Volume 13, Number 6 ISSN 1078-4950

JOURNAL OF THE INTERNATIONAL ACADEMY FOR CASE STUDIES

An official Journal of the

International Academy for Case Studies, Inc. and the Allied Academies, Inc.

Editors
Inge Nickerson, Barry University
Charles Rarick, Barry University

Editorial and Academy Information
are published on the Allied Academies' web page
www.alliedacademies.org

The International Academy for Case Studies is an affiliate of the Allied Academies, Inc., a non-profit association of scholars, whose purpose is to support and encourage research and the sharing and exchange of ideas and insights 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.

Whitney Press, Inc.

Printed by Whitney Press, Inc.
PO Box 1064, Cullowhee, NC 28723
www.whitneypress.com

The *Journal of the International Academy for Case Studies* is published by the Allied Academies, PO Box 2689, 145 Travis Road, Cullowhee, NC 28723, (828) 293-9151, FAX (828) 293-9407. Those interested in subscribing to the *Journal*, advertising in the *Journal*, submitting manuscripts to the Journal, or otherwise communicating with the *Journal,* should contact the Executive Director at info@alliedacademies.org.

EDITORIAL BOARD MEMBERS

EDITORIAL BOARD MEMBERS

EDITORIAL BOARD MEMBERS

EDITORIAL BOARD MEMBERS

JOURNAL OF THE INTERNATIONAL ACADEMY FOR CASE STUDIES

CONTENTS

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

If any reader is interested in obtaining a case, an instructor's note, permission to publish, or any other information about a case, the reader 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.

Inge Nickerson, Barry University
Charles Rarick, Barry University

CASE NOTES

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.

INSTRUCTORS' NOTES

Case Questions

1. Why was Jaguar not a good acquisition for Ford?

This case is about a bad strategic decision – Jaguar was not a good fit for Ford. First, Jaguar was on the market because it wasn't a viable profit center. If a firm acquires such a company they should have a turnaround strategy before making the acquisition. Ford didn't have such a strategy, and in an increasingly competitive and cost pressure industry, acquiring a firm with a high cost production location without the likelihood of being able to change that fact was foolish.

Jaguar had little choice in the merger. It needed Ford's financial backing to stay afloat—there was no synergy. Jaguar saw Ford as a kind of savior, at least throughout most of the 1990s when times were good. When the bottom began to fall-out and Ford demanded better performance the marriage was over, and Jaguar was pressured to produce results quickly.

There was also a "clash of cultures." Both companies are "car-companies" with proud and rich traditions, but that is where the similarities end. Ford produces millions of cars for markets all over the world. Jaguar is a niche-player that must export 85% of its products. Thus, just the scale that each company must focus on is completely different. Jaguar cars are still produced in its historical Coventry plant that was bombed by the Luftwaffe in WWII. The craft of making cars is handed down from one generation to the next. Ford, on the other hand, cannot produce cars this way. Ford must compete across the world in all auto categories. Thus, the cultures clashed.

In 1990 when Ford purchased Jaguar it did so to begin to become a "worldwide automobile company." Its strategy was linked to the increasing globalization of all markets. The strategy is a sound one, but the choice of Jaguar to execute this strategy was a poor one. Ford already had a luxury brand in the USA --- Lincoln. Granted Lincoln has never been a great success, but why purchase another brand to compete directly with it. Additionally, with the purchase of Volvo and Aston Martin the strategy execution becomes even more convoluted. Ford gained little in the acquisition. Jaguar had poor production facilities, no great R&D secrets, and required capital. Ford probably made the purchase because it "thought" it helped them globally and because it was cheap. These are not good reasons to make an acquisition.

Ford now has five brands of cars competing in the luxury car market --- Lincoln, Jaguar, Volvo, Aston-Martin, and some Land Rover models. This is just plain stupid. Each of these brands competing for the same limited customer base just increases costs while keeping Ford from being able to concentrate its limited resources.

2. Should Ford keep Jaguar?

Ford must look at the costs of keeping Jaguar, selling Jaguar, or closing Jaguar's doors. It is doubtful if Jaguar will ever be a money maker. The worldwide automobile industry is consolidating at a fantastic rate. Experts believe that in ten years there will only be five or six automotive companies producing cars worldwide. It is generally believed that Toyota, Honda, Nissan, and Mercedes will make the cut. Who the other big-player(s) will be is anyone's guess. One thing is for sure --- Jaguar will never be a stand alone car company. The company has never produced more than 125,000 cars in a year, which places it in the minor leagues. With the Chinese auto industry just beginning to flex its muscles, the picture becomes even more cloudy and unpredictable.

Thus, the possibility of Ford "spinning off" Jaguar as a public company is zero. No investment bank would underwrite the public offering because no one would buy the stock. Jaguar's management could not take the company private (i.e., LBO) because there is not enough cash-flow to make the substantial interest payments.

This is a good time to talk about how Ford's investment (capital, lost profits, and cash flows) are sunk costs. Therefore, deciding what it should do with Jaguar should be driven by what the future holds for the brand --- the past is the past and should be forgotten in this situation. This is the problem: The future looks just as bleak as the past five years, especially in the USA market where the luxury car market has become a slugfest and Jaguar is the biggest underdog. Thus, based on Jaguar's profit and loss projection students might say dump it – Ford should cut their losses and walk away.

Ford could sell the company, but buyers would be hard to find. The British government would not step forward as they did in 1975. Worldwide, there is too much auto production capacity and this is especially true in "high-labor cost" countries like the UK, Germany, and the USA. So selling the company is a long-shot option, but one that should be explored. It might be possible to sell the Jaguar "brand" instead of the company (i.e., assets and production capabilities).

The next point that needs to be made is that Ford is dealing with a "national treasure". Jaguar is part of the very fabric of the British. They are not too happy with "Yanks" owning one of their most scared institutions. They would probably be hostile towards Ford if they just closed the doors on Jaguar. Ford would take all of the blame for "running a great car company into the ground". The negative impact on Ford's image in Britain and Europe cannot be estimated --- along with its impact on EU sales of its products and moral at Volvo, Land Rover, and Aston-Martin.

Ford made a commitment to Jaguar. It is irreversible not so much because of sunk costs or even opportunity costs, but because the harm that Ford would incur for letting this great brand die. Thus, this commitment has limited what Ford can do strategically with Jaguar. So it looks like Ford is stuck with Jaguar for a long-time to come and must at least minimize losses.

3. If Ford keeps Jaguar, what should they do now?

Ford is in a life and death struggle. Jaguar's situation is not a high priority to upper management at Ford. We are confident that Jaguar is being "starved" because Ford must marshal all of its resources to execute its turnaround strategy. The best that could happen in this situation is that Ford is successful with its new products --- Ford-500, Fusion, Hybrid vehicles, F-pickups, and SUVs worldwide.

However, if Ford chooses to revitalize Jaguar, it must focus on fixing the USA market, which accounts for 62% of Jaguar sales. There are two time periods to consider: 1) the short-term and 2) the long-term. Because in the long-term Jaguar will be dead, if something is not done immediately, we suggest that all focus be given to addressing immediate concerns. We realize that the long-term problems of poor customer appeal, lack of brand awareness, and staid products must be dealt with, but those problems will take years, if not decades to address. For now, it is imperative that Ford get more Americans in Jaguars.

Therefore, Ford must create some type of immediate buzz around the Jaguar brand. This "awareness" will lead to consideration and trial (i.e., show room traffic and test drives). Once show room traffic increases, the Jaguar sales team must become expert "converters" (i.e., they must convert all trials into actual sales). This generally means generous sales commissions and price incentives for buyers. Dealer and sales incentives are different than the "rebate iniatives" used by GM and Ford. While they reduce the cost of the car to the consumer they do not "cheapen the brand" as an overall rebate program does. It is imperative that Jaguar maintain its image as a luxury car --- it is one of the few key success factors it possesses. The easiest method for creating attention for any product is linking the brand to a celebrity (i.e., not a celebrity endorsement, but illustrating that a celebrity is involved with the brand). This type of promotion can also backfire and alienate potential customers, but in the short-term it can create attention for the brand. Right now Jag needs to become relevant again.

Because the Jaguar brand represents a luxury product, the celebrity and the method of linking have to be carefully determined. For example, having a celebrity associated with status and grandeur, have his/her Jaguar "refabed" on the popular TV show "Pimp My Ride" might be great for the brand. Jaguar would be linked to a high-status individual who is highly involved with the brand and the car. But the choice of celebrity is critical. The same program with a different celebrity could kill the Jaguar brand with potential buyers.

Another method for creating a buzz (and dealer foot traffic) is the concept or signature car. (This strategy has been used by many auto manufacturers to increase awareness of a brand.) Carlos Ghosen (the brilliant CEO of Nissan) used this strategy to perfection to engineer Nissan's turnaround. In 1999 Nissan lost $6.5 billion and had a product line of "loser" models. Ghosen, who was appointed COO in late 1999, knew that he had to create exciting cars that would entice potential customers back to the show room. In 2001, he introduced the Nissan 350Z. This sports car was the direct descendent of the Datsun 240Z, Nissan's most important, popular and exciting car ever. The 240Z was introduced in 1969 and became an instant hit in the USA, and introduced an entire nation to Datsun (later Datsun was changed to Nissan). At its peak, there was an eight-month wait for a 240Z. Many customers bought a 240Z, drove it for a year, and then sold it for more money than they had paid for it. Ghosen knew that he needed another signature car and so he ordered a complete re-design of the Z car. The result was spectacular. The new 350Z created a buzz and brought people back to Nissan. It allowed Nissan the time to overhaul its model line in the image of the new Z. And the results for Nissan and Ghosen have been just as spectacular. Carlos Ghosen is considered the premier automotive CEO of this generation and Nissan (which had profits of over $5 billion in 2004) is one of the most profitable car companies in the world.

