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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.

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 should 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.

Inge Nickerson, Barry University
Charles Rarick, Barry University

CASE NOTES

SITEASY FURNITURE COMPANY GOES INTERNATIONAL

Richard Sjolander, The University of West Florida

CASE DESCRIPTION

The primary subject matter of this case is the first introduction of a company's products into International Markets. Secondary issues include conducting secondary market research by small firms in foreign markets; international terms of trade; identifying relevant tariffs; market segmentation; exchange rates and exchange rate fluctuation. This case has a difficulty level of 4-5 and is targeted at business students in a first course in international business or international marketing. The case can be used either as an introductory course case, as it covers many of the problems typically encountered as a business expands into international business, or as a relatively straightforward functional case on pricing in the international environment. One hour of class time should be sufficient to handle the case discussion and students should budget 3-4 hours of time for case preparation.

CASE SYNOPSIS

The SitEasy Corporation is a small manufacturer of quality furniture located in Colorado Springs, Colorado, USA. Sales at the 12 year old company have grown steadily and the company expanded two years ago into a much larger factory capable of doubling their output, while maintaining their quality level. However, the housing market peaked shortly after their move in 2005 and in 2006 it started to soften. Current distribution is to exclusive stores on the west coast and the upper northeast in the U.S. The idea for foreign expansion was initiated in response to flat sales in current markets and a lot of excess capacity in the new factory. Past comments from two, large northeastern retailers that a large number of their customers were shipping the furniture directly to Canada led to the idea of exploring international markets. Following a discussion of the relative change in value of the US dollar and the Canadian dollar, the case fast forwards to the issue at hand, answering the inquiry from a potential Swedish distributor met at a German furniture trade show.

Pricing must be established for a portion of their exclusive furniture line for the Swedish market, along with forecasts of expected sales and expected effect on plant capacity and firm profitability. This requires identification of accepted terms of trade, relevant tariffs on the type of goods being offered, consideration of exchange rates, and most importantly, the expected size of the market for SitEasy furniture in Sweden.

INSTRUCTORS' NOTES

Answers to Case Questions

1. **Discuss the motivations behind the plant expansion and advantages and threats caused by this action.**
   The expansion can be seen to be driven by multiple factors. First, there is a stated need to have more space for warehousing raw materials. Then there is the issue of having room for more machinery. It can also be assumed that the old facility may have been nearing the capacity, in which case they needed additional production space in order to meet forecast demand. Even with the slowdown, they are at 73% of capacity and have been growing at 8% per year. The threat to expansion is the situation they are currently facing – meeting the additional overhead cost of the larger facility necessitates additional sales. Otherwise they will lose profitability. It would be good if the class looked at the expansion in terms of sales, too. When the expansion took place, SitEasy sales must have been in the 60 million dollar range. That was quite ambitious to assume that the firm could sustain an increase in debt that would require a 25% increase in sales just to break even!

2. **Should SitEasy expect that the decreases in material cost for its furniture will continue to decline in the future? Explain your answer.**

   No. We should expect that the company would experience a one time reduction in cost as they increased their order size, which appears to have been the case in the 2nd half of 2004.

3. **What type of forecasting does it appear that SitEasy is using for its demand forecast?**

   SitEasy appears to be using historic sales as the basis for its forecast. This rather naïve prediction assumes that the future will be like the past. This is quite surprising for the firm, especially considering that they state that furniture sales are highly correlated to housing sales – with a lag. Given the availability of housing information, the use of this information might give them a better idea about future sales.

4. **Estimate the number of years to capacity for their facility given current estimates of domestic demand. Be specific in terms of the assumptions being made and try to come up with a range of estimates, rather than just one point.**

   Students typically flounder in estimating years to capacity and especially arriving at a range of estimates.

The following information usually underlies a good answer to this question:

Change in sales: We know that sales are currently flat, following a 6% increase last year and 8% in each of the previous 4 years: a 4-8 % growth range may be reasonable.

Therefore, most students assume that plant capacity, currently at 65% will increase by between 0-4 % over the next few years.

On the high side, we could assume an 8% increase in sales, at which rate they would reach capacity in just over four years: 100-65= 35% unused capacity / (8%) = 4.36 years.

On the low side, we could assume a 4% increase in sales, at which rate they would not reach capacity until almost 9 years: 100-65= 35% unused capacity / (4%) = 8.75 years.

5. What is the main problem illustrated in this case?

The problem is the age old one of identifying attractive target markets for the firm's products. Students providing a more in depth answer would begin with the assumptions surrounding the expansion completed in 2004, which assumed the firm would continue to expand at 8% per year until 2010. This does not appear to be happening in their current markets, and the additional overhead they acquired requires an additional $15 million in sales for break even, which they have not met. In fact, assuming a growth rate of the stated 8% for 2004 and 6% for 2005, with flat sales for 2006 it is easy to work backwards from their current position of $73 million to see what level of sales are actually required.

Current sales = 2005 sales = $73,000,000
2004 sales = 2005 sales/1.06 = $68,867,925
2003 sales = 2004 sales/1.08 = $63,766,597= sales before expansion. Therefore, sales must reach $78.7 million to break even on the increased overhead from the expansion. SitEasy is close to reaching this goal, so the situation is not as dire as it might initially appear.

6. How large is the change in the relative value of the 'Loonie' over the past 4 years and what might be some of the factors leading to this change, and why is the money called 'loonies'?

The loonie has appreciated 25% relative to the U.S. dollar over the 4 year period. Exchange rate fluctuations are the result of changing demand and supply conditions for the two currencies. There will be students going into much greater detail, listing trade deficits, inflation rates, interest rates, etc. and while these are factors, a simple answer may be sufficient.

The currency is called 'loonies' due to the picture of the loon on the backside of $1 coins (Queen Elizabeth is on the front). There is no paper money worth less than $5.

7. What will Lisa include to Bob about pricing? Include a detailed answer of the incremental cost items and conclude with price per unit for each chair. Is there any room for downward negotiation on the part of SitEasy without forcing them to sell at below cost?

The cost includes several items set out in the table below:

Model	1308		1600	
	In $	in Sw. kr.	In $	In Sw. kr.
Fob buyer's dock price	$602		$791	
Pack/Ship	$50.		$50.	
Marine ins. (1.5%)	$9.78		$12.62	
CIF	$661.78		$853.62	
Tariff	Free		Free	
V.A.T. (25%)	$165.45		$213.40	
TOTAL incl. CIF + VAT	$827.23	6056.0	$1067.02	7811.4

These prices are for orders of mixed quantities of the two chairs in container loads of 32 pieces shipped to the port of Gothenburg. Shipment to either Stockholm or Malmö would cost an additional $10 per chair.

In answer to the second part of this question, YES, there is the possibility of some negotiation. Domestic prices are bases on a 15% mark up on cost. Thus the unit price of each model could be reduced by as much as the total mark up, which is found by the formula:

Price – cost, where cost is found by the formula:
(cost + .15cost) = Price
Cost for the model 1308 = $523.48 and mark up = $78.52, which is a simple answer as to the amount by which the price could be reduced and still contribute to profit. Actually the

reduction could be even more if you assume that these additional sales need only cover marginal cost and not contribute to overhead. By the same reasoning, the figures for model 1600 are:

Cost = $687.83 and mark up = $103.17.

8. What type of forecast numbers could Lisa develop quickly for the Swedish market? Come up with specific assumptions and forecasts.

The easiest forecast to make for this new market would be by analogy. Looking at the numbers, we notice that the age distribution of the population of Sweden is similar to that of the U.S. Further, though the income distribution in more equal in Sweden, it can be assumed that this may increase the number of people with relatively high incomes - their target market in the states. We suggest that if one compares the relative population sizes she can come up with a quick estimate:

1/3 of 295 million people = $73,000,000 in sales, therefore
9 million people should support (9 / 98) * $73,000,000 = $6.7 million in sales. This figure, of course, should be reduced, especially in the first years on the market due to a lack of customer awareness of the product and probable lack of distribution locations, among other things.

INTERLANDDATA WEB HOSTING: STRUCTURING THE ORGANIZATION FOR GROWTH

Javad Kargar, North Carolina Central University

CASE DESCRIPTION

The primary subject matter in this case is formulating strategic decisions that need to be made regarding a small entrepreneurial firm's future direction. The owners are a couple who are faced with the decision of whether or not to expand as well as with the challenges of obtaining the necessary financing, structuring the organization for growth, and allocating management time. This raises several issues and illustrates several lessons. In particular, management proposes potential changes, offering students the opportunity to critique their plans. Evaluated carefully, students should identify the critical success factors and whether and how these elements can be leveraged as they implement their expansion plans. The purpose of this case is to provide students with enough information about the business situation to be able to chart what course of action the company should take at a given point in time. This case has a difficulty level of four, appropriate for senior level. It is designed to be taught in two class hours and is expected to require four hours of outside preparation by students.

CASE SYNOPSIS

During the summer of 2004, the owners of InterlandData, Mark and Susan Hamidi, began to assess their current position within the Web hosting industry and their alternatives for expansion. After nine years in operation, the company had achieved a reasonably stable, yet not highly profitable financial footing. Both owners are experiencing considerable pressure to expand their organization. They believe that opportunities exist to franchise the operation, or grow by expansion. The case ends with the co-owners faced with making a strategic decision about the best way to expand and how to find both the managerial and financial resources to do so. An implicit question in the case involves the long-term viability of the business.

INSTRUCTORS' NOTES

Case Methodology and Data Sources

This case is a field research study. Information about the company was gathered from interviews with the owners/managers and their employees. Background information on the industry was drawn primarily from publicly available information.

Case Objectives and Use

This case is intended for an undergraduate or graduate course in Business Strategy or Entrepreneurship. The case is positioned to discuss the profitability and potential growth issues facing a small company in a broad market.

A major theme of the case is the market potential for expansion. The case can serve as a basis for discussion about:

The competitive forces in the Web hosting industry.

1. Strategic positioning within an industry.
2. The role of the owners/managers in a small business.
3. The opportunities for growth; in particular opportunities and problems presented by franchising.

The case should lend itself to lively discussion of the problems and potential of a small business in a dynamic industry. Students should see how commitment from the entrepreneur is essential to the success of such a venture. In addition, they can assess the potential for growth and expansion.

It is a good case for relatively early in the semester when students have learned to identify strategy, have been introduced to the competitive environment, and are ready to be forced to make strategic choices. It provides a good opportunity to deal with the strategic alternative of franchising, and its pros and cons. There are two ways to approach this case: (1) as a "straight" case, asking students to first detail the current strategy and then focusing on strategic problems facing the firm, evaluating the alternatives, and making a decision; (2) as an out of class group exercise asking students to determine the appropriate long-term strategy InterladData should follow. Each group should evaluate the alternatives, financially as well as organizationally and managerially, and then come to class prepared to present and defend their choices.

DISCUSSION QUESTIONS AND ANSWERS

1. What are the competitive forces in the Web hosting industry and for the InterlandData Web Host?

Porter's Five-Forces can be used to show the competitive forces that impact the InterlandData Web Host.

Potential Entrants. Although Web hosting industry is less regulated industry, it is not an easy industry to enter, as evidenced by the heavy capital investment in equipment, network connectivity and physical plant. However, this barrier can be overcome by entering into the business as a reseller or an information technology (IT) consultant. The likely entrants are new entrepreneurs who believe that they can reach a more specialized market as a consultant or reseller. Excess supply of Web hosting services over demand is also a big barrier, which has created a very competitive environment for existing Web hosting firms. There is a threat from big Web hosting firms by expanding their market share. Because Web hosting margins are thin, and because the InterlandData is one of the first movers in the industry, the threat of new entrants into the local market is weak.

Substitutes. Mark and Susan clearly see a broad range of substitute products competing for small business advertising dollars. Since many Web sites are established for advertising purposes, there are many establishments that vie for their customers such as newspaper and magazine advertising, radio and television marketing, the Yellow pages, flyers, and brochures. However, the cost of Web hosting services is significantly cheaper than any of the substitutes and its reach is global. Students may also mention that free Web hosting services for businesses, may encourage some potential customers to spend their money on advertising other than Web sites. However, this is a weak substitute since use of a customer's domain name as the Web-site address is not available with this type of free Web space. Some other companies are offering their ready-made Websites for rent. It seems that these emergent competitors pose little competitive threat to InterlandData. In the Web design market, there are currently very few threatening substitutes. Some companies offer do-it-yourself software and books for Website design.

Suppliers. The supply of software packages and data centers is also a problematic issue. Constantly upgrading software packages is critical to the success of this type of business. Web hosting firms have to be able to adapt to these changes in order to meet their customers' needs. Mark claims to have good relationships with software companies and data centers, but it is likely that the big Web hosting firms have an edge in price discounts and contract terms. In addition, the supply of technical support staff is critical to Web hosting business operations. Technical staff should have the ability to analyze a current problem, and posses the ability to respond and correct the problem in a timely and efficient manner. There appears to be an adequate availability of competent employees.

Customers. The InterlandData caters specifically to two main customer groups: resellers, and any individual or organization that needs a website. Resellers are individual small companies who purchase dedicated server space and resell the space to individuals or businesses. Resellers tend to go to Web hosting providers that offer better volume discount, better technical support, fast connection, and better security. It is also likely that small businesses will check Internet for Web hosting services before contacting InterlandData. It seems that attracting and maintaining small business customers is the most problematic issue since customer service is critical to the success of this type of organization. Because InterlandData does not advertise in main search engines, customers can obtain their purchases elsewhere. The company may have some competitive advantage because of its well-developed customer network coupled with its customer service which takes time to develop. However, these do not pose barriers if other organizations choose to compete. Clearly, customers have considerable power in this industry.

Competition. Competition in the Web hosting industry is fierce, due to the highly saturated market, and a high degree of fragmentation. The existing players in the market in addition to thousands of pure Web hosting companies include application server providers (ASP), Internet service providers (ISP), telecommunications companies, computer hardware suppliers and large information technology firms. Although there are some big players in the industry, there are no big profits. The competition became fiercer when Yahoo! and AOL offered small-business hosting services. In addition, Web hosting products are becoming a commodity product. Competing factors across the Web hosting industry include prices, reliability (reduced down time), quality technical support, technology (having the necessary software and platform), strategic alliances, search engine tools and Web design portfolios. While it is unlikely that the large Web hosting companies feel much competition from small Web hosting companies like InterlanData, small Web hosting firms have little to offer that the big ones do not.

2. Describe InterlandData's marketing strategy. How do you think it has worked so far?

The company's marketing strategy is mainly focused on referral system. Susan believes that Internet advertising is very expensive and most paid advertisements do not bring in new customers. Mark and Susan position their business as a customer service oriented.

Susan also places ads in local yellow pages, and make presentations at professional association meetings. It seems that the company is not visible in both the local community and in the greater global community. The fact that the company gets new customers through referral, presentations and the fact that its revenues have been increasing are evidence that this strategy has been effective in the past. However, the changing competitive environment may warrant a change in marketing strategy. Students may want to discuss options for increased advertising to increase the company's customer base.

3. What are the key success factors in this industry?

Because price discounting is becoming common, volume is a key to success in the Web hosting industry. Since Power Web Host's market is unlimited, it needs to focus on increasing number of customers by better advertising. Because the product is becoming more a commodity product, Web hosting companies are trying to differentiate themselves on the basis of customer services.

4. What is the current strategy of InterlandData? How would you define the business in which the company is engaged?

The case suggests that Mark and Susan are pursuing basic Web design and Web hosting businesses for individuals and small to medium sized firms, globally by relying on word-of-mouth to get their name out. In a sense, the company is following a broader market with no advertising and no differentiation of product. Both owners define the Web hosting as the core business and the foundation of the firm. It is the business they know the best.

It seems that there are a variety of elements that have contributed to the survival of InterlandData. The management team knew their perspective business and complemented each other. They were able to delineate areas of responsibility where each could maximize their strengths and experience. The partners shared the same vision and their good chemistry radiated throughout the organization. They focused on profitability and cash flow, and have emphasized quality in their concept above all else. The partners, following the Internet boom in 1992, identified a market opportunity where there was little competition. They have moved slowly, ensuring they had the success formula, before expanding.

5. What are the major problems facing InterlandData in 2003? What are its major opportunities and threats?

Undoubtedly, the most important problem facing InterandData in 2004 relates to its weak financial position. However, to address this particular problem it becomes necessary to analyze the underlying reasons why this situation has occurred. These reasons/ problems are discussed below.

(1) InterlandData's current strategy is inconsistent with both its resources and the needs and motives of customers in the marketplace. InterlandData has long considered itself as a full-line Web hosting provider and built its clientele over the years based on this perception. Unfortunately, InterlandData was never in position to compete across-the-board in the Web hosting industry due to its limited size. The full-line strategy prohibited the development of any economies of scale in operations or any expertise in serving the needs of a specific customer group. Furthermore, InterlandData assumed that customers were more interested in quality service than price and that they were able to differentiate its products from competitors in this regard. In fact, the customers of Web hosting products were more likely to be motivated by price and acceptable quality as well as their familiarity with the brand name.

(2) In accordance with its full-line strategy, InterlandData had attempted to serve a broad range of customers. Part of the company's problems lie in its reluctance or inability to define who its customers were, and more importantly, who they should be. Mark and Susan know that competition in Web hosting is fierce, yet they have failed to pinpoint where best their company fits into the marketplace. They have not, for example, clearly defined what business they are in. Which markets should they serve? Which markets offer the greatest payoff? What is the best strategy to sell them? What image should they project to prospective clients?

(3) There are some indications in the case that InterlandData was inefficient in its operations function. In its latest full year, the company's operating efficiency, as measured by the return on sales revenues, was 0.15 percent, calculated as follows:

Return on sales = (Operating Profit/Sales Revenues) x 100
= ($1,078/$719,345) x 100
= 0.15%

The return on sales of 0.15 percent means that the management has not done a good job of controlling the company's operating costs in relation to its sales. It seems that controlling cost is difficult to carry out in fast-growing companies like InterlandData. It is important for management to achieve stability as well as growth.

Another measure of InterlandData's managerial skills is return on investment. Over the past three years, the company reported negative equity. In 2003, the company made only $1,078 profit with negative equity. One might argue that the management is doing a good job by earning profit without any equity. If we look at the company's latest balance sheet, it is obvious that there is a heavy debt noted as deferred revenue. In fact, customers really own 100 percent of the venture.

(4) InerlandData is lacking adequate personnel necessary to handle its operating and strategic problems. Both Mark and Susan were forced to wear several hats, not all of which seemed to fit. In addition, serving the global market, the company does not have any local representative in any country.

(5) Since InterlandData seemed to be trying to emphasize small businesses, it is surprising that the firm had done so little in the way of promotional support for its products. The firm's failure to invest in its marketing function is inconsistent with its full-line, quality strategy since the customers need to be informed and convinced that this quality exists and that it is worth the higher prices changed for the company's products.

(6) As the case indicated, sales of Web hosting had actually declined over the last three years. This means it would be extremely difficult for the company to expand its market share without capturing sales from rivals. Considering the company's high prices and lack of promotional support this seems an unlikely occurrence.

Besides these problems, InterlandData was faced with several threats that could well affect the firm in the future. These threats included: (1) the Web hosting business is highly competitive, (2) demand is very price sensitive, and (3) industry margin is low.

Finally, on the bright side, there were several emerging trends that offered InterlandData some opportunities in the future. (1) Web hosting market is expected to grow, and (2) there are good growth opportunities in vertical markets.

6. Should InterlandData grow by franchising? Why/why not? What requirements would the company need to meet to successfully franchise? How well does the current operation meet those requirements?

One decision issue in the case relates to whether Mark and Susan should pursue franchising their business. In order to successfully franchise a business, the owners/managers must be completely involved in the development and start-up of the franchise systems. In addition, ongoing attention and management to both the original organization and to franchises is necessary. In this case, Mark and Susan are still extremely involved in the day-to-day activities of their current operations. Building a franchise would require one or both of them to devote most of their time to the franchise which would then lead to the need for at least one additional staff member to manage InterlandData's present operations. The initial time requirement would be utilized in developing complete and transferable systems. The franchise would also require managerial time as franchisees would need training and support throughout the relationship.

The franchise alternative can be evaluated by using operating requirements, financial projections as well as capital requirements.

Operating Requirements

A franchise operation requires:

a) Legal contracts, including a prospectus and a franchise agreement
A prospectus and franchise agreement must be developed prior to discussing the franchise with any prospective franchisees. The prospectus would discuss the past and future performance of InterlandData. The franchise agreement would detail the relationship between the franchisor and the franchisee, including the control mechanisms and reporting requirements. The franchise fee and royalties are also established in the franchise agreement.

b) Training programs for franchisees
As part of the obligation to the franchisee, the franchisor must provide initial and ongoing training to the franchisees. The start-up training shows the franchisee how to run the franchise through observation of the existing business. This is usually a one- to two-week intensive course where the franchisee learns everything there is to know about the business.

c) Operations manuals, including guides and performance measurements
Included in the initial training would be thorough instruction on the use of the operations manual, which would later be used as a reference for the franchise. The

operations manual should also include explicit forms for reporting operating performance to the franchisor. Training for the franchisees should be ongoing so that they always have the most updated information on the business and its functions. This type of two-way communication during the relationship is part of the franchise agreement.

d) Marketing tools for soliciting franchisees
Marketing programs aimed at soliciting qualified franchisees must be developed. These programs could be print advertisements in publications for small businesses or trade journals.

e) Marketing support, including advertising and promotion for franchises
With franchising, advertising and promotion must also be designed for the entire franchise organization. This benefits all the franchises and the parent company. By providing this support, the parent company would incur all advertising expenses as a necessary service to the franchisees.

Financial Projections

In analyzing the franchise option, first a franchisor needs to do financial projections to examine the company's financial results from operations. One of the criteria for a successful franchisor is a strong financial picture of the current operations. The franchisor must be able to demonstrate to prospective franchisees that the company's operation is successful and the success is likely to continue, and will be profitable to them as well.

In order to develop a five-year financial plan, the franchisor must make assumptions about the operating environment. Based on the industry trends and the owners' knowledge of their business, the most likely scenario for InterlandData is 25 percent growth in revenues per year. Expenses for the most part are projected to increase 25 percent per year. Based on these assumptions, the most likely scenario shows positive income over the next five years. Total profit for the five years is $1,229 (see Exhibit 1). Since InterlandData uses a cash basis accounting system, profit is the best approximation of cash flow. (Note that students may make different assumptions with correspondingly different results.)

In analyzing financial results, a sensitivity analysis can be conducted to develop a best and worst case scenario using different growth rates. The best case, based on 28 percent growth in revenues shows much improved financial performance with a five-year total profit of $641,990. The worst case assumes only 19 percent growth in revenues of all products. Under these conditions, profits and cash flow will be negative in each of the next five years. These projections serve to illustrate the importance of continuing to grow revenues because expenses will continue to increase regardless of revenues.

Capital Requirements

Any franchise operation requires capital for legal fees, inventory, and start-up costs unless the primary business generates enough cash by itself to support the new system. The capital requirements to initiate a franchising strategy are significant for InterlandData in light of their cash flow. InterlandData franchises could require anywhere from $50,000 to $150,000 in start-up capital, which would be spread out over the number of franchises offered. Because the company is a service organization that does not require inventory, the bulk of the capital would be needed for legal fees to develop the franchise agreement. A good estimate of legal fees is $110,000 in the first two years of the plan to get the project started. Other expenses attributed to franchising include advertising expenditures to solicit franchises, travel costs to monitor franchise start-up, developing and printing training and operating manuals and printing administrative forms.

These expenses would be partially offset by a franchising fee estimated at $10,000, and franchise royalties at 10 percent of the franchisees' gross revenues for a local license. These figures are in line with other franchise fees and royalties based on the nature of the company's business.

With these additional assumptions for capital requirements, financial performance will be much different than under the most likely scenario discussed above. In the first two years of the franchising program, the company would need about $55,000 a year because of the expected negative cash flow. From this point forward, profit and cash flow should improve much faster than they would without the franchising plan. The result is dependent on the financial success of the franchisees.

From the standpoint of financial projections alone, InterlandData could franchise its business if the necessary start-up capital could be obtained. The long-term financial picture is much stronger under the franchising option than under the present conditions. However the operational changes and managerial requirements necessary to implement a successful franchise system make franchising much more risky than a simple financial analysis suggests. The company's owners need to evaluate its operations in light of all the criteria for a successful franchise and not merely the financial criteria.

First, InterlandData has been moderately successful to date. The owners have taken relatively modest salaries. Although the business can be considered moderately successful with its current profit, it would be difficult to take on the financial burden and sell franchises with its current operating history. Both owners are highly committed to making InterlandData work. It is not clear that franchisees would have the same level of commitment or the same willingness to take only a modest salary and profit out of the business as the founders have. To the extent that franchisees are in the business for profits, their chances of perceiving the operation to be successful are much less.

Second, the operating environment that has made InterlandData successful may be duplicated in another location with different personnel. In examining the entire business, it appears that the location and the market environment have been critical to the success of the company. Major forces that created Web hosting opportunity are fundamentally changed. There are far more competitors, the price umbrella is gone, and the window of opportunity has been closed. Things have changed and the opportunity is not nearly as attractive. Market conditions are no longer as positive: the shortage situation has disappeared and buyer's power has substantially increased.

Another critical issue for duplication of the business is the owners' involvement in and influence on the organization. Although the owners may be willing to teach their business to franchisees, relating to the technical people on the one hand, and to clients on the other, may be difficult to learn. Therefore, duplication of the business may be more difficult than it would appear at first glance.

Third, InterlandData does not have a well-documented operating system for administrating its business. This could easily be developed into a standardized operating manual because routine aspects of the business are easy to copy and learn. This could help in developing standard operating procedures for franchises.

Fourth, the company does not have strong name recognition in the market. In order to develop the economies of scale needed to develop and sustain a strong franchise system, InterlandData will need more capital and managerial resources for marketing as well as organizational development. At this point, the owners do not seem willing to take on this financial or administrative burden, nor do they necessarily have the managerial skills or financial resources to do so.

On the basis of the foregoing analysis, it would be reasonable to conclude that franchising may not be the best growth device at the present time. In order for franchising to flourish at InerlandData, they must have a success story to tell prospective franchisees – a story they do not now have. Note from the company's latest balance sheet in 2003, although the company's retained earnings show a positive number, it has a negative equity. Such financial performance would hardly inspire an informed prospect to buy the company's franchise. In addition, neither Mark nor Susan has any experience in franchising.

In any case, the owners must first perfect their business concept before attempting to sell franchises. Their goal would be to design a model office reproducible almost anywhere. Otherwise, deceived and disgruntled franchisees may sue the company for selling franchises in order to collect franchise fees.

Mark and Susan might consider launching one or two offices in other locations with new partners to develop some expertise. Once they have achieved financial success, and have a designed office model, they are ready to sell franchises intelligently and aggressively. Doing so, however, would be complex. Many reputable law firms and management consulting firms have experts who can help entrepreneurs franchise their businesses. Mark and Susan should enlist their help, although their fees are high. While it is an obvious opportunity to leverage the company's image, new offices require a strong marketing effort. We will also suggest that Mark and Susan re-examine their goals. Do they really want to manage a large organization?

7. What are other possible strategic alternatives? What recommendations would you suggest for Mark and Susan at this time? Is InterlandData a viable business?

InterlandData is not resistant to change and is open to strategic choices. Strategic planning takes place in an informal manner and the process is creative rather than structured. Being creative allows the organization the flexibility to move in several different directions but poses the risk of diffused energy or lack of strategic focus.

Growth by licensing does not seem to be a viable alternative. From the licensee's perspective, a licensee is seeking a company with unique and highly marketable products and services. InterlandData's product offering is not distinguishable from others in the industry. Even though the company gets high marks for service levels from clients, it has not been able to build a brand that would attract the volume of potential licensees necessary for licensing to become an effective growth strategy. In addition, as industry analysis revealed, the Web hosting is not an attractive industry. Furthermore, it seems that a person deciding to go into the business of Web hosting can easily do so without entering into a licensing arrangement. In the future, if the company finds that the industry is becoming attractive and the company has some unique products to offer, then it can evaluate to determine whether or not licensing might be a viable growth strategy for them.

Some students may suggest that one option for expansion is targeting a specific industry. Such niche strategy might narrow the gap between what Web hosting companies say their software will do and what a business actually needs it to do. Growth by niche strategy might also put less strain on the organization and still permit the owners to maintain close controls over operations. Students think one obvious target of special promise might be the restaurant market.

Few other students think that another option for expansion is to focus mainly on Web design market. However, there is not enough information contained in the case to examine the feasibility of focusing on Web design market.

More risk-prone students may desire to either diversify into the complete information technology (IT) solution or other types of services quite rapidly. Although diversifying outside of its core business can bring additional revenue for the company, it could be a major risk since owner/managers know little about the areas.

Now that the company is on its feet, they need to think about the future, especially about ways to create more customers. They need to research their markets thoroughly, define their target market very carefully, forecast their sales, and prepare a marketing strategy. They need to perform some experiments in order to test whether the business concept works. They have to find out which markets, the competitors in his area are ignoring, and which competitors are aggressively serving the market. As part of their market research, they have to look at how strong his competitors are. They also need to find out what complaints the customers register most.

Whatever alternative is considered, it is important that students be forced to address the implications regarding (1) revenue projection; (2) initial costs; (3) managerial resources; (4) organizational change and design; (5) systems and support; (6) marketing; (7) staffing; and (8) return on investment.

It is clear that money is a major problem for this company. While Mark and the company have a good reputation among existing customers, the profitability is limited. Students need to examine Mark and Susan's goals. What business are they in? What business do they want to be in? What do they want for themselves?

