to students or let them locate it through a Web search. http://www.vivendiuniversal.com/vu2/en/_home/home.cfm

To find their most recent annual report at the site: Click on: Shareholders; Click on: 2001 Annual Report Form 20-F; On page 127 of the 2001.

Form 20-F - Notes to Consolidated Financial Statements is Note 1 which describes their accounting policies.

NOTE 1 - DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Revenues and Costs - Music:

Revenues from the sale of recorded music, net of a provision for estimated returns and allowances, are recognized upon shipment to third parties. Advances to established recording artists and direct costs associated with the creation of record masters are capitalized and are charged to expense as the related royalties are earned, or when the amounts are determined to be unrecoverable. The advances are expensed when past performance or current popularity does not provide a sound basis for estimating that the advance will be recovered from future royalties.

In connection with Vivendi's accounting policies, instructors may want to spend a few minutes deciding the appropriate GAAP standards in this area. SFAS No. 50 - Financial Reporting in the Record and Music Industry gives the authoritative guidance. (Relevant portions of the standard are in the Appendix to the Teaching Notes.) At this point it might be obvious that the wording of Vivendi's policies is taken directly from SFAS No. 50.

Financial Accounting Question 4

Question: **Put yourself in the role of the controller for MCA. Prepare a report recommending the proper accounting for the revenues and expenses related to the Carly Hennessy project over the years 1999-2002. In your report, cite corporate accounting policies and be specific as to when the album revenue and related costs should be recognized. Make any reasonable allocation assumptions necessary to complete your recommendations.**

Although many students will understand the capital expenditure versus the revenue expenditure concept, the instructor will have to steer many students toward the specifics of how it relates to this situation. Briefly, Vivendi's accounting policies are real-life applications of the basic revenue and expense recognition concepts.

Revenue should be recognized when it's realized (realizable) and earned. For most merchandisers, this occurs when the product is shipped. This is Vivendi's revenue recognition policy.

Expenses should be recognized when incurred which is in the period that the cost contributes to revenue generation. This is the matching principle underlying accrual accounting. Practically, the conceptual framework gives three guidelines for when to recognize expenses: direct matching with revenue, proportional allocation and immediate recognition in the current period (see SFAC No. 6 in the Appendices).

Vivendi's policy for recording costs and artist advances approaches the expense/revenue matching dilemma by deferring such costs until either a) the related royalty revenue is earned or b) the costs are determined to be unrecoverable.

At some point in the discussion, the exact amounts and timing of MCA's costs will arise. Here is a summary:

Table 1: Summary of MCA's Costs for the Carly Hennessey Project

Event	Advance	Living Costs $5000 @ mo.	Recording Costs	Promotion Costs	Video Costs
Year 1999 &2000 up to release "Mind"	$100,000	$60,000	$350,000	$450,000	$250,000
Year 2001 up to Release of Ultimate High		$60,000	$650,000	$500,000	
Total Costs	$100,000	$120,000	$1,000,000	$950,000	$250,000

These costs total $2.42 million which includes the $120,000 of living costs ($5,000 @ month for two years) and the $100,000 advance. Recording and promotional costs alone are $2.2 million.

Having identified the key events in 1999 -2001 in Question 2, studied Vivendi's accounting policies and reviewed the relevant financial accounting theory, students should be ready to make some concrete recommendations to MCA.

Since Vivendi's policy is to capitalize production costs and advances, most students will likely recommend that all costs for 1999 be capitalized and some students will recommend similar treatment for the costs incurred in 2000. As discussed earlier, there is still some possibility at the end of 2000 that Ms. Hennessy will still have a successful release in the future. Note that at the end of 2000, there were still no revenues attributable to Ms. Hennessy's recordings.

By the end of 2001, most students should be recommending that all costs be expensed. Two justifications might be made here. First, since MCA had virtually given up on her in the U. S. market, only in 2001 would there ever be any revenue to match the expenses against. Secondly, since future recoverability of any deferred costs was highly unlikely at this point, their policy is to write off deferred costs "…when past performance or current popularity does not provide a sound basis for estimating that the advance will be recovered from future royalties". (Reference to SFAS No. 50 would be appropriate here since Vivendi is following, to the letter, GAAP principles in the recording industry.)

ADDITIONAL FINANCIAL ACCOUNTING ISSUES

Amortizing Acquired Musical Assets:

In a subsequent section of Vivendi's Footnote No. 1 is the following description of their accounting for acquired music assets. This might be introduced to the class as a contrast in accounting for acquired versus internally-developed music assets.

Other intangible assets:

Vivendi universal has significant acquired other intangible assets, including music catalogs, artists contracts, music and audiovisual publishing assets, film and television libraries, international television networks, editorial resources and plates, distribution networks, customer relationships, copyrights and trademarks, among others. Acquired music catalogs, artists' contracts and music publishing assets are amortized over periods ranging from 14 to 20 years. Most other intangibles are amortized over a four-year period, on a straight line basis.

Comparison with R & D Accounting:

If the basics of R & D accounting are included in the course, instructors might introduce it again as comparison of GAAP options available for different types of potential revenue expenditures. A brief review of the key accounting issues and GAAP mandates (see SFAS no. 2 in the Appendices) for R & D expenditures show both strong consistency and inconsistency with the GAAP guidelines for music assets. While GAAP requires full expensing of R & D costs, recording companies have the option of expensing or not the production and promotional costs for developing new recordings.

A further look at the rationale of SFAS No. 2 (See Par. 39: high failure rate of most R & D spending) indicates that those conditions also exist in the recording business. Yet, GAAP allows more choices in the music industry. Why? In R & D, GAAP mandates immediate expensing which prevents any deferrals. In the recording industry, while deferral is certainly an option, the low likelihood of future recording success for artists in general would also suggest immediate expensing of promotion and production costs.

Conservatism and Materiality:

Instructors might bring up the accounting concept of conservatism which would suggest immediate expensing of most production and promotion costs in all situations. Also, the concept of materiality might arise. MCA is facing a maximum write-off of approximately $2.2 million in year 2000 or 2001. Since Vivendi had total music revenue of approximately 6.5 billion Euros (music operating income of 719 million Euros) in 2001, it's not likely that a 2.2 million dollar write-off will materially affect anyone's analysis of their financial results.

Foreign Currency Translation:

Vivendi is a French company whose stock is sold on the Paris Bourse. When students access the Web site, they will likely encounter financial statements presented in both euros and U. S. dollars. Since MCA's U. S. operations will be originally reported to Vivendi in dollars, Vivendi corporate will have to translate those amounts into euros before consolidation.

Since many students enjoy discussing this topic, instructors might want to briefly discuss the concept of currency translation and foreign currency gains and losses. In June 2003, the euro equaled approximately $1.18 U. S. (1 U. S. dollar equaled 84.5 euros). However, in mid-2002, the euro only equaled approximately $.88 U. S. (1 U. S. dollar equaled 1.14 euros).

Throwing good money after bad? In discussions with students, the question will come up as to why MCA persisted with this project long after future did not look promising for her. MCA's president, Jay Boberg, originally heard and signed Carly Hennessy to her recording contract with MCA. Partly to save face and keep some new artists in the MCA "pipeline", Mr. Boberg undoubtedly felt pressure to make her a success (see: Ordoñez, Jennifer: "Behind the Music…"). In addition, the business strategies for Vivendi's music units specifically targets investing in new releases and new talents.

Business strategies for Vivendi Universal's Music Units:

- *Local / Global:* optimize the balance and diversity between local music and global hit production, to keep growing market share both on a worldwide and local basis
- *New releases / Catalogs:* optimize the balance between new releases and back catalogs to meet consumers' needs and tastes
- *Artists & Repertoire and New labels:* keep investing in A & R to detect and develop new talents, as well as support emerging and promising labels
- *Fight piracy* by developing technology, by legal/legislative efforts and by developing commercial alternatives
- *Online Music:* capitalize on UMG's extensive music library and VU's expertise in online technology (MP3.com) to derive new revenue streams from online music subscription service *pressplay*™, the JV with Sony Music Entertainment, Inc., as well as other internet sites (MusicNet, FarmClub, GetMusic,etc.).

(Source: http://finance.vivendiuniversal.com/finance/strategy/businessunits.cfm#04)

MANAGERIAL ACCOUNTING ISSUES

Managerial Accounting Question 1

Question: **What does the term "break even" 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?**

This question should help students begin to see the relevance of some common managerial accounting concepts. The break-even point is where total sales revenue equals total costs (in other words, $0 of profit or loss). Most managerial accounting texts present the break-even formula as: BE level of sales = Fixed Costs / (Selling price - Variable Cost @ Unit).

The case says that, on average, CDs must reach sales of 500,000 to 700,000 to break even. The actual number is not the key focus in this question, but rather the idea that a lot of CDs must be sold to break even and how few CDs ever come close to that level. For the calculations in question 4 below, it would be appropriate for the class to agree on which sales volume to use.

Managerial Accounting Questions 2 and 3

Questions: **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 fixed or variable costs for the recording industry. Give reasons for your choices. What are some other possible cost behaviors other than pure fixed and pure variable costs? Give examples of each related to the recording industry.**

The objectives of Questions 2 and 3 are to give students an opportunity to discuss the basics of cost behavior in a setting with which they have some interest and familiarity (at least on the consumer side). Fixed costs stay constant over the relevant range of sales volume. Variable costs change proportionately with sales volume.

Other types of cost behavior include step-variable, mixed, discretionary and committed. Step- variable costs vary as sales volume changes but only over wide ranges (not proportionately). Mixed costs have both fixed and variable elements (also called semi-variable costs). Discretionary fixed costs represent a short-term commitment to a project and vary based on annual spending decisions. Committed fixed costs relate to costs necessary for the basic organizational structure and represent long-term capacity commitments.

After reading the case and Appendices A and B, students will likely list the following cost categories: production and recording costs for the record master, general promotional costs, promotional video costs, artist advances and living expenses, packaging and manufacturing costs, primary artist royalties and mechanical royalties for other artists.

The only true variable costs related to CD sales are the actual manufacturing and packaging costs and the mechanical royalties for other artists. The other costs identified in the case are primarily fixed or semi-fixed costs. Artist advances are fixed costs and living expenses do vary but in proportion to time, not sales volume. Promotional costs for new releases are mostly fixed costs since they are incurred primarily before most sales occur in an effort to get name and product recognition. The costs of producing the record master from which copies are made are also fixed costs with no variability related to sales volume (includes studio and musician costs, producer, engineer, etc.).

Discretionary fixed costs would include artists' living expenses and car and the promotional and video costs. Committed fixed costs would include artist advances and most of the costs of producing the record master

Managerial Accounting Question 4

Question: **Based on your response to question 1 and 2, compute the approximate variable cost for MCA records related to the CD "Ultimate High". 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.)**

Students must commit to their previous cost behavior decisions since a quantitative answer is asked for. In the following calculations, these amounts were used:

- The higher break-even volume of 700,000 was used since MCA spent more than normal in producing and promoting the CD and it would likely take more sales to break even.
- A CD retail price of $12.50 was used (the case says that CD sales were only $5,000 for 400 copies).

- Record company sales revenue is based on wholesale, not retail. Therefore, revenue of $6.25 @ CD was used (retail of $12.50 x 50% distributor rate - see Appendix A).
- Fixed costs for production and promotion for the CD "Ultimate High" are $2.4 million. No other corporate costs are included in the case and are ignored in this analysis.

Although Ms. Hennesy's contract provides that her royalties are only applied to 50% of promotional video costs, the entire video cost of $250,000 was included in the $2.4 million to simplify the calculations.

Using these values in the formula for break-even volume of sales yields the following:

➜ Break-even volume = FC / (Price - VC)
➜ 700,000 = $ 2.4 million / ($6.25 - VC)
➜ 700,000 * ($6.25 - VC) = $2.4 million
➜ $4.375 million - 700,000 VC = $2.4 million
➜ $1.975 million = 700,000 VC
➜ $2.82 = VC per CD

➜ Contribution margin = Price - VC
➜ CM = $6.25 - $2.82
➜ CM = $3.43

At a variable cost of $2.82 @ unit, the record company achieves a contribution margin (amount of sales that can contribute to fixed costs) of $3.43 @ CD. This may seem low to most consumers but the analysis below might put this in a new perspective. The variable cost of $2.42 @ consists of packaging, manufacturing and mechanical royalty costs.

Why are Ms. Hennessey's royalties (15% of retail price) not included here as a variable cost? Most artist contracts provide that artist royalties are first applied to recovering the recording and promotional costs incurred by the record company. Therefore, the royalty is not a variable cost to the record company until the break-even sales level is reached. Therefore, the record company's contribution margin will be greater up to the break-even level than it is above that level (see Question 5).

Managerial Accounting Question 5

Question: **After a CD reaches the break-even level of sales, what happens to the record company's costs? Is this a change in fixed costs or variable costs? Explain. Using the data for the album "Ultimate High", 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.**

With sales of 700,000 copies, MCA would presumably break even on the CD "Ultimate High". (Of course, we're ignoring all other corporate costs in this analysis). But, what happens to their cost structure above the BE level of sales?

Above the BE level of sales, the record company's costs change. The artist's royalty, which the artist supposedly "earned" on the first 700,000 copies, was actually treated by the record company as contribution to their fixed costs (in other words, company revenue). Above the BE level, however, the artist is entitled to actually receive her royalties and this amount must now be included as an additional variable cost to the record company. At this point, they no longer have any fixed costs related to promotion and production.

With an artist royalty of 15% of retail, Ms. Hennessy would now be owed $1.875 @ copy sold ($12.50 x 15%). With this additional VC, MCA's profit on the next 100,000 copies sold above the BE level would be:

Revenue (100,000 @ $6.25)	$ 625,000
Original VC (100,000 @ $2.82)	-282,000
Royalty VC (100,000 @ $1.875)	-187,500
Profit (Contribution Margin of $1.56 @)	$ 155,500

If the royalty was computed as a straight 15% of retail, MCA enjoys a $1.555 @ unit contribution to other corporate costs and profits. Any future production and promotional costs will also be charged against the artist's royalty.

After reviewing the economics of artist contracts in Appendix A, it isn't likely that her royalty would be computed as a straight 15% on retail price. For example, if MCA deducts the 25% packaging fee and reduces the sales volume level to cover possible returns and breakages, her royalty amount would be computed as:

Retail price	$12.50
Less: Packaging fee (25%)	- 3.125
Net retail price	$ 9.375
Reduction for returns, etc.	x 90%

Net retail for royalty calculation	$ 8.438
Royalty	x 15%
Royalty per unit sold	$ 1.27

Using this variation, MCA's profit on the next 100,000 of sales above the BE level gives:

Revenue (100,000 @ $6.25)	$ 625,000
Original VC (100,000 @ $2.82)	-282,000
Royalty VC (100,000 @ $1.27)	-127,000
Profit (Contribution Margin $2.15 @)	$ 215,000

In this scenario, MCA now has a $2.15 @ unit contribution towards other costs and profits.

Students will like come up with several variations on these calculations depending on how they interpret and apply the various provisions in artists' contracts. However, the key point is for them to understand the concepts of cost behaviors

APPENDICES - TEACHING NOTES

Statement of Financial Accounting Concepts No. 6 - Elements of Financial Statements

Paragraphs 145 - 149: Accrual accounting uses accrual, deferral and allocation procedures whose goal is to relate revenues, expenses, gains, and losses to periods to reflect an entity's performance instead of merely listing its cash receipts than outlays. Thus, recognition of revenues, expenses, gains and losses and related increments or decrements in assets and liabilities-including matching of cost and revenues, allocation and amortization-is the essence of using accrual accounting to measure performance of entities. The goal of accrual accounting is to account in the periods in which they occur for the effects of an entity of transactions and other events and circumstances, to the extent that those financial effects are recognizable and measurable.

Some expenses can be directly matched with related revenues as part of the same transaction. Other types of expenses cannot be directly related to particular revenues but are incurred to obtain benefits that are exhausted. Other types of assets yield their benefits to entities over several periods. In these cases expenses resulting from their use are normally allocated to the periods over their estimated useful lives in a systematic and rational allocation procedure.