Ford used this tactic with some success in 2005. In the 2005 model year it created two re-designed models based on legends from Ford's past. The first was the Mustang GT. This is a direct re-design of the 1966 Mustang fastback driven by Steve McQueen in the movie "Bullit". The car chase scene set the standard for all action films to come and was the perfect stage in 1968 for the Ford Mustang. To recapture this stage Ford launched its new 2005 Ford Mustang GT with a 300 horsepower, 4.6 liter, V-8 engine and all the accouterments of the original "muscle-street-car". And all of this for just $30,000. The results were spectacular. Mustang sales increased by 25% and it was the only Ford model of 2005 that did not require a rebate program.

Ford's other signature car is the re-design of the 1966 GT-40. The GT-40 was Ford's most famous racing car that placed 1-2-3 in the 1966 Le Mans 24-hour endurance race. Ford achieved these victories after only two years of Grand Prix racing and the GT-40 became the classic racing car of the 60s. The 2006 GT is a direct re-make of the 1966 version. Bill Ford (CEO of Ford) called the new GT the "pace car for the entire company". In other words, Bill Ford knows that this car will create buzz and awareness for Ford --- if it turns a profit that is wonderful, but not necessary. The new GT is a mid-engine, 500 horsepower, street-version of the famous racing car. It is painted Tungsten-Grey and has the famous blue racing stripes. At $150,000 a pop it is not cheap, but several avid car collectors including Jay Leno and Jerry Seinfeld have purchased the GT and the reviews have been all raves. Thus, Ford has used this promotional ploy to create interest in its cars again. The Mustang GT or the GT will not save Ford, but they will create needed foot traffic to sell the F-150s, Ford-500s, and Escapes.

Thus, we suggest that Jaguar create a signature car based on its most successful auto the XK-E. This strategy should be much like Ford's re-design of the Mustang. It will allow Jaguar to bask in the glory of the 1960s when it made the greatest production race-cars in the world. It will bring back these memories in the minds of aging baby-boomers (who can afford to purchase the car) and it will create new memories in the minds of Generations X and Y about what a great car can be.

Another immediate change needed in Jaguar's strategy is its advertising. Currently, Jaguar allocates most of its advertising budget to print advertising in magazines aimed at high net worth individuals. Because Jags cost $55,000 to $75,000 this seems to make sense (i.e., Architectural Digest and Forbes are what the rich read). But the print ads are boring, elitist, and non-emotional. In fact, the best visual is a picture of the jaguar hood-ornament. While the hood-ornament is a brand-badge for Jaguar, if it becomes the central theme of the car, the auto must be really, really bad. We suggest a more creative, emotional ad campaign, based on the perceived uniqueness of the Jaguar --- not the hood-ornament. We also suggest a broadening of the target market. Even though high-net-worth individuals are Jaguar's target market, they must realize that they must establish a brand image with younger consumers --- who will grow up to be high-net-worth consumers. This mistake was made by Cadillac. In 1991 the average age of a Cadillac owner was 64 and no one under 40 would consider buying a Caddie. GM then realized that eventually all of its current Cadillac owners were going to die and the next generation of luxury car buyers did not know the brand. Consequently, GM spent ten years and hundreds of millions of dollars re-inventing the Caddie brand and product.

4. If you are Jaguar, what do you need to do now?

The best thing Jaguar management can do is to use its limited resources judiciously to re-build the brand with better products and promotion. To keep Ford from "closing the doors," Jaguar must produce "better" cars. By "better" we mean more unique, more appealing, and more quality oriented --- create more customer value. This is a substantial order for Jaguar. The USA luxury market is hyper-competitive. Jaguar should begin building on two factors that the brand possesses --- a perceived different product and a rich history of producing performance cars. It must take these two attitudes and create a relevant product and brand.

Jaguar needs to re-engineer their supply and value chains. They must immediately work with suppliers to cut costs and increase efficiencies. This will be difficult because we are confident that their supply-chain is linked to the Ford supply-chain. Thus, they must work with Ford to improve this situation.

Value chain re-engineering seems to be the most important area to begin the overhaul of the Jag brand. Besides a new promotional strategy (discussed above) and producing more exciting and unique luxury cars Jaguar management must consider many options. For example, the distribution (i.e., network) of dealers: Is there a way to cut the costs of this network? Next, while Jaguar is a "luxury British automobile" can some of the manufacturing be outsourced to Eastern European countries to take advantage of labor cost savings? Can Jaguar produce a production sports car again? Today Jaguar only produces luxury saloons, but it is best known for its racing heritage. Why not produce racing cars once again and create more value for all stakeholders?

GOOGLE'S DUTCH AUCTION INITIAL PUBLIC OFFERING

Sara Robicheaux, Birmingham-Southern College
Christopher Herrington, Birmingham-Southern College

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.

INSTRUCTORS' NOTES

Overview

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. The case is intended to be used in an undergraduate corporate finance class. It can be taught in two hours of class time and should take about two hours of outside preparation by the students. The case concludes with nine questions students should address in analyzing this case. Below we will give some possible direction and answers to these questions although these are not meant to be the only "correct" solutions. Also, several of the questions involve the student doing research beyond what they read in the case.

Discussion Questions

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.**

   Even though the IPO market was not "hot" at the time Google chose to go public, it appears the market was ready to invest in Google. The post IPO performance of the company indicates that investors anticipate great things from Google. Nine months after the IPO the stock was trading at 2.7 times the offer price which is very unusual. Unlike many dotcom IPOs of the late 90's, Google actually was a profitable company with positive net income and cash flows.

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?**

   Discuss why companies do not want excessive amounts of cash on hand. What are the advantages & disadvantages to cash? Also discuss why IPOs are beneficial to companies.

   The Google IPO brought in 1.67 Billion dollars. This is a large amount of cash and the company needs to be able to explain how they plan to spend/invest this cash. Some of the cash was used to pay off $201 million in settlement disputes with Yahoo. In order for shareholders to buy shares in Google they must anticipate that Google will be able to generate the same or higher returns than they could earn elsewhere investing in a similar risk company. Google needs to be able to articulate to their investors how they are going to generate returns on their investments.

   There are unlimited possibilities of what Google could do with the proceeds from their IPO. Some possibilities: they could acquire smaller technology companies, hire more employees, increase compensation of existing staff to retain the talent they currently have, develop new products (e.g. customized home pages which they released in May 2005).

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?

Use this question to discuss the whole IPO process: underwriting, syndicates of investment banks, best effort, firm commitment, red herring, underpricing, book building, road show, and beauty contest. Students will need to understand the typical IPO process in order to understand why Google's use of a Dutch Auction was so unique.

The idea behind Google using a Dutch Auction IPO was to help prevent underpricing that traditionally occurs in hot IPOs and also allow small investors the ability to buy shares. A traditional IPO involves a syndicate of investment banks who underwrite the offer and set the offer price based upon the book building process which incorporates the demand for the new shares based on feedback from the road show. The syndicate then distributes these shares to their interested clients. When an IPO is in high demand, as was the case with Google, in a traditional underwriting environment shares typically go to high-end investors who invest in many IPOs and the average investor does not have the opportunity to buy shares.

Although the Dutch Auction did allow small investors to buy shares in Google it did not eliminate the underpricing of Google. In fact, the underpricing on Google was (100.34-85)/85=18.05% on day 1. Studies actually show that IPO underpricing averages between 11% to 20%. One IPO that had an extremely large amount of publicity was Netscape which was underpriced by (54-28)/28=93%. Having shown that the underpricing as defined by the closing price on day 1 being above the offer price did occur with the Google IPO but was still in the range of being normal, the six month and nine month returns for Google are what makes the offer price appear too low. The reasons why the underpricing on day 1 was average but the returns 9 months later make the offer price appear way to low are addressed in the next question.

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?**

This question could be used to discuss Ethical Issues, SEC violations, SEC filings and quiet periods.

It appears that all these events hindered the success of the IPO in the sense that the offer price was lowered from its initially announced range. The offer price appears to be approximately set correctly for the time in which the stock went public due to the amount of underpricing that occurred. However, if they had waited until some of the bad press had ended, possibly several months later, the offer price might have been set higher. Failing to register shares was probably the most troublesome news that came out around the time of the IPO. This is an SEC violation and can have financial consequences.

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?

A good exercise for students would be to do a ratio analysis for Google and compare it to the industry average ratios and Yahoo.

Unlike many of the Internet and technology companies that failed when the dot com bubble bust in 2000, Google had been generating positive net income and cash flows for several years. In fact they had growth of net income in 2003 of 6% and in 2004 of 278%. Net cash from operating activities has also grown tremendously in the last three years. It appears that Google should not be concerned about its current financial status. However, they do need to focus on what they are going to do with the new cash they received from the IPO and determine how to generate the superior returns that their investors are predicting.

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?

"Google's mission is to organize the world's information and make it universally accessible and useful." (http://www.google.com/intl/en/corporate/index.html) Their success has come from their ability to be the best at organizing the world's information and make it universally accessible and useful. Their strategy has not changed and there are no plans for it to change in the future. Their mission statement is broad enough that it is not time sensitive to changes in technology.

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?

In 2003 & 2004, approximately 96% of Google's total revenues came from fees they charge their advertisers. Based on Google's strategy the capital needs over the next few years will be driven by creating a larger employee base and infrastructure to handle their growth as well as acquiring other technology companies. Their plans at the time of the IPO involved spending $300 million on capital equipment in 2004. (http://investor.google.com/pdf/20040630_10-Q.pdf)

Other sources of potential capital could come from venture capital funds, bank loans, or private equity. Students should define each and discuss the pros and cons of each given Google's earnings history.

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

This answer will depend on when the case is analyzed. Students should at a minimum consider: the current stock price, various analyst predictions of Google's future, Google's own earnings forecast, the industry outlook, the market outlook. The risky attributes of Google are largely related to them being a part of the technology industry which is constantly evolving.