Another major obstacle to growth for IterlandData is the owners' unwillingness to relinquish the day-to-day operations of the business. They have determined that it will be necessary to expand the business in order to reach their long-term profit objectives. It is not clear that they have made the commitment to become managers as opposed to entrepreneurs. Hence they face the same issue that many small entrepreneurial organizations face: growth into a large entity that requires professional management more than entrepreneurship. Some students suggest that, if Mark and Susan are truly serious about reaching higher profit goals, they should go back to the drawing board and prepare a business plan. Such a plan would focus on (1) expanding both sales and profits at the existing operations, (2) expanding operations justified by marketing research, (3) attracting new investors, although Mark and Susan may be reluctant to share ownership with others, and (4) forming their board of directors, which they now seem to ignore entirely.

In addition, there are serious questions about the long-term viability of the company given its profitability levels to date. It has made only $15,182 in profit in the first eight years of its existence and the owners have taken very modest salaries, in part because they are committed to the success of the business. Certainly others not so committed might not be as willing to work as hard do Mark and Susan for so little reward.

8. Comment on Mark's and Susan's entrepreneurial and managerial qualities.

At the time of the case, InterlandData had only two managers: Mark and Susan. Mark seems to be more entrepreneurial than managerial. His strongest entrepreneurial trait seems to be self-confidence. After all, he majored in computer science in university and earned high marks as an early Internet service provider with IBM. It was this self-confidence that led him to believe he could strike off on his own and do better both financially and technically. Mark seems to be a take-charge, responsible, highly motivated entrepreneur. After nine years in business for himself, Mark reflects many of the qualities that distinguish successful entrepreneurs. He works hard, takes reasonable risks, and enjoys innovations and problem solving. Yet he really hasn't done well, at least not financially. In any single year he has yet to make as much money as he would otherwise have earned working for a large company. Why?

One answer may be that Mark seems to be a poor manager. True, he believes in a marketing plan concept, but he seems to fall short in one vital respect: execution. It seems doubtful that he faithfully carried out any marketing plan. Is he going after the right clients? In marketing their Web hosting services, what are other firms doing that InterlandData should be doing. Students generally admire Mark's determination to succeed. After nine years of just getting by, he is not about to give up. Unless he mends his managerial ways, however, he is unlikely to do much better.

Although Mark is a successful entrepreneur, he is less comfortable managing people and organization. He is more inclined toward creative development and technical problem solving. At the same time, however, he is reluctant to surrender responsibility or control of the company. Mark lacks in experience and perhaps in skill in the management of a dynamic company.

Susan is president of the company, and vice president of marketing. She is relatively experienced in management. The marketing position is one that is critical to the company's success. Susan's lack of the level of marketing experience required may impede her ability to meet the challenges of her position.

They need to bring experienced management into the company. But will Susan allow him/her to be the CEO?

9. If you were a venture capitalist, would you invest in the company? Why?

Despite the shaky financial condition of InterlandData, most students conclude that, they would invest in the firm. They are especially impressed with Mark's talents as a technical person and with his depth of concern about the quality of his work. He demands from himself the finest work of technical support, so that he guarantees his clients full satisfaction. He needs only to become a much better manager to succeed. There is some doubt whether the company would appeal to venture capital firms. For one thing, the company has not yet proved that it had a competent management team. For another, InterladData does not have anyone serving as board of directors. For still another, the company's projections of sales revenues and profits seem optimistic. These projections are all the more suspect in view of their strong intent to franchise the company before building a sound financial base. For that reason, perhaps more than any other, venture capital firms are not likely to finance their ambitious plans.

10. Can Mark and Susan afford to take the time to formulate a business plan themselves?

We may reasonably speculate that both founders have their hands full--Susan on the administrative side and Mark on the client relations and technical side. No other existing employees seem capable of taking over these responsibilities at this time. Moreover, the company cannot afford the risk of higher costs that might result if one founder took off to work on a business plan. Being so closely involved in the day-to-day operations of the business, they cannot take much time off, even to investigate related business opportunities. What was easy to launch becomes difficult to transform into a self-sustaining operation. Without capable employees, it may be impossible.

11. To what extent is this business delivering to Mark and Susan what they want in life?

While an analysis of a strategy for the company cannot exclude an analysis of its owners, this question is posed last so that students will analyze the economic factors impacting the business before examining the role of its managers. The instructor may ask, "Why isn't Mark rich?" or "Why does he continue to spend so much energy in the Web hosting business when he could probably make more money with less effort somewhere else?" Clearly Mark derives satisfaction and status from his position as business owner.

The main question that students should ask when conducting their final analysis is, "What is Mark's mission?" Here the instructor can merge the discussion of Mark's personal goals (status, respect, etc.) with his goal of having a profitable business.

DISNEY'S RESPONSE TO THE NEW GOVERNANCE LANDSCAPE

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CASE DESCRIPTION

The primary subject matter of this case is corporate governance, and The Walt Disney Company is used as an example of the strengths and weaknesses that can be found in governance systems. Secondary issues examined include CEO role duality, board independence, entrenchment, and succession planning. The case has a difficulty level of four and is most appropriate for undergraduate or graduate-level business education, either in strategic management or leadership. It is designed to be taught in 1½ class hours and is expected to require 1-2 hours of outside preparation. Specifically, students should first become familiar with the federally-legislated Sarbanes-Oxley Act of 2002 and would be well-served to read the case titled Michael Eisner and his Reign at Disney, which can be found in this issue. The case here seeks to demonstrate that what appears to be strong governance may in fact be a facade, by elucidating the subtle components of corporate governance that can slip under the radar but which are crucial if governance is to be effective. When is meeting the letter of the law enough, and how is that determined by shareholders?

CASE SYNOPSIS

This case discusses the corporate governance practices at The Walt Disney Company. It discusses the company's governance issues and mechanisms prior to the breakout of scandalous activity in corporate America, which began with the crisis at Enron in 2001. We discuss the years that immediately followed, with particular attention to the changes in the governance landscape – that is, the new expectations imposed on US businesses, either voluntarily or by federal legislation or stock exchange regulation. Among the topics discussed are board independence and board size, fees for services, succession planning, diversity, entrenchment, and CEO duality. We then address the steps that The Walt Disney Company has taken towards complying with these new rules, not only to highlight how far the company has come but also to show how much more needs to be done in order to restore investor confidence and corporate reputation. In a separate case in this issue, we discuss the conflicts that arose among the company's CEO and two of its board *members, which may have contributed significantly to negative perceptions regarding Disney's governance practices.*

INSTRUCTORS' NOTES

ASSIGNED QUESTIONS

1. **Review The Walt Disney Company's definition of board independence, which can be found on the company's website. Are there any inconsistencies in the way "insider" and "independent" are defined? Which directors could be seen as taking advantage of those loopholes?**

(Disney's definition of board independence appears below the response). The case stated that director Robert A.M. Stern did not qualify as independent, since he provided professional services to the company. Interestingly, George Mitchell, the other fees-for-services recipient and former US senator, was deemed independent and was subsequently appointed to the outsider position of presiding director. This has critics questioning the consistency with which the "independence" standards are enforced. Neither did Stanley Gold qualify as an independent director, although he did not receive fees for services rendered to Disney. His connection was to a Disney family member - Gold was President and CEO of a company owned by Roy Disney. Yet, as a result, Gold was no longer eligible to chair the Governance and Nominating Committee of the board.

Additional Instructor Information: According to the 2003 Proxy Statement, none of the members of the Compensation Committee have been officers or employees of the Company, but it makes reference to what might be considered possible exceptions. Committee member John Bryson's wife is an executive at Lifetime Entertainment Television, which is half-owned by Disney. Director Raymond Watson, whose son is employed at the Disney Channel, served on the Compensation Committee in 2002, as did Director Thomas Murphy, former Chairman and CEO of Capital Cities/ABC prior to its acquisition by the company in 1996. These relationships are disclosed in the company's proxy statements under "Relationships and Certain Transactions." It is reassuring; however, that Disney's governance overhaul included the removal of Watson and Murphy from the Compensation Committee.

2. **Using the Internet,research the events that led up to Congress enacting the Sarbanes-Oxley Act in 2002. In addition to the citations you find in your general search, explore the SEC website for information (www.sec.gov).**

Students should have no trouble using Google or AskJeeves for Internet searches of the events leading up to the Sarbanes-Oxley Act (e.g., typing "What events led up to Sarbanes-Oxley?" at www.askjeeves.com led to numerous links, some of which are summarized below). Students are probably familiar with the Enron scandal, but probably less familiar with some of the others that contributed to passing the Sarbanes-0xley Act, such as WorldCom and Global Crossing.

*From the SEC (http://www.sec.gov/about/laws.shtml) website:

> On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002, which he characterized as "the most far reaching reforms of American business practices since the time of Franklin Delano Roosevelt." The Act mandated a number of reforms to enhance corporate responsibility, enhance financial disclosures and combat corporate and accounting fraud, and created the "Public Company Accounting Oversight Board," also known as the PCAOB, to oversee the activities of the auditing profession. The full text of the Act is available at: http://www.sec.gov/about/laws/soa2002.pdf. You can find links to all Commission rulemaking and reports issued under the Sarbanes-Oxley Act at http://www.sec.gov/spotlight/sarbanes-oxley.htm.

Students may find it helpful to look at the Sarbanes-Oxley 101.com website (http://www.sarbanes-oxley-101.com/?gg=us&kw=sarbanes%20oxley%20act%20of%202002), which provides in-depth compliance information for corporations, as well as the following summary:

The Sarbanes-Oxley Act of 2002, sponsored by US Senator Paul Sarbanes and US Representative Michael Oxley, represents the biggest change to federal securities laws in a long time. It came as a result of the large corporate financial scandals involving Enron, WorldCom, Global Crossing and Arthur Andersen. Effective in 2004, all publicly-traded companies are required to submit an annual report of the effectiveness of their internal accounting controls to the Securities and Exchange Commission (SEC).

The major provisions of the Sarbanes Oxley Act (SOX) include criminal and civil penalties for noncompliance violations, certification of internal auditing by external auditors, and increased disclosure regarding all financial statements. It affects many public U.S. companies as well as non-U.S. companies with a presence in the U.S.

Senator Sarbanes, co-author of the Sarbanes-Oxley Act, addressed the American Law Institute on May 18, 2004. The following is a summary of his comments (http://www.ali.org/ali/R2604-04-Speakers.htm):

Senator Sarbanes recollected that, in response to the "crisis in investor confidence" resulting from the Enron and WorldCom business scandals, the Senate Banking Committee, of which he was Chair, held hearings for six weeks in early 2002 and identified various problems, including "inadequate oversight of accountants; lack of auditor independence; weak corporate-governance procedures; stock analysts' conflicts of interest," "inadequate disclosure provisions," and "grossly inadequate funding" of the Securities and Exchange Commission. He then explained how the Sarbanes-Oxley Act, which was signed into law in July 2002, addresses these problems by establishing effective oversight of accountants, assigning regulatory responsibility to a newly created Public Company Accounting Oversight Board, mandating auditor independence, setting corporate-governance standards, and requiring a broad range of disclosures.

Especially insightful are comments from an SEC commissioner who was involved in the historic legislation. The following is from a speech before the SIEPR Economic Summit: Assessment of the Sarbanes-Oxley Act Critical Issue Session by Cynthia A. Glassman, Commissioner, U.S. Securities and Exchange Commission in Stanford, CA on February 11, 2005 (http://www.sec.gov/news/speech/spch021105cag.htm):

Since the title of this panel is an "Assessment of Sarbanes-Oxley," I would like to set the stage with a brief overview of the climate and events that produced one of the most sweeping corporate governance reforms in history and led to the Sarbanes-Oxley legislation. What many may not realize is that certain of the core corporate governance reforms ultimately included in Sarbanes-Oxley were recommended by the SEC and President Bush's Ten-Point Plan to Improve Corporate Responsibility prior to the July 2002 enactment of SOx. While I believe certain of these reforms likely would have been implemented by the SEC even without SOx, it is undeniable that the scandals and climate focused Congressional attention on the problems and broadened the scope and certainly accelerated the timing of adoption of the reforms the administration and Commission had been advocating and proposing.

I am not going to dwell on the background, as you know it all too well. Starting in the mid-90s, we experienced the period Alan Greenspan referred to as "irrational exuberance," fueled in large part by investor interest in the entrepreneurs and dot.coms right here in the Silicon Valley. We saw retail investors participating in the markets as never before, each trying to get a piece of that next hot IPO. Unfortunately, beginning in the second quarter of 2000, the bubble burst, IPOs dried up, companies were being delisted left and right, and a new round of class action suits began.

It was in this period of shock and loss that we began to learn that some of the most successful companies, so we thought, were no more than a house of cards built upon a free-wheeling, "do whatever it takes" mentality to beat, or even just meet, the street's forecast of earnings per share for the quarter. The names Enron, WorldCom, HealthSouth and others became synonymous with fraud. In the end, we were left with investors filled with distrust and anger, and securities markets that resembled tires with the air let out of them -- a state of affairs completely contrary to the SEC's mission and goal of protecting investors and maintaining the integrity of the markets.

It was in this environment that I joined the Commission in January 2002. Very soon afterward, I became swept up in a flurry of proposed reforms expressed in the President's Ten-Point Plan, announced in March 2002 and in which the Commission was actively involved, as well as the numerous initiatives put forth by the Commission itself. I have put together a chart (see the Exhibit), distributed to each of you today, detailing these regulatory initiatives and proposals, many of which arguably served as a basis for, and were ultimately codified in, Sarbanes-Oxley. As you can see, five general themes or goals of needed reforms developed. I will discuss each in turn.

First was restoring confidence in the accounting profession. In June 2002, the SEC proposed a new, independent regulatory board which would require registration of any auditor of a public company. Inherent in the SEC's proposal was a recognition that certain deficiencies in the then-existing system of oversight of auditors, including peer review, contributed to the decline of investor confidence in financial information and the integrity of audits. At the time, the Commission called this new body a "Public Accountability Board." As codified by SOx, it became the Public Company Accounting Oversight Board, an organization that, as we originally proposed, is overseen by the SEC.

A second theme was improving the "tone at the top" of public companies. I have heard repeatedly of the collective looks of disbelief that occurred when, during the Congressional investigation of Enron, Jeff Skilling stated that he was 'simply' the CEO and not responsible for Enron's financial statements. Statements like this were a catalyst for the officer certifications required pursuant to SOx, a reform previously recommended by the President's Ten-Point Plan that called for CEOs to personally vouch for the veracity of their companies' financial statements. In June 2002, the SEC proposed that the principal executive and financial officers certify, on a going-forward basis, as to the accuracy of the information included in a company's annual and quarterly reports. Also in June 2002, prompted in part by the WorldCom announcement of its pending restatement due to the fraudulent inflation of its earnings by several billion dollars,1 the SEC ordered the principal executive and financial officers of the largest 947 public companies to certify, on a one-time basis, the completeness and accuracy of their companies' most recent financials. The certification requirement was then incorporated into the Sarbanes-Oxley legislation.

Third, we focused on improving disclosure and financial reporting. Beginning in December 2001, the SEC issued a series of statements regarding the use and disclosure of pro forma financial information, off-balance sheet arrangements and the effects of transactions with related parties. In June 2002, the SEC proposed amendments to Form 8-K to increase the number of "presumptively material" events requiring the filing of the form, as well as shortening the time period for filing. These initiatives were further codified in SOx under its provisions relating to off-balance sheet arrangements and non-GAAP measures, as well as requirements for disclosure, on a "rapid and current basis," of material changes in a company's financial condition or operations.

A fourth goal was improving the performance of gatekeepers. In addition to the SEC recommendation to establish an independent regulatory board to oversee the auditing profession, beginning in March 2002 the SEC commenced studies into the activities and effects of rating agencies in the capital markets, as well as the practices of analysts and the conflicts that can arise in the securities industry. These studies provided the basis from which we conducted a SOx-mandated study on credit rating agencies as well as SEC approval of new rules relating to analyst conflicts of interests proposed by the exchanges and Nasdaq.

And finally, enforcement tools were enhanced. The Ten-Point Plan, with the backing of the SEC, clearly called for an expanded focus on removing corporate officers who proved their unfitness to serve in leadership positions. Through the Corporate Fraud Task Force, established by the President in July 2002, the SEC began working with the Department of Justice and other governmental agencies in ways unprecedented to investigate and charge fraud. Congress responded to inter-agency requests for assistance in this initiative, with numerous provisions under SOX intended to enhance enforcement capabilities, including lowering the standard for imposing officer and director bars and increasing criminal penalties. ____ (The initial June 25, 2002 announcement by WorldCom stated that it intended to restate its financial statements by approximately $4 billion. The ultimate restatement, however, was approximately $11 billion.)

3. Evaluate the Disney board against the following governance components: age and diversity, and the number of other boards on which the directors serve.

Age: As of 2003 (or, for those no longer serving on the board, in their last year as a director), six are in their 70s, seven are in their 60s, five are in their 50s, and only two directors are under the age of 50, and those two are in their late 40s.

Diversity: The 2003 13-member Disney board has only two females (Judith Estrin and Monica Lozano), and has had only a total of five female directors since 1999. Only two directors since 1999 have been African-American (the actor Sidney Poitier, and the elementary school principal Reveta Bowers), and only two Hispanics have served on the board in that time (Igancio Lozano, Jr. and Monica Lozano). The information given in the case on the various directors does indicate, however, a greater level of diversity in terms of occupation and career experience. Students should note that some directors not only have business experience, but also considerable political connections, as well as contacts with educational institutions (however, Ms. Bowers was the principal of the elementary school formerly attended by the Eisner children, and Father O'Donovan is President Emeritus of Georgetown University, the alma mater of one of Eisner's sons and which was the recipient of over one million dollars from Eisner). Disney is also recognizing the need to equip the board with financial experience and fresh viewpoints, and to ensure that board members have adequate time to devote to their board responsibilities. Matschullat, the new appointee to the board and previous CFO of Seagram Company, Ltd., has the requisite experience in finance as well as in strategic planning, tax, accounting and risk management.

Number of other directorships: As illustrated in Exhibit 3, Disney directors have often had numerous other board memberships. Recently, however, Disney has decided to limit directors with full-time jobs elsewhere to serving on three public boards at a time, and directors who are retired from active employment are limited to six.

4. Select two or three of Disney's key competitors, such as Viacom, AOL Time Warner, and/or GE. Other competitors can be found in annual listings of the Fortune 500 companies, among other places.

a. Since 1996, Business Week has surveyed industry experts four times to create lists of the best and worst boards (the four issues were published in Nov. 25, 1996; Dec. 8, 1997; Jan. 24, 2000; and Oct. 7, 2002). How did Disney's rankings change over time? How did they rank compared to the key competitors you identified?

TIP: Although Disney has numerous competitors, Viacom and AOL Time Warner are especially powerful competitors. GE, as owner of NBC network, can also be considered a competitor in the broadcasting sector. The instructor may wish to simply assign these as the competitors to investigate, thus ensuring comparability across students. The instructor might also want to specify that the students compare these firms' 2002 and 2003 proxies.

In the 1996 Business Week ranking, Disney was ranked as the 14th worst board (score = 29.8 out of a possible 100 points), with the following stated under "Details": "Board too cozy, with 5 of 11 insiders, including two who draw fees from company." Time Warner was ranked as the 22nd worst board (score = 36.8 out of 100): "Investors unhappy with lagging performance; 1 director on 16 boards"). Viacom did not appear on either the best or worst list. In sharp contrast, GE was ranked as the second best board, with a score of 79.6: "CEO sits on one board: his. Each outside director owns more than $450K of GE stock."

In the 1997 list, Disney was ranked as the number one worst board, with a score of only 10.3 out of a possible 100 points! The table summarized their problems as "Investors decry board for conflicts; many directors own little if any stock," and the accompanying article goes into considerable detail. Time Warner was ranked as the 15th worst board (also moving in the wrong direction in the rankings, with a score of 33.5), and Business Week noted, "Many directors sit on too many boards; investors unhappy with performance." Viacom was not listed. GE was again the second best board (score = 74.7; "Won most votes in poll for best board; outside directors own lots of GE stock").

In the 2000 list, Disney was named worst board for the second time (score = 14.0; "Board reforms viewed as token gestures as Disney performance lags"). In this listing, Time Warner does not appear and, interestingly, the two AOL stars (Bob Pittman and Steve Case) of the newly formed AOL Time Warner are on the cover as "Men of the Century." Viacom was again not listed. GE was the now ranked as the number one best board (score =81.1; "Outside directors average $6.6million in GE stock. New recruits diversify a board of heavyweights").

In the October 7, 2002 list, actual scores on the rankings were not provided; however, Disney was named to the newly-created Most Improved list. Business Week noted, "Finally taking steps to improve a reputation for lousy governance. Under pressure from director Stanley P. Gold, manager of the Disney family fortune, and other shareholders, the company has severed business relationships with two directors. Tightened board's definition of independence. Recruited governance expert Ira Millstein to advise board" (p. 110). AOL Time Warner and Viacom are not included in the lists. GE was on the Best Boards list for the fourth time (and it is listed fourth in the listing this time; no score provided) with the following noted: "This talent-packed board, with an unrivaled record of creating shareholder value, remains a favorite with governance experts, although there have been recent revelations of lavish retirement perks for former CEO Jack Welch. The company is improving board independence; it recently added Ralph Larsen, former CEO of Johnson & Johnson and a longtime champion of good governance. The board recently moved to expense options" (p. 106).

b. Consider the issue of board independence. How do the criteria used by Disney's competitors compare to that used by Disney? When did board independence begin to be an issue for these companies? You will need to review proxy statements (especially the 2002 and 2003 proxy statements) which can be accessed from the SEC website (www.sec.gov).

TIP: The instructor might want to give the students a brief tutorial in using the EDGAR database on the SEC website (www.sec.gov). Students will find that this source is generally more historically complete than a company's website, which often only has the most current proxy statement. This exercise can also lead to a discussion of the various filings that a public firm has to make with the SEC, including proxy statements, 10-Ks, 10-Qs, and so forth.

Viacom. The student should find that Viacom's 2002 proxy statement does not even consider the topic of director independence. Apparently this was not a topic of concern until after the New York Stock Exchange began developing guidelines for board independence. Viacom's 2003 proxy statement describes the independence requirements for their directors as follows:

INDEPENDENCE OF DIRECTORS

In January 2003, the Board of Directors adopted Corporate Governance Guidelines (the "Guidelines"), addressing, among other things, guidelines to assist the Board in determining the independence of the Company's directors. The full text of the Guidelines can be viewed in the Corporate Governance section of the Company's website at www.viacom.com/shareholder.tin and a copy of the Guidelines can be obtained by sending a written request to Viacom Inc., 1515 Broadway, New York, NY 10036-5794, Attention: Investor Relations.

Pursuant to the Guidelines, the Board and the Corporate Governance Advisory Panel reviewed the independence of the director nominees in March 2003. During this review, transactions and relationships between each director nominee or any member of his or her immediate family and the Company were considered, including, among others, those reported below under "Compensation Committee Interlocks and Insider Participation" and "Related Transactions". The purpose of this review was to determine whether each director nominee met the applicable criteria for independence under the NYSE rules and the Guidelines.

As a result of this review, a determination was made that eleven of the seventeen directors nominated for election at the annual meeting are independent of the Company and its management. The eleven independent director nominees are: Messrs. Califano, Cohen, Gray, Greenberg, Leschly, McLaughlin, Salerno, Schwartz, Seidenberg and Walter and Ms. Stonesifer.

If the students try to follow the link given in the 2003 Proxy statement, they will find that that particular citation is no longer valid. Examination of Viacom's website as of September 2005 could only reveal the firm's current policy on board member independence (given below). By having the independence criteria only available online (as opposed to being clearly stated in the Proxy) limits our ability to monitor how (or if) this definition may have changed since originally developed in 2003. This should lead students to the realization that there are serious limitations to the Internet as a research tool.

As an additional assignment or in-class exercise, the students can examine the biographical information given in the proxy to try to determine why six of the Viacom directors were deemed as non-independent.

From Viacom's corporate governance guidelines on their website as of September 2005 (the site reveals that the guidelines were last revised as of June 14, 2005):

BOARD MEMBERSHIP CRITERIA

Directors of Viacom should be individuals with substantial accomplishments in their professional backgrounds, and should be current or former leaders in the important companies or institutions with which they are or have been affiliated. They should be able to make independent, analytical inquiries and should exhibit practical wisdom and mature judgment. Directors of Viacom are expected to possess the highest personal and professional ethics, integrity and values, and should be committed to promoting the long-term interests of Viacom's stockholders.

Independence. A majority of Viacom's directors will meet the criteria for independence established by the New York Stock Exchange (NYSE) corporate governance listing standards. Whether directors meet the criteria for independence will be reviewed annually prior to their standing for election to the Board and at such other times as the Board deems appropriate. The independent directors will be identified in Viacom's annual proxy statement. In accordance with the NYSE listing standards, a Viacom director will not be independent if any of the following relationships exist:

(i) the director is, or has been within the last three years, an employee of Viacom; (ii) an immediate family member of the director is, or has been within the last three years, an executive officer of Viacom; (iii) the director has received, or an immediate family member of the director has received for service as an executive officer, during any twelve-month period within the last three years, more than $100,000 in direct compensation from Viacom, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service); (iv) (A) the director or an immediate family member of the director is a current partner of a firm that is Viacom's internal or external auditor; (B) the director is a current employee of such a firm; (C) an immediate family member of the director is a current employee of such firm and participates in such firm's audit, assurance or tax compliance (but not tax planning) practice; or (D) the director or an immediate family member of the director was within the last three years (but is no longer) a partner or employee of such a firm and personally worked on Viacom's audit within that time; (v) a Viacom executive officer is, or has been within the last three years, on the compensation committee of a company which at the same time employed the Viacom director or an immediate family member of the director as an executive officer; or (vi) the director is an employee, or an immediate family member of the director is an executive officer, of a company that has made payments to, or received payments from, Viacom for property or services in an amount which, in any of the last three fiscal years, exceeded the greater of $1 million or 2% of such other company's consolidated gross revenues.

In addition, for a director to be considered independent under the NYSE listing standards, the Board must determine that the director does not have a material relationship with Viacom. The Board has established the following standards to assist it in determining what constitutes a material relationship:

If the types of relationships identified by the NYSE as set forth above that have a look-back period of three years occurred more than three but less than five years ago, the Board will consider whether a material relationship exists; if the relationship occurred more than five years ago, it will not be considered a material relationship that would impair a director's independence. In addition, if a relationship of the type described in (iii) above exists and the amount involved is less than $100,000, it will not be considered a material relationship that would impair a director's independence.

The following relationships will not be considered material relationships that would impair a director's independence: (i) the director is an executive officer or employee, or an immediate family member of the director is an executive officer, of a company that made payments to, or received payments from, Viacom for property or services in an amount which, in any of the last three fiscal years, is less than 1% of the annual consolidated gross revenues of such other company; (ii) the director is an executive officer or employee, or an immediate family member of the director is an executive officer, of a company which is indebted to Viacom, or to which Viacom is indebted, and the total amount of either company's indebtedness to the other is less than 1% of the total consolidated assets of such other company; and (iii) the director is an executive officer or employee, or an immediate family member of the director is an executive officer, of a tax exempt organization, and Viacom's contributions to the organization in the prior fiscal year are less than the greater of $500,000 or 1% of that organization's consolidated gross revenues.

For relationships that exceed the thresholds set forth above, the determination of whether the relationship is material or not, and therefore whether the director would be independent or not, shall be made by the directors who are independent. For example, if a director is the CEO of a company that is indebted to Viacom in an amount in excess of 1% of that company's total consolidated assets, the independent directors could determine, after considering all of the relevant circumstances, that such a relationship was immaterial, and that director would therefore be considered independent for purposes of the NYSE listing standards. Generally, types of relationships not addressed by the NYSE listing standards or otherwise described above will not cause an otherwise independent director to be considered not independent. However, the Board may determine that a director is not independent for any reason it deems appropriate. To the extent required by law or the NYSE listing standards, Viacom would explain in the next proxy statement the basis for any Board determination that a director was independent despite the fact that he or she did not meet or fit within the categorical standards for a material relationship set forth above. For purposes of this section, references to "Viacom" mean Viacom Inc. and its consolidated subsidiaries.

AOL Time Warner. Unlike Viacom, AOL Time Warner actually established the standard of having the majority of directors to be independent prior to the requirements imposed by the New York Stock Exchange. Unfortunately, the exact specifications for independence are not obtainable online, as they are included by being referenced (i.e., the firm's by-laws lay out the specifics of board independence).

From the 2002 Proxy statement:

The Company believes that, in the best interest of its stockholders, a majority of the members of its Board of Directors should, in the Board's judgment, be classified as "independent" pursuant to the Company's By-laws, which generally require the absence of any direct or indirect material economic relationship with the Company other than as a result of customary directors' compensation or stock ownership (such directors, the "Independent Directors" and all other directors, the "Affiliated Directors"). Under the Company's By-laws, when the Board sets the slate of director nominees for election at an annual meeting of stockholders, it must determine that a majority of its members will be Independent Directors, assuming the election of such slate. Assuming the election of these nominees, of the 15 directors, the Board of Directors has determined that 9 will be Independent Directors and 6 will be Affiliated Directors. The Company also has a policy limiting the eligibility for nomination by the Board of Directors as a director to those under 72 years old.

From the 2003 Proxy statement:

Independence. Under the Company's By-laws, a majority of the Board must be independent under the criteria set forth in the By-laws, and the Board has established as a goal that a substantial majority of the Board should be independent. The percentage of independent directors has increased since the consummation of the AOL-TW Merger (as defined below). In addition, the Board's policy requires that all of the members of the Nominating and Governance, Compensation, and Audit and Finance Committees must be independent.

As of September 2005, AOL Time Warner's website states the following:
Originally adopted by the Board of Directors in January 2002 and most recently revised in February 2005, the Corporate Governance Policy describes the principles and practices that guide the Board of Directors in carrying out its responsibilities. The Policy addresses subjects including the Board's composition, responsibilities, meetings and structure.