Statement of Financial Accounting Standards No. 50 - Financial Reporting in the Record and Music Industry

(This statement extracts the specialized accounting principles and practices for AICPA Statement of Position 76-1, Accounting Practices in the Record and Music Industry and establishes standard of financial accounting and reporting for licensors and licensees in the record and music industry. …. It also establishes accounting standards for artist compensation cost and cost of record masters.)

Artist compensation cost

Paragraph 10. The amount of royalties earned by artists, as adjusted for anticipated returns, shall be charged to expense of the period in which the sale of the record takes place. An advance royalty paid to an artist shall be reported as an asset if the past performance and current popularity of the artist to whom the advance is made provide a sound basis for estimating that the amount of the advance will be recoverable from future royalties to be earned by the artist. Advances shall be charged to expense as subsequent royalties are earned by the artist. Any portion of advances that subsequently appear not to be fully recoverable from future royalties to be earned by the artist shall be charged to expense during the period in which the loss becomes evident. Advance royalties shall be classified as current and noncurrent assets, as appropriate.

Cost of record masters

Paragraph 11. The portion of the cost of a record master borne by the record Company shall be reported as an asset if the past performance and current popularity the artist provides a sound basis for estimating that the cost will be recovered from future sales. Otherwise, that cost shall be charged to expense. The amount recognized as an asset shall be amortized over the estimated life of the recorded performance using a method that reasonably relates the amount to the net revenue expected to be realized.

Paragraph 12. The portion of the cost of a record master recoverable from the artist's royalties shall be accounted for as advance loyalty, as discussed in paragraph 10.

Glossary

Advance Royalty - An amount paid to music publishers, record producers, songwriters, or other artists in advance of their earning royalties from record or music sales. Such an amount is based on contractual terms and is generally nonrefundable.

Record Master - The master tape resulting from the performance of the artist. It is used to produce molds for commercial record production and other tapes for use of making cartridges, cassettes, and reel tapes. The costs of producing a record master include a) the cost of musical talent (musicians, vocal background, and arrangements); b) the cost of the technical talent for engineering, directing, and mixing; c) costs for the use of the equipment to record and produce the master; and d) studio facility charges. Under the standard type of artist contract, the record company bears a portion of the costs and recovers a portion of the cost from the artist out of designated royalties. However, either party may bear all or most of the cost.

Royalties - Amounts paid to record producers, songwriters, or other artist for their participation in making records and to music publishers for their copyright interest in music. Amounts for artists are determined by the terms of personal service contracts negotiated between artist and record companies and usually are determined based upon a percentage of sales activity and license fee income, adjusted for estimated sales returns.

Statement of Financial Accounting Standards No. 2 - Research and Development Costs

Accounting for Research and Development Cost

Paragraph 12. All research and development costs encompassed by the statement shall be charged to expense when incurred.

Appendix B - Basis for Conclusions - Uncertainty of future benefits

Paragraph 39. There is normally a high degree of uncertainty about the future benefits of individual research and development projects, although the element of uncertainty may diminish as a project progresses. Estimates of the rate of success of research and development projects vary markedly-depending in part on how narrowly one defines a project and how one defines success-but all such estimates indicate a high failure rate. For example, one study of a number of industries found an average of less than 2 percent of new product ideas and less than 15 percent of product development projects were commercially successful.

VIRTUALLY THERE TECHNOLOGIES: A CASE STUDY OF EARNINGS MANAGEMENT AND FRAUD

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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.

INSTRUCTORS' NOTES

Recommendations for Teaching Approaches

This case can be discussed in class or assigned as a project to be completed outside of class. The requirement to prepare a memorandum of their findings was designed to improve written communication skills and professional judgement. The requirements to prepare adjusting journal entries and determine the effect on income were designed to improve the students critical thinking skills and to reinforce the necessity of being aware of how proposed journal entries effect income per the books.

The case may also be used to improve analytical and verbal communication skills by requiring students to present or discuss in class, the problems encountered, their proposed corrections, and the effect on income. For example, students can be required to make a presentation to the company's Board of Directors to discuss their investigation and explain their findings.

Versions of this case have been used for the last two years in one of the author's Intermediate Financial Accounting II classes. The vast majority of the students felt that the case helped them integrate and apply the materials covered in the course. The case was distributed approximately three-quarters of the way through the course and collected on the last day of class. It was weighted at approximately 7% of the final grade for the course.

The basic methods of manipulating income were discussed in class. Students were expected to complete the requirements of the case outside of class. However, they were also strongly urged to have their journal entries reviewed before handing in the case. This gave the instructor the opportunity to meet with the students, evaluate their reasoning processes, and reinforce critical concepts. In cases where several students had difficulties with the same journal entry, the issue was discussed in class. This required students to logically express their reasoning process and to develop their verbal communication skills. An additional benefit was that the students were exposed to audit procedures that would be covered later in their course work.

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.

AJE	Description	DR	CR	Effect on net income
	Income per trial balance			$1,864,000
1				
2				

SOLUTIONS: REQUIREMENT A

1. It appears that the sales journal for December was kept open into January. The $800,000 of sales should not have been recorded in December because the goods had not been shipped by year-end. The sales and related accounts receivable should be removed from the books. The inventory of $640,000 was still owned and was correctly included on the books. The adjusting journal entry will reduce income by $800,000. This could be an intentional misstatement.
2. Sales were recorded before the income was earned. The sales should be reversed and unearned revenue should be recorded. The adjusting journal entry will reduce income by $250,000. This is probably an unintentional error.
3. The original transaction of $600,000 was not a real sale and should be removed from the books along with the related accounts receivable. The inventory was owned by the company but was not counted at year-end (it wasn't there) or included in ending inventory. The $480,000 of inventory should be added to the inventory per the books. The adjusting journal entry will reduce income by $120,000. This is a fraudulent misstatement.
4. The sales return and reduction of accounts receivable in the amount of $310,000 should have been recorded before year-end. The inventory was correct and no adjustment is needed for inventory or cost of goods sold. The adjusting journal entry will reduce income by $310,000. This is a fraudulent misstatement.
5. The sales and related receivables appear to be fictitious and should be removed from the books. The adjusting journal entry will reduce income by $350,000. This is a fraudulent misstatement.

6. The sales return should have been recorded, but was not. The sales return and related reduction of accounts receivable of $400,000 should be recorded on the books. In addition, inventory should be reduced and cost of goods sold increased by $320,000. The adjusting journal entry will reduce income by $720,000. This could have been an intentional misstatement.
7. The allowance for doubtful accounts and the related bad debt expense are understated by $220,000. The allowance for doubtful accounts should be adjusted to its estimated balance. The adjusting journal entry will reduce income by $220,000. This was probably an aggressive interpretation of generally accepted accounting principles.
8. Rebate expenses should be reported as incurred. The expense and related liability should be recorded on the books in December. The adjusting journal entry will reduce income by $300,000. This was an infrequent transaction and was probably an unintentional error. In addition, an adjusting entry would be required in January (not required for this project).
9. The ending inventory contains obsolete inventory that should be written off. Inventory should be reduced and the related cost of goods sold should be increased by $210,000. The adjusting journal entry will reduce income by $210,000. This was probably an unintentional error.
10. The components of the partially completed units included in work-in-process inventory (WIP) that are not yet operable and which are not compatible with any other game systems produced by the company, should be expensed as research and development expenses. The adjusting journal entry will reduce income by $400,000. The finished goods inventory costs associated with the software to be used exclusively by this game system of $280,000 should also be expensed as research and development expenses because a working model has still not been developed. These are probably unintentional errors.
11. These transactions were in effect sales on consignment. Accounts receivable related to consignment sales should not be recorded until the consignee sells the goods. The accounts receivable and related sales of $750,000 should be reversed. Also, the inventory of $600,000 should be put back on the books and cost of goods sold should be reduced. The adjusting journal entry will reduce income by $150,000. This could be an intentional misstatement.
12. Depreciation expense and the related accumulated depreciation account are understated and should be increased by $900,000 (i.e. $2,100,000 - (12 x $100,000) = $900,000). The adjusting journal entry will reduce income by $900,000. This appears to be an overly aggressive interpretation of generally accepted accounting principles.
13. The "customer acquisition costs" should be classified as advertising costs and should be expensed in the period incurred. The adjusting journal entry will reduce income by $250,000. This appears to be an overly aggressive interpretation of generally accepted accounting principles.

14. The cost of the patent should be expensed as research and development expense. The adjusting journal entry will reduce income by $200,000. This appears to be an unintentional error.
15. The $500,000 incurred before working versions were created should be expensed and not capitalized. Computer software should be reduced and research and development expense increased by $500,000. The adjusting journal entry will reduce income by $500,000. This could be an intentional misstatement.
16. Liabilities should be recorded in the period they are incurred. The related inventory was already received and counted. Cost of goods sold and accounts payable should be increased by $250,000. The adjusting journal entry will reduce income by $250,000. This appears to be an unintentional error.
17. Liabilities should be recorded in the period they are incurred. The related inventory was already received and included in the year-end inventory counts. Cost of goods sold and accounts payable should be increased by $350,000. The adjusting journal entry will reduce income by $350,000. This appears to be a fraudulent misstatement.
18. Commission expense and the related liability should be reported in the period in which the services were rendered. The timing of the expense should be matched to the period in which the sales were recorded. Accrued commissions should be recorded in the amount of $310,000 [$150,000 + $160,000 (i.e. $3,200,000 x .05 = $160,000)]. The adjusting journal entry will reduce income by $310,000. An adjusting entry would also be required in January (not required for this project). This appears to be an unintentional error.
19. Payroll expense and the related liability should be reported in the period in which the services were rendered. The liability should be adjusted to its estimated balance and the related expense should be recorded on the books in December. The adjusting journal entry will reduce income by $60,000. An adjusting entry would also be required in January (not required for this project). This appears to be an unintentional error.

Note: If all of the errors go in the same direction (i.e. to increase income), then they may actually be intentional misstatements.

SOLUTIONS: REQUIREMENT B				
AJE	Description	DR	CR	Effect on income
	Income per trial balance			1,864,000
1	Sales	800,000		(800,000)
	Accounts receivable		800,000	
2	Sales	250,000		(250,000)
	Unearned revenue		250,000	
3	Sales	600,000		(600,000)
	Accounts receivable		600,000	
	Inventory	480,000		
	Cost of goods sold		480,000	480,000
4	Sales returns	310,000		(310,000)
	Accounts receivable		310,000	
5	Sales	350,000		(350,000)
	Accounts receivable		350,000	
6	Sales returns	400,000		(400,000)
	Accounts receivable		400,000	
	Cost of goods sold	320,000		(320,000)
	Inventory		320,000	
7	Bad debts	220,000		(220,000)
	Allowance for doubtful accounts		220,000	
8	Rebate expense	300,000		(300,000)
	Rebates payable		300,000	
9	Cost of goods sold	210,000		(210,000)
	Inventory		210,000	
10	Research and development expense	680,000		(680,000)
	Inventory		680,000	
11	Sales	750,000		(750,000)
	Accounts receivable		750,000	
	Inventory: Consigned	600,000		
	Cost of goods sold		600,000	600,000
12	Depreciation expense	900,000		(900,000)
	Accumulated depreciation		900,000	

SOLUTIONS: REQUIREMENT B

AJE	Description	DR	CR	Effect on income
	Income per trial balance			1,864,000
13	Advertising expense	250,000		(250,000)
	Customer acquisition costs		250,000	
14	Research and development expense	200,000		(200,000)
	Patents		200,000	
15	Research and development expense	500,000		(500,000)
	Computer software		500,000	
16	Cost of goods sold	250,000		(250,000)
	Accounts payable		250,000	
17	Cost of goods sold	350,000		(350,000)
	Accounts payable		350,000	
18	Commission expense	310,000		(310,000)
	Commissions payable		310,000	
19	Payroll expense	60,000		(60,000)
	Accrued payroll		60,000	
	Net income (loss) before taxes			(5,066,000)

WORLDCOM INC.: SURVIVAL AT STAKE

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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.

INSTRUCTORS' NOTES

OVERVIEW

This case focuses on the growth and decline of WorldCom. The case traces the growth of WorldCom, till it filed for bankruptcy in 2002. Although accounting fraud issues have taken center stage when discussing the bankruptcy of WorldCom, the roots of WorldCom's decline lie in its turbulent industry, and strategic and management errors made. WorldCom shows meteoric rise and an equally meteoric fall. The case traces the developments in the telecommunications industry from the breakup of AT&T till 2002. Deregulation and technology have had major roles in shaping the industry. While deregulation increased competition in the long distance business, the local exchange business was not so transformed. Long distance business became increasingly commoditized and competition was price based. Technological advances allowed for massive increases in the transmission capability of networks, resulting in the expectation that there will be a convergence in data, voice and video. Many firms wanted to be the provider who would provide all these services to the consumer and greatly increased their network capacity by laying new lines. Unfortunately the demand boom expected did not happen and all that resulted was a gross mismatch between supply and demand.

WorldCom started as a small long distance reseller and by a series of acquisitions managed to become a national player, with a strong presence in the rapidly growing data business. WorldCom was the leader in the internet backbone business and was strong in the business segment of long distance telephony. WorldCom went on to buy MCI, a company much larger than itself. Various problems may be seen with the merger. The price paid was too high and the company took on a lot of debt. MCI was in a slow growing highly competitive segment - the long distance segment. By buying MCI, WorldCom was increasing its exposure to this segment. Whatever synergies and cost savings that this merger might have obtained were quashed with the poor implementation of the integration. Culture clashes and unreasonable cost cutting resulted in MCI executives leaving the company. Another problem with WorldCom was its lack of presence in the wireless business. WorldCom's attempt to correct that - by its bid to acquire Sprint - was defeated when the Justice department turned down the merger. This left WorldCom with strategic weaknesses, financial burdens, and with a large exposure to the slow growing long distance business. The situation came to a head with disclosures of accounting fraud that involved top management - right from the CEO. Failure to make payments resulted in WorldCom filing for bankruptcy protection.

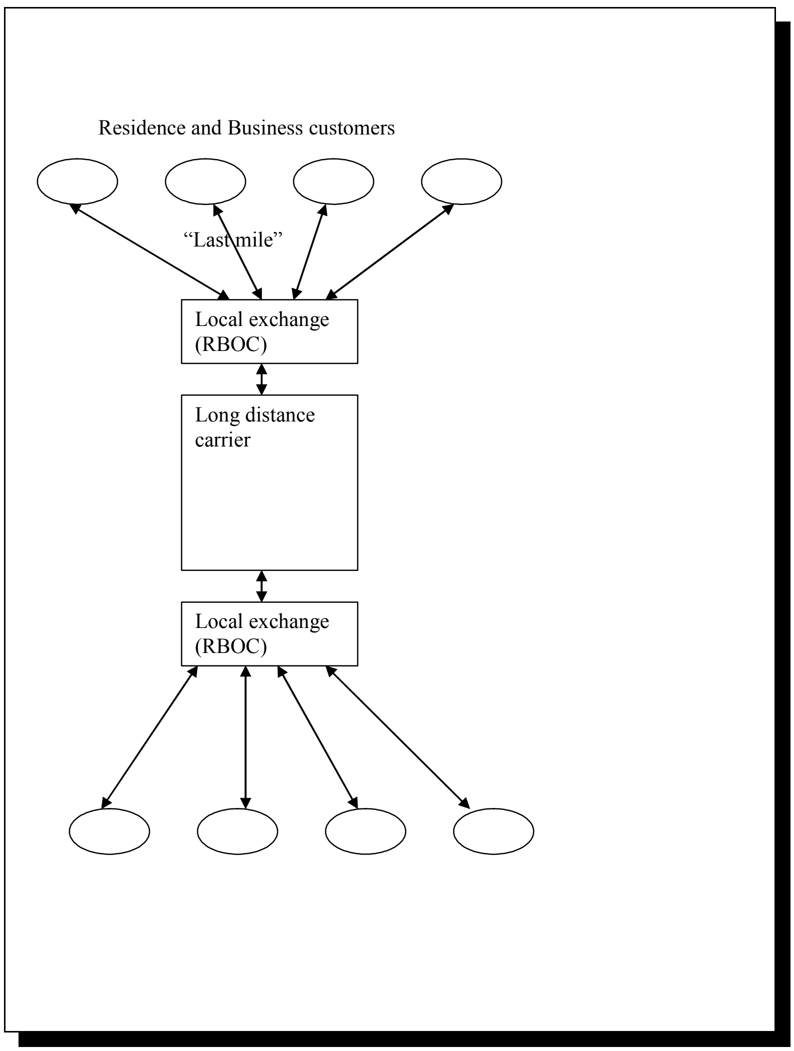
DISCUSSION QUESTIONS

1. What are the major driving forces in the telecommunications industry? How have they affected the long distance business?