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

Not necessarily. The primary difference between book building (the traditional form of IPO offering) and an auction (Dutch or otherwise) is that book building allows discretion to the underwriter in allocating extra shares in the case of oversubscription (i.e. most offerings). It has been argued that this discretion allows the issue to shape its share structure to suit insiders. Some argue rationing favors large shareholders to improve monitoring; some argue rationing is against large shareholders to decrease monitoring. There is little empirical evidence supporting either idea. On the other hand, if you think that management wants a disperse ownership to reduce monitoring then the Dutch auction might give them that more so than book building. However, given that insiders bear the agency costs (as Jensen and Meckling suggest), then reduced monitoring increases agency costs and the shareholders should be indifferent.

COOKIE JAR RESERVES: THE CASE OF CALLAWAY GOLF COMPANY

Brad J. Reed, Southern Illinois University Edwardsville
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.

INSTRUCTORS' NOTES

The accounting issue raised in this case is the proper accounting treatment for the change in the estimated warranty liability by Callaway. There are three possible alternatives to consider: 1) a change in estimate, 2) a change in principle inseparable from a change in estimate and 3) the correction of an error. Note: In 2002 when the dispute arose, the governing accounting standard was Accounting Principles Board No. 20 (APB No. 20) Accounting Changes. In May 2005, Statement of Financial Accounting Standards No. 154 (FAS No. 154), Accounting Changes and Error Corrections, was issued and became effective December 15, 2005. The following teaching notes use FAS No. 154 for guidance since it is the current standard. It is important to note that as FAS No. 154 applies to this case, the guidance is no different from the guidance in APB No. 20, therefore the dispute that existed in 2002 between Callaway and KPMG applies equally to the new standard FAS No. 154.

This case has been tested and found to work well as an assignment (memo) that students prepare outside of class and then bring their memo to class to use in a discussion format. Questions that the student can be asked to address in the assigned memo are detailed in the following section along with suggested answers to the questions. The case is also sufficiently succinct to be presented by the professor in one class section and used as a discussion vehicle for teaching accounting changes and error corrections.

KEY ISSUES FOR DISCUSSION/STUDENT ASSIGNMENT

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 in Callaway's financial statements?**

An estimate is a necessary consequence of periodic financial reporting. Changes are usually made in the light of new information. FAS No. 154 paragraph 2(d) defines a change in accounting estimate as follows:

> *Change in accounting estimate* – a change that has the effect of adjusting the carrying amount of an existing asset or liability or altering the subsequent accounting for existing or future assets or liabilities. A change in accounting estimate is a necessary consequence of the assessment, in conjunction with the periodic presentation of financial statements, of the present status and expected future benefits and obligations associated with assets and liabilities. Changes in accounting estimates result from new information. Examples of items for which estimates are necessary are uncollectible receivables, inventory obsolescence, service lives and salvage values of depreciable assets, and warranty obligations.

It is interesting to note that FAS No. 154 specifically mentions warranties as an example of an item that might be changed due to a change in accounting estimate. If Callaway is changing its estimate of future warranty costs due to new information, then the change would fit the definition of a change in accounting estimate given above.

FAS No. 154 require that changes in accounting estimates be accounted for on a prospective basis. The change should be accounted for in (a) the period of change if the change affects that period only or (b) the period of change and future periods if the change affects both. Prior period's financial statements are not restated and pro forma amounts from prior periods are not reported. The standard also requires the effect on income from continuing operations, net income and related per share amounts of the current period be disclosed if material. If the reduction in estimated warranty liability were to be treated as a change in estimate, the required journal entry would be:

Estimated Warranty Liability	17,000,000	
Miscellaneous Revenues (or expenses)		17,000,000

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 in Callaway's financial statements?

FAS No. 154 paragraph 2(h) defines an error as follows:

> *Error in previously issued financial statements*—an error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in the application of GAAP, or oversight or misuse of facts that existed at the time the financials statements were prepared.

As noted from FAS No. 154, errors occur when financial statement amounts are incorrectly stated or omitted. They occur as a result of mathematical mistakes, mistakes in the application of GAAP, or oversight or misuse of facts that existed at the time the financial statements were prepared Estimates not made in good faith and estimates made by individuals lacking the necessary expertise would also be considered errors. If in the past Callaway was intentionally overstating the warranty liability to enable the company to dip in to the "cookie jar" when they needed additional earnings, then the change in the warranty liability could be considered a correction of an error.

KPMG disagreed with Callaway's treatment of the change in estimated warranty liability. KPMG wanted to treat the change as a correction of error since a substantial portion of the change related to prior periods. The significant impact of the $17,000,000 on the income of 2002 would tend to support this view. Inclusion of the full amount in 2002 causes, income to increase by 19 percent compared to the 10 percent decline if the amount were totally excluded. Even Callaway agreed that the magnitude of the adjustment was unusual and unlikely to reoccur in the near future.

The most important difference between treating the change as a change in accounting estimate vs. the correction of an error is the effect on the current year's income. If the change is treated as the correction of an error, then it would not be included in the current year's income statement. Per FAS No. 154 errors in financial statements of a prior period, discovered subsequent to their issuance, should be reported as a prior period adjustment by restating the prior period's financial statements. Since comparative statements are presented, the required journal entries for the prior periods would be:

Estimated Warranty Liability	XX	
Warranty Expense		XX

for all prior periods presented, and any catch-up adjustment should be recorded as

Estimated Warranty Liability	XX	
Retained Earnings (prior period adjustment)		XX

for the earliest period reported.

Additionally, if the change is treated as the correction of an error, FAS No. 154 requires that:

1. The cumulative effect of the error on periods prior to those presented should be reflected in the carrying amounts of the assets and liabilities as of the beginning of the first period presented.
2. An offsetting adjustment, if any, should be made to the opening balance of retained earnings for that period.
3. Financial statements for each individual prior period presented should be adjusted to reflect correction of the period specific effects of the error.
4. The company is also required to disclose that its previously issued financial statements have been restated and a description of the nature of the error.
5. The company must also disclose a) the effect of the correction on each financial statement line item and each per share amount for each period presented and b) the cumulative effect of the change on retained earnings as of the beginning of the earliest period presented
6. Subsequent financial statements need not repeat the disclosures.

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?

After dismissing KPMG as auditor over this dispute, Callaway hired Deloitte & Touche as their new auditor. With Deloitte & Touche as the new auditor Callaway issued the disputed financial statements and treated the change as a Change in Principle Inseparable from a Change in Estimate. It is interesting to note that this wasn't one of the choices involved in the dispute between KPMG and Callaway.

As noted in FAS No. 154, it is sometimes difficult to distinguish between a change in accounting principle and a change in accounting estimate, especially if the change in estimate is effected by a change in accounting principle. FAS No. 154 paragraph 20 provides the following guidance:

> Distinguishing between a change in an accounting principle and a change in an accounting estimate is sometimes difficult. In some cases, a change in accounting estimate is effected by a change in accounting principle. One example of this type of change is a change in method of depreciation, amortization or depletion for long-lived, nonfinancial assets (hereinafter

> referred to as depreciation method). The new depreciation method is adopted in partial or complete recognition of a change in the estimated future benefits inherent in the asset, the pattern of consumption of those benefits, or the information available to the entity about those benefits. The effect of the change in accounting principle, or the method of applying it, may be inseparable from the effect of the change in accounting estimate. Changes of that type often are related to the continuing process of obtaining additional information and revising estimates and, therefore, are considered changes in estimates for purposes of applying this Statement.

As noted in the standard, a change in accounting estimate effected by a change in accounting principle is accounted for in the same way as a change in estimate. Therefore, the distinction, while important, has no meaningful impact on the financial statements.

As noted in the case, beginning in the second quarter of 2002, Callaway began to gather data relating to the timing of warranty claims in relation to product life cycles. In the third quarter of 2002, based on the collected data, Callaway's significantly changed its warranty liability estimation methodology resulting in a reduction in estimated warranty liability of $17,000,000. In the end, the company took the view that the change in the estimated warranty liability was a change in accounting principle inseparable from a change in accounting estimate, and therefore the proper accounting treatment would be to include the effect of the change in the third quarter of 2002. The required journal entry would be:

Estimated Warranty Liability	17,000,000	
Miscellaneous Revenues		17,000,000

Interestingly, Callaway debited Estimated Warranty Liability and credited Cost of Sales. This treats warranty expense as a product cost instead of a selling expense. Even though the effect on net income is the same in either case, the former has the effect of improving gross profit while the latter has no effect on gross profit.

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

Based upon publicly available information, the authors of this case are of the opinion that the change in the warranty liability should have been accounted for as a change in estimate. A warranty liability is based upon an estimate of future warranty costs. When the estimate of those future warranty costs change, it results in a change in estimate. We believe that KPMG was probably being particularly sensitive to an accounting change that had the effect of increasing income, due to the time period when the change was taking place. During this timeframe, due to numerous accounting scandals, the SEC had issued numerous statements warning the accounting profession of the practice of smoothing earnings through cookie jar reserves. By taking the position stated by KPMG, KPMG must have believed that Callaway had been overstating the warranty reserve on purpose and now when they needed earnings, Callaway was dipping into the cookie jar to increase the current year's income. If KPMG could prove that the past overstatement of the warranty reserve was done in bad faith, then treating the change as a correction of an error would be appropriate.

We believe that Deloitte & Touche did not want to side with KPMG nor with Callaway. Treating the change as a change in estimate inseparable from a change in principle was a way to mediate the problem without taking sides in the dispute.

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

Disclosure of accounting policies is governed by Accounting Principles Board Opinion No. 22 (APB No. 22) entitled Disclosure of Accounting Policies. APB No. 22 paragraph 12 states "disclosure of accounting policies should identify and describe the accounting principles followed by the reporting entity and the methods of applying those principles that materially affect the determination of financial position, cash flows, or results of operations. In general, the disclosure should encompass important judgments as to the appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods".

In 2001, the year prior to the change discussed in the case, Callaway provided the following note regarding its warranty policy (Callaway 2001 annual report). The disclosure was included as part of Callaway's note discussing Significant Accounting Policies.

