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LETTER FROM THE EDITORS

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

The cases contained in this volume have been double blind refereed, and each was required to have a complete teaching note before consideration. The acceptance rate for manuscripts in this issue, 25%, conforms to our editorial policies. The Instructor's Note for each case in this volume will be published in a separate issue of the *JIACS.*

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

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

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

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CASES

JAGUAR:
WHAT TO DO WITH A TROUBLED LEGEND?

Shelley Morrisette, Shippensburg University
Louise Hatfield, Shippensburg University

CASE DESCRIPTION

The subject matter of this case addresses the issues of turnaround, spin-off, sunk cost, and international image. This case would be most appropriate for undergraduate courses in entrepreneurship, small business 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

This case traces the rise and fall of a once great company and product—a product that is still considered a British "national treasure". At one level, this case addresses the need for a turnaround—the need to rejuvenate a once classic brand. At another level, this case addresses the dilemma of what to do with a once great product that should never have been acquired in the first place.

INTRODUCTION

Jaguar is a British "national treasure". British Prime-Minister Tony Blair is driven in a bottle-green Jaguar XJ8. The character, Arthur Daley, in the British television series *Minder* was generally to be seen driving a Jaguar XJ6. Inspector Morse, in the British television series of that name, drove a Jaguar Mark 2. Harold, of *Harold and Maude*, had a Jaguar E-Type hearse. A silver Jaguar E-type is featured in the film 52 Pick-Up. Austin Powers drove a Jaguar E-Type, calling it a Shaguar. In the 1968 movie "Danger: Diabolik", Diabolik drove a black Jaguar E-Type. His love interest, Eva, drove a white one. The made-for-cable 1989 film "The Heist" (shown on HBO) featured two dark green Jaguar XJS coupes - it was used during a bait and switch scene where contraband was hidden in the trunk panel. Sting drove a Jaguar in the music video for his song "Desert Rose" -- because of this, the song has been used in lots of past Jaguar commercials. While Jaguar doesn't use the song anymore, the song is still associated with Jaguar. Thus, Jaguar, the car,

and the brand, are closely tied to Britain and her people. To the British, Jaguar is a living legend and institution, not just a car.

However, in 1984 Jaguar was "floated" off as a separate company on the stock market. The British government felt it could no longer subsidize Jaguar and, thus, cut them off, so this national treasure was up for grabs in the marketplace. Jaguar was forced to enter a new competitive reality and learn how to cope with being a profit center.

HISTORY

Founded in 1922 as the Swallow Sidecar Company by William Lyons, it was renamed Jaguar Cars after World War II because of the unfavorable connotations of the initials, SS (i.e., SS was the insignia of Hitler's storm troopers and personal guards). The company is now owned by the Ford Motor Company. Jaguar is known for its luxury saloons and sports cars, market segments it has been producing since the 1930s (See Figure 1).

FIGURE 1
JAGUAR ROAD CARS 1945-PRESENT

A subsidiary of the Ford Motor Company **Jaguar Cars road car timeline, 1945-present**

Type	1940s	1950s	1960s	1970s	1980s	1990s	2000s	
	5 6 7 8 9	0 1 2 3 4 5 6 7 8 9	0 1 2 3 4 5 6 7 8 9	0 1 2 3 4 5 6 7 8 9	0 1 2 3 4 5 6 7 8 9	0 1 2 3 4 5 6 7 8 9	0 1 2 3 4 5	6 7 8 9
Sports	XK120	XK140, XK150	E-type S1	S2, S3, XJ-S	XJ-S HE	XJS	XK8/XKR	XK
Small Saloon		Mark 1	Mark 2				X-TYPE	
Mid Saloon			S-type	XJ6, XJ6 II	XJ6 III	XJ6 XJ40, XJ6	S-TYPE	
Large Saloon	Mk IV, Mk V	Mk VII, Mk VIII, Mk IX	Mk X, 420G	XJ12, XJ12 II	XJ12 III	XJ12, XJ12, XJ8	XJ8	
Racing		C-Type, D-Type, XJR-13	E-Type			XJR-15		
Supercar						XJ220		

Jaguar reached its zenith in the 1950s and 60s. In 1950 it was decided to take three cars to France for the world famous Le Mans 24 hour race, merely to assess their capabilities against international competition. Their cars did not do well, but valuable lessons were learned. In 1951 three C-types returned to France. One was driven by the legendary Sterling Moss. Amazingly the three cars were 1-2-3 with less than two hours left in the race. Minor problems eliminated two of the C-types, but the third car held on for victory and the Jaguar legend was born. In 1953 another C-type won at Le Mans. In 1954, the D-type made its debut and placed 1-2-4 at Le Mans. The D-type won again in 1957. A series of tragic accidents, a factory fire, and financial problems lead

Jaguar to leave racing after the 1957 season. Most company officials felt that the hiatus would last only a few years. Instead, Jaguar did not officially re-enter racing for more than 35 years.

In 1961 Jaguar introduced the E-type or XK-E as it would become known in the States. It was a performance production car that was very fast, had vivid acceleration, great flexibility -- unheard of comfort and refinement for such a car, and pure good looks. The car could do 150 mph off the show room floor and sold for only $3,000. During the swinging 60s, it became "The Performance Car" of a generation.

Besides producing performance cars Jaguar produces luxury autos. Introducing the large Mark VII Sedan in 1951, a car especially conceived for the American Market, Jaguar soon found itself overwhelmed with orders. The Mark VII and its successors gathered rave review after rave review from magazines such as "Road and Track" and "Motor". In 1956 a Jaguar Mark VII won the prestigious Monte-Carlo Rally. The 1955 Mark I was the first monocoque (unibody) car from Jaguar. In 1959, the car was improved with a larger engine and wider windows and became the Mark II, one of the most recognizable Jaguar models ever produced.

Of the more recent saloons, the most significant is the XJ (1968-present), still the definitive Jaguar car for many. Since 1968 the Series I XJ has seen major changes in 1973 (to Series II), 1979 (to Series III), 1986 [Europe] / 1987 [United States] (XJ40), 1995 (X300), 1997 (to the V-8 powered X308), 2003 (the present model, X350). The most luxurious XJ models carry either the Vanden Plas or Daimler nameplates.

Jaguar merged with the British Motor Corporation (the Austin-Morris combination) to form British Motor Holdings in 1966. After a merger with Leyland and Rover, the resultant company then became British Leyland Motor Corporation in 1968. The reason for these mergers was poor financial performance for all companies. Financial difficulties continued and with the publication of the Ryder Report, British Leyland was effectively nationalized in 1975 and it became British Leyland Ltd, known just as BL. The British government essentially kept the automobile industry afloat during the 1970s because the industry and the cars were not competitive. The reasons for this were many --- poor labor relations, safety and environmental regulations, under capitalization, poor management, and generally uncompetitive products.

In 1984, Jaguar was "floated" off as a separate company on the stock market (one of the Thatcher government's many privatizations) - with the rest of BL named the Austin Rover group. Then it was taken over by the Ford Motor Company in 1989-1990. In 1999 it was made part of Ford's new Premier Automotive Group, along with Aston Martin, Volvo Cars, and Lincoln. Land Rover was added to the group in 2001 following its purchase from BMW.

FORD MOTOR COMPANY

In 1989, CEO Trotman (who happened to be British) was looking for opportunities to expand globally and Jaguar just happened to be available. Trotman was anxious to take advantage of new

business opportunities from the emerging borderless economy. Ford purchased Jaguar in 1990 for two reasons --- 1) the purchase fit its global strategy of becoming a worldwide producer of automobiles and 2) the troubled company (with a well recognized brand) was inexpensive. Since then Jaguar has been nothing but a pain in Ford's side, and it has never been a good strategic fit. Although Ford does not break down specific sales and profit figures for each brand of automobile, the Premier Automotive Group lost $740 million in 2005. It is estimated that Jaguar was a major contributor to this figure. It is further estimated that Jaguar's cumulative losses to Ford are in excess of $1.3 billion. This does not include capital Ford has invested in the company to make it more competitive.

During the 1990s Ford was flush with profits and this go-go decade meant good times for most car companies. Ford enjoyed record profits with sales of pick-ups, SUVs, and high end vehicles reaching record numbers. These high margin products allowed Ford to purchase Volvo, Jaguar, Mazda, and other brands, as well as expand domestic capacity. But as the decade came to a close it became obvious that Ford and GM had brought too much capacity online. Additionally, sales of its most profitable products crashed. The result was record losses to both companies. Both Ford and GM are now fighting for their corporate lives. Currently they are seeking "cram-downs" on labor costs and benefits and closing plants to stop the hemorrhaging of cash. But the problems continue. In the first nine months of 2005 Ford lost $1.8 billion, while its stock price has dropped from $29 to $7. Its new restructuring plan (i.e. "Way Forward") calls for closing plants in the United States and throughout the world and cutting 8% of the white collar work force. Additionally, Ford's credit rating has dropped dramatically. S&P placed the bonds at double B-minus -- two notches deeper into junk bond territory. This indicates a total lack of confidence by the credit community in Ford's ability to turn things around domestically or worldwide, in the near future.

INDUSTRY

Today Ford is in terrible shape. In 2005 its share of the North American market was down for the fourth year in a row. It currently stands at just 18.3% for the USA market. A far cry from the 25% Ford once thought it could capture in the 1990s. Sales for 2006 are expected to be flat. Rising interest rates and gasoline prices are hurting sales of its most profitable vehicles --- SUVs, pick-up trucks, and luxury autos. GM, its domestic competitor continues to engage in mindless "price-cutting" programs which kill margins, while competitors from Japan, Korea, and Europe steal market share. Ford must overhaul its entire operations and do it quickly or face either a takeover or bankruptcy.

A competitive analysis of the USA luxury car market clearly indicates the problems facing Jaguar (See Figure 2). The grid illustrates that Jaguar does not enjoy a clear advantage in any area of luxury car keys for success. Additionally, syndicated data from J.D. Powers indicates that Jaguar dramatically trails other luxury brands in two critical areas --- overall performance and appeal.

While Jags are perceived as having a certain "cache" they are most often thought of as "staid" and "too white shoe" by potential buyers. Thus, while they are perceived as being distinctive, the distinction is not favorable. Also younger consumers have almost no knowledge of the brand and what it stands for. Thus, Jaguar suffers from many problems in its most critical market --- a bland, stogy product, poor perceptions by many potential customers, and a lack of brand awareness among younger consumers.

FIGURE 2
COMPETITIVE STRENGTH GRID FOR THE U.S. LUXURY CAR MARKET

	U.S.		Japanese			European				
	Cadillac (GM)	Lincoln (Ford)	Lexus (Toyota)	Acura (Honda)	Infiniti (Nissan)	Mercedes Benz	Volvo	BMW	Audi	Jaguar
Assets and Competencies										
Key for Success										
Product quality	-	-	+	0	0	+	0	0	0	0
Product differentiation	0	-	0	-	-	+	+	+	0	+
Dealer satisfaction	-	0	+	0	0	+	0	+	0	0
Market share	+	+	0	0	-	+	0	+	-	-
Quality of service	0	-	+	0	0	0	+	+	-	-
Secondary Importance										
Financial capability	0	0	+	0	0	0	0	+	-	0
Quality of management	+	+	0	0	0	-	0	0	0	-
Sales force/distribution	+	+	0	0	0	0	-	0	-	-
Brand name recognition	+	+	0	0	-	+	0	+	-	0
Advertising/promotion	+	+	0	0	0	0	-	-	-	-

3-pt scale
1 = Less than average: –
2 = Average: 0
3 = Above average: +

JAGUAR BUSINESS STRATEGY

In 2005 Jaguar produced 85,000 cars. Sales have fallen 35% since the 1997 model year. As recently as 2001 Jaguar produced over 100,000 cars annually. In 2006 production is scheduled to drop another 7% to just 79,000 units. Obviously, automobile production is capital intensive and volume must be maintained to cover the incredible fixed costs. Today Jaguar is not producing enough cars to cover its fixed costs. Additionally, due to the weak dollar, sales to its most important export market (i.e., United States) are way down. It is estimated that 80% of all Jaguars are produced for export and 75% of those are sold in the USA. Thus, gaining market share in the USA is critical to the success of Jaguar.

The Jag product and the promotional strategy must be strengthened in the critical USA market. But with limited resources and time running out can this proud company be saved?

Specifically, if you are Ford --- what would you do with Jaguar? If you are Jaguar --- what would you propose to Ford to help save your company? Finally, how and why did Ford and Jaguar reach such a predicament?

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GOOGLE'S DUTCH AUCTION INITIAL PUBLIC OFFERING

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CASE DESCRIPTION

This case concerns the Initial Public Offering of Google, Inc. in August 2004. Instead of using the traditional best-efforts style IPO, Google used a Dutch Auction to allow small investors to buy in on the IPO. This case is intended to be used in an advanced corporate finance class. It can be taught in two hours of class time and should take about two to three hours of outside preparation by the students.

CASE SYNOPSIS

In August 2004, Google, Inc. took its firm's stock public for the first time using a Dutch auction process. This case study details the company's history as an Internet search engine company. Then it explains Google's initial public offering and the market environment in which Google was going public. The case concludes with questions for discussion.

COMPANY HISTORY

Google, Inc. is an Internet search engine company that was established in a California garage on September 7, 1998. The company was created during a time of unprecedented growth and innovation in the technology industry. The company chose its name as a pun on the word "googol," which is represented by the numeral 1 followed by 100 zeros. The name is representative of Google's goal of organizing the infinite information on the Internet. It all started when Larry Page and Sergey Brin met while they were graduate students at Stanford University in 1995. Urban legend says that they did not like each other at first and could not agree on anything. Then they found something they did agree on, the fact that there needed to be a better search engine on the Internet. The two decided to merge their respective talents in an effort to solve this problem. Page took on the responsibility of developing algorithms and the computer programs while Brin is the company's visionary.

Page and Brin first started working on the search engine in 1996 and called it "BackRub." At the time, there were a multitude of search engines available for free on the Internet, but Page and Brin believed their search engine would be distinct from all the others. The unique thing that would separate their website from others was that it performed a mathematical analysis of the relationships between websites in order to get more accurate and relevant search results. Seeing the potential in their new technology, David Filo, the cofounder of their main competitor Yahoo!, recommended that they start the company in 1998. After several months, while they still had their office in a garage, they already had 10,000 search queries a day. More importantly, they had established recognition among people in the high tech field and were named one of top 100 web sites and search engines for 1998 by PC Magazine.

In 1999, Google moved into an office building with 8 employees, at which point they had more than 500,000 search queries a day. Later the same year, they moved once more into the "Googleplex," which remains the company's main headquarters in Mountain View, California. The main reason they were able to move into the "Googleplex" at such an early stage in the growth of the company was that they received $25 million in capital from the venture capital firms Sequoia Capital and Kleiner Perkins Caufield & Byers. Page and Brin also used the money to hire more people and expand their young company. As part of the capital funding agreement, both of the contributing companies received a seat on Google's board of directors to enable them to have a say in Google's leadership and direction. Mike Moritz represented Sequoia and John Doerr represented Kleiner Perkins. Shortly after their move, Google's reputation continued to grow as the company appeared on Time Magazine's top ten best cybertech list. Google continued to grow rapidly in 1999, as other major companies such as AOL/Netscape, the Italian portal Virgilio, and the UK's best online guide Virgin Net,began recognizing the value of Google technology and incorporating it into their own businesses. By the end of 1999, the number of customers Google served daily had bypassed 3 million.

In 2000, Google achieved the Webby Award and a People's Voice Award for technical achievement. The company also made a major strategic move in the market when it made a deal to post supplementary search results on Yahoo. This proved how good the company really was to the rest of the world, not to mention the fact that it was now handling 18 million queries a day. After this deal, NetEase, China's best portal and NEC's BIGLOBE portal in Japan made a partnership deal with Google. The company was now known all over the world. As the year 2000 drew to a close, Google introduced the Google Toolbar, which allowed "Googlers" (a term coined for people who search the Internet using Google) to use the search engine anywhere on the web without going to the homepage. The tool bar also had other desirable features, such as the ability to have keywords highlighted in the search results, which made them easier to sort through for relevance. The toolbar proved to be very successful and Google was handling over 100 million queries a day by year-end 2000. Finally, as an act of homage to Google's roots in academia, the company began to offer free search service to schools and universities all over the world.

In 2001, Google made a strategic move to attract more customers by putting wireless search capability into the hands of millions through the use of mobile communication technologies. To accomplish this goal, Google developed numerous partnerships with companies like Sprint PCS, Cingular and AT&T Wireless, whose customers were granted access to the 1.6 billion web documents in Google through their wireless devices. As Google's popularity soared through the roof their profitability grew through 2001. Agreements with large corporations worldwide brought Google search to new groups of Asians and Latin Americans. Hamburg and Tokyo emerged as cites for new sales offices because of the immense popularity of Google's advertising programs. By the end of 2001, Google created Google Image Search, which allowed users the capability to search through millions of digital images on the web, as well as Google Catalog Search, which allowed Googlers to search and browse virtual versions of more than 1,100 mail order catalogs. Google's index of searchable web documents also reached a new high of 3 billion, which showed that Google was well on their way to achieving their goal of making all of the world's information accessible.

From the beginning, advertising had been the core of Google's revenues. In February 2002, Google revamped its self-service advertising system, Adwords, to be more cost-effective for both small and large businesses who wanted to advertise on the Google website. Google has always maintained an advertising philosophy which focuses on the user. In other words, Google's system used keywords input by the user to find the most appropriate ads and select which ones the user would see. For advertisers, this meant that their ads were not being wasted on customers who did not care, but were being targeted specifically to users who had indirectly expressed some interest in their product. In May 2002, the success of advertising on Google earned the company a partnership with America Online (AOL). AOL called Google "the reigning champ of online search" and chose it to provide both search and advertising to over 34 million AOL subscribers and customers (http://www.google.com/corporate/history.html). At the end of 2002, Google introduced Froogle, a service which allowed frugal Googlers to search for products online and instantly access a list of pictures and prices for the desired items.

In the spring of 2003, version 2.0 of the Google Toolbar was released, and the Google Deskbar followed it in the months soon after. The newest version of the toolbar came with a pop-up blocker and form filler, while the Deskbar went one step further, allowing users to search Google from their desktop without even opening a web browser. In addition, many more options were available with these two added features, including a calculator, parcel tracking, and flight information. One of Google's latest innovations, called "Gmail" was announced in April of 2004. Gmail is a free email account similar to many others on the web, but it is different in that it provides users with a powerful built-in search function, which can store emails for years because they are archived in the system and easily accessible. (Unless otherwise cited, all information in "Company History" section was obtained from "Google History" or "The Google Timeline.")

INITIAL PUBLIC OFFERING

As was mentioned earlier, Google lagged behind the high-tech wave of the 1990's. While hundreds of other Internet and technology companies were gearing up to go public in the late 90's – during one of the hottest IPO periods in history – Google was just beginning to gain its footing as a company. Jay Ritter reports that there were 4,417 initial public offerings in the ten year period from 1991 to 2000, which averages out to about 442 per year (Ritter, 2004)). By comparison, there were only 81 initial public offerings in 2001, 71 in 2002, and 67 in 2003. By far, 1999 and 2000 were the most profitable years, with IPO's grossing over $65 billion each year. Additionally, Ritter notes that the average first-day return on initial public offering stocks was nearly 70% in 1999 and around 55% in 2000. Granted, many of the companies that did choose to go public during this IPO frenzy were too unstable and immature, which is why many ended up going out of business within two or three years. But regardless of whether the companies were correct in going public when they did, there is little debate about the fact that the IPO market was as ripe for entry as it has ever been.

GOOGLE'S IPO

Without a doubt, Google was not ready to go public during the tech-stock boom, but on April 29, 2004, Google filed its first document ever with the Securities and Exchange Commission (SEC), an S-1 form which stated Google's intention of ending its tenure as a private company by holding an initial public offering. The move created a worldwide buzz among both investment firms and individual investors, all of whom wanted to get their own piece of the success that Google had experienced over the past 6 years. However, some analysts questioned whether Google was choosing the appropriate time for its IPO. While the now-established company was much more stable and financially secure than several years before, the IPO market was not. Having come off of its all-time high, the market was anything but ripe and ready. Gross proceeds from all initial public offerings had fallen drastically, from all time highs of over $65 billion in 1999 and 2000, to a ten-year low of only $10 billion in 2003(Ritter, 2004). Simply put, investors were not as willing to put their money into risky new stocks as they were several years prior.

In addition to the less-than-ideal circumstances, wary investors both large and small would have to cope with the fact that the Google IPO, like the company itself, would be far from ordinary. In fact, the process would be fraught with miscalculations, hiccups, and even questionable decisions by Google executives that bordered on SEC violations. From the very beginning of its first SEC filing, Google stated that it "is not a conventional company," and that it would not proceed through the IPO process in the conventional ways accepted by Wall Street (Google, Inc. S-1 Form). If investors did not like this, they could simply choose not to invest; as far as Google was concerned, they only wanted investors who were willing to trust the company leadership, hang in for the long haul, and allow the company to operate on the same unorthodox methods that have proven

successful for it as a private company (Google, Inc. S-1 Form). The first hint that the Google IPO would be different was that the company chose to use a Dutch auction process to value its shares rather than relying on underwriters to set the IPO price, as is traditional. Under the Dutch auction method, the company allowed all investors, from the world's largest investment banks down to individual investors, to bid on Google shares based on what each was willing to pay. Google's intention, it stated in the S-1 filing, was to ensure that the company was priced at fair market value, and that the company had a good blend of both large institutional and small individual investors. Under the traditional IPO process, individual investors are omitted and can only buy shares second-hand from investment banks, after the IPO has taken place. Google, however, wanted to have a true public offering, so they opened bidding to anyone who was willing to buy a minimum of at least 5 shares.

While Google's intentions with the auction process seemed noble enough, they caused a lot of discomfort throughout Wall Street, making even some of the largest investment firms wary about underwriting the Google IPO. Initially, there were 31 firms lined up to underwrite the Google IPO headed up by lead underwriting firms Morgan Stanley and Credit Suisse First Boston. As the preparation for the IPO proceeded, however, several of the underwriters decided to drop out, including one of the largest firms, Wall Street giant Merrill Lynch. Officially, Merrill Lynch stated that it discontinued its services because the fees of 3% of the offer price were not sufficient to cover its costs associated with the IPO. Unofficially, it was widely rumored that Merrill Lynch was concerned about the stock offering being overpriced, among other uncertainties (Craig & Sidel, 2004).

Despite initial hurdles and concerns, though, Google pressed onward and continued to tout the merits of its stock auction. On June 13, 2004, Google announced that it would be listing its stock on the NASDAQ exchange rather than vying for a seat on the New York Stock Exchange. While a price range still had not been stated at this point, more details were beginning to emerge in the media about the IPO. For one, Google would be dividing its stock into two different classes, labeled classes A and B. Class A stock would be the standard variety sold daily to common investors, and each share would carry one vote, whereas class B stock was reserved for the founders and insiders of the company and carried ten votes per share (Google, Inc. S-1 Form). The stated purpose of this discrepancy was to allow the founders the control they wanted over the company's direction and decisions, and to keep outsiders from having too much control over Google (Google, Inc. S-1 Form). Again, this decision highlighted the fact that investors would be placing a lot of trust in the hands of Google executives, and that Google would not conform to conventional methods. While some investors may have viewed these decisions as signs of Google's strength as a company and a culture, others found it to be unnerving and felt less secure placing their investments with the company.

Undeterred, Google announced on July 26, 2004, that it projected its shares to sell between $108 and $135 per share. This was an unusually high price range for an IPO. While no price was set in stone yet, if the IPO did occur as Google predicted it would raise as much as $2.7 billion for

the company in a single day. Additionally, Google's total market value would be near $36 billion, which would have been comparable to several well-established companies such as McDonald's, eBay, Yahoo! and Ford Motor Company. Google executives went on a pre-IPO road show with this information, but news began circulating that many investment firms they visited were not completely satisfied with the details and responses they were receiving from the company. One major point left unaddressed was what exactly the Google executives intended to do with the overnight capital they would be getting from such a sale. The lack of answers contributed to the growing sense of uncertainty surrounding Google and its initial public offering.