Mix of Inside and Independent Directors. Under the Company's By-laws, a majority of directors must be independent. It is the Board's objective, however, that a substantial majority of the directors shall be independent. On at least an annual basis (and whenever an individual is considered by the Nominating and Governance Committee for election as a director), management will collect information from the Company's records and, as appropriate, from the individual directors, to conduct an analysis of each current or prospective director's eligibility to be classified as "independent" under the Company's By-laws, Corporate Governance Policy, and applicable statutes and regulations (including applicable listing standards set forth by the New York Stock Exchange and rules and regulations issued by the Securities and Exchange Commission and Internal Revenue Service). This analysis shall address each individual's eligibility to be classified as "independent" for purposes of serving on the Board and on each of the Board's committees. This analysis shall be submitted to the Nominating and Governance Committee, which shall make a recommendation regarding each individual's independence to the full Board of Directors, which in turn shall make the final determination of each individual's independence.

As set forth in the Company's By-laws, the Board may establish categorical standards to guide it in determining whether an individual has a "material relationship" with the Company. The Board has adopted the following categorical standards, in addition to the standards for independence established under applicable statutes and regulations, which it may amend or supplement from time to time: Transactions (such as advertising, the purchase of goods and services, financing, and the purchase or sale of assets) between the Company and another entity with which a director or a member of a director's family is affiliated shall generally be deemed not to create a material relationship (i) if they occurred more than three years prior to determination of materiality or (ii) if they occur in the ordinary course of business and are consistent with other transactions in which the Company has engaged with third parties, unless (a) the director serves as an executive officer, employee, or substantial owner, or an immediate family member (as defined in the New York Stock Exchange's rules) is an executive officer, of the other entity and (b) such transactions represent more than 5% of the Company's consolidated gross revenues for the prior fiscal year or 2% of the other entity's gross revenues for the prior fiscal year.

Discretionary charitable contributions by the Company to established non-profit entities with which a director or a member of the director's family is affiliated shall generally be deemed not to create a material relationship (i) if they occurred more than three years prior to determination of materiality or (ii) if they are consistent with the Company's philanthropic practices, unless (a) the director or spouse is a executive officer or director of the organization and (b) the Company's contributions represent more than the greater of $100,000 or 10% of any individual organization's annual gross revenues (or the greater of $1 million or 2% of all such organizations' annual gross revenues in the aggregate).

The employment by the Corporation or any of its consolidated subsidiaries of a member of a director's family shall generally be deemed not to create a material relationship, other than employment at an annual salary of more than $50,000 per year of a director's current spouse, domestic partner, or child. Vested and non-forfeitable equity-based benefits and retirement benefits under qualified plans as a result of prior employment shall generally be deemed not to create a material relationship.

5. Entrenchment refers to the unchanging composition of the board, which can lead to stagnation and apathetic board performance, as opposed to the stimulation of ideas and diverse perspectives. Evaluate the extent to which the board and its committees are entrenched.

The description of board members indicates the extent to which directors remained on the board. Roy Disney has had the greatest longevity, with 36 years of service. His relationship to the family as Walt Disney's nephew is likely to have contributed to his initial nomination to the board. Michael Eisner has served on the board as its Chairman since he joined the company 19 years ago. This indicates longevity as well as CEO duality, which some say is a case of the "fox watching the henhouse", in that it may difficult to be objective in controlling managerial opportunism if he is both the head of the governing body and the top manager of the company. Bowers, Gold, I. Lozano, Russell, Stern, Watson, and Wilson have also served in the double digits, while it has been recommended that directors serve for no longer than 10 years. Of these, Gold, Watson, and Wilson still remained on the board following the company's annual meeting and re-elections in 2003. We can also discuss the extent to which the various committees may be entrenched. As shown in Exhibit 2, The Executive Performance Subcommittee and the Capital Stock Committee were not standing committees, as they only existed for two or three years. The Executive Committee has perhaps been the most entrenched over the past five years. Each of its five members has served on the committee for the entire period, which the exception of Irwin E. Russell, who retired from the board in 2001. Further, Watson remained Chairman for those five years. There appears to have been more rotation on the Compensation Committee, and the chair rotated in the last of the five years as well. It should be noted, however, that Thomas Murphy's chairmanship from 1999 to 2002 is in violation of the standards for complete committee independence on this committee, which the NYSE requires. However, the change in leadership here may have been due to the new regulations, or perhaps in anticipation of them. Similarly, the Audit Committee has not been entrenched. Twelve separate directors have served on this committee over the past five years, with rotating chairmanship as well. Again, Murphy was the only insider to serve, and again only until 2002. In looking at the Nominating Committee, we can see that Stanley P. Gold was its Chairman from 1999-2002. He may have served longer, had the board not excluded him from independence based on his connection to Roy Disney and to Shamrock Holdings, where his daughter is employed. Recall that the NYSE, where Disney is listed, requires a fully independent Nominating Committee.

6. Briefly examine investor confidence in Disney at the end of 2003. Compare Disney to the market-has it suffered in the past few years? What might be expected in the next 2-3 years given the corporate governance issues facing the company?

Disney is not the only company to endure the backlash of substandard governance. It has been in good company, alongside Apple Computer, H.J. Heinz and AT&T in the Business Week rankings of corporate boards. Thanks to companies such as Enron, Tyco, and Worldcom, governance scrutiny has tightened. Disney has made many changes to its governance structure, some even before the Enron implosion, and many more after. But at the close of 2003, the question remains as to whether or not Disney has made enough change in its governance structure. The sudden resignation of Roy Disney and Stanley Gold has created a dramatic stage for future Disney actions. Obviously Disney has been underperforming for a number of years. Eisner's future probably will be closely tied to the success of Disney - much more so than in the last six years. With a stronger (if not perfect) board, he is less likely to retain his unassailable position unless Disney soon returns to its glory days. Disney has had poor governance in the past, but even being named to Business Week's worst board lists in 1996 and 1997 had little real fallout for Eisner -- it was only when Disney's share prices began to drop that there was serious investor unrest.

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ALZA CORPORATION: A CASE STUDY CONCERNING R&D ACCOUNTING PRACTICES IN THE PHARMACEUTICAL INDUSTRY

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CASE DESCRIPTION

The primary subject matter of this case concerns variable interest entities (VIEs), accounting for research and development (R&D) arrangements, and consolidated financial statements. The case has a difficulty level of four for five, appropriate for senior or first-year graduate level. The case is designed to be taught in one class hour and is expected to require three hours of outside preparation by students.

CASE SYNOPSIS

This case illustrates the innovative off-balance sheet financing techniques used by ALZA Pharmaceuticals Corporation in the 1990s to fund its R&D activities. The case shows that, although ALZA technically adhered to generally accepted accounting principles (GAAP) in effect at the time, its financial statements failed to reflect economic reality by overstating revenues and net income. The case is a prime example of how accounting for VIEs prior to current GAAP failed to capture economic reality. The case details two of ALZA's R&D funding arrangements, illustrates the accounting practices used to capture them, and evaluates the manner in which their results were reported in the financial statements. Furthermore, the accounting and reporting procedures used will be compared to those required by ARB No. 51, Consolidated Financial Statements, FASB Interpretation No. 46(R) Consolidation of Variable Interest Entities—an Interpretation of ARB No. 51, and EITF 99-16, Accounting for Transactions with Elements of Research and Development Arrangements. This comparison will help students understand the relevance and need for the new pronouncements.

INSTRUCTORS' NOTES

In a strategy decision to become a fully-integrated pharmaceutical company, ALZA Pharmaceutical Corporation devised two off-balance sheet R&D arrangements. The first was Therapeutic Discovery Corporation (TDC), which operated from mid-1993 through 1997. The second was Crescendo Corporation, which operated from 1997 through 2000. In both arrangements, ALZA invested cash in the corporations, issued stock in the new corporations to ALZA stockholders, and performed R&D activities for the new corporations. Amounts invested in the new corporations flowed back to ALZA and were recorded as R&D revenue. Since ALZA was recording both the revenue received from TDC and Crescendo and its own expense, the company claimed that the impact on income was not significant.

This case reviews the journal entries made to record the investments in TDC and Crescendo and leads students through an evaluation of ALZA's claim that the arrangements had an insignificant impact on its reported net income. This case illustrates that ALZA's assertion is not an accurate assessment of the impact of the arrangement. Without the R&D arrangements, ALZA would simply be recording R&D expense as it was incurred, thereby reducing net income by the amount of R&D expense. Using TDC & Crescendo arrangements, ALZA recorded both revenue and expense, thereby eliminating the reduction of net income for its R&D expense. Students are asked to evaluate ALZA's accounting and reporting procedures in light of ARB No. 51, *Consolidated Financial Statements*, FASB Interpretation No. 46 (R) *Consolidation of Variable Interest Entities—an Interpretation of ARB No. 51,* and EITF 99-16, *Accounting for Transactions with Elements of Research and Development Arrangements*.

The following pages explain and provide details about the suggested answer to each question asked in the case.

DISCUSSION QUESTIONS

1. What effect did the TDC and Crescendo arrangements have on ALZA's R&D reported on the income statement? What were the balance sheet effects?

Table 1 provided in the case and reproduced below shows the Product Development Revenue recorded on the books of ALZA and the R&D Expense recorded on the books of TDC during the years 1993 through 1997. As shown, the total revenue recorded by ALZA was \$275.1 million while the total expense recorded by TDC was \$254 million. When preparing its consolidated financial statements, ALZA did not include the assets, liabilities, equity, revenue, or expense accounts of TDC; therefore, the financial results reported in TDC's financial statements were not reflected in ALZA's consolidated financial statements.

Table 1: Comparison of ALZA R&D Revenue and TDC R&D Expense (in millions)						
	1993	1994	1995	1996	1997	Total
ALZA's Product Development Revenue from TDC	$4.9	$31.6	$70.1	$100.7	$67.8	$275.1
TDC's R&D Expense to ALZA	$4.9	$31.6	$68.9	$100.0	$48.6	$254.0

Table 2 provided in the case and reproduced below shows the product development revenue recorded on the books of ALZA and the R&D expense recorded on the books of Crescendo. At first glance, the numbers seem to be confusing since Crescendo's expense exceeds ALZA's revenue in all but the final year. Apparently there were some timing issues regarding ALZA's recording of product development revenue and Crescendo's recording of R&D expense. Over the term of the agreement, ALZA recorded total product development revenue of $283.5 million, and Crescendo's recorded total R&D expense of $278.2 million. As with TDC, ALZA did not incorporate the assets, liabilities, equity, revenue, or expense accounts of Crescendo in its consolidated financial statements.

Table 2: Comparison of ALZA R&D Revenue and Crescendo R&D Expense (in millions)					
	1997	1998	1999	2000	Total
ALZA's Product Development Revenue from Crescendo	$29.7	$95.0	$90.5	$68.3	$283.5
Crescendo's R&D Expense to ALZA	$32.3	$106.0	$97.7	$42.2	$278.2

Over the life of both TDC and Crescendo, ALZA recorded total Product Development Revenue from the two companies of $558.6 million ($275.1 + $283.5). TDC and Crescendo reported total R&D expense of $532.2 million ($254.0 + $278.2). Since, however, ALZA did not consolidate TDC's and Crescendo's operating results with its own, ALZA increased its revenue by $558.6 million and recorded its own R&D expense on its own books. The R&D expense recorded by TDC and Crescendo was not reported in ALZA's financial statements. The effect was to overstate revenues and net income. The overstatement of income by these transactions was mitigated by the one-time charge to ALZA's earnings of $247 million recorded in the Crescendo transaction.

2 Do you agree with the claim in ALZA's financial statement footnotes that there was no income effect of the transactions with TDC and Crescendo? Why or why not?

Table 3 reproduced below shows students the amount of R&D revenue, the amount of R&D expense, the one-time charge to income for the creation of Crescendo, and net income reported in ALZA's financial reports for the years 1993 through 2000. In addition, the amount of revenue received from TDC and Crescendo is shown.

Table 3: Items Included in ALZA's Financial Reports (in millions)

	1993	1994	1995	1996	1997	1998	1999	2000	Total
*Total R&D Revenue	$46.8	$68.7	$104.0	$131.2	$135.0	$124.4	$120.8	$100.1	$831.0
Total R&D Expense	53.1	76.1	103.4	141.6	156.8	182.8	183.6	190.8	1,088.2
Net R&D Expense	$6.3	$7.4	($.6)	$10.4	$21.8	$58.4	$62.8	$90.7	$257.2
One-Time Crescendo									
Charge to Income					$247.0				
Net Income	$45.7	$58.1	$72.4	$92.4	($261.1)	$108.3	$91.0	$223.3	$430.1
**Total R&D Revenue includes the following amounts from TDC and Crescendo:*									
TDC & Crescendo Revenue	$4.9	$31.6	$70.1	$100.7	$97.5	$95.0	$90.5	$68.3	$558.6

ALZA's financial reports also stated, however, that when the revenue the company recorded from TDC and Crescendo was netted against its own R&D expense, the activities did not contribute significantly to operating results. This is not an accurate assessment as demonstrated in Table 4 (not provided to students).

Table 4: ALZA Net Income After Eliminating Effects of TDC & Crescendo Transactions (in millions)

	1993	1994	1995	1996	1997	1998	1999	2000	Total
ALZA Net Income as Reported	$45.7	$58.1	$72.4	$92.4	($261.1)	$108.3	$91.0	$223.3	$430.1
Less: TDC and Crescendo Revenue	4.9	31.6	70.1	100.7	97.5	95.0	90.5	68.3	558.6
Plus: Crescendo One-Time Charge					247.0				247.0
ALZA Revised Net Income	$40.8	$26.5	$2.3	($8.3)	($111.6)	$13.3	$0.5	$155.0	$118.5

Table 4 shows the amount of ALZA's reported net income as reported for each of the eight years 1993 through 2000. Then, the R&D revenue received from TDC and Crescendo is subtracted to show the actual net income for those years. Notice that the one-time charge against ALZA's net income in the year Crescendo was formed has been added back to 1997 when computing revised net income. Eliminating intercompany revenue significantly reduced ALZA's net income in the years affected. In fact, rather than cumulative earnings of $430.1 million over the eight years, the company actually had cumulative earnings of $118.5 million.

Table 4 shows that the TDC and Crescendo arrangements effectively allowed ALZA to avoid recognizing the impact on net income of the R&D expense associated with the TDC and Crescendo development projects. In addition, ALZA overstated revenue by $558.6 million, the amount received from TDC and Crescendo. Net income was overstated by a total of $311.6 million ($430.1 - $118.5) over a period of eight years. ALZA's accounting for its R&D arrangements allowed the company to take funds off its balance sheet, place them in controlled investment vehicles, and then bring them back into the company recognizing them as revenues to offset current R&D expenses.

Clearly, failing to consolidate the operations of TDC and Crescendo caused ALZA's revenue and net income to be overstated by a significant amount. The consolidation procedure would have offset the R&D revenue recorded on the books of ALZA against the R&D expense recorded on the books of TDC and Crescendo. In other words, ALZA's product development revenue should not have been offset against its own R&D expense; rather, it should have been offset against TDC's and Crescendo's R&D expense leaving a net effect equal to the R&D expense incurred by ALZA. Stated yet another way, ALZA included TDC and Crescendo revenue in its financial statements, while failing to include TDC and Crescendo expense.

3 What is earnings management? Do you believe ALZA used TDC and Crescendo to manage its earnings? Explain.

Several definitions of earnings management exist. Schipper (1989, p. 92) defines it as a "purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain (as opposed to say, merely facilitating the neutral operation of the process)." Healy and Whalen (1999, p. 368) define it as "when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting numbers." Earnings management negatively impacts the quality of earnings if it occurs to such an extent as to impair the usefulness income statement to predict future earnings. It must be stated that ALZA did not technically violate GAAP (although it did circumvent the intent of GAAP), and ALZA, TDC, and Crescendo all received clean audit opinions. The fact still remains, however, that the manner in which ALZA reported its R&D activities in its financial statements eliminated the reduction in income that its R&D expense should have caused. ALZA used TDC and Crescendo to manipulate income by overstating revenues.

Table 4 illustrates that the TDC and Crescendo arrangements effectively allowed ALZA to avoid recognizing the impact of R&D expense on net income. In addition, ALZA overstated revenue by the total revenue by $558.6 million, the amount received from TDC and Crescendo. Net income was overstated by a total of $311.6 million over a period of eight years. ALZA's accounting for its R&D arrangements allowed the company to take funds off its balance sheet, place them in controlled investment vehicles, and then bring them back into the company recognizing them as revenues to offset current R&D expenses.

Since the SEC allowed the TDC dividend to be charged to paid-in capital and retained earnings, the arrangement essentially turned cash into retained earnings by overstating income for 1993 through 1997. The effect of R&D expense for certain projects was erased from earnings. Not only did ALZA's bottom line remain intact (as opposed to decreasing it for R&D expense), its top line actually improved because of its own cash flowing back as revenue.

The SEC required the Crescendo agreement to be recorded as a one-time charge to income (Sellers 2000). Therefore, ALZA was forced to record a large earnings reduction in the year of Crescendo's creation, but that reduction was recovered through overstated earnings from 1997-2000. To the extent analysts tend to disregard one-time charges, the 1997 charge may not have been a severe penalty for ALZA. Clayman (1995) suggests that companies with infrequent one-time charges are not necessarily penalized in the market and, depending on the nature of the charge, may outperform the broad index.

4. What is meant by the term "off-balance-sheet financing"? Would the TDC and Crescendo arrangements constitute off-balance-sheet financing? Why or why not?

Off-balance-sheet financing is an attempt to borrow money in such a way that obligations are not recorded on a company's balance sheet (Kieso, Weygandt, and Kimmel 2004, p. 689). The TDC and Crescendo arrangements do not represent off-balance-sheet financing in that ALZA was not excluding debt from its balance sheet. They are off-balance-sheet arrangements, however, that did allow ALZA to remove the effects of R&D expense from its income statement.

The primary reasons for off-balance sheet financing are to make the financial statements more attractive and to manage income tax positions (Gamble 1997). The financial community is divided on whether off-balance sheet arrangements mislead financial statement users. Many creditors prepare adjustments for common off-balance sheet arrangements such as leasing. However, the TDC and Crescendo arrangements are much more sophisticated and certainly much less transparent.

The creation of TDC and Crescendo did not change ALZA's fundamental R&D activities. The R&D could have been conducted by ALZA with or without the two spun off entities. Why then were the two entities created? One reason not mentioned in the case is that ALZA received a tax benefit by sheltering royalty income on its tax return by using TDC losses (Moukheiber 1999). Another reason is that the TDC and Crescendo arrangements significantly enhanced ALZA's revenues and net income.

5. Refer to ARB No. 51, *Consolidated Financial Statements*. According to that statement, when should consolidated financial statements be presented? Do you think those requirements were met with the TDC and Crescendo arrangements? Why or why not?

According to Accounting Research Bulletin (ARB) No. 51 (AICPA 1959), *Consolidated Financial Statements,* the purpose of consolidated financial statements is to present the results of operations and the financial position of a parent and subsidiary as if they were one entity (paragraph 1). Doing so benefits shareholders and creditors. ARB No. 51 states that, usually, controlling interest is evidenced when one company owns a majority voting interest in the other (paragraph 2). In addition, the Bulletin states that consolidated financial statements should be presented when one company ***directly or indirectly*** (emphasis added) owns a controlling interest in the other (paragraph 1). Therefore, even though ALZA did not have controlling interests as evidenced by a majority voting interest, the company clearly controlled the operations of TDC and Crescendo. ALZA directed the projects that were to be researched, possessed the power to block any impairment of its rights regarding TDC and Crescendo, and maintained the right to purchase the TDC and Crescendo shares upon dissolution of the two organizations. Therefore, ALZA may have met the letter of prescribed GAAP, but did not adhere to the intent of ARB No. 51. According to the intent of ARB No. 51, both Crescendo and TDC should have been included in ALZA's consolidated financial statements.

6. Refer to FASB issued Interpretation No. 46(R) *Consolidation of Variable Interest Entities—an Interpretation of ARB No. 51*. What is the definition of the term variable interest entity? Would TDC and Crescendo be classified as variable interest entities? Why or why not?

In recent years, more and more companies have circumvented the intention of ARB No. 51 by using special purpose entities (SPEs) to provide off-balance sheet financing. These SPEs are structured to avoid giving the controlling company voting rights; rather, financial interest is achieved through arrangements not involving voting interests.

The increasing prevalence of unconsolidated SPEs has resulted in many cases of misleading financial statements. To address the problem, the FASB issued Interpretation No. 46(R) (FASB 2003) *Consolidation of Variable Interest Entities—an Interpretation of ARB No. 51*. Interpretation No. 46(R) uses the term variable interest entity (VIE) instead of SPE to more clearly define and include all entities that are subject to the intent of the Interpretation. Regardless of whether the entity is a corporation, partnership, or trust (paragraph 3), it qualifies as a VIE and is subject to consolidation if the equity of the VIE is not sufficient to permit it to finance its activities without subordinated financial support from other parties ***or*** if equity investors lack the ability to make decisions about the VIE's activities, are not obligated to absorb VIE losses, or will not receive residual VIE returns (paragraph 5). Stated another way, if an enterprise will absorb a majority of a VIE's expected losses or receive a majority of a VIE's residual returns, that enterprise must consolidate the VIE. A strong indication that an enterprise possesses one or both of these characteristics is present if the enterprise has the direct or indirect ability to make decisions that significantly affect the results of the activities of a VIE.

Therefore, had FASB Interpretation No. 46(R) been in effect during the operation of TDC and Crescendo, both would have been classified as VIEs. ALZA clearly controlled TDC and Crescendo. ALZA selected the projects for research and development, maintained the right to patent resulting products, and prohibited TDC and Crescendo from patenting rejected products. ALZA shared employees with TDC and Crescendo. Both companies owned no facilities, leased corporate offices from ALZA, received administrative services from ALZA, and were dependent on ALZA for its operating and accounting systems. TDC and Crescendo were prohibited from licensing its products to any company other than ALZA. Finally, as sole owner of Class B Common Stock, ALZA could block any action that might impair ALZA's rights or increase TDC's or Crescendo's authorized capitalization without ALZA's permission. Finally, ALZA held an option to purchase all of TDC's and Crescendo's Class A Common Stock, the holders of that stock had nothing invested since it was distributed to them in a property dividend. Therefore, they bore no risk of loss of their investment since they had no investment.

7. **Summarize the content and purpose of EITF 99-16, *Accounting for Transactions with Elements of Research and Development Arrangements*. Has this standard effectively shut down the off-balance sheet strategy used by ALZA in this case?**

The Issue prescribes the accounting for arrangements such as those ALZA made with TDC and Crescendo. The Issue specifically addresses transactions where a sponsor capitalizes a new company with cash and technology rights in exchange for Class A and Class B stock. The Class A stock is distributed to the sponsor's shareholders subject to a purchase option, while the Class B stock is retained which carries no voting rights but does carry certain blocking rights. The sponsor subsequently performs research and development activities for the new company. The Task Force noted that the accounting prescribed has the essentially the same effect as requiring consolidation of the new company by the sponsor.

The Task Force concluded that the sponsor should treat the cash paid for the new company Class A stock as restricted cash and recognize research and development expense as they perform the research and development activities. The distribution of the new company Class A stock should be treated as a dividend to common stockholders of the sponsor based on the fair value of the stock at the time of distribution. Furthermore, the new company Class A common stock should be presented on the sponsor's balance sheet in a similar manner as minority interest.

Had EITF 99-16 been in effect at the time of the formation of TDC and Crescendo, ALZA would have debited restricted cash for $250 million and $300 million respectively. At the same time, the company would have debited dividends and credited an account similar to minority interests in the amount of each stock's fair market value ($44.9 million for TDC and $57.7 million for Crescendo).

EITF 99-16 requires that, as R&D activities are performed by the sponsor, R&D expense is recognized. Rather that recognizing revenue from the new company, however, the sponsor credits restricted cash. If this EITF had been in effect, therefore, ALZA would not have credited R&D revenue, and the overstatement of revenue would have been avoided. The Task Force noted that the accounting prescribed has the essentially the same effect as requiring consolidation of the new company by the sponsor.

During the last year of Crescendo's existence the FASB's Emerging Issues Task Force completed discussion on EITF 99-16. The conclusions of the EITF applied to research and development arrangements consummated after May 18, 2000, and to existing research and development arrangements in which a commitment to provide funding is made after May 18, 2000. It has effectively shut down the off-balance sheet strategy used by ALZA in this case.

8. Refer to Statement of Financial Accounting Standard No. 141, *Business Combinations*. How might the enactment of this standard have influenced the timing of Johnson & Johnson's acquisition of ALZA?

In 2001, about a year after Crescendo was dissolved, ALZA merged with the Johnson and Johnson family of companies in a tax-free reorganization treated as a pooling of interests for financial reporting purposes. A pooling of interests avoids revaluing the investee's assets to fair market value on the date of combination. In addition, goodwill is not recognized, and all revenues and expenses of the investee are combined with those of the investor regardless of the date on which the combination was effected.

FASB 141 did away with the pooling method of recording business combinations. Effective for all business combinations initiated after June 30, 2001, all business combinations must be recorded using the purchase method. Under the purchase method assets (including goodwill and other intangibles) and liabilities of the investee are reported at their fair market value on the date of purchase. In addition, the only income consolidated with the parent's is the income earned after consolidation.

Whether the enactment of SFAS No. 141 influenced the timing of Johnson and Johnson's acquisition is speculative, of course. The pooling method, however, was used, and the combination was effected shortly before SFAS No. 141 became effective.

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KOMBAR REX: ADVENTURE FILM PRODUCERS

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CASE DESCRIPTION

The primary subject matter of this case concerns the interpretation of contracts and the calculation of revenue. Secondary issues examined include distinguishing cash flow vs. GAAP (Generally Accepted Accounting Principles) income, understanding the timing of revenue recognition and understanding how to budget revenue. The case has a difficulty level of three (appropriate for junior level). The case is designed to be taught in 1-1.5 class hours and is expected to require 3-5 hours of outside preparation by students.

CASE SYNOPSIS

In this case study, students must examine a film distribution agreement to determine its validity, scope and consequences. Adventure Film Producers entered a movie distribution agreement with a large movie theatre chain, Mammoth Theatres, Inc. One of Adventure's "hit" movies was bundled with four "filler" films, each requiring a certain number of screenings. Consideration for the contract was based partly on lump sum payments and partly on the number of screenings. In exchange, the distributor was given exclusive screening rights. After the distributor discovered that the films were being shown in Canada (where Mammoth had no theaters) they alleged that Adventure breached the agreement and demanded a return of all monies paid. Students must examine whether Adventure breached the exclusivity provision of the contract by allowing showings in Canada and must then perform the financial analyses to determine revenues. In order to analyze revenue, students must prepare a budget of expected minimum revenues, apply established revenue recognition criteria, and calculate the reportable revenue using GAAP principles. Students then prepare a schedule showing cash flow and distinguish that number from revenue.

INSTRUCTORS' NOTES

SUGGESTED SOLUTIONS

1. Did Adventure breach the contract? Specifically discuss whether the showing by a competitor movie chain in Toronto constituted a violation of the Adventure/Mammoth agreement.

The discussion should focus on the scope of the distribution agreement. Specifically looking at the Exclusivity paragraph of the contract, what was the geographic limitation of the agreement? If Mammoth was granted an exclusive license to distribute the Kombat Rex films anywhere in the world for the six month period, then Adventure Films' conduct of granting distribution rights of the movies to a theatre in Toronto would be In violation of that agreement. On the other hand, we need to look at what the parties intended. Since Mammoth had theaters located only in the U.S., is it reasonable to interpret the agreement as granting Mammoth exclusive distribution only in the U.S.?

Briefly, there should be a discussion of how, despite the ambiguity about the relevant territory, there is really no question that the parties intended a contract. There should be some reference to DeSantis or Bohman in the library materials to the effect that the parties reasonably intended to be bound (and base their business expectations) on the enforceability of the contract, and a court will enforce the contract with its interpretation of the parties' reasonable expectations.

Mammoth will argue that Adventure Films was barred from allowing the Toronto theater to screen the films. In support of that point, Mammoth can argue that the plain language of the contract contains no geographical limitation. Since an important purpose in entering the contract (and for which Mammoth presumably paid a premium) would be the sole right to screen the film, and since the plain language of the agreement contains no restriction on the geographical region, then Adventure Films breached the agreement by allowing a Canadian theater to screen the films. The Morey case and Witkin (from the Library materials) would be relevant in identifying that the objective manifestations of the parties' intent is to be used to interpret the contract.

Adventure Films would argue that since Mammoth had theaters only in the U.S., and not Canada, their agreement was, by implication, limited to the U.S. Of what business purpose would it be to Mammoth to have an exclusive contract in a country in which they had no theaters? A logical reading of the contract (Adventure would argue) would be that the contract's exclusivity clause applied only to areas in which Mammoth had theaters, i.e. the U.S. Adventure would use Morey for the proposition that not only the objective language of a contract but also the parties' object in the contract should be used in determining its meaning. Surely Mammoth's object must have been to limit competition in areas in which Mammoth theaters were located.

It would frustrate no business purpose of Mammoth to allow a Canadian theater to show the films, since Toronto is not close enough to any American market that would draw viewers who might otherwise see the film in the U.S. The same could not be said, for example, if the theater were in Windsor, Canada (on the border near Detroit); however, Toronto is obviously not a destination to which one would travel just to see a movie. Therefore, it is consistent with a logical interpretation of the agreement's purpose to limit the exclusivity to areas in which Mammoth had legitimate concerns about competition, i.e. the U.S. or immediately adjoining areas. Mammoth would use Levi Strauss to support their argument that the contract means what the parties designate; agreements are not re-made by courts and that therefore the broad language apparently granting Mammoth worldwide filming rights should be enforced. Adventure would counter that Cal Civ. Code §1648 and Rivers show that contracts extend only to those things intended by the parties (no matter how broadly written), which, according to Adventure Films, would be the U.S. theater market.

2. Assuming the contract is valid, prepare the following financial analyses:

a. Prepare a budget of expected minimum revenues from the set of five films over the term of the contract.