> *Warranty Policy*—The Company's warranty policy provides two-year limited coverage for golf clubs following the date of purchase. The Company's policy is to accrue the estimated cost of warranty coverage at the time the sale is recorded. In estimating its future warranty obligations the Company considers various relevant factors, including the Company's stated warranty policies and practices, the historical frequency of claims, and the cost to replace or repair its products under warranty. During 2001, 2000 and 1999, the company recorded a warranty provision of $9,527,000, $17,675,000 and $18,023,000, respectively.

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

FAS No. 154 paragraph 22 requires the following disclosures when a company makes a change in estimate.

> The effect on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), and any related per-share amounts of the current period shall be disclosed for a change in estimate that affects several future periods, such as a change in service lives of depreciable assets. Disclosure of those effects is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts or inventory obsolescence; however, disclosure is required if the effect of a change in the estimate is material.

As an example, Callaway's disclosure when they made the change is as follows:

> Beginning in the second quarter of 2001, the Company began to compile data that illustrated the timing of warranty claims in relation to product life cycles. In the third quarter of 2002, the Company determined it had gathered sufficient data and concluded it should enhance its warranty accrual estimation methodology to utilize the additional data. The analysis of the data, in management's judgment, provided management with more insight into timing of claims and demonstrated that some product failures are more likely to occur early in a product's life cycle while other product failures occur in amore linear fashion over the product's life cycle. As a result of its analysis of the recently collected additional information, the Company believes it has gained better insight and improved judgment to more accurately project the ultimate failure rates of its products. As a result of this refinement in its methodology, the Company concluded that it should change its methodology of estimating warranty accruals and reduce its warranty reserve by approximately $17.0 million. The $17.0 million reduction is recorded in cost of sales and favorably impacted gross profit as a percentage of net sales by 2 percentage points for the year ended December 31, 2002. The change in methodology has been accounted for as a change in accounting principle inseparable from a change in estimate.

After the previous paragraph, Callaway then provided a table that showed the impact of the change on net income and earnings per share.

CONCLUSION

While the recommended solution to the case is to treat the change to the warranty reserve as a change in estimate, the company treated the change as a change in principle, inseparable from a change in estimate. Callaway's new auditor, Deloitte & Touche, noted no objection to this accounting treatment in their audit report. The decision to treat the change in this manner might have been a result of Deloitte & Touche not wanting to side with Callaway in the public dispute between Callaway and KPMG, but it also allowed Callaway to report the impact of the change in the current year's income.

REFERENCES

Accounting Principles Board (APB). (1971). *Accounting Changes*. APB No. 20.

Accounting Principles Board (APB) (1972). *Disclosure of Accounting Policies*. APB No. 22.

Callaway Golf Company, *Annual Report*, December 31, 2001.

Callaway Golf Company, 8-K, December 12, 2002, filed December 19, 2002.

Callaway Golf Company, 10-K, December 31, 2002.

Financial Accounting Standards Board (FASB). (2005). *Accounting Changes and Error Corrections*. SFAS No. 154. Stamford, CT: FASB.

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

Holly J. Payne, Western Kentucky University

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.

INSTRUCTORS' NOTES

This case has been developed based on real organization(s) and real organizational experiences. Names, facts, and situations have been changed to protect the privacy of individuals and organizations.

RECOMMENDATIONS FOR TEACHING APPROACHES

Case studies are valuable instructional tools that allow students to apply theoretical, sometimes abstract concepts to different organizational realities (Kreps, 1990; Zorn, 1991). To maximize the effectiveness of this method, instructors should focus on the process of planned, structured discussion as the mode for gaining understanding and developing concise solutions and conclusions (McDade, 1995). Preface "Hard Times at Kelsey High" with a discussion of the difference between the Communication Culture and the Communication Climate of an organization.

Depending on one's approach to the concept, organizational culture is either something an organization *has* with variables that can be manipulated such as rituals, symbols, power structures, etc.(functionalism), or culture is something that an organization *is*, a social construction (symbolism) (Schultz, 1995). In other words culture is created through interaction. Regardless of the theoretical approach to culture, most research on the topic looks at the symbolic nature of organizations and how meaning is created and shared. Researchers primarily use qualitative methods to study culture such as participant observations, structured interviews, or the analysis of texts and symbols.

Organizational climate is the general quality of communication in an organization and is composed of multiple dimensions including communication patterns, openness, trust, and types of messages. Measured quantitatively, this construct is used to assess the overall communication patterns of an organization. Climate is considered an outcome of organizational structure and yet the climate of an organization is commonly held by members of the organization and can be measured by looking for common patterns of perception. According to Denison (1996) and Tagiuri (1968), climate involves organizational conditions and individual reactions. This case presents elements of both culture and climate which students can identify.

Once students have read the case, divide them into groups of no more than five. The group may appoint a chairperson to lead the discussion of their conclusions. Zuelke and Willerman (1995) offer a four-step case study method to move students through the discussion including: 1.) identifying the problem; 2.) stating a short-range solution; 3.) stating a long-range solution; 4.) applying the theories, values, laws, etc. that help the students arrive at the solution. These authors offer the following guidelines for guiding students through the steps.

First, instructors should ask students to provide specific problem identification statements which give examples and detail from the case situation. In other words, students should avoid using generic terms or labels. In creating sound solutions, students should identify key behavioral changes as opposed to single, prescriptive steps. Consider asking students to role play conversations or elements of their solution in action. You can then play devil's advocate or other groups may take on the role of introducing unexpected issues. This allows students to develop strategies which deal with contingencies and it may also tap personal experiences. Long range solutions can be more general in nature. Here, students may identify how the immediate problems are indicative of larger issues. Keep students on track by having them address more general behaviors, problems, or concepts, and develop solutions which follow-up on these issues. In terms of theory application, make sure students do more than identify the applicable theory, by asking them to apply the specific terms and focus on how more than one theory may apply. The discussion questions below lead students through this model. Each group can discuss all of the questions and organize their responses for class discussion as the instructor moves between groups asking questions, offering clarification, and facilitating thoughtful analysis.

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?**

power symbols:	the title of tenured vs. untenured
rituals:	development of the school improvement plan by the administration, faculty meetings, faculty workshops
stories:	The "days of Jack Hatfield"
heroes:	Jack Hatfield, members of the faculty who openly protested change were heroes among their cliques
metaphors:	the "fortress mentality" toward the central district office
norms:	non-constructive forms of resistance, more judgmental that open dialogue
beliefs:	resistance toward state standardized testing, inability to teach students who aren't motivated to learn, lack of trust in newcomers
values:	order, control, smooth running schedules, student discipline, autonomy in the classroom, view of principal as the operations manager, not the instructional leader

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?**

According to Redding (1979) an organization's communication climate is determined by levels of supportiveness, participation in decision making, levels of trust, confidence, and credibility in leaders, and levels of openness and candor. James, Joyce, and Slocum (1988) outline five attitudinal variables which measure climate including: conflict and ambiguity, job challenge, importance, and variety, leader facilitation and support, work group cooperation, friendliness and warmth, and professional and organization esprit. Students can pick numerous examples which describe these characteristics.

- Pressure from state and local stakeholders regarding substandard test scores
- Low morale due to administration's lack of responsiveness to faculty concerns, lack of unity among faculty, no team spirit to work together for student learning.
- New teachers perceived a lack of openness with tenured faculty (cliquey)
- Lack of confidence in the old principal who avoided complex personnel issues
- Faculty focus on student disciplinary problems, which they perceived the administration could remedy.
- Perception of Rose as the superintendent's change agent which lead to a lack of trust as well as the tentative role of being the "interim" principal.

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?

While Rose's perspective is probably somewhat accurate, she is lacking perspective on the steps involved and the time-table for implementing change. The *role of change agent* is critical in ensuring success. Strong change agents must *listen* and *communicate* with the organization's members. Specifically, Rose should *recognize the types of resistance* to any change including general resistance to new ideas due to upsetting the status quo, personal resistance based on how the change will impact the individual, resistance based on the success or failure of other changes (the history of change within the organization), and resistance to the change agent based on communication issues, association with management, a lack of developed relationships with members across the organization and even gender (Lange, 1984).

According to Rogers (1995) *change and innovation are made up of 5 steps*: knowledge, persuasion, decision, implementation, and confirmation. Rose seems to be rushing the steps and needs to *focus more on persuasion*. Timing is a big problem and she's trying to do too much, too soon. Employees base their impression of the change on the advantages, compatibility, and complexity of the project with their current work lives.

Clampitt (2005) proposes a *strategic change process* focusing specifically on communication. The change agent, in this case, Rose, should study how the change will impact the culture, the major groups impacted by the change, groups who might pose resistance or key opinion leaders in groups, design of objectives for the change including unifying themes, and *tactics for communicating* and negotiating change through channels, messages, timing, and people.

Finally, Rose should understand the value of resistance as a form of dialogue. Specifically, she should *seek resistance* and invite discussion and debate publicly with a focus on listening and jointly creating solutions. In essence this is what is happening at the end of the story and it gives her hope.

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.**

Suggestions for Rose:

- Focus on reducing role conflict by delegating more facilities issues to Assistant Principals
- Increase listening and dialogue by conducting one-on-one and group meetings
- Show commitment to helping faculty workload, facilitate dialogue by asking them for solutions to the problems which contribute to the schools goals and mission
- Create a workload committee whose focus is on how create balance for teachers including program assistance and scheduling issues
- Integrate new programs, but get rid of ones that don't work
- Develop action research groups to study the effectiveness of new instructional programs to assist in making decisions of the continued use of programs and activities
- Plan a strategic communication plan for meeting with various school groups and opinion leaders
- Work to transform the negative climate by:
    - Seeking more information by listening openly (which does not mean acceptance of the status quo but does mean acceptance of criticism)
    - Asking for specifics, ask questions, ask for opinions on needs, ask about the impact of Rose's behavior on the faculty
    - Agreeing with the critics
    - Agreeing with the truth, but disagreeing with the judgment, working to understand perception

As change agent, Rose needs to focus more on relationship development which takes time.

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?**

(Open response)

Students can identify the specific elements of culture that may block change. If they can't think of an example, ask them to develop a change scenario they feel would be difficult for their current organizations. Ask other students to develop strategies for resolving the issues addressed.