On July 30, Google officially opened the registration process to investors, and said that it would allow about a week for everyone interested to make their bids, but after "logistical troubles," the registration process was kept open for another week, until August 13. In the days preceding the close of registration, Google ran into some of its most intense speed bumps to date. On August 10, after a lengthy legal debate with rival Yahoo! over patent and copyright disputes, Google agreed to settle by giving Yahoo! more than $300 million worth of the shares to be issued. Not only would this decision cut into the number of shares that could be sold, it forced Google to announce that it would probably experience a third-quarter loss in net income – not at all a good prospectus for a company trying to sell itself. Two days later, on August 12, another unusual snafu hit Google when an article appeared in Playboy magazine containing an interview with Google founders Larry Page and Sergey Brin. The interview was a huge deal for Google because it potentially broke one of the SEC's rules requiring company insiders to maintain a period of silence for a certain time before and after the initial stock sale in order to keep from artificially inflating the demand for the stock. The interview was originally conducted on April 22, 2004, one week prior to Google's official filing of the S-1 form with the SEC stating its intentions to go public. Reportedly, Google had no say in when the article would be published. In Google's defense, executives claimed they refused a follow-up interview that would have taken place after the April 29th filing of the S-1 form. Because of the timing of the article, though, it raised great concern about SEC rules violations and threatened to further delay the already controversial IPO.

As Google inched closer and closer to the big day, it hit perhaps its greatest hurdle with the SEC on August 16, when the commission realized that Google had failed to register 23 million shares of stock that it had issued to 1,046 company employees between September of 2001 and July of 2004. Google claimed, naively and somewhat untruthfully, that it did not know it had to register the shares with the SEC because the shares were issued as options to insiders and selected suppliers rather than the general public (Dwyer). The SEC threatened legal action, so Google offered to buy back the shares at a cost of over $26 million dollars. However, holders of the options were not likely to accept the buyback deal as their shares currently valued at $3 on average, would likely sell for over $100 once the stock went public.

In the most shocking announcement yet, on August 18, 2004, the day before the stock began trading under the ticker symbol GOOG on the NASDAQ exchange, Google lowered the projected

price range of the stock from between $108 and $135 to between $85 and $95. In addition, they cut the number of shares they planned to sell almost in half, to 19.6 million. In combination, the two moves effectively lowered the company's potential market value from $36 billion by over 30% to $25.8 billion. Additionally, the projected capital gains from the sale were cut substantially, from about $2.7 billion to $1.9 billion, far less than Google executives had intended to earn from the sale.

POST IPO STOCK PRICES

After one of the most unusual roller-coaster rides in IPO history, Google stock began trading at $85 on August 19, 2004. When all was said and done, Google had brought in only $1.67 billion from the sale of 19.6 million shares. By the end of trading on day one, the stock price was already up over $100, exactly the price inflation that Google executives had hoped to avoid by using the Dutch Auction process. Chart A shows the closing stock prices between August 2004 and May 2005. About six weeks after the IPO, on October 4th, GOOG stock topped $135, the upper price limit that was initially anticipated by Google. The stock continued to rise, and by November 3rd, the stock had crept across the $200 mark. In May 2005, the stock continued to rise to a high of $232 per share.

CONCLUSION

The Google Dutch Auction IPO was the first of its kind for a well established technology company. It was watched by many small investors who hoped to be able to benefit from traditional IPO underpricing. Nine months after the IPO the stock was trading at 2.7 times the offer price, which is very unusual. This case presents the history of Google and their initial public offering process. Tables of the company's income statements, balance sheets and cash flows for 2002 through 2004 are provided.

QUESTIONS FOR EXPLORATION

1. Much controversy was centered on the whether or not both the IPO market and Google as a company were ready for the IPO. Did Google, Inc. make the correct decision by choosing to go public when it did? Explain why the move was or was not justified financially and circumstantially. Financial statements are provided in Tables 1, 2, and 3 for 2002-2004

2. One major complaint of potential investors was that Google was not specific enough in explaining how the money from the IPO would be used. Explain why this is or is not a justified grievance, and detail some of the options Google should consider for spending of the IPO capital. Which option is most promising?

3. One of Google's main intentions in using the Dutch auction process to price its stock was to get the most accurate price possible. Was the Dutch auction successful in achieving this goal? Would the price have been more representative of fair value if Google had let the underwriters set the price, as is traditional? Based on your calculations, what would you have considered to be a fair market value for Google stock?

4. Google hit several speed bumps along the road to its initial public offering, many of which were exacerbated by Google's own actions (e.g. failing to register shares, losing major underwriters, Playboy article, etc.). Which ones, if any, hindered the successfulness of Google's IPO and why?

5. Now that Google's IPO has come and gone somewhat successfully, what strategy should Google adopt for the coming years to avoid a fate like so many other Internet and technology companies? Are there any issues in Google's financial data that you feel are problematic and should be addressed by the company's management?

6. What has led to Google's success? What appears to be its strategy? Has their strategy changed since they went public? Do you see a need for their strategy to change in the future?

7. Did Google need to go public to satisfy its need for capital? What would you forecast their capital needs will be over the next few years? What sources other than common stock could be used to satisfy those capital needs?

8. If you were a stock analysis hired by a mutual fund to make a buy, sell or hold recommendation on Goggle today, what would you recommendation? Why? What characteristics of the company make it a risky investment?

9. In the context of agency theory, do you think Google's choice to go with a Dutch auction favored their insiders?

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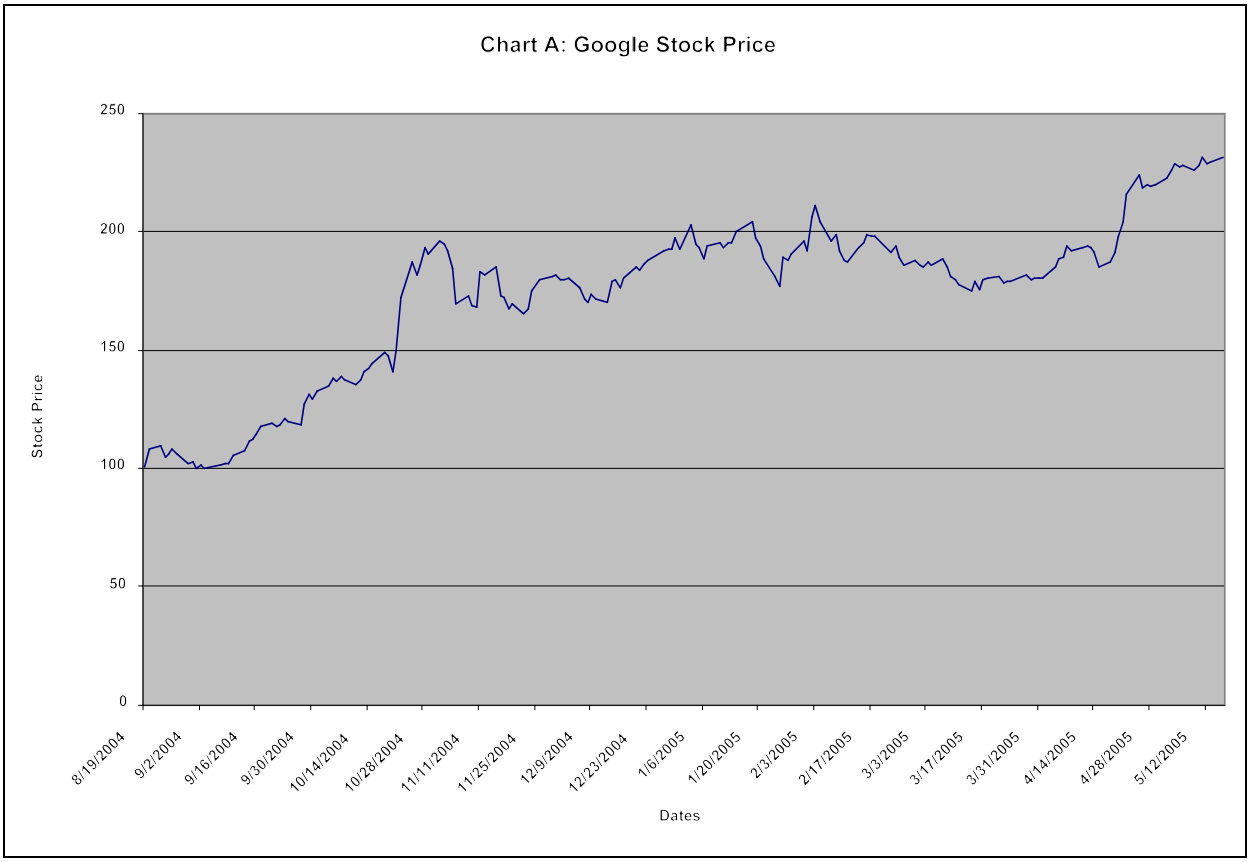
Table 1: Google Inc. Consolidated Statements of Income (In Thousands)			
	2002	2003	2004
Revenues	439,508	1,465,934	3,189,223
Costs and expenses:			
Cost of revenues	131,510	625,854	1,457,653
Research and development	31,748	91,228	225,632
Sales and marketing	43,849	120,328	246,300
General and administrative	24,300	56,699	139,700
Stock-based compensation(1)	21,635	229,361	278,746
Non-recurring portion of settlement disputes with Yahoo			201,000
Total costs and expenses	253,042	1,123,470	2,549,031
Income from operations	186,466	342,464	640,234
Interest income (expense) and other, net	(1,551)	4,190	10,042
Income before income taxes	184,915	346,654	650,234
Provision for income taxes	85,259	241,006	251,115
Net income	99,656	105,648	399,119
**Financial Data acquired from Google, Inc. 2004 Annual Report.			

Table 2: Google Inc. Consolidated Balance Sheets (In Thousands, Except Par Value)			
	2002	2003	2004
Current assets:			
Cash and cash equivalents	57,752	148,995	426,873
Short-term investments	88,579	185,723	1,705,424
Accounts receivable, net of allowance of $2,297, $4,670 and $5,611	61,994	154,690	311,836
Income taxes receivable	-	-	70,509
Deferred income taxes	12,646	22,105	19,463
Prepaid revenue share, expenses and other assets	10,825	48,721	159,360
Total Current Assets	231,796	560,234	2,693,465
Property and equipment, net	53,873	188,255	378,916
Goodwill	-	87,442	122,818
Intangible assets, net	96	18,114	71,069
Deferred income taxes, net, non-current	-	-	11,590
Prepaid revenue share, expenses and other assets, non-current	1,127	17,413	35,493
Total assets	286,892	871,458	3,313,351

Table 2: Google Inc. Consolidated Balance Sheets (In Thousands, Except Par Value)			
	2002	2003	2004
Current liabilities:			
Accounts payable	9,394	46,175	32,672
Accrued compensation and benefits	14,528	33,522	82,631
Accrued expenses and other current liabilities	10,810	26,411	64,111
Accrued revenue share	13,100	88,672	122,544
Deferred revenue	11,345	15,346	36,508
Income taxes payable	25,981	20,705	-
Current portion of equipment leases	4,350	4,621	1,902
Total current liabilities	89,508	235,452	340,368
Long-term portion of equipment leases	6,512	1,988	-
Deferred revenue, long-term	1,901	5,014	7,443
Liability for stock options exercised early, long-term	567	6,341	5,982
Deferred income taxes	580	18,510	-
Other long-term liabilities	-	1,512	30,502
Redeemable convertible preferred stock warrant	13,871	13,871	-
Total Liabilities	112,939	282,688	384,295
Stockholders Equity			
Convertible preferred stock, $0.001 par value,	44,346	44,346	-
Class A and Class B common stock, $0.001 par	145	161	267
Additional paid-in capital	83,410	725,219	2,582,352
Note receivable from officer/stockholder	(4,300)	(4,300)	-
Deferred stock-based compensation	(35,401)	(369,668)	(249,470)
Accumulated other comprehensive income	49	1,660	5,436
Retained earnings	85,704	191,352	590,471
Total stockholders' equity	173,953	588,770	2,929,056
Total liabilities, redeemable convertible			
preferred stock warrant and stockholders' equity	286,892	871,458	3,313,351
**Financial Data acquired from Google, Inc. 2004 Annual Report.			

Table 3: Google Inc.Consolidated Statements of Cash Flows(In Thousands)			
	2002	2003	2004
Operating activities			
Net income	99,656	105,648	399,119
Adjustments to reconcile net income to net			
cash provided by operating activities:			
Depreciation and amortization of property and equipment	17,815	43,851	128,523
Amortization of warrants & intangibles	11,168	11,198	19,950
In-process research and development	-	11,618	11,343
Stock-based compensation	21,635	229,361	278,746
Tax benefits from exercise of warrants and other	-	-	191,570
Non-recurring portion of settlement of disputes with Yahoo	-	-	201,000
Changes in assets and liabilities, of acquisitions:			
Accounts receivable	(43,877)	(90,385)	(156,928)
Income taxes, net	11,517	(6,319)	(125,227)
Prepaid revenue share, expenses and other assets	(5,875)	(58,913)	(99,779)
Accounts payable	5,645	36,699	(13,516)
Accrued expenses and other liabilities	15,393	31,104	86,374
Accrued revenue share	13,100	74,603	33,872
Deferred revenue	9,088	6,980	21,997
Net cash provided by operating activities	155,265	395,445	977,044
Investing activities			
Purchases of property and equipment	(37,198)	(176,801)	(318,995)
Purchase of short-term investments	(93,061)	(316,599)	(4,134,576)
Maturities and sales of short-term investments	20,443	219,404	2,611,078
Acquisitions, net of cash acquired	-	(39,958)	(21,957)
Change in other assets	99	-	(36,906)
Net cash used in investing activities	(109,717)	(313,954)	(1,901,356)
Financing activities			
Proceeds from exercise of warrants	-	-	21,944
Proceeds from exercise of stock options, net	2,262	15,476	12,001
Net Proceeds from Initial Public Offering			1,161,080
Payments of notes receivable from stockholders	-	-	4,300
Payments of principal on capital leases and equipment loans	(7,735)	(7,386)	(4,707)
Net cash provided by (used in) financing activities	(5,473)	8,090	1,194,618

Table 3: Google Inc.Consolidated Statements of Cash Flows(In Thousands)			
	2002	2003	2004
Effect of exchange rate changes on cash and cash equivalents	-	1,662	7,572
Net increase (decrease) in cash and cash equivalents	40,075	91,243	277,878
Cash and cash equivalents at beginning of year	17,677	57,752	148,995
Cash and cash equivalents at end of period	57,752	148,995	426,873
**Financial Data acquired from Google, Inc. 2004 Annual Report.			



COOKIE JAR RESERVES: THE CASE OF CALLAWAY GOLF COMPANY

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Ena Rose-Green, Southern Illinois University Edwardsville

CASE DESCRIPTION

This case requires the student to evaluate how estimates and more importantly changes in estimates affect a company's financial statements. Students are required to research Generally Accepted Accounting Principles (GAAP) regarding, changes in estimates and the correction of errors. The case is appropriate for junior level intermediate financial accounting courses or senior level auditing courses. While the accounting issue is easy to understand, there is room for interpretation of the accounting standards that make the case interesting. The difficulty level of the case is medium. The suggested final product of this case is a short memo where the student evaluates possible treatments for the accounting change and makes a recommendation of how the accounting change should be treated by the company in their annual financial statements. The student is also asked to evaluate the impact of the recommended solution on the company's financial statements. It is also possible to use the case as a vehicle for discussion when presented by the professor in a class setting.

The case is adapted from Callaway Golf Company's 8-K filing where a disagreement between Callaway Golf Company and their auditor is discussed. Additional information is taken from Callaway Golf Company's 10-K filing. As such, this case exposes students to a real-world situation where accountants and auditors are required to make an important judgment call.

CASE SYNOPSIS

How could a publicly held company that is in the public's eye and whose stock is traded on the NYSE have four different auditors in approximately one year? This case details the strange set of events that led Callaway Golf Company (Callaway) to have four different auditors in a short period of time. The culminating event of the case is a disagreement between Callaway and the auditing firm of KPMG Peat Marwick (KPMG) regarding the appropriate accounting treatment for a financial statement item. While most companies and auditors go to great efforts to keep any accounting dispute private, both Callaway and the auditor in this case were willing to make the details of the dispute public. As such, this case provides some interesting details on the relationship

between a company and its auditor and how accounting standards are often open to different interpretations.

Callaway is known for making numerous types of golf equipment, including clubs, putters, balls, and drivers. In March of 2002, Arthur Andersen was dismissed by the Board of Directors of Callaway because the audit committee was concerned about the future of the accounting firm. Callaway hired KPMG to replace Arthur Andersen. In December 2002, Callaway Golf dismissed KPMG due to disagreements with management about accounting for Callaway's warranty reserves. Callaway thought that the change in the warranty reserve should be treated as a change in estimate, while KPMG thought that the change should be treated as a correction of an error. Callaway felt so strongly about this accounting issue, that when Callaway and KPMG could not agree on the appropriate accounting treatment, Callaway dismissed KPMG and hired a replacement auditor.

HISTORY

In 1991 Callaway introduced the Big Bertha driver. The Big Bertha was the first wide body stainless steel "wood" introduced in the golf market. The founder of Callaway Golf, Ely Reeves Callaway Jr., is credited with the idea of a stainless steel golf club taking its name from a World War I German cannon known for its long-distance capabilities. In 1991 Mark Brooks was the first PGA Tour player to use the Big Bertha to win a PGA tournament at the Greater Greensboro Open. The Big Bertha was an instant success and the following year the company went public on the NYSE under the ticker symbol ELY (Callaway website).

PricewatherhouseCoopers LLP had been the company's auditor since Callaway's IPO, but the firm was released in 2001 because the audit committee believed that having a new auditor would enhance the auditor's independence. Arthur Andersen LLP was appointed as the new auditor in 2001. In March 2002, Arthur Andersen was dismissed due to concerns about the future of Arthur Andersen and KPMG was hired. In December 2002, KPMG was dismissed due to a disagreement over an accounting issue involving the company's warranty liability and Deloitte & Touche was appointed as the new auditor. It is important to note that Callaway had always received an unqualified audit opinion on its financial statements (Callaway 8-K, 10-K).

ACCOUNTING ISSUE

At the end of 2001 Callaway had an accrued warranty liability of $34.8 million. In the third quarter of 2002 Callaway completed a review of its warranty reserves and implemented a new methodology to estimate the future warranty obligations. Based upon this new analysis, management determined that the warranty liability was overstated by $17 million. KPMG who was the auditor at the time agreed that the warranty liability was overstated by $17 million, however, management and KPMG could not agree on the appropriate way to handle the change. Management

believed that because the warranty liability was based upon an estimate of future warranty costs, the change in the estimation process used to estimate the warranty liability should be treated as a change in estimate (Callaway 8-K, 10-K).

KPMG, on the other hand, determined through their analysis that a significant portion of the reduction in the warranty liability related to periods prior to 2002, and the Company's financial statements for these prior periods should be restated for a correction of an error to reflect the warranty liability based upon information that was available to management at the time the prior financial statements were prepared. The following quote indicates the magnitude of the disagreement over the accounting issue that occurred between the management of Callway and KPMG. "Despite lengthy discussions between management and KPMG, including consultation with the staff of the Securities and Exchange Commission, management and KPMG could not reach agreement on proper accounting treatment." (Callaway 8-K). The disagreement led to Callaway dismissing KPMG as the company's auditor and replacing KPMG with the auditing firm of Deloitte & Touche (Callaway 8-K, 10-K).

Required:

1. What is a change in estimate according to GAAP, and if Callaway treated the change in the warranty liability as a change in estimate, what would be the effect on Callaway's financial statements?

2. What is a correction of an error according to GAAP, and if Callaway treated the change in the warranty liability as a correction of an error, what would be the effect on Callaway's financial statements?

3. What is a change in accounting estimate effected by a change in accounting principle according to GAAP, and if Callaway treated the change in the warranty liability as a change in accounting estimate effected by a change in accounting principle, what would be the effect in Callaway's financial statements?

4. How should Callaway have accounted for the change in the estimated warranty liability?

5. What disclosures are required by Callaway regarding its warranty policy (assuming no change was being made)?

6. What disclosures are required when a company makes a change in estimates in the financial statements?

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HARD TIMES AT KELSEY HIGH: ISSUES OF CHANGE, CLIMATE, AND CULTURE

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CASE DESCRIPTION

The primary subject matter of this case concerns how organizational culture and climate impact new leaders in an organization, particularly in an educational institution. Secondary issues examined include how new leaders should implement change initiatives, communication barriers to new programs, and a focus on the role of perception and dialogue. The case has a difficulty level of three, appropriate for third year, undergraduate students in management, communication, or education. The case is designed for an organizational communication, organizational behavior, introductory management, leadership, or education administration course. It can be covered in one class hour and is expected to require one hour or less outside preparation time by students.

CASE SYNOPSIS

Educational institutions are rich environments for exploring multiple facets of functional and dysfunctional communication. In this case, Kelsey High School experiences culture and climate issues not unlike for-profit institutions. Written from the perspective of Rose, the new interim principal, students are able to explore problems with implementing change initiatives from a newcomer's perspective. As Rose acclimates to her new position and organization, she begins to recognize the engrained values, symbols, power centers, and stories inherent in the school. Additionally, she must maneuver the communication landmines inherent within the school climate, which seem to stifle new ideas and discourage dialogue.

This case offers the opportunity for students to explore leadership challenges and ends by raising more questions than it answers. Students are left to wonder what the potential outcomes are and asked to analyze how issues of closed communication climates can be remedied. Also, students should consider how change is a slow and strategic process where perception is key.

HARD TIMES AT KELSEY HIGH

Having been in an administrative role in a small school district for one year, Rose felt ready to take on the challenge of being the new high school principal in a one-high-school-town. Kelsey High School, with 900 students and 60 faculty, needed a new leader following the previous

principal's promotion to a district-level position. School was out for the summer when the announcement was made and the school council, made up of parents and teachers, wouldn't have time to conduct a full-length search, so the superintendent appointed Rose as the interim principal. It seemed like the perfect situation. Rose had the guarantee that she could return to her old position or apply and interview for the principal's job once the position was officially posted at the end of the year. What better position could she be in? Being the interim principal would be like a yearlong trial period. She was up for the challenge and viewed this as a great professional opportunity.

THE STATE OF AFFAIRS

Before officially accepting the position as interim principal at Kelsey High School, Rose was briefed about the school's performance. Student scores on the standardized state test were lower than the established goal but consistently remained at a level right above the cut-off for a school needing assistance from the state. Rose had also been told that faculty morale was at an all-time low. Explanations for the low morale were numerous and radically different depending on who was asked. Teachers claimed the administration had not been responsive to basic issues like discipline. There seemed to be inconsistency in how rules were enforced. The school had experienced rapid turn over in the administration: two principals in four years, not to mention turnover in superintendents. The faculty agreed that morale was low because they lacked unity and team spirit. New teachers thought the environment was "cliquey" with older, more experienced teachers occupying faculty leadership positions. The superintendent and board members alike warned Rose about the "unwelcoming environment" of the school, and attributed some of the morale problems to the outgoing principal. Poor administrative communication on the part of the former principal and his unwillingness to deal with hard personnel issues had created resentment among the teachers.

THE FIRST FACULTY MEETING

Having dealt with the politics of "the teachers vs. the administration" in previous roles, Rose felt confident and excited about the challenge ahead. She loved big picture thinking, and saw the morale issue as a crisis in leadership. She got to work analyzing the school's strategic plan, which was developed by the faculty and addressed three main needs: involving parents and the community, increasing expectations for student performance, and incorporating technology into the classroom. She was a believer in research-based practices and devoured studies offering new ideas for increasing student performance. So, at the first faculty meeting, Rose reviewed the goals of the strategic plan and mentioned that one way to increase student performance was by reconfiguring the way classes are offered. Instead of offering "basic level" classes, Rose cited research suggesting that all classes should be at the college preparatory level regardless of a student's post-secondary

education plans. Studies show that students rise to the challenge of harder classes, plus students who are interested in even more rigorous classes have the option of entering the honors program.