Expected Minimum Revenue					
Film/Fee	# of Theatres	# of showings per contract	Total contracted showings	Revenue per showing	Budgeted Revenue
Kombat Rex	475	42	19,950	$500	$9,975,000
KR II	475	18	8,550	$500	$4,275,000
KR III	475	18	8,550	$500	$4,275,000
KR IV	475	18	8,550	$500	$4,275,000
KR V	475	18	8,550	$500	$4,275,000
Contract Fee					$5,000,000
Total Budgeted Revenue			54,150		$32,075,000

b. What are the general revenue recognition criteria established under Generally Accepted Accounting Principles (GAAP)?

Per GAAP, for revenue to be recognized, it must be realized or realizable and earned

Realized or realizable means that the amounts being recognized as revenue have been received in cash or your company has a claim to cash through a receivable. The receivable must be from a company with a good credit rating; that is, the receivable must be collectible.

Earned means that your company has performed the most important tasks to be entitled to the revenue. Usually this means that you have delivered merchandise or rendered a service to a customer and title has legally passed for the merchandise to the buyer or the buyer is legally obligated to pay for the service received.

c. How would you apply the GAAP criteria for revenue recognition to account for the revenues under this contract? Explain your logic for both realizable and earned.

It is difficult to apply the GAAP criteria to this contract for several reasons.

First, the contract isn't exactly clear what the $5,000,000 fee is for. Presumably, it relates to providing Mammoth the exclusive right to show the set of films in its theatres. If so, then although all of the $5,000,000 is realized by 12/31/3, it isn't earned until Mammoth gains exclusive use for a full six months. Given that logic, you might divide the $5,000,000 by six months and recognize it evenly with the passage of time over the six-month period. Others might argue that the $5,000,000 was simply an inducement for signing the contract; they will want to recognize it all as revenue when it is received in cash. Some students may want to postpone recognition until the entire 6-month period is over and Adventure has fulfilled its part of the contract.

Industry rules written by the American institute of Certified Public Accountants (not available to students, but you might want to mention these at the end of the presentation and discussion) suggest that the amount can be recognized:

1. with the passage of time (divide by 6 months and recognize $833,333 per month)
2. or with the showing of the films (for example, 10,925 at year end divided by 54,150 minimum showings expected under the contract times $5,000,000 or $1,008,772 would be recognized by 12/31.)

The other difficulty with the revenues under this contract is the number of times that Mammoth reports showing the films at 12/31/03. They have only shown 10,925 movies of the 54,150 total showings expected. It seems that they may not be meeting the contract terms to show each KRII-V 18 times per 42 showings of Kombat Rex. In the four months, Kombat Rex has been shown 8,550 times. That is approximately 42.8% of the total showings allowed (19,950). That means that approximately 14,638 showings of KRII-V should have occurred (34,200 in total times 42.8%.) This creates a dilemma. Adventure needs a report that shows if each theatre has lived up to the contract terms to show each of the lesser films 18 times while showing Kombat Rex 42 times. If they haven't (and they don't intend to do so), then Adventure may be owed more money than they were paid in January or perhaps Mammoth has breached the contract.

Regardless of how the audit of the number of showings comes out, the $5,462,500 shown on the 12/31/03 summary is a receivable at year-end. In fact, it was paid in January 2004, so the receivable did exist. These facts mean that this amount meets the realizable test for revenue recognition. In addition, that amount was also earned, since Adventure provided Mammoth with the films for showing and Mammoth showed the films.

d. Using the logic you developed in part c, calculate the revenue that Adventure Films should report for the set of five films for the year ended 12/31/2003.

Assuming that the $5,000,000 will be recognized evenly over 6 months and that Mammoth does have a plan at 12/31/03 to show each film the required minimum times in the remaining months of the contract, I would recognize:

Revenue	Calculation	Total
Fee	$5,000,000/6 * 4	$3,333,333
Film Showings	Given in Mammoth's table	$5,462,500
Total revenue from contract at 12/31/03		$8,795,833

Notice that Adventure cannot anticipate additional revenues until they audit a theatre-by-theatre schedule of movies shown and scheduled. Accountants want to be conservative when they recognize revenues.

e. For the year ended 12/31/2003, prepare a schedule that shows the cash flows received from Mammoth for the contract.

Source	Explanation	Amount
Fee	Received on contract signature and September 1	$5,000,000
Films	Received by Adventure in January 2004	0
Total cash received		$5,000,000

f. Why do cash flows and revenues recognized differ, if they differ under your calculations?

Cash flow measures the amount of cash that Adventure had available from the contract through 12/31/03. Cash is real; it is a balance sheet asset. It is used to pay operating bills, finance expansion, or invest. It is important to understand the timing of expected cash flows so a cash budget can be prepared. If we plan excess cash, we can plan to invest it. If we budget a cash shortage, then the company can arrange to borrow either temporarily or long term to meet upcoming obligations.

Revenue, on the other hand, is a measure of the amount of work that the company performed during the period whether or not cash was received (as long as the company has a claim to cash.) Revenues go on the income statement. The income statement provides investors and creditors with information about the results of the earnings activity during a time period. It is a measure of the company's effectiveness (revenues show that people buy our products/services) and efficiency (the amount of expenses the company incurs to earn those revenues.)

Since the purpose of information about cash flow and revenues differs, the amounts should not be the same under normal circumstances.

STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS

Statement 5. Recognition and Measurement in Financial Statements of Business Enterprises
Financial Accounting Standards Board

GUIDANCE IN APPLYING CRITERIA TO COMPONENTS OF EARNINGS

CON5, Par. 78
CON5, Par. 78

78. This section discusses the need for and provides further guidance in applying the fundamental criteria in recognizing components of earnings. Changes in net assets are recognized as components of earnings if they qualify under the guidance in paragraphs 83-87. Certain changes in net assets (discussed in paragraphs 42-44 and 49-51) that meet the four fundamental recognition criteria just described may qualify for recognition in comprehensive income even though they do not qualify for recognition as components of earnings based on that guidance.

CON5, Par. 79

79. Further guidance in applying the recognition criteria to components of earnings is necessary because of the widely acknowledged importance of information about earnings and its components as a primary measure of performance for a period. The performance measured is that of the entity, not necessarily that of its management, and includes the recognized effects upon the entity of events and circumstances both within and beyond the control of the entity and its management.48 The widely acknowledged importance of earnings information leads to guidance intended in part to provide more stringent requirements for recognizing components of earnings than for recognizing other changes in assets or liabilities.

CON5, Par. 80

80. As noted in paragraph 36, earnings measures the extent to which asset inflows (revenues and gains) associated with substantially completed cash-to-cash cycles exceed asset outflows (expenses and losses) associated, directly or indirectly, with the same cycles. Guidance for recognizing components of earnings is concerned with identifying which cycles are substantially complete and with associating particular revenues, gains, expenses, and losses with those cycles.

CON5, Par. 81

81. In assessing the prospect that as yet uncompleted transactions will be concluded successfully, a degree of skepticism is often warranted.49 Moreover, as a reaction to uncertainty, more stringent requirements historically have been imposed for recognizing revenues and gains than for recognizing expenses and losses, and those conservative reactions influence the guidance for applying the recognition criteria to components of earnings.

CON5, Par. 82

82. The guidance stated here is intended to summarize key considerations in a form useful for guidance for future standard setting—guidance which also is consistent with the vast bulk of current practice. The following paragraphs provide guidance separately for recognition of revenues and gains and for expenses and losses as components of earnings.

Revenues and Gains

CON5, Par. 83

CON5, Par. 83

83. Further guidance for recognition of revenues and gains is intended to provide an acceptable level of assurance of the existence and amounts of revenues and gains before they are recognized. Revenues and gains of an enterprise during a period are generally measured by the exchange values of the assets (goods or services) or liabilities involved, and recognition involves consideration of two factors (a) being realized or realizable and (b) being earned, with sometimes one and sometimes the other being the more important consideration.

84.a. Realized or realizable. Revenues and gains generally are not recognized until realized or realizable.50 Revenues and gains are realized when products (goods or services), merchandise, or other assets are exchanged for cash or claims to cash. Revenues and gains are realizable when related assets received or held are readily convertible to known amounts of cash or claims to cash. Readily convertible assets have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.
b. Earned. Revenues are not recognized until earned. An entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations,51 and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. Gains commonly result from transactions and other events that involve no "earning process," and for recognizing gains, being earned is generally less significant than being realized or realizable.

CON5, Par. 84

KIBBUTZ TZUBA: MEETING THE SOCIAL AND ECONOMIC CHALLENGES OF A CHANGING ISRAELI SOCIETY

Larry Goldstein, Iona College

CASE DESCRIPTION

The primary subject matter of this case concerns business policy. Secondary issues examined include organizational theory, marketing decision-making and the effects of cultural institutions and political orientations on decision-making. The case has a difficulty level of four, appropriate for senior level courses. The case is designed to be taught in two class hours and is expected to require three hours of outside preparation by students.

CASE SYNOPSIS

This case deals with a culture (Israeli) about which most students know little and an Israeli institution (the kibbutz) about which most students know nothing. It presents the history of the kibbutz movement and its evolution to the present. This is done to establish the cultural environment in which a particular kibbutz, Kibbutz Tzuba, operates. Like other kibbutzim, Kibbutz Tzuba was founded as a socialistic agricultural collective. And like most of the other kibbutzim, it has had to adapt and embrace elements of capitalism to survive the social and economic changes within Israeli society. While it has retained some elements of socialism, Kibbutz Tzuba has become entrepreneurial and has engaged in a number of capitalist ventures. However, the decisions it has made may not be sufficient to ensure its long-term survival.

INSTRUCTORS' NOTES

This case was developed as a result of discovering that among the many cases in international marketing available for study, there are almost none dealing with Israel. This case is the product of secondary research of books and newspaper archives and original research with some of the principals of Kibbutz Tzuba.

This case lends itself to both discussion and debate. The instructor can lead a discussion of the questions presented in the case, preceded by a lecture presented by the instructor or by students of relevant background information. This information can be gleaned from a number of sources, including some very good books that have been written about the kibbutz. Among these are Mort, J.A. & Brenner G. (2003). *Our Hearts Invented a Place: Can Kibbutzim Survive in Today's Israel?* Ithaca, NY: Cornell University Press; Blasi J.R. (1986). *The Communal Experience of the Kibbutz*. Somerset, NJ: Transaction Publishers; Blasi, J.R. (1978). *The Quality of Life in a Kibbutz Co-operative Community. Israel: Givat Chaviva Educational Foundation*; Krausz, E. (1983). *The Sociology of the Kibbutz*. Somerset, NJ: Transaction Publishers; Rayman, P.A. (1982). *The Kibbutz Community*. Princeton, NJ: Princeton University Press; and Rosner, M. (1984). *The Integration of Agriculture and Industry in Cooperative Villages: The Experience of the Kibbutz*. Israel: Haifa University.

An abundance of information can be found about the kibbutz with an online Google search. In addition, information about Israel and the kibbutzim can be accessed by searching the archives of the "Jerusalem Post", http://www.jpost.com, and the "Jerusalem Report", http://www.jrep.com.

The author has found that students enjoy debating case issues. Questions that could be debated include whether or not there is a place for the kibbutz in contemporary Israel society, whether or not Kibbutz Tzuba should become fully privatized, whether or not Kibbutz Tzuba should abandon its agricultural businesses in favor of more profitable industrial or service businesses, and whether or not Kibbutz Tzuba should pursue global marketing opportunities.

CASE OVERVIEW

Like all other kibbutzim, Kibbutz Tzuba was founded as a socialistic agricultural collective. Member families relied upon each other and the kibbutz took care of all their needs, including room and board, employment, education, medical care, and child care. There was no private ownership of anything. The system worked well until the 1980s, when heavy debt brought many kibbutzim to the brink of bankruptcy. As Israel evolved from a socialistic to a capitalistic society, greater economic opportunities were to be found outside of the kibbutz and many young individuals and families abandoned the kibbutz way of life. As a result, kibbutz membership declined as the average age of kibbutz members increased.

To survive, many kibbutzim abandoned the philosophy of the collective (or significantly modified it) and embraced privatization and competition. While members could own their own homes, for example, productive assets of the kibbutz remained the property of the kibbutz, although members could own shares in those assets. Many kibbutzim branched out into industry, treating their businesses as profit centers and competing in both domestic and international markets.

The need to survive forced Kibbutz Tzuba to evolve as well, but its members did not want to fully abandon their socialistic underpinnings. Members do not own their own homes and they do not pay rent. They pass their salaries to a common pool and live on budgeted allowances. However, the communal food budget has been privatized and members are expected to pay for their own meals, though the cost of those meals to members is heavily subsidized by the kibbutz.

Competition and (limited) marketing have found their way onto Kibbutz Tzuba. The kibbutz' agricultural output is sold on the open market and the kibbutz is involved in a number of non-agricultural domestic business enterprises, such as a family entertainment center, a hotel and convention center, a dining room/restaurant, a glass factory and an automobile service center.

Notwithstanding all that has transpired, many questions remain. Is the "renewed kibbutz" really a kibbutz in the historical sense? Is there still a need for the kibbutz system? What purpose(s) does the contemporary kibbutz serve? Should Kibbutz Tzuba fully embrace privatization? Is its governance structure optimal? What can it do to increase the profitability of its enterprises? What other opportunities are available to it? Should it consider international markets?

After a discussion of the case and background reading, students should understand how a kibbutz is and should be governed, the role of the kibbutz in Israeli society, and the kinds of decisions (social, cultural and economic) that a kibbutz must make if it is to survive and prosper in a society whose values would seem to be antithetical to those of the original kibbutz movement. Students should also realize the conflict members of kibbutzim have between retaining a culture that fosters mutual cooperation and adopting a culture that is centered on competition and the individual. Additionally, students should be able to evaluate what global marketing opportunities Kibbutz Tzuba has in light of the anti-Israel sentiment that exists in many global markets.

DISCUSSION QUESTIONS

1. What role did the kibbutzim play in Israeli society?

The kibbutz represented a way of life consonant with the socialist values of the early settlers of the land. On the kibbutz, there was no class system – everyone was equal. There was no private property – the kibbutz owned all assets. The emphasis was on community – members helped each other and felt responsibility for each other. This unique society that was the kibbutz movement was instrumental in many aspects of the struggle towards the creation of the State of Israel and in its early development. The kibbutzim had a disproportionate role in the settlement of the country, in its defense during the country's founding wars, in immigrant absorption and in the development of agriculture.

2. What role do the kibbutzim have in contemporary Israeli society?

There are those who declare that kibbutzim have no role in contemporary Israeli society and forecast their imminent demise. Their reasoning is that the communal, socialist ideology which was the basis of traditional kibbutz life is no longer in tune with individualism, modern technology and the economic realities of the global economy. Others attribute the decline of the kibbutz to the decline of agriculture. The kibbutzim have been too successful in increasing agricultural productivity, resulting in plummeting agricultural employment.

On the other hand, there are those who believe that the kibbutzim continue to be important to Israeli society. With about 1% of the Israeli population, kibbutzim account for one-third of Israel's total agricultural output. In addition, there are individuals and families who continue to be attracted to the kibbutz lifestyle. In fact, the Kibbutz Movement has recently launched a program to attract families in the United States and Canada to settle on a kibbutz. Advertisements placed on Web sites and at a series of conferences in the United States and Canada promote the social advantages of kibbutz life. To date, over 200 families have responded to this campaign and have settled on a kibbutz. Two reasons stand out for their decision: the community that exists on a kibbutz and the free, high-quality education available on the kibbutz.

3. Evaluate the "renewed kibbutz".

The renewed kibbutz is the Kibbutz Movement's response to changes in Israeli society which had led to declines in the kibbutz population as Israel evolved into a competitive industrial nation. In the renewed kibbutz, members can own their own houses, work outside of the kibbutz, and receive differential salaries according to their contribution to their kibbutz' economy. All productive assets remain in the ownership of the kibbutzim, but kibbutz members can own shares of those assets. To attract new members kibbutzim use a more flexible definition of membership to make it easier to join the kibbutz. While these changes are a radical departure from the traditional kibbutz, other aspects of the traditional kibbutz have been retained, viz., improved social security programs, particularly pension plans, for the rapidly aging kibbutz population; and provision for members' education, health care, welfare and care for members with special needs.

One result of the renewed kibbutz has been the elimination of equality and the introduction of personal competition. With differential salaries, clearly some jobs are valued more highly than others, which suggests the creation of a class system. Certainly the lowest class would consist of people who work in low-technology positions and live on the kibbutz but are not kibbutz members. Along with differential salaries comes the state of mind that demands a bigger house and a finer car to reflect one's higher position.

The renewed kibbutz may have spurred an economic revival and an increase in kibbutz populations, according to the most recent (2003) statistics. Total kibbutz revenue was 27.95 billion shekels, up from 26.29 billion shekels in 2002. Of the total income, 5.2 billion shekels came from agricultural production, 19.37 billion shekels came from industrial production, 1.6 billion shekels came from services and 1.73 billion shekels came from members who work away from their kibbutz. The number of people living on kibbutzim increased to 116,200, representing an increase of 0.5 percent from 2002. Of these, 97,944 are permanent members. The average income per kibbutz member is 9,948 shekels a month, which is below the national average.

Overall, about 60 kibbutzim are in a very strong financial position, where members receive excellent health care, pensions and education, in addition to providing high-quality cultural events and facilities. About 40 kibbutzim are said to be in need of assistance and the remaining 100-130 kibbutzim are in a state of recovery and getting stronger.

Another indicator of improved kibbutz economic activity is represented by the increase in total economic operations of the *Mishke Hakibbutzim* corporation, an organization established to provide financial services and assistance to kibbutz members. Those operations reached 1.05 billion shekels in 2004, representing a growth of 8% from 2003. This growth came as a result of new activities such as car rentals and providing loans to members wishing to purchase a vehicle. With about 38% of kibbutz members working outside their kibbutz, kibbutzim spent 404 million shekels in 2004 on car purchases so that members could drive to their jobs. About 45,000 kibbutz members held credit cards and in 2004, made credit purchases in the amount of 550 million shekels.

4. What are the benefits of becoming a member of a kibbutz?

Psychologically, becoming a member of a kibbutz satisfies the need of *belonging* that individuals have. Being part of a group reduces one's feeling of loneliness and alienation. Sociologically, becoming a member of a kibbutz provides a sense of *community*. All too often, particularly in urban environments, people do not know their neighbors. In the kibbutz environment, people tend to know each other and feel as if they were part of an extended family (although this might change in the renewed kibbutz where capitalism, competition and a flexible definition of membership could very well bore into the traditional communal spirit). Economically, becoming a member of a kibbutz provides job security as one can move from one kibbutz enterprise to another with relative ease. In addition, membership offers the benefits of health care, pensions and education. Finally, in a renewed kibbutz, members can be shareholders of the kibbutz' productive assets.

5. Should kibbutzim encourage membership? What are the consequences of doing this? How can it be done?

16% of those living on kibbutzim are not members of a kibbutz. This situation was necessitated by the decline over many years of the kibbutz work force. In addition to these nonmembers, many kibbutzim found it necessary to employ outside, often foreign, labor to work in their fields and in their industries. If kibbutzim were to encourage membership, it could reduce their reliance on foreign labor, elevate the social class of people who are currently nonmembers and increase total revenue. On the other hand, successfully encouraging membership would increase the kibbutz' expenses as housing would have to be built if it was not currently available and the economic benefits offered to members would have to be funded.

If a kibbutz wanted to encourage membership it would have to promote the benefits and opportunities available with membership, including the psychological, sociological and economic benefits discussed above. Opportunities exist to work outside of the kibbutz, and within the kibbutz there are choices of where one could work and there is always the potential for advancement into management. Promotional campaigns would have to be waged not only in Israel but in countries with sizeable Jewish populations, such as the United States, Canada, England, France and South Africa.

6. Is Kibbutz Tzuba a traditional or a renewed kibbutz?

In a renewed kibbutz, members own their own homes and have shares of the kibbutz' productive assets. This is not the case in Kibbutz Tzuba where members live rent-free in homes owned by the kibbutz and work in kibbutz-owned enterprises. Although Kibbutz Tzuba does have some characteristics of the renewed kibbutz, such as members able to work outside of the kibbutz, some privatization and treating the kibbutz' industries as profit centers, overall Kibbutz Tzuba is a traditional kibbutz that has embraced capitalism and competition.

7. Evaluate the organizational structure of Kibbutz Tzuba.

Unlike in a renewed kibbutz where the managers of the kibbutz' enterprises report to a board of directors, the latter having replaced the traditional general assembly, in Kibbutz Tzuba the general assembly has been retained and meets every two to three weeks to discuss the major issues facing the kibbutz. It also ratifies the annual budget and oversees the elections of key kibbutz personnel. It is the Kibbutz Authority, consisting of a series of committees that governs all aspects of kibbutz life. The two major committees are the Secretariat, which authorizes all the other committees, and the Economic Board, which makes all the economic decisions that affect the kibbutz.

In essence, even though a kibbutz enterprise is a profit center, its manager is not free to make major decisions but must go to a committee, the Economic Board, to make those decisions. The Economic Board, itself, is responsible to another committee, the Secretariat. Finally, the General Assembly has the power to approve or veto any decision brought before it. Thus a qualified manager's decision could be overridden by kibbutz members who are not qualified to make such decisions.

For example, the indoor skating rink at Kiftzuba was built in 2000 at great expense and closed in 2004 because of exorbitant labor and insurance costs. These costs should have been considered before the rink was built. A cost-benefit analysis might have led to a decision not to construct the rink. Consider, too, the decision to stop selling the kibbutz' grapes to a wine-producing company and to establish its own winery and its own brand. This is a venture that requires both expertise and capital. Even if Kibbutz Tzuba has both, why decide to restrict sales to a visitors' center?

8. Should Kibbutz Tzuba sell off its housing to its members? How might the proceeds from such a sale be used?

Many of the members of Kibbutz Tzuba are wedded to the concept of the traditional kibbutz. Privatizing the housing is antithetical to this concept. However, selling off the housing to members ties members to the kibbutz and might serve as an incentive for new individuals to join.

Kibbutz Tzuba has approximately 150 family apartments and an additional 120 single apartments. It is estimated that each family apartment would sell for $250,000, while each single apartment would sell for $150,000. The total value of such sales would amount to some $55.7 million. It should be noted that the prices of the apartments include parcels of land, too. Uses of funds from the hypothetical sales of the apartments are limited only by the students' imagination.

9. What marketing opportunities exist for Kibbutz Tzuba?

Subject to the availability of funds and sufficient demand, the following are some marketing opportunities available to Kibbutz Tzuba.

a. Expand the operations of the glass factory by targeting different users of safety glass, for example, shower doors, display cases for businesses like Stern & Co., commercial aircraft.
b. Expand Kiftzuba by providing facilities for older teenagers and possibly for adults, making Kiftzuba a total family entertainment center,
c. Open Kiftzuba-type entertainment centers in other parts of the country.
d. Promote the archeological sites on the kibbutz to encourage visits by different groups, such as students, tourists (both Israeli and foreign) and amateur archeologists. This could be tied to a stay at the Hotel Belmont and to meals in the kibbutz dining room. It could also be part of a Kibbutz Tzuba-organized visit to

other archeological sites in and around Jerusalem.

e. Promote Hotel Belmont to organizations both in Israel and abroad as a convention center of choice, making sure that additional amenities are offered, for example, an indoor swimming pool, transportation to Jerusalem and activities both day and night for attendees and their guests.

f. Build a sit-down restaurant with its own menu which would be open for lunch and dinner. Promote the dining room as the place to eat to experience kibbutz dining and promote the restaurant as the place to eat for impeccable service and gourmet cuisine.

g. Expand the handicrafts store and make it inviting to visitors. Maintain regular hours of operation.

It is doubtful that Kibbutz Tzuba, by itself, has any opportunities to market abroad.

CASINO CITY, INC. V U.S. DEPARTMENT OF JUSTICE CAMPUS ACCESS TO INTERNET GAMBLING AND THE FIRST AMENDMENT

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CASE DESCRIPTION

The primary subject matter of this case is the concept of "standing" which mandates that, under Article III of the United States Constitution, each litigant is permitted to pursue his or her cause of action only if it presents a genuine "case or controversy," in the absence of which the federal district courts lack jurisdiction to adjudicate.

This case also explores United States statutes declaring internet gambling to be illegal, and examines whether First Amendment protection of commercial speech precludes government restrictions on advertisements promoting internet gambling.

Finally this case reviews the rapid growth of the online gambling industry, the swiftly increasing participation of university students in online gambling, the ethical implications of marketing efforts designed to entice university students to engage in internet gambling, and the Federal income tax consequences of gambling online.

This case would be appropriate for use in business law/legal environment of business, internet marketing, or e-Business courses with a difficulty level of two or three depending on the course.

CASE SYNOPSIS

Michael A. Corfman, the founder and CEO of Casino City, Inc., a Louisiana corporation that operates gaming websites that disseminate information about gambling, initiated a lawsuit against the United States Department of Justice (DOJ) seeking declaratory judgment that prosecution by the Department of Justice for accepting advertisements for internet gambling operations on CasinoCity.com violated its First Amendment right to engage in commercial speech..

Casino City's website attracts individuals seeking gambling information, and gambling establishments throughout the world advertise on Casino City's website, providing Casino City with substantial advertising revenues.

Casino City claims that the Department of Justice threatened to prosecute broadcasters who accept advertisements for online gambling for aiding and abetting illegal activities, and issued subpoenas to media outlets, internet portals, public relations companies and technology companies to obtain information about advertisements purchased by online casinos and bookmaking companies. Casino City also alleges that these threats of prosecution infringe upon Casino City's right to engage in commercial speech contrary to the First Amendment.

This case analyzes (1) the requirement in Article III of the United States Constitution mandating that Federal courts can entertain only those causes of action that present a genuine "case or controversy," (2) the protection accorded to commercial speech under the First Amendment, (3) the legality of internet gambling, (4) the rapidly increasing participation in online gambling by university students, and (5) the ethical implications of marketing efforts designed to entice university students to engage in internet gambling.

Careful discussion of the case should enable the students to better understand (1) the concept of "standing" and "ripeness" which prohibit courts from exercising jurisdiction in hypothetical claims prematurely presented for court resolution; (2) the legal and ethical implications of the vastly expanding business of online gambling; (3) the application of First Amendment protection of commercial speech to internet gambling advertisements; (4) the rising participation of university students in online gambling and dangers posed by those activities through the increasing incidence of pathological gambling; (5) the effectiveness of marketing strategies which promote online gambling; and (6) the Federal income tax consequences of gambling activities.

INSTRUCTORS' NOTES

Discussion Questions

(1) The Federal District Court ruled that, contrary to Article III of the United States Constitution, Casino City lacked "standing" to pursue its claim in the absence of which the Court lacked jurisdiction to hear Casino City's claim. What role does the requirement of "standing" play in managing the caseloads of Federal courts? Do you agree that Federal courts should be limited to adjudicating claims that present a genuine "case or controversy"?

Article III of the Constitution imposes a minimal "standing" requirement on all potential plaintiffs. In order to bring a law suit, a party must have standing to sue, that is, a personal stake in the outcome. In addition, standing to sue requires that the issue at hand be a "justicable controversy"— one that is real and substantial, not merely academic or hypothetical.

This "case or controversy" clause of the Constitution prevents plaintiffs from the adjudication of abstract questions and speculative claims. The required injury must be both real and immediate. Consequentially, this stringent requirement limits the number and types of cases brought before the courts. Although "case or controversy" clause helps to minimize the caseload of federal courts, such limitations may also benefit the individuals against whom the suit is brought by providing them with the ability to ward off imminent and costly lawsuits.

(2) The United States Department of Justice claims that internet gambling is illegal and that accepting money for placing advertisements for online gambling may constitute aiding and abetting in the commission of a felony. If the Department of Justice is correct, does the First Amendment protection of commercial speech apply to advertisements promoting online gambling on websites maintained within countries that permit online gambling?

Because Casino Inc.'s activities facilitating the advertising of online gambling took place in the United States, and because the resulting advertisements appearing on Casino City's webpage promote online gambling which is illegal in the United States, the advertisements in question are not protected by the First Amendment, regardless of the location of the websites on which the actual gambling takes place. On the other hand, if the web based activities promoting online gambling took place totally outside the United States in a country or countries that permitted online gambling, those advertisements would not be illegal, and, because they took place beyond the jurisdiction of the United States, the advertisements would not be entitled to First Amendment protection.

Online commercial activities are increasingly creating situations in which courts must sort out and apply conflicting laws of different nations. Recently, Yahoo, a U.S. firm which operates an online auction site, was sued in a French court by the International League against Racism and Anti-Semitism for displaying Nazi memorabilia on its website. In France, such a display subjected the party to both criminal and civil liability. After losing in the French court, Yahoo pursued an action for declaratory judgment in a United States federal district court to answer the question of whether or not a foreign court could dictate what appears on a United States company's website and whether such order violated the First Amendment. While recognizing that "the government and people of France have a different judgment based on their own experience," the court, reasoning that "it is preferable to permit the nonviolent expression of offensive viewpoints rather than impose viewpoint based government regulation upon speech," found that the French court's decision violated the First Amendment (*Yahoo! Inc. v LaLigue Contre le Racisme et l'Antisemitisme*, 169 F. Supp. 2d 1181, N.D. Cal. 2001).

The facts in the Yahoo! case are nearly, although not exactly, the international opposite of the question posed. In other words, had the situation been reversed and Yahoo been a foreign internet gambling site which promoted online gambling within the United States, would it be granted the First Amendment right to advertise in the United States? While commercial speech receives less protection under the First Amendment than protected political and religious speech, restrictions on commercial speech will be upheld if they seek to implement a substantial governmental interest. It is likely that the United States court, like the French court, would determine that internet gambling has been declared illegal in order to protect the welfare of its citizens, that a substantial government interest is advanced by enforcing prohibitions on online gambling, and that commercial speech promoting illegal conduct is unprotected by the First Amendment.