The major driving forces are: regulation/deregulation and technology.

Impact of Regulation/deregulation: Initially, the telecom industry was a monopoly and consisted of one firm: AT&T. AT&T controlled all aspects of telephony - it owned all the local and long distance networks in the US. Thus a call would travel from the home or business of a subscriber on AT&T lines.

Deregulation began when AT&T was ordered to break up. A distinction was made between the local and long distance businesses. Figure 1, shows the process of transmission. While local exchanges continued to be monopolies, the long distance business was opened up to competition. Local exchange was controlled by the creation of 22 separate holding companies (Regional Bell Operating Companies or RBOC's also called Baby Bells). The original company, AT&T, stayed in the long distance segment. Subscribers could now choose their long distance company (AT&T, MCI etc), but did not have a choice in who provided them local services - local service was provided by the RBOC controlling their geographical area. These RBOCs controlled a crucial component of the communication network - the "last mile" or the final connection to the consumer's home. A long distance carrier had to use these local networks to reach their subscribers and was charged an access fee by the RBOCs. The result was an entry of new competitors into the long distance business, which was becoming increasingly competitive. Prices for long distance calls dropped amongst allegations of high access fees pushing up costs.



Increased deregulation took place with the passage of the Telecomm Act of 1996. Under this Act, long distance companies were allowed to provide local services by setting up their own facilities if they did not want to pay access charges. Local exchange carriers were required to open their networks and provide access at wholesale prices. This opened up the door for long distance companies to set up their own facilities to reach their customers and avoid the access fee. Two dominant business models emerged - facilities based operators (companies that invested in laying down lines and networks) and resellers (companies that bought access to networks from facilities based competitors at wholesale prices and sold it to customers for a markup).

Impact of Technology

While deregulation opened the door for competition, technological changes amplified trends and created turbulence in the industry. Digital technology allowed for longer transmissions without signal losses, with better quality at no big cost increase. Developments in the carrying capacity of fiber and increasing substitution of fiber for traditional cable resulted in big increases in bandwidth (volume of data that can be transferred through a network). Towards the end of the 90's there was considerable euphoria as to the potential market size in telecom. This euphoria was fuelled by increased bandwidth that was available that would potentially allow the same provider to provide a subscriber access to the internet (data), entertainment (video) and telephone (voice). The opportunity to provide data, video and voice with the same network is referred to as convergence. The potential of staking a leadership position in a converged telecom industry, the rapid growth of the internet, and the easy availability of capital during the stockmarket boom resulted in huge capital investments in networks. Industry transmission capacity increased 500-fold between 1998 and 2001 (when we account for the technological evolution of carrying capacity of the fiber optic cable). Thus there was a massive increase in supply of telecommunication services, both in number of firms offering the services and total volume of transmission capability. Unfortunately, the exponential demand growth expected from converged networks did not happen. Further, technological progress in wireless networks resulted in a switch from wired to wireless networks further dampening the demand for all the additional capacity. Demand growth during the period when supply increased 500-fold was only 4-fold. Thus we see a huge mismatch between demand and supply and an industry moving rapidly from one of great promise and opportunity to one with tremendous overcapacity.

These changes may be summarized as given below:

Demand
Wireless (-)
Price decrease (+)
Convergence (?)

Supply
New entrants (+)
Capital availability (+)
Fiber capacity (+)

2. What is WorldCom's corporate strategy till 1997? Did it add value?

WorldCom's corporate strategy can be classified as one of related diversification. WorldCom started out as a reseller, but by acquiring companies with facilities it increased its geographic coverage, became a facilities based provider and increased its market power. Later on, with the belief that networks would converge, Worldcom opted to diversify into related products. Many of the early acquisitions were small, entrepreneurial companies - similar to WorldCom.

A strategic shift occurred when WorldCom started to acquire companies not in the telephone business, but firms in related businesses. The goal of these acquisitions seems to be to establish a leadership position in the converged networks. To this end, WorldCom acquired MFS, the parent of UUNet to give it a major presence in the internet/ data business. IDB Communications, gave WorldCom fax and data connections, television and radio transmission services, and mobile satellite communications potential. A gap in WorldCom's portfolio was the absence of a strong wireless presence.

Overall, WorldCom's corporate strategy can be seen mostly as growth by acquisition, versus building up what it had. In the early years, WorldCom's strategy of acquiring other long distance companies to increase its geographical coverage and market power added value. Integration of these firms was also easier since most were small entrepreneurial startups like WorldCom. During this period, WorldCom's shareholders saw their stock price go up.

3. Discuss WorldCom's acquisition of MCI. This deal was hailed by the media as "the deal of the century". Why did it fail to live up to expectations?

In 1997, WorldCom made its largest purchase - MCI. MCI was the second largest long distance company and WorldCom was the 4th largest. By purchasing MCI, WorldCom would be a major player in the long distance business. WorldCom beat the next best offer of $28 billion, by offering $37 billion. This is in contrast to British telecom which after having worked with MCI for many years, dropped its offer from $23 billion to $17.9 billion. WorldCom justified its premium by the expected synergies from sharing networks and reducing costs. Further, they expected to use MCI's strong marketing skills to enhance their other businesses. In concept there was potential in these arguments, but numerous problems emerged in implementation (discussed below).

The effectiveness of corporate strategy could be evaluated in light of the value added to shareholders.

Porter (1987) suggests using three criteria:

- *Attractiveness test:* The attractiveness of the industry being entered into
- *Cost of entry test:* Cost should not overshoot future profits
- *Better off test:* Either the new unit or the corporation must be better off

In the MCI-WorldCom merger, none of these three criteria were met. By 1997, the long distance business was not attractive - it had excess capacity, severe price competition, and was viewed by customers mostly as a commodity - giving firms little opportunity to differentiate. Regarding the cost of entry, it might be inferred that WorldCom paid a premium for MCI. British Telecom had worked closely with MCI for the previous few years actually dropped its offer from $23 billion to $17.9 billion based on MCI's performance and the potential of future revenues. This deal also required WorldCom to take on a lot of debt to pay British Telecom its 20% share in MCI.

Regarding the better off test, Bernie Ebbers, the CEO, referred to a large number of potential cost savings and synergies. It was hoped that WorldCom could cut down the costs of MCI in the price sensitive, increasingly commodity type long distance business, while MCI could strengthen the marketing of WorldCom's high growth data businesses. However, not much was actually realized. There were major problems of culture clash between WorldCom and MCI. WorldCom was a smaller, newer, lean company, while MCI was a more established, larger company. While WorldCom's growth was by acquisitions and cost cutting, MCI grew internally through innovation. The sort of culture and skills needed for a strategy based on cost leadership is quite different from that needed for innovation. What resulted was a major clash in cultures making integration of operations essential for cost savings elusive. Moreover, the austerity measures taken by Ebbers to cut costs went overboard (eg., removing water coolers) and some 70% of MCI executives left the firm. One can presume that with their exit, some of the marketing skills that WorldCom wanted also left MCI.

Adding to these strategic and implementation problems, the long distance business continued to deteriorate, with increased price competition. By 2000, just 3 years after acquisition of MCI, WorldCom decided to partition the two companies and created a tracking stock for MCI to allow focus on its faster growing data business.

4. How do you explain the poor performance leading to the bankruptcy of WorldCom?

Although the media has focused on the ethics issues as the cause of failure of WorldCom, there are many other equally important issues.

Problems in the Long Distance Business: Deregulation increased competition in the long distance segment of the telephone business, not the local exchange. Local exchanges were still monopolies and long distance companies had to pay large access fees to reach their subscribers. Since 1996 when local exchanges were opened for competition, it was possible for long distance companies to lay down lines to reach their customers, but this was very capital intensive and took place mostly in the densely populated areas.

Unforeseen Industry Shifts: In the mid 90's the telecommunication business was seen as an extremely high potential industry. Rapid technological advances in carrying capacity of optical fiber and internet, led to the expectation that entertainment, access to the internet and telephone service could be offered by one firm. Unfortunately, while the capacity of optical fiber to transmit information lived up to its potential, the boom in entertainment delivery and convergence did not occur. Other than densely populated urban areas, many areas did not have high speed access from their homes as the local exchange companies continued to keep the copper lines rather than update them. This acted as a bottleneck in data and video transfers through the network (even if the long distance companies had optical fiber lines, the local exchange did not, therefore slowing delivery). This resulted slower than anticipated demand contrasted with massive overcapacity since many firms had laid down networks in the hope of being the firm of choice in a converged environment.

While the above industry pressures acted on all firms in the telecommunications industry, WorldCom was hit very hard. MCIWorldCom had invested a lot of money in laying down long distance networks, and owned the largest chunk of internet backbone. By owning MCI, WorldCom increased its exposure to the hard hit long distance business.

Lack of Presence in the Wireless Business: WorldCom lacked a strong presence in the fast growing wireless business. Although WorldCom tried to address this problem by making a bid for Sprint, the failure of the Justice department to allow the merger, resulted in a conspicuous gap in its product offering. Most other long distance companies had a stronger presence in the growing wireless segment. This not gave them a strategic advantage in allowing them to offer a complete line of communication offering to customers, it kept them out of benefiting from the growth of the wireless segment.

High Acquisition Price for MCI: The high price paid for the acquisition of MCI seems more a result of managerial hubris than based on careful research into costs and benefits. Prior successes with acquisitions, and the easy availability of capital during the stockmarket boom are likely to have reinforced feels of bravado. As suggested in the research on reasons for high premiums paid for acquisitions (Hayward & Hambrick, 1997), the past success with acquisitions, the media blitz surrounding the CEO might have lead to the high price paid for acquisition. The resulting debt weakened WorldCom's balance sheet in comparison to other telecom firms.

Managerial Errors: There seem major problems in both choice of MCI as the firm to acquire as well as in attempts to integrate the firm. The obvious differences in culture should have warned WorldCom about the potential problems in realizing synergies from MCI. Further, it seems that cost cutting went too far. The report that 70% of MCI executives left following austerity measures indicates serious managerial problems. It is quite likely that the most promising executives left as it was probably easiest for them to find jobs. This drain on talent from MCI further decreased the benefits WorldCom was counting on - that MCI's marketing executives would help WorldCom with their marketing.

Failure of Ethics: Worldcom has been charged with overstating accounting irregularities of $9 billion. Studies on failure of ethics point to some underlying features - pressure to deliver results that are probably unachievable, leadership and culture of the company. Initial investigations suggest that fraud in WorldCom started from the top. The CFO of WorldCom has been accused of being directly involved in misrepresenting accounts. The CEo, Ebbers, involvement in this fraud is also being investigated. In any case, it is not likely that Ebbers will emerge as a role model for ethical behavior in the company. Ebbers, it is alleged has personally benefited from various transactions with the firm . For example, he received low interest loans from the company to cover personal margin calls made on company's stock. In addition to the failure of leadership, we should note the tremendous pressures faced by the company. The turbulence in the telecommunications industry, unforeseen negative events especially in the long distance sector, in which WorldCom had high exposure, coupled with high debt and shrinking capital availability obviously put tremendous pressures on WorldCom to improve performance.

EPILOGUE

In the last quarter of 2002, WorldCom's MCI unit sharply raised many of its domestic and international rates, in some instances by as much as 80 percent, marking a departure from its previous role as an industry leader in cost cutting. MCI sought to shed its least-profitable customers and focus on its most-profitable plans, such as the Neighborhood with flat-rate pricing. "In the past, they had focused on every customer," "Now they are focused on customers that are the highest value." (Wallack, 2002)

In April 2003, WorldCom filed a reorganization plan that changed its name to MCI, and shifting its headquarters to Virginia from Clinton, Mississippi, the town associated with disgraced co-founder Bernie Ebbers. According to the new Chairman and chief executive Michael Capellas, the company ``wanted a new name that would make us proud". ``With established brand equity and a name that stands for integrity, innovation and value, we're ready to regain our leadership position in the marketplace." (Dalton, 2003)

In July 2003, new allegations were uncovered against MCI: schemes apparently designed to defraud its competitors that stretched back into the 1990s and that were still in place. Secret schemes to reduce the charges that the company paid to rival telecoms groups to complete long-distance calls. Mr Krutchen told investigators about schemes to reroute long-distance traffic via small independent telecoms operators in an attempt to disguise the origins of the calls and thereby avoid paying network access fees to local operators such as Verizon and SBC. MCI responded that just 8 per cent of its traffic is directed to least-cost routing companies.

As a result, in late July 2003, WorldCom was banned from bidding for US government contracts, worth about $1 billion a year. The General Services Administration, the body that hands out government deals, said: "It is important that all companies and individuals doing business with the federal government be ethical and responsible." (English, 2003) In response, MCI decided to hire a chief ethics officer to improve its image. Michael Capellas observed, "We are in the process of rebuilding our ethics program and understand that there is still more work to do." (English, 2003)

In August 2003, WorldCom proposed changes in how the board would govern the company, as part of its reorganization plan. It accepted 78 recommendations by the court-appointed monitor reflecting specific weaknesses exposed by WorldCom's collapse. The changes aim to give the new MCI overwhelmingly independent and extremely active directors. The company will have 8 to 12 directors, with the chief executive as the only insider. The changes required the board to meet at least eight times a year, visit company sites and undergo annual training. The role of chairman will be turned over to an outsider who would run the board. It barred directors and auditor from serving more than 10 years, and mandated departure of at least one director each year. Strict standards for defining independence of the directors eliminated virtually any dealings with MCI. Most significantly, to give shareholders a bigger voice, an Internet site was to be created where MCI investors could bring concerns to the attention of the board and other shareholders. The site would allow investors to have resolutions voted on without having to gain approval to do so at the annual meeting. No employee will be paid more than $15 million a year without shareholder approval and severance packages will be limited (Feber, 2003).

In October 2003, WorldCom's reorganization plan was approved, and it looked forward to doing business as MCI starting 2004. MCI repaid most creditors just 36 cents on the dollar and wiped out all its former shareholders. MCI now had $2.3 billion in cash and $5.8 billion of debt, down from $41 billion when it filed for bankruptcy in July 2002. The work force was reduced by more than a third to 55,000, down from 85,000 before the bankruptcy. WorldCom had fired the executives responsible for the fraud and replaced the CEO, CFO and entire board of directors. The new policies and procedures - including state-of-the-art board of directors' guidelines, and an extensive corporate ethics program - make MCI a model of corporate governance. The federal judge overseeing the litigation against WorldCom recently opined that never has a company "so rapidly and so completely divorced itself from the misdeeds of the immediate past and undertaken such extraordinary steps to prevent such misdeeds in the future." (Garn, 2003)

In Jan 2004, the government ban on MCI bidding for government contracts was lifted. The representative of the government agency, General Services Administration, stated that "Now you have a company that has corrected the way it does business, and it's safe for the government to do business with it." (Young, 2004)

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NIGERIAN PACKAGED GOODS, LTD.

D.K. Smith, Southeast Missouri State University

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.*

(d) 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.

INSTRUCTORS' NOTE

Our hero, Brian Keith, newly-appointed Managing Director of the Nigerian Packaged Goods Ltd. (hence, NIPAG) subsidiary of Global Packaged Goods Ltd. (hence, GLOPAG), faces the following situation:

1. NIPAG has just recorded a huge loss.
2. The former Managing Director and most of his team have retired.
3. It is by no means certain that NIPAG will continue to enjoy continued support for ongoing operations from the worldwide headquarters of its parent company (GLOPAG) in Belgium.

As regards lessons and/or information which students should learn from this case, at least four points can be made:

1. At the beginning of the case, students will need to consider the extent to which developed-world models and conceptual frameworks can be applied to challenges and opportunities in the developing world. By the end of the case discussion, they will have discovered that many conceptual frameworks (for example, models of corporate performance, models of marketing strategy, etc.) can be useful guides to managerial action not only in the developed world but in the developing world as well.
2. Students will be able to compare their plan to double the company's business in four years to the successful plan developed by the hero of the case, that is, the managing director of the company.
3. Students will discover that managerial initiatives (in this case, a plan for doubling corporate revenues within four years) are powerfully impacted by the nature of the model and/or process used to develop the initiative. Specifically, a plan based on a "corporate performance" framework is likely to differ considerably from a plan based on a "marketing strategy" or a "grow the business" framework.
4. As they work through the case, students are exposed not only to a bit of information on the most populous market in Africa (Nigeria) but also to a bit of history on the

involvement in Nigeria of one of the world's great consumer packaged goods companies.