Rose gave this suggestion to the faculty for consideration and asked them to investigate this option. As she spoke, tension filled the room. Some rolled their eyes, others refused to make eye contact, and a small group began barraging her with questions. Mr. Dill, head of the science department asked, "How could we do that without watering down the curriculum for ALL students?" Ms. Lex chimed in, "Some kids will NEVER be proficient! Don't you think it's unrealistic to expect all students to do college level work? Wouldn't this be more work for teachers? We'd have to modify everything we do for the diversity of students we'd be teaching!"

Rose really wasn't sure what was happening. How could they be so negative about a positive change…a science-based practice? All she asked them to do was *consider* and explore the option. They created this improvement plan, why weren't they willing to follow it?

The resistance to the idea continued for weeks. Word was going around the school that the superintendent had a grand plan for putting Rose at the high school to implement major changes. Rose was seen as the superintendent's pawn and the teachers weren't playing. A bit panicked and disappointed about the faculty's reaction to this idea, Rose decided to drop the issue. Little did she know she had ignited a firestorm of skepticism that was difficult to extinguish. She decided to lay low, and get to know specific teachers so she could learn more about the culture.

THE CULTURE

Rose slowly colleted morsels of information, gaining insight into the faculty morale issue at Kelsey High School. She learned about the "days of Jack Hatfield." Jack Hatfield had been the principal at the school for 12 years, but had retired four years ago. The teachers loved him, and since his departure Rose was the third principal in place. According to the superintendent, "Jack nurtured a fortress mentality against the district. He built a power base by protecting his people from the 'unreasonable demands' of the central office. He turned the teachers against anyone on the outside. In other words, he didn't focus on instruction and was not accountable to the state's performance standards. Jack is your problem."

The teachers viewed Jack as the perfect principal. According to Ms. Paris, a tenured English teacher, "He didn't get in the way of the teachers' work; he expected teachers to teach and students to learn." Other teachers talked about how good Jack was at running the operations of the school. He took care of the grounds and discipline issues, and he protected teachers from the pressure of state school reform. He fostered the autonomy of the teachers.

As a picture of the school's culture began to emerge, Rose gained a clearer understanding of the difficulty the faculty had with change. But, she noticed a particular group of teachers was more disgruntled than the others…the tenured faculty. The majority of the faculty at the school was young and inexperienced, excited about engaging students but not always sure of how to raise

expectations for student performance. This group seemed more receptive to Rose's ideas. However, there was a group of tenured faculty in leadership positions within the school with different views of administration. They wanted the principal to provide a smooth running schedule, deal with facilities issues, and implement a consistent discipline policy that sent a message to students. According to Mr. Hite, a tenured math teacher, "We do all we can for the students with our limited planning time. If students get it, they get it, if they don't, they don't. It's their choice as to whether they want to take the opportunity to learn." Later, Rose found out that the teachers didn't even write the strategic plan; the former principal had taken it upon himself to write it, viewing faculty input as futile.

Rose was starting to see that this group of teachers did not see the principal as the leader of curriculum and instruction, and she wasn't sure what to do. She wasn't really interested in facilities issues; teaching had always been her passion, plus the superintendent hired her as the interim principal to help the school improve its performance.

THE VOICE IN THE BACKGROUND

With this information, Rose was at an impasse. She was excited about change and the wealth of opportunities at the school, but the teachers valued autonomy above all else. Just when things seemed to be settling down a bit, Rose was in for a surprise. At a workshop addressing ways to increase student performance, scheduling issues came up. A committee had been formed earlier in the year to address whether or not to change the current block schedule. Mr. Schlenk, head of the appointed scheduling committee and member of the school council announced, "There's faculty consensus that a change in the student schedule shouldn't be made until the new principal is hired." Rose felt like she'd taken a hit. This wasn't the first time where the tentative nature of her position had been publicly thrown in her face, but she thought they were beyond this. It seemed obvious that her plan to wow the faculty in this interim position was turning into a failure; regardless of how hard she tried. Silence filled the room.

Suddenly, Ms. Jakes stood and said, "What do you mean there's a faculty consensus? This is the first I've heard about scheduling." Other teachers around the room joined in and discussion ensued. There seemed genuine interest in different scheduling options, but it was apparent that the committee had not researched the issue or discussed it with the faculty. Ms. Paris stood and said, "I'm excited about changing the schedule, it could give students more continuity in their coursework, plus it would give us extra planning time, but this is the first I've heard of this."

Rose took a step back and watched as the room filled with discussion. Maybe she was getting through to them, or maybe the resistance wasn't as organized as it seemed. She'd been seriously considering not submitting her application for the position to the school council, to avoid the humiliation of not getting the job, but now perhaps the tide was beginning to turn…or was it?

DISCUSSION QUESTIONS

1. What elements of organizational culture are present at Kelsey High School? What are the values, symbols, and stories used to represent the culture?

2. Identify the major communication problems or barriers at Kelsey High School. How do the communication patterns indicate problems with the organizational climate? What degree of trust, openness, and confirming messages exist?

3. Given the interim nature of Rose's position and the existing climate, how should she encourage the teachers to see her role as instructional leader? Is Rose lacking perspective on the situation or is her assessment accurate?

4. Regardless of whether Rose remains principal, how might you, as a consultant, improve the work environment overall? Think of specific programs, training, or incentives that might be effective.

5. Can you describe a similar experience you've had in trying to implement a change or in working through change in an organization? Were the issues resolved? If so, how?

HOW CAN I JUMP, WHEN I HAVE NO PLACE TO STAND? ACCOUNTING TO MEET THE NEEDS OF A CHANGING MARKET

Martha Lair Sale, Sam Houston State University

CASE DESCRIPTION

This case, based on the Fleming-Mason Energy electric cooperative, is the result of the personal experience and commitment of Mr. David E. Smart who at the time of the case was employed with Fleming-Mason Energy as Engineering Superintendent. The case is set when the company must examine the costs of providing "unbundled" individual services due to competition brought about by deregulation. It leads the student to examine the activities necessary to provide the services offered by the company and possible Activity Based Cost pools into which the costs of these activities might be grouped. It also asks the student to consider the competitive impact of deregulation and formulate an analysis of the strengths and weaknesses of the company to assess the possibility that the company will not be able to provide all its current services at a competitive cost once consumers are able to pick and choose service providers. The case is appropriate for students at any level who have completed an introduction to Activity Based Costing. Students with a deeper knowledge of costing will be able to do a more in-depth analysis. The case can be covered in a single fifty-minute class for use in an undergraduate class, or it may be analyzed in enough detail to occupy twice that time in an advanced management accounting or masters level class. The solution should take no more than ninety minutes of outside preparation by the student.

CASE SYNOPSIS

The primary focus of this case is the development of Activity Based Costing (ABC) cost pools. The company upon which the case is based is facing heightened competition due to deregulation. Traditionally, the company's services have been priced on a cost basis calculated on the overall cost of providing the complete bundle of services offered. Due to deregulation, customers will be allowed the opportunity to choose other providers for individual services based on the cost of these services. Management plans to use ABC as a tool to determine more accurate costs of the various services they offer and help determine the areas in which the company can be most competitive. A secondary focus of the case is the development of a SWOT analysis.

INDUSTRY BACKGROUND

Electric utility companies provide their customers with a wide range of services that are essential in delivery of the electricity. These services are broadly grouped into the areas of generation, transmission, and distribution. Generation includes the building and maintenance of generation stations to produce power from any of a wide variety of fuels. Transmission is the process of moving the power in high-voltage lines over what may be long distances to get it to the general area of the customer and includes provision and maintenance of the lines and other equipment necessary to the process. Distribution includes transforming the power to lower voltage and distributing it over smaller lines to the individual customer, installing and maintaining power distribution lines to new and existing customers and providing emergency response in the event of disruption of service. Distribution services include metering, billings, and marketing.

The electric utility industry is changing dramatically. Traditionally customers were compelled to purchase power from the company that provided the distribution service to the customer's location. Deregulation is removing this restriction and removing the monopolistic hold the distribution company exerted in its service area. It will allow service providers to compete for individual customer's business, and allow the customer to determine which service provider best fills individual needs. These changes will certainly affect the cost, the price, and the reliability of electric service. It will also necessitate changes to the ways utility providers account for and report the cost of providing their services to both the regulating agencies that had been charged with protecting the customer and to the customer.

For those in the electric business, retail wheeling has been a hot topic for several years now, and is one of various proposals to dramatically change how customers buy their power. Retail wheeling refers to the ability of the customer to contract for electric power in the open market. Deregulation to allow retail wheeling would allow the customer to "wheel in" power from various sources. Under retail wheeling, power owned by a supplier is delivered to the customer over transmission and distribution lines owned by a third, unrelated party. The owner of the lines charges a fee for letting others use them. A wheeling charge is levied for both transmission and distribution line usage. Today, few utilities have any retail wheeling transactions, because each utility actually has purchased and owns the electricity that flows across its lines to retail customers. However, some of the larger commercial and industrial electricity customers, especially in states with high power costs, believe that they can save money by wheeling in less expensive electricity from a supplier other than their existing source. To save money under these conditions the combined price for the power plus the wheeling charge would be less than the cost currently incurred for power from the owner of the transmission and distribution lines servicing the buyer.

This apparent boon to purchasers in high rate areas could conceivably divert power from areas with low power rate structures to areas where the power might be sold more profitably. It also has implications for utility companies such as customer-owned electric cooperatives that exist with

the purpose of providing low-cost electricity to low volume users. These users traditionally are widely dispersed and the cost of installing and maintaining transmission and distribution lines is relatively higher than in areas of greater customer concentration.

Investor-owned utilities and customer-owned utilities, such as these electric cooperative, are preparing for a market based on customer choice. California, Pennsylvania, and Illinois, are all states that have enacted some form of legislation allowing competition in the power industry within the state. In order to remain the supplier of choice, each utility will need to determine ways to keep their electric rates as low as possible, but they must also continue to assure that their customers have access to the wide range of services necessary for power delivery. All electric suppliers will be forced to analyze the cost and range of services they provide to their customers.

FLEMING-MASON ENERGY

Fleming-Mason Energy was incorporated in 1937, and currently provides electric service to more than 20,000 customers in eight Kentucky counties. Like most rural electric cooperatives, it was formed in the 1930's with funding provided by the Rural Electrification Administration (REA). Throughout the years, REA provided low-cost government loans to help ensure that all Americans have access to electric power. The major purpose of the non-profit cooperatives funded by these loans was to provide electric service to areas where customers were dispersed so widely, and the cost of providing transmission lines was so large compared to the volume of power used, that investor-owned utility services could not profitably operate. The major difference between an investor-owned utility and a cooperative is that the investor-owned utility has a mission to maximize shareholder wealth, while the cooperative is a customer-owned non-profit company committed to providing good service at the lowest possible cost.

RUS (Rural Utilities Services), which in 1995 combined the former REA with services to provide other rural utilities such as water and fiber-optics, provides loan funds for a variety of utility cooperatives throughout the United States. The uniform system of accounts established by RUS, is required for all RUS electric borrowers so that comparability can be maintained. The RUS accounting system is primarily concerned with providing information to the creditors and customer members of the cooperatives. Like most electric cooperatives, Fleming-Mason Energy currently uses the financial accounting system established by RUS to manage and report their financial activities.

In the competitive environment, in which Mason-Fleming now finds itself, this accounting system is inadequate. As a financial accounting system, it does not focus on where and why costs occur. In general, costs are incurred because of activities that must be performed to provide services. Using a traditional accounting system, service costs may be allocated without sufficient consideration of what activities are needed to perform those services. In addition, there is no consistent relationship between the cost of labor to provide the service and the total cost of the

service. This makes traditional product costing using direct labor as the allocation base for indirect cost especially inaccurate.

Managers of Fleming-Mason Energy think that in order to compete in an open market, a more detailed management accounting system must be established. Therefore, Fleming-Mason Energy is implementing an activity-based costing (ABC) system. ABC helps establish a link between the services offered, the activities that are necessary to provide these services and the expenditures necessary to perform the activities. By establishing this link, costs can be tracked and assigned to processes and activities performed by the cooperative. By examining the services that require these processes and activities the costs can be assigned more accurately to different services. Once a clear picture emerges of which services require which activities and the cost of these activities is established, managers can make better choices on which services to offer and how to price them. ABC systems assist managers in determining what causes costs, and how they can manage activities or processes to reduce these costs.

With the emergence of a competitive marketplace, Fleming-Mason Energy will re-evaluate policies as well as cost structures. Currently, the electric rates paid by members are determined by the costs required to provide a bundle of services including many of those mentioned above such as installing and maintaining power transmission and distribution lines to new and existing customers and providing emergency response in the event of disruption of service. Other services offered by Fleming-Mason Energy, such as metering, billings, and marketing, are already open to outside competition. After deregulation, all the services will be open to competition.

Another change to the accounting system that will be brought about by deregulation will be unbundled billing. Cooperatives under state utility commissions will be forced to file cost reports based on known and measurable unbundled costs. Fleming-Mason Energy's current rates consist of a customer meter charge, a kWh charge, and in larger commercial installations, a demand charge. Fleming-Mason Energy currently purchases all of its' power requirement needs from one power generation and transmission cooperative. This power supplier charges Fleming-Mason Energy substation charges, energy charges, and demand charges. As a generation and transmission company this power supplier’s costs are affected by changes in the cost of fuel. Therefore, the customers' bills are subject to an increase or decrease from the approved rate, depending upon the current cost of fuel. In an unbundled billing system, it will be necessary to present the costs in more detail. What was a simple billing method will become very complex for the utilities and for the customers. Under an unbundled billing system, the customer bill will include charges for the following: electric energy generation, transmission wheeling, distribution facilities, distribution line, distribution service, meter reading, and billing. The new bill will also include a stranded cost recovery charge. Under deregulation, customers will be able to choose their electric supplier. However, the chosen supplier will be forced to pay the owner of the transmission and distribution lines servicing the customer for the use of distribution facilities. The charges paid by the new supplier to the old supplier will include a stranded investment recovery cost to allow the owner of

the transmission and distribution system to recover the cost of installing the system. The existing supplier has made an investment to provide service to that customer. When the customer changes suppliers, the new supplier has no investment in the distribution service. Therefore, the new supplier must reimburse the old supplier for their stranded costs. In states that have deregulated the electric industry, the recovery of stranded investments has given rise to the most heated discussion and been the most difficult portion of the deregulation process upon which to reach an agreement. Fleming-Mason Energy, as well as every other utility, will be forced to put a price on stranded investments. Unbundled billing through deregulation is forcing every utility to rethink the way they keep their financial records.

Fleming-Mason Energy will be forced to determine the strengths and weaknesses within the range of services offered. In the event Fleming-Mason Energy cannot compete effectively in a given area of the business, they will be forced to cede that process to a third party provider. Losing any of these processes could be harmful to the relationships Fleming-Mason Energy has with its cooperative member customers. Therefore, Fleming-Mason Energy must determine cost and performance measures in the critical areas of their business, to ensure that they can retain control of their core business activities and processes. As an example, many investor-owned utilities are going through the process of determining what areas of the business they perform best, and what areas provide the most profit. Many investor-owned utilities are merging in order to reduce operating costs, and in order to gain a larger market share. Other investor-owned utilities have determined that it is best for them to be in the generation and transmission business, not the distribution business. Therefore, they have sold portions of their distribution systems to other utilities. In order to make these decisions with confidence, the managers of these utilities relied widely upon ABC accounting information instead of traditional cost accounting information. The cooperatives that have not implemented an ABC system will be forced to make uninformed decisions in the future. The companies that will succeed in a competitive market are the companies who fully understand their costs, and make sound decisions based upon their cost data.

Managers can work toward understanding the optimum mix of services they must provide to maximize customer satisfaction and work toward improving the efficiency of the underlying activities necessary in providing these services. They can then consider outsourcing essential services that they cannot provide competitively and the possibility of eliminating services that are both non-essential to customer relationships and which they cannot perform at a competitive cost. During this process, they might find that they are especially efficient at providing certain services. Services that fall into this category are core competencies that should be identified for maximum expansion. Through this process the ABC system will provide cooperative managers with the cost information needed to make sound economic and strategic decisions.

Fleming-Mason Energy recently participated in a performance-benchmarking workshop in which utilities of similar sizes were benchmarked against one another and the industry at large. Benchmarking is the practice of identifying which companies are the best performers in certain areas

of their business. The electric power distribution benchmarking process included a variety of areas such as engineering design, outage response and restoration, right-of-way maintenance, line construction, and line maintenance. The benchmarking process involved compiling the accounting cost data into an ABC accounting format.

According to Fleming-Mason Energy management, the idea of the benchmarking process was to establish a database that would allow extraction of relevant cost data through the use of uniform definitions. For example, Fleming-Mason Energy had always expensed outages based on the amount of time elapsed from the initial customer call until power was restored and the employees returned home. The benchmarking process required that they break the outage time into three distinct areas. The first area was response time. How long did it take the on-call crews to arrive at the office after the outage call was received? The second area was travel time. How long did it take the crews to drive from the office to the location of the outage, and to return home after repairing the outage? The third area was repair time. How long did it actually take the crews to find the cause of the outage, and to repair and restore electric power? Breaking the outage information into three different areas offered a better understanding of the distinct activities performed and highlighted possible inefficiencies.

The method of computing the cost of running a service to a new customer was revised. In the past, all costs to provide the service drop were grouped together in the same account. Under the benchmarking process, Fleming-Mason Energy managers broke the cost of providing a new service drop into two areas. Services that included the addition of a pole were grouped together, and services that included just running additional wire were grouped together. With the added knowledge gained by breaking down these costs, the engineering department was able to make better decisions when determining how service should be provided to a customer.

As a result of the benchmarking program, Fleming-Mason Energy managers learned several ways in which cost data could accurately be grouped by activity then tied to the services provided. Because many of the companies participating in the benchmarking workshop did not keep records with as much detail as those required for the workshop, some of the benchmarking comparisons were inaccurate. However, Fleming-Mason Energy management learned that if Fleming-Mason Energy had performed at a level equal to the best performer in all the benchmarked areas their savings would have been over $1.2 million for the year.

In conclusion, the electric utility industry is changing, and will continue to change over the next decade. Territorial boundaries will be broken down, as competition begins dictating the electric market. Many utilities are still using financial cost accounting records for their primary financial data. In a deregulated industry, the utilities that learn to implement an advanced cost management system will have an advantage over their competition. Fleming-Mason Energy is currently implementing ABC in hopes of being able to make sound decisions in their changing environment. Small cooperatives like Fleming-Mason Energy may not survive in a deregulated marketplace. Many utility experts believe that deregulation will lead to an industry with only a few extremely

large power companies. The cooperatives working together are striving to become one of those large power companies. Many cooperatives have joined forces and created Touchstone Energy. As a group, Touchstone Energy Cooperatives are the largest provider of electric service in the United States. Through the use of marketing and management decisions based upon actual cost data, the cooperatives, including Fleming-Mason Energy, are preparing for the future.

DISCUSSION QUESTIONS

1. In as much detail as possible given the information provided, make a list of services that are likely provided by Fleming-Mason Energy.

2. What are the activities that Fleming-Mason Energy is likely to perform in providing these services?

3. What are the cost pools to which you would suggest these actives be assigned?

4. Are these cost pools sufficiently detailed to provide information for unbundled billing? What additional information do you think will be necessary to provide this type of billing? Choose one of the cost pools identified above and show how the cost collected in that cost pool could be traced to specific services. It may be helpful to use assumed amounts and demonstrate the process.

5. What is Fleming-Mason Energy's strategy?

6. What services do you think are core to this strategy?

7. Are other services provided by Fleming-Mason Energy that are not core to their strategy that they might consider outsourcing?

8. What are some of the considerations that they should examine when making outsourcing decisions?

SMALL BUSINESS PROPOSALS FOR THE INSTALLATION OF RESIDENTIAL AIR-CONDITIONING AND HEATING EQUIPMENT

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CASE DESCRIPTION

This case relates to business firms (mostly small business) who sell and install residential air conditioning and heating equipment as a major part of their business. More specifically, this case analyzes "what" (the contents) is included in the contractors' proposals presented to sell and install this equipment.

The objectives of this case study are as follows: (1) to show that these proposals lack clarity, completeness, and mutual comparability; (2) to suggest how to address these problems when writing such proposals; (3) to help students learn how to analyze business proposals; and (4) to show the process of selecting one proposal, out of many, dealing with such products.

This case is very appropriate for students in an intro to business course.

A teacher would require about an hour to explain the significance of the case. A student would require about 2-3 hours preparing the case, and about half an hour to present the case to the class, if so required. Time would vary if the case is analyzed and presented using a team approach.

This case presents a valuable opportunity for students to learn how to make a major purchase decision involving air conditioners and gas heaters.

CASE SYNOPSIS

This case study would help homeowners evaluate these costly proposals more carefully and completely. Such an evaluation would help them make their decisions in a timely fashion, buy the equipment at a reasonable price, and enjoy its use at an early date. Additionally, an early decision by homeowners to buy their air-conditioning and heating equipment would help the manufacturers and contractors receive their cash flow from equipment sales a few weeks sooner than they do now. In a multibillion-dollar industry [Checket-Hanks 2003], a sale of this expensive equipment two to three weeks earlier--and the cash flow associated with it--can save these manufacturers and contractors millions of dollars in finance costs. Finally, an early sale would enable the thousands of individual sales persons working in this industry to receive their commissions sooner.

INTRODUCTION

The various parts of the air conditioning and heating (air-heat) industry that deal with residential central air conditioning and central gas heating can be divided into four segments. Segment 1 consists of companies, many of them quite large, which manufacture various kinds of equipment for home use. In segment 2, there are a few thousand individual small business contractors who actually install this equipment in homes around the country. Segment 3 is made up of many thousands of sales persons who work part time or full time for these contractors to sell the equipment to individual homeowners. (Many times the contractor and the sales person are the same). Finally, in segment 4, there are millions of homeowners who need to have the equipment installed in their homes. These four segments of the air-heat industry account for a multi-billion dollar business affecting millions of people in many different ways.

This case is based upon the process and experience that a particular family went through in order to replace its air-heat equipment when the time came to do so. The family received various proposals from local contractors to replace the equipment, analyzed the proposals, and selected one of the proposals. While this case is real, all names, places, dates, events, and some minor details pertaining to the actual manufacturer of the equipment, actual contractor who sold and installed the equipment, and the real homeowner involved have been disguised for the sake of objectivity.

OBJECTIVES AND ADVANTAGES

The objectives and advantages of this case study follow:

Management and marketing texts and journals are replete with cases dealing with many important, but general, topics of management and marketing. These include goal setting, strategy formulation, communication, leadership, advertising, promotion, pricing, and distribution. Many of these cases relate to the service sector of the economy. There is a shortage of cases that show how to write sales proposals for the installation of some very technical and expensive products of daily use. This comprehensive real-life case is a serious attempt to fill this gap.

In particular, from a contextual point of view, this case deals with writing sales proposals for the installation of a residential central air conditioner and a residential central gas furnace.

The case is written in a manner that requires students to carefully review the facts presented in the case, conduct a complete analysis of the facts, and present their findings and recommendations to the class and/or the instructor as required.

The facts of the case, necessary for doing this analytical work, are presented in four exhibits. Exhibit 1 narrates certain facts about the central air conditioners and the items (such as brand name, model, capacity, tonnage and efficiency, fuse line, PVC flue, and refrigerant piping) related to them, as described in different proposals. Exhibit 2 narrates facts about the central gas furnaces as

described in these proposals. Exhibit 3 narrates the warranties as described in these proposals. Exhibit 4 summarizes the comparative prices as quoted in these proposals.