(3) What are the ethical implications of advertising and promoting online gambling to University students? Are there expected limitations to such marketing efforts?

Targeting any particular market segment can generate controversy. This is especially true when the product being promoted is perceived as being for adults or is potentially addictive. There are several significant examples of this corporate problem.

The use of alcohol-related advertising and promotion in order to target college students periodically leads to recommendations for a ban of such promotional strategies. In both 1994 and 2003, studies of binge drinking on college campuses referred to promotional strategies of the liquor industry as exacerbating the problem (Kuo, et al, 2003; Eaton, 1994). Both studies concluded that regulating the promotion strategies for alcohol consumption may reduce "[college] binge drinking and its accompanying problems" (Kuo, et al, 2003, p 210).

A more profound problem occurs when the marketer appears to target audiences for whom the product is unsuitable. R .J. Reynolds use of the character, "Joe Camel", to promote Camel cigarettes from 1988 until 1997 was seen by many as an attempt to encourage addictive behavior in minors. The controversy led to FTC intervention, civil lawsuit, and a public relations nightmare for the firm.

As recent studies suggest that college students may be at risk for "problem gambling" or "gambling addictions," promotion strategies for internet gambling should be both thoughtful and restrained if it is not to be the target of legislative control. If online or internet gambling is to target its promotions towards college students, then the focus of such activities should be on adult recreation and entertainment. The appearance that promotions are also targeting minors in either the message or the artwork would have negative consequences for the industry. Thus, as a socially responsible act, such promotions should actively discourage use by minors. It should also be noted that the appearance of encouraging or enabling addictive behaviors would be seen as an irresponsible corporate behavior and should also be avoided.

(4) Many countries permit online gambling as a legal form of recreation. Do you agree that citizens and residents of the United States participate in illegal conduct when they gamble on websites maintained in countries that permit online gambling is legal? Explain briefly.

Several federal acts outlined in this case seem to indicate that web-based gambling is clearly illegal when engaged in by United States citizens and residents on American soil. However, the issue becomes cloudy when viewed through the kaleidoscope of cases, state statutes and international tribunals that have addressed this activity.

Because internet activities transcend borders, an argument can be advanced that the site of an input device should not control the legality of an activity. For example, if gambling is legal in Nevada, why should internet-based gambling be illegal within the same jurisdiction? The basic argument is that the ability to protect minors is greatly compromised in an online setting and that to promote the general welfare of the population and ensure adherence to accepted moral standards, such prohibitions should be in place. For example, on April 20, 2005, the Dispute Settlement Body of the World Trade Organization (WTO) ruled that the United States had violated certain commitments made under Article XVI of the General Agreement on Trade in Services (GATS), by effectively imposing a total prohibition on the international delivery of gambling services (99 A.J.I.L. 861, *International Decision: U.S.-Measures Affecting The Cross-Border Supply of Gambling and Betting Services*, October, 2005). This ruling emerged from a challenge brought by Antigua and Barbuda where such gambling is permitted, and resulted in a finding by the WTO that the United States had failed to present compelling evidence that its zero-tolerance position was necessary to uphold public morals as required under Article XIV of GATS (99 A.J.I.L. 861, 2005, at 862). There was much ado about the definition of "sporting" under the relevant GATS provision and whether the exclusion applicable to it extended to exclude "gambling" under the "other recreational services" section (99 A.J.I.L. 861, 2005, at 864). In time, it may result in the legalization of online betting extending to horse racing conducted on tracks in foreign countries. Add to this the recent attempts by North Dakota, Illinois and Georgia to legalize internet gambling within their borders, the current legislation by Nevada legalizing online gambling through mobile handheld devices used inside casinos and resorts and conflicting Circuit Court rulings, and it is easy to see why closure on this issue seems distant (Palmer, 2006).

The main argument proffered by the Department of Justice (DOJ) against online gambling is through the 1961 Wire Wager Act. The Act prohibits wagers on "any sporting event or contest" but does not specifically preclude wagers made on typical casino games. However, this statute has never been invoked by a federal court to strike down a non-sports gambling activity.

A review of the relevant cases, rulings, and legislation present emerging arguments represent both sides of this issue. The only thing that seems clear is that any challenge to the applicability of existing Federal Acts, as applied against online betting, may be the biggest gamble of all. If this is clearly a federal issue, it is time that Congress passes appropriate legislation that plainly prohibits or permits online gambling.

(5) Using a marketing perspective, assess the ethical implications of marketing efforts designed to entice university students to engage in internet gambling. What ethical standards apply to such efforts?

Most promotional activity is aimed at "enticing" the target market. Unfortunately, in this case, the question is not the use of "enticements," but rather the promotion of an activity in a country where it would certainly be illegal if not conducted on the Internet.

Besides the issues related to targeting young adults as a market for adult recreation or entertainment, the broader strategic implications relate to the different ethical standards that may exist in different countries or cultures. At the ends of the continuum are two different perspectives, ethical imperialism and cultural relativism.

If one embraces ethical imperialism, then the ethical standards that exist in one's home country should be applied to activities conducted in other countries or on the Internet. On the other hand, if one embraces cultural relativism, then the ethical standards of the host country should be applied to marketing activities. In that case, it does not matter whether the activity is actually conducted in a different country or on the Internet, the standards of the host country would seem to apply.

While the perspective of ethical imperialism guides much business activity in the United States, it is not the most common view globally. In addition, it is still unclear that Internet activities, which do transcend geographic boundaries, falls within this perspective in the public consciousness.

(6) What are the Federal income tax implications of the gambling revenues claimed by Michael Sandberg? To what extent, if any, are gambling losses deductible for Federal income tax purposes?

Gambling activities are governed by a unique set of rules within the tax code and are unlike most other trade, business, and personal transactions. Profits derived from such activities are considered gross income for tax purposes. Although no specific code provision lists gambling revenues as an item of gross income, they are generally understood to be included within the gamut of Code Section 61(a) (See Rev Proc. 77-29, 1977-2CB 538, January 1, 1977). All accessions to wealth from whatever source derived have been held to be includible in gross income, unless specifically excluded under the code (See *Commissioner v Glenshaw Glass Co*., 348 U.S. 426, 75 S. Ct. 473, rehearing denied, 349 U.S. 925, 75 S. Ct. 657, 1955). This has been interpreted to include gains derived from wagering transactions in a trade or business setting as well as winnings realized by the occasional gambler. Since there are no code provisions that exclude gambling winnings from gross income and in the light of Code Section 165(d) limiting the deductibility of wagering losses to the extent of the gambling gains, it is reasonable to infer that Congress had always considered them to be within the purview of Code Section 61. At least it is apparent to the Internal Revenue Service - IRS Publication No. 529 states "You must report the full amount of your gambling winnings for the year on line 21, Form 1040" (IRS-PUB, 2004, IRS Publication No. 529).

Generally, losses are deductible in full against items of income, except in the case of losses derived from hobby and passive activities and most personal use assets, while gambling losses are limited to gambling winnings (Code Section 165(d), 26 U.S.C. §165(d); and Code Section 183 and 469 limiting hobby losses and passive losses, respectively). Prior to the Revenue Act of 1934, losses incurred in the operation of a gambling trade or business were treated as any other legitimate business and accordingly, were deductible in full.

Gambling activity is considered a trade or business, if undertaken for the primary purpose of producing income or profit and if pursued full-time in good faith and with regularity, as described in Code Sections 62 and 162 (*Commissioner v R.P. Groetzinger, 1980*). In *Commissioner v Groetzinger*, a taxpayer was held to be in the trade or business of gambling when he engaged in pari-mutuel wagering six days a week an average of 60-80 hours for 48 consecutive weeks. Using the standard adopted in the Groetzinger case, Sandberg would likely be considered self-employed for tax purposes and actively engaged in a trade or business. Amazingly, the Board of Tax Appeals denied a deduction for gambling losses to a nonresident citizen in *Beaumont v Commissioner* (1932) because his wagering activities were held not to be engaged in "for profit". It is hard to imagine that a person would engage in gambling if there were no chance of winning. Notwithstanding, since the enactment of Code Section 165(d) the profit motive limitation imposed by 165(c) is relaxed. The distinction is still controlling however, on the deductibility of other ordinary and necessary business expenses under Code Section 162. Here, professional gamblers benefit from deductions otherwise lost to the occasional gambler. In the instant case, Michael Sandberg devoted up to ten hours per day over a seven-month period playing poker at casinos in Atlantic City and online. Indeed, he even expressed views regarding gambling as a potential career opportunity. And although all gambling losses are deductible to the extent of gambling winnings, losses incurred in the conduct of a trade or business are deductions in full in arriving at adjusted gross income, while personal gambling losses are allowable only to the extent they exceed two percent of a taxpayer's adjusted gross income. This could have a significant impact on Sandberg's ultimate tax liability.

If Sandberg were to lose a challenge to his self-employment status, and assuming he was a dependant for purposes of determining his standard deduction, his allowable gambling losses would have to exceed two percent of $120,000 or $24,000. In other words, the first $24,000 of losses would be disallowed if he were not deemed to be engaged in an active trade or business. Also, his traveling expenses, Internet connection fees and other ordinary expenses would be permanently lost.

Usually, it is difficult for a taxpayer, intentionally or otherwise, to exclude gambling winnings from gross income because of the mandatory reporting requirements imposed by the treasury regulations. Effective May 1, 1977, all persons operating bingo games or slot machines must report payments of $1,200 or more made to customers in the ordinary course of business on Form W-2G, Statement for Certain Gambling Winnings (Temporary Reg. 7.6041-1, T.D. 7492, 1977-2 C.B. 463). The threshold is increased to $1,500 for keno winnings and in the case of wagers made on horse racing, dog racing or jai alai, the amount of reportable winnings is reduced to $600 as long as they are at least 300 times the wagered amount. Further, before the IRS will allow any deduction, taxpayers are required to provide appropriate documentation. The IRS has set forth guidelines for gamblers to substantiate winnings and losses. Where these guidelines have not been adequately followed by a taxpayer, courts have stepped in with multiple formulas to determine the sufficiency of evidence of gambling winnings and losses (See *G.P. Green v Commr*; *B.L. Dunnock v Commr*, and *T.L. Wolkomir v Commr*).

CONCLUSION/EPILOGUE

In dismissing Casino City's request for declaratory judgment that the United States Department of Justice violated its First Amendment rights to engage in commercial speech by threatening to prosecute those who accepted advertisements for internet gambling, the Federal District Court applied the concept of "standing" derived from Article III of the United States Constitution.

The court concluded that Casino City had failed to present a genuine case or controversy and failed to demonstrate that it faced a credible threat of Federal prosecution. "Standing" is an important constitutional concept that is frequently overlooked in business law and legal environment of business courses. This case permits instructors in those courses to make the concept clear to their students.

This case also permits instructors in business law/legal environment of business, internet marketing, and/or eBusiness courses to explore the legal and ethical implication of online activities that may be legal in one jurisdiction and unlawful in another, and to apply ethical standards to advertisements promoting online gambling.

The past decade has witnessed enormous growth in the online gambling business and rapidly increasing participation of university students in online gambling activities. This case permits the instructor to bring the dangers lurking in, and income tax consequences of, online gambling activities to the attention of their students.

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TAKE THE MONEY AND RUN: WHITE COLLAR CRIME AT DHR PATIO HOMES, LLC

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CASE DESCRIPTION

This is a field-based disguised case which describes how a small family business deals with crimes committed by a trusted employee. The problem for the characters in question is how to deal with their most trusted employee, someone they treated like a family member, who they discovered had stolen nearly $25,000 from them over a two year period. Several factors complicate the owners' decision as to how to proceed: the person in question was their most tenured employee and had become part of the family, the employee and his family were renting a house built by the protagonists for the employee until the employee could establish his own credit, and the employee's brother worked for the firm. The case has a difficulty level appropriate for a sophomore or junior level course in business ethics or small business management. The case is designed to be taught in one class period (may vary from fifty to one hundred minutes depending upon the course structure and the instructional approach employed, see instructor's note) and is expected to require between four to eight hours of outside preparation by students (again, depending upon instructor's choice of class preparation method).

CASE SYNOPSIS

Derived from observation, field interviews, and e-mails, the case describes how two college professors operating several businesses were confronted with the fact that their most senior and competent employee appeared to have purloined nearly $ 25,000 in company funds. The employee in question, Alan Thompson, was originally hired with his wife Wilma to finish basements in Davis and Hodgetts' rental units. This project was such a success that as the business moved into private home construction Alan became the defacto on-the-job contractor. Growth in their business cost them their bookkeeper and they secured the services of James Carroll, CPA for the firm. When examining the firms' books, Mr. Carroll noticed that certain expenses were either for personal items or duplicates for similar expenses incurred a short time ago. An audit indicated that Alan Thompson was the culprit for these expenses as well as the fact that several charge card receipts had a signature that was not Mr. Thompson's. Davis and Hodgetts had to decide what if any legal action would they take, if they wanted to try to recover any of the stolen funds and if so, how; and how do they want to confront Alan with their findings?

INSTRUCTORS' NOTES

According to Justice Department estimates, nearly 30% of the nation's employees are hard-core pilferers, and up to 80% will steal if no active security measures are in place. Internal theft is costing businesses more than $60 billion a year. The impact of stealing on small business is especially telling: US Chamber of Commerce statistics show 50% of the failures within the first year of business can be linked to sticky fingers.[1] Formby and Williams noted that "there are 2 types of internal theft - theft of cash and theft of merchandise. Opportunities for theft of cash are available at the cash register, in the credit department, or in payroll or other bookkeeping functions. Merchandise thefts can range from employees taking small items home in their pockets to complex operations. The following factors can determine the extent to which internal theft problems may be correctable: 1. The employer must be aware of the problem. 2. The employer must realize that anyone is a possible offender. 3. The employer must be willing to make security revisions. 4. The system must be evaluated constantly."[2]

Since employee theft has been well documented over the past twenty years and received much press coverage as of late, thanks to the Enron debacle, one would have thought that theft in the workplace would be expected, detected, punished, and eventually minimized. However, Joshua Kuarantzick indicated that nothing has changed in terms of employee theft in the post Enron era. "Lying and dishonesty simply have become a much more accepted part of business – and of American life. … Greed still rules the day."[3] Worse, the lack of legal, no less moral, behavior on the part of workers has extended not only their own materialism and avarice but has become so rampant as to have created "an engrained tolerance of [others'] lying and bad behavior."[4] We have come to not only expect illegal and immoral business behavior, but in fact to accept it.

Ironically, this was not the case (pun intended) with Richard and Adrienne Davis and Stephen Hodgetts. They expected Alan Thompson and his wife Wilma to be of high moral character and disposition since Alan and Wilma had become an integral part of the family business; a positive attribute according to Ernest Doud Jr.. "Healthy family relationships drive businesses forward, whereas conflict-centered family relationships drive businesses down. Strength and unity of the family management team sends important messages to four key groups: employees; customers; suppliers; and competitors. Effective working relationships and a unified management team send good news that can pay dividends. Your employees will consider your business a good place to work. The dividend--a more productive work force."[5]

Yet the Davis's and Hodgetts should not have been shocked by the Alan's behavior. [Michelle] "Goodman lost her company because a trusted employee embezzled almost $1 million, which financially ruined her business. Bonnie J. Merrell was convicted of the crime and started a three year jail sentence last April, according to Maricopa County Superior Court records…. Small businesses tend to fall prey to this swindle because they often give too much financial control to one trusted employee, and often don't have the checks and balances in place to prevent it."[6]

The second irony is that, according to Anita Dennis, it is when the small firms that are doing well that they are the most susceptible to theft or fraud. "A risk of a strong economy is that small business clients may loosen their internal controls, discovering fraud or theft only long after it has happened. The most vulnerable are private companies in the $10 million to $30 million range because they are large enough to lose substantial sums but often not yet big enough for adequate finance departments. Employee resentment, misplaced trust and technology are elements that make fraud possible."[7] Davis and Hodgetts' operation grew from a small home rental business to not one but two home construction companies – clearly a long term employee of the firm could interpret this growth as success, success that the employee might feel has lead to the inequitable distribution of wealth back to the owners.[8]

RESEARCH METHODOLOGY

This research is phenomenological in nature and written by two of the characters in the case, the co-owners of the companies in question. This field-based case is disguised and derived from observation, field interviews, reflections, and e-mails.

INTENDED INSTRUCTIONAL AUDIENCE & PLACEMENT IN COURSE INSTRUCTION

This case was primarily developed for undergraduates taking a course in business ethics, although the context of the case, a small business, would also make the case suitable for a course in Small Business Management. The content of the case does include issues in human resource management (i.e. how should the firm now deal with Alan Thompson) and the legal environment of business (what are the legal ramifications of the alleged actions by Alan and Wilma Thompson) and therefore could also be utilized in these topic-driven functional courses . The case specifically deals with how a firm handles the discovery of embezzlement and fraud and should be introduced after the students have read material on white-collar crimes.[9] The case also deals with employee theft, specifically credit card fraud and embezzlement, as well as conspiracy to commit a crime (the RICO act)[10] - students may benefit from a review of this material.

In terms of a Business Ethics or Business and Society course, the case should be presented in conjunction with readings addressing the topic of the employees and the corporation[11] and should be employed as either an end-of-chapter case (for chapter review purposes) or as a case to be read just prior to the chapter material (as an ice-breaking exercise). For a Small Business Management course, this case should be taught in concurrence with readings in managing employees, business law and crime prevention, and business ethics.[12] Given the fact that these topics cover numerous text chapters, this case is more comprehensive in nature and should be employed towards the end of the semester, perhaps as a sectional review.

Secondary Applications

Although not originally intended for these purposes, the strong emphasis on legal issues (and the associated legal research) and the presence of a licensed accountant (with legal obligations) may provide for additional uses for this case. For example, this case may be quite appropriate for a legal environment of business course (a course usually required for business majors who are not majoring in accounting) given the fact that both criminal and contract law are addressed in the case. This case therefore could serve as a sectional or comprehensive case since it would be covering several issues addressed in the course, including business ethics.[13]

This case may also prove quite useful for students majoring in accounting since it not only describes the legal issues that would be covered in a Business Law I and Business Law II class (the typical classes taken by undergraduate students pursuing an accounting degree) but also the legal and ethical obligations of the accountant who uncovers the embezzlement and fraud discussed in the case. Please note that case question number two addresses this issue but only indirectly – the instructor would have to specify, perhaps in a separate question, that students should include the accountant in their analysis of stakeholder rights, responsibilities and obligations.[14] Given the breadth of material that this case encompasses, it is strongly recommended that this case be used as a sectional case or comprehensive case since it addresses constitutional, criminal, and contract issues.

Regardless of the course in which this case is employed, instructors should be aware that students will have to perform secondary research in order to develop good, very good, and excellent answers to the questions posed in this teaching note. Instructors may decide to offset this need for research by cutting and pasting the secondary material from the case answers into a handout to distribute to their students.

LEARNING OBJECTIVES

The overall purpose of this case is to have students examine two critical and interrelated ethical issues; the uncovering of a white collar crime and the handling of the employee alleged to have committed that crime. This case in particular has practical value to students since many of them may find that they as general employees, supervisors, and in the future HRM specialists and business owners will have to deal with similar situations. Students are asked to probe beyond personalities and the immediacy of the moment and examine the underlying nuances of the posed problem.

Specific learning objectives are as follows:

1 For students to understand the legal ramifications and moral obligations associated with uncovering white-collar crimes and to employ secondary research on these topics to support their case answers.
2 For students to analyze the legal options available to Davis and Hodgetts.

3 For students to develop a plan of action for Davis and Hodgetts including whether and how and if they were going to confront Alan Thompson with these allegations.
4. For students to decide whether and how the alleged stolen funds should be recovered.

TEACHING STRATEGIES

Preparing the Student Prior to Case Analysis

There are several approaches, not mutually exclusive, that an instructor may employ in terms of utilizing this case. It is strongly recommended that prior to reading this case, (regardless of the specific methodology employed) students be exposed to some material on embezzlement, forgery[15] and the proper method for handling an employee suspected of committing a white collar crime.[16] (See Appendix A. This may be used as a class handout if the instructor so chooses.) This will provide students with the proper perspective and allow them to recognize some of the legal and ethical issues embedded in the case.

This conceptual framework may be delivered prior to assigning the case by using at least one (1) of the follow methods:

- a short lecture and/or discussion session on the above noted topics.
- a reading assignment prior to reading the case that covers several of the topics mentioned.
- a short student presentation on each topic.
- a guest lecturer on one of the topics
- a literature search on the described topics.

Case Method

Although most of the students in a business ethics or small business management course may have had some exposure to the case method, it behooves the instructor to provide the students with a review of the case method of analysis. In the traditional case method, the student assumes the role of a manager or consultant and therein takes a generalist approach to analyzing and solving the problems of an organization. This approach requires students to utilize all of their prior learning in other subject areas although the focus should be on the current course content. It is strongly suggested that students prepare for the case prior to class discussion, using the following recommendations:

- allow adequate time in preparing the case
- read the case at least twice
- focus on the key issues
- adopt the appropriate time frame
- draw on all your knowledge of business.[17]

The instructor's role in case analysis is one of a facilitator. The instructor helps to keep the class focused on the key issues; creates a classroom environment that encourages classroom discussion and creativity; bridges "theory to practice" by referring back to key concepts learned in this or prior courses; and challenges students' analyses in order to stimulate further learning and discussion. There are several variations of the aforementioned approach including: written assignments, oral presentations, team assignments, structured case competitions, and supplemental field work.[18]

Regardless of the variation employed, it is recommended that the students' work be evaluated and graded as partial fulfillment of the course's requirements. However, if this case is not employed as a comprehensive case, it is not recommended that this case (and its related assignments) have a large weight or impact on students' overall course standing.

Using Case Questions

Whether or not the instructor assigns questions for students to analyze with the case is usually a matter of educational philosophy and student readiness. Naumes and Naumes, for example, thought that if the questions were handed out with the case "students will tend to focus only on the issues specifically raised by the questions …"[19]. Lynn, on the other hand, noted that the use of assignment questions provided students with more concrete guidance in case preparation and analysis; specifically directing them to consider the decision to be reached.[20]

In deciding whether or not to assign questions, the instructor should first answer the following questions:

1. What is the level of course instruction?
2. What type of case is being taught? (Iceberg, incident, illustrative, head, dialogue, application, data, issue, or prediction – see Lundberg et. al. for full descriptions.)[21]
3. What is the instructor's preliminary assessment of the students' ability to be self-directed learners?
4 What are the students' previous experience with case instruction?
5. If the students have already been exposed to the case method, what types of cases have they been exposed to? Case incidents (1-2 page cases with questions)? Short cases (3-8 page cases with and/or without case questions)? Comprehensive cases (greater than 8-15 pages) Harvard-style cases (greater than 15 pages)?[22]
6 What is the instructor's preferred method for case instruction? (For example, "sage on the stage", "guide on the side", "student as teacher" (student-lead discussions), "observer and final commentator" (open class discussion with faculty summation), etc….

Role-Playing (100 minutes)

Role-playing enacts a case and allows the students to explore the human, social, and political dynamics of a case situation. This case lends itself quite well to a two-part role playing exercise since it involves a rather simple situation with only three to four characters and therefore most of the class can role play in this exercise.

Prior to role-playing the case part

Prior to role-playing the case part, students should be asked to not only read the case part but to answer the following questions:

1. Who are the key participants in the case? Why?
2. What is the "role" of each of these participants in the organization?
3. What is their motivation or rationale for their behavior?
4. What is the dilemma that the character is facing and/or how can the character assist someone else in solving a problem?

The instructor may either go through these questions prior to case enactment or wait for the role playing exercise to be completed in order to use this material to debrief the class.

Step 1: Assignment of Roles & Instructions (10 minutes)

The class should form groups of three to four students with three of the students enacting the key roles in the case (Richard and Adrienne Davis, and Stephen Hodgetts) and the other acting as observer. The instructor should pass out a short reminder notice about participants staying within their roles.

Step 2: Enactment 1 – Deciding What to Do (20 minutes)

The student enacting the role of Richard Davis should be instructed to start the conversation, summarizing the situation. The instructions to the students playing Richard Davis is that he is highly hurt and offended by Alan Thompson's embezzlement. He wants to deal with this situation as quickly as possible yet he also wants to recover as much of the stolen money as possible. The instructions to the students playing Hodgetts is that although he is for pursuing legal action against Alan Thomson, he is most worried about what type of damage the Thompson's might do to the home that they are now renting from the firm. Adrienne Davis feels betrayed by the Alan and Wilma and just wants to put this whole incident behind her and the firm. The instructor should note how well each group enacts the role-play and offer suggestions (if necessary) if some groups seem a bit confused or lost.

Step 3: Debriefing 1 (20 minutes)

The instructor might want to ask the following questions:

- What was the results of the meeting? What did the Davis' and Hodgetts decide to do?
- How many groups decided to go to the police and file a complaint? If so, why?
- How many groups decided they needed to contact a lawyer, an accountant, or an alternative expert for advice?
- Did the Davis's and Hodgetts agree or disagree as to the actions they should take? If they disagreed, what were the reasons?

Step 4: Enactment 2 – The Confrontation (20 minutes)

Four roles will need to be enacted, those of the Davis', Hodgetts and Alan Thompson. The student enacting the role of Richard Davis should be instructed to start the conversation, with summarizing the situation and providing the evidence to support his accusations. The student enacting the part should be instructed to display Richard's emotions (hurt and offended) but to not over-dramatize the situation. The instructions to the students playing Hodgetts and Adrienne should be similar to those in the first exercise.

One method of role play would be to have the student playing Alan Thompson be given a set of choices as to how to enact this role. Those choices could include abject denial, silence, admitting guilt, admitting guilt but protecting his wife, or requesting that his lawyer be present during these discussions. This choice would not only increase the student's motivation to enact the role but also may provide some insight into the student's general outlook on the case. A second method would be for the instructor to assign a different role each student playing the role of Alan Thompson. This would allow, in the debriefing session, comparisons of results based upon how each group's Alan Thompson reacted to the accusations.

Step 5: Debriefing 2 (20 minutes)

The instructor might want to ask the following questions:

- How did Alan Thompson react to the accusations?
- In how many groups was Alan Thompson still retained by the firm? Why or why not?
- In how many groups did Davis and Hodgetts decide to contact the police and press legal charges? In how many groups was this a threat posed by Davis and Hodgetts?
- What were the results of the meeting?

The instructor should then have the class as a whole comment on the results of the role-play and determine with the class their overall sentiment towards DHR's problem. Students should also be given the opportunity to comment on the role-playing exercise as a learning instrument. The instructor might ask the class the following questions:

- Did this exercise animate the case? Did students get a "feel" for the issues surrounding the business offer?
- What were the strengths and weaknesses of the exercise? What changes would they make to the exercise given their experiences with it?

The debriefing session should produce closure for students by connecting the theory of ethical decision-making and trust with case specifics and the results of the role-playing exercise.

SUGGESTED CASE QUESTIONS

Please note that answers to these suggested case questions contain material from secondary sources not provided in the case. Students should be instructed to perform secondary research on the topics raised in each case question.

1. Explain how terms like embezzlement, forgery, and the RICO act might apply to this case.

The purpose of this question is to determine whether students understand the basic precepts of embezzlement, fraud and conspiracy; the underlying legal issues surrounding this case. Since this question solicits definitions from secondary sources, a *poor answer* to this question would be either a partial answer to this question (does not address all of the crimes listed in the question and/or describe the application to the case) or does not provide proper footnoting which would designate the sources of information.

A *fair answer* to this question would provide solely the definitions. "Embezzlement is defined as the misappropriation of items with which a person has been entrusted.

Embezzlement differs from larceny in that the perpetrator of embezzlement comes into possession of property legally, but fraudulently assumes rights to it. Charges of embezzlement can even be levied if the embezzler intended to return the property later."[23]

Forgery is "the act of criminally making or altering a written instrument for the purpose of fraud or deceit; for example, signing another person's name to a check. To write payee's endorsement or signature on a check without the payee's permission or authority. The 'payee' of a check is the true owner or person to whom the check was payable."[24]

The RICO act refers to the conspiracy to commit a crime. "The RICO Act was passed by the United States Congress to enable persons financially injured by a pattern of criminal activity to seek redress through the state or federal courts. The RICO Act applies to a wide variety of crimes. Originally, the breadth of the RICO Act was intended to give law enforcement, and private persons, broad power to fight organized crime, whether "organized crime" was traditional mobsters, members of a drug ring, or gangsters. The RICO Act has over time, however, resulted in unforeseen applications."[25]

A *good answer* to this question would along with the definitions include examples from the case. For example, embezzlement would refer to any items purchased by Alan Thompson using the corporate credit card (the purchase is legal) but then bought either for his own use (i.e. Christmas tree, gasoline) or in order to be resold (i.e. tools). An act of forgery would have occurred if the signatures on some of the credit card receipts were definitely not Alan's although they were signed in his name. RICO would apply if Alan had conspired with his wife Wilma to embezzle these goods as well as planned with his wife for her to forge his name on credit card purchases.

An *excellent answer* might go beyond merely defining embezzlement, forgery, and RICO by providing more details. For example, "One of the most common instances of embezzlement in today's society is employee theft. Employees of many companies have access to company property, creating the potential for embezzlement. Examples include such small crimes as theft of retail items, discounted sale of retail items, and theft from cash registers, but can also include the theft of millions by employees of large firms.

There are a number of warning signs of employee embezzlement. Some general indicators may include:

- ♦ Missing documents
- ♦ Delayed bank deposits
- ♦ Holes in accounting records
- ♦ A large drop in profits
- ♦ A jump in business with one particular customer
- ♦ Customers complaining about double billing
- ♦ Repeated duplicate payments

- ♦ Numerous outstanding checks or bills
- ♦ Disparity between accounts payable and receivable
- ♦ Disappearance of petty cash."[26]

In terms of forgery, "there are many kinds of forgery, especially subjected to punishment by statutes enacted by the national and state legislatures. … The making of a whole written instrument in the name of another with a fraudulent intent is undoubtedly a sufficient making but a fraudulent insertion, alteration or erasure, even of a letter, in any material part of the instrument, whereby a new operation is given to it, will amount to a forgery; and this, although it be afterwards executed by a person ignorant of the deceit.