DISCUSSION QUESTIONS

I often select one student to lead the discussion. Another approach would be to solicit input from various students at various stages of the analysis. Either way, my usual approach to this case is threefold:

1. Solicit from many students the details of the case, including information about the macroeconomic environment at the time of the case; information on the company; information on the competitive environment; information on customers, information on strategies the company has used over the years, and information on how those strategies have been implemented. Usually, I write much of this information on the board, so that if questions on "facts of the case" arise, we will have much of that information in front of us.
2. Ask an individual student or the class as a whole to address a very specific series of questions. Those questions, and comments relating to three possible solutions to the case, are as listed below:

1. What is the main problem?

Students usually conclude that Brian Keith must develop a plan for achieving the objective which he and his boss (Johnson Ojo) have agreed on, that is, to double the turnover of Nigerian Packaged Goods, Ltd. within the next four years. I reinforce the idea that if we were Keith, this is a reasonable statement of the challenge he faces.

2. What kind of problem is this?

Instructors should not be surprised if there are as many answers to this question as there are students in the class. Clearly, there is no one "right" answer. However, three alternative approaches, each of which seem quite relevant to the situation, are as indicated below:

1. Corporate Performance.
2. Marketing Strategy.
3. "Grow the business."

3. For the kind of problem selected, what are the key variables and which expert says so?

For students concluding that the main problem is a "corporate performance" problem, Smith (1985) suggests that the following five categories of variables impact powerfully on corporate performance: (1) Macroeconomic factors; (2) Industry characteristics; (3) "Environmental" characteristics (that is, company, competitor, and customer characteristics); (4) Own-company strategy; and (5) Own-company implementation and/or tactics. For students concluding that the main problem is a "marketing strategy" problem, Perreault and McCarthy (2002) suggest that the key marketing strategy variables are target market and the marketing mix (that is, product, place, price, and promotion). For students concluding that the main problem is a "grow the business" problem, Ansoff (1965) suggests that the available options include:

1. Market penetration.
2. Product development.
3. Market development.
4. Diversification.

4. What data from the case relate to the key variables?

As implied above (and this is one of the key learning points of the case), the data students present will depend on the main problem they identify. Those believing the main problem is "corporate performance" should focus on and reference data relating to the five key performance variables identified earlier, that is, macro-factors, industry factors, "environmental" factors, marketing strategy factors, and tactics/implementation-related factors. Appendix 1 identifies data from the case which relate to each of these five variables.

Students believing the main problem is "marketing strategy" will focus on the two key variables identified earlier, that is, target market and marketing mix. The "marketing strategy" section of Appendix 1 identifies data from the case which relate to each of the key variables.

Students believing that the main problem is "grow the business" will focus on the four options listed earlier, that is: (1) Market penetration; (2) Product development; (3) Market development; and (4) Diversification. Appendix 2 identifies data from the case which relate to each of those alternatives.

5. What alternative solutions can be identified?

Because research suggests we make better decisions if we identify alternatives and then chose one, I require students to identify at least two alternatives. Of course, students having difficulties coming up with a second alternative can be reminded that one possible solution is to "change nothing."

6. Which one alternative does the class/student recommend, and why?

"Changing nothing" is unlikely to help Brian Keith achieve his objective, that is, to double his turnover within the next four years. Thus, it appears that students believing the main problem is the need for a "grow the business" strategy will recommend use of that sort of strategy, while students believing the main problem is the need for a new marketing strategy will recommend that approach. Similarly, students believing that "corporate performance" is the main problem will recommend a different approach to performance.

The approach used successfully by the Managing Director was "corporate performance-based;" for additional information on exactly what he did, please see the epilogue.

7. What negatives are associated with the alternative selected by the class leader and/or other members of the class?

Very few solutions are risk and/or problem-free. Negatives associated with the solution proposed by the class leader and/or other members of the class could include the following: (1) The chosen alternative, if it requires Nigerian Packaged Goods, Ltd. to acquire specialized skills which the organization doesn't currently possess, could be expensive both in terms of time and money. Also, since the case probably doesn't provide all the data a decision maker would need (in other words, it is likely that important data is missing), it is possible that assumptions made by the class leader regarding the actual situation Nigerian Packaged Goods, Ltd. faces are incorrect, and that in reality, the proposed solution might be inappropriate.

EPILOGUE

Brian Keith not only prepared and implemented a plan but also achieved his objective (that is, doubling Nigerian Packaged Goods, Ltd.'s turnover within four years. As indicated earlier, of the three conceptual frameworks suggested, Keith's actual approach was most consistent with the "corporate performance" model. Keith's comments regarding his plan to resuscitate Nigerian Packaged Goods, Ltd. (hence, NIPAG) are as indicated below.

On the financial side, and a indicated earlier, over 1.2 billion naira of non-existent and/or uncollectible accounts receivable were written off. It was important to take the hit and get this behind us.

Regarding staff, and as indicated in the case, Johnson Ojo replaced Erasmus Adepo and I became Vice-chairman and CEO. Most NIPAG directors were also replaced, together with many senior managers just below the director level. At the same time, an intense scrutiny of staffing was conducted. When the new team was finalized, the number of managers had been reduced 40%.

Regarding employee benefits and compensation programs, we substantially upgraded these. Pay levels at NIPAG were raised 20-30%, so as to be competitive with compensation at other leading companies in Nigeria. In addition, benefits provided to managers by NIPAG were increased to include features (for example, financial assistance in purchasing housing or cars) provided to managers by other leading companies in Nigeria. At the junior staff (that is, production workers) level, we have begun organizing the cross-functional teams which have been used in factories elsewhere in the world to substantially improve performance and productivity.

Regarding physical assets, we closed our two Lagos factories, and began a program to upgrade to worldclass levels the production facilities in our remaining three factories. Dedicated communications with major customers have been established, and we have dramatically increased our internet capabilities as well.

We sold our head office complex for more than one billion naira, and moved our head office to a suburb outside of Lagos. The new head office building provides worldclass workspaces and includes internet connections and computers at every workstation. Capabilities for non-internet communications with customers have also been dramatically upgraded. In the new headquarters building, directors are located alongside the managers who report to them, not in a directors' wing.

Regarding processes, NIPAG now outsources (both at headquarters and at its factories) a number of functions (canteen, medical care, security services, etc.) to third-party specialists. The services provided by these external third parties are higher quality and lower priced than the services we had provided ourselves.

We have established programs to motivate and reward employees to come forward with suggestions for improving our operations. We reassure our people constantly that there is a future at NIPAG for employees who come to work each day with the idea that they need to be making positive contributions to the company's current and future success.

We have also established programs to focus employee attention and efforts on safety, health, and productivity. Furthermore, NIPAG has introduced programs to reward employees who do care, do try, and do perform on these key issues. Under the new programs, and similar to worldclass factories elsewhere in the world, junior staff who meet specified health, productivity, quality, and safety goals can double their earnings. Specific changes in the behaviors of junior (that is, production) staff include the fact that now, when shifts change, there is intense coordination between staff coming off the line and those going on. Incoming workers assemble 15 minutes before shift change, so as to be able to coordinate the change-over and avoid situations where the production team's productivity is hurt because production lines must be halted.

We have resumed the practice of sending NIPAG staff on overseas postings to gain experience and insights. The inflow of overseas staff to ensure that we here at NIPAG are aware of worldclass ideas and practices has also resumed.

MARKETING STRATEGY-RELATED REVISIONS

Our target market continues to be Nigerian consumers at all socio-economic levels but especially those at the middle and higher levels. However, we are now making special efforts to ensure that our products are ongoingly available in rural markets all across Nigeria.

NIPAG has dramatically reorganized our interactions with customers. We now deal directly with only 150 of the 850 wholesalers and large retailers (that is, direct customers) we used to deal with directly. Also, we have dramatically increased the profile and importance of our customer service function. The person who now leads this area is on NIPAG's Board of Directors.

We have eliminated many of the low-volume products which were costly to produce and disruptive to our production operations. Our product line is now ten major brands and 50 items (down from 350). We have re-launched each of these major brands and, in the process, have increased and/or improved active ingredients to ensure that the brands we manufacture here in Nigeria meet and/or exceed the levels of performance and value for money set by worldclass products flowing into Nigeria from elsewhere.

As for promotion, we have over the last several months tripled our advertising expenditures. NIPAG's total promotional expenditures and share of voice this year will be dramatically greater than at any other time in recent memory.

Regarding distribution, we have closed the 28 depots NIPAG owned and operated all around the country. We have outsourced the distribution of our products to specialists. The quality of market presence provided by these specialists is better than what we had been able to do ourselves. Furthermore, the cost of purchasing these services from these independent third party specialists has been far lower than the cost of providing these services ourselves.

As indicated earlier, we are investing substantially to ensure that our products are available not only in urban markets but also in rural markets as well. Furthermore, in many major urban markets we now have only one direct wholesale customer and we run nearly all our business in that urban market through that one wholesaler. As we rework our approach to distribution, we are assuring our distributor partners that we will work with them to maximize the probability that they will earn a designated target return on whatever investments they make (financial, human capital) in support of their NIPAG business. Furthermore, we now insist that banks lending to our key distributors make this money available at the same rate at which they lend money to NIPAG itself.

Regarding pricing-related issues, and as a result of the product reformulations and relaunches mentioned earlier, the value for money for NIPAG products is now comparable to worldclass products entering Nigeria from anywhere else in the world.

As illustrated above, the initiative which Keith developed to turnaround the situation at NIPAG involves not just marketing strategy-related variables (that is, target market and marketing mix). Keith's approach clearly involves a full-range of "performance" variables (that is, macro and industry and company and customer and competitor and tactical issues). As to concluding observations, Keith notes the final two additional points:

1. In my opinion, the key success factors for this kind of initiative (together with brief descriptions and/or examples of each of those factors) are:
   - A. *ORGANIZATION:* This is all about clarity and simplification. We simplified structures and made sure that people were very clear about their responsibilities. We introduced the concept of multi-functional team work to ensure there was a greater awareness of interdependence within the entire organization. Having taken care of the ‘hard' issues in terms of job reductions etc. we were able to take an inclusive approach to those that remained.
   - B. *LEADERSHIP*: In Africa, leadership is essential. Part of Nigeria's national problems are related to poor leadership and appalling examples of bad behavior. In NIPAG we set out a very clear objective of what we wanted to achieve (double the business in 4 years) and how we were going to do it. We were then seen to take action accordingly. We also clearly demonstrated that "the Nigerian factor" was not acceptable. We would operate to GLOPAG's international standards. We demonstrated this in every aspect of the business.
   - C. *SELF-DEVELOPMENT:* One of the problems in NIPAG was summed up as "management should do something about this," referring to the unacceptable things that were happening. However it was actually management that was saying this. A symptom of a culture where all decisions were taken at the top. We insisted that management must manage, and instituted a programme of coaching and counseling workshops aimed at ensuring accountability at all levels. Team-based structures and open dialogue with the Board also assisted, as did celebrating with those managers that showed the right approach. We got rid of the ‘blame' culture.
   - D. *TEAMWORK:* Not an easy concept in Africa, as generally social structure is built around hierarchy. It has not been easy to introduce. However, we have worked hard at it and introduced team work training to assist. When moving to our new offices and factories we built open offices and work stations where multi-functional teams actually sat together. Rewards were focused on individual and team results. Team successes were celebrated.

E. *COMMUNICATION:* Absolutely critical. We just kept repeating the same message: you know you are succeeding when you start to get it fed back to you from the most junior employees in the company. So I and my colleagues did regular briefings, we had a total company "Change Fair," we issue monthly newsletters, we issue "elevator speeches" on credit cards, and rewards mirror the key message. In summary everything in the Genesis Programme (that is, the corporate change programme) was aligned through communication. We also had some real big events that demonstrated real change, i.e. new factories, new offices, a change in everything we did and an open approach to challenging everything that we formerly took as "the way we do things."

F. *PROJECT MANAGER/CHANGE COORDINATOR:* The Project Manager/Change Coordinator (it is one and the same person) worked with a multi-functional team to ensure that our milestones were achieved and kept us honest to the organizational philosophy we had created for the company. This was a critical role and vital to maintain momentum.

2. The degree of success one can achieve with this sort of initiative is also powerfully impacted by the extent to which the macro-environment of the country is improving. Here in Nigeria the macro-environment is improving, and we are succeeding. In Zimbabwe, on the other hand, the political and economic environment is deteriorating, and the very similar initiative launched by GLOPAG's people there has failed.

APPENDIX 1
CASE DATA RELATING TO PERFORMANCE MODEL

1. Macroeconomic considerations from the case:

For years, government had placed many restrictions (duties, tariffs, quotas, and so on) on the ability of companies outside of Nigeria to sell into the Nigerian market. NIPAG benefitted greatly from these policies. Over the last couple of years, however, government has greatly liberalized its policies and eliminated most restrictions on commercial activities in Nigeria of companies outside the country. Now, worldclass products (in terms of price and quality) are flowing into Nigeria from all over the world.

2. Industry characteristics:

As stated above, the case indicates that worldclass consumer products are flowing into Nigeria from all over the world. In other words, the approach NIPAG has used in the past (reduce costs by reducing active ingredients and debase brands manufactured in Nigeria by providing lower levels of performance) is not likely to succeed in the future.

3. "Environmental characteristics":

A. Company characteristics (that is, financial, human, and physical assets and operations).

Over the period 1991-1997, NIPAG pushed products out to buyers who were unable to pay. The result is that over 1.2 billion naira of non-existent and/or uncollectible accounts receivable was written off. When the three month long suspension on trading NIPAG shares on the Nigerian Stock Exchange was lifted, the value of an NIPAG share fell from 13 naira to 5 naira.

When Erasmus Adepo retired, nearly all of NIPAG's directors also stepped down. Many other senior managers just below the director level also left the company at this time.

NIPAG's employee benefits and compensation programs have not been updated in many years. Pay levels at NIPAG are 20-30% lower than at other leading companies in Nigeria. In addition, benefits provided to managers by NIPAG do not include features (for example, financial assistance in purchasing housing or cars) which are provided to managers by other leading companies in Nigeria.

The 5 factories NIPAG operates are all old and full of old equipment. NIPAG has no dedicated communications with major customers, and has very little ability to assess the internet as well. NIPAG's head office is also full of old equipment and technologies, and has very limited ability to communicate with the companies depots and customers, very little access to internet, etc.

At the most senior management level, directors are all located in a directors' wing, far from the managers who report to them. At the junior staff (that is, production workers) level, NIPAG has made no effort to organize cross-functional teams, even though factories elsewhere in the world have substantially improved performance and productivity by adopting cross-functional approaches.

NIPAG provides its own canteen and medical care and security services. Such services could be outsourced. The quality of services available from external third parties is higher than what NIPAG now has plus the costs would be considerably lower.

The attitude of a typical NIPAG employee is not "how can I improve the performance of the company" but "how can I enrich myself and my relatives and/or friends." Employees fear there is no future for them at NIPAG, do not feel challenged or motivated, and tend not to perceive that "coming to work" is a good thing to do.

In its factories, NIPAG has no programs focusing on safety, health, productivity, etc. Furthermore, NIPAG has no programs which reward employees who do care, do try, and do perform on key issues such as safety, productivity, quality of products produced, etc. In worldclass factories elsewhere, safety, health, and productivity are worked on intensively, and junior staff who perform on these issues can double their earnings. An unfortunate consequence of NIPAG's lack of attention to these issues is that NIPAG junior staff do not take responsibility for quality and production but their colleagues elsewhere in the world do. There is no peer pressure at NIPAG for employees to be on time or even show up for work. Furthermore, when shifts change, there is no coordination between employees coming off the line and those going on. The result is that lines are likely to come to a total halt as shifts change, thus reducing production and increasing the cost of products produced.