The questions presented at the end of the case ask the students to analyze the facts, point out what was included in these proposals and what was missed, and then to offer suggestions for improvements in the writing of these sales proposals for future use.

When combined with its "instructors' notes," such review, analysis, and recommendations would help students learn what unclear, incomplete, and mutually incomparable sales proposals look like, and, secondly, how the writing of these proposals could be improved.

This case, as stated below, has many practical applications for homeowners, manufacturers of air heat equipment, installation contractors for such equipment, and the sales representatives who make proposals to homeowners for the sale of such equipment.

1. It would create an awareness of the problems, as stated above, among all four segments of the air-heat industry. It would help motivate all concerned to try to correct these problems.
2. It would help homeowners evaluate these proposals more carefully and completely. Such an evaluation would help them make their decisions in a timely fashion, buy the equipment at a reasonable price, and enjoy its use at an early date.
3. An early decision by homeowners to buy their air-heat equipment would help the first two segments of the industry (manufacturers and contractors) receive their cash flow from the sales a few weeks sooner than they do now. In a multibillion-dollar industry, a two-to-three week earlier sale of this expensive equipment--and the cash flow associated with it--could save them millions of dollars in finance costs. The increased turnover rate will also add to their volume of business and amount of profits.
4. It would enable the thousands of sales persons mentioned above (Segment 3) to receive their commissions sooner.
5. It would encourage people to try to improve similar writings and presentations in other areas of business.

This case is appropriate for both undergraduate (junior and senior levels) and graduate level students. A teacher would require about an hour to explain its significance. It would take a student about 2-3 hours to prepare the case and about half an hour to present it to the class, if so required. Time would vary depending on whether the case is analyzed and presented using a team approach or not.

Because of the technical nature of the case, a team approach may be more meaningful in studying this case.

This case would be very helpful in courses such as management, marketing, and production--which deal with topics such as writing sales proposals, analyzing these proposals, and choosing a proposal.

THE AIR CONDITIONER BREAK DOWN

While the sweltering heat was still a few weeks away, approaching summer was clearly in the air. Then one day, without any warning, Peter and Janice Brown's eighteen-year-old central air conditioner broke down. Peter called the local utility company (which provided a maintenance agreement covering the air conditioner and other household items) to have them look into the problem.

After an inspection, the utility company's representative concluded that the compressor in the air conditioner unit sitting outside the house was inoperative, and that its refrigerant might be leaking. He said that while the service call is covered under the maintenance agreement, a new compressor and the process of searching and locating the refrigerant leak are not. He offered to locate and fix the leak at the rate of $80 an hour for the labor time. He also offered to replace the compressor itself for $2,470. But there is no guarantee, he added, that these steps would fix the problem--especially if the problem is not in the compressor or the compressor coils surrounding it, but somewhere between the air conditioning unit outside the house and the indoor cooling coils sitting on top of the central gas furnace inside the house. The furnace is located in a corner closet in the basement.

The Browns paid $90 plus tax to another specialist to get a second opinion, which reached similar conclusions.

Peter and Janice decided not only to replace the central air conditioner, but also the central gas-heating furnace at the same time. The latter equipment, although currently working well, was nonetheless more than 25 years old. A combination of a new air conditioner and an old furnace could create problems for both units. However, if both pieces of equipment were new, they would work more efficiently together.

Of the couple, Peter is primarily responsible for the household jobs that require working with outside contractors. He never enjoys trying to decipher contractors' proposals to do things in and around the house, with their terms fine-printed on the back of the customer's yellow colored carbon copy. He remembered what Bishop Fulton J. Sheen once said, "The big print giveth, the fine print taketh away" [Scarborough and Zimmerer, 2003]. However, with all his limitations, Peter had to do what he had to do. Summer had already begun.

In its May 2001 issue, *Consumer Reports* presented an analysis of "repair history of central cooling systems" purchased between 1994 and 2000. This annual analysis was based on more than 51,500 responses the magazine had received. American Standard, Ruud, and Trane were rated at the top of the list (with fewer "repairs and serious problems"). They were followed, in order, by Tempstar, Rheem, Lennox, Comfortmaker, Bryant, Heil, Coleman Evcon, Carrier, Goodman, York, and Janitrol.

After some discussion, Peter and Janice selected air and heat equipment made by a company called "Home Comfort" (a fictitious name) for their home.

PROPOSALS FROM CONTRACTORS

According to the Division of Consumer Affairs of the state in which Peter and Janice reside, a homeowner should get at least three written estimates for installing a central air conditioner. Over the next few weeks, Peter actually spoke with several contractors. Most of these were small businesses, except for one, which was associated with a large business. Coincidentally, all the contractors and the sales persons to whom Peter and Janice spoke were men.

Some of these contractors were too busy to consider taking another customer for the next several weeks. Some of them proposed to install equipment made by companies other than those made by "Home Comfort," their chosen brand. Some of them did not have some of the most basic information that Peter wanted to see in these proposals, such as legibility, price breakdowns, and equipment descriptions. Peter gave no further consideration to the proposals which lacked even basic information. He selected four proposals, which while lacking in some minor details, were reasonably complete and comparable to each other, for further consideration.

For the sake of convenience, these four proposals, for the purpose of this case study, are called Proposal 1, Proposal 2, Proposal 3, and Proposal 4, respectively. Similarly, the contractors who submitted them are called Contractor 1, Contractor 2, Contractor 3, and Contractor 4, respectively.

MAKING A DECISION

Peter and Janice now had to select one of these four contractors to install this expensive equipment at their home. In order to facilitate such selection, Peter summarized the important aspects of these proposals in the form of four comparable, tabular exhibits. Exhibit 1 narrates facts about the central air conditioners and the items related to them (such as brand name, model, capacity, tonnage and efficiency, fuse line, PVC flue, and refrigerant piping) as described in different proposals.

Similarly, Exhibit 2 narrates facts about the central gas furnaces as described in these proposals. Exhibit 3 narrates the warranties as described in these proposals. Finally, Exhibit 4 summarizes various prices as quoted in these proposals.

Analyzing data that are technical and diverse in nature is a very challenging job. The Browns, therefore, decided to select you as their consultant to help them in this matter.

DISCUSSION QUESTIONS

1. Exhibit 1 presents comparative facts about the central air conditioners and the several items/parts associated with them, as described in the four proposals. Compare these business proposals with each other in terms of the information that is provided and the information

that is not provided. What would you suggest should be changed and/or added to make these proposals more complete and comparable to each other?

2. Exhibit 2 presents comparative facts about the central gas furnaces and the several items/parts associated with them, as described in the four proposals. Compare these business proposals with each other in terms of the information that is provided and the information that is not provided. What would you suggest should be changed and/or added to make these proposals more complete and comparable to each other?

3. Exhibit 3 presents comparative facts about the equipment warranties and the variables/conditions associated with them, as described in the four proposals. Compare these proposals with each other in terms of the information provided and not provided. What would you suggest should be changed and/or added to make these proposals more complete and comparable to each other?

4. Exhibit 4 presents comparative facts about the various prices and the different variables associated with them, as described in the four proposals. Compare these proposals with each other in terms of the information that is provided and the information that is not provided. What would you suggest should be changed and/or added to make these price quotations clear, complete, and comparable to each other?

5. Now review all four questions and your answers to them. Which one of the four proposals would you recommend to Peter and Janice Brown for adoption, and why?

6. Are there any other items of importance that in your opinion should have been included in these proposals? In order to answer this question, students should talk to some people who recently had residential central air-conditioning and/or heating equipment installed in their homes.

7. What other suggestions would you make?

8. Identify at least one of the major manufacturers of central air conditioner and central gas heating equipment in the country. Give information about its size, products, revenues, employees, and management (no more than a page).

ENDNOTE

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EXHIBIT: CENTRAL AIR CONDITIONERS AS DESCRIBED IN DIFFERENT PROPOSALS

Contractor	Brand Name, Model Name	Model #	Cooling Capacity	Tonnage	Efficiency	Coil Name, Number	Fuse Line, Refrigerant Pipe	Discharge of Condensate	Concrete Slab Under A/C: a. Removing Old B. Placing New
1.	Home Comfort A/C 1400	HC/CAC /1451	42,000 BTUs	NM	SEER 14.00	ABC 12345	Included	Through gravity feed to sump pit	a. NM b. Yes
2.	Home Comfort A/C 1400	HC/CAC /1452	NM	4	SEER 14.00	ABC 12345	Included	Through gravity feed to sump pit	a. NM b. Yes
3.	Home Comfort A/C 1400	NM	42,000 BTUs	NM	SEER 14.00	Matching coil	Included	Through existing pipeline to sump pit	a. NM b. NM
4.	Home Comfort	HC/CAC /1351	42,000 BTUs	NM	SEER 13.00	Illegible	Included	Not mentioned	a. NM b. Yes

The real model names and numbers have been changed to fictitious ones.
NM = Not mentioned.
BTU = British Thermal Unit. In scientific terms, it represents the amount of energy required to raise one pound of water one degree Fahrenheit. One BTU is the equivalent of the heat given off by a single wooden kitchen match. It represents the measure of heat given off when fuel is burned for heating, or the measure of heat extracted from home for cooling.
Tonnage = A measure of airflow. Ordinarily, 400 cubic feet per minute of air flow is generated per ton.
SEER = Seasonal Energy Efficiency Ratio. It is a standard measure of air conditioning efficiency established by the U. S. Department of Energy. The higher the rating, the larger the energy efficiency.
Source for definitions: American Standard Heating and Air Conditioning Glossary of Terms.

EXHIBIT 2: CENTRAL GAS FURNACES AS DESCRIBED IN DIFFERENT PROPOSALS

Con-tractor	Brand Name, Model Name	Model #	Input Capacity (BTUs)	Tonnage	Output AFUE	Direct Vent Capability	Special Air Filter
1.	Home Comfort, E&Q	HC/CGF/ 120-001	120,000	NM	92%	Yes	Available, extra charge
2.	Home Comfort, E&Q	HC/CGF/ 120	120,000	4	92%	Yes	Available, extra charge
3.	Home Comfort, E&Q	NM	100,000	NM	92.5%	Yes	Available, extra charge
4.	Home Comfort, E&Q	HC/CGF/ 100-001	100,000	NM	90%	NM	NM

The real model names and numbers have been changed to fictitious ones.
NM = Not mentioned.
AFUE = Annual fuel utilization efficiency measures a furnace's efficiency in converting fuel to energy. A 92% efficiency means that 92% of the fuel is converted into heat.
Tonnage = A measure of airflow. Ordinarily, 400 cubic feet per minute of air flow is generated per ton.
Source for definitions: American Standard Heating and Air Conditioning Glossary of Terms.

EXHIBIT 3: WARRANTIES AS DESCRIBED IN DIFFERENT PROPOSALS

Items	Contractor 1	Contractor 2	Contractor 3	Contractor 4
Air conditioner	2 years parts and labor by contractor	2 years parts and labor by contractor	2 years parts and labor by the contractor	5 years labor, and 5 years parts by the contractor
A/C Compressor	10 years by manufacturer	10 years for parts. Unclear who is the provider	10 years by manufacturer	10 years. Unclear if by contractor or manufacturer
A/C condenser coil	5 years by manufacturer	10 years for parts. Unclear who is the provider	10 years on the outdoor coil and 1 year on the indoor coil; by manufacturer	Not mentioned separately.
Gas furnace	20-years and/or life time by manufacturer for the heating element only; applies to the original owner only	1 year parts and labor by contractor. For life on heat exchanger, parts only. Unclear who is the provider	2 years parts and labor by contractor; for life on heat exchanger by manufacturer	1 year labor, 5 years parts, 20 years heat exchanger. Unclear who is the provider
Misc.	All service provided during normal business hours.	The warranties are limited; it was not stated that the services are to be performed during normal business hours	The warranties are limited. Customer must have regular seasonal maintenance performed by the contractor to maintain extended guarantee coverage. Service provided between 8 am -- 4:30 pm; Mon-Fri	The word "limited warranties" not used; it was not stated that the services are to be performed during normal business hours

EXHIBIT 4: PRICES AS QUOTED IN DIFFERENT PROPOSALS

Items ?	Contractor 1	Contractor 2	Contractor 3	Contractor 4
Basic price	$5,660	$6,200	$6,650	$6,754 Minus approx cost of a humidifier included in it: -300 Net: $6, 454
Township permits fees	Included	Approx. $120	Approx. $120	Approx. $120
10 year extended warranty	$406	$450	Approx. $406	$590 Sales tax $35
Rebate from manufacturer	-$300	NM	-$400	NM
Total cost before utility company rebate	$5,766	$6,770	$6,776	$7,499
Utility company rebate	A/C: -$550 Furnace: -$300	A/C: -$550 Furnace: -$300	A/C: -$550 Furnace: -$300	A/C: -$370 Furnace: -$300
Final cost	?	?	?	?
Schedule of payments	Advance: $690 Balance on job completion	Flexible	Advance: $650 Balance on job completion	Flexible

Notes: (1) An approximate cost of a humidifier included in Proposal 4 has been deducted from its original basic price for comparison purpose. Cost of a special air filter has not been included in any of the proposals. (2) The manufacturer's extended warranty (both parts and labor) covers only the air conditioning and heating equipment made by the manufacturer. It does not apply to the special air filters made by other manufacturers.

DIXON'S FAMOUS CHILI: A WOMAN-OWNED, FOURTH GENERATION, FAMILY BUSINESS CASE STUDY

Todd D. Mick, Missouri Western State University

CASE DESCRIPTION

Dixon's Famous Chili is the oldest, continuously operating, family owned restaurant in Kansas City, Missouri. From Dixon's beginning in the early 1900's, women have played pivotal roles, including owners in three out of four generations. The societal pressures and life events that impacted these women and their families are presented to exemplify the struggles women have faced when operating a small business. The case begins and ends in the present day with the current owner facing divorce, raising three school aged children, and having no means of support except the failing family restaurant. Teaching note and references reviewed.

CASE SYNOPSIS

Dixon's Famous Chili is the oldest, continuously operating, family owned restaurant in Kansas City, Missouri. From Dixon's beginning in the early 1900's, women have played pivotal roles, including owners in three out of four generations. The societal pressures and life events that impacted these women and their families are presented to exemplify the struggles women have faced when operating a small business. The case begins and ends in the present day with the current owner facing divorce, raising three school aged children, and having no means of support except the failing family restaurant.

The teaching note uses current research on both woman-owned and family-owned small businesses to present a real world context for theory and model application. The teaching note is easily applied to either entry level undergraduate, upper level undergraduate or graduate classes. The teaching note also offers various combinations of theory, models and discussion points to bring the theoretical into a real world context. Practitioners and students enjoy seeing the relevancy of their studies and in turn, the impact of entrepreneurial decisions.

Case studies in both a woman-owned and family business context are increasing, but are still rare. The examples set by the three generations of women in the Dixon's Famous Chili case study are powerful, not only for aspiring women entrepreneurs, but for men as well to understand the dynamics of marriage, family and partnership.

The women, men and families in the Dixon's Famous Chili case faced real world situations that can be seen and understood with the use of entrepreneurial and small business theory providing students a bridge between their course work and their future.

INTRODUCTION

Kansas City, Missouri's oldest family owned restaurant was going to close; it was inevitable. The new owner was a freshly divorced, single mother with three school age children and no business experience. Her only asset was a business that was pest infested, in debt and without suppliers. The third generation to own Dixon's Famous Chili was doomed to be the last. As the owner looked at the young faces of the fourth generation, she realized she would pass nothing of the family legacy down to them except memories. Was there any way to save her self, her family and her family legacy?

FOUNDING HISTORY

Vergne Dixon started selling chili out of a cart in the early 1900's in downtown Kansas City, Missouri. The business and recipe were little more than a hobby and a passing curiosity for both owner and client. The uniqueness, however, soon settled into a regular money making business and a permanent location was soon a goal. By 1919, Dixon's Chili was located in a permanent building in downtown Kansas City. Interestingly, all the waiters were male due to a unique hiring system; Vergne hired recently paroled convicts and the homeless as labor, paying them in food. And so another unique feature of Dixon's came to be. The men were so moved by Uncle Vergne's support that many worked for decades after Uncle Vergne's death in 1963, with the last parolee retiring from Dixon's in the early 1980s.

During the lunch hour, the busiest time for Dixon's, Aunt Lela took all the cash home. As Vergne's wife, she quickly assumed the multi-role responsibilities of bookkeeper, accountant, and homemaker. Still, the family missed the freedom of the old cart. Realizing that the hot and humid Missouri summer months had a direct impact on chili sales, the Dixon's decided to close for the summer, and if the result was an extended summer vacation for the family as well, all the better. This tradition held until 1970 and the addition of air conditioning.

For the first 50 years, the menu never changed, including Uncle Vergne's rule of no ketchup. In fact, while customers would sneak in ketchup, Uncle Vergne would fine them 10 cents if he caught anyone using ketchup on his unique chili. To this day, while ketchup is on the menu, the price is still 10 cents in honor of Uncle Vergne. The chili powder was so unique and sought after that the chili powder is patented and Dixon's chili recipe has remained unchanged since the early 1900's.

Through two world wars and a great depression, Dixon's Chili managed to survive. Thriving was a different question, but the family was able to make a decent living through good times and bad and no one complained or sought to change the business. That was until 1952, when President Truman came in for lunch. President Truman, being from the Kansas City area, had always liked Dixon's Chili and was a frequent customer. But when you are President of the world's most powerful country and have just won a contentious election, the American press follows you everywhere. Such was the case when Life magazine published a photo of President Truman enjoying a bizarre looking concoction that no one would ever mistake for chili anywhere else in the country. You see, Dixon's chili is not served in a bowl, but on a plate. The meat, juices and all the fixings are served and billed separately (remember the ketchup, as well as onions, cheese, sour cream and so on). The photo put Dixon's on the tourist map of where to eat in Kansas City and business began a steady growth. As a result, the "Famous" was added to the restaurant name. As a side note, what the Life photo did not show was the owner going across the street to get President Truman a beer. Dixon's had never applied for a liquor license and President Truman preferred beer with his chili. Dixon's Famous Chili hand delivered a bowl of chili every year to President Truman for his birthday and received a hand written thank you note every year as well.

THE SECOND GENERATION

In 1961, Uncle Vergne and Aunt Lela retired without having had children. Their sole extended family member was Aunt Lela's sister, Edith and her son, Leonard. Leonard's wife was Virginia, who had a particularly close relationship to both Uncle Vergne and Aunt Lela, who regarded Virginia as the daughter they never had. Wanting to keep the business in the family, Uncle Vergne decided to sell the restaurant at a dramatically reduced price of $10,000 to Leonard. But Uncle Vergne had one condition; that Aunt Lela be paid a stipend of $500 per month for the rest of her life after his death. Uncle Vergne died in 1963, while Aunt Lela lived on another 15 years, always receiving her $500 monthly Dixon's stipend.

Leonard did not sit still on the original Dixon's, as he felt Uncle Vergne had been doing. Leonard expanded to nearly a dozen different locations; two in Kansas, one in Minnesota and the rest in Missouri. All these sites Leonard kept in the hands of family and friends. In 1970, Leonard formed a corporation, selling shares only to family and friends. That same year, Leonard closed the original location, placing the headquarters in the second oldest restaurant located in Independence, the first major suburb of Kansas City, directly east of the city.

Unfortunately, while Leonard was good at initially spreading the wealth among family and friends, he was not a good manager of these same family and friends. Nor were these new owners and operators selected on the basis of their business skills, restaurant knowledge or customer service skills. The only qualification required to operate a Dixon's was your personal relationship to Leonard.

Yet, the Dixon's name and originality carried the budding chain for years, as well as Leonard's contagious enthusiasm for customer service and the value of the Dixon's Famous Chili name. In the 21st century, people still reflect back on Leonard's smile requirement of all his employees and how their faces ached at the end of the day from always smiling. Leonard believed in knowing customers on a first-name basis and training the staff on all the possible combinations of Dixon ingredients. However, despite Leonard's obvious enthusiasm, he could not be in all dozen stores at once and the long term prospects for Dixon's remained in question. The sudden death of Leonard in 1973 at the age of 52 put the future of Dixon's in even greater doubt.

THE THIRD GENERATION

Virginia, Leonard's wife, inherited the Dixon's Famous Chili business and immediately appointed her son Vince to run it. Vince opened several more stores taking Dixon's to 16 total locations, which did not change until the mid 1980s. But the same issues facing his father quickly faced Vince as well; lack of central control and inexperienced manager/owners. Vince had all he could handle battling the continual deterioration of Dixon's hard-won quality, service and reputation. The 16 store expansion was in danger if imploding from within.

Virginia and Leonard's other child, Terri, worked the restaurant after school, weekends and summers to earn some spending money, but was not involved nor interested in any aspect of Dixon's. Terri's goal, after meeting and marrying her husband Steve, was to be a full time mother to her three children. Steve had other ideas.

THE THIRD GENERATION PART 2

By 1982, after a decade of Vince's control, Steve envisioned greater things for Dixon's. While profits were fine for a family lifestyle business, no one was getting rich. Steve, involved as a manager for the chain under Vince, was chafing at the family control and their supposed lack of vision. Steve believed he could expand Dixon's and make the restaurant work as a regional, if not national, franchise, with professional managers and even greater cash flows and profits. However, standing in his way was his mother-in-law, the sole owner. As luck, or unluck, depending on your perspective, would have it, Virginia developed a drinking problem. Steve saw an opportunity to gain influence over Virginia and began a campaign to discredit her son, Vince. And he was good at it. One day mom walked in, fired her own son by simply saying, "You're out!", and put Steve in charge. Terri was now married to the president of Dixon's Famous Chili and the sister of the former president.

What was going through Terri's mind? She had been raised by Leonard and Virginia to be a wife and mother, with her parents never voicing a strong opinion that she continue her education after high school or learn the family business. The assumption must have been that Terri, like Aunt

Lela, Edith and Virginia, would simply work tirelessly behind the scenes on the home front in support of the family business. In all honesty, Terri stated, she was simply ignorant of the business side of Dixon's and only cognizant of the family side. Terri's goal in life at that time, she stated, was to stay home and raise her children.

In regards to family relationships, even there Terri was not really involved if Dixon's was involved. The family was very adept at keeping family and business separate. As far as her mother working with her brother or her husband, or Steve working with Vince; Terri, by her own admission, was just thinking about her children. And the others were comfortable with that role.

Terri's life would only be comfortable for three short years. By 1985, Dixon's was imploding and was down to two franchises and the original in Independence. Steve's grand design was fatally flawed, and just how flawed would soon become apparent. In 1985, at the age of 30, with three children ages 4, 6, and 8 and a mother who was dying, Terri (for reasons not related to Dixon's, of course) filed for divorce. However, during this process, Virginia dies, leaving Dixon's to Terri and Steve. The family's way of life in Dixon's and Terri's marriage were now both falling apart and her mother was gone.

THE THIRD GENERATION PART 3

Terri's demand in the divorce was twofold; first, that she get her children and second, her family legacy, Dixon's Famous Chili. Terri really can not quite explain why this sudden need to possess Dixon's, except that she was staring at three children under 10, she felt strongly that Dixon's should stay in the family as a legacy of her father, and Dixon's was the only way she knew to support her family. Steve drove a hard bargain; Terri gave up her home, financial support and the two franchises to keep her children and Dixon's Famous Chili.

Literally, Steve walked out of Dixon's one day and Terri walked in the next. Yet Terri knew nothing of the restaurant business or even business in general, management or accounting. Vince, her brother, did come back to help some, mostly over the phone, as Terri worked her way through the office. The few things Terri did bring to Dixon's she learned from her dad; customer service and Dixon's quality. Leonard always set as a goal for the wait staff to learn ten new customer names each week. To this day, returning customers that used to ask Leonard about Terri now ask Terri about her children.