REFERENCES

Clampitt, P.G. (2005). *Communicating for managerial effectiveness (Third Edition).* Thousand Oaks, CA: Sage Publications, Inc.

Denison, D.R. (1996). What is the difference between organizational culture and organizational climate? A native's point of view on a decade of paradigm wars. *Academy of Management Review, 21*, 619-655.

James, L., Joyce, W., Slocum, J. (1988). Comment: Organizations do not cognize. *Academy of Management Review, 12*(1), 129-132.

Kreps, G.L. (1990). *Organizational communication: Theory and practice*. New York: Longman.

Lange, J. (1984). Seeking client resistance: Rhetorical strategy in communication consulting. *Journal of Applied Communication Research, 12*, 50-67.

McDade, S.A. (1995). Case study pedagogy to advance critical thinking. *Teaching of psychology, 22,* 9-10.

Redding, W.C. (1972). *Communication within the organization: An interpretive review of theory and research*. New York: Industrial Communication Council.

Rogers, E.M. (1995). *Diffusion of innovations (Fourth Edition).* New York: The Free Press.

Schultz, M. (1995). *On studying organizational cultures: Diagnosis and understanding.* New York: Walter de Gruyter.

Tagiuri, R. (1968). The concepts of organizational climate. In R. Tagiuri and G. Litwin (Eds.), *Organizational climate: Exploration of a concept*. Boston, MA: Harvard Press.

Zorn, T.E. (1991). Willy Loman's lesson: Teaching identity management with 'Death of a Salesman.' *Communication Education, 40*, 219-224.

Zuekle, D.C. & Willerman, M. (1995). The case study approach to teaching in education administration and supervision preparation programs. *Education, 115,* 604-611.

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.

INSTRUCTORS' NOTES

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

   See response to Question 2, below.

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

   In response to the first two questions, students will undoubtedly imagine a wide range of specific services and a variety of activities necessary to perform these services, however, the text of the case provides enough detail that students should be able to identify a number of services and activities. The following table provides an example that is neither exhaustive nor is it intended to represent a minimum response.

Table 1: Services Provided by Mason-fleming

SERVICE	ACTIVITIES
Line Construction	Engineering and planning Obtain right-of way Purchasing Construction
Substation Construction	Obtain site Engineering and planning Purchasing Construction
Line Maintenance	Clearing right-of way Replacing poles Replacing lines Engineering and planning
Substation Maintenance	Cleaning and clearing site Replacing/ maintaining equipment Engineering and planning
Power Purchasing	Project need Contract negotiation
Power Distribution	Transformation Metering Billing Collections

Table 1: Services Provided by Mason-fleming	
SERVICE	ACTIVITIES
Outage Response and Restoration	Monitoring Activation of response team Travel to and from site Repair
Marketing	Planning Artistic control Media purchases Effectiveness assessment

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

In answering the third question, students will likely observe that certain activities such as engineering are common to more than one service. They should be able to identify pools such as: engineering, purchasing, accounts payable, power demand forecasting, power acquisition, real property acquisition, real property maintenance, personnel, billing and accounts collectable, plant asset planning and acquisition, plant asset maintenance, and marketing. In the United States most ABC systems use a limited number of pools. The specific number of cost pools and whether activities are grouped together into fewer pools or accounted for in more detail is a function of the detail identified in the first two questions.

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.

In response to the fourth question, students will be able to conclude that it is possible to pool like activities across services as long as they provide the level of detail necessary to meet the billing requirements of unbundled billing. To provide the necessary detail the billing must be subdivided by individual service. To accomplish this task the activities must be logically and equitably identified with the different services they support. Following this process helps students understand the difference between ABC and traditional volume-based costing and helps them identify how ABC is superior. It should be come apparent to them that there are a number of costs associated with an activity and that these costs can be passed along to the service based on the level of usage of the activity. To complete this question, they might choose some activity such as Engineering that had been identified as appropriate for a separate cost pool. They would then list the costs of providing an Engineering Department. These costs should include the cost of engineer's salaries and benefits, the cost of the office space in which they work, and the cost of the supplies they use. A very detailed student response, from students who have a good background in costing, might include assigned cost from other pools like personnel and utilities. Depending on the knowledge level of the students and the goals of the instructor, this could even be expanded into a discussion of joint cost allocation and the different joint allocation methods. This is one area where the solution one would expect of lower-level students and the response one would expect of those in an advanced class might be considerably different. A response using assumed simplified numbers is presented below.

Engineering Department Cost		
Salaries and Benefits	$10,000	
Work Space	6,000	
Supplies	4,000	-
Total Cost	$20,000	
Percentage of Engineering time spent in each service and resulting cost to that service:		
Line Construction	45%	($20,000) =$9,000
Substation Construction	15%	($20,000) = 3,000
Line Maintenance	20%	($20,000) = 4,000
Substation Maintenance	20%	($20,000) = 4,000

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

Fleming-Mason Energy, like all electric cooperatives, serves a restricted area and is likely to follow a focus strategy. Students may be encouraged to do some additional research on the original purpose of the REA and conclude that the quality of service is historically more important to these owner/customers than is price. However, with deregulation, and the increased population in many of the areas served by electric cooperatives, competing on price will become necessary. If students are encouraged to obtain additional information, the following web sites are helpful.

http://www.usda.gov./rus/electric/index.htm
http://www.fmenergy.net/
http://v001u22was.maximumasp.com/kaec/default.htm

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

In response to the sixth questions, it is not unreasonable to conclude that Fleming-Mason Energy will stress its position as a customer owned entity and its long history of service spanning a time when larger for-profit providers were unwilling to provide service to rural areas. This strategy will necessitate that Fleming-Mason Energy identify those services the members identify as characteristic of the customer/company relationship and continue to control those services. Distribution and outage response and restoration are likely the two services most central to this relationship.

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

See response to Question 8, below.

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

All areas not identified as core services in Question 6 might be considered for outsourcing in response to the seventh question. However, students should realize that careful consideration must be given to the cost, quality, and reliability of these services as provided by others versus the cost, quality, and reliability as provided by Fleming-Mason Energy. An appropriate discussion here would include the danger of relying on an outside supplier who might provide the services at a lower cost until Fleming-Mason Energy lost the capacity to supply the service then raise the price to force Fleming-Mason Energy to pay more or reinvest in capacity.

Additional information is available on this company from the website (http://www.fmenergy.net/) listed above. I have also included a set of the most recent publicly available financial statements for Mason-Fleming Energy. These statements are not essential to arriving at a satisfactory solution to the case, but the instructor may wish to incorporate the information into a longer or more detailed discussion of the case.

Table 2: MASON FLEMING BALANCE SHEET 1/1/2003 Part 1 Assets and Other Debits		
Item	Balance Beginning of Year	Balance End of Year
UTILITY PLANT		
Utility Plant	$54,946,616.00	$57,968,083.00
Less: Accumulated Provision for		
Depreciation and Amortization	$13,823,066.00	$15,016,287.00
Net Utility Plant	$41,123,550.00	$42,951,796.00
OTHER PROPERTY AND INVESTMENTS		
Investments in Assoc. Organizations	$10,086,084.00	$,1309,1134.00
Other Investments	$27,886.00	$41,403.00
Total Other Property and Investments	$10,113,970.00	$13,132,537.00
Cash-General	$396,812.00	$509,923.00
Working Funds	$935.00	$890.00
Consumer Accounts Receivable	$4,202,767.00	$4,308,119.00
Other Accounts Receivable	$827,870.00	$2,778,336.00
Accumulated Provision for Uncollectable Receivables -Cr	$139,109.00	$53,224.00
Materials and Supplies-Electric	$253,840.00	$232,217.00
Prepayments	$222,442.00	$206,276.00
Interest and Dividends Receivable	$6,920.00	$6,922.00
Total Current and Accrued Assets	$5,772,477.00	$7,989,459.00
DEFERRED DEBITS		
Preliminary Survey and Investigation Charges	$37,000.00	$27,750.00
Miscellaneous Deferred Debits	$10,156.00	
Total Deferred Debits	$47,156.00	$27,750.00
TOTAL ASSETS AND OTHER DEBITS	$57,057,153.00	$64,101,542.00

Table 3: MASON FLEMING BALANCE SHEET 1/1/2003 Part 2 Liabilities and Other Credits		
EQUITIES AND MARGINS		
Memberships	$212,964.00	$216,734.00
Patronage Capitol	$17,572,575.00	$20,808,489.00
Donated Capital	$17,369.00	$18,696.00
Other Margins and Equities	$3,312,249.00	$2,547,207.00
Total Equities and Margins	$21,115,157.00	$23,591,126.00
LONG TERM DEBT		
Long-Term Debt-REA Construction - Net	$10,024,356.00	$9,622,299.00
Long-Term Debt-CFC Construction - Net	$4,549,229.00	$4,389,726.00
Other Long-Term Debt	$11,784,810.00	$17,300,916.00
Total Long Term Debt	$26,358,395.00	$31,312,941.00
Accumulated Operating Provisions	$1,197,474.00	$1,359,898.00
CURRENT AND ACCRUED LIABILITIES		
Notes Payable	$3,366,693.00	$2,333,593.00
Accounts Payable	$3,521,375.00	$3,910,894.00
Consumers Deposits	$594,078.00	$582,600.00
Taxes Accrued	$32,140.00	$14,933.00
Interest Accrued	$44,083.00	$37,894.00
Tax Collections Payable	$4,781.00	$4,887.00
Misc. Current and Accrued Liabilities	$803,138.00	$953,284.00
Total Current and Accrued Liabilities	$8,366,288.00	$7,838,085.00
DEFERRED CREDITS		
Consumer Adv. for Construction	$15,326.00	$13,844.00
Consumers Energy Prepayments	$,5440.00	$4,633.00
Other Deferred Credits	($927.00)	($18,985.00)
Total Deferred Credits	$19,839.00	($508.00)
TOTAL LIABILITIES AND OTHER CREDITS	$57,057,153.00	$64,101,542.00