In the past, a regular flow of NIPAG staff overseas to gain experience, and overseas staff into NIPAG to ensure awareness at NIPAG of worldclass ideas and practices. At the time of the case, however, neither of these exchange programs was still functioning.

B. Competitor characteristics:

As indicated earlier, there are competitors in Nigeria who manufacture the same sort of products as NIPAG. However, the really dangerous competitors and the ones to whom NIPAG is losing business are traders who purchase worldclass products produced at worldclass factories elsewhere in the world and then smuggle those products into Nigeria.

C. Customers

NIPAG has 850 direct customers, that is, wholesalers and large retailers. They are located in urban areas all across Nigeria.

Since the end of the oil boom, levels of income and spending for Nigerian consumers (that is, NIPAG's indirect customers) have fallen sharply.

4. Marketing strategy:

A. Target Market:

As indicated earlier, NIPAG has 850 direct customers, that is, wholesalers and large retailers in urban areas all across Nigeria. However, the target market is Nigerian consumers at all socio-economic levels but especially those at the middle and higher levels.

B. Product:

NIPAG sells 350 products, many of which are low-volume items which are costly to produce. Furthermore, these low-volume items are very disruptive of factory operations. To produce these items, NIPAG has to stop its production lines, clean its equipment, change ingredients, run small batches, and then stop its lines again and go repeat the entire process before beginning to produce the next product.

In response to deteriorating economic conditions (see "macroeconomic considerations") and its need to lower costs, NIPAG had reduced the active ingredients in many of the branded products it manufacturers in Nigeria. Consequently, the performance of these products is not as good as the performance of the worldclass products flowing into Nigeria from elsewhere. In other words, NIPAG has debased the value of its brands. Relative to worldclass products, value for money of NIPAG products is very low.

C. Promotion:

Historically, NIPAG's promotional budgets have been set at 3% of turnover. Because current turnovers are now approximately half of previous levels, NIPAG's total promotional expenditures and share of voice are dramatically lower than in the past.

D. Distribution:

NIPAG owns and operates 28 depots all around the country. This approach to distribution is very costly. While it would not have been possible ten years ago, it would now be possible for NIPAG to outsource the physical distribution and logistics functions to specialists. The quality of services offered by these specialists is higher than the quality of the distribution and logistics functions which NIPAG produces itself.

Because most NIPAG direct customers (that is, wholesalers and large retailers) are located in urban areas, the company's products are not widely available in rural areas. In many urban areas, on the other hand, multiple distributors are competing ferociously with each other. For example, NIPAG has six distributions in Jos, 4 in Maidugari, etc. In such situations, competition is intense, no one is making any money, and no one is very happy.

In Nigeria, distributors and large retailers arrange their own lines of credit, paying 4 or 5 points more than high-profile companies like NIPAG for similar credit facilities. NIPAG pumps products to them, works intensively on getting them to increase purchases, but does not assist in any way on arranging credit facilities.

E. Price:

As a result of the product debasing programs described earlier, value for money for NIPAG products is low compared with worldclass products entering Nigeria from elsewhere in the world.

5. Own-company tactics/implementation:

A number of issues relating to implementation and/or tactics have been raised earlier.

APPENDIX 2
CASE DATA RELATING TO THE "GROW THE BUSINESS" MODEL

1. Market penetration:

As indicated in Appendix 7, NIPAG has major distributors and/or large retail customers in major urban areas all across Nigeria. Thus, increasing market penetration in urban areas should be possible, given products which offer consumers high levels of performance and high "value for money." Unfortunately, the case also indicates that many NIPAG brands have been debased to the point where they do not offer high performance or "value for money." Thus, before mounting any effort to increase market penetration in urban areas, NIPAG may need to consider improving the "value for money" profiles of its products.

The case indicates that NIPAG products do not have a strong presence in rural areas. It seems likely that increasing market penetration in rural areas may require NIPAG to increase distribution and market coverage efforts in rural areas.

2. Product development:

The case indicates that NIPAG is manufacturing 350 products, some of which are low volume, high cost items. The case also indicates that the low-volume items can be very disruptive of factory operations. To produce these items, NIPAG has to stop its production lines, clean its equipment, change ingredients, run small batches, and then stop its lines again and go repeat the entire process before beginning to produce the next product.

3. Market development:

As indicated earlier, NIPAG has strong presence in many urban areas. However, NIPAG's presence in rural markets is weak. It appears that rural areas could represent an opportunity, if NIPAG can increase market coverage in rural areas. Another possible area of market opportunity for NIPAG could be exports to markets outside of Nigeria. However, because NIPAG has reduced the active ingredients in many of the branded products it manufacturers in Nigeria, the performance of these products is not as good as the performance of the worldclass products manufactured elsewhere. In other words, before pursuing export opportunities, NIPAG would need to ensure that the performance and "value for money" offered by NIPAG products is least as good as what is offered by worldclass products from elsewhere.

4. Diversification:

Because NIPAG's product line is already large (350 products), and because this large number of products already impacts negatively on the efficiency of NIPAG's factory operations and the cost of its products, it seems unlikely that moving into new products for new markets is a high-priority initiative for NIPAG at this time. Furthermore, since diversification is the riskiest of the business growth options (because firms pursuing diversification lack deep knowledge not only of the new products but also of the new markets), and given the huge problems NIPAG already faces, it seems unlikely that taking on additional high-risk opportunities is a high priority item on NIPAG's current agenda.

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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.

INSTRUCTORS' NOTES

The Overpaid Student case illustrates many of the problems created when wage systems are developed which focus on seniority rather than work performance or job demands. Ask your students to read the case and prepare answers to the discussion questions or assign them into small groups and have them analyze the case and make recommendations to Peoria University. As you discuss the case, try to keep the class focused on the motivational and managerial issues that must be resolved at Peoria University. Since issues of pay equity and fairness permeate the case, expect lively class debates and differences of opinion.

DISCUSSION QUESTIONS

1. Evaluate the wage scale in use at Peoria University. What does a pay system like this encourage?

The wage scale seems to primarily reward students for their academic progress. Peoria University hasn't developed job descriptions for students, and there isn't any evidence that the pay categories are related to needed skills or task difficulty. Students can theoretically be assigned to any job. Pay category is determined strictly by who you are, not what you can do. As the case illustrates, the starting pay level for an inexperienced senior is equal to or higher than the best performing freshman or sophomore. This implies that the designers of the pay system thought that academic maturity and experience were worth paying for, but should we assume that all freshmen and sophomores deserve less pay, regardless of their experience, job demands or work accomplishments? Most students at the university work in jobs which have little to do with their academic or educational pursuits. Why then should class standing be used to determine a student's wage category?

The architects of this plan were not sensitive to the motivational implications of their pay system. They probably wanted a simple, uncomplicated pay scale which could be used by supervisors all across the campus. While this wage system is intuitive and easy to administer when students are first hired, it becomes problematic when students work hard and expect more recognition for their accomplishments.

The pay range within each wage category does offer some incentive to work because students who perform well may get a raise if their supervisor recommends it. However, students are likely to receive some pay increases anyway, because over time they will automatically advance into a higher "class," and thus qualify for a higher wage category. Theoretically, over three or four years, a mediocre worker should receive raises almost as large as those received by an outstanding worker. Unfortunately, mediocre students can receive pay increases whether they stay in their current jobs or switch to other positions within the university, because pay isn't tied to seniority in a position, but rather to class standing. Thus this particular wage system doesn't appear to encourage job stability or longevity.

While there is a wage progression within each pay category, the criteria for advancement are not clear. The whole process seems somewhat arbitrary. Supervisors can decide if and when they want to recommend pay increases. The timing and rationale for the raises are left up to them because there are no formal performance appraisal procedures or timetables for students. One would assume that pay increases would be justified on the basis of work performance or mastery of the job, but this isn't clear in the case. As long as a recommended wage adjustment remains within the appropriate class range, no official will question it. Wage adjustments that fall outside of the guidelines are possible, but they are extremely rare and require a strong rationale and top management approval.

In summary, the student pay system at Peoria University does not equitably recognize or reward students for their skills, their performance, or their job loyalty and commitment. It appears to be a wage scale of convenience for university supervisors, and is biased toward the most academically advanced students.

2. Did Cindy receive an appropriate wage increase? Why are some supervisors and students upset?

There is no question that Cindy was an excellent student worker and was entitled to be recognized as such. The problem occurred when her supervisor, Mrs. Wong, felt that her existing pay category (sophomore) was too restrictive, and sought to give Cindy an exceptional wage (outside of her pay category). Mrs. Wong felt it was inequitable to pay Cindy a sophomore rate while requiring her to perform difficult tasks that graduate students normally performed, but the exception was a clear violation of the wage system. When Mrs. Wong received permission to grant Cindy an exceptional raise, other supervisors also sought exceptions because they didn't want their excellent students to be disadvantaged. If it was ok for Mrs. Wong's workers to get exceptions, why not mine?

Theoretically, when wage exceptions are granted, those who have faithfully followed the pay scale will feel disadvantaged or cheated, and they will begin to ask for exceptions, too. If very many wage exceptions are granted, the integrity of the scale becomes compromised and the wage scale becomes meaningless. Thus, to maintain order, wage exceptions must be kept to an absolute minimum and must only be granted in highly extraordinary or unusual situations.

When Cindy received her exceptional raise while others were denied, a few supervisors suspected that favoritism was at work, and they aired their frustrations in places where their students could overhear. This fed the rumor mill and reinforced feelings of unfairness in the minds of some of the better student workers like Wendy, who were not as fortunate as Cindy.

One wonders which criteria were considered when Cindy's pay exception was granted while Wendy's was denied. Was there any consistency in how the exception requests were decided? Both students were reported to be truly excellent workers and both had made commitments to stay at their jobs through the summer. Was Mrs. Wong's story about Cindy taking over the graduate student's difficult job the deciding factor, or was it the fact that the departmental budget could afford the increase? We really don't know which criteria were considered "legitimate reasons" to compromise the wage scale, and we can only hope that the university business manager made these decisions in a thoughtful, consistent manner.

What we do know is that Wendy feels terribly wronged. She cannot understand why she is worth so much less than her friend Cindy. If Cindy had not received the exceptional wage adjustment, she would be earning $7.00 per hour, identical to what Wendy and most other high-performing sophomores are paid. No jealousy or animosity would have developed and the two would still be best friends. Similarly, if Wendy had received her exceptional wage adjustment she would not feel unfairly treated, she and Cindy would still be friends, and she never would have quit her job in the accounting department.

Thus, the exceptions and the unknown criteria used in making these decisions were probably what triggered dissatisfaction with the wage adjustments. If deviations from the pay scale are permitted, the criteria used for these exceptions must be well understood and the determination process must be transparent and consistently applied. In this way the university will be able to maintain a sense of wage equity, fairness and trust. Otherwise, exceptions and wage deviations should not be permitted under any circumstances.

3. Is there anything Cindy can do to defuse this situation? Help Cindy evaluate her options.

Cindy feels very bad about being at the center of this controversy. She doesn't think she has done anything wrong and feels she earned the wage adjustment that she received. It wasn't her fault that some wage exceptions were granted while others were denied. Yet, she's disturbed by the things that some supervisors and students have been saying about her and her supervisor, and now she's lost her best friend because of jealousy and unhappiness.

The class should discuss whether Cindy can do anything which might reduce her felt stress and improve the situation. She could simply tolerate the rumors and hope that things quiet down and her friends stop blaming her for their misfortunes. Cindy could go public and tell her friends about all the other students who are receiving exceptional wages. This would divert attention away from her, but it would probably make the supervisors and disappointed students even more angry and upset. It would also require divulging confidential job information which is ethically questionable, and could result in her being fired. She could quit her job and go to work somewhere else like Wal-Mart. Quitting would demonstrate to both her supervisor and her friends that she feels the wage system at the school is unfair. However, it would also cost her a job she really likes, and reduce her summer earnings by several hundred dollars. Furthermore, there is no guarantee that Wendy would see this as an act of solidarity and restore their friendship. Cindy could ask Mrs. Wong to reassign her to a different position and reduce her pay back to $7.00 per hour. This action would also send a strong signal to her friends and to her supervisor that she was uncomfortable being "overpaid" according to the wage scale. It would also result in the loss of several hundred dollars of summer income and most of her friends would probably think she was foolish to do this. Cindy is not in a position to change the wage scale, but she could suggest to Mrs. Wong that she has been under a great deal of stress as a result of the well-intentioned raise. Perhaps Mrs. Wong could be persuaded to press the university to redesign the wage system, or figure out some other way of recognizing and rewarding excellent work.

Students will generate many ideas and suggestions for Cindy, but they should realize that the problem is much bigger than Cindy. The actions she takes may deflect some of her felt stress and pressure, but unless the university redesigns either the wage scale or the exception process, other students will be subjected to similar pressures in the future.

4. Identify the issues that must be addressed by the university if these problems are to be avoided in the future.

What does the university really want to pay its students for? It doesn't seem logical to pay students based on their academic class standing when the nature of their work has little to do with the degree they are pursuing. The school needs to develop a wage system that is equitable and relevant to the work being performed. Should progression from lower to higher wage categories be based on job difficulty or seniority? If the most demanding and difficult jobs deserve to be paid the most, then job descriptions and job specifications need to be developed for all student positions. Each job could then be analyzed for difficulty and assigned to the appropriate wage category, and it would make no difference whether the position was filled by a freshman or a graduate student, the range of pay would be the same for anyone holding that job. On the other hand, if the school wishes to tie pay categories to seniority and long-term occupancy of a job, then the pay categories should correspond to increasing tenure or occupancy of a job (less than one year, one to two years, two to three years, etc). Either of these progression systems would be more logical than what is currently in use at Peoria University. The seniority or job tenure system would be easier to create and implement, but the wage system based on job difficulty would be better at rewarding effort and job performance.

Next, the university should consider how to recognize outstanding job performance. The pay ranges within each pay category (beginning, midpoint, top rate) could be widened or elongated ($6.00 to $8.00) so that more increments were possible than just beginning, midpoint and top rate. This would give the supervisor greater flexibility in recognizing work excellence. If the existing pay ranges each went one dollar higher, Mrs. Wong may not have felt that an exception to the scale was necessary for Cindy. Similarly, Wendy would have received her raise to $8.00 per hour without question. If you believe in rewarding performance, there must be a significant number of possible steps or increments available in each pay category.

The case mentioned that exceptions were often granted for students who made a commitment to work through the summer months. If this is a major reason for the exception system, is it fair to tinker with wages to reward students for this? When student wages are raised by the exception policy, the rates don't drop back down when the summer is over. Thus, a pay exception based on a summer work commitment will be continued indefinitely, as long as the student continues in the job. Perhaps the school should offer these students a special "summer worker" scholarship instead. It would give students a significant reward for their summer commitment, but would not compromise the integrity of a wage system built to recognize job effort and performance. This would also eliminate most of the need for exceptions to the wage scale.

If these changes are implemented, a more equitable and consistent wage system should result. The exception process should no longer be needed. Supervisors will have greater flexibility and discretion in rewarding their outstanding workers, and students will have more incentive to perform their jobs well.

EPILOGUE

Cindy continued to work in the payroll office for the remainder of the summer. Wendy never was a close friend again and left Peoria University to pursue her studies elsewhere. Concerns about the unfairness of the exception system were partially addressed when the school began to offer all summer workers either a free class or reduced room and board in exchange for working through the summer. Exceptions were just about eliminated because most of the wage exceptions at the university had been granted in exchange for a commitment to summer work, not for outstanding work performance. To this day, Peoria University still uses a student wage scale based on academic class.

NOTE

The names of individuals and the organization have been disguised.

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.

INSTRUCTORS' NOTES

Case Development and Teaching Approaches

This case was developed through one of the author's personal experience. The case material tracks very closely the actual presentation made by Jason and Patrick in the class. The name of the organization and individuals were disguised at the company's request.

This case is intended for use in an Employee Selection class in a discussion of recruitment practices. Alternatively, the case can be used early in the Business Policy course as "reality check" for those students nearing graduation. 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. The case is not designed to encompass a review of the corporation's entire recruitment strategy, but to illustrate the students' level of interest in less well-known organizations.