The fraudulent application of a true signature to a false instrument for which it was not intended or vice versa, will also be a forgery. For example, it is forgery in an individual who is requested to draw a will for a sick person in a particular way, instead of doing so, to insert legacies of his own head and then procuring the signature of such sick person to be affixed to the paper without revealing to him the legacies thus fraudulently inserted.

It has even been intimated that a party who makes a copy of a receipt and adds to such copy material words not in the original and then offers it in evidence on the ground that the original has been lost, may be prosecuted for forgery."[27]

Additional information on RICO may include the fact that "corporations have been sued under the RICO Act for allegedly distributing false advertisements; lawyers, bankers, accountants, and other professionals, have been sued under the RICO Act for allegedly assisting clients in organizing, or assisting in the organization of, schemes to defraud; spouses have been sued for allegedly concealing the value of marital assets in divorce proceedings; and, civil protest groups have been sued for intimidating and extorting the customers of the industries that the protest aimed to disrupt. Although Congress may not have intended these more unusual applications of the RICO Act, they can be legitimate uses of the RICO Act. If you have been injured by a violation of the RICO Act, you may sue the person who allegedly violated the Act and, if successful, recover a monetary award equivalent to three times the value of the property you lost or that was stolen from you, plus the legal costs and fees you incurred to bring the lawsuit."[28]

An *excellent answer* may also describe additional laws that may have been violated by Alan Thompson. For example, if Alan found out about his wife's forgery and did nothing he would be an accessory to a crime after the fact. An accessory is one "who is not the chief actor in the perpetration of the offence, nor present at its performance, but is some way concerned therein, either before or after the fact committed. … An accessory after the fact, is one who knowing a felony to have been committed, receives, relieves, comforts, or assists the felon."[29] "Accessories after the fact are in general punishable with imprisonment (with or without hard labor) for a period not exceeding two years, but in the case of murder punishable by penal servitude for life, or not less than three years, or by imprisonment (with or without hard labor) to the extent of two years."[30] Three points need to be met under this law:

a. Must have knowledge that a felony has been committed.
b. Must aid or assist the felon in some way.
c. The purpose of the aid must be to help the felon escape from the authorities.[31]

2. What are the rights, responsibilities, and obligations for each of the parties involved in this case?

Corporations and individuals alike are empowered by our constitution and our federal laws to own property and to maximize their own wealth (or the wealth of their stockholders). With those rights are attached responsibilities and obligations; both individuals and corporations must be held accountable for their actions.[32] The purpose of this question is twofold: a) for students to be able to discern all of the stakeholders involved in the case; b) for students to determine what are the rights, responsibilities, and obligations of each of the stakeholders and how each of these rights, responsibilities, and obligations of each stakeholder impact one another.

A *poor answer* to this question would either leave out at last one of the two key stakeholder groups in this case (either the members of DHR Patio Homes or Alan and Wilma Thompson) and/or would omit at least one of the three factors (rights, responsibilities, and obligations) in the discussion of each party.

A *fair answer* will take a legalistic approach to this question, be overly general, and only focus on the two major parties in question. This answer might first start with a definition of the major three factors described in the question (rights, responsibilities, and obligations). A person's basic rights are those rights shared by all people and are spelled out in 'the law of the land'; for the United States those rights would be described in the Bill of Rights and the United States Constitution. The 10th amendment to the constitution indicated that rights not delegated to the federal government would then be delegated to the state or the people (local government).[33] A corporation's rights were not directly defined in the U.S. Constitution until after the Civil War. "Corporations were chartered for a specific limited purpose (for example, building a toll road or canal) and for a specific, limited period of time (usually 20 or 30 years). … Congress had written the 14th Amendment to protect the rights of freed slaves, but in an 1886 decision (Santa Clara County v. Southern Pacific Railroad) this was expanded when the courts declared that no state shall deprive a corporation '. . . of life, liberty or property without due process of law'."[34] The corporation, therefore, was awarded the same rights as any U.S. citizen.

Since rights are defined by the law, responsibilities and obligations are based upon the law. "Civil law focuses on legal relationships between people and the protection of a person's rights. Criminal law focuses on wrongs against a person, property, or society."[35]

Based upon these definitions, the following answer may be presented in Table Form:

Table 1: A Fair Answer: Legal Rights, Responsibilities, and Obligations

Stakeholder	Rights	Responsibilities and Obligations
Alan and Wilma Thompson	● Civil rights as contracted labor. Contract law. ● Any legal rights associated with a criminal investigation. I.E. The right to an attorney, assumed innocent before proven guilty.	♦ To abide by the contract requirements and the laws governing contract labor relations. ♦ To not commit any criminal acts.
DHR Patio Homes, Inc.	■ Civil rights as a contractor of labor. ■ The right to receive any funds embezzled from the firm.	▸ To abide by the contract requirements and the laws governing contract labor relations. ▸ To provide evidence supporting their allegation of embezzlement in any legal proceedings.

A *good answer* will have the student first realize that the situation has several complications, although the student may still employ a legalistic approach. First, Alan and Wilma Thompson may be accused of committing different crimes (Alan embezzlement, Wilma forgery) by DHR Patio Homes and there is still a question as to whether collusion is involved or if Alan may be an accessory to a crime after the fact. A good answer by a student may go beyond the legalistic framework with the student noting that Alan and Wilma have the right and obligation to protect themselves, their family (if they have one), and their business and should seek out legal counsel even before any charges are brought against them.

Secondly, DHR Patio Homes may claim a breach of contract with Alan and Wilma's A&W Construction LLC and not only terminate their services but also sue for damages relative to the embezzled amounts. A good answer by a student may indicate that DHR Patio Homes has the right and obligation to protect the interests of its stockholders (Richard, Adrienne, and Stephen) by pursuing the recovery of the stolen funds. DHR Patio Homes should also consult legal counsel and determine whether or not it is in the corporation's best interest to press legal charges along with seeking compensation for their lost funds.

Third, a good answer will denote that the accountant in this case has rights, responsibilities, and obligations relative to his client (DHR Patio Homes) and include student research on the AICPA code of conduct for accountants. The accountant certainly had the right to request and receive ‘the books’ from DHR’s bookkeeper and to then familiarize himself with those books. Once the accountant suspected that non-business related charges were billed as expenses to Davis and Hodgetts’ corporations, he had a responsibility and an obligation to his clients to:

- *act professionally*. “The quest for excellence is the essence of due care. Due care requires a member to discharge professional responsibilities with competence and diligence. It imposes the obligation to perform professional services to the best of a member's ability with concern for the best interest of those for whom the services are performed and consistent with the profession's responsibility to the public.”[36]
- *inform the client but to keep the information confidential*. “Rule 301—Confidential client information. A member in public practice shall not disclose any confidential client information without the specific consent of the client.”[37]
- *act with integrity*. “Integrity requires a member to be, among other things, honest and candid within the constraints of client confidentiality. Service and the public trust should not be subordinated to personal gain and advantage. ”[38]

The accountant, however, also has a responsibility to his profession and the public at large. For example, if the accountant does find erroneous reporting and/or illegal acts by his clients he is expected to act in the interest of the public, an act that may be in conflict with his clients’ interests. “In discharging their professional responsibilities, members may encounter conflicting pressures from among each of those groups. In resolving those conflicts, members should act with integrity, guided by the precept that when members fulfill their responsibility to the public, clients' and employers' interests are best served.”[39] “Integrity can accommodate the inadvertent error and the honest difference of opinion; it cannot accommodate deceit or subordination of principle.”[40] In this case, the accountant is obligated to continue his audit of the firm’s expenses in order to determine whether the expenses were incorrectly charged to the firm or if there was possible embezzlement.

A *very good* answer by a student will include the aforementioned analysis but go beyond a legalistic framework when dealing with parties’ rights, responsibilities, and obligations. The student providing this answer will note that there may be ethical and moral rights and obligations of each of the parties in this case.[41] Generally speaking, when someone says of an act that it is a ‘moral obligation,’ they refer to a belief that the act is one prescribed by their set of values.”[42] The real question underlying this answer will be what values are driving these obligations and actions.

For example, this student might observe that Alan Thompson may have a moral and ethical responsibility to his employer that goes beyond mere contract obligations, especially since he was treated as one of the family. It was Davis and Hodgetts who gave Alan Thompson his start so to speak in the business and students might believe that there is a personal obligation attached to the relationship. This same student might also note that the reverse is true, without Alan Thompson, Davis and Hodgetts would probably not have developed their second and third businesses. This student would be trying to determine how loyalty as a value impacts this case.

Yet what of Alan's loyalty to his wife in this case? Assuming that Alan did not know of the forgeries, what is his ethical obligation to his wife? In the basic marriage vows, obligations are set forth for husband and wife. "I take you for my lawful husband (or wife) to have and to hold from this day forward, for better, for worse, for richer, for poorer, in sickness and in health, until death do us part."[43] For example, the Ohio Legislators defined marriage as having "mutual obligations. Husband and wife contract towards each other obligations of mutual respect, fidelity, and support."[44]

The question that this student then might raise is, how far does this ethical 'support' for husband and wife go? From a legal standpoint, certainly Alan and Wilma have spousal privilege and privileged communications. These rights granted to married couples include the right of a person to refuse to testify against their spouse in the court of law and the right that any communication between spouses not be entered into evidence against them.[45] The ethical question then is, should Alan either try to cover up his wife's illegal actions, or worse, take the blame for the all of the criminal actions? What are his values relative to his wife and relative to upholding the law?

An *excellent answer* to this question by a student will first expand the impacted parties in the case into a broader, stakeholder framework. Besides the parties immediately impacted by this case and the accountant who dug up the potentially incriminating evidence, there are other stakeholders also impacted by this case including, but not limited to: Alan and Wilma's immediate family (his brother working with him on the job as well as any children they may have), DHR's other subcontractors (who will they now report to, what message does this send them), Davis' and Hodgetts' family (given their socializing with the Thompsons'), suppliers who were doing business with Alan (less sales, perhaps some even assisting Alan in the alleged embezzlement), the local community where the alleged crimes were committed, and the local legal system (where both civil and criminal charges may be brought).

Secondly, in an excellent answer the student will acknowledge that many of the parties in this case may have to deal with conflicting values. Going back to the earlier example, Alan may be dealing with conflicting values of loyalty (his wife, his business associates and friends, and the legal system) brought on by differing responsibilities and obligations. This conflict of values and obligations may create cognitive dissonance. "In brief, the theory of cognitive dissonance holds that contradicting cognitions serve as a driving force that compel the human mind to acquire or invent new thoughts or beliefs, or to modify existing beliefs, so as to minimize the amount of dissonance (conflict) between cognitions."[46] In the above situation, for example, Alan may decide that 'blood is thicker than water' therein reducing the importance of loyalty to friends and business associates as compared to family.

For the Davis' and Hodgetts, the student might note multiple conflicts. They certainly want to recover their embezzled funds but are they willing to prosecute Alan and Wilma in order to obtain those funds? Secondly, they may also want to claim that Alan and Wilma's actions are a breach of contract but how can they recover their funds from them if Alan longer has a paying job? Third, how would keeping Alan on the job so he can pay off the embezzled funds and pay rent on his house affect the other subcontractors as well as the quality of Alan's work? Furthermore, Alan and Wilma are currently renting a home that they were supposed to buy from the firm – how would this whole incident affect the sale? If Alan is released from his contract how can he pay for the house, or even the rent? What retaliatory actions might Wilma and Alan taken in terms of the house (damage) once Alan is accussed of embezzlement?

In summary, an *excellent answer* by a student will signify the complexities associated with identifying who is directly and indirectly affected by this case and the difficulties in determine which responsibilities and obligations (given the conflicted nature of the underlying values) will drive the parties in question.

3. Develop an action plan for Davis and Hodgetts that will resolve this situation.

This question directly addresses the issue of what Davis and Hodgetts should do in terms of dealing with the discovered embezzlement and forgery. Clearly there are numerous options available to Davis and Hodgetts (including doing nothing) and students answering this question will have to determine what are Davis and Hodgetts' goals and the priority of those goals relative to developing a solution strategy.

A fundamental attribute of any answer to this question is that, regardless of the solution strategy posed, that there be a general description of the problem being addressed by Davis and Hodgetts. A *poor answer* by a student will then be quite terse (will not be a plan as such) and deal directly with the problem without either describing the problem or dealing with the nuances and associated impacts of the proposed decision. For example, the student in this answer may suggest firing Alan Thompson and then not deal with the associated outcomes: i.e. who is going to replace him on the job, how are the embezzled funds to be recovered, how can DHR protect their rented home from damage, etc….

Regardless of the decision made by the student, there will be no stated goal for the decision-makers. The focus will be upon the immediacy of the problem and a quick and clear solution that promptly deals with the problem.

A student with a *fair answer* will first describe the problem simplistically. At this level of analysis the student may focus either on the legal ramifications of the act (should Alan and his wife be prosecuted for committing these offenses?) or the business ramifications (how do we recover the lost funds? should we fire Alan and who should replace him?), but not both. This student would also note that any decision that is discussed should first be run past legal counsel. Legal counsel will then determine if there are any potential gains and liabilities that the corporation and/or its individual owners might accrue before actually enacting the solution strategy.

For example, if Davis and Hodgetts decided to break their contract with Alan Thompson's corporation (under contract law - an illegal activity by one party of a contact makes the contract null and void),[47] what compensatory and punitive damages (punitive damages must involve malicious conduct – an intentional tort)[48] would they be entitled to? Would Thompson have a good case to counterclaim? Furthermore, the student in this answer might suggest that the lawyer recommend some sort of compromise; i.e. Alan Thompson agrees to pay back the embezzled funds over a 24 month period at $1000/month and agrees to terminate his contract with DHR Patio Homes.[49]

There are numerous possible problem definitions and solution strategies. Some more likely problem definitions and answers are listed in Table 2 below.

Table 2: Likely Case Problem Definitions and Associated Solution Strategies*

Problem	Possible Solutions
Alan and Wilma have broken the law through alleged embezzlement and forgery.	Take no legal action. Discuss what their accountant had found with law enforcement officials. Allow their lawyer to handle the matter. Confront Alan and Wilma with the charges before going to the police. File a complaint and press charges.
The firm has accrued $24,000 of inappropriate and perhaps illegal expenses due to Alan and Wilma's actions.	Do nothing to recover the funds. The expenses have already been incurred. Confront Alan and Wilma to determine how Alan and Wilma will pay back the funds. Develop a payback plan ahead of time and then confront Alan and Wilma with their alleged illegal activities.

Table 2: Likely Case Problem Definitions and Associated Solution Strategies*	
Problem	Possible Solutions
Given Alan and Wilma's actions, the firm can no longer trust them and must sever their contract with Alan's firm.	Confront Alan and Wilma – allow Alan the option of volunteering to break the contract. Threaten Alan and Wilma into volunteering to break the contract. Have their lawyer send a notice that they are in breach of contract due to their illegal activities. Unilaterally break the contract – fire Alan without an explanation.
Alan will need to be replaced (both as the "acting" contractor on the job and as subcontractor).	Contractor Have either Adrienne or Richard Davis temporary serve as contractor. Hire one of the subcontractors to serve as acting contractor. Recruit a new contractor from outside the firm's subcontractors. Subcontractor Have Alan's brother take over the subcontract and form his own LLC. Solicit a new subcontractor.
* Not an inclusive list.	

A *good answer* will certainly include the first two elements of the answers described above (a specific recommendation which should first be run past the company's lawyer) and will deal with both the legal and business ramifications of the case. Furthermore, the student developing a good answer will ask a more fundamental question, that is, what is it that the owners want to accomplish given the circumstances? Until the owners of the company have a goal in mind as to how they want to resolve this problem, it will be difficult for legal counsel to recommend action beyond the most cursory cost/benefit analysis. For example, if Davis and Hodgetts just want to get rid of Alan as quickly as possible, the lawyer might suggest actions that will support a breach of contract and an injunction[50] but will not support recovery of the embezzled funds, protection of the rented property from damage, defending society from this "law breaker", nor collecting damages caused by a potential work slowdown (replacement costs).

A *very good answer* by a student will also indicate that the owners might have multiple objectives in mind and that these objectives might operate synergistically (they support one another) or are at cross purposes (operate against one another). In the above plan, where Davis and Hodgetts want to break their contract with Alan Thompson, complimentary objectives might be to seek both civil and legal remedies to their problem with the goal of legally breaking the contract while having Alan convicted of embezzlement.[51] Crossed purpose goals, on the other hand, would be a desire for the repayment of the embezzled funds through legal action while seeking to break the work contract (assuming that Alan has no real assets to attach and no immediate employment elsewhere). The courts may in fact order Alan to repay the funds but he would have no clear way in which to pay them back.

An *excellent answer* would have the student require that Davis and Hodgetts first prioritize their goals (i.e. recover of funds, protecting their business assets, getting rid of Alan, protecting society, revenge, etc…) and then develop several scenarios for achieving those objectives. Going back to our earlier example, if Davis and Hodgetts' primary goal is to retrieve the stolen funds then they will have to develop several plans that aim at obtaining that goal while perhaps meeting secondary objectives. For example, if Davis and Hodgetts wanted to recuperate the allegedly stolen funds while extracting some form of revenge they could:

a. threaten to go to the police if Alan does not pay them back (develop a payment schedule that would not exceed the statute of limitations)[52]
b. go to the police and file a report alleging embezzlement and/or forgery and threaten to push ahead with their claim if Alan does pay them back
c. not only extract the embezzled funds from Alan but threaten to go to the police if Alan doesn't provide them with a very low bid on future services rendered. (Please note that we are in no way advocating these actions, especially since they involve blackmail.)[53]

Note: The instructor may also want students to use a particular format or rubric for developing these action plans and should feel free to do so. These approaches could include a SWOT, cost/benefit, or a stakeholder approach. See below two examples of stakeholder analysis.

Table 3: Evaluating a Stakeholder Based Upon Influence and Importance[54]

Influence of Stakeholder	Importance of Stakeholder			
	Unknown	Little/No Importance	Some Importance	Significant Importance
Unknown				
Little/No Influence				
Somewhat Influential				
Significant Influence				

Table 4: The Stakeholder Analysis Matrix[55]

Stakeholder	Stakeholder Interest(s) in the Project	Assessment of Impact	Potential Strategies for Obtaining Support or Reducing Obstacles

4. Assume that the above plan includes confronting Alan Thompson with these accusations, what would be the most effective way for Davis and Hodgetts to do this?

This question forces students to deal with one of the most difficult solutions to this problem, and the one most usually recommended for dealing with conflict resolution, confrontation.[56] The student is asked to deal with the delicacies of the situation (accusing someone of embezzlement and his wife of forgery is a very serious charge) and specifically must address how Davis and Hodgetts can best protect their legal rights and business interests, as well as perhaps their personal safety. The students must also be very cognizant of Alan Thompson's rights as well and his potential reaction to the accusations.

All students in their answers should indicate that "unless there is some urgency arising from the circumstances surrounding the employee theft, it is generally better to map out a plan and discuss the matter with an attorney before confronting the employee. Once confronted, employees are likely to cover their tracks, hide assets or flee with assets. Nonetheless, an employee should be confronted as soon as possible after the thefts are discovered."[57]

A *poor answer* to this question would suggest either avoiding the confrontation, if at all possible, or suggest having a third party (i.e. the accountant, the firm's attorney) meet with Alan to discuss the issue. Although third party consultation is recommended for resolving strong conflicts, it is not recommended that the accusing party be absent from the meeting. [58] From a legal standpoint, Alan (as the accused) has the right to confront his accuser(s) as well the witnesses that may testify against him.[59]

A *fair answer* by a student would discuss the procedures that Davis and Hodgetts should follow during the confrontation, they include:

a) *communicating care* - confrontations that occur out of revenge, spite and anger are typically not effective.
b) *identifying the specific actions that they are questioning* – rather than making an accusation, discuss the specific findings of the accountant.
c) *sharing true feelings* – by sharing their feelings with Alan about the situation, Alan will have a greater appreciation of Davis and Hodgetts' position.
d) *communicating future expectations* – based upon the conversation, Davis and Hodgetts need to clearly lay out what steps they will take and what steps Alan needs to take in order to resolve this situation.
e) *maintaining control of the conversation and be prepared to be accused as well* – Alan may want to put Davis and Hodgetts on the defensive by accusing them of erroneous and/or illegal behavior. Davis and Hodgetts need to allow Alan to air his

grievances but bring the conversation back the to problem of the inappropriate expenses and the forged signature.[60]

A *good answer* would include the above guidelines but also include details dealing with the structure of the confrontation; specifically, having a neutral site for the meeting, the formality of the setting, and the timeboundedness of the meeting.[61] Given the seriousness of the meeting, a good student's answer would recommend that the meeting take place in a formal meeting area that is not affiliated with either DHR or any of their hired professionals (lawyer, accountant, banker, broker, etc…), perhaps a small meeting room at a hotel or restaurant, and that only beverages be available (a meal would indicate less formality). Secondly, the meeting should take place at a time convenient to both parties and allot enough time (say at least one hour) to go over the accusation as well as a discussion of solution strategies. One or both parties might feel threatened as the meeting progresses and certainly should be allowed to request a second meeting where third parties may be present to represent the interest of both parties in question.

A *very good answer* will go beyond the above answers by having Davis and Hodgetts prepare for the worst case scenario, a threat of violence. Once violence is threatened, Davis and Hodgetts should:

- ❑ "Remain calm and try to be professional. Do not reflect the confrontational person's behavior.
- ❑ Empathize with the individual and actively listen to that person's concerns and issues.
- ❑ Allow the person to vent. Sometimes a person will verbally act out if an audience is present. Removing the person to a more private area (if it's safe to do so) to discuss the problem is ideal.
- ❑ Use the team approach. If a disruptive person is more responsive to another employee, let that staff member handle the transaction.
- ❑ Comply with the request if the disruptive person wants to speak with a [third party] supervisor. Never deny an individual the opportunity to take a matter to a higher authority.
- ❑ Tell the individual that his/her behavior is unacceptable if the individual starts to become confrontational. Let the person know that you will discontinue service if he or she continues to act that way.
- ❑ Call a supervisor, other staff members or security personnel to assist you if the situation escalates and you feel threatened.

- ❏ Always be aware of your surroundings especially if you know you are dealing with a person with behavioral problems. Make sure to leave yourself an avenue of escape.
- ❏ Call 911 immediately if you observe a coworker or individual being subjected to disruptive behavior where the activity becomes life threatening."[62]

An *excellent answer* will include the above material but most importantly recognize that no matter how much Davis and Hodgetts put into their preparation and planning for this meeting that the unexpected may happen. Nonetheless, a student presenting an excellent answer will also make sure to at least have Davis and Hodgetts develop some possible responses Alan may have to their accusations and what their reaction might be to that response. See Table 5 below for examples.

Table 5: Alan's Possible Responses and Davis and Hodgetts' Possible Reactions*

	Alan's Possible Responses	Davis and Hodgetts' Possible Reactions
1.	Denies allegations that the expenses were inappropriate and/or his signature was forged. Includes pleading ignorance.	Davis and Hodgetts threaten to take legal action against Alan and/or Wilma (criminal and/or civil). Davis and Hodgetts suggest that Alan consult an attorney and then meet with DHR, their accountant and their attorney to discuss this issue. Davis and Hodgetts say nothing more at the meeting and take whatever actions they deem fit (i.e. legal actions, firing Alan, etc…).
2.	Walks out of the meeting without saying anything.	Davis and Hodgetts go ahead and file both civil and criminal charges. Davis and Hodgetts try to arrange another meeting. Adrienne tries to meet with Wilma to discuss what is going on.
3.	Thompson admits embezzlement and wife's forgery.	Davis and Hodgetts go ahead and file both civil and criminal charges. Davis and Hodgetts suggest that Alan consult an attorney and then meet with them, DHR's accountant and attorney to discuss this issue. Davis and Hodgetts work out a payment plan for the embezzled funds. Davis and Hodgetts claim breach of work contract but do not file criminal charges.
4.	Thompson admits embezzlement but denies forgery.	Same as above.

* Not an inclusive list.

5. Assume that you were Alan Thompson and accused of these crimes. How would you react if you were innocent of the charges? How would you react if you were innocent of these charges but your wife was guilty of forging your signature? How would you react if both you and your wife were guilty?

Questions three and four looked at this case from the viewpoint of Davis and Hodgetts. The purpose of this question is to have the students put themselves in Alan Thompson's place (a place we hope they never have to be in but certainly may find themselves in), that of the suspected perpetrator of a crime that may not only lead to a loss of income but also a loss of freedom. They also must address the issue of what are the rights of the accused in this case, regardless of innocence or guilt.

A *poor answer* by a student will overlook the issue of the rights of the accused and directly answer the question based upon his or her own personal values or the student's perception of Alan's values. For example, the student might indicate that an innocent person has nothing to hide and therefore if Alan were innocent he should fully cooperate with Davis and Hodgetts while denying the charges. If Alan was innocent, but his wife was not, the student might have Alan either deny her guilt or admit her guilt and then determine whether or not Alan was willing to cooperate with Davis and Hodgetts in order to protect his wife. If both parties were guilty, the student might have Alan deny his and his wife's guilt, have Alan "scapegoat" his wife, or admit that they were both guilty and willing to work things out with Davis and Hodgetts.

A *fair answer* by a student will first recognize the seriousness of the situation, regardless of Alan and his wife's guilt or innocence. "They say that a man who represents himself [in court] has a fool for a client. And with God as my witness, I am that fool!"[63] In other words, individuals proceeding without any attorney when accused of a crime take a high stakes gamble with their freedom, their money, or both.[64] The student in this answer would therefore strongly suggest that Alan and his wife consult with an attorney so that Alan and his wife will both understand what their guilt and/or innocence would mean in this situation and to develop a legal strategy for dealing with this accusation. This student would then cover the possible options described in *the poor answer* for each set of circumstances (guilty or not guilty) except that these options would be discussed with their attorney.

A good answer would start off by acknowledging Alan's rights as someone who is accused of a crime and then certainly suggest that Alan seek legal counsel regardless of his guilt or innocence. The rights of the accused include, but are not limited to: the presumption of innocence, the right to counsel, the right against self-incrimination, the right to information (i.e. charges, witnesses), the right to a speedy and public trial, the right to put on a defense, and the right to appeal.[65] These rights are derived from the Bill of Rights and are as follows:

Fourth Amendment. The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated, and no Warrants shall issue, but upon probable cause, supported by Oath or affirmation, and particularly describing the place to be searched, and the persons or things to be seized.

Fifth Amendment. No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury . . . nor shall any person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall he be compelled in any criminal case to be a witness against himself, nor deprived of life, liberty, or property, without due process of law. . . .

Sixth Amendment. In all criminal prosecutions, the accused shall enjoy the right to a speedy and public trial by an impartial jury... and to be informed of the nature and cause of the accusation; to be confronted with the witness against him; to have compulsory process for obtaining Witnesses in his favor, and to have the Assistance of Counsel for his defense.

Fourteenth Amendment. Nor shall any State deprive any person of life, liberty, or property, without due process of law.[66]

This answer would include the material in the *poor* and *fair* answers but also would likely suggest that the attorney, not Alan, be the one to contact Davis and Hodgetts re: the accusation. The attorney might request, for example, to meet with the accountant to make sure that the inappropriate and duplicate expenses were accurate and that the forgery was just not a 'lazy' signature. From a procedural standpoint in dealing with Davis and Hodgetts, the lawyer's actions (regardless of Alan's guilt or innocence) may be quite similar; try to discredit the evidence and the expert while developing plausible alternative explanations for the alleged inappropriate, duplicate expenses, and the forgery. If Alan's lawyer believes that Davis and Hodgetts have solid evidence, the lawyer might then try to broker a deal with Davis and Hodgetts that keeps this whole affair away from the courts (regardless of Alan's admittance of innocence or guilt). The lawyer may also suggest a deal to Alan and Wilma, (regardless of their innocence or guilt) if the lawyer believes that the reached agreement would cost less than his or her attorney fees and possible court charges.

A *very good answer* would include all of the prior material but also point out that Alan and Wilma in all probability do not have a personal attorney nor be able to afford one. The likelihood that Alan would consult an attorney therefore would be quite low and the student providing this *very good answer* might suggest that perhaps at best Alan might retain the services of a public defender. More importantly, the student would point out in this answer that in all probability Davis and Hodgetts do have a lawyer and certainly are in a better position to afford an attorney than Alan and Wilma. This would put Alan in a very poor power position in his dealings with Davis and Hodgetts[67] (regardless of his guilt or innocence) and certainly allow Davis and Hodgetts to use conflict resolution tactics of forcing and coercion.[68] This student might conclude that even if Alan were blameless, it would make no sense for him to insist on his innocence since Davis and Hodgetts were in a position to presume his guilt and require proof to the contrary. Immediately settling the matter with Davis and Hodgetts in this situation would presumably be the best approach (regardless of actual guilt or virtuousness) since Alan seemed to have little ammunition to prove his innocence.