Table 4: SCHEDULE OF ELECTRIC PLANT ASSETS IN SERVICE					
Item	Depreciation Rate	Balance Beginning of Year	Additions	Retirements	Balance End of Year
INTANGIBLE PLANT					
Misc. Intangible Plant	3.07	$15,634.00			$15,634.00
Total Intangible Plant		$15,634.00			$15,634.00
DISTRIBUTION PLANT					
Poles Towers and Fixtures	3.96	$21,014,407.00	$967,268.00	$230,035.00	$21,751,639.00
Overhead Conduit and Devices	2.87	$12,354,162.00	$717,796.00	$98,847.00	$12,973,111.00
Underground Conduit & Devices	3.14	$691,390.00	$31,002.00	$270.00	$722,122.00
Line transformers	3.60	$10,953,593.00	$691,692.00	$298,140.00	$11,347,145.00
Services	3.80	$3,410,363.00	$256,294.00	$17,210.00	$3,649,448.00
Meters	4.78	$1,932,797.00	$209,364.00	$58,813.00	$2,083,347.00
Installed on Customer Premises	3.42	$928,250.00	$63,313.00	$4,982.00	$986,581.00
Total Distribution Plant		$51,284,962.00	$2,936,729.00	$708,297.00	$53,513,394.00
GENERAL PLANT					
Land and Land Rights		$21,979.00			$21,979.00
Structures and Improvements	2.50	$718,025.00	$11,000.00	$8,445.00	$720,580.00
Office Furniture and Equip	6.00	$454,534.00	$36,392.00	$11,937.00	$478,988.00
Transportation Equipment	VARIOUS	$1,419,064.00	$178,658.00	$105,580.00	$1,492,142.00
Stores equipment	4.50	$25,391.00			$25,390.00
Tools Shop and Garage Equip	5.00	$152,021.00	$28,512.00	$15,174.00	$165,360.00
Laboratory Equipment	4.00	$51,609.00			$51,609.00
Power Operated Equip	16.00	$20,922.00			$20,922.00
Communication Equip	5.00	$94,396.00	$48,116.00	$67,312.00	$75,200.00
Miscellaneous Equip	4.00	$42,235.00	$1,663.00	$292.00	$43,606.00
Total General Plant		$3,000,176.00	$304,341.00	$208,740.00	$3,095,777.00
TOTAL ELECTRIC					
PLANT IN SERVICE		$54,300,772.00	$3,241,070.00	$917,037.00	$56,624,805.00

Table 5: ACCUMULATED PROVISIONS FOR DEPRECIATION OF ELECTRIC PLANT ASSETS IN SERVICE		
Item	Amount	
Balance Beginning of Year		$13,823,066.00
Depreciation Provisions for Year Charged To:		
Depreciation Expenses		$1,962,608.00
Transportation Expense-Clearing		$160,526.00
Other Accounts (detail)		
Stores Expense - Clearing	$1,028.00	
Total Depreciation Provisions for Year		$2,124,162.00
Credit Adjustments (describe)		
Reimbursements - Line Relocations	$71,723.00	
Sale of Scrap Material	$3,192.00	
Total Credits for Year		$74,915.00
Net Charges for Plant Retired		
Book Cost of Plant Retired		$917,037.00
Cost or Removal		$115,766.00
Salvage (Credit)		$1,834.00
Net Charges for Plant Retired:		$1,030,969.00
Debit Adjustments (describe)		
Retirement Work in Progress	($25,113.00)	
Total Debits for Year		$1,005,856.00
Balance End of Year		$15,016,287.00

Table 6: STATEMENT OF INCOME FOR THE YEAR			
Item	Avg. No. of Consumers	Kilowatt Hrs. Sold	Amount
OPERATING REVENUES			
Residential Sales			
Rural	16,434	245,727,668	$15,416,022.00
Seasonal	4,021	13,444,703	$1,094,778.00
Towns and Villages	0	0	$0.00
Total	20,455	259,172,371	$16,510,800.00
Irrigation Sales	0	0	$0.00
Commercial and Industrial Sales			
Small	1,401	10,823,8065	$6,000,923.00
Large	5	524,192,657	$18,947,175.00
Total	1,406	632,430,722	$24,948,098.00
Public Street and Highway Lighting	3	74,868	$7,992.00
Sales to Public Buildings and Authorities	258	2,221,014	$154,153.00
Sales for Resale	0	0	$0.00
Total Sales of Electricity	22,122	893,898,975	$41,621,043.00
OTHER OPERATING REVENUES			
Forfeited Discounts			$224,458.00
Miscellaneous Service Revenues			$178,365.00
Rent From Electric Property			$274,549.00
Other Electric Revenues			$5,184.00
Total Other Operating Revenues			$682,555.00
Total Electric Operating Revenues			$42,303,598.00

Table 7: STATEMENT OF INCOME FOR THE YEAR (Continued)			
OPERATING EXPENSES			
Total Operation and Maintenance Expenses			$38916210.00
Depreciation Expense			$1962608.00
Amortization Expense			$0.00
Taxes Other Than Income Taxes			$42545.00
Total Operating Expenses			$40921363.00
Operating Income			$1382234.00
OTHER DEDUCTIONS			
Taxes Other Than Income Taxes - OTHER			$0.00
Misc Income Deductions			$8949.00
Interest on Long Term Debt			$802619.00
CFC Non-Cash Dividend - Cr			$0.00
Amortization of Debt Discount and Expense			$0.00
Other Interest Charges			$112464.00
Total Other Deductions			$924032.00
Net Income From Electric Operations			$458202.00
OTHER INCOME			
Revs. From Mdse. Jobbing and Ct. Work			$16699.00
Costs and Expenses of Mdse. Jobbing and Ct. Work			($15578.00)
Income From Non-Utility Operations			$0.00
Nonoperating Rental Income			($173863.00)
Interest and Dividend Income			$66473.00
Miscellaneous Nonoperating Income			($26239.00)
G & T Coop Capital Credits			$2265834.00
Other Capital Credits			$30286.00
Total Other Income	0	0	$2163612.00
NET INCOME	0	0	$2621814.00

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

Narendra C. Bhandari, Pace University

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.

INSTRUCTORS' NOTES

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

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.

RECOMMENDATIONS FOR TEACHING APPROACHES

As presented below, there is more than one way to teach this case.

Individual Study

A teacher can distribute this case among his/her students, ask them to study it individually, and ask them to answer all the discussion questions.

Each student can then individually present his/her findings to the class. Depending upon the number of students in the class, the individual presentations can take several hours.

If appropriate, an entire class discussion could follow. The teacher can then make his/her own observations.

The students may also be required to write all their answers in a formal manner and give them to the teacher. In this case, the teacher should make sure to read all the papers and return them to the students with his/her comments in a timely fashion.

Team Project

A teacher may divide his/her class into small teams, with each team made up of 2-4 students. Each team should study the case, discuss it, and answer all questions presented at the end of the case.

A representative from each group should verbally present his/her team's answers to the entire class.

If appropriate, an entire class discussion could follow. The teacher can then make his/her own observations.

The team may also be required to write all their answers in a formal manner and give them to the teacher. In this case, the teacher should make sure to read all the papers and return them to the teams with his/her comments in a timely fashion.

Use of Technology

Whatever the approach, class discussion could be enhanced by using equipment such as a PowerPoint projector or an overhead transparency projector.

ANSWERS TO 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?

A careful review and comparison of the facts as presented in Exhibit 1 is classified and discussed as follows:

Equipment Brand Name, Model, Capacity, Tonnage, and Efficiency

As presented in Exhibit 1, all four proposals received by the Browns mentioned the brand name of the air conditioning equipment (Home Comfort) that the contractors proposed to install. However, the similarity ended there. While Contractors 1, 2, and 3 also mentioned the model name, Contractor 4 did not do so. Contractors 1, 2 and 4 mentioned their respective model numbers, but Contractor 3 did not. Contractors 1, 3, and 4 mentioned their equipment's cooling capacity, but Contractor 2, did not.

Contractors 1, 2, and 3 offered to install a 14 SEER unit, while Contractor 4 offered to install a 13 SEER unit. The former is more efficient than the latter.

All four proposals stated that the air conditioning equipment would come with a coil (indoor cooling coil). The similarity of this description, however, ended there. Proposals 1 and 2 mentioned the accompanying coil's brand name. Proposal 3 did not mention the brand name of the coil. This proposal only stated that the company would provide a "matching coil." Proposal 4's writing was illegible in this regard. While Proposals 1 and 2 also mentioned the model number of the coil, the other two proposals did not do so.

Fuse Line, Refrigerant Piping

All four proposals stated that the outside air conditioner unit would be connected with the inside cooling coil using a fuse line and a refrigerant pipe.

Disconnect Switch

Proposals 1, 2 and 4 stated that they would install a "disconnect switch" near the air conditioner unit outside the house. Contractor 3 did not mention this item in his proposal. (Installation of a disconnect switch is a legal requirement in the state where the Browns live.)

Discharge of Condensate

Both Proposals 1 and 2 offered to install a gravity feed pump on the floor (in the basement of the house, next to the furnace), to carry the condensate generated by the inside cooling coil into the sump pump pit located in a corner of the basement. Contractor 3, instead, suggested using the existing pipeline to carry the condensate to the sump pump pit. Proposal 4 did not mention how the condensate would be discharged.

Concrete Slab Under the Air Conditioner

Proposals 1, 2, and 4 stated that the company would place a concrete slab under the new air conditioner (outside the house). None of them, however, mentioned that they would remove the concrete slab on which the old air conditioner was resting. Contractor 3 did not mention any kind of slab in his proposal at all.