And what Terri inherited from her divorce was not a successful business, not even one in good operation. The business was rundown and dirty, bills and taxes were all unpaid, the air conditioning was broken and the whole building was infested with bugs. Suppliers had written off Dixon's and were on a cash-only basis. Yet Terri would not let Dixon's go. She started cleaning, she started organizing bills, and she began working with suppliers, creating those relationships all over again. Terri began by working deals where she could, since she had no cash, but she paid on time and added extra to make up for any debt. Eventually she won them all over. The bottom line

for Terri, and she communicated this to anyone who would listen, was that Dixon's was her family business and she and her children were the family.

Key to Dixon's continued survival was Sunday beer sales. At that time, there were no Sunday retail liquor sales so on Sunday's, Dixon's would line up coolers in the front window and sell beer at a 60% profit, making $3000 per Sunday. Again, however, Terri's continued bad luck would plague her. In 1985, the year of Terri's divorce and her mother's death, the state of Missouri passed a law that all business taxes must be paid and verified to keep a liquor license. Since Steve had not been paying Missouri business taxes, Dixon's lost their license for 1985. Terri fought all year to regain the Dixon liquor license, going to the state capital city of Jefferson City to continually monitor and get the taxes caught up and paid.

In addition to the three hour one way drive to Jefferson City, Terri concentrated on cleaning and maintenance, learning as she went. A key success factor here was her landlady, a widow who admired Terri and enjoyed Terri's three kids. Terri had no choice, but to always have the children with her at Dixon's. The landlady decided to keep the Dixon's rent the same, $1300 per month, while Terri owned the business. So, from 1985 until the landlady's death in 2001, the rent never changed. Upon the landlady's death, she and Terri had an agreement that Terri could buy the building at fair market value and that is exactly what Terri did.

Interestingly enough, when Terri looks back on these days, she felt like no major mistakes were made; she felt like she and Dixon's were always moving forward. Admittedly, the progress may not have been dramatic at times, but Terri never felt like she was moving backwards. Throughout this time, she also felt the presence of her father beside her, encouraging her, and that what she was doing was best for her family. Dixon employees, for the most part, were behind here. Given the length of employment for many of the Dixon employees, many had known Terri since she was a child. Working on a new relationship of employer/employee was interesting, Terri said, for both sides, but Terri never felt any hostility. More curiosity from the employees than anything as everyone was anxious to see how Dixon's would turn out, so the employees gave Terri the benefit of the doubt and stayed out of her way. In return, Terri has rewarded them with continued employment.

With Dixon's Famous Chili still open for business, Terri just started working, kids in tow, while living out of a duplex. Not making money really, just treading water financially, the entire family usually ate two out of three meals a day at Dixon's. By the 4th grade, the kids were busing tables and dishwashing. Moving forward, never moving back, paid off for within five years, Terri and kids were living in a wealthy subdivision in the suburbs and lunch receipts had grown from $300 per day to over $3000 in 2004.

THE FOURTH GENERATION

By 2004, Terri's oldest daughter was an elementary teacher and never regarded Dixon's as anything but a way to pay for college and launch her own career. A happy member of the extended Dixon's family, Terri's eldest is happy to watch her younger siblings carry the full time Dixon's legacy. Julie, the second child, also never expressed any long-term interest in working at Dixon's. She too worked Dixon's all her teen years and through her bachelor's degree from Northwest Missouri State University. Stephen, the youngest and only son, always expressed a very strong interest in carrying on the family business. But he was soon to be joined by another.

When Julie was a senior at Northwest, Terri called and told Julie that she needed some time off; some time away from Dixon's. Terri asked Julie to find a new grad from Northwest, someone the family could trust, to operate the business under Terri. Even with her network of eager young grads at Northwest, Julie was unable to find someone she felt Terri would approve of, train and work with. So Julie came home and did the job herself, while looking for a full time job in the greater Kansas City area. Realizing she enjoyed Dixon's, Julie asked Terri/mom if she could apply for the new manager job. Terri trained Julie for a month and then took some time off. Interestingly, three employees that had been at Dixon's for over 20 years were not interested in the manager position.

In September, 2003 Dixon's crossed a milestone with the opening of their 2nd location in Lee's Summit, Missouri, the fastest growing Kansas City suburb on the Missouri side. Terri's goal is for this newest operation to be run exclusively by Stephen while Julie maintains control of the Independence location.

Julie has already started making changes to the Dixon's traditional menu. Since tamales have always been the most popular option with Dixon's Famous Chili, adding tacos was an easy transition given that most of the chili fixings can also be used on tacos. Julie started all you can eat Taco Tuesday's in the winter and all you can eat taco summers, with sales dramatically increasing for the summer months when traditionally sales were nearly cut in half.

Yet, Terri has kept control of all bookkeeping and banking relationships. She taught her self all financial aspects of running a business with no one to ask and no one to help. Her ex-husband had destroyed all these relationships and her brother preferred to keep his distance. While she involved both children in the finances, Terri maintains strict control and plans on maintaining control for the foreseeable future.

Long term, Terri and children would like to return Dixon's to franchising. In their favor is a relatively simple menu and the prep is also easy to master. Currently, Stephen, a recent business graduate from Missouri Western State University, will be responsible for exploring franchising. Terri emphasized the word, "exploring". She has had many offers by potential franchisees, but she has been frustrated by the complexity of franchising. Terri maintains that franchising is a goal, but is simply not in process right now. For Terri, franchising is "scary and expensive" which seems to reflect her past history with Dixon's and franchising. So wisely, Terri is waiting for the kids to

come on board, learn the business and then when the family, i.e. Terri, is comfortable with expanding, she will consider the options.

One issue facing the Independence location is Julie's desire for a family of her own and her plan on only working part time once she has children. This will be a staffing issue that so far has been tabled until children are expected.

In regards to her extended family, Terri has always stressed family comes first; friends come and go. Terri did eventually remarry and her second husband gutted and rebuilt the Lee's Summit Dixon's location. Granted, like all families, Terri's has their moments of disagreement, but with Dixon's Famous Chili, the sole owner, Terri, has the final word. Both Julie and Stephen are Vice Presidents in the Dixon's corporation, but they have no voting shares.

In family matters, discussions are held and Terri does not have absolute power like she did when the children were young and she was single. Vince, her brother and previous owner, has never left the family, but he has moved on from Dixon's and is successful in the insurance industry. Terri's second husband will soon be joining Vince in his business, leaving Terri and her children in sole control of Dixon's. Now that the Lee's Summit location is up and running with newly graduated Stephen in control, Terri is concerned with business communication; she wants a formalized way of getting together instead of simply over the phone or dinner at home. And with the growth of the business, she stresses that she wants Dixon business talk to stay at Dixon's and dinner at home to be over other family life events.

Terri's exit strategy is to sell Dixon's Famous Chili to the children and go on a monthly stipend just like Aunt Lela.

MARITIME ENTERPRISES AND REGULATED COMPETITION

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CASE DESCRIPTION

The primary subject matter of this case concerns two U.S. domestic maritime enterprises engaged in liner shipping and interacting in a regulated market. Secondary issues examined include U.S. Cabotage Laws, market contestability, government regulation and potential domestic entrants. The case has a difficulty level of four, appropriate for senior level. The case is designed to be taught in one class hour and is expected to require three hours of outside preparation by students. The case is designed for use in either the Managerial Economics or Business Policy and Strategy (otherwise entitled Corporate Strategy or Strategic Management) course.

CASE SYNOPSIS

Two U.S. domestic maritime enterprises are profiled. Students are asked to advise the Chief Strategy Officer for each of the two firms identified in the case study in terms of price and freight carrying (shipping) capacity competition. The students are required to formulate and justify their recommendations for each firm's strategic actions regarding price adjustments, shipping capacity adjustments or some combination of the two. The recommendation should consider the rivals' past behaviors and likely future responses.

INTRODUCTION

Liner shipping embodies a high fixed cost structure and extensive government regulation as well as asymmetric and, at times, seasonal demand. In the international arena rivals' concerns that they may be disadvantaged as a result of strategic maneuvering are at the core of liner conference agreements, consortia, and strategic alliances. Background information pertaining to these arrangements is provided:

Liner conferences occur when shipping companies organize themselves to set common freight rates, regulate shipping capacity, and coordinate timetables for international ocean borne freight movements. Liner conferences are most prevalent on routes between Europe, on the one hand, and North America and the Far East, on the other hand. This activity is permitted by governmental authorities on the assumption that it is necessary to ensure the provision of reliable ocean transportation services. Liner conferences do not engage in operational co-operation and do not provide joint liner shipping services. It is the responsibility of the individual lines, consortia or alliances to offer such services.

Consortia are groupings of shipping companies providing maritime cargo transport services. Each shipping company strives to improve both its effectiveness and efficiency when providing liner shipping services thus benefiting customers.

Strategic alliances among liner shipping companies started in the mid-1990s. Alliance members are not involved in establishing common freight rates; rather they formulate goals related to operational synergies by such mechanisms as vessel, terminal and equipment sharing, joint-scheduling, and chartering.

The above mentioned strategic options of liner conference agreements, consortia, and strategic alliances are unavailable to U.S. domestic liner shipping companies who must conform to Cabotage laws. These companies are constrained by what is commonly called the Jones Act:

Title I of the U.S. Merchant Marine Act of 1936 declares, in part, that the national defense and the development of domestic commerce of the United States require a merchant marine sufficient to carry the nation's domestic waterborne commerce. A number of federal laws guide this policy, including several that restrict domestic commerce to vessels that are constructed in the United States, owned by U.S. citizens, and registered under the U.S. flag. While actual interpretation and enforcement of those laws is the responsibility of the U.S. Customs Service and the U.S. Coast Guard, the Maritime Administration (MARAD) is concerned with their effect on the national programs that it administers. Accordingly, MARAD is frequently the first of the three agencies to be contacted on questions concerning the coastwise laws. The ***Jones Act*** refers to several U.S. laws that govern the domestic transportation of merchandise and passengers by water. Strictly speaking, it applies only to Section 27 of the Merchant Marine Act of 1920 [46 U.S.C. 883; 19 CFR 4.80 and 4.80(b)] which has come to bear the name of its sponsor, Senator Wesley L. Jones. The Jones Act provides that merchandise transported entirely or partly by water between U.S. points--either directly or via a foreign point--must travel in U.S.-built, U.S.-citizen owned vessels that are U.S.-documented by the Coast Guard for such carriage.

Maritime conglomerates, like most business firms, attempt to maximize profit rather than revenue. Thus, two issues assume paramount importance. One, pricing to generate revenue results from the tension between sales volume and sales profitability. Two, capacity utilization must be continually fine-tuned due to changing market conditions to provide the optimal balance between acquired resources and their profitable utilization.

Companies in this industry respond strategically in terms of price and shipping capacity decisions. Strategic responses may be either to hold shipping capacity constant and vary price, hold price constant and vary shipping capacity, or vary both shipping capacity and price. One rival becomes the initiator, acting first on its understanding of unfolding market conditions. Other rivals

respond both to the initiator and to their own understanding of market conditions. Initiating strategic change may result in unanticipated outcomes. The U.S. Maritime Administration and the U.S. Federal Maritime Commission seemingly prefer to maintain a minimal level of competition by ensuring at least two firms operate in nominal competition, but low profitability and close regulation appear to discourage additional firms from entering these markets. Cabotage laws protect the domestic rivals from foreign competition, but not from each other. Rivals must also respond to any action initiated by the regulatory authority, which alters the contours of the market environment.

THE COMPETITORS

This case study presents the operations of two U.S. domestic maritime business competitors: CSX Lines, a subsidiary of CSX Corporation, and Matson, a subsidiary of Alexander & Baldwin. These two firms have a history of competing in the Hawaii/U.S. West Coast trade routes regulated under the U.S. Cabotage Laws.

CSX HISTORY

CSX Lines financial performance, developed based upon a review of its annual reports and website, is provided at Appendix 1. The company can be traced to the announcement by CSX Corporation on April 21, 1986 that it would acquire Sea-Land with the approval of the U.S. Interstate Commerce Commission. CSX Lines (as Sea-Land Service, Inc.) entered the Hawaii and Guam trades in 1987 with the goal to provide the most reliable and cost-effective containerized ocean shipping. CSX Lines offered eight linehaul vessels in the Hawaii/Guam service with multiple weekly sailings between the U.S. Pacific Coast and Honolulu. Regular continuing barge service to the five Neighbour Islands of Hawaii was also offered.

During 1996, the U.S. domestic market experienced rate weakness and high fuel costs, but the firm realized record results and market share increases in each major trade lane. Fifteen vessels were enrolled in a U.S. subsidized program for which $2.1 million a year for each participating vessel was expected to be received. Projections called for improvement in the container-shipping industry with further consolidations and U.S. government deregulation while anticipating over-capacity to peak in 1997. However, subsequent developments revealed CSX's expectations to have been wildly over-optimistic, as excess capacity and significant rate deterioration persisted through 1997. Continued consolidation and increased government deregulation were forecast.

A major reorganization took place at Sea-Land during March 16, 1999 as the subsidiary was reformed into three business units; global container shipping, international terminal operations, and domestic trade under the U.S. Cabotage Law. A few months later, on July 22, agreement was reached for A.P. Moller-Maersk Line to purchase the international liner business of Sea-Land. The transaction was completed December 10, 1999.

During the period 1996 to 2001, as viewed in Table 1, CSX Lines performance deteriorated and contributed a declining share of operating income to the CSX Corporation. This resulted in a sizable loss by CSX Lines in 1999, which was only halted by the sale of the international component of Sea-Land. Notably, before the sale, CSX Lines' expenses accounted for approximately 40-50% of CSX Corporation's expenses compared to approximately only a 35-40% contribution to revenues. After the sale CSX Lines' expenses accounted for approximately 9% of CSX Corporation's revenues as opposed to approximately 8% of revenues.

MATSON HISTORY

The company is a wholly-owned subsidiary of Alexander & Baldwin, Inc. Matson enjoys a longer history in the maritime sector than CSX Lines. Matson's 1996-2000 financial performance, based upon a review of its annual reports and website, is given in Appendix 2. Matson traces its origins to 1882, when Captain William Matson sailed his three-masted schooner *Emma Claudina* from San Francisco to Hilo, Hawaii, carrying 300 tons of food, plantation supplies, and general merchandise. Matson has maintained its primary interest, as its fleet expanded, to carry freight between the U.S. Pacific Coast and Hawaii.

Among its many innovations and technological advancements, Matson introduced freight containerization, revolutionizing Pacific cargo shipping in the 1950s. Matson, continually striving for efficiency and customer service, expanded its fleet during the 1980s and early 1990s with container and Roll On-Roll Off (RoRo) vessels whereby wheeled vehicles are driven rather than hoisted on and off ships. In February 1996, Matson and American President Lines (APL) inaugurated a 10-year alliance agreement which allowed both carriers to serve their respective markets in a cost-effective manner. For Matson, this involved the domestic trade of Guam and Micronesia and for APL, international ports in East Asia.

Matson is the parent company of *Matson Intermodal Systems, Inc*. which was established in 1987. Matson Intermodal is an intermodal marketing company that arranges North American rail and truck transportation for shippers and carriers, frequently in conjunction with ocean transportation. *Matson Logistics Solutions, Inc*. was formed in 1998 to provide supply and distribution services for Matson customers, including management of transportation purchases, inventory and on-time deliveries. This subsidiary also handles special projects, including moves for unusual cargo, construction projects and film production units. Another Matson subsidiary, Matson Terminals, Inc., established in 1921, provides container stevedoring, terminal and equipment maintenance services for Matson and other carriers in Honolulu. Stevedoring Services of America Terminals (SSAT), which is partly owned by Matson, manages the company's container stevedoring and terminal services in the West Coast ports of Los Angeles, Oakland and Seattle. The remaining subsidiary, Matson Services Company, Inc., established in 1969, provides harbor tugboat assistance for vessels in Kahului, Maui and Hilo, Hawaii.

THE STRATEGIC DECISION

Historically, Matson has generally been the industry leader in the U.S. West Coast-Hawaii trade route, initiating change and innovation more frequently. However, CSX sometimes initiates change, forcing Matson to respond, so it should be kept in mind that the distinction between leader and responder is generic and can always be reversed. First the case of price competition when shipping capacity is held constant is considered. For convenience the market leader, the firm which initiates each round of change, is generically called firm A. Once firm A has chosen a strategy, firm B is free to respond. Only qualitative changes in price, assuming fixed shipping capacity, are examined. There are a variety of reasons why capacity might not change when price is changed. It might be a conscious strategic decision on the part of the competing firms. Regulatory authorities might in the past have required firms to demonstrate increases in capacity to justify past price increases. Regulators will not look with favor on firms which later reduce capacity, if they permit such behavior.

A series of assumptions are offered for reviewing Appendices 3-7. The cost structure typically facing maritime firms is illustrated in Appendix 3. In the short-run, modest per-unit cost savings can be realized with larger ships and larger fleets, provided excess capacity is kept low, which it typically is. In the short-term, the firm is constrained by past choice of fleet size, and operates on a particular short-run marginal cost curve (SRMC). Negligible excess capacity is assumed and therefore little scope for customer substitution between the two firms exists. In accordance with demand conditions on the U.S. West Coast-Hawaii route, total demand is assumed to be perfectly inelastic, that is, there is a certain volume of goods which must be shipped, almost regardless of the price, and this demand is not very sensitive to the magnitude of price changes. Because shipping capacity is held fixed, there is no scope for transfer of freight between firms. Whenever one firm charges less than the other with fixed capacity, it earns lower profits than its competitor. First, a firm can increase price, maintain price, or lower price, providing a 3 x 3 matrix of nine possible outcomes. Strategic outcome possibilities based on price competition are summarized in Appendix 4. Second, the case of shipping capacity competition when price is held constant is considered. Strategic outcome possibilities based on shipping capacity competition are presented in Appendix 5.

Third and finally, the general case where both competitors are free to change both price and shipping capacity is considered. A firm is defined as the preferred or low-price carrier whenever its shipping rates are lower than those of its competitors. This occurs whenever a firm lowers its rates if its competitor maintains or raises rates or whenever the competing firm raises rates and the first firm maintains or lowers rates. Preferred carriers always gain market share and shipping volume unless shipping capacity constraints prevent the transfer of share and volume. However, a preferred carrier must increase capacity to gain volume. A preferred carrier will lose volume if it reduces capacity.

Even in the absence of one of the two competitors being the low-cost or preferred shipper, any firm that increases capacity while its rival decreases capacity must gain share at the expense of its rival. If a firm increases capacity and its competitor increases capacity, the firm can only gain share if it is the preferred or low-cost carrier, and that may result in lower profits.

If a firm increases capacity and its competitor maintains capacity, it increases share if and only if it is the preferred carrier. If neither firm is preferred, neither gains share, but the firm which increases capacity, increases excess capacity, incurring added costs, without gaining added revenue, thus losing profits, and then the other firm gains strategic advantage. If a firm increases shipping capacity and its competitor decreases capacity, it gains market share regardless of price changes. When shipping volume shifts between firms because of shipping capacity constraints, volume is supply constrained. When volume shifts due to price, volume is demand constrained.

If a firm maintains shipping capacity, and its competitor increases capacity, there is no shift in demand or market share unless the rival becomes the preferred carrier by lowering price or if the first firm raised price. If both firms maintain capacity, there is no shift in demand or market share unless one firm is preferred, and then the transfer is limited by the gaining firm's initial excess capacity. If a firm maintains capacity, and its competitor decreases capacity, demand and market share shift to the first firm regardless of price changes.

The above considerations are formalized:

- Strategic Decision Rule 1 (diagonal symmetry): When two competitors make matching decisions with regard to changing or maintaining price and shipping capacity, both must either gain or lose profits together, and neither firm gains strategic advantage.
- Strategic Decision Rule 2 (off-diagonal symmetry): The firm initiating a strategic decision with regard to changing or maintaining price and shipping capacity has no special strategic advantage, thus the same combination of price and capacity changes leads to the same strategic outcome, without regard to which firm initiated the decision. As a result the matrix of outcomes is symmetric about the principal diagonal.
- Strategic Decision Rule 3 (capacity constraint): A firm receives more shipping volume whenever it increases shipping capacity and its rival decreases capacity, *or* when it increases capacity and is the preferred or low-cost carrier. Conversely, a firm loses shipping volume if it lowers capacity, or if its competitor is the preferred carrier, and its rival increases capacity.
- Strategic Decision Rule 4 (decreasing long-run average cost (LRAC)): Firms move to new short-run marginal cost (SRMC) curves whenever they increase shipping capacity, with lower minima. (This assumes constantly and perceptibly improving technology, and lowering capacity raises the minimum short-run average cost

(SRAC)). Firms incur higher marginal costs when they have to carry unused excess capacity, which occurs when both firms increase capacity and the competitor is the preferred or low-cost carrier.

Based on the four strategic decision rules, the strategist at each company is asked to determine strategic advantage according to Appendix 6, which can be thought of as a tree diagram. This schematic is constructed from the perspective of firm A, but applies equally well to firm B. The outcomes are presented in Appendix 7, based on application of the four strategic decision rules. Since each firm chooses from among nine possible actions with regard to price and capacity, the outcomes constitute a 9x9 matrix with 81 cells. Seventeen outcomes and cells have already been determined as presented in Appendices 4 and 5. One cell is common to all three tables. In some cases both firms increase profits, thus both gain absolute advantage, though neither gains relative advantage. In other cases there is a clear gainer of strategic advantage as one firm either receives higher profits, or the other receives lower profits, or both. In several cases (footnote 3 in Appendices 4 and 5, footnote 4 in Appendix 7), both firms clearly lose profits. There are also several instances where one firm clearly gains strategic advantage over the other, in terms of imposing higher costs or drawing volume and revenue from the competitor, though both lose profits - a Pyrrhic victory.

IMPLICATIONS FOR STRATEGIC BEHAVIOR

It is not entirely clear that B will cooperate with A, however. B can choose two alternative courses which would make it gain strategic advantage. The cost of this short-term gain is that A will be unlikely to make future changes which B can profit from. In the short term, B should cooperate as long as it gains profits equal to or greater than any profits it could gain by double-crossing A. Regulators have created a competitive environment which discourages innovation in price-setting or capacity. Thus, regulators must assume the responsibility of initiating this kind of narrowly delimited change. There is no clear disincentive against technological innovation which lowers costs and thus must always confer competitive advantage; clearly Matson has acted as the industry leader in the past by initiating containerization, pioneering intermodal integration and providing comprehensive logistical support. CSX Lines, as the subsidiary of a railroad, can also be considered an innovator in intermodal integration.

In this context, firms face conflicting incentives. In the short-term, there is no incentive to innovate in terms of either price or capacity. Given the range of alternative outcomes, firms will only innovate with long-term cooperative gains in view. Faced with innovation, the responding firm faces a short-term incentive to choose the outcome most favorable for itself. Long-term incentives present the possibility of cooperative behavior. Once firms establish a history of cooperative

behavior, the incentive is to continue the cooperation. In this event, regulatory authorities must intervene in the public interest.

ANALYSIS

You are to be assigned in the role of advisor to the Chief Strategy Officer for either Firm A or Firm B by your instructor. In your role, you are required to analyze the data presented in the case and formulate and justify a recommended course of action to the firm's senior management team regarding price adjustments, capacity adjustments or some combination of the two. The recommendation should consider the rivals' past behaviors and likely future responses.