An *excellent answer* would include the above information but also to discuss attorney-client interaction in more detail. "The relationship of client and attorney is one of trust, binding an attorney to the utmost good faith in dealing with his client. In the discharge of that trust, an attorney must act with complete fairness, honor, honesty, loyalty, and fidelity in all his dealings with his client. An attorney is held to strict accountability for the performance and observance of those professional duties and for a breach or violation thereof, the client may hold the attorney liable or accountable. Beal v. Mars Larsen Ranch Corp., Inc., 99 Idaho 662, 667-668, 586 P.2d 1378, 1383-1384 (1978) (citation omitted)."[69]

Given this relationship, this student might question how an attorney could represent Alan and Wilma if they were actually guilty. "The easy answer to this is that the defense attorney should never ask the client that question or allow the client to confess to him/her. It is not for the defense attorney to determine whether a crime was committed. To do so is a substitution of the values of the defense attorney in the place of the jury's determination of a legal conclusion and undermines the search for justice within the system. The more difficult answer is that the defense attorney should not concern him/herself with overtaking the job of the jury and passing judgment on the client. That not only is contrary to the role of the defense attorney, but interferes with the role that is expected of him/her. The most zealous advocacy of a client's position cannot be attained when the defense attorney is morally troubled in an attempt to judge a client. In this situation, justice is served by ignorance."[70] More specifically, Alan's attorney, when interacting with Davis and Hodgetts (or their representatives), should always assume the position that his client is innocent until proven in court otherwise.

The student might also ask what the attorney should do if one of the two parties (Alan and Wilma) is innocent, the other guilty, or, more importantly, the interests of Alan and Wilma seem at odds with one another. For example, "as guaranteed by section 15 of article I of the California Constitution, the right to effective assistance of counsel "... means more than mere competence. Lawyering may be deficient when conflict of interest deprives the client of undivided loyalty and effort." (*Maxwell v. Superior Court* (1982) 30 Cal.3d 606, 612 [180 Cal.Rptr. 177, 639 P.2d 248, 18 A.L.R.4th 333]. … Conflicts of interest broadly embrace all situations in which an attorney's loyalty to, or efforts on behalf of, a client are threatened by his responsibilities to another client or a third person or by his own interests.)"[71]

In this situation, if the attorney felt that Alan would be better off by 'bargaining off his wife' so to speak in order to achieve the best deal possible with Davis and Hodgetts, the lawyer should immediately inform the couple that he can not represent both of them in this matter. This student would probably conclude that regardless of the situation, it would be better if Alan and Wilma had separate attorneys.

EPILOGUE

After a discussion with their lawyer, Hodgetts and the Davis' agreed to confront Alan with their accountant's findings. It turned into a very uncomfortable meeting. Evidence was presented as to the inappropriate credit card charges, the multiple purchases of gas and tools, and the felonious signature on certain credit card charges. Further evidence was presented to Alan that matched his wife's signature to some of the credit card charges. Alan neither agreed to nor denied the charges. That being the case, Richard took the keys to the company truck and tool shed and then described to Alan what their continued working relationship would be. Rather than being fired, Alan would be working for his brother (who would form his own company) and his brother's monthly check would be docked approximately $4000/month to recover all the losses. Furthermore, Alan would now have to find a way to get a mortgage for his house or vacate the premises within 30 days. Alan still made no comments and left the meeting.

The next day Adrienne filed a police report detailing both Alan's and Wilma's actions while Alan and Wilma packed in order to vacate the rented house. When Adrienne went to submit the police report she found out there was already a warrant for Wilma's arrest for passing checks with insufficient funds. It was issued two years ago, and they couldn't find her. However, they weren't actively looking. Adrienne supplied the police with Wilma's current address yet no actions were taken and Adrienne did not press charges.

Alan, Wilma, and their family vacated the home they were renting within the 30 day time period. A foreman was hired to supervise all of the subcontractors' work (including Alan and his brother) and discharged Alan and his brother for poor workmanship about a month after. Approximately $ 9,000 was recovered from Alan although the cost of redoing his and his brother's poor workmanship exceeded the compensated funds.

APPENDIX A

EMBEZZLEMENT (http://www.whitecollarcrimefyi.com/embezzlement.html)

What is embezzlement? Embezzlement is defined as the misappropriation of items with which a person has been entrusted. Embezzlement differs from larceny in that the perpetrator of embezzlement comes into possession of property legally, but fraudulently assumes rights to it. Charges of embezzlement can even be levied if the embezzler intended to return the property later.

Four points must be proven to support the case for embezzlement:

1. The relationship between the defendant and the aggrieved party was a fiduciary one
2. The lost property came into the defendant's possession through that relationship
3. The defendant fraudulently assumed ownership of the property or transferred it into the ownership of another
4. The defendant's misappropriation of the property was intentional

How does embezzlement relate to employee theft?One of the most common instances of embezzlement in today's society is employee theft. Employees of many companies have access to company property, creating the potential for embezzlement. Examples include such small crimes as theft of retail items, discounted sale of retail items, and theft from cash registers, but can also include the theft of millions by employees of large firms.

How can employee embezzlement be detected? There are a number of warning signs of employee embezzlement. Some general indicators may include: Missing documents, delayed bank deposits, holes in accounting records, a large drop in profits, a jump in business with one particular customer, customers complaining about double billing, repeated duplicate payments, numerous outstanding checks or bills, disparity between accounts payable and receivable, and disappearance of petty cash.

A particular employee may be embezzling money if he or she: goes out of his or her way to work overtime, begins spending more lavishly than salary might indicate, and has the same address as a vendor

What steps can an employer take to investigate and resolve possible embezzlement? Since embezzlement is usually discovered by way of circumstantial evidence, an active approach by the employer is required to uncover the perpetrators of the crime. An investigation should be conducted quickly but subtly. Company officials should compile a list of employees who may have had the opportunity to commit the suspected embezzlement. These employees should be interviewed, more than once if necessary. The employer should try to recover as many records as possible to find accounting discrepancies or other evidence. If the crime appears to exist on a large scale, the employer may need to contact outside advisors – including attorneys, insurance agents, and investigative specialists – to assist with the inquiry.

If guilt can be assigned to one or more individuals, the employer will have to determine what action to take against them within the company. Termination is not out of the question if there is strong evidence indicating guilt. Then, the employer must decide whether or not a civil suit will be filed and whether or not to turn the evidence over to public authorities for a criminal trial.

How are embezzlers punished? The penalty for an embezzlement violation typically depends on the value of the property that is misappropriated. A perpetrator is usually fined an amount on the same order of the value of the property, and may receive a prison sentence as well.

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JOJA'S DELI: A FRANCHISE IN NEED OF DIRECTION

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CASE DESCRIPTION

The subject matter of this case addresses the problems and opportunities for a new franchise concept. This case would be most appropriate for undergraduate courses in entrepreneurship, small business management, franchise management, and strategic management, as a written assignment—and graduate courses as a class discussion. The case is designed to be discussed in one to one and one-half hours and should take students no more than three hours of outside preparation.

CASE SYNOPSIS

At one level, this case traces the success and growth pains of a small business transformed into a franchise. It follows a family business from start-up, through change, to success, and finally to potential high value creation. Throughout this journey the problems and opportunities of running a small business are illustrated.

INSTRUCTORS' NOTES

The Levin brothers are attempting to create substantial value by duplicating their tried and true deli service delivery system. The JoJa's service delivery system provides the deli product/service to a specific customer group that has a very high demand for this good. The problem facing the Levin brothers is not the quality of the product/service, the validity of the service delivery system, or the targeting of the specific customer group, but how do you grow this concept from a local franchise (with the inherent high risks) to a regional/national franchise?

The individuals in this case are real, but their names, locations, and other trivial facts have been changed to protect their identity. The fundamental facts of the case and the financial information are accurate. Some information has been factored up or down to keep critical facts secret, but the relevant information has been accurately maintained.

Case Questions

1. **What do you think of the JoJa's concept as a franchise opportunity? What would you do to improve the concept?**

JoJa's is a first class franchise opportunity. First, the Levins have established a business that relies on a best-cost provider strategy --- it gives customers (and franchisees) more value for the money. A JoJa's deli creates the highest quality products. The food has won numerous awards and is considered a great value. Thus, JoJa's delivers superior value by satisfying customer expectations on key quality/service/features/performance attributes while beating their expectations on price. JoJa's has done this by incorporating attractive attributes at much lower prices than their chief rivals. For example, JoJa's sandwiches are the highest quality --- comparable to Panera Bread, but at almost half the cost. Although their food is somewhat more expensive than Subway's or other sub shops, the taste and quality is far superior. Because this is a hybrid strategy JoJa's must target value-conscious customers --- which is a very sizable part of the business lunch market. These customers tend to be sensitive to price and value. The only risk is that JoJa's target market becomes squeezed between options that provide lower cost products (i.e., bringing lunch or Subway Sandwiches) or highly differentiated rivals (i.e., Panera Bread).

Because of this strategy, JoJa's is able to offer their franchisees the same best-cost provider strategy. A JoJa's franchise is relatively cheap and the product (i.e., the service delivery system) is first rate. The franchise provides many things that franchisees are looking for --- high profits, efficient operations, multiple streams of income, short operation schedule, significant margins, easy to reach customers, and moderate growth. Thus, the JoJa concept has a significant competitive advantage over its retail and franchise rivals.

Beyond the competitive benefits of the franchise, JoJa's offers its franchisees significant returns on investment. The investment payback on most units is one year, if you do not factor in management salaries. This is a remarkably short payback period. Two of the franchisees are receiving over $200,000 each in yearly cash flow (i.e., management salary and profits). This is a remarkable return on an $110,000 investment.

Yet, there are problems with the franchise. The greatest problem is the lack of corporate and operational support. The Levin brothers seldom visit franchised units. Thus, there is a lack of control over operations. The franchise agreement entitles the Levins to "control" operations, but the brothers' natural tendency is to "keep out of the way". Because most JoJa franchisees are first-time business owners, problems arise. Such things as failure to provide a complete menu at some units, poor quality control, and irregular hours of operation are some of the biggest franchisee infractions. The Levin brothers must begin to "control" the franchisees more closely.

Another issue is the slow pace of franchise sales. Eight units have been sold in almost eight years. It is obvious that change is necessary. Several other sandwich and sub shops have become aware of JoJa's business model and it is only a matter of time before other deli concepts begin to compete in their niche. Next, something must be done to improve franchisee relations. Franchisees are upset with the lack of field support. Also, no formal system exists to trade "best-practices" and such. Thus, the Levins must begin to manage the franchisee network as it grows. Otherwise they will have a system of independent owners running the show. Finally, the Levins should begin a series of plans and budgets. Currently, they have no real idea of cash flows. They have no existing process to manage fees and royalties and then determine how to use this capital to build the franchise system.

2. What do you think of the Levin brothers' management of the JoJa's franchise business?

Corporate management at JoJa's is a schizoid situation. On one hand the Levin brothers have done a fantastic job of creating the JoJa's service delivery system, concept, and business plan. JoJa's offers its customers and its franchisees real value. Additionally, the Levins have developed all of the tools (i.e., manuals, training videos, recipes, etc.) necessary to launch a JoJa's franchise. Thus, initial management of JoJa's has been tremendous. The problem arises when the two owners "get out of their area of expertise". The Levins know how to create and operate a great deli shop, but they do not have the entrepreneurial talent to franchise this concept and take it to the next level. For that they will need to realize that change is necessary. That change could take many forms:

Hire expertise in certain areas such as franchise sales and operations.
Step aside from the management of the company and hire an experienced manager.
Sell the business. Even with slow sales and poor profits the franchise is worth millions.
Bring Joey and Steve Levin into the business. Both are much more flexible about running the franchise business.

The Levin brothers have a wide array of change options, but change they must. If the franchise operations continue as they have, problems will plague this company. Additionally, competitors will steal their space if they do not begin to move into critical franchise areas. Remember there are a limited number of sites that fit the JoJa's model (perhaps 800 or so). While this sounds like a great deal of potential one must factor in such things as established competition, franchisee availability, and retail space. Considering these factors, the number of possible unit sites begins to shrink dramatically (to perhaps 500 or so units). Thus, the window of opportunity for this franchise concept is closing and the Levin brothers need to make some fast decisions.

3. What should the Levin brothers do to expand franchises?

JoJa's is a great business opportunity and the Levins can create great value for themselves, their franchisees, and their customers in the next 10 years. But the brothers need a plan and additional talent. The most fundamental issue is franchise growth. The Levins need a business growth plan and someone (i.e., Director of Franchise Sales) responsible for executing this plan. The Levins have used a very unsophisticated model to sell franchises --- one-offs to independent, usually inexperienced, franchisees. This model almost insures slow growth because it is difficult to target these individuals. Most successful, national franchises sell "territory" franchises to sophisticated individuals or corporations. This is also called "area development rights". For example, Wendy's International sold a seven county territory in South-central Pennsylvania to an experienced group of investors. This agreement states that this group of investors can own and operate as many Wendy's units as they want in this region. The agreement also specifies a minimum number of units that must be opened per year. This group has access to capital, management expertise, and substantial knowledge of the region and the fast-food industry. This type of franchise marketing relieves Wendy's International of many problems. Thus, the Levins must develop a growth plan and hire the talent to execute the plan.

Next, the Levins must get control of their franchise operations (i.e., Director of Franchise Operations). They should hire an experienced fast-food operations guru. This individual should be responsible for developing operations and field support --- training, technical support, control, etc. for the deli chain. This should include store audits, best-practice and knowledge management, and support of all operations. Eventually when the business has grown it will require marketing, advertising, and promotional support, as well. With growth and the sophistication of franchisees it will be necessary to also hire a Director of Association of Franchisees. This individual must be franchisees' voice in the corporation. It is imperative that this person be an experienced and savvy leader, because he/she must balance the needs of the corporation with the demands of the franchisees.

Finally, all of this will take time and money. Once the new business plan has been developed it is critical that it be presented and discussed with all franchisees in a suitable forum. It will be necessary for the Levin brothers to "sell" this new growth plan to the franchisees. They must understand that they will be receiving more support and input, but will also be charged a higher royalty fee. Yes, there is no such thing as a free deli lunch. To pay for all of the additional talent and services it will be necessary to raise royalties and franchise fees. This should be fully explained to every JoJa's team member. The franchise agreement states that fees can be raised to pay for additional services, so this move is within the bounds of the franchise agreement. Still the franchisees will object and see this as a zero-sum-loss. That is why it is important for the Levins to explain that these additional franchisee costs are being "plowed-back" into the business to grow the pie. Without these franchise improvements all members of the JoJa family are at risk and, therefore, it must be done.

If the Levin brothers make these or similar changes the franchise can be improved and invigorated. If not, the Levins should seriously think about selling their business concept and then look at other business opportunities --- business lunch catering, growing an on-line gift basket business, or opening a new more scaled-down deli concept.

4. If you were to sell the business, how much is the company worth?

Determining the value of this business is really tough. The most direct approach is to use yearly cash flows times an appropriate multiple. Agreeing on what multiple to use is the tricky part. Because of the relative slow growth of the company a multiple of "8" or so would seem reasonable. But because JoJa's has so much upside potential a higher multiple seems necessary. If the franchise was operated more effectively growth and profits would be much greater due to the fantastic business model, clear value proposition, and desirable niche. Therefore, a multiple of "15" is more reasonable.

Next, royalties should be increased to 4%. This will increase profits, but not double them because the Levins must hire additional talent and provide more services to franchisees. EBIT in 2004 was roughly $75,000. Clearly, profits could increase to $100,000 a year with the increase in royalties. Thus, the simple answer to the question is $100,000 x 15, or $1.5 million. But we feel that this is a "floor" value for JoJa's. A back of the envelope calculation illustrates why we believe this to be true.

If the franchise has 300 units @ at an average of $650,000 in sales @ 4% royalty = $7.8 million per year in revenues. This does not include one-time franchise fees for the 300 units. We realize that the $7.8 million is a revenue figure, but the potential is obvious. But the future is never sure and it may be a long way away.

A QUESTION OF ETHICS IN A UNIVERSITY SENATE

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CASE DESCRIPTION

The primary subject matter of this case is the ethical use of power and peer pressure within a group of people with significantly different status – a university senate comprised of a provost, deans, administrative VPs, faculty members, and students. Secondary issues include how the same events can be experienced differently, leading to different assessments as to the ethical behavior of those involved. Case difficulty is 2 (sophomore). The case is designed to be taught in an introductory management or ethics course requiring from 50-75 minutes of class time and either no outside preparation, or about 20 minutes of pre-class preparation.

CASE SYNOPSIS

This case is about a University Senate meeting in which lobbying is done by the Chair of the Senate prior to the meeting. The Chair caucuses a group of student senators and pitches her views regarding an upcoming vote. As the Chair is a senior faculty member, she has power over the students – even though the ideology of the university senate in question is that all members are equal. During this caucus, the Chair asks for a show of support to vote down a motion – thereby making public among those present an expression of each person's intended vote. The Chair's use of power and status and her use of peer pressure among students are questions to be explored.

Ethical decision making is frequently learned through experiential means – short cases and role play exercises. It is often taught by providing multiple perspectives on an issue and generating confusion or ambiguity in the minds of the learners regarding their initial 'right' and 'wrong' views of a situation. It is not the clearly unethical situations that cause people to get into trouble. Most black and white situations are easy to identify. Rather, it is situations in between – the gray areas that are challenging and require discussion and dialogue. These more complex and sometimes confusing situations are reasons why faculty members provide students with ethical frameworks through which they might recognize their own values and then learn to make choices that are consistent with those values.

The case provides two points of view on the same situation and can be used to demonstrate different ethical frameworks, e.g., comparing the ethical philosophy of Hobbes (1958) to that of Kant (1959). Each view in the case below is by a different newcomer to the Senate – a new student *senator and a new dean senator. The differences in their roles, perspectives, and how the caucus and outcome of the vote affects them are significant.*

INSTRUCTORS' NOTES

All should read the introductory section entitled: A University Senate. If your University has a Senate, you might share its charter and bylaws with the class in advance.

The Student Senator – Dean Senator sections can be used in multiple ways. One might choose to use only one or the other, but they are likely best used together. The Dean Senator case is designed to have students question the behavior of the Chair of the Senate. The Student Senator case complicates the initial thinking of the student with additional perspectives on the situation.

SMALL CLASS, UP TO 75 MINUTES OF CLASS TIME (NO OUTSIDE WORK)

In using the case, one option is to provide all students with the University Senate section and the Dean Senator section -- allow time for all to read these twos sections individually. Next, ask students to break into small groups to discuss their opinions about the case and to develop their rationale. Opening questions might include:

1. **If there is an ethical issue here, what is it?**

   The ethical issues include: (1) whether or not the Senate Chair misused her power or status, (2) whether or not the ill-preparedness of the dean was a breach of his ethical responsibilities, and (3) whether or not the student senators responded to the power or status differential of the Senate Chair versus the content of her argument. Note: While the intention of the authors is to provide a vehicle for the discussion of ethics, some instructors might want to add in a discussion of power and influence.]

2. **Did anyone behave unethically? The Senate Chair? The Dean? The Students? What specific actions were taken that you view as unethical?**

   The unethical behaviors might include: (1) the Senate Chair singling out the students for the pre-meeting caucus rather than having a more open dialogue with all around, (2) the dean avoiding the issue when asked at the caucus, and (3) the student senators looking primarily to each other rather than other senators for further input.]

3. Which ethical models are you using to support your view that this is an ethical issue?

These would depend on the ethical frameworks that are part of the course. E.g., consider Hobbes' views. One argument that shows the deleterious effects of self-oriented behavior was urged by Thomas Hobbes in the 17th century. Noting that if everyone were to adopt the cardinal rule of egoism, namely, that one should pursue one's own self-interest even at the expense of others, there would result a "war of all against all" and life would be "solitary, poor, nasty, brutish and short" (Hobbes, 1958, p 13). His solution was to postulate the need for an omnipotent sovereign (*a Leviathan*) to restrain the citizenry from such self-defeating and short-sighted conduct. One might argue that the Senate Chair was behaving as an 'egoist' and abusing her formal role as the omnipotent sovereign.

If we consider Kant, then the argument might go as follows. Kant established the "categorical imperative" whose focus is on the nature of the action itself, rather than its consequences, to determine the morality of actions. This categorical imperative moreover must emanate from a "good will" which, for Kant, is the only attribute of the person which is good without qualification. "The good will is not good because of what it effects or accomplishes or because of its adequacy to achieve some proposed end; it is good only because of its willing, i.e., it is good of itself." (Kant, 1959, p. 9). Put differently, the good will is good because it is governed by duty. The important question for Kant is determining what duty commands, determining what evaluative criteria can be employed to enable us to know whether an action is moral or immoral. Kant (1959) answers this question with his notable three-part formulation of the categorical imperative:

Act only according to that maxim by which you can at the same time will that it should become a universal law.
Act so that you treat humanity, whether in your own person or in that of another, always as an end and never as a means only.
So act as if your maxims should serve at the same time as the universal law (of all rational beings).

Depending on ones response to the questions above, you could argue that each player did not act fully from their duty – the Senate Chair has a duty to not use the power of position to influence others to her views; the dean has a duty to be informed and prepared in this governance role; the student senators have a duty to be fully informed and take into account the perspectives of the different university constituencies – not just a single constituency.]

4. Is there anything inherent in the structure of the senate that has contributed to these questionable behaviors?

One might raise the following questions for further discussion. Can a student senator really have an equal say in situations that involve faculty members who may be subsequently involved in grading their in-class performance? Is the status and power differential to great to consistently support open and honest dialogue among all members? It is appropriate to have public votes when the individuals doing the voting have greatly different power over each other – with this applying to faculty over students and deans/administrators over faculty?]

One of the students in each group should be assigned a "report out" role to insure dialogue from each small group. Allow the small groups three to five minutes to discuss their positions. Anyone wishing to add or clarify during the reporting out phase should be encouraged to do so. Then, allow fifteen to twenty minutes total for all groups to report out and to give their rationale. Record major points on a board for all to see.

Once discussion winds down, distribute the Student Senator section -- allowing time for each individual to read. Again, ask students to discuss at the small group level and to make note of any changes in opinions with their rationale. New questions might include: "Does the added information alter your conclusions?" "If yes, what information caused a change in your opinions? Why?" Allow three to five minutes for the small group discussion and fifteen to twenty for the reporting out process.

Students should be asked to identify the theoretical frameworks from their text, reading, and previous class discussions that were used by them.

LARGER CLASS, 50 MINUTE CLASS SESSION, 20 MINUTES OUTSIDE READING

Distribute the University Senate and Dean Senator sections to half the class and University Senate and Student Senator sections to the other half of the class. If possible have students read their materials in advance. Allow 10 minutes for each group to discuss their case among themselves in class. Before reporting out the opinions of their group, ask for a volunteer to reiterate the facts of the Dean Senator case for the benefit of the other half of the room. Then allow ten to fifteen minutes to have the Dean Senator groups report out, keeping notes on a black/white board.

Next, ask for a volunteer to reiterate the facts of Student Senator case. Allow ten or fifteen minutes to have Student Senator groups report out, keeping notes on a board.

With both sides in full view, ask students which facts from the other side have had an impact on their opinion. Ask students to identify ethical frameworks used by them and the pros/cons of each.

LEARNING POINTS FOR BOTH OPTIONS (10 MINUTES)

The de-brief lessons would include:

1. That which is clearly black or white for some people may be gray for others. It is the gray areas that are most in need of ethical frameworks for analysis.

2. Everyone needs to "stand for something or they will fall for anything!" Are you clear on what it is that your were standing for in your assessment of the conduct of the various parties in the case?

3. One may have a clear position that becomes shaken by new information.

4. Status and power incongruity can compromise the integrity of group decision making processes as those with greater power over others may consciously (or unconsciously) exercise that power to their own ends.

5. The development of an ethical framework to help oneself navigate ethical issues is a critical management skill.

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ENDNOTE

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MANULIFE FINANCIAL AND THE JOHN HANCOCK ACQUISITION

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CASE DESCRIPTION

This case mainly deals with the opportunity for Manulife Financial to acquire the legendary John Hancock Financial Services, Inc. Students must consider both financial and non-financial aspects of the acquisition decision. Secondary aspects include a host of other financial and strategic issues facing Manulife Financial. The case would be relevant for either a senior undergraduate or graduate course in strategy or financial management as it requires analysis and support drawing from both disciplines. The case is designed to be taught in one to two class hours and is expected to require approximately five hours of outside preparation time. Students need to be familiar with financial management concepts and strategic analysis and formulation.

CASE SYNOPSIS

In 2003 Dominic D'Alessandro is facing his most challenging time since becoming CEO of Manulife almost ten years prior. D'Alessandro must not only decide where to invest Manulife's large cash reserve now that a competitor, Great West Life, became the successful bidder for Canada Life Financial, he must also look at the strategic direction he is to set as consolidation in the financial services industry comes to a close. There are many investment alternatives, including the relatively safe bond market; but, more risky and rewarding options may be required if D'Alessandro wants to continue Manulife's legacy of exceptional financial performance.

Aside from the investment and related strategic decisions, D'Alessandro must contend with an appreciating Canadian dollar, the increased re-insurance risk made evident by the events of September 11th, 2001 and the emergence of the Sudden Acute Respiratory Syndrome (SARS) in the Asian continent. In short, D'Alessandro must pursue an investment course that is strategic, and formulate and implement a plan that will ensure the future profitability and viability of Manulife Financial in the short and long run.

INSTRUCTORS' NOTES

Teaching Focus and Goals

This case is written in a manner such that the students assume the role of a Chief Executive Office of a large, public company. In this particular case, students assume the role of Dominic D'Alessandro, the CEO of Manulife Financial, a large financial institution with global operations. It should be noted at this point that while there is no 'correct' solution to this case, some recommendations are better than others taking into account the information provided in the case. This is an exercise in analysis and judgment that will allow students to develop alternatives and provide support for what they believe is the best strategy, decision and course of action.

Although this case deals with a financial institution it is not a pure finance case. The case deals with strategic issues as much as financial. Detailed financial information is not provided and advanced statistical valuation techniques are not required to develop an adequate solution. As outlined below, the investment decision is more geared towards an analysis of organizational fit, post-acquisition implementation plan and goal congruency rather than detailed financial analysis. Specifically, the teaching goals are for students who take on the top management role to:

1. understand the business model of the industry and the firm;
2. learn how industry and larger social forces, as well as internal strengths and competencies shape top management decision-making;
3. examine feasible options facing the decision-maker in the case, and how the chosen option fits or can be made to fit with both a firm's external (i.e., social and industry) and internal (i.e., functional, cultural and strategic) environments.

Life Insurance and the Manulife Business Model

It is vital to understand the basic business model of Manulife in the context of the insurance business to fully understand this case. Essentially, an insurance company collects a premium from a client in return for providing financial assistance in the case of a catastrophe. For example, a company will collect $100 per year to provide financial assistance of $100,000 in the case of a death. A property and casualty insurance company will collect $1,000 per year to provide payments for third party liability or to repair damage from collision in the case of an accident. If the catastrophe does not incur over the period of coverage (i.e. the term on the insurance) then no payments are made by the insurance company and the proceeds are retained. However, the law of large numbers dictates that a certain proportion of all insurance policies will make a claim.

Determining the price of the premium is a complex process performed by actuaries. Essentially, the price of the premium is set to equal the present value of the probable future cash outflow plus the administration costs including an amount for profit. The mathematical principal of expected value is used to calculate the premium whereby the probability of each future scenario is multiplied by the total cash payout under each scenario. For example, Table 1 shows the pricing calculation for insurance coverage for a one-year term.

Table 1 – Calculation of Premium Price (one year term)

Scenario	Probability of Occurrence A	Cash Settlement B	A X B
Major Catastrophe	0.0001	100,000	$10
Minor Catastrophe	0.1	10,000	$1,000
No Catastrophe	0.8999	0	0
Expected Payout			$1,010
Administration			$105
Premium Price			$1,115

The calculation is more complex when the term of the coverage is more than one year. In this case, there will be a timing difference between the premiums collected and the cash settlement. Since there is a timing difference between when the premium is collected (present day) and when the potential cash payment occurs (future date), the time-value of money must be taken into account when calculating the price of a premium. As such, actuaries must make assumptions on the rates of return on the invested premiums.

A simple example will help illustrate the pricing of a premium that is longer than one period. For simplicity, assume that the term of the insurance policy is two years (although this solution will apply to more than two years). The insurance company assumes that it will be able to generate a rate of return on invested premiums of 10 percent per annum. Based on life expectancy rates (mortality tables) the following probabilities of cash payments are calculated as noted in Table 1. Therefore, the probability of a cash payment in year 1 and in year two is $1,115 (assume for simplicity; however, the expected payout normally increases as an individual ages).

Since the company can earn 10 percent per annum on invested premiums, the calculation of the premium price requires the present value of money calculations as follows:

$$\text{Premium Price} = \text{Expected Payout}_t + \text{Expected Payout}_{t+1} / (1+r)$$
$$= 1{,}115 + (1{,}115 / 1.1) \qquad = 1{,}115 + 1{,}013 \qquad = \$2{,}128$$

Therefore, at the current time, this contract has a present value of expected cash flows of $2,128. Spread out over the two year span, the annual premium price is equal to $1,064. Note that normally the annual premium would be calculated by discounting the payments to the present.

The nature of the insurance industry makes it evident that returns realized on the premiums investment is critical to the financial success of company. If the expected return used to calculate the price of the premium is greater than the return actually realized, the insurance company will likely not be profitable. However, the company should experience high levels of profitability if the return realized is greater than that expected return.

To illustrate this point, assume that the company prices the premium as described above. However, the company only realizes a return of 5 percent per annum. Therefore, the future value of the premiums would be calculated as follows:

$$= 1{,}064\ (1.05) + 1{,}064 \qquad = 1{,}117 + 1{,}064 \qquad = 2{,}181$$

Therefore, the company would have assets of $2,181 at the end of the second year. Based on the assumptions provided in pricing the contract, the expected payout of the contract would be calculated as follows:

$$= 1{,}064\ (1.1) + 1{,}064 \qquad = 1{,}170 + 1{,}064 \qquad = 2{,}234$$

Therefore, on average, the company would lose $53 per contract calculated as the expected payout of $2,234 minus the cash on hand of $2,181.

The opposite is true if the actual realized returns on the investments are higher than what was expected and used to calculate the contract price. In this case, the company would realize an excess profit on each contract. For this reason, investment returns are vital to the profitability of an insurance company. The higher the investment return earned, the greater the profitability that accrue to the shareholders after each contract is settled.