The case can be used for a general discussion of the recruitment process and the role of campus visits in particular. Employee Recruitment is an area of study that has come into its own in the previous two decades. Until recently researchers have not attempted to measure a number of important process, intervening, and outcome variables. It has become clearer that recruitment is a pivotal step in the overall success of any employee selection initiative. For a current review of the recruitment literature see Breaugh and Starke (2000). You may then walk the students through the process as it explicitly or implicitly applies to OrgServices Corporation. Additionally, based on their own perceptions of what it would be like to work for OrgServices, students could describe what kind of information they would need before considering a job offer there or anywhere. Students could then describe the demographics and qualifications of the recruiter needed to convey this information. Finally, the students could describe the key components of the recruitment presentation that OrgServices should consider using.

The case also offers students the chance to role-play the parts of Jason and Patrick with the class. Alternatively, you may ask students to assume the roles of Patrick and Ann in order to design the presentation for their next visit. After hearing a brief presentation by the participants, you may have the class express whether they would pick up information on the company. Have each of the groups (interested vs. not interested) break into discussion groups to outline their rationale. Then have both groups place their rationale on the board to facilitate discussion with the entire class.

The case also presents a good opportunity to explore student's expectations regarding the job market in general and their specific desires regarding a suitable employer. 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 "reality check" for many of the students who have not been collecting this information. It may also be instructive to have the students visit the U.S. Bureau of Labor Statistics website (listed below) to view industries and occupations with the largest job growth. Additionally a review of Fortune's list of the "Fasting Growing Companies" may also be enlightening regarding job prospects.

QUESTIONS FOR CLASS DISCUSSION

1. Why were the students so uninterested in this opportunity? What are you looking for in a first job?

These open-ended questions elicit a number of responses from students and are a good way to kickoff the class discussion for this case. Our students offered the following comments in the next class meeting following the presentation. Many of the students expressed surprise that the presentation centered so much on the company, its products, and its future potential. Most students would have preferred more specific comments concerning pay, benefits, promotion, and location. The students specifically commented on how they related to the presenters being graduates of their institution. The typical comments were, "It made me feel that if they can do it, so can I", or "It made me feel confident that I could get a job with my degree".

Students specifically remarked on how the job opportunities at OrgServices did not meet their stereotype of an ideal job right out of college. One student remarked, "I really hadn't thought much about the kind of company I want to work for". Moreover, the students agreed that they were in their senior year and more than half of the class had not done any advanced preparation for a job. In this regard, the educational institution had failed the students by not specifically confronting their attitudes and perspectives concerning the job search.

Students didn't appear to be sure what they were looking for. Although they were not willing to admit it, it seemed as if they were willing to go to the "highest bidder" salary-wise. Absent more specific salary information, then "folding towels" right out of college didn't sound attractive. Students seemed unprepared to demonstrate how they would add value to a prospective employer. Rather, they felt that the value should be evident in the college degree.

2. What specific information do you look for when evaluating the attractiveness of a job opening? Did Patrick and Jason's presentation provide this information?

These questions serve as a follow-up to the discussion generated by the questions above. It gives the professor a chance to tailor the case to their own institution's students. In terms of the actual recruitment message, the breadth of knowledge conveyed, specificity of information provided, and timing of communications are all-important variables that should be mentioned by students. During the job search process, external applicants are seeking specific job-related information on such issues as starting salary, benefits, raise determination, career advancement, and the success rate of new hires. Recruitment sources that do not meet applicant's expectations in these areas are seen as "lacking professionalism" and cause disinterest in the applicant. Even in cases where the recruiter tries to convey specific information, they may fall short in unsuspecting ways. For example, applicants desire more specific information than "competitive salary range", and the need for uncertainty avoidance may stimulate applicant disinterest. Furthermore, when the job or company is less well known the specificity and timing of information becomes critical. More well known companies may benefit from earlier recruitment and job offers than companies who are lesser known.

When answering this question information provided by students will vary, but regardless of the responses students should be pressed to provide the rationale for their answers. What are they looking for, a job or a career? How important are salary, benefits, training, advancement, etc. Their responses may be divided into job-related and company-specific information. Examples of company-specific information include the history, products/services offered, and growth prospects. Students may also point out that company success is important. Jason and Patrick pointed out that sales and profit growth over the past 20 years had been exceptional as has the stock performance. The company had also been recognized by Fortune magazine as one of the Most Admired Companies. Better students should point out that just because you may not have heard of the company does little to lessen its accomplishments. OrgServices may be less well known than other companies, thereby requiring a little more information on company-specific items. In this regard, the recruitment message needs to be informative enough to address the students need to overcome information ambiguity. When it comes to job-related information desired by students they will readily point out that salary, benefits, raise determination, career advancement, and the success rate of new hires would be appropriate. Students may be directed to search http://salary.com for salary information by field and desired work location. This helps give students some perspective on the salary range for management trainees mentioned in the case. Some students feel Jason and Patrick's comment that "selection into the program is competitive with salaries starting in the mid-30's" may have been a little too vague, but students should be pressed to consider the applicant's qualifications and its affect on starting salary. The content may have been better served if it had addressed more areas of student concern including benefits, and how raises are determined, but given the relative unfamiliarity with the company this was not practical. Better students will point out that well-known companies have the luxury of dispensing with much of the company-specific information and concentrating on job-related items.

3. What recruitment objectives and strategies would be appropriate for a company like OrgServices?

The early stages of recruitment should speak to a number of key organizational variables that are critical to the success of human resource selection. These variables are specific to the organization's context and many should be considered consistent with overall corporate strategy. These variables include cost and speed of filling jobs, number of applicants, desired diversity of applicants, historical ratio of offers to acceptances, retention rate, and job performance variables. Specifically, the company would need to determine what variables are significantly related to successful employee performance, satisfaction, and overall retention. Recruitment objectives dictate the who, how, and when of recruitment procedures that follow, and are an indispensable first step. Once objectives have been identified, consistent recruitment strategies are developed. A typical organization views recruitment as a vehicle toward increasing the applicant pool at a minimal cost.

If you performed the lecture on recruitment, students will tend to answer this question by restating the variables including cost and speed of filling jobs, number of applicants, diversity of applicants, historical ratio of offers to acceptances, retention rate, and job performance variables. Given the growth prospects for OrgServices the sheer number of applicants possessing management potential is an important objective. Therefore, a source that promises to yield those applications would be highly desirable. College recruitment efforts would be part of a larger effort including newspapers, employee referrals, and direct applications. The objectives and strategies for the recruiting effort would be set by the corporate-level human resource department at OrgServices. Patrick and Jason were merely the instruments of the implementation of the company recruitment strategy. However, one can infer that given the growth projections, OrgServices would need a broad-based approach. Their willingness to consider all majors for the management training program is in keeping with this approach.

4. Were you surprised at the growth projections presented for OrgServices? What other industries do you think are projected to grow in employment?

Students are usually surprised by the growth of OrgServices? The U.S. Bureau of Labor Statistics tracks information related to job growth that you may want to share with students or have them retrieve on their own at http://www.bls.gov/emp/home.htm#tables. The Computer and data processing services industry is projected to grow at an average rate of 6.4% between 2000-2010 followed by Residential care (5.0%), Health services (4.6%), Cable and pay television services (4.2%), Water and sanitation (3.8), and miscellaneous business services (3.7%). It is also sobering for college students to note the fastest growing occupations found at this website. Food preparation, customer service reps, registered nurses, retail salespersons, computer support specialists, cashiers, office clerks, security guards, software engineers, and waiter and waitresses are listed as the fastest growing occupations through 2010. Additionally, the website has a detailed list of employment changes by Standard Industrial Classification Code. This allows students to focus on specific industries of interest.

Fortune's list of "Fastest Growing Companies" provides an additional source of information that students may use to gauge their own aspirations with the opportunities in the marketplace http://www.fortune.com. This information combined with headlines of layoffs at America's largest companies may serve to educate students regarding the sources of new jobs. Additionally, a list of companies recruiting on your campus might be used during this discussion.

5. Were Patrick and Jason appropriate choices to be recruiters?

Research suggests that the recruiter has a strong influence on the outcome of the recruitment process. Unfortunately, research also indicates that companies devote little or no training to their recruiters (Rynes & Boudreau, 1986). Among those that do train, about thirty percent of the time is devoted to interpersonal skills training, whereas only about ten percent is given to developing actual recruitment content.

The role of the recruiter is especially important because candidates use the recruiter as signals of unknown organizational attributes. Information that is conveyed should come from a credible source, and be job positive. To be persuasive applicants need to perceive that the recruiter has considerable expertise and is trustworthy. Applicants who perceive recruiters as personable and informative also view the prospective employer as attractive. Typically recruiters are defined according to demographics and functional job held. With respect to demographics, applicants may develop more positive attitudes when the recruiter is similar to them demographically (gender, ethnicity, and age). However, as a caveat to demographics, research has concluded that experienced recruiters leave a more favorable impression among applicants. As for functional job held, recruiters who are job-incumbents appear more credible. Human resource specialists who recruit for all units are often seen as less trustworthy than actual job incumbents. Additionally, recruiters should convey realistic job information as first year retention rate among new hires may be related to a perception of employer honesty during the recruitment process.

When answering this question, the student's initial response to this question tends to focus on the recruiters' familiarity with the school and its student body and their ability to relate to the students. You may have to prompt the students to comment on Patrick and Jason's credibility, trustworthiness, and expertise. Research suggests that the functional job held, demographic match, and the realism of the presentation are important variable in stimulating applicant interest. Having successfully completed the management training program and currently working as service managers bolsters Patrick and Jason's credibility and trustworthiness. Their candor regarding "going to college to fold clothes" also enhanced the realism of the presentation. Although the demographics of the class were not included, students may reasonably fault OrgServices for sending two males to do the recruiting. Students should also point out that race and age would also influence the recruiter's credibility. Patrick and Jason's race and age were not explicitly identified in the case, although most students assume them to be young because they graduated four years earlier. Students who assume that Patrick and Jason were young may be reflecting a bias toward non-traditional students. Better students will point out that four years experience (two of which were in management training) may indicate limited experience in recruiting. It also may mean that students view the recruiters' short tenure as a lack of expertise thereby offsetting the credibility of the pair.

6. Why do companies send employees to their alma maters to recruit? Is this a sound practice?

Better students will also point out that this time-honored practice has some solid rationale behind it. Consistent with the comments presented in Question 1 earlier, recruiters from the students' alma mater get the attention of the students and provide a certain degree of credibility and trustworthiness to the recruitment presentation. Additionally, when setting recruitment strategies, many organizations have used source tracking techniques to help correlate recruitment sources with any number of "post-hire" outcomes. These include cost and speed of filling jobs, number of applicants, diversity of applicants, historical ratio of offers to acceptances, retention rate, and job performance variables. Based on the objectives set in these areas, it makes theoretical and economic sense for employers to return the source of its past successes in recruitment and selection.

7. What should Patrick do differently in his next visit?

Some students may argue that nothing needs to be changed until Patrick makes an additional visit to see if the next class has a similar response. Overall, Jason and Patrick appear to have done a good job of presenting OrgServices to the class. Their comments regarding their reaction to "folding clothes" as a college graduate constituted a realistic job preview. Furthermore, students may point out that the addition of Ann from HR improves the demographic diversity and the recruitment expertise level.

Students advocating changes for the next visit will base their recommendations on their earlier responses to what they are looking for in their own job search. Students may argue that the presentation should cover more specific information such as vacation time, health benefits, a narrower salary range, and other specific perquisites. These students should be challenged to provide ideas on how to overcome the relative obscurity of OrgServices in order to "free up" the time for the additional information the student desires. Additionally, some students may perceive the presentation to be more professional if the recruiter has used a software presentation package rather than overhead transparencies.

EPILOGUE

Patrick and Ann visited the Professor's class the following month and received much greater interest from the students. The same basic information was delivered with the assistance of PowerPoint slides. OrgServices continues to recruit on campus by providing class speakers and participating in Career Center activities.

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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

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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.

INSTRUCTORS' NOTES

Recommendations for a General Teaching Approach

The process described in the case has been used in a Management/Organizational Behavior class to specifically illustrate a formal method of mission statement evaluation. The case is equally applicable to senior level courses in Strategic Management. The case is designed to be used in two, fifty-minute class sessions (though it could certainly be used in two ninety-minute classes as well). It requires students to evaluate both the process of mission statement evaluation and revision (as described in the case) and the subsequent results (as appear in the case). In addition, students are asked to apply this process to the mission statement of their own college or university.

Though there are numerous approaches to using the case, a general instruction approach would be as follows:

1. Make sure students have read and prepared for the case prior to the class discussion. During the first half of first class period, have students discuss the five areas listed in question one as they apply to the activities in the case.

2. Approximately halfway through the first class period, provide students with a copy of the mission statement of the university. Have students use the Mission Statement Evaluation Scale (as provided as an Appendix in the case) to evaluate the mission of the university. Students should be familiar with how to apply the scale from their work analyzing the case. Scores for each individual area included in the scale as well as an overall score for the mission statement should be calculated. The instructor should tabulate the results, identify the two lowest-score areas and an overall mission statement score, prior to the next class period.

3. Under the direction of a facilitator, attack each deficient area (average score below 5) using a brainstorming, multi-voting technique designed 1) to generate a maximum number of ideas related to improvement from all participants and 2) to build a consensus concerning which of the ideas should actually be incorporated in the improved mission statement. The work done during this portion of the process impacts the quality of the mission statement. The technique follows a specific process:

    a. Carefully describe the area of concern and ask all class participants to focus solely on improvement in that area.
    b. Ask class participants to list three ideas that they believe will correct the deficiency.
    c. Poll participants and list each idea until all ideas are exhausted.
    d. Divide the total number of ideas by three to determine the initial number of votes to be allocated to each class participant.
    e. Ask participants to consider the list of ideas and vote for those they believe merit remaining on the list.
    f. Tally the votes and remove ideas receiving none or only a few votes from the list.

g. Divide the number of remaining ideas by three to determine the number of votes to be allocated.
h. Again ask class participants to multi-vote.
i. Tally the votes and rank the remaining ideas ranked from high to low.
j. Ask class participants to consider the top three to five ideas.
k. Ask participants, "If these ideas are incorporated into the mission statement, are you satisfied that the mission statement will be improved in terms of completeness and quality?"

4. Have students discuss the suggested changes to the mission statement in terms of the items listed in question 1. at the end of the case.

ANSWERS TO CASE QUESTIONS

1. Discuss the value of the mission revision process described in the case in terms of:

a. The improvement in completeness of the mission statement.

Note that the completeness score improved from 61% to 92% after completion of the revision process. Note also that all individual item scores improved, not just the four specific deficient items subjected to the revision process. The revision process resulted in a significantly more complete mission statement.

b. The improvement in quality of the mission statement.

Quality improvement depends heavily upon the efforts of the facilitator and participants during the brainstorming, multi-voting portion of the revision process. This specific technique is designed to draw an exhaustive list of potential improvements from all participants and to develop a consensus among the participants concerning which specific ideas should be adopted.

c. Increased familiarity with the organization's purpose and vision on the part of the process participants.

Note that all faculty and staff members were included and necessarily participated in the revision process. All reviewed and evaluated the existing mission statement and all provided and voted on specific ideas for improvement. This type of participation served to remind long time faculty and staff members of the contents of the existing mission and of potential revisions. Additionally, newer faculty and staff members should have become thoroughly familiar with the contents of and potential revision to the mission statement.

d. Increased internalization of the organization's purpose and vision on the part of the process participants.

Faculty and staff members participating in the process should come away with a sense of ownership in the mission. It is one thing to read the mission statement and quite another to participate in its development. Such participation should result in an internalization of the mission statement by both faculty and staff members. Such internalization should increase the probability that all actions by those members will be aligned with the school's mission.

e. Implications of internalization on the organization's long-term performance.

Internalization of the school's mission should serve to focus all school members on the purpose and vision of the school. All resulting activities undertaken by the members should be directed toward fulfillment of the stated mission. It is, therefore, reasonable to conclude that improved organizational performance will result from such internalization.

2. For your university's mission statement, use the Mission Statement Evaluation Scale to:

a. Assess the completeness of your university's mission statement.

This assessment should emphasize the primary components of a mission statement (purpose and vision) and the nine specific areas that should be discussed in a complete mission statement.

b. Summarize the results of the evaluation and compute item averages and an overall completeness score.