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Appendix 1: CSX Lines Financial Performance[1,2,3]

Year	CSX Lines Operating Revenue	CSX Corp. Operating Revenue	CSX Lines as Percentage of CSX Corp.	CSX Lines Expenses	CSX Corp. Expenses	CSX Lines as Percentage CSX Corp.	CSX Lines Operating Income	CSX Corp. Operating Income	CSX Lines as Percentage of CSX Corp.
2001	$681	$8,110	8.40%	$649	$7,153	9.07%	$32	$957	3.34%
2000	$666	$8,191	8.13%	$666	$7,386	9.02%	$0	$805	-
1999	$3,809	$10,375	36.71%	$4,020	$9,802	41.01%	($211)	$573	-
1998	$3,916	$9,490	41.26%	$3,783	$8,359	45.26%	$133	$1,131	11.76%
1997	$3,991	$10,232	39.01%	$3,713	$8,673	42.81%	$278	$1,559	17.83%
1996	$4,051	$10,220	39.64%	$3,733	$8,715	42.83%	$318	$1,505	21.13%

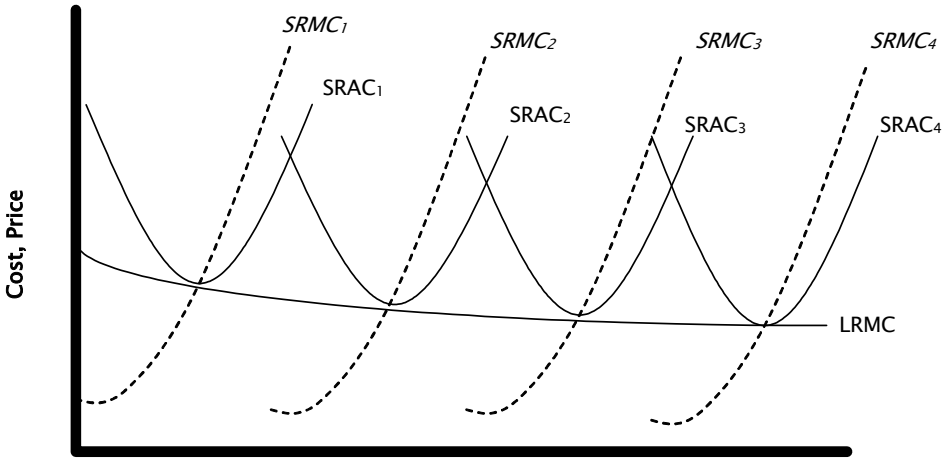
Notes:
[1] All monetary values stated in millions of dollars.
[2] Reclassification and presentation of financial data occurred at time of Sea-Land sale to Maersk on December 10, 1999.
[3] Source: Prepared by authors.

Appendix 2: Matson Financial Performance[1,2]

Year	Matson Operating Revenue	A & B Operating Revenue	Matson as Percentage of A & B	Matson Expenses	A & B Expenses	Matson as Percentage A & B	Matson Operating Profit	A & B Operating Profit	Matson as Percentage of A & B
2001	$797	$1,190	66.97%	$735	$942	78.03%	$62	$248	25.00%
2000	$851	$1,069	79.61%	$757	$910	83.19%	$94	$159	59.12%
1999	$779	$1,000	77.90%	$695	$857	81.10%	$84	$143	58.74%
1998	$748	$1,343	55.70%	$682	$1,208	56.46%	$66	$135	48.89%
1997	$721	$1,290	55.89%	$641	$1,142	56.13%	$80	$148	54.05%
1996	$687	$1,270	54.09%	$605	$1,119	54.07%	$82	$151	54.30%

Notes:
[1]All monetary units stated in millions of dollars.
[2] Source: Prepared by authors.

Appendix 3: Maritime Long-run and Short-run Cost Structure



Key:
SRMC = short-run marginal cost
SRAC = short-run average cost
LRMC = long-run marginal cost
TEUs = twenty-foot equivalent units
Source: Prepared by Lombardo and Mulligan, 2004.

Appendix 4: Strategic Outcome Possibilities Based on Price Competition[1,2,4]

		B_{PC}		
		Increase Price	Maintain Price	Decrease Price
A_{PC}	Increase Price	**AB**	**A**	**A**
	Maintain Price	**B**	**X**	**A**
	Decrease Price	**B**	**B**	**X**[3]

Notes:

[1] Assumptions:

1. Shipping capacity held constant.
2. No transfer of freight carriage between firms.

[2] Company/companies gaining strategic advantage indicated in cells. "AB" indicates both firms benefit equally through increased profits. "X" indicates indeterminate outcome.

[3] Both firms lose profits.

[4] Source: Prepared by Lombardo and Mulligan 2004.

Appendix 5: Strategic Outcome Possibilities Based on Shipping Capacity[1,2,4]

		B_{SC}		
		Increase Shipping Capacity	Maintain Shipping Capacity	Decrease Shipping Capacity
A_{SC}	Increase Shipping Capacity	**X**[3]	**B**	**A**
	Maintain Shipping Capacity	**A**	**X**	**A**
	Decrease Shipping Capacity	**B**	**B**	**X**[3]

Notes:

[1] Assumptions:

1. Prices held constant.
2. No additional latent demand.
3. Lowering capacity raises minimum SRAC.
4. Raising capacity lowers minimum SRAC.

[2] Company/companies gaining strategic advantage indicated in cells. "X" indicates indeterminate outcome.

[3] Both firms lose profits.

[4] Source: Prepared by Lombardo and Mulligan 2004.

Appendix 6: Conditions for Strategic Advantage[1]			
A gains strategic advantage	increases A's profits	increases A's revenue	increase A's price with fixed volume
			increase A's volume with fixed price
			increase both A's price and volume
		decreases A's costs	increase A's capacity and volume
	lowers B's profits	decreases B's revenue	lower B's volume with fixed price
			B lowers price with fixed volume
			B lowers price and volume
		increases B's costs	A draws volume from B

[1] Source: Prepared by authors.

Appendix 7: Strategic Outcome Possibilities Based on both Price Competition and Shipping Capacity[1,2,3,5]

A_{PCSC}		B_{PCSC}								
		P↑ C↑	P↑ C↔	P↑ C↓	P↔ C↑	P↔C↔	P↔C↓	P↓ C↑	P↓ C↔	P↓ C↓
	P↑ C↑	**X**[4]	**B**	**A**	**B**	**B**	**A**	**B**	**X**[4]	**A**
	P↑ C↔	**A**	**AB**	**A**	**B**	**A**	**A**	**B**	**A**	**A**
	P↑ C↓	**B**	**B**	**AB**	**B**	**A**	**A**	**B**	**X**	**A**
	P↔C↑	**A**	**A**	**A**	**X**[4]	**B**	**A**	**B**	**X**[4]	**A**
	P↔C↔	**A**	**B**	**B**	**A**	**X**	**A**	**B**	**A**	**A**
	P↔C↓	**B**	**B**	**B**	**B**	**B**	**X**[4]	**B**	**X**[4]	**A**
	P↓ C↑	**A**	**A**	**A**	**A**	**A**	**A**	**X**[4]	**B**[4]	**A**
	P↓ C↔	**X**[4]	**B**	**X**	**X**[4]	**B**	**X**[4]	**A**[4]	**X**[4]	**A**[4]
	P↓ C↓	**B**	**B**	**B**	**B**	**B**	**B**	**B**	**B**[4]	**X**[4]

Notes:

[1] ↑ signifies an increase; ↔ signifies maintain (neither increase nor decrease); and ↓ signifies a decrease.

[2] Assumptions:

1. No additional latent demand.
2. Lowering capacity raises minimum SRAC.
3. Raising capacity lowers minimum SRAC.

[3] Company/companies gaining strategic advantage indicated in cells. "AB" indicates both firms benefit equally through increased profits. "X" indicates indeterminate outcome.

[4] Both firms lose profits.

[5] Source: Prepared by authors.

NOVACO: THE CHALLENGE OF INTERNATIONAL ENTREPRENEURSHIP OF A NEW FIRM

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Charlie E. Mahone, Jr., Howard University

CASE DESCRIPTION

The primary subject matter of this case concerns the international public birth and development of a pioneering Internet firm with a short existence before its slow but positive growth in a market dominated by large multinational firms which also made it the prime target for takeover and purchase. The issue of valuation of the firm's initial public offering shares is the central focus for the case evaluator and student. How should the stock market value a firm whose major competitors are virtual giants in the Internet world and specifically, the multinational dot.com world? The case has a difficulty level of five, appropriate for first year graduate level. The case has both current and historical applicability for MBA students concentrating in corporate finance, international financial management, or multinational corporate entrepreneurial relations and serves as a pedagogically sound tool for applied valuation of shares for multinational high-tech firms. The case is designed to be taught in three class hours and is expected to require 6-8 hours of outside preparation by students.

CASE SYNOPSIS

This case affords students an opportunity -- from both a strategic and financial point of view -- to evaluate the decision made by Novaco to go public while simultaneously assisting the fledgling firm to decide from an international perspective the best alternative approach of market survival. The appraisal hinges on the analysis of two kinds of restructuring: 1) the restructuring of other major players in the industry (Microsoft, HP and others) and the forces that motivate it and 2) the restructuring of a single firm's residual-ownership interest or equity restructuring of a new firm in a potentially saturated industry whose primary product was simply known as the Internet which is widely known and accepted now. Of primary concern throughout is why firms go public domestically and internationally and how the offering price can be estimated and evaluated, especially when the forces of international markets are involved. Further, a peripheral issue is the impact of capital restructuring -- the design of the firm's debt and equity claims with an emphasis on changes in and additions to its clientele and investors, the allocation and determination of its asset value, and the real potential for failure in new markets, especially international ones, by firms

with limited operating history. All data elements and statements were derived from public Internet data and public financial data, and Novaco represents a fictitious firm, although its financials may resemble others in the industry. No private or insider information was provided or extracted from company files or other such cases.

INTRODUCTION

In August 2003, the Board of Directors of Novaco Incorporated faced the decision threshold concerning several issues facing the firm including: (1) a reasonable price to set for the firm's first public share offering; (2) which international market would best "fit" the mission of the firm; and more specifically (3) how does this firm survive in an international Internet service provider market when it is but a small dot on the industry horizon. The most immediate task facing the Board is that it has to arrive at a reasonable and fair estimate by issue day in order to satisfy the underwriting team of J. P. Morgan Chase, Inc. and Wachovia Securities, Inc., who would be handling the issue. According to Wall Street estimates and CNN News.com, the underwriters have agreed to fully underwrite 6,000,000 shares of Novaco's common stock which, if successful, would not enter the record books but would be considered one of the largest IPOs in this market for this period by a virtual unknown. The underwriters were also granted the option to purchase up to 750,000 additional shares from the company to cover any over-allotments. There were numerous risk factors to consider with respect to the IPO, including the company's limited operating history and its rapid emergence into this technological market, which traditionally has led to share price volatility, and a hearty "best offer" underwriting. Following an extensive investigation, management had discovered that most entrepreneurial firms had stumbled after an initial period of rapid growth but felt that Novaco's development had been relatively successful thus far. But its potential investors would be the ultimate deciders of the fate of the firm.

COMPANY BACKGROUND

James ("Jim") Olson is the founder, Chairman of the Board, and CEO of Novaco, International. After earning his BS in electrical engineering from Howard University, Jim worked in the information systems industry for five years during which time the idea for Novaco began to develop. He later enrolled in the Wharton School where he earned his MBA in information systems and marketing. While at Wharton he worked with Wharton's Small Business Development Center where he continued developing his ideas for the products and services that would ultimately be offered by Novaco. When he displayed the concept at various high-technology conferences, the reaction by potential users was that of excitement.

Novaco was incorporated in May 2002 by Jim Olsen upon his graduation from Wharton. Initially, the firm's primary activities included developing, producing, marketing and supporting

open client, server, and applications software for information exchange and commerce over the Internet. The company's objective was to make its software and systems management the standard for secure software, publishing information, and executing transactions on the Internet and for Internet protocol (IP) networks in the domestic and foreign markets. The firm produces hard-coded software applications developed for business purposes and web use which is adapted to large capacity super computing networks. The unique characteristic of the firm's product is that it is nearly immune to all viral contagion so prevalent with Microsoft operating and application software [code contagion such as viruses, bugs and vermin]. Novaco manufactures chips with the application hard-coded into the chips which essentially removes the possibility of tampering by outside hackers. The tampering can only occur at the factory where the chips are produced. Input from client programmers is not necessary. The company believed that its product would be increasingly used by organizations of various sizes and perhaps ultimately by individuals also.

The six months following incorporation were very busy but also very exciting for Jim and for Novaco. He had to raise initial funds for his venture. For that he invested some of his own funds, and was able to obtain additional funds from family, friends and even one of his college professors. In addition he was able to convince a venture capital firm to provide some start-up seed money, a rare feat. He next had to assemble a management team of very talented individuals that were committed to the vision he had for Novaco. One of the first to sign on was Chuck Martin, an early investor, who was also named Chief Operating Officer because of his years of international technical and marketing experience in the field of information technology. The management team also consisted of similarly talented managers of R&D/production, marketing, and finance. The Board was composed of some of the early investors including the professor, representatives of the venture capital firm, Jim and Chuck.

Jim viewed the firm's core competencies as its ability to efficiently design and produce high quality, reasonably priced, hard-coded chips which are 98% virus-proof and can be combined with reentrant code sold off the shelf with predetermined business applications. The firm developed the architecture internally and has a patent on the product. The firm has the ability to service its clients with replacement or redundant chips to reduce firm downtime to its smallest level.

By September, the company had produced and successfully beta-tested it first prototypes. Novaco shipped its initial products to customers and realized its first revenue in November 2002.

THE US MARKET

The firm's primary customers since inception have been the small business units (SBU) located in the US that either could not afford or didn't care to invest in the security measures necessary to prevent viral infections in their electronic business operations. The firm quickly moved into the medium and large firm segments that also have the same direction and purpose for selecting its chips. Since major security analysts, programmers and other operational personnel are not

necessary, the firm offers large cost-savings to its customers. In addition, in each of its selected markets, the company provides each customer with "a service promise to have your application up and running within five hours from your service call". Customer uptime is therefore maximized because computer delays are minimized, which generates higher returns for the customers in terms of being able to maintain its revenue flow 95% of the time. So Novaco's core values of providing its customers significant cost savings, optimal revenue flow, and predictability are to be valued into the firm's core value of predictive future growth and firm value.

In the US, the firm provides the products and services nationwide through local centers in Charlotte (NC), Los Angeles, Fort Wayne (IN), Houston, Miami, and Fort Lauderdale. Other major markets such as New York, Atlanta, and San Francisco have proven to be more difficult for the firm to penetrate but they are on the firm's marketing and production wish list.

To accelerate acceptance of its products and services and to further diffuse Internet usage in the domestic and international marketplace, Novaco entered into agreements with leading telecommunications and computing companies with complementary resources and technologies. In essence, Novaco would provide its chips to hardware manufacturers, specifically Apple Computer, MCI Telecommunications, Sun Microsystems, and Hewlett-Packard. The acceptance of this joint effort was said to be in line with current business leveraging and collaborative practices, i.e., establishing and expanding markets through the internals of the computers sold domestically and internationally. Novaco believes that it can continue to increase its market share in this growing US market.

MCI Telecommunications and Bell-Eastern Research Ltd. accounted for 20% and 10%, respectively with the remaining sales coming from a few other MNCs and from numerous small to medium sized firms.

THE INTERNATIONAL MARKET

Historically global Internet infrastructures and backbones have been used extensively by academic institutions, defense contractors and government agencies. However, by January 2003, the number of commercial domains on the Internet had surpassed the number of educational domains, and approximately 10.5 million servers worldwide were connected directly or indirectly to the Internet. The increasing popularity of the Internet in the global market was said to have been primarily attributable to the fact that in addition to government agencies and universities, numerous small and medium sized companies and multinational corporations were increasingly providing Internet access to their individual subscribers. Increasingly, financial institutions were also becoming more comfortable with facilitating transactions on the Internet, as were an increasing number of their clients. Service and consultative tools were also needed to make that web connection easier and more user-friendly and were guided through access walls where only marginal telecommunications were available for public use. Once connected, users needed access to

thousands of computers across the globe. Whether this global communication network was in response to or a cause of the emergence of the global market/globalization is very analogous to the case of the chicken and the egg.

The company has been exploring opportunities in the international marketplace which has more challenges than operating in the US. At the time of the company's inception, distribution and usage of the Internet and the World Wide Web in Canada, most of Europe, and other industrialized countries were similar to that in the US. Additionally, most industrialized countries had few regulations and restrictions affecting access to or commerce on the Internet. US export controls are one of several exceptions. But in this case, while the firm used precautions against unlawful exportation, the global nature of their business would make it virtually impossible to effectively control the distribution of the company's products and services.

In the emerging markets in Africa, Asia, and South America, the Internet and the World Wide Web were not fully distributed. In many of these markets the company could be negatively affected by existing and potential new government controls, laws, and policies (or the lack thereof) such as: (1) user privacy, pricing, characteristics, and quality of products and service; (2) property ownership, libel, and personal privacy; and (3) controls on repatriation and currency conversion. Additionally, software maintenance and virus protection are more difficult generally because of varying levels of Internet security needed from international hackers.

On the other hand, growth rates and usage of the Internet exceeded those of the industrialized markets. The opportunities in these markets were huge, notwithstanding the challenges. And the firm's goal of gaining many of the un-and undersubscribed customers in these markets represented the long-term growth and life of Novaco, which seemed challenging but attainable.

In early 2003, when its reputation and global Internet sales took off, so did the revenues of Novaco. The groundwork had been laid by December 2002 when Chuck Martin, Novaco's Chief Operating Officer, took the bold, courageous step of offering sales and services at a 30% discount rate to the members of the European Union, grossly underpricing a large number of the firm's competitors and agitating the market. By the spring 2003, nearly seven percent of this very lucrative market was owned by Novaco.

According to Jim, it was critically important for Novaco to use "first mover advantage" to establish its presence in Canada, in five of the top EU markets, and in Japan. He was sure that competitors would soon be targeting these markets and he wanted to be there to welcome them when they arrive. Novaco's initial foray into the international markets had been through the use of distributors. However the goal was to obtain the resources necessary to establish sales offices initially in each of these markets with regional R&D production facilities to follow. At the same time, Jim heard the beckoning call of the emerging markets.

THE INDUSTRY AND COMPETITIVE FACTORS

The key success factors in the industry were quality, delivery, reliability, and after-sales service. Price was also a factor, but usually only in the short to medium term before competitors could respond.

The firm was in direct competition with large MNCs primarily from the US, the EU, and Japan. There were also small-medium sized competitors from the US and elsewhere starting to enter the global marketplace as well. While the industry as a whole was mature and had many proven products and players, the market continued to evolve, and as such, it was difficult to predict market size and future growth rates. The firm was acutely aware that segments of the market for Internet-based software and services were intensely competitive and subject to rapid technological change. The firm's analysts predicted that, upon entering the market, its competition would continue, increase, and intensify. Almost all of the company's current and potential competitors had longer operating histories, greater name recognition, larger client-customer bases, and significantly greater financial, technical, and marketing resources than Novaco. In their dominant positions, the competitors were able to successfully thwart the competitive efforts of new entrants, and it was possible that Novaco would experience the same fate. Its competitors included Microsoft vendors, Web server software and service vendors, PC and UNIX software vendors, Bloomberg, Reuters, and online service providers.

The wireless web networks, which allowed computers seamlessly attached to networks to talk to each other, needed an international leader, one with that marginal, competitive edge over the rest of the pack. Did Novaco have the wherewithal to assume that role and accomplish the task? Novaco's management believed that its core competencies positioned it as the best candidate.

THE NEED FOR AN IPO AND RISK FACTORS

The IPO was sorely needed to provide capital for the firm's domestic and international growth. Although its sales were high, Novaco's growth sustainability without cash infusions was relatively low for the software industry. To maintain its operational and financial growth to match and perhaps exceed its competitors, IPOs and major cash infusions without interest payments were needed just to maintain a competitive level.

Despite its success to date, the company has had a limited operating history upon which an IPO evaluation could be based. As is true with any young company, there were risks associated with an investment in Novaco. It is not clear how big of a market share the company would be able to obtain in the US market and how big that market would eventually be. Its heavy reliance upon the development of the global Internet market was another unknown that becomes a risk issue. It is possible that its service and guidance in the Internet and other applications could prove not to make a viable commercial marketplace, because of inadequate development and compatibility of the

necessary intra-and infrastructure of international firms and countries. As previously noted, the area was a developing one whose acceptance was fairly unproven, and the sustainability of demand for its products and services were riddled with uncertainty. Moreover, security, reliability, cost, ease of use, and access on a global scale all remained as unresolved issues which could have a serious impact on the company's future success.

The market price of the company's common stock was likely to be highly volatile. It seemed that the high-tech market was subject to wide fluctuations in response to quarterly variations in operating results, announcements of technological innovations or new product releases by the firm's competitors, and changes in financial estimates by securities analysts. In addition, the stock market generally had experienced significant price and volume fluctuations that had particularly affected the market prices of equity securities of many non-high-tech companies, and often the fluctuations were unrelated to the operating performance of such companies. These broad market fluctuations would adversely affect the market price of Novaco's IPO and its ability to compete for needed equity funding in the emerging markets environment.

FINANCIAL INFORMATION

The company revenues were derived from sales of its products and from fees related to access, service, customized presentation and multilingual support, and product support. From inception to December 31, 2002, the company earned revenues totaling $696,000. The subsequent two quarters saw a marked growth in the level of the company's sales, which were $4,738,000 for the quarter ended March 31, 2003, and $11,888,000 for the quarter ended June 30, 2003. The quarter ended March 31, 2003 was the first full quarter in which the company's products and services were made commercially available. International revenues were immaterial in the company's early days of operations; however, plans for overseas expansion were implemented with substantial success in the EU. Consolidated financial information is available in Exhibits 1-4.

Noteworthy was the fact that the company's expenditures were, to a large extent, based on its apparent expectations of future revenues. Revenues and operating results were dependent on the volume and timing of orders and the company's ability to fulfill orders, which proved difficult to predict. In light of the heavy dependence and the constraints on cash flows which resulted, the company was probably unable to adjust spending to compensate for any shortfall in revenues, which would severely impact the company's operating position. Moreover, with plans of expansion afoot and other capital ventures, the company was in need of the flexibility that additional financing could provide. Theoretically, the principal purpose of the IPO issue was not only to obtain additional financing but also to create a public market for the company's common stock and to facilitate its future access to public equity markets. As of June 30, 2003, there were 33,161,444 shares of common stock outstanding, and some 212 stockholders holding those shares.

PRE-ISSUE SITUATION

The decision facing the Board regarding the IPO was a tricky one. There were risks associated with either underpricing or overpricing the issue. Given the high risks associated with the company, the industry, and the technology, an overpriced issue would surely result in an under-subscribed offer. Not only would the underwriting team have to absorb these shares and risk eventual damage to their reputation, but the company's need for financing would go unresolved, thereby exposing it to potential downturns in the market and risk of potential decline in operations. An underpriced issue may ensure sale of the company's stock, but J. P. Morgan Chase and Wachovia Securities, Inc. would be severely criticized for failing to obtain the maximum value for the firm.

Despite the uncertainty surrounding this profitable industry tied to the Internet, the domestic and international markets appeared ready to accept the firm's introduction into the 'global information age.' The use of the Internet received constant press and found its way into a large number of homes, offices, and schools, with the government's support seemingly assured. But more importantly, the commercial uses of the Internet and the Web were increasing exponentially in the global commercial sector. As the firm approached its IPO issue, the market appeared fairly stable, and it would probably be in the best interests of all concerned to act quickly and take full advantage of the market optimism.

In consideration of the appropriate price, the Novaco's underwriters looked for some comparable IPO issues made by companies in the industry. Thompson Financial Services' issue in May 2003 was offered at $14.00, and had increased to a price at or near $28.50. So a more thorough analysis of Thompson's financials would first be necessary (see Exhibits 6 & 7). It is important to note that Thompson was burdened by an accumulated deficit of $27.6 million and a sizeable debt portfolio at the time of execution of its IPO. Given its expansion plans and the expectations of losses for 2004, it would have been difficult for Thompson to secure debt financing with its outlook. The firm's most viable financing option remained in going public. The Novaco underwriters also tested comparable methods of accurately valuing the firm, namely through discounted cash flow analysis, book value analysis, and a comparison of price-to-earnings ratios.

CLOSING

What is the offering price of the Initial Public Offering and how will that equity issue affect the market value of the Novaco Corporation? Also, determine whether or not the underwriting firms should exercise the option to buy the shares offered. Finally, and more importantly, determine a clearing price for the firm's shares based on one of many IPO entry valuation methods.