Recommendations to Contractors

I make the following recommendations to all these contractors to help them write their proposals in a clear, complete and comparable way:

1. Each proposal should provide a clear and complete description of the brand name, model number, cooling capacity, and efficiency of the air conditioning equipment to be installed.
2. Each proposal should provide a clear and complete description of the coil to be used: its brand name, model number, and capacity.
3. Each proposal should clearly mention that fuse line and refrigerant pipe would be used for connecting the outside unit to the inside coils.
4. Each proposal should clearly mention that a disconnect switch would be installed outside the home near the central air conditioning unit. (This is required by the local laws.) Additionally, it should mention that the homeowner should lockup the switchbox in order to protect it from any possible vandalism or pranks. The contractors may also provide this lock to the homeowner.
5. Each proposal should clearly describe how the condensate would be discharged. What kind of pump would be used for this purpose? What are the brand name, model number, and the capacity of the pump? The size, length, and composition of the plastic tube to carry the condensate should be described.
6. Each proposal should clearly describe (if applicable) how the existing concrete slab sitting under the current air conditioning unit would be disposed of, and the kind, shape, and size of the replacement slab.

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?

A careful review and analysis of the facts as presented in Exhibit 2 are classified and discussed as follows:

Heating Equipment

As shown in Exhibit 2, all four proposals stated the brand name (Home Comfort) and the model name (E&Q) of the central gas-heating furnace that they proposed to install. In terms of the model number of their equipment, Proposals 1 and 4 fully stated this number, Proposal 2 mentioned it only partially, and Proposal 3 ignored it completely.

The Browns studied the Home Comfort brochures that the contractors left with them and found that the furnaces proposed by Contractors 1, 2, and 3 have a direct vent capability, if needed, while the one proposed by Contractor 4 does not. (A direct vent unit takes air in from outside the home for combustion.)

All proposals stated the input capacity of their equipment. They all also mentioned their output efficiency. Proposal 3 stated that its 100,000 BTUs capacity unit would have a 92.5% efficiency. Home Comfort makes several varieties (non-direct, direct, up flow, down flow, etc.) of gas furnaces in the 100,000 BTUs category. No furnace with a 92.5% efficiency, however, was included in the Home Comfort brochures that the contractors made available to the Browns. Therefore, it is not clear which furnace model this contractor proposed to install.

Proposal 3 also did not mention the model number of its equipment, nor its tonnage. The Browns, therefore, were unable to know which particular equipment Contractor 3 was proposing to install.

The tonnage of a furnace, a measure of airflow, was mentioned only in Proposal 2. Proposals 1, 3, and 4 did not do so.

Air filter

A regular air filter comes with the furnace at no additional charge. Contractors 1, 2, and 3 offered special air filters at an additional charge. Contractor 4 did not include a special air filter in his proposal.

Recommendations to Contractors

I make the following recommendations to all these contractors to help them write these proposals in a clear, complete, and comparable way:

1. In addition to providing clear and complete information about the brand name and the model name of the central gas-heating furnace, each proposal should also provide clear and complete information about the model number of the equipment.
2. Each proposal should fully and clearly state if the proposed equipment has the direct vent capability, and if this option would be used.
3. In addition to stating the input capacity of the furnace, each proposal should also mention its output capacity.
4. Each proposal should clearly and completely mention the tonnage (a measure of air flow) of the equipment proposed for installation

Following these recommendations is in the interest of the contractors. It would help them increase their credibility and enhance their business.

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?

Exhibit 3 is a prime example of how these proposals can present unclear, confusing, and incomparable information. In the case of a gas furnace, for example, Proposal 1 offered a 20-year and/or lifetime limited warranty on the heat element to the original owner. Proposal 2 stated that the contractor would provide a one-year warranty on parts and labor. It added that there is a lifetime warranty on the heat exchanger parts (not the labor). However, it was not stated who is to provide these warranties, the contractor or the manufacturer.

Proposal 3 stated that the contractor would provide a two-year warranty on parts and labor, and that the manufacturer would provide a lifetime warranty on the heat exchanger. Proposal 4 offered a one-year warranty on labor, five years on parts, and twenty years on the heat exchanger.

Recommendations to Contractors

Comparing these warranties offered by the four contractors appears to be the most challenging task. I therefore make the following recommendations to all these contractors to help them write these proposals in a clearer, more complete, and comparable way:

1. Warranties should be offered on every important item such as air conditioning unit, coil, and heat exchanger.
2. Warranties should be offered on the overall work.
3. The following items should be clearly stated:
    a. What is covered by the warranty: parts and/or labor,
    b. The cost of warranties to the home-owner,
    c. The time period of warranties, and
    d. The name, address, and contact information of the warranty provider (contractor or manufacturer).

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?

While most of the quotations are self-explanatory, Proposals 2 and 4 did not mention the rebate available from the manufacturer. Was this an attempt by contractors 2 and 4 to keep these rebates for themselves?

Contractors 1 and 3 offered flexible financial arrangements. Contractors 2 and 4 did not mention their financial terms in their proposals at all.

The final net price of each contractor added up as follows: \$4,916 (Contractor 1), \$5,920 (Contractor 2), \$5,926 (Contractor 3), and \$6,529 (Contractor 4). Contractor 1 had the lowest bid.

Recommendations to Contractors

I make the following recommendations to all these contractors to help them write these proposals in a clear, complete, and comparable way:

1. Each proposal should clearly provide a complete breakdown of all cost components.

2. While I recognize that different contractors have different cost structures and markups, too much price differential between the various contractors can make some of them lose good business. Contractor 4's proposal, that offered lower capacity and lower efficiency equipment, was, however, the most expensive one--about 33% higher than that of Contractor 1.
3. It would be helpful to the contractors to study (without violating the anti-trust laws) the prices their competitors charge to do these jobs.

I must recognize here the possibility that some contractors prefer not to share many details with their customers about what and how they would implement their proposals. They have plenty of jobs available to them. They can afford to lose a few of them. The practice of not sharing certain details gives them the opportunity to charge extra to their customers for doing things that the original proposals did not clarify.

From the homeowners' point of view, consequently, it makes sense to make an extra effort to clarify all the things that they can.

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?

After an extensive analysis of the facts presented in the Exhibits 1-4, I recommend that the Brown family select the proposal made by Contractor 1. My reasons for this recommendation follow:

1. Compared to the other three contractors, Contractor 1 provided clearer, more complete, and comparable information about the brand name, model number, cooling capacity, and the efficiency of the air conditioning equipment it proposed to install.
2. Compared to the other three contractors, Contractor 1 provided clearer, more complete, and comparable information about the brand name, model number, input capacity, and the output efficiency of the gas-heating equipment that it proposed to install.
3 Overall, the warranties offered by Contractor 1 are better and more clearly stated, as compared to those offered by the other three contractors.
4. The final net price of each contractor added up as follows: $4,916 (Contractor 1), $5,920 (Contractor 2), $5,926 (Contractor 3), and $6,529 (Contractor 4). It is clear that Contractor 1 had the lowest bid. Overall, he also offered better equipment. The choice is clear.

It is important to emphasize here that providing clear, complete, and comparable information about one's products and services is a major requirement of success in any business. As in this case, for example, if a contractor does not specify which particular equipment (brand name, model number, etc.,) he is proposing to install, the homeowner would never know exactly what equipment is being proposed. Even with good intentions, the equipment actually installed may be different from what was intended. The devil could very well be in the details. At the very least, it slows down the selection process.

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.

I suggest that these proposals should also state/provide the following information to make them clear, complete, and meaningful:

1. That the contractor and his/her workers, while on the job, are all fully covered by the contractor's liability and workman's compensation insurance;
2. That the workers who would do this job are fully qualified to do the job;
3. That the work will be done in conformance with the existing legal codes;
4. That all equipment and parts to be installed are new;
5. That all old equipment, parts, and other items would be removed properly by the contractor;
6. That, once started, the work will be finished in, say, four business days;
7. That the workers would sweep, clean, and remove all debris from the premises at the end of each day;
8. That the final payment would be made after the township has approved the work; and
9. That the contractor would be glad to provide references, if needed.

7. What other suggestions would you make?

I make the following additional suggestions:

1. If it was not just a coincidence that none of the contractors or sales persons that the Browns met were women, interested women should consider exploring employment or entrepreneurial opportunities in this industry. This industry has good profit potential for the following reasons:

a. Once the contractors have submitted their proposals to the home owners, the former seldom call back the latter about the latter's decision. It shows that the contractors have plenty of business available to them and do not waste their time making the follow-up calls.

b. Assuming that small businesses cannot survive for long without making reasonable profits, and recognizing the fact that there is a substantial price difference among various proposals, the contractors have the opportunity to make small and large profits, depending on the amount of business that they do.

2. My research shows that there are instructional videos available for doing different kinds of construction, electric, and mechanical projects in and around the house, such as building a patio, installing in-ground sprinklers, and auto repairs. A video for the installation of air heat equipment would also be very useful. While the Browns, and millions of people like them, may never install such complicated equipment themselves, a video can certainly help them learn how the people working for them are doing it. Besides, for the home improvement stores, this would be an additional revenue-generating item.

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.

Many well-known companies are involved in the manufacturing of this equipment in the U.S. They include General Electric, Honeywell, Kelvinator, Samsung, and Trane, among others. (For financial and other information about these companies, students should refer to publications such as *Value Line* and *Standard and Poor's*.)

ENDNOTE

The author thanks Pace University, New York and Diana Ward of its editorial support office, for providing support in preparing this article. The author is also thankful to the JIACS's reviewers for their very valuable suggestions for its completion.

REFERENCES

Checket-Hanks, B. (2003, December 22). Profits are there for the taking, *Air Conditioning, Heating, & Refrigeration News,* 220 (17), 1.

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.

INSTRUCTORS' NOTES

Teaching objective

The Dixon's Famous Chili case covers a wide range of family, woman, and entrepreneurial issues that are addressed below. Due to the issue breadth of this case, the various issues are broken down below. Instructors are then free to choose any combination of discussion areas depending upon the structure of the class and when the Dixon's case is used. The case is designed for an upper level undergraduate or beginning graduate course.