Summarization should serve to provide overall and item scores that facilitate an overall evaluation of completeness and identification of areas of deficiency.

c. Rank the areas from low to high according to area means. Note the areas with scores of less than 5.00.

This step should assist in identifying the specific areas were improvement is most needed. Rather than attempting to generally improve the statement, this ranking focuses the improvement efforts.

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.

Once specific deficiencies have been identified, this process provides a structured approach that results in improvement. Through their participation, students both learn about and gain experience in the application of the brainstorming and multi-voting techniques.

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

This step affords students an opportunity to quantify the improvement in the mission statement that results from their efforts. Hopefully, at this stage students will conclude that the mission statement has been improved both in terms of completeness and quality as a result of their efforts in following the mission statement revision process.

BIG FLICKS STUDIO: A CASE ANALYSIS OF EQUITY STRUCTURING POLICY AND EARNINGS MANAGEMENT

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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 earnings. Instructors may use this case to provide students with a basic understanding of the use of special purpose entities as a précis for a discussion of the Enron situation.

INSTRUCTORS' NOTES

RELEVANT STATEMENTS ISSUED BY THE FASB AND SEC

Both the FASB and the SEC have had many meeting and discussions on defining what is appropriate for disclosure of 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). . These interpretations attempt to clarify when an SPE should be consolidated. The FASB has also issued several standards regarding the disclosure of certain transactions. For example see SFAS No. 5, Accounting for Contingencies, SFAS No. 57 Related Party Disclosures, and SFAS No. 129, Disclosure of Information about Capital Structure. In addition, the FASB Emerging Issues Task Force (EITF) has issued 13 statements on off-balance sheet financing to help accountants determine the proper financial reporting of transactions.

The accounting literature regarding SPE consolidation is found in materials issued by the EITF: EITF No. 90-15, Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions; EITF No. 96-21, Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities; EITF Topic No. D-99, Questions and Answers Related to Servicing Activities in a Qualifying Special Purpose Entity under FASB Statement No. 140, and EITF Topic No. D-14, Transactions involving Special-Purpose Entities.

The SEC is also seriously evaluating disclosure requirements. In a speech before the Committee on Banking, Housing and Urban Affairs, United States Senate, SEC Chairman Harvey L. Pitt stated that "investors need to know more about liquidity risk, market price risks, and effects of 'off-balance sheet' transaction structures. MD&A should mandate specific disclosures by companies concerning transactions, arrangements and other relationships with these unconsolidated entities, or other persons, when they are reasonably likely to have a material effect on a company's liquidity, its capital resources or its requirements for capital." The SEC responded by issuing Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations. This statement discusses three disclosure requirements within the MD&A that the SEC believes should be improved upon: (1) "liquidity and capital resources, including off-balance sheet arrangements;" (2) "certain trading activities involving non-exchange traded contracts accounted for at fair value; and" (3) "relationships and transactions with persons or entities that derive benefits from their non-independent relationship with the registrant or the registrant's related parties."

RELEVANT STATEMENTS FOR FINANCIAL REPORTING IN THE FILM INDUSTRY

The FASB initially issued SFAS No. 53, "Financial reporting by producers and distributors of motion picture films" in 1981. At that time, the majority of a film's revenue resulted from the distribution to movie theaters and free television. Since the issuance of SFAS No 53, numerous additional forms of exploitation such as home video, satellite and cable television, and pay-per-view television have either come into existence, or have become far more meaningful as revenue sources. As a result, the FASB rescinded SFAS 53 and now requires film producing companies to use the AICPA statement of position SOP 00-2, Accounting by Producers or Distributors of Films.

The application of SOP 00-2 requires the film company to recognize 100% of any expected ultimate loss on a film in the year of release, and to recognize the profits for a film expected to be profitable over the revenue producing life of the film (not to exceed 10 years). The application of this rule accelerates losses into earlier periods and defers profits until earned. Such an approach provides managers with an incentive to look for ways to smooth the uneven and uncertain earnings that can result. An additional aspect of the application of recognizing the losses up front is that the film library, i.e. films released in earlier years, throws off annual gross profits. In effect, once a film studio stops releasing new films, only the profits from prior releases remain to be recognized.

SUGGESTED SOLUTIONS TO THE BIG FLICKS CASE

Students can readily access some of the latest form 10-K public filings for public limited partnerships in film financing through the Securities and Exchange Commission's EDGAR database. Most structured financings are done by means of unregistered, i.e. non-public, securities, so the ability for students to see some "real-life" documents that relate to transactions of this nature is a plus in using this exercise. Having students either learn to access the EDGAR database, or reinforce these skills, is a nice corollary benefit of this case. The 1996 form 10-K for Delphi Film Associates V provides a good example of the Picture Partners structure. An example of a more complex structure can be found by searching for the public filings of ML Delphi Premier Partners.

The material used in this case has been greatly simplified from the actual structures of this type of transaction for pedagogical purposes. We have also used a flat 35% tax rate for the exercise, and have deliberately omitted what can be extremely complex tax motivations from the exercise so the exercise can be completed in a one and a half hour class session.

QUESTIONS AND SOLUTIONS

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.

Big Flicks Earnings (in millions)						
Year	1	2	3	4	5	Total
Film Library	$30	$30	$30	$30	$30	$150
The Tax Master	6	6	6	6	6	30
The Houston Story	(20)	0	0	0	0	(20)
TOTAL	$16	$36	$36	$36	$36	$160
Net of 35% tax	$10.40	$23.40	$23.40	$23.40	$23.40	$104
EPS	$1.04	$2.34	$2.34	$2.34	$2.34	

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.**

Big Flicks Earnings (in millions)						
Year	1	2	3	4	5	Total
Film Library	$30	$30	$30	$30	$30	$150
Share of Picture Partners from below	(7)	3	3	3	3	5
TOTAL	$23	$33	$33	$33	$33	$155
Net of net of 35% tax	$14.95	$21.45	$21.45	$21.45	$21.45	$100.75
EPS	$1.50	$2.15	$2.15	$2.15	$2.15	
Picture Partners						
The Tax Master	$6	$6	$6	$6	$6	$30
The Houston Story	(20)	0	0	0	0	(20)
TOTAL	$(14)	$6	$6	$6	$6	$10
50% to Big Flicks	$(7)	$3	$3	$3	$3	$5
50$ to Filmvest	$(7)	$3	$3	$3	$3	$5

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.

Alternative #1 Without Picture Partners	YEAR				
	1	2	3	4	5
Big Flicks EPS	$1.04	$2.34	$2.34	$2.34	$2.34
Share Price 15 x EPS	$15.60	$35.10	$35.10	$35.10	$35.10
Market Capitalization (in millions)	$156	$351	$351	$351	$351
Alternative #2 With Picture Partners					
Big Flicks EPS	$1.50	$2.15	$2.15	$2.15	$2.15
Share Price 15 x EPS*	$22.43	$32.18	$32.18	$32.18	$32.18
Market Capitalization (in millions)*	$224.25	$321.75	$321.75	$321.75	$321.75
Increase (decrease) in Market Cap.	$68.25	$(29.25)	$(29.25)	$(29.25)	$(29.25)
Cumulative Effect	$68.25	$39.0	$9.75	$(19.50)	$(48.75)

* Share Price and Market Capitalization calculations are based on carrying the EPS to three decimal places, i.e. Share Price for year 1 is calculated as 15 * $1.495.

Note that year 1 EPS would be reported as $1.04 per share without Picture Partners. With Picture *Partners, Big Flicks is able to report EPS of $1.50 for year 1. This occurs because half the loss on The Houston Story* is passed onto Filmvest through the Picture Partners. Taking the five-year period as a whole, Big Flicks reports less earnings because half of the profit on *The Tax Master* is also passed to Filmvest through Picture Partners. This occurs if only one transaction of this type is entered into. By entering into a series of transactions Big Flicks can defer the negative impact well into the future. We have also ignored the present value effect of the negative impact. Depending upon the cost of capital to Big Flicks a Picture Partners transaction may result in a "real" gain despite the reduced earnings reported over the five-year period. Putting this point another way, does the value to Big Flicks in "real" terms of a higher current market capitalization, with its attendant ability to impact on other capital pricing matters, out weigh the cost of an earnings reduction spread out over the following four years? These points can be used to sensitize accounting students to the impact that reported earnings may have on firm capital pricing in the market, reinforcing the conceptual relationship between corporate finance and accounting matters, and illustrating the importance of accounting matters to firms.

It is important to realize that the market may or may not be viewed as efficient in the sense that the market is able to see through transactions such as Picture Partners. However, the prevalence of these structured financing arrangements leads to the conclusion that managers do not believe the market can readily see through these types of transactions. As accountants, it is critical for us to understand the motivations for and the implications that these arrangements can have on firms. To illustrate the potential effects of entering into Picture Partners for Big Flicks, the example now introduces some potential market effects of the arrangement. Again, for pedagogical purposes we have made the example very simple and again note that realism has been sacrificed to simplicity for illustrative purposes.

After year 1, the Big Flicks stock price will be \$15.60 per share (\$1.04 x 15) without Picture Partners and \$22.50 per share with Picture Partners. This represents a potential net gain of \$6.825 per share in market value, or a total market capitalization increase of \$68.25 million.

Note, that without the production of additional films for year 2 Big Flicks will report less earnings, \$ 21.45 million versus \$23.4 million. This would result in a decrease in EPS for year 2 of \$.19 per share corresponding to a market capitalization decrease of \$29.25 million. However, at the end of the second year Big Flicks is still \$39.05 million ahead in market capitalization.

Again assuming no new film production in year 3, Big Flicks assuming P would again underreport by \$.19 per share and potentially lose another \$29.25 million of market capitalization. However, Big Flicks is still net ahead after three years by \$9.8 million in cumulative market capitalization.

It is not until year 4 that Big Flicks would actually feel the effects of having entered into Picture Partners. Note the cumulative decrease in market capitalization of \$19.5 million. What can Big Flicks do to offset the ultimate negative effects of participating in Picture Partners? After all, Big Flicks has given up some \$5 million of gross profit over time (\$160-155) and \$48.75 million in net market capitalization. The net decrease in market capitalization is equal to 15 times the after-tax lost profit of (\$5 million times 65% = \$3.25 million times 15= \$48.75 million). They can enter into another Picture Partners and continue to defer the reversal into the future. Additionally, if there are real losses on the films the outside partner in Picture Partners and any subsequent entities may bear a real cost and Big Flicks would pick up a real gain. However, if managers hold a short-term orientation, arrangements such as Picture Partners can be very attractive.

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?

Arguments for entertaining the structured financing are: First, earnings can be smoothed and increased in early periods and allow a measure of control to reported results. The market tends to reward firms with predictable and rising earnings with higher multiples than firms with volatile and unpredictable earnings. Accordingly, there may be a disproportionately large beneficial effect to Big Flicks from entering into Picture Partners type arrangements.

Second, in the event of a series of unsuccessful films Big Flicks may receive real economic gains from having an outside entity bear some of the risk associated with the film projects.

Third, the monies provided by the outside partner are not on the Big Flicks balance sheet and may provide Big Flicks with additional operating flexibility in running the business. It may also aid Big Flicks in maintaining its financial ratios under bank loan arrangements.

Fourth, the increase in the firm's market capitalization may aid the firm by providing additional financing sources in the capital markets.

Arguments for not entering into a Picture Partners type arrangement are: First, the firm owes a fiduciary responsibility to constituencies to provide financial reports that actually reflect the results of the firm's business and do not result from creative financing structures.

Are structured financings a breach of this duty and therefore unethical?

Second, structured transactions are time consuming and may distract managers from pursuing more lucrative "real" business opportunities.

Third, structured financings can be costly bearing high initial and frequently ongoing transaction costs. These transactions can cost upwards of 10% of the capital involved for attorneys, accountants, and various investment-banking fees.

Finally, let us now consider the decision to enter into Picture Partners from the perspective of a Big Flicks executive with 30,000 vested stock options to acquire Big Flicks at $20 expiring in year 1. Also assume this executive has personal gain as his primary motivation for action.

Entering into the Picture Partners can boost year 1 earnings by $.46 per share and the market price of the stock from $15.60 to $22.43 per share. At $15.60 per share the executive's options are worthless. At $22.43 per share the executive's options are worth $72,900. This potential effect when viewed across a group of senior managers can be a large incentive.

It is likely that personal impact on executives may be a driver of decisions to enter into transactions that provide short-term benefits. An executive group with personal stakes in reported firm performance may be easily tempted to participate in transactions that provide increased reported earnings over short-term horizons irrespective of whether the transactions are in the long-run best interest of the firm.

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?

Regarding the first exposure draft, Consolidation of Certain Special-Purpose Entities - an interpretation of ARB No. 51 the FASB has explained the reason for the proposed change as follows:

Under current practice, [ARB No. 51] two enterprises generally have been included in consolidated financial statements because one enterprise controls the other through voting ownership interests. This proposed Interpretation would explain how to identify an SPE that is not subject to control through voting ownership interests and would require each enterprise involved with such an SPE to determine whether it provides financial support to the SPE through a variable interest. Variable interests may arise from financial instruments, service contracts, nonvoting ownership interests, or other arrangements. If an enterprise holds (a) a majority of the variable interests in the SPE or (b) a significant variable interest that is significantly more than any other party's variable interest, that enterprise would be the primary beneficiary. The primary beneficiary would be required to include the assets, liabilities, and results of the activities of the SPE in its consolidated financial statements. pg i

Clearly, the exposure draft is designed to address partnership, rather than corporate, type SPEs. Picture Partners is just the type of SPE the exposure draft is pointed at. However, under the facts we assumed above, Big Flicks would neither have the required majority of variable interests, nor have a variable interest that is significantly more than any other parties variable interest. This is because each party is truly an equal partner in Picture Partners. This means that Big Flicks would not be the primary beneficiary and not required to consolidate Picture Partners.

If we changed the facts a bit and had Big Flicks charging a fee for its distribution services to Picture Partners, the matter is not so clear. In that instance, Big Flicks may indeed have a majority of the variable interest when you take the financial investment and the service contract together. This issue provides an opportunity to discuss with students the difficulties involved in setting standards regarding consolidation. One point for the discussion can be that all Filmvest really provides to Picture Partners is capital, no particular business expertise. Conceptually, should mere structured financing conduits be allowed to alter reported earnings? Should we adopt a substance over form rule that would require consolidation in all circumstances, unless the partnering entity was bringing some expertise or real assets beyond financial assets to the party?

The second exposure draft, 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, does not impact Big Flicks Studio. Guarantees usually require the parent company to cover various shortfalls by the SPC or subsidiary corporation if the SPC cannot meet its obligations. Big Flicks Studio does not provide a guarantee to Picture Partners; therefore there are no disclosure requirements under this exposure draft.

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MISSOURI SOLVENTS: THE CAPITAL INVESTMENT DECISION

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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.

INSTRUCTORS' NOTES

CASE OVERVIEW

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. Missouri Solvents is a regional distributor of liquid and dry chemicals. 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.

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 that he was not certain, but indicated that based on historic information they seemed 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.

CASE USE

This case may be used in a number of business courses and may be particularly appropriate for accounting, finance, or business ethics courses where ethics is integrated into the curriculum. It represents a common professional issue: What should a subordinate do when directed by a superior to act in a manner the subordinate considers questionable or inappropriate. In this case the subordinate, David, was directed by a senior manager, Scott, to use more favorable operating assumptions to ensure a project meets company investment criteria. Additionally, the controller, Ann Nye, asked that he use Scott's assumptions and run the analysis. How far should an employee go when they have a general professional opinion that something is inappropriate or incorrect?

The instructor needs to keep in mind that the primary objective for this case is the critical analysis of the ethical issues related to this business situation. The students are provided a predetermined process for the ethical analysis of a realistic business situation. There is no one correct answer to the case. Students are expected to apply critical thinking skills in a forum that foster comprehensive student involvement. Students should be encouraged to move from a dualistic view of this ethical problem solving to that which considers multiple viewpoints.

STUDENT TASK

Use the Seven Step Model, developed by Velasquez, to recommend a course of action for Allen David.

Students would have no trouble recommending a course of action without the Seven Step Model, but the objective of the case is to provide the students with a systematic process to justify their recommendation, rather than a solution based solely on feelings.