EXHIBIT 1
NOVACO CORPORATION
CONSOLIDATED BALANCE SHEETS

	Dec. 31, 2002	June 30, 2003 (Unaudited)	ProForma Stockholders' Equity June 30, 2003 (Unaudited)
Current assets:			
Cash and cash equivalents	$3,243,510	$8,868,436	
Short-term investments	--	16,567,300	
Accounts receivable, net of allowance for doubtful accounts of $131,153 in 2003	701,649	8,277,869	
Other current assets	67,284	804,971	
Total current assets	4,012,443	34,518,576	
Property and equipment, net	2,447,098	6,761,045	
Deposits and other assets	699,100	1,251,582	
Total Assets	$7,158,641	$42,531,203	
Current liabilities:			
Accounts payable	$855,068	$4,607,174	
Accrued compensation and related liabilities	527,340	1,075,066	
Over accrued liabilities	667,503	1,897,819	
Deferred revenues	2,575,145	14,963,843	
Current portion of long-term obligations	725,000	725,000	
Installment notes payable	---	551.449	
Total current liabilities	5,350,056	23,820,351	
Long-term obligations	725,000	725,000	
Installment notes payable	--	1,511,331	

EXHIBIT 1
NOVACO CORPORATION
CONSOLIDATED BALANCE SHEETS

	Dec. 31, 2002	June 30, 2003 (Unaudited)	ProForma Stockholders' Equity June 30, 2003 (Unaudited)
Stockholders' equity:			
Preferred stock **	701	901	
Common stock***	451	1,514	3,316
Additional paid-in capital	9,552,278	39,683,666	39,682,765
Notes receivable from stockholders	--	(638,065)	(638,065)
Deferred compensation	--	(9,812,151)	(9,812,151)
Accumulated deficit	(8,469,845)	(12,777,561)	(12,777,561)
Accumulated transaction adjustment	--	16,217	16,217
Total stockholders' equity	1,083,585	16,474,521	$16,474,521
	$7,158,641	$42,531,203	

** Preferred stock, $0.0001 par value; issuable in series; 7,608,222 shares in 2002 and 11,286,222 shares in 2003 authorized, authorized, 7,008,222 shares in 2002 and 9,008,222 shares in 2003 issued and outstanding; aggregate liquidation preference of $27,541,999 (5,000,000 shares authorized, none issued and outstanding, pro forma)

*** Common stock, $0.0001 par value; 30,000,000 shares authorized, 4,511,000 shares in 2002 and 15,145,000 shares in 1995 issued and shares in 2003 issued and outstanding (100,000,000 shares authorized, 33,161,444 shares issued and outstanding, pro forma) outstanding, pro forma)

EXHIBIT 2
NOVACO CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS

	Inception (May 31, 2002) to December 31, 2002	Inception (May 31, 2002) to June 30, 2002 (Unaudited)	Six Months Ended June 30, 2003 (Unaudited)
Revenues:			
Product revenues	$378,490	$--	$15,580,258
Service revenues	317,381	--	1,045,133
Total revenues	695,871	--	16,625,391
Cost of revenues:			
Cost of product revenues	114,777	--	1,222,045
Cost of service revenues	104,313	--	513,767
Total cost of revenues	219,090	--	1,735,812
Gross profit	476,781	--	14,889,579
Operating expenses:			
Research and development	2,031,986	172,065	6,115,152
Sales and marketing	2,813,689	48,369	9,256,066
General and administrative	1,669,193	232,519	3,693,005
Property rights agreement and related			
Charges	2,486,688	--	500,000
Total operating expenses	9,001,556	452,953	19,564,223
Operating loss	(8,524,775)	(452,953)	(4,674,644)
Interest income	55,238	--	495,583
Interest expense	-308	--	(128,655)
Net loss	($8,469,845)	($452,953)	($4,307,716)
Net loss per share	($0.26)	($0.01)	($0.13)
Shares used in computing net loss per share	32,256,307	30,767,418	33,000,751

EXHIBIT 3
NOVACO CORPORATION
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	Preferred Stock	Common Stock	Additional Paid-in Capital	Receivable from Stockholders	Deferred Compensation	Accumulated Deficit	Accumulated Translation Adjustment	Total Stockholders' Equity
Issuance of 3,750,000 shares of common stock to founders and employees for cash	$ --	$375	$16,300	$ --	$ --	$ --	$ --	$16,675
Issuance of 4,151,000 shares of Series A convertible Preferred stock at cash and $0.75 per share for technology	$415	$ --	$3,112,835	$ --	$ --	$ --	$ --	$3,113,250
Issuance of 2,857,222 shares of Series B convertible Preferred stock at $2.25 per share for cash, net of issuance costs of $33,933	$286	$ --	$6,394,531	$ --	$ --	$ --	$ --	$6,394,817
Exercise of 761,000 shares of common stock options	$ --	$76	$28,612	$ --	$ --	$ --	$ --	$28,688
Net Loss	$ --	$ --	$ --	$ --	$ --	($8,469,845)	$ --	($8,469,845))
Balance as of: Dec. 31, 2002	$701	$451	$9,552,278	$ --	$ --	($8,469,845)	$ --	$1,083,585
Issuance of 10,634,000 shares of common Stock upon exercise of stock options, net of repurchases for cash and notes (Unaudited)	$ --	$1,063	$1,744,535	($638,065)	$ --	$ --	$ --	$1,107,533

EXHIBIT 3
NOVACO CORPORATION
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	Preferred Stock	Common Stock	Additional Paid-in Capital	Receivable from Stockholders	Deferred Compensation	Accumulated Deficit	Accumulated Translation Adjustment	Total Stockholders' Equity
Issuance of 2,000,000 shares of Series C convertible Preferred stock at $9.00 per share for cash, net of issuance costs of $700,000 (Unaudited)	$200	$ --	$17,299,800	$ --	$ --	$ --	$ --	$17,300,000
Deferred compensation related to grant of Stock options (Unaudited)	$ --	$ --	$11,087,053	$ --	($11,087,053)	$ --	$ --	$ --
Amortization of deferred compensation (Unaudited)	$ --	$ --	$ --	$ --	$1,274,902	$ --	$ --	$1,274,902
Net Loss (Unaudited)	$ --	$ --	$ --	$ --	$ --	($4,307,716)	$ --	($4,307,716))
Accumulated Translation adjustment (Unaudited)	$ --	$ --	$ --	$ --	$ --	$ --	$16,217	$16,217
Balance at June 30, 2003 (Unaudited):	$901	$1,514	$39,683,666	($638,065)	($9,812,151)	($12,777,561)	$16,217	$16,474,521

EXHIBIT 4
NOVACO CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
Increase (decrease) in cash and cash equivalents

	Inception (May 31, 1994) to December 31, 2002	Inception (May 31, 2002) to June 30, 2002 (Unaudited)	Six Months Ended to June 30, 2003 (Unaudited)
Cash flows from operating activities			
Net loss	$(8,469,845)	$(452,953)	$(4,307,716)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:			
Amortization of deferred compensation		-	1,274,902
Depreciation and amortization	215,868	9,133	701,698
Changes in assets and liabilities:			
Accounts receivable	(701,649)	(17,302)	(7,576,220)
Other current assets	(67,284)	(52,411)	(737,687)
Accounts payable	855,068	14,519	3,752,106
Accrued compensation and related liabilities	527,340	114,396	547,726
Other accrued liabilities	667,503	--	1,246,533
Deferred revenues	2,575,145	--	12,388,698
Long-term obligations	1,450,000	--	--
Net cash (used in) provided by operating activities	(2,947,854)	(384,618)	7,290,040
Cash flows from investing activities			
Capital expenditures	(2,947,854)	(346,131)	(4,954,920)
Increase in deposits and other assets	(654,100)	(42,973)	(613,207)
Purchase of short-term investments	--	--	(16,567,300)
Net cash used in investing activities	(3,317,066)	(389,104)	(22,135,427)
Cash flows from financing activities			
Proceeds from the issuance of installment notes payable	--	--	2,200,000
Payments on installment notes payable	--	--	(137,220)
Proceeds from issuance of preferred stock, net	9,508,430	1,001,675	17,300,000
Proceeds from issuance of common stock, net	45,363	1,675	1,107,533
Net cash provided by financing activities	9,508,430	1,001,675	20,470,313
Net increase in cash and cash equivalents	3,243,510	227,953	5,624,926
Cash and cash equivalents at beginning			
Cash and cash equivalents at end of period	$3,243,510	227,953	$8,868,436

EXHIBIT 5
COMPUTER SOFTWARE & SERVICES INDUSTRY DATA

Year	Sales (millions)	Net Income (millions)	EPS	Price Range (high-low)	Dividend	P/E Ratio	Book Value (millions)	Working Capital (millions)	Capital Expenditures (millions)
1998	$45.210	$8.080	$3.32	$87.23-$48.20	0.58	20.4	$23.970	$10.690	$1.780
1999	34.980	7.030	3.24	91.50- 54.27	0.39	24.7	17.840	8.960	1.880
2000	41.410	21.170	4.47	108.99- 82.14	0.42	21.4	16.940	10.110	2.200
2001	49.480	25.880	4.48	149.31-107.04	0.47	28.6	19.750	11.320	2.560
2002	43.630	11.700	5.51	165.77-120.12	0.36	25.9	21.630	12.520	2.210

EXHIBIT 6
THOMPSON FINANCIAL INC.
CONSOLIDATED STATEMENT OF OPERATIONS

	1999	2000	2001	2002	2003
Revenues					
Internet Services	4,979	7,054	10,019	16,860	71,521
Software	9,201	13,342	13,980	16,278	22,940
Total	14,180	20,396	24,019	33,138	94,461
Cost and Expenses					
Cost of Revenues					
Internet Services	2,618	3,556	6,452	10,262	46,393
Software	3,842	7,454	7,240	9,369	12,946
Network operations	1,850	1,658	3,850	6,764	13,127
Sales and Marketing	2,512	3,055	5,558	9,681	18,762
General & Admin.	1,532	3,071	2,248	5,288	12,709
Acquisition Expense					11,067
Total	12,354	18,794	25,348	41,364	115,004
Operating Income (loss)	1,826	1,602	(1,329)	(8,226)	(20,543)
Interest Income	52	29	36	440	2,747
Interest Expense	(139)	(198)	(103)	(76)	(808)
Equity in Net loss of affiliates					(127)
Loss on sale of investment in related party			(433)		
Other		20			
Income (loss) before taxes	1,739	1,453	(1,829)	(7,862)	(18,731)
Benefit (provision) for taxes	(441)	(739)	(197)	(126)	474
Net Income (loss)	1,298	1,074	(2,026)	(7,988)	(18,257)

EXHIBIT 7
THOMPSON FINANCIAL, INC.
CONSOLIDATED BALANCE SHEETS

ASSETS	2002	2003
Current Assets		
Cash and cash equivalents	10,493	60,424
Accounts Receivable	5,387	17,768
Inventories	1,214	1,251
Prepaid Expenses & other	1,253	2,149
Total Current Assets	18,347	81,592
Property & Equipment (Net)	11,080	54,523
Investments in affiliates		1,321
Other Assets	198	174
Total Assets	29,625	137,610
Liabilities and Stockholders' Equity		
Current liabilities:		
Current portion of notes	1,060	4,652
Accounts Payable	4,876	10,580
Accrued Expenses	4,826	24,604
Deferred revenues	3,315	3,421
Total current liabilities	14,077	43,257
Notes Payable, net of current portion	1,196	13,686
Total Liabilities	15,273	56,943
Total stockholders' equity	279	80,667
Total Liabilities and Stockholders Equity	29,625	137,610

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EMPLOYER LIABILITY FOR NON-EMPLOYEE SEXUAL HARASSMENT

John Hoft, Columbus State University
Neal F. Thomson, Columbus State University

CASE DESCRIPTION

The primary subject matter of this case sexual harassment. This case has a difficulty level of three to four, and is appropriate for an upper division, undergraduate level. This case is designed to be taught in one class hour, and is expected to require two to three hours of outside preparation by students.

CASE SYNOPSIS

This case examines the limits of employer responsibility for sexual harassment of their employees. Title VII of the Civil Rights Act of 1964 prohibits discrimination based on race, color, religion, sex or national origin. Sexual harassment is considered sex discrimination, and is prohibited under this act (Meritor Savings Bank v. Vinson, 1986). A majority of employers are well aware that sex harassment by supervisors and co-workers is an unlawful employment practice that will subject the employer to vicarious liability (Harris v. Forklift Systems, Inc., 1993). Not so well known is the fact that sex harassment by non-employees such as independent contractors, customers, clients, and suppliers will also subject the employer to exposure for discrimination liability (Lockard v. Pizza Hut, Inc., 1998). The following case presents basic information about non-employee sexual harassment law, followed by several vignettes. In each case, students are to evaluate the vignette, determine whether sexual harassment has taken place, and whether the employer can be held liable for the discriminatory acts of non-employees.

INTRODUCTION

Title VII of the Civil Rights act of 1964 prohibits discrimination based on race, color, religion, sex or national origin. This law provides the foundation upon which much of our anti-discrimination law and policy is built. Section 703 of Title VII states that:

> *It shall be an unlawful employment practice for an employer...to discriminate against any individual with respect to his compensation, terms conditions or privileges of*

> *employment, because of such individual's race, color, religion, sex, or national origin.* (Title VII, 1964)

In 1980, the EEOC issued the Guidelines on Discrimination Because of Sex, 29 C.F.R. Section 1604.11 which stated that sexual harassment violated this portion of section 703. This document provides guidance on the types of behaviors that constitute sexual harassment, and the events that must occur for an employer to be liable. According to the EEOC, the following constitute sexual harassment:

> *Unwelcome sexual advances, requests for sexual favors, and other verbal or physical conduct of a sexual nature constitute sexual harassment when this conduct explicitly or implicitly affects an individual's employment, unreasonably interferes with an individual's work performance, or creates an intimidating, hostile, or offensive work environment* (Sexual Harassment, 2006).

In addition, the EEOC stipulates the several circumstances, which must be met for sexual harassment to occur. The harasser, and the victim, may be either male or female. Additionally the harasser may be a supervisor (either the victim's or another supervisor), co-worker, agent of the firm, or a third-party non-employee. The victim does not have to be the person harassed, it may be another worker, who finds the behavior offensive. However, the behavior does have to be unwelcome, in order to be unlawful harassment. If both parties welcome the behavior, then it does not constitute harassment. (Sexual Harassment, 2006).

Sexual harassment is generally subdivided into two types. The first, which involves explicit demands for sexual behavior in exchange for favorable treatment in some work aspect, is often called Quid Pro Quo sexual harassment. This type of sexual harassment can only be perpetrated by a company employee in a supervisory position capable of taking a tangible employment action for or against the victim of discrimination (Mendoza v. Borden, Inc., 1999). The employer is strictly liable if a tangible employment action resulted from the supervisory harassment (Johnson v. Booker T. Washington Broadcasting Service, Inc., 2000). The second type of sex discrimination is often referred to as environmental sexual harassment. The criterion for environmental sexual harassment is somewhat less clear. Environmental sexual harassment is described as hostile work environment discrimination and can be perpetrated by supervisors, co-workers and non-employees. Any sexually offensive behavior, which is so severe or pervasive that it interferes with the employee's ability to do her job and creates an abusive working environment, may be the basis for environmental sexual harassment (Meritor Savings Bank v. Vinson, 1986). The key element is whether the hostile work environment is sufficiently severe or pervasive that it alters the conditions of the victim's employment and unreasonably interferes with her job performance (Allen v. Tyson Foods, 1997). It is difficult to conclusively define what actions create a hostile work environment. Everything from

sex oriented jokes, to bikini calendars, to stories told at the water cooler, have been alleged to be harassment, at one time or another, but the courts are vigilant about assuring that Title VII does not become a mere "general civility code" (Faragher v. City of Boca Raton, 1998). Title VII does not prohibit all verbal or physical harassment in the workplace (Oncale v. Sundowner Offshore Servs. Inc. 1998). However, an employer is liable for environmental discrimination when the harassment is sufficiently severe or pervasive and causes an abusive working environment and the employer knew or should have known of the harassment and failed to take remedial action (Breda v. Wolf Camera & Video, 2000). Confounding the issue of employer liability for sex discrimination even further is the fact that not only can employers be vicariously liable for discrimination perpetrated by its employees and supervisors, employers can also be held liable for the actions of third party non-employees (Folkerson v. Circus Circus Enterprises, Inc., 1997).

As part of its Guidelines on Discrimination Because of Sex the EEOC has addressed employer liability for the acts of third-party non-employees in Section 1604.11(e) which provides: An employer may also be responsible for the acts of non-employees, with respect to sexual harassment of employees in the workplace, where the employer (or its agents or supervisory employees) knows or should have known of the conduct and fails to take immediate and appropriate corrective action. In reviewing these cases the Commission will consider the extent of the employer's control and any other legal responsibility which the employer may have with respect to the conduct of such non-employee.

THE CASES

You have recently been hired as a member of an HR department, at a large multinational corporation. Among your duties is dealing with EEOC compliance. After a recent training program, dealing with the issue of environmental sexual harassment, your office has received several new complaints. Your job is to review each complaint, and decide how to deal with it.

Complaint 1 - The employee sales rep and a customer.

Susan is a sales representative for the wholesale beer and wine portion of your company's operations. It is her job to meet with the owners/managers of stores, restaurants, bars, liquor stores and other retailers who sell the company's products. Many of these businesses are run by people with little formal management training, and varying degrees of professionalism. In this instance, Susan has filed a complaint, alleging that one of the customers she serves, the owner of a local tavern, has made inappropriate advances, has repeatedly made vulgar sexual comments, and ogled her mercilessly when in the same room. She has repeatedly responded by turning down his advances, while trying not to be too harsh, as he is a long-term customer, and the company would not want to lose his business.

Complaint 2 – The employee maintenance personnel and an independent contractor.

Sam is a full time employee and a member of your clean-up and maintenance department. Your facilities include a lunchroom with vending machines that are serviced by an independent food vendor, Aramark. Aramark is a separate and distinct entity from your employer. Aramark employee, Mertisse Wilson, is assigned to service the vending machines in your company lunchroom. Aramark employees are supervised, disciplined and paid by Aramark and your company does not have the right to fire an Aramark employee. Part of Sam's duties includes keeping the lunchroom clean and sanitary. Sam and Wilson frequently come into contact with one another in the company lunchroom while each performs their respective duties. Ms. Wilson repeatedly directed sexual language and offensive conduct toward Sam in the workplace. During the past two months approximately every two weeks Ms. Wilson would very explicitly invite Sam to engage in several different types of sexual behavior, while she would touch herself inappropriately in Sam's presence. Sam promptly made complaints about Ms. Wilson's conduct totaling 20 verbal complaints and more than seven written complaints. Sam's immediate supervisors laughed at him and made no attempt to correct Wilson's behavior.

Complaint 3 - Employee receptionist encounters a supplier.

Mary is the receptionist for your employer and works at a desk in the reception area of your facility. Two male employees of a supplier with whom your company has not done business visit your facility on a cold call and encounter Mary at the reception desk. The men are rowdy and one made sexually offensive comments to her such as "I would like to get into your pants" and the other touched her breast. Mary ran away and the two men left. Mary has threatened to file a complaint with the EEOC for hostile work environment sexual harassment because your company failed to take corrective action after this incident.

Complaint 4 – Public Relations Employee Raped by Client

Jane is employed by your employer as a public relations specialist in a position that required her "to develop an ongoing business relationship and contacts with potential clients in order to obtain and retain corporate business". One of your corporate clients is Starbucks Corporation and its Director of Human Resources, Mr. Guerrero, informed Jane that he was contemplating sending more business to your employer. Jane had two business lunches with Mr. Guerrero in the spirit of fostering good will. This month, Jane accepted Guerrero's invitation to discuss the account at a restaurant. After eating dinner with Guerrero and having a couple of drinks, Jane suddenly became ill and passed out. She awoke to find herself being raped by Guerrero in his car. She fought him off and jumped out of the car, but again she became violently ill. Guerrero put her back in the car

and took her to his apartment where he raped her again. Afterward, he showered and drove her to her car. Jane was initially afraid to report the rape because she was concerned that the episode might impair your company's efforts to obtaining the exclusive Starbucks account. However, nine days after the incident Jane reported the rape to Ms. Jones, a vice-president, and your company's harassment complaint-receiving manager. Ms. Jones commiserated with Jane but told her that it would be best for Jane to "put it behind her", to receive therapy, and discontinue working the Starbucks account. Despite being removed from the Starbucks account your company's president continued to inquire of Jane about progress on the account. Finally, Jane told your president about the rape. Your company president told Jane he did not want to hear about it and then told her that her salary was being reduced effective immediately.

QUESTIONS- ANSWER THESE FOR EACH CASE

1) Do the actions detailed in this complaint constitute environmental sexual harassment, that is, is this scenario sufficiently severe or pervasive to alter the terms and conditions of your employee's employment and create an abusive working environment?

2) Does your employee express a basis upon which your company can be held liable for the harassment?

3) What could your employer do, if anything, to reduce its exposure for liability for discrimination?

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INVESTING IN ARKETIA

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CASE DESCRIPTION

The primary subject matter of this case is the integration of statistics, macroeconomics, and business ethics. Secondary issues include descriptive statistics (interpretation of standard deviation), normal distribution, and statistical hypothesis testing. The case has a difficulty level of three, appropriate for junior level. The case is designed to be taught in three class hours, including a formal case presentation by a team and a challenge by another student team. Three hours of outside preparation by students are required.

CASE SYNOPSIS

Students must balance bottom-line financial criteria against ethical issues of social responsibility as they decide if they should invest in one of two developing countries. East Arketia has a poorly educated work force, an inefficient government, and may not enforce property rights, but it has a democratic government with free speech protection. West Arketia is undemocratic, without free speech, but has a pro-business economic policy and a higher education level compared to East Arketia.

Students interpret the standard deviation in terms of the "gap between the rich and the poor" and use the normal area table to estimate the proportion of households below the poverty level in each country. In addition, they use hypothesis testing to estimate average household disposable income, as well as the proportion of prisoners who are political prisoners.

In the economics question, students evaluate the potential for growth in the two countries. The last question asks students to apply ethical principles to their decision, with specific references to the issue of the alternative political systems. "Does your company have an obligation to support the more democratic political regime of East Arketia, even if it turns out that returns to your firm will be lower?"

INTRODUCTION

Westman, Inc., a large manufacturer of consumer durables, is considering expanding into two developing countries. East and West Arketia recently split off from the former Soviet Union and may provide opportunities for both manufacturing and sales. While the two countries have

similar backgrounds and current GDPs, they differ substantially in economic policies. Because of limited resources, Westman can only expand into one country. Westman, Inc. would like to invest in a country that will be growing rapidly so that the citizens will be able to afford to buy its products.

The president of Westman has hired your consulting firm. Members of your firm are assessing the prospects for investing in the two countries. They have met with the Minister of Commerce for West Arketia, Ms. Coranish, and the Minister for Development for East Arketia, Mr. Aliel. Your company has also sent a number of representatives to the two countries to gather data to help make a decision.

EAST ARKETIA

East Arketia has had a democratic and populist tradition. This has resulted in the people enjoying substantial civil rights after independence, including free speech and popular elections. However, the government has an inefficient civil service and a mixed record of enforcing property rights. Investment in education and physical capital is low even though public spending and the federal deficit are high.

WEST ARKETIA

West Arketia is run by a generally peaceful one-party government. The government budget has been balanced, with taxes and tariffs at a level typical for a developing country. Government spending has focused on education with the goal of universal primary education. The legal system is well developed and has been effective in supporting property rights (although less effective for political rights). Corruption is low.

Unlike East Arketia, West Arketia is more restrictive in terms of civil rights and democracy. There are no prospects for elections in the near future and a number of opposition leaders have been jailed. All television and radio is run by the government. Newspapers have a close relationship with the government and generally follow a pro-government line.