Insurance companies tend to invest their premiums in a balanced portfolio of stocks, bonds, and long-term investments in subsidiaries. Risk management is essential during the investment process because large losses resulting from excess risk would eventually lead to insolvency as future liabilities will exceed assets.

External and Internal Analysis

The students should approach the solutions by taking into consideration the information provided regarding the history, vision and strategies of Manulife Financial. Furthermore, when assuming the role of Dominic D’Alessandro, students should make decisions that are consistent with the biography presented in the case. The recommendations and implementation plan should be congruent with the company's vision and renewed strategy. The vision presented in the case.

The existing vision seems appropriate and consistent with the 'PRIDE" values, expressed as goals that resonate with major stakeholders of Manulife (explicitly customer and employees and implicitly shareholders). The PRIDE values are stated in terms these four attributes (refer to Manulife Case, pp.3, for a description of the PRIDE values).

The main SWOT (strengths, weaknesses, opportunities, threats) may be derived from the analysis of the internal functions and structure of Manulife, beginning with financial position and also including analysis of the marketing, operations and human resources functions, and analysis of the industry in the context of the more macro or social environment.

The industry may be characterized as a favorable four out of five stars, using Porter's (1980) '5 forces' model of industry analysis (forces that have little power over strong incumbents such as Manulife are suppliers, individual buyers, substitutes and competitors, the latter becoming fewer as the industry consolidates). The only unfavorable force is new entrants, namely banks which are increasingly packaging insurance offerings with their other services, especially loans. Looking to social factors, all seem favorable. The political landscape appears to keep insurance separate from banking, both in terms of services and ownership; however, this is changing, evidenced in the near mergers in the recent past.

The strengths of Manulife include financial acumen, efficient systems, investment savvy and, although only implied in the case, a productive and employee workforce, all of which contribute to superior performance. Further to these valuable and difficult to imitate resources (Barney 1991), Manulife also seems to have deep rooted competencies (Prahalad and Hamel, 1990) that allow for integrating with merger partners. This is possible with the coherent vision and PRIDE values. Such an approach to strategic analysis as outlined here can be found in any good strategic management text, e.g., Hill and Jones (2004, p. C2).

One challenge is to craft a renewed strategy that is consistent with the vision as *"the most professional life insurance company in the world: providing the very best financial protection and investment management services."* In Porter's (1980) terms this must mean an increasingly differentiated provider. Since there are undoubtedly learning and scale effects that favor large players, Manulife's determination to become one of the larger players seems entirely appropriate.

All that remains is to know when to acquire suitable partners that already share or have the potential to adopt Manulife's values, vision and strategy. After the scale and scope of service is secured, then it will be a matter of continually renewing the strategy to keep Manulife moving in the direction to becoming the preferred financial institution, worldwide. This takes us to the specifics of the decision of where next to invest.

Feasible Investment Options

At this point in time, feasible options revolve around where to place the resources of Manulife and some basic questions need answering, starting with:

1. **Where should the large cash reserves be invested? What is the feasibility of Manulife acquiring John Hancock Financial, or merging with the Canadian Imperial Bank of Commerce? Would the safer bond market be the best place to invest the money?**

This is main issues of the case. Manulife Financial has a large cash reserve left over from an unsuccessful bid for Canada Life Financial. A large cash balance is not effective investment management as cash tends to have very low returns. The cash must be invested to earn larger returns. The following is a discussion of the potential pros and cons that students should identify and analyze while reaching a conclusion on where to invest the large cash reserves.

John Hancock Financial Acquisition

Advantages

The acquisition of John Hancock will give Manulife increased presence in the United States and will complement its service offerings. Manulife has experience in the U.S., with their U.S. Division, and is familiar with the market, regulations and customs.

- ♦ The fact that the Canadian dollar has been steadily appreciating recently has made a potential acquisition of a U.S. company less expensive. Manulife Financial will need less Canadian dollars to purchase the firm in U.S. dollars as the currency appreciates.
- ♦ John Hancock management fully expects cross-border purchases and is open to the idea of Manulife Financial acquiring John Hancock financial. The case also mentions that the CEO John Hancock indirectly confirmed that Manulife would be a suitable merger. This is in stark contrast to the Canada Life Financial attempted take-over, whereby management did not want Manulife to become their parent company. This is a crucial point that should be identified.
- ♦ Manulife Financial has a long history of acquiring other companies as an engine of growth. Shareholders and management are familiar and accustomed to acquisitions. It is safe to assume that the current management has the experience with acquisitions.

Disadvantages

- ♦ This may seem to be a relatively risky option when compared to the more stable and secure bond market, though the risk of the John Handcock acquisition is mitigated by its consistency with the direction the industry is heading (consolidation for reasons of scope and scale) and the apparent fit between the two companies.

Canadian Imperial Bank of Commerce Merger

Advantages

- ♦ A merger with CIBC would allow Manulife to increase the breadth and reach of their products and service by cross-selling products through the CIBC bank branches. Insurance can be combined with other banking services and sold in bundles.
- ♦ There are a host of potential cost savings and synergies that could arise from the merger. Branches or service outlets of CIBC and Manulife can be merged, thus reducing the total number of branches and employees required.
- ♦ A merger of this caliber will also create the largest financial institution in Canada, thus allowing for certain economies of scale and for increased competition against some of the larger, global institutions.
- ♦ CIBC's business should also benefit from the merger for the same reason that sales of the Manulife products would increase. CIBC would be able to promote and sell their banking services to the large number of client dealing with Manulife.
- ♦ The share price of CIBC is currently below what would be its fair market value because of some losses (Amicus bank and Enron) that are not expected to recur. The currently suppressed share price makes it an attractive target to attempt a merger/acquisitions.

Disadvantages

- ♦ This option is currently not feasible. A cross-pillar merger is not allowed by the Canadian Government at this time for fear of a monopoly and decreased competition, which is against the public's general interest. Therefore, taking the role of Dominic D'Alessandro, the student should identify a lobbying strategy as part of their recommendation.
- ♦ This is a very risky, and time consuming proposition.
- ♦ A merger with another institution of this caliber may be difficult if the

organization's cultures are very different: i.e. between banks and insurance companies.

- It is not currently possible to identify who would have control of the corporations after the merger. CIBC and Manulife are both larger Canadian financial institutions and their maybe a risk that Manulife may lose control of the corporation after a merger.

Bond Market

Advantages

- The primary advantage of the bond market is that there is very little risk involved in this option.

Disadvantages

- The primary disadvantage of the bond market is that there is no potential for large excess returns that will help Manulife achieve its financial goals.
- The current yields on bond markets are low compared to the historical averages.

Students can make a case for all three possible investments. There is no correct investment choice, although the case does give some hints to the students that should lead them to conclude that purchasing John Hancock Financial is the most appealing strategic option. However, the fact that Manulife subsequently did purchase John Hancock does not necessarily corroborate the notion that this purchase was the best course of action. Some of the hints in the case are as follows:

- Manulife has a history of using acquisitions as a vehicle of growth.
- The case hints that D'Alessandro may have to take on a risky strategy, compared to the bond market, to ensure that the financial targets are met.
- The CEO of John Hancock is open to Manulife purchasing the firm. This is in stark contrast to the past acquisition attempt.
- The case outlines that business researchers have identified the fact that acquisition in the same line of business are most successful than when a company purchase a company in another line of business (i.e. a bank – CIBC vs. an insurance company – John Hancock).

The advantages and disadvantages outlined above is by no means an exhaustive list. Students may identify other advantages and disadvantages that were not discussed thus far. The purpose of this case is to help students walk through the more qualitative aspects of a large scale investment decision.

2. Furthermore, if an acquisition was the best investment option, how would Manulife Financial handle the post-acquisition strategy to ensure that Manulife adds value in its offerings in different markets over the long term?

If students recommend an acquisition or merger, an analysis of the post acquisition strategy should be included as part of the implementation plan. The case provides hints at what would be required as part of the strategy.

The case has a specific paragraph that should prompt students to consider the post purchase plan. Business literature presents some conclusions regarding mergers and acquisitions. There are many difficulties of implementing a successful value added acquisition strategy, as post-acquisition difficulties arise because managers of the acquiring company did not deeply understand the target company at the time of acquisition, or that the acquirer imposed an inappropriate organizational design on the target as part of the post-acquisition process. Also, inappropriate management incentives that exist at both the top management and divisional level led to unsuccessful mergers. Acquiring returns are greater in acquisitions in which the acquirer and the target are in the same line of business. The acquirer should have a deep understanding of the targets business and industry before negotiations.

There is a wide variety of studies conducted on post merger acquisition strategies. The research provides some insight into the activities that create a successful strategy. There is a host of research conducted on the factors that help in achieving success in an acquisition/merger. Pautler (2003) prepared a summary and analysis (quasi meta-analysis) of the research. The resulting factors of success vary depending upon the type of transaction, but there are some commonalities amongst the findings that apply to a wide range of circumstances:

- ♦ Acquisitions that preserve the original focus of the firm tend to result in superior outcomes.
- ♦ Equal-sized firms that merge work less often than others. This is a caveat against the merger with CIBC, although students are not expected to be aware of this fact.
- ♦ The chances of success are greatly improved if planning for the integration of the new physical and human assets begins at an early stage.
- ♦ Quick integrations and early pursuit of available cost savings improves outcomes.

- Managers must be aware of cultural differences between the two organizations. Management must create tailored communication with employees, customers, and stakeholders to avoid conflicts.
- Successful integration requires managers to retain the talent that resides in the acquired firm, particularly in mergers involving technology and human capital.
- Minimizing the attrition of both customers and sales force.

While the overall financial outcome of mergers is clearly of interest in many of the consulting firm studies, the studies also focus on why mergers might have performed as they did, and whether performance could be improved by better implementation of merger-related changes. These factors are discussed below as identified by Pautler 2003.

Sometimes problems with the integration occur because the acquired assets did not fit into a broad strategy of the acquiring firm. Other times the broad strategy includes the intention to move the firm beyond its traditional area of competence and the firm is simply unable to effectively integrate the assets in this new area. The first case is a mistake in matching; the second case is a mistake in over-reaching.

Both bad ideas and implementation are less likely to occur if the acquiring firm has experience with the type of assets it is acquiring. A factor that has been found to make deals work more frequently is a close relationship between the acquired assets and the core expertise of the acquiring firm. Geographic market extension and capacity expansion deals are thus more likely to be successful than are cross-border transactions aimed at corporate diversification.

Other factors that are revealed include the importance of maintaining pre-merger revenue growth rates, the importance of clearly delimiting responsibility for merger implementation, and the need to communicate to all the parties involved in the transition.

A number of other financial and organizational aspects of post-merger integration are found to be important. Early integration planning is almost universally recognized as a way to increase the probability of success in a merger. Similarly, many studies emphasize the need to define corporate goals and clearly transmit these goals from the management team to the new merged entity, while simultaneously addressing differences in the corporate cultures of merging businesses. The importance of retaining customers and key staff during the initial transition period is another highlighted factor, as is timely handling of regulatory issues. In terms of enhancing shareholder value, authors lay varying amounts of stress on maintaining or expanding revenue growth after the merger, and identifying and achieving cost synergies.

The speed of a post-merger transition is frequently said to be a key factor in improving merger performance, but in mergers such as those done to acquire new skills or technology, this factor may not be of primary importance. Several consulting firms focus on gains from traditional synergy sources such as scale and scope economies, while others focus more on cross-selling, bundling, and various revenue-side effects of mergers. In addition, some disagreement exists regarding whether experience in merger activity is an important determinant of success.

An article written by Chanmugam, Anslinger and Park (2004) outlines the most common myths and realities regarding post acquisition implementation strategies. Students may fall into the belief of these myths. A brief summary of the most common myths and realities is as follows:

Myth: The post-merger integration process begins when the deal is closed.

Reality: The probability of deal success increases when the key elements of post-merger integration are not only started before closing, but when the likely risks and challenges of the integration are considered at the very beginning of the acquisition process. All of the elements that affect post-merger integration success, especially the culture of the companies, must be assessed and rolled into the synergy value (and price to pay) calculation.

Myth: There is one best way to conduct post-merger integration.

Reality: Using the logic that any deal can be made to work if an exact approach is used, some companies follow by-the-book approaches to integration. Instead of using a one size fits all approach; the integration process must instead be customized to the specific transaction's particular complexities and idiosyncrasies.

Myth: During the integration, make as few changes as possible to cultures.
Reality: Not making changes during the integration phase misses a tremendous opportunity to take advantage of a ripe environment for change. Change is always disruptive—but during integration, change is not only necessary, but expected. The integration period is an excellent time to rethink old ways of doing business and to create a clean sheet of cost structures, cultures, operational processes, and resource and technology requirements.

Booz-Allen and Hamilton (2001) developed a set of principals that the student, taking the role of Dominic D'Alessandro, can use to create a successful integration process. The principals:

1. *Communicate the shared vision for value creation*. The shared vision should include fundamental questions that drive the integration process: how will we create value,

how will we approach this merger, how will this merger be led, and what people strategy is required?

2. *Seize defining moments to make explicit choices and trade-offs*. There are a host of trade-offs that arise. There are four key areas that require explicit trade-offs:
   a. How will we create value (sources of synergy)?
   b. How will we approach the merger (integration vs. new entity)?
   c. How will this merger be led (CEO role, decision-making involvement)?
   d. What people strategy is required (desired culture, retention, leadership)?
3. *Simultaneously execute against competing critical imperatives.* The imperatives for successful integration include translating the shared vision, building stakeholder enthusiasm, creating one unified company, capture value through synergies, maintaining stable operations, and closing the deal in an appropriate manner.
4. *Employ a rigorous integration planning process.*

There is no 'one size fits all' formula for different situations. However, there are specific issues that must be addressed by the students as part of their implementation.

♦ Define and make the John Hancock Financial employees aware of Manulife's corporate goals and the PRIDE values to ensure future actions are congruent with Manulife's corporate identity.
♦ Make organizational cultures compatible.
♦ Cross-selling through John Hancock Financial distribution channel.
♦ Identify the need to keep key employees and talent currently at John Hancock Financial within the combined entity.
♦ Identify potential synergies, cost savings, and economies of scale.

3. What, if anything, should be done with respect to the appreciation Canadian dollar?

Students may be inclined to assess the movements of the Canadian dollar subsequent to June 2003. The Canadian dollar subsequently rose much higher that the 74 cents identified in the case. As of early 2006, the CAD/US dollar exchange rate was approximately 85 cents.

Manulife discloses its foreign currency risk strategies. The Manulife Financial 2003 Annual Report states that "*the Company's foreign currency risk management program incorporates a policy of matching the currency of its assets with the currency of the liabilities these assets support. The program also incorporates a policy of generally matching the currency of its equity, up to its target MCCSR ratio, with the currency of its liabilities, to limit the impact of changes in foreign exchange rates on the Company's*

MCCSR ratio. The Company holds equity in excess of its target MCCSR ratio predominantly in Canadian dollars to mitigate the impact of changes in foreign exchange rates on shareholders' equity. The program also delineates the currencies in which the Company is authorized to transact."

The MCCSR ratio measures the Minimum Continuing Capital and Surplus Requirements of a financial institution. In Canada, risk-based capital requirements that federally licensed insurers must meet in order to be considered solvent. The MCCSR are similar to the National Association of Insurance Commissioners (NAIC) risk-based capital (RBC) ratio requirements in the United States. The ratio is defined by the Office of Superintendent of Financial Institutions in Canada and is to complex to be considered by students.

The Canadian dollar's appreciation is a problem outlined in the case; although it may also be an opportunity. As the Canadian dollar appreciates, the potential acquisition of John Hancock Financial will be less expensive. Furthermore, since Manulife re-invests all of their earnings from the U.S. Division back into the United States, there is no real loss of purchasing power. The translation losses are therefore mostly a paper/accounting loss and may be offset the decreased purchase price of John Hancock Financial. Therefore, regardless of the case information, student may suggest that the appreciating Canadian dollar is not a real economic threat.

Students may also suggest the use of financial derivatives/instruments to hedge the effects of the Canadian Dollar. The futures or forward market, or options can be suggested to reduce the effects a rising Canadian Dollar into the future. All of these potential hedging instruments are viable options; however, students should be caution that U.S. Dollars are only converted into Canadian Dollars for accounting translation purposes. Since returns are re-invested in the U.S., there is no actual foreign currency translation that takes place. If a hedge is suggested, student should be aware of the fact that the Manulife must actually take delivery of the foreign currency regardless of the flow of cash from their operations.

4. **As the profits from the reinsurance divisions decreased to abnormally low levels, what can be done to manage or mitigate the increased risk of man-made catastrophes?**

Before presenting some of the possible solutions of the risk of terrorism, it is vital to understand the effects that the acts of September 11, 2001 had on the reinsurance operations of insurance companies. Tight market conditions were already in place before the September 11th terrorist attacks. Climbing combined ratios, after several years in a soft market, had led to double-digit price increases in policies. The North American economy was spiraling downward; low interest rates prevailed. There was the rout of technology stocks, weak stock markets, low investment returns. Furthermore, the insurance industry was being faced with the potential losses from asbestos and mold claims.

The terrorist attacks forced reinsurers to rethink their approach to business, to develop new rating models, and to revise underwriting philosophy. The affordability of reinsurance was severely impaired and most reinsurers no longer covered terrorism risks. Some reinsurers ceased operations (i.e. Scandinavian Re, Fortress Re, & Copenhagen Re), while the ratings of other reinsurers have suffered severely. The four major effects of September 11th include:

- ♦ *Contraction in global reinsurance capacity:* Insurers have become more cautious in their underwriting of risks. Reinsurers may find their arrangements inadequate to cope with the future size of claims. Primary insurers may wish to seek greater reinsurance protection but reinsurers may instead wish to reduce their capacity on offer.
- ♦ *Hardening of Premium Rates:* Price for reinsurance protection has risen dramatically, leading to a rise in price for direct insurance. This is a function of many factors other than contraction in capacity and the need for reinsurance companies to rebuild their reserves. The tragic events have introduced new types of risks and larger potential losses. The amount of capital required for insurance risks is greater than formerly understood.
- ♦ *More Coverage Restriction:* Some reinsurers may find specific sectors to be of such high risk that they are not prepared to provide cover. Underwriting standards will tighten and catastrophe reinsurance can become too expensive to acquire.
- ♦ *Financial Strain on Certain Insurers:* Given the uncertainties surrounding the cost of the terrorist attacks, some less capitalized insurers may not be able to weather the storm.

Reinsurers now analyze risk differently, by placing greater focus on the bottom line. Historical business relationships have a lower priority, as reinsurers are taking a more hard-nosed approach. They ask: Will this business generate the type of return needed on my capital to justify writing it?

Pricing methodologies are also being revisited because reinsurers are aware of the fact that there can be a correlation between losses of different lines of business. Most reinsurers believe Terrorism is a non-insurable peril (without a Government backstop). Terrorism is a man-made event, unpredictable, and impossible to price and assets of reinsurers are finite. Reinsurers can supply a limited amount of capacity, as overall exposure is too large for the industry to assume.

Insurers have typically hedged the risk they assume to insure property, reducing their exposure to acceptable levels by purchasing coverage from reinsurers. The perception was that the U.S. was effectively immune to terrorist attack, so that insurance companies did not need to demand additional premiums for such coverage. This changed on September 11. Immediately following the September attacks, the reinsurance industry informed insurance companies that they would no longer include coverage for terrorism in their policies without an extra cost.

The impact of the terrorist attacks has been immense on Manulife. "*As a result of the terrorist events of September 11, 2001, exposure to loss is estimated at $360 million before catastrophe coverage, reserves and taxes. Accident reinsurance exposures accounted for 80 per cent of this amount with Property & Casualty and Life risks accounting for the balance. These exposures were reduced by $120 million of catastrophe coverage, $60 million of expected tax deductions and $80 million of existing net reserves. Actual Reinsurance Division claims will not be known for several years; therefore, the Company established additional net reserves of $50 million during the third quarter of 2001*" (Manulife 2001).

The profits from the reinsurance division have decreased to an abnormally low level because of these acts of terror. However, the financial losses resulting from the events of September 11th, 2001 are not controllable any-longer. They are historic costs that have already been incurred. Students should identify that these events have made evident the real risk in the insurance market and offer possible actions plans to deal with these risks into the future. Some of the possible recommendations regarding the increased risk of terror include, but are not limited to:

- *Increase Premiums:* The most obvious solution to the terrorism risk is to re-develop the pricing formula used to calculate the premium prices. The price has already increased since 2001 as a result of the increased risk of future payouts. By including the probability of large scale man-made catastrophes in the pricing formula, the risk of these actions will essentially become a mute point similar to any other risk.
- *Avoid Insuring These Acts:* Students may also suggest that Manulife should stipulate that property and casualty insurance contracts do not cover these actions. Therefore, the risk of these actions will be essentially eliminated.
- *Separate Insurance Contract:* Furthermore, it may be possible for Manulife to offer a separate insurance contract for these specific acts. The contracts will be priced separately from other types of catastrophes and will offer coverage for these specific acts.

5. **Although contingency planning has commenced for the Canadian divisions and changes have been made to financial operations of Taiwan, was this enough to handle the SARS risk?**

Life insurance companies have a variety of ways to avoid or mitigate the risk of catastrophes, the most common of which is transferring the risk of multiple deaths to reinsurers (although the cost has increased dramatically since the recent terrorists attacks).

However, Manulife has been much more proactive in dealing with the SARS situation and has already implemented many procedures to deal with the SARS situation and maintain goodwill (as opposed to dodging the risks). These actions are consistent with the PRIDE values. Manulife has already undertaken the following actions, as outlined in the case:

1. The daily hospital income benefit from Manulife medical riders will be doubled for hospital confinement as a result of SARS related case.
2. When a policyholder recovers from SARS and quarantined at home, 50 per cent of the daily hospital income will continue to be payable during the 10 day quarantine period.
3. For death within 30 days after the confirmation of SARS, an extra death benefit of 100 per cent of the sum assured under the life policies, subject to a maximum additional benefit of $100,000, will become payable.
4. Manulife Taiwan confirmed that all health insurance policies include statutory infectious diseases. If a policyholder has the misfortune of contracting SARS, they will be eligible to claim for medical expenses as per the standard provisions.

SUMMARY, POST-CASE EVENTS AND OTHER CONSIDERATIONS

This is an exciting time. It is clear that Manulife is a superior performer in the financial services industry and in the insurance industry in particular and the Manulife CEO has the vision and the strategy to make this possible by taking advantage of opportunities such as the John Hancock acquisition. The question then becomes how Manulife will fare once the consolidation in the industry is complete. The CEO will certainly have to guard against complacency and keep Manulife abreast of the risks and rewards of a world that is growing increasingly global and interdependent, as the recent scares with September 11, 2001 and more recently over SARS and other potential pandemics and disasters have amply shown. This is what happened.

On April 28th, 2004 Manulife acquired John Handcock and became North America's second-largest life insurance company and the fifth largest worldwide. Manulife's 2004 Annual Report provides insight on how the acquisition of John Hancock was handled:

"Throughout 2004, the integration of the John Hancock businesses was a primary focus of the Company's management and employees. We made good progress on integrating our operations and expect that we will be substantially finished with this endeavor by the end of 2005. It is an enormous task that has significantly effected each of our divisions....

The John Hancock merger, as would be expected, had its most dramatic effect on our U.S. Operations where the transaction added tremendous diversity and scale. Within both our U.S. Protection and Wealth Management Divisions, we broadened product lines, expanded the breadth and reach of our distribution channels, added to the depth and expertise of our management team and finally, added the well recognized John Hancock brand. In 2005, across all our U.S. businesses, our products will be marketed using the well established John Hancock brand...

Successfully integrating two large and prestigious organizations such as Manulife and John Hancock is a difficult task that would be impossible without a constant focus on providing real value to customers and attracting and retaining the best and most talented teams in the industry" (p. 6).

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ASSET-LIABILITY MANAGEMENT AT GEM STATE CREDIT UNION

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CASE DESCRIPTION

The primary subject matter of this case involves the use of GAP analysis to measure the interest-rate risk exposure of a credit union. Secondary issues examined include interest-rate changes in the economy overtime and the Fisher Effect. The case has a difficulty level appropriate for junior level students and is designed to be taught in about 45 minutes. This case could be used for classes in money and banking (economics), managerial economics, depository institutions management and possibly other management courses.

CASE SYNOPSIS

This case could be used to familiarize students with the balance sheet of a credit union and to understand the interest-rate risk that results from the nature of a depository institution's balance sheet. Students will also learn to calculate a GAP analysis for the credit union and to critically analyze the GAP methodology used by credit union management and are asked to offer an opinion on what this credit union could do to manage their interest-rate risk.

INSTRUCTORS' NOTES

Recommendations for Teaching

The following questions could be used in teaching this case.

1. **In general, how can changing interest rates affect the profitability of DIs? What is the Fisher Effect and what significance does it have on asset-liability management?**

   The case covers quite thoroughly how changing interest rates affect the profitability of DIs. Basically, their assets and liabilities will have different sensitiveness to changes in rates. For example, if the GAP is negative, as is often the case for DIs, then if rates increase, profitability will decrease, and vice versa.

The Fisher Effect states that the nominal interest rate = the real interest rate + the expected rate of inflation. Thus, rising inflation (which happened in the 1970s and into the early 1980s) will cause nominal interest rates to increase, causing profitability to decrease for DIs with a negative GAP.

2. Use the same GAP analysis as GSCU to calculate rate-sensitive assets and liabilities and the GAP. If annual interest rates increased by five percent, what happens to profitability? What happens if annual interest rates decrease by five percent?

The GAP analysis is in table TN-1. Since the GAP is a negative $962,964, if annual interest rates increase by 5 %, then over the 6-month examination period, profitability will fall by (2.5 %) ($962,964) = $24,074, which would be about 0.5 % of its total capital ($24,074/ $4,589,239). The opposite would happen if annual interest rates decrease by 5 %.

Table TN-1.
GAP Analysis for Question 2

Rate-Sensitive (variable-rate real estate) Loans	$ 3913162
Loans that Mature in Six Months	8073368
Rate-Sensitive Investments	4806182
Cash Adjustment	(53005)
Total Rate-Sensitive Assets	$16739707
Rate-Sensitive Deposits	$ 4985594
CDs that Mature in Six or Less Months	5812083
Money Market Deposits	6904995
Total Rate-Sensitive Liabilities	$ 17702672
Rate-Sensitive GAP	($962964)
GAP as Percentage of Total Assets	-1.89%

3. Suppose that John Harris prevails and GSCU decides to count 100 percent of checking and savings deposits as rate sensitive (still treating the IRA savings deposits as not being rate-sensitive). Now, calculate its GAP. If annual interest rates increased by

five percent, what happens to profitability? What happens if annual interest rates go down by five percent?

The GAP analysis is in table TN-2. Since the GAP is now a negative $21,203,993, if annual interest rates increase by 5%, then over the 6-month examination period, profitability will fall by (2.5 %) ($21,203,993) = $ 530,100, which would now be about 11.6 % of their total capital ($503,100/ $4,589,239). This happens to be about what GSCU made in undivided earnings (profits) for 2002. The opposite would happen if annual interest rates would decrease by 5 %.

Table TN-2.
GAP Analysis for Question 3

Rate-sensitive (variable-rate real estate) Loans	$ 3913162
Loans that Mature in Six Months	8073368
Rate-Sensitive Investments	4806182
Cash Adjustment	(53005)
Total Rate-Sensitive Assets	$ 16739707
Rate-Sensitive Deposits	$ 25226662
CDs that Mature in Six or Less Months	5812083
Money Market Deposits	6904995
Total Rate-Sensitive Liabilities	$ 37943700
Rate-Sensitive GAP	($21203993)
GAP as a Percentage of Total Assets	-41.70%

4. **How does the percent of the checking and savings deposits that GSCU assigns as rate sensitive affect the GAP analysis and the resulting change in profits from a change in interest rates. What percent of the checking and savings deposits do you think should be classified as rate sensitive?**

By assigning all savings plus checking deposits (less the IRA savings deposits) as rate sensitive deposits, the gap becomes much more negative and results in a much larger loss of profits when interest-rates go up, and vice versa. The second question asks an opinion that does not have a right or wrong answer. The assumption in question two, which is commonly used in the credit union industry, probably makes more sense. When interest-rates increase, DIs are usually slower to raise deposit rates than loan rates. Over the next 6 months, if rates did rise, then the assumption that about 10 % of checking and 25 % of savings deposits would move to other deposits at the credit union or leave it all together if savings and checking rates did not change seems reasonable. Still, the assumption used for what percentage of checking and savings deposits to classify as rate sensitive is a difficult one for the credit union.

5. Compare the risk of GSCU having some real estate loans on the asset side of its balance sheet to that of S&Ls.

The added interest-rate risk for GSCU by making these real estate loans is quite small. Of the roughly $8.3 million in real estate loans, about half or $3.9 million have variable rates. Hence, only about ten percent ($ 4.4 million/ $ 41.5 million) of the total loans are fixed-rate real estate loans. And since these loans are largely secondary mortgages and home-equity-lines-of-credit loans, their maximum maturity is 15 years, while their average loan maturity is typically around 8 years. (This average maturity for fixed-rate real estate loans was about 8.3 years in November 2002.) In contrast, S&Ls must under the 1989 Financial Institutions Reform, Recovery and Enforcement Act hold 70% or more of total asset in mortgages or mortgage-related assets. Hence, S&Ls are bound to face more interest-rate risk from their mortgage assets then GSCU does.

6. What do you think is the best way for GSCU to manage its interest rate risk? Defend your answer.

Answers will vary, but should be based on the pros and cons of the three methods discussed in the last section.

7. The web site NCUA.GOV has up-to-date financial statements (including balance sheets) for credit unions. Using the most recent data available, perform a GAP analysis for a local credit union of your choice (omit cash adjustments since it is not available on the web site and it is relatively very small). What do you think is the current interest-rate risk for the credit union?

The GAP analysis would be similar to those in questions 2 and 3. It might be interesting to compare what students think current interest-rate risk is for the local credit union.