QUESTIONS AND ANSWERS

1) **What are the relevant facts? Identify the primary factors that impact the business event and provide an ethical issue.**

   a) Allen David is the financial analyst completing an analysis of the proposed purchase of drum filling equipment.
   b) Stewart Scott is the Vice President wanting the new equipment. He is also the person providing the projections upon which the analysis is completed.
   c) Initial analysis was not favorable for the purchase of the equipment.
   d) Scott suggests a further analysis based on more favorable sales assumptions and increased assumed selling price.
   e) David's supervisor appears to support the revised analysis of proposed purchase.

2) **What are the ethical issues?**

   There may be many business related issues that are separate from identified ethical issues. The value of this step is to stimulate student discussion, not to find one best issue for the case. Remember, there are no definitively correct answers to this case. The fostering of the critical analysis of the case situation is extremely important in any ethical analysis. It is suggested that the instructor not provide any suggestion of the "correct" answer because it would be an expression of a personal opinion and it would be inappropriate to the purpose of the ethical analysis. The following questions can be used to stimulate discussion.

   a) What is David's responsibility to Missouri Solvents?
      i) Should he be conservative and do all he can to protect the assets of Missouri Solvents?

- ii) Should he be willing to assume additional risks for possible greater gain for the company?
- b) What is David's responsibility to himself?
  - i) Should he complete analysis that he feels is overly aggressive and possibly place his career and his family's future in jeopardy?
  - ii) Should he only complete the original analysis and protect his career with the company?
- c) What is David's responsibility to his supervisors' instructions?
  - i) Should he blindly follow the strong requests of his supervisors?
  - ii) What are the likely outcomes for David if the higher assumptions prove to be incorrect?
- d) Should David take his concerns to the company president?
  - i) How will the company president react to his concerns?
  - ii) How will his supervisor, Nye, react if he bypasses the chain of command?
- e) What are Scott's and Nye's responsibilities to Missouri Solvents?
- f) Are Scott and Nye willing to take a risk in hopes of furthering their own careers at the expense of company performance?

3) Who are the primary stakeholders?

- a) David
- b) Scott
- c) Nye
- d) Company Management
- e) Company Stockholders
- f) Company Customers
- g) Company Financial Lenders
- h) David's family

4) What are the possible alternatives?

Remember, there is no one best solution - only a number of solutions that are supported by different sets of values and goals. All of these alternatives need to be considered in light of the ramifications of decisions each has on David's job security, personal/family situation, and career advancement. Broadly speaking, after the above areas are discussed and considered, the alternatives may fall along one of the following possibilities.

- a) Refuse to complete the analysis based on the revised estimates in sales and price.

b) Complete the analysis based on the revised sales and sales price estimates while not saying anything to any supervisor.

c) Complete the analysis based on the revised sales and sales price estimates while telling supervisor about skeptical sales and sale price estimates.

d) Complete the analysis using a number of different assumptions (best, most likely and worse case scenario).

5) Discuss the ethics of the alternatives from the perspective of Teleology (both egoism and utilitarianism), Deontology, and Relativist. Again, keep in mind, there is no one best answer! There are multiple answers and each needs to be supported by a set of logical arguments.

a) Teleology suggests actions may be judged correct or acceptable if they provide desired results (maximizes benefits and minimizes costs). Possible discussions of benefits and costs considerations may include the following:
   i) Which action would provide the greatest benefit and least costs to the greatest number of stakeholders?
   ii) Do the benefits to David for continuing to questions the analysis (e.g. future promotion, supervisor and peer respect, financial award, etc) exceed the benefits for not questioning the revised assumptions?
   iii) Which stakeholders have the greatest risks if a revised analysis provides a situation that turns out to be financially undesirable?

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. Potential behaviors may include the following:
   i) Does David have the right to always speak his mind if he honestly believes the assumptions are overly aggressive?
   ii) Does David have the freedom to consent or not to consent with the wishes of his supervisor/peer to revise the estimates based on aggressive assumptions?
   iii) Are there any codes of professional conduct that address the appropriate behavior by David?

c) The Relativists look at what others do in this situation, and base their action accordingly. Possible considerations may include the following:
   i) What does David feel or know of what other company accountants do in similar situation for suggestions to revise analysis of business decision situations? Does he just follow their example?

6) What are the practical constraints?

There are many possible constraints, among these may include the following:

a) David may hurt his promotion chances by continuing to question the underlying assumptions of the revised analysis.
b) The company could loose valuable future sales if the equipment is not purchased based on an analysis using overly conservative initial assumptions.
c) If the sales assumptions are not realistic the company will not generate the required return on a sizable investment.

7) What actions should be taken?

As you might understand by now, there is no one best decision for David. It depends upon the company, the situation, and the individuals involved. With that in mind, the following course of action is provided as one alternative that students may provide to the rest of the class.

We need to remember that David is a relatively new employee. He will likely want to stay on the good side of his manager/evaluator Nye. To go directly against what his supervisor suggests would be very risky, especially given that fact that Scott has more direct experience in the business. Given these considerations, David may eventually decide to develop a number of possible analysis scenarios that utilize a range of data related to projected sales and prices. These scenarios may include the original sales and price projections provided by Scott (remember, analysis from these projections did not justify the equipment purchase); projection levels that indicate a breakeven point on the equipment purchase; and projection levels, as suggested by Scott in his final request, that showed a favorable return on investment in new equipment.

The scenario, as suggested above, would likely be considered a teleology perspective because it would be looking at the different results of the alternative projections. More precisely, David would be using the egoism perspective because he would be looking out for his own best interest in the analysis. He would provide analysis without assuming responsibility for the final decision. David thus can take credit if the project goes ahead and is successful, avoid responsibility if it goes bad, and can say to his supervisor that he did his honest best if there is the decision not to pursue the project. David will be doing what he can to maximize personal gain (prestige) while minimizing his personal risk (any unfavorable perceived judgment or performance).

CONCLUSION

This case provides an opportunity for an instructor to examine an interesting ethical case in the classroom with a structured approach to its analysis. While there is no definitive correct solution to this case, there is enough guidance to allow a healthy discussion of an important business situation. One of the most difficult aspects of any classroom analysis of an ethical situation is the encouragement of students to critically evaluate the situation without the fear that their view will be incorrect. Remember, it is the systematic and logical analysis of the ethical situation that is important in the learning environment. Unlike accounting and finance analysis where there is usually a defined correct answer to many problems, the ethical analysis of the business situation requires the student to make an analysis that is logical, yet may yield a solution that may be quite different from solutions provided by other students in class.

SILVER BREAD BAKERY: A SMALL BUSINESS CASE FROM THE SULTANATE OF OMAN

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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.

INSTRUCTORS' NOTES

Key Issues in the Case

1. Advantages and disadvantages of buying an existing business
2. Decision making under conditions of risk (ambiguity)
3. Human resources in small business
4. Cross-cultural small business
5. SWOT analysis and environmental scanning
6. Operational issues in small business
7. Entrepreneurship and small business management

Teaching Methods

This case is designed to involve the student in the context and information available leading up to a decision to buy or not buy an existing business and the challenges faced in turning it around. It would thus be best for discussion in a course in entrepreneurship or small business management at either the undergraduate or MBA level.

The case should normally be used during discussions of the trade offs between starting a new business versus buying an existing versus franchising. The case would illustrate well the the challenges of buying an existing business as well as the managerial challenges faced to turn it into a more successful small business. Discussions of the operations of the business from human resource decisions to production could be held, as well as those related to market trends, competition and their implications for the business.

DISCUSSION QUESTIONS

1. Research and write a brief summary of the history of Oman and its development. Describe the business practices in Oman.

The following links are a sample of several that could be used to review the history of the country and the region. Also Appendix B provides a brief summary of the history of Oman and the region.

http://www.legend.net/oman/menu.htm

http://www.omaninfo.com/

Business practices are detailed throughout the case itself and center around 51% ownership rules operating in the country. These rules have set the tone for the whole private sector and the behaviors revealed in the case.

2. Discuss the history of the business and the owners involved leading up to Hamad's purchase.

The Hussain and Abdulla Bakery was started in the mid-to-late 1980s by Abdulla, a director in one of the government ministries, and Dr. Hussain, an eye consultant in a local hospital in Muscat, Sultanate of Oman. Neither of the partners had any experience in running a business. They operated the business until around 1990.

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. He lived some 300km from Al Khodh where the business was located. He was clearly an absentee owner and was not able to be actively involved in the business, nor did he have the expertise to actually run the business. By 1991, Sadeq is looking for a way out of this situation and was looking to Hamad to as a solution.

3. Analyze the pros and cons of buying this business. Which issues seem to be unique to this setting?

Advantages:

- ♦ has existing operations, licenses, employees, customers, cash flow, etc.
- ♦ employees are already present and have residence visas*
- ♦ Hamad has a sense of what the real issues are in the business
- ♦ operations have plenty of room for improvement (nowhere to go but up?)
- ♦ desperate, novice seller suggests potential to buy at a good price
- ♦ market trends suggest likely growth in consumption
- ♦ limited competition and existing competitor is weak

Disadvantages:

- ♦ lack of financial information about the business
- ♦ poor financial performance of the business
- ♦ poor market reputation
- ♦ weak market presence
- ♦ human resource/performance problems

- poor quality equipment/poorly maintained
- employee visa restrictions mean owner must be easily accessible to solve problems requiring trips to neighboring UAE*
- lack of local suppliers or support of this technology*
- not always easy to get new employee visas*

* reflects those issues that would be rather unique to the Arab (Persian) Gulf

4. Summarize several key operational decisions made by the owner during the period covered in the case.

There seemed to be two main issues dealt with by the owner after taking over the business. First was the human resource problems that affected all other operational issues. By learning the details as to how bread was made, the owner removed a major source of performance problems. He made sure that more than one person knew how to do a particular job, reducing individual employee power. He sought to improve employee knowledge of the bread making process. Second, and related to the first, was the assurance of organizational reliability as a quality, reasonably-priced supplier of bread. This was discussed more thoroughly in Part A of this company case, but mentioned in this part as well. This involved not only better human resources, already mentioned earlier, but also better systems and technology.

5. Conduct a SWOT analysis for the business at the end of 2000.

Strengths:

- good, recognized location
- Hamad's experience as a business person in the area
- solid business reputation in marketplace
- good quality product and reliable service
- cross-trained workforce
- low-cost structure of business

Weaknesses:

- small size of the company in light of larger competitors
- limited production capacities
- poor to non-existent marketing skills/activities

- relatively weak financial management skills

Opportunities:

- high growth market
- social trends support more business
- university market largely untapped
- product in wide demand, good times or bad

Threats:

- increasing competition
- changing market demographics
- changing social trends and purchasing habits

Note: Porter's 5-forces model could be used to assess this case as well.

6. Conduct a financial analysis of Silver Bread Bakery during the 1995-2000 period.

Because there is moderate amount of financial information available, simple analysis could be made related to cost structure, rearranging the statement into variable vs fixed costs or cost of goods vs operating expenses and such. Comparisons for common size are also possible.

Appendix A attached to these notes compares Silver Bakery with U.S. industry ratios for both retail and wholesale bakery businesses, the two closest SIC categories researched. Recall that about half the business revenue came from both retail and commercial accounts, with the business conducting itself as both a retailer and manufacturer. As the data is derived from US businesses using full financial accounting procedures, caution needs to be made when comparing this company with those included in the RMA resources.

In looking at Appendices A and B, the significant difference in operating expenses may largely be due to the fact that no depreciation is included. Additionally, no interest costs for the loans are noted. Further, the cost of goods seem high relatively speaking. There are no corporate taxes in Oman at this time.

7. Recommend at least two significant things Hamad should consider doing to insure the future health of the business.

The standard recommendations might involve considering expansion to other smaller communities or neighborhoods, increasing marketing activities (and their costs) to solidify local reputation and business, and continuous quality improvements to enhance reputation relative to competitors.

APPENDIX A
Silver Bread Bakery
Comparative Financial Data (US Dollars)

Silver Bread Bakery		Bread Mfg SIC#2051		Bread Retail SIC#5461	
By Sales		By Assets	By Sales	By Assets	By Sales
		0-500 Million	0-1 Million	0-500 Million	0-1 Million
%	INCOME DATA	%	%	%	%
100	Net Sales	100	N/A	100	100
44.7	Gross Profit	49.9	N/A	51.4	51.5
28.8	Operating Expenses	45.3	N/A	46.2	47
15.9	Operating Profit	4.6	N/A	5.2	4.4
2	Other Expenses (net)	1.2	N/A	1.1	0.7
13.9	Profit Before Taxes	3.4	N/A	4.1	3.7

Note: Comparative data reported taken from RMA 2001 reports. Silver Bakery data was taken from an average of the available 3-year data (years 1995, 1996, 2000).

APPENDIX B: Constructing a Cash-Basis Profit/Loss Statement (US Dollars)

Sales	251,625
COGS	139,257
Gross Profit	112,368
Utilities	5,178
Rent (Emp housing)	3,163
Rent Miscellaneous	7,354
Management Fee	4,680
Car Payment	4,303
Other Air Tickets	2,352
Labor Card Fees	2,557
Total Expenses	77,393
Profit	34,975

NOTES TO PROFIT-LOSS STATEMENT

No balance sheet exists and how to construct one is unknown to the owner. Income/expense details are lacking for years 1997-99, but summary data was available. Table 2 contains average expense details for 3 years, all that was available for the period presented.

Sales are comprised of delivery drivers who act as sales people who run routes and try to generate more business. The drivers are charged a certain rate for the bread they take and they can sell it for the price they are able, paying for their product at the end of each week. The retail category is comprised of walk-in traffic at the single location.

Raw materials include the ingredients to make the various breads sold - flour, oil, yeast, etc.

Rent (employee housing) involves barracks-like facilities provided by the sponsor/owner and is a rented space used to house workers. This arrangement is typical of companies who bring expatriate labor in. Rent (business) is for the lease expense for the business.

Miscellaneous. A rather catch all account that is used rather inconsistently by the owner for various petty cash type purchases such as maintenance, various fees, etc.

Management fee. Hamad draws a fee for the active management of the business. He also shares in the dividends split up each year between the two partners.

Car payment. Two delivery vehicles were bought on credit during period.

Air tickets. Employees have round-trip airfares paid for by the sponsor. They are eligible for the benefit every two years to return home to visit family. In this particular business, the employees often waited three or more years before they actually took the benefit as they apparently needed to make the money. Most expatriates send the money home, and in these groups of labor, their whole purpose for being overseas is to be able to send money home in support of extended families. Many spend most of their working lives away from their families. The benefit was only available if you actually flew home; there was no encashment option.

Labor cards. As indicated earlier, labor cards are becoming increasingly more valuable as the government is attempting to restrict work visas

APPENDIX C: Cultural Context for This Case

The six Arab countries that make up the Gulf Cooperation Council (GCC) include Saudi Arabia, Oman, United Arab Emirates, Kuwait, Qatar and Bahrain. They are nations of an estimated 28.9 million residents of whom approximately 7.3 million (31%) are expatriate. Furthermore, these expatriates make up nearly 70% of the workforce in these countries (The Europa World Year Book, 1999). Islam is the dominant religion in the region and the monarchical form of government is the only administrative system.

GCC countries have experienced much growth and change in their economic and social conditions over the past decades as a result of the vast revenues from oil. By the late 1970s, faced with the desire to gain national control over vital sections of their respective economies, many governments in the region adopted a policy of giving first priority to nationals in filling administrative/management positions. This was particularly emphasized in the government sector, where government mandates gave exclusive rights to nationals for these positions (Abdel-Halim & Ashour, 1995).

On the other hand, however, faced with the fact that the national workforce in the region was sorely under-skilled, governments had to utilize foreign workers to provide the skills necessary to support the established government goals for development. These non-national workers provided most of this diverse labor requirement, ranging from the least skilled laborers to managerial and technical skills. In the 1980s, oil prices plummeted and revenues from oil fell sharply from their peak levels. Along with the rapid population growth, governments in the region could not absorb the graduates coming out of their educational systems. Thus, the nativization policies began to focus on the private sector.

Despite efforts to encourage nationals to work in the private sector, it remains a sector dominated by expatriates, especially in unskilled and semi-skilled employment. In light of Oman's recent development experience and the diverse work context that has developed, the attitudes and performance-related behaviors of organizational members here are of particular interest in this study.