REQUIRED

Your consulting firm has been asked by the president of Westman, Inc. to report on the expansion possibilities into East and West Arketia. Write a report incorporating answers to the questions below.

1. Statistics provided by developing countries are not always reliable. Data can be hard to gather and is sometimes reported incorrectly. From the analysis of West Arketia, you conclude that citizens there average $1100 per month in household disposable income. The

Minister of Development for East Arketia says that disposable income is the same in his country. To see if the data supports this, your company has randomly sampled 100 households from East Arketia and obtained data on household disposable income. The sample has a mean of $923.62, and a standard deviation of $ 84.64. Test the hypothesis, at the 1% significance level, that East Arketia also has a mean monthly household disposable income of $1100.

2. Suppose East Arketia's government now reports that its population mean disposable household income is $925 per month, with a standard deviation of $70. West Arketia's population mean is $1100, with a standard deviation of $350.

   a. Which country has more variation in income? Explain using popular phrases, such as "gap between rich and poor."

   b. Each country defines the poverty level to be $800. If you assume that income has a normal distribution, find the probability that a household's income is below the poverty level in West Arketia

      i. East Arketia
      ii. West Arketia

      Does it seem reasonable to assume a normal distribution? Is income symmetric or skewed?

3. In explaining why their country is an attractive place to invest, the Minister of Commerce from West Arketia has argued that the political problems have been exaggerated and that fewer people have been imprisoned for political reasons than you have been led to believe. However, Amnesty International reports that one third of the prisoners in West Arketia are political prisoners. A representative from your company visited a prison and randomly sampled 500 prisoners in West Arketia, concluding that 100 of them are political prisoners. Test the hypothesis, at the 10% significance level, that one third of the prisoners in West Arketia are political prisoners. Does this data support the Minister of Commerce or Amnesty International? What other issues might be important when evaluating this data?

4. Based on the economic and statistical issues, evaluate the potential for growth in the two countries.

5. Westman, Inc. also wanted to know whether economic growth could reduce income disparity

and problems with poverty. You collected data from 20 countries and found that 6 had rapid economic growth, 8 currently have a major problem with poverty, and 1 had both rapid economic growth and a major poverty problem.

a. Given rapid growth, what is the conditional probability of a major poverty problem?
b. Are the two events independent? Justify your answer.
c. If you are concerned about poverty, would prospects of economic growth affect your concern? How might this relate to the Arketia region?

6. Some managers at Westman were concerned about the arbitrary definitions of "rapid" growth and "major" poverty problem. A new sample was taken from 6 countries that report more precise data. The new data are:

X	4	6	5	2	1	8
Y	23	18	24	32	28	7

Where X = percentage economic growth rate and Y = percentage households below the poverty line.

a. Find the regression equation to estimate Y given X.
b. If a country has a 3% growth rate, estimate the percentage below the poverty line.
c. How does this affect your decision regarding the Arketia region?

7. If it is found that find that economic prospects are better in West Arketia, should Westman invest there? Or, does the company have an obligation to support the more democratic political regime of East Arketia, even if it turns out that the returns to the firm will be lower? To what extent are ethical issues relevant to your recommendation?

STONEBRIDGE COUNTRY CLUB: CASH…IS THERE ENOUGH?

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CASE DESCRIPTION

The primary subject matter of this case concerns the development and use of a cash budget as a key component in a cash management system. The case requires students to have an introductory knowledge of accounting, finance and general business issues, thus the case has a difficulty level of three (junior level) or higher. The case is designed to be taught in one class session of approximately 1.25 hours and is expected to require 4-6 hours of preparation time from the students.

CASE SYNOPSIS

Paul Sparks, a successful pharmacist and avid golfer, recently sold his family drug store and is negotiating with Golf Corp LLC to purchase Stonebridge Country Club. Stonebridge Country Club is a private golf course that Sparks has been a member of for the last 20 years. Sparks and Golf Corp LLC have tentatively agreed on a purchase price providing Sparks can arrange financing. Sparks has developed projected income statements, balance sheets and cash flow statements for the first four years of operation for his new company and approached a local commercial bank for a working capital loan and equipment financing. The bank expressed an interest in making the loans but requested Sparks include a cash budget for the first year of operation.

STONEBRIDGE COUNTRY CLUB BACKGROUND

Stonebridge Country Club opened in 1979 as part of a 450-acre residential real estate development in Abilene, Texas, a west Texas community located 190 miles from Dallas/Ft. Worth. Abilene, like many Texas cities, benefited greatly from soaring oil prices during the late 1970's and early 1980's. In 1979, Abilene had a population of over 100,000 and only 36 holes of golf, one 18-hole private course at Abilene Country Club and one public 18-hole municipal course. Mike and Josh Andrews, owners of LaMiss Inc., a 40,000 barrel-a-day refinery located in Louisiana on the Mississippi River, were the primary investors in Stonebridge. The Andrews brothers reasoned the

time was right to build an additional private course in Abilene. San Angelo, a smaller city to the south of Abilene, already had five golf courses in 1979. In addition, Abilene Country Club was known more for its dining and social aspects rather than quality golf. The Andrews brothers hoped the community would respond to a high quality, golf oriented country club. Initially, their assumptions proved correct and during its peak, Stonebridge attracted over 400 members. However, even as early as 1982, there were signs that the oil boom was nearing its end. The gradual decline of oil prices made it less and less profitable for many companies to continue operations in the oil patches of West Texas. By the late 1980's, LaMiss Inc. had ceased operations as giant competitors were refining 500,000 barrels of oil a day more economically.

Concurrently, Stonebridge's membership steadily declined and the Andrews brothers eventually sold the club in 1990 to a local civic-minded philanthropist, Jane Nichols, who continued operating the club while Stonebridge members set about trying to increase membership to raise money and buy the club. Nichols realized if Stonebridge Country Club closed, the property values around the club might drop which would reduce school funding and limit growth during an already turbulent economic period.

Stonebridge members eventually arranged to purchased the club in 1993 from Nichols, but were not able to completely pay off the debt until 1999 when members, after several years of disagreement concerning the club's future, finally agreed to sell Stonebridge to Golf Corp LLC, a private company specializing in country clubs. According to a former member, "There were a lot of arguments about why membership was stagnant and who we should borrow more money from, and it appeared that there was really no other way out".

In January of 1999, Golf Corp LLC purchased the club and grounds, and invested over $1 million in renovations, repairs and remolding in order to boost membership. Golf Corp LLC was founded in 1991 with a strategy to acquire and manage golf courses in "demand driven" markets that provide opportunities for revenue growth and margin improvement through Golf Corp's integrated marketing and operational programs. The essence of Golf Corp's strategy is to "market" each course as a separate brand with well-defined customer segments, distinctive positioning, tailored "one-to-one" programs - and responsive tracking and follow-up. However, by 2004, Stonebridge was not expected to provide the return required by Golf Corp's investors and once again, Stonebridge Country Club was up for sale.

BUYERS BACKGROUND

Paul Sparks is sixty-one years old and recently sold the family drug store he opened 30 years ago. Sparks graduated from the University of Texas' College of Pharmacy in 1965 and a few years later returned to Abilene to open Hillsdale Pharmacy. Mr. Sparks is an accomplished golfer with regional recognition, having won numerous local amateur tournaments over the past 20 years. Traditional retirement activities were not enough to completely satisfy Sparks and when the

opportunity to purchase Stonebridge Country Club arose, he decided to pursue a lifelong dream of owning a golf course.

Sparks lived in the residential community adjacent to Stonebridge Country Club and had been a member of the club on and off over the last 20 years. Initially, Stonebridge was a fabulous golf facility with adequate dining, clubhouse and pool facilities, but the decline in oil prices led to a decline in membership and eventually a decline in capital improvement spending needed for maintenance and upkeep. Sparks had dropped his membership in 1992 and joined Abilene Country Club even though it was less conveniently located across town. Sparks, like many of his friends, had become increasingly frustrated by the deterioration of Stonebridge's golf course conditions over the years. Sparks decided to rejoin Stonebridge in 1999, when the club was sold to Golf Corp LLC, under the impression that Golf Corp LLC would have the financial resources to return the golf course to its previous splendor.

Reportedly, Golf Corp LLC had invested over $1 million in renovations and improvements, but in Sparks' opinion, course conditions remained adequate at best. Most of the revitalization efforts were targeted at the dining facilities, club house, and pool. Although membership numbers at Stonebridge had risen to around 200, up from 160 in 1999, the club was no where near the over 400 members seen during the oil boom years of the late 1970s and early 1980s.

GOLF INDUSTRY

Prior to 1970, the golf market had two different types of courses, lower budget courses operated mainly by municipalities, and more upscale private country clubs. In the earlier 1970's a new trend known as "A Country Club for a Day" began to emerge as the title for newer upscale daily fee courses. These courses were open to the public and provided high quality design, maintenance and service. At present, most of the industry research is based on a three segment framework, which classifies courses as municipal, daily-fee, or private. Table One provides a historical perspective on the number of golf facilities under each of the traditional market segments. Over the last 30 years, the golf course market has gradually emerged from a three segment market to one that contains many market segments.

In reality, the golf course market now contains many more market segments. These market segments are based on several interrelated factors with a focus on the type of customer served. For example, a private club may serve local residents in a certain income bracket, while a similar private club may be structured to serve corporate clients.

On the demand side, the total number of golfers in the United States has remained fairly flat over the last five years, but has increased from 10 years ago. In 1994, an estimated 23 million Americans were classified as golfers having played 421 million rounds of golf at approximately 11 thousand courses. By 2004, the number of American golfers has grown to 27.4 million and the number of rounds played increased to approximately 498 million. Of the 27.4 million total golfers

in the US, 12.8 million are classified as core golfers (playing more that seven rounds per year) and 14.6 million are occasional golfers (playing one to seven rounds per year). The average core golfer plays 37 rounds per year (see Table Two for a year by year comparison of growth).

THE SITUATION

Sparks and Golf Corp LLC have tentatively agreed on a purchase price providing Sparks can arrange financing. During the negotiation process with Golf Corp LLC, Sparks was assisted by Rick Scott, an associate with Williams Inc; headquartered in Little Rock, Arkansas. Williams Inc. is one of the largest investment banking firms off of Wall Street and has a long historical record of assisting firms arrange financing for new ventures. Williams Inc maintains over 30 offices in key financial cities throughout the United States, including Dallas and Austin.

Sparks, with the help of Scott, developed projected income statements, balance sheets and cash flow statements for the first four years of operation for his new company and approached a local commercial bank for a revolving credit agreement of $200,000 and property and equipment mortgage loan of $1,700,000 (no principal payment is required until maturity). Sparks would invest $700,000 as equity. The projected income statement, balance sheet and cash flow statement for the first year of operation is provided in Tables Three, Four and Five. The bank has expressed an interest in providing the credit but asked Sparks to prepare a cash budget for the first year of operation to ensure the requested financing is adequate. Sparks was unsure how to begin and requested Scott's assistance. Scott stated that similar to preparing forecasted financial statements, they needed to prepare a list of operating assumptions.

ASSUMPTIONS

Sparks and Scott used historical information provided by Golf Corp LLC and the information used in developing the forecasted financial statements to prepare the cash budget assumptions.

1. Only plant, property and equipment will be purchased from Golf Corp. Inventory and receivables will not be acquired.
2. The bank provides the requested $200,000 revolving credit agreement and the $1,700,000 mortgage loan. Stonebridge will begin the year using $123,000 of the revolving credit agreement.
3. A $30,000 cash balance will be maintained. Excess cash will used to reduce short-term borrowing.
4. Cash Inflows: Member dues, initiation fees, guest green fees, food and beverage sales and merchandise sales (pro shop) are expected to be the primary cash inflows.
    a. Monthly inflows will be influenced by golf activities. Projected golf rounds for the

first year are 12,895 (10,990 member and 1,885, guest). One hundred new members are expected. Annual projections were converted to monthly projections.

b. Timing of new members was heavily weighted toward the beginning of the year to coincide with the improving weather conditions and a planned membership drive. The membership drive is planned for the months of March, April and May.

	Members		
	Existing	New	Total
January	200	5	205
February	205	10	215
March	215	20	235
April	235	25	260
May	260	15	275
June	275	15	290
July	290	5	295
August	295	5	300
September	300	0	300
October	300	0	300
November	300	0	300
December	300	0	300
Total		100	

Golf rounds were based on membership and an estimate of rounds per month.						
	Monthly Rounds per Member	Monthly Rounds per Guest	Total Number of Members	Member Rounds	Guest Rounds	Total Rounds
Jan	0.5	0.0	205	103	0	103
Feb	1.0	0.0	215	215	0	215
Mar	4.5	0.0	235	1,058	0	1,058
Apr	5.0	0.5	260	1,300	130	1,430
May	6.0	1.0	275	1,650	275	1,925
Jun	6.0	1.5	290	1,740	435	2,175

Golf rounds were based on membership and an estimate of rounds per month.						
	Monthly Rounds per Member	Monthly Rounds per Guest	Total Number of Members	Member Rounds	Guest Rounds	Total Rounds
Jul	5.0	1.0	295	1,475	295	1,770
Aug	4.5	1.0	300	1,350	300	1,650
Sep	4.0	1.0	300	1,200	300	1,500
Oct	2.0	0.5	300	600	150	750
Nov	0.5	0.0	300	150	0	150
Dec	0.5	0.0	300	150	0	150
Total				10,990	1,885	12,875

c. Member dues for year one are expected to total $655,000 ($200 per month) and are expected to be collected during the month. (e.g. January dues are collected in January).

d. One hundred new members are projected. Initiation fees are $3,000, half paid in the month when membership is activated and half paid the following year. The full $3,000 is recognized as revenue in the month the membership is activated.

e. Members do not pay green fees, they are included in their dues, but guests are charged green fees of $40 per round. Guest green fees are billed to members and are expected to be collected the month following the guest round.

f. Food and beverage sales from the club lounge, restaurant and snack bar are expected to generate revenues of $103,000 based on an average member/guest expenditure of $8 per round. All sales are billed to the member and are expected to be collected the month following the sale.

g. Merchandise sales from the pro shop for year one are projected to total $90,125 based on an average sale of $7 per round. As with food and beverage sales, all merchandise sales are billed to the member and are expected to be collected the month following the sale.

h. Other revenue sources were expected to total $12,000 and it was decided to base monthly sales on golf rounds. Other revenue will be collected during the month of the sale.

Monthly Golf Rounds as % of Total Rounds			
Month	%	Month	%
January	0. 80	July	13.75
February	1.67	August	12.82
March	8.21	September	11.65
April	11.11	October	5.83
May	14.95	November	1.16
June	16.89	December	1.16
		Total	100.00

5. Cash Outflows: Food and beverage supplies and labor, merchandise cost, course maintenance, cart operation and maintenance, marketing activities, general and administrative, capital expenditures, interest charges and income taxes are expected to be the primary cash outflows.
   a. Food and beverage costs are projected to be 36% of food and beverage sales and will be paid the month following the sale.
   b. Merchandise cost of goods sold is expected to be 70% of merchandise sales and will be paid two months following the sale.
   c. Annual cost to operate the pro shop is expected to total $24,000 and will be allocated as follows:

Pro Shop Operating Costs			
Month	$	Month	$
January	1,000	July	3,000
February	1,000	August	2,000
March	2,000	September	2,000
April	2,000	October	2,000
May	2,000	November	2,000
June	3,000	December	2,000
		Total	24,000
Operating costs are paid in the month incurred.			

   d. The largest cash outflow is projected to be course maintenance and is allocated to reflect spring work to prepare the course for the increased spring and summer activity.

Course Maintenance			
Month	$	Month	$
January	5,000	July	35,000
February	5,000	August	35,000
March	25,000	September	30,000
April	25,000	October	25,000
May	30,000	November	10,000
June	35,000	December	10,000
		Total	270,000
Maintenance costs are paid in the month incurred.			

e. Annual cart operation and maintenance is expected to total $38,625 based on $3 per golf rounds. Maintenance costs are paid in the month the maintenance is performed.

f. Food and beverage labor is estimate to be 39% of food and beverage revenue and will be paid in the month of the sale.

g. Planned annual marketing costs of $34,000 and will be allocated as follows reflecting a spring membership drive. Costs will be paid in the month incurred.

Marketing			
Month	$		
January	3,000	July	2,000
February	3,000	August	0
March	5,000	September	0
April	8,000	October	0
May	8,000	November	0
June	5,000	December	0
		Total	34,000

h. General and administrative costs for year one are expected to total $90,000 and are expected to be incurred evenly over the twelve months. Costs will be paid in the month incurred.

i. Other/miscellaneous expenses are expected to total $2,000 and will be divided evenly over the twelve months. Cash outflow and expense will occur in the same month.

j. Capital expenditures are expected to be $300,000 for the year with $100,000 occurring in February, $100,000 in April and $100,000 in May. Cash will be disbursed in the month the expenditure occurs.

k. Annual interest expense of $144,000 will be paid quarterly with one-fourth of the annual expense paid in the months of March, June, September and December.

l. Annual income taxes of $111,380 will be paid quarterly with one-fourth paid in the months of April, July and October. The last tax payment will be paid in January of year two.

THE TASK

Prepare answers to the following questions:

1. Construct a monthly cash budget for Stonebridge for the period January through December 2005. Assume that all cash flows occur on the 15th of each month. Is the requested $200,000 revolving credit agreement sufficient to meet the needs of Stonebridge during the year? Explain your answer.

2. The cash budget contains both cash inflow and cash outflows. Which do you feel are likely to be the most accurate? Explain your answer.

3. Scott thought it would be beneficial to prepare two additional cash budgets, one based on 75 new members and another with 125 members. Construct two additional monthly cash budgets using the different levels of new members and again assume that all cash flows occur on the 15th of each month. Income statements are provided in table 3. How do the different new membership numbers impact Stonebridge's cash needs? Will the $200,000 revolving credit agreement be sufficient? Explain your answer.

	New Members		
	100	125	75
January	5	5	2
February	10	15	10
March	20	25	15
April	25	30	15
May	15	20	15
June	15	20	10
July	5	5	5
August	5	5	2

New Members			
	100	125	75
January	5	5	2
September	0	0	1
October	0	0	0
November	0	0	0
December	0	0	0

4. Without constructing a new cash budget, explain the impact on Stonebridge's cash requirements if the 100 new members are recruited but there is a three month delay when they join (e.g. expected January members don't actually join until April, February members join in May, etc.).

5. Why is depreciation expense not part of the cash budget?

6. The monthly cash budget prepared assumes that all cash flows occur on the 15th of each month. Suppose most of Stonebridge's outflows are at the beginning of the month, while its collections are toward the end of each month. How would this fact alter the cash budget?

7. Suppose the bank refused to grant the revolving credit agreement what options are available to the company?

8. Temporary excess cash can be invested in marketable securities. What are the characteristics of marketable securities? If excess cash is projected to be continuing rather than temporary, are marketable securities the appropriate investment? Explain your answer.

9. Once again assume all cash flows occur on the 15th of each month. How large of a revolving credit agreement would you recommend Sparks arrange with the bank? Defend your answer.

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Table One: Historical Perspective of Golf Course Facilities				
Year	**Daily Fee**	**Municipal**	**Private**	***Total***
1990	6,024	2,012	4,810	12,846
1991	6,272	2,046	4,686	13,004
1992	6,552	2,090	4,568	13,210
1993	6,803	2,144	4,492	13,439
1994	7,126	2,190	4,367	13,683
1995	7,491	2,259	4,324	14,074
1996	7,729	2,306	4,306	14,341
1997	7,984	2,361	4,257	14,602
1998	8,247	2,402	4,251	14,900
1999	8,470	2,440	4,285	15,195
2000	8,759	2,438	4,290	15,487
2001	8,972	2,404	4,313	15,689
2002	9,113	2,388	4,326	15,827
2003	9,156	2,390	4,353	15,899
2004	9,284	2,406	4,367	16,057

Table Two: Historical Perspective in Number of Golfers by Classification (in Millions) Core Golfer: Plays more than seven rounds per year Occasional Golfer: Plays one to seven rounds per year			
Year	**Core Golfer**	**Occasional Golfer**	***Total Golfers***
1990	11.8	13.9	25.7
1991	11.5	11.5	23.0
1992	11.6	11.5	23.1
1993	11.3	11.3	22.6
1994	11.2	11.5	22.7
1995	11.6	11.4	23.0
1996	11.4	11.6	23.0
1997	13.5	10.6	24.1
1998	13.9	10.4	24.3
1999	13.7	10.7	24.4
2000	14.1	13.0	27.1
2001	12.0	15.8	27.8
2002	12.9	14.6	27.5
2003	13.4	15.0	28.4
2004	12.8	14.6	27.4

Table Three: Stonebridge Country Club Income Statement (years ending December 31)			
	100	125	75
	New Members	New Members	New Members
	Year 1	Year 1	Year 1
	Projection	Projection	Projection
	$	$	$
Revenues			
Dues	655,000	700,000	610,600
Initiation Fees	300,000	375,000	225,000
Green Fees (guests)	75,400	81,500	69,480
Food and Beverage	103,000	110,680	95,548
Merchandise	90,125	96,845	83,605
Miscellaneous	12,000	12,000	12,000
	1,235,525	1,376,025	1,096,233
Cost of Sales			
Food and Beverage	37,080	39,845	34,397
Merchandise	63,088	67,792	58,523
	100,168	107,637	92,920
Operating Expenses			
Pro Shop	24,000	24,000	24,000
Course Maintenance	270,000	270,000	270,000
Carts	38,625	41,505	35,831
Food and Beverage	40,170	43,165	37,264
Marketing	34,000	34,000	34,000
General and Administrative	90,000	90,000	90,000
Other	2,000	2,000	2,000
	498,795	504,670	493,095
Total Operating Costs & Expenses	598,963	612,307	586,015
Depreciation Expense	121,300	121,300	121,300
Operating income	515,262	642,418	388,918
Interest expense	144,000	144,000	144,000
Income before income taxes	371,262	498,418	244,918
Income tax expenses	111,379	149,527	73,475
Net Income	259,883	348,893	171,443

Table Four: Stonebridge Country Club
Balance Sheets (100 New Members)
(For the year ending December 31)

	Year 0	Year 1
	$	$
Current assets		
Cash & Marketable Securities	50,000	30,000
A/R Initiation Fees	0	150,000
A/R Food and Beverage	0	1,200
A/R Merchandise	0	1,050
Total current assets	50,000	182,250
Property and equipment at cost		
Land	1,860,000	1,860,000
Plant, property and equipment	613,000	913,000
Less accumulated depreciation	0	(121,300)
Net plant, property and equipment	613,000	791,700
Total assets	2,523,000	2,833,950
Current liabilities		
Accounts payable - F&B	0	432
Accounts payable - Merchandise	0	1,470
Income tax payable		26,345
Short-term note*	123,000	144,320
Total current liabilities	123,000	174,067
*Long-term obligations***	1,700,000	1,700,000
Total liabilities	1,823,000	1,874,067
Shareholders' equity		
Paid in capital	700,000	700,000
Retained earnings	0	259,883
Total shareholders' equity	700,000	959,883
Total liabilities and equity	2,523,000	2,833,950

*Used portion of $200,000 revolving credit agreement
** Interest only mortgage loan

Table Five
Stonebridge Country Club
Cash Flow Statement for Year 1 (100 New Members)
(For the year ending December 31)

	Year 1
	$
Cash Flow from Operating Activities	
Net Income	259,883
Depreciation Expense	121,300
Increase A/R - Initiation Fees	(150,000)
Increase A/R - Food and Beverage	(1,200)
Increase A/R - Merchandise	(1,050)
Increase Accounts Payable - F&B	432
Increase Accounts Payable - Merchandise	1,470
Increase Income Taxes Payable	27,845
	258,680
Cash Flow from Investing Activities	(300,000)
Cash Flow from Financing Activities	
Short-term Notes Payable	21,320
Long-term Obligations	0
	21,320
Net Cash Flow	(20,000)
Beginning Cash Balance	50,000
Ending Cash balance	30,000