Introduction

Everyone has some sort of experience with restaurants; many students have worked or are still working in food service while in college. For the rest of us, who hasn't eaten out at least once in their lifetime? Given the universality of restaurants, a good way of beginning discussion is on the key success factors for restaurants (Bygrave, 1996):

• Menu	• Quality of food
• Quality of service	• Easy access
• Chef	• Reliable, friendly staff
• Atmosphere	• Control of costs
• Location	• Price

Family Business Structure

Family businesses grow through a life cycle just like any other type of business but this time with the added dynamic of a family. Family businesses move through the following five stages (Gallo, 2002):

1. Family Employment Firm (FEF) – as many family members as can be accommodated are employed in the new endeavor.
2. Family Management Firm (FMF) – family members with formal education move into management roles.

3. Family Governance Firm (FGF) – family members move out of direct daily management and into roles as officers and board members.
4. Family Governance and Investment Firm (FGIF) – the family firm is now moving into community involvement and creating/funding new family ventures.
5. Family Firm Turning Point – time at which the family decides to cease being a strictly family owned firm.

FAMILY BUSINESS STRUCTURE DISCUSSION PART 1

Keep in mind that all models attempt to approximate reality by putting an understandable framework around what are often times, particularly in the social sciences, unpredictable phenomena.

1. Given this, what do you think of the above model? While the model does make logical sense, more questions are raised than answered. How do firms progress from one state to the other? What demarks the beginning of one stage and the ending of another? Can firms occupy more than one stage at a time?

2. Now that you have critically examined the model, how does Dixon's Famous Chili fit with the model? At this point students can view the model as having utility as well. Too often students take what they read as gospel truth or as complete wrong. The reality is that no model can perfectly capture the human experience, but there is worth is both critical analysis as well as model application.

   A key factor left out of this model is conflict. Conflict is inevitable, after varying lengths of time, anytime two or more people are together. Families can be together for the longest time possible, a lifetime, while the business is designed to outlive them all.

   Have the students think of positive conflict; when does conflict serve as a good thing? Answers should appear from all areas of life, but for the most part, when conflict remains impersonal and focused on the problem or issue, and not an individual, organizations can use conflict to change, improve and move forward. If students believe that some conflict must become personal ask them to clarify and then move the discussion into possible solutions; was the wrong person in the wrong place at the wrong time. Oftentimes, through no fault of our own, individuals find themselves in the heart of conflict with no understanding of how they got there or what to do next. Hopefully, the majority of your students can relate to such a situation and begin to see conflict as a positive growth opportunity, not an individual bullying and blaming opportunity.

   When self-interest overtakes the interest of the family and/or the best interests of the family firm, conflict has unlinked the family from the business. Positive conflict does not lose sight of the cohesion between the family and the business. When dealing with conflict, linked families keep in mind the impact their behaviors have on the firm and hence, the family's welfare. When this link is broken, conflict becomes individualized, relationships destroyed and decisions are now made without taking the family and the business' welfare into account (Kellermanns and Eddleston, 2004).

Another factor left out of Gallo's (2002) family business structure is time; time spent in each level or the amount of time that needs to be spent at each level. The time factor most applicable to the Dixon's case study is generational time. As this case proves, it is possible for a family owned firm to move up and down in the Gallo (2002) model over generations. Building upon the issue of generational time, the influence of the founder, while powerful and oftentimes ongoing (Kelly et al, 2000) will be reinterpreted and adjusted by succeeding generations. Conflict is often the launching point for reinterpreting the founder's vision as well as the impact of changing culture and markets.

FAMILY BUSINESS STRUCTURE DISCUSSION PART 2

Based upon the general conflict discussion that took place, move that into a family business environment and Dixon's in particular, keeping in mind that positive conflict is not an oxymoron.

1. When did positive conflict take place? Vergne's decision to sell, the stipend to his wife, Leonard's customer service drive, Terri's family focus.

2. When did negative conflict occur? Steve is the easy answer, but think of Leonard putting friends and family before the business or Terri ignoring (intentionally?) the deterioration of Dixon's.

3.. Discuss how the passage of time has influenced family owned firms or even firms strongly identified with a family legacy as well as Dixon's. Wal-Mart is an example of a family owned firm that is still strongly under the legacy of its founder while adapting modern technology to maintain the lowest prices, Sam Walton's overarching goal. Disney is a family name known the world over, but contrast their changing image from the 1960s, 1970s, 1980s, 1990s, and now. Assigning student teams to each decade and researching how Disney marketed their image and made money is an interesting exercise. And finally Dixon's. Each generation had their impact on the Dixon's restaurant and the argument could be make that Terri has simply brought the restaurant back to how the founder intended; a small, life-style business supporting the immediate family

REPUTATION

Even worse than a newly founded business (discussion could start here with the "liability of newness" as first presented by Stinchcombe in 1965), Dixon's Famous Chili under Terri's new ownership found itself not only facing reputation building, but starting with a negative reputation from both suppliers, customers and government. In contrast, a positive reputation is seen as proof of a firm's overall success with all the above as well as other stakeholders (Goldberg et al, 2003). The cost of supplies, terms of contracts, ease of operating within a regulatory environment, attractiveness to customers and investors, and the ability to attract talented personnel are all indicative of a firm's reputation (Goldberg et al, 2003).

Reputation Discussion

1. Given this, what barriers did Terri face in regards to her reputation? Terri succeeded here by building upon the strategic relationships that were required for her business to succeed. Key to a small woman-owned family business is the ability to develop organizational skills, i.e. finances, human resources, operations, and strategic management (Lerner and Almor, 2002). All these skills can be learned in a formal environment, but the application of these key business skills can only be learned by experience. While lacking formal education, Terri was able to succeed, but it is interesting to note that she has insisted that her children receive a formal education and all three are now four-year college graduates. Terri learned the hard way, as the saying goes, and she has determined that her children will not.

2. What steps did she take to create a positive reputation? Interestingly enough, Goldberg et al (2003) found that few small businesses engage in active reputation building like Terri eventually accomplished, and even fewer small businesses have a reputation strategy. Furthermore, the Goldberg et al (2003) research found a three-pronged approach was most effective in creating a positive and profitable business reputation;
   - Focusing on internal strengths.
   - Focusing on external relationships.
   - Creating a positive image.

While these may approach looking like truisms, discuss how Terri tackled each one of these issues and the end results. The students should then realize that these three areas of reputation building work in concert together towards the overall goal of increasing cash flow and profits. As Terri found and Goldberg et al's (2003) research supports, a broad approach to reputation building yields the quickest and most successful results. A narrow reputation building focus was found to be less successful.

SUCCESSION

As students should be aware by now, the majority of family owned firms do not survive intact through the second generation; only 30% survive the second generation while only 15% of family owned firms survive the third generation (Beckhard and Dyer, 1983; Ward, 1987; Kellemanns and Eddleston, 2004). Discussing any personal experiences with this is helpful; however, if you have a more rural student population, family farms and small rural businesses in the mom and pop format are often the exception. Discussing why this is (family support network, built-in reputation, working in a fish bowl) and then how these same success factors have been breaking down the last 50 years can also lead to an interesting interdisciplinary discussion. This discussion can focus on the changing role of families, women, dramatic demographic shifts since the 1940s and the pressure of technology.

The reasons why most family businesses do not survive the second generation can be grouped into five factors (Green, 2002):

- Ending of the product life cycle.
- The business did not reinvent itself.
- The business could not finance itself.
- No estate planning.
- Estate taxes forced the business to sell.

Discussion on Succession

How did Dixon's face or overcome each of these?

- Ending of the product life cycle. Chili doesn't really have one, or if there is an end to chili's life cycle, the U.S. has yet to reach it. Restaurants, on the other hand, often have a life cycle, but Dixon's has remained a community favorite by creating a positive reputation in the local area and relying on their core customers during the worst of times. Business without a dedicated customer base do not.
- The business did not reinvent itself. Dixon's seems to almost pride itself on not reinventing, but being a constant in an ever-changing world, even down to still charging 10 cents for ketchup. However, the addition of tamales and summer hours has improved Dixon's cash flow, broadened their menu while staying faithful to their core competencies of food and service.
- The business could not finance itself. Finances almost drove Dixon's out of business and it was only through Terri's shear force of will and determination that Dixon's was able to maintain a supplier base, albeit a skeptical one, and muster on. Dixon's did

finance itself, but there was little left over for the owner until business improved. If business had not improved, not be able to finance itself would have been the end of Dixon's.

- No estate planning. Granted, this was manipulated by others at one point, but with that one exception, the family has passed Dixon's on without issue for nearly 100 years. Their estate planning has succeeded.
- Estate taxes forced the business to sell. Not an issue so far given the size of the estate or the cost of the business for the next generation to purchase.

SUCCESSION PLANNING

Succession planning is initiated at the home by educating future family business leaders in the value of the family business; where children are raised to either love their future in the business or hate it. At home, children learn the family values that are reflected in the business which are in turn reflected in how the family operates. Equally important is learning the family business history and how the family currently builds upon that legacy. A united family, one that successfully deals with conflict, is taught and learned by succeeding generations. The key process uniting all this is education of the young (Gallo, 2002). However, it is important to keep in mind when considering the low successful succession rate of family firms, that families are complex social units with their own histories and conflicts, conflicts that are usually far more intense and long lasting than conflict found in non-family businesses (Kellermanns and Eddleston, 2004). Succession is further complicated by the transfer of daily management of the firm and ownership of the firm. These can be mutually exclusive and take place at different times with different family members setting up potential conflict (Birley 2002).

If you would like proof of this and want to get your students talking in general terms, ask them to talk about long running family feuds.

As education progresses in the family business, it is only natural for work experience to emerge as the child ages. Work experience is necessary to bridge the gap between formal education and the family business processes. For example, how best to interact with key personnel, suppliers and consumers; current competition and their strengths and weaknesses. Probably the best way to learn how to adapt or change a business organization comes experience with that organization, not formal education (Gallo, 2002).

Succession Planning Discussion

1. How were the family values of Dixon's Famous Chili passed on? Customer service, unique recipe and serving style are the three major ones. There is also support of the elderly and Terri's approach to creating two family members as manager/owners.

2. What are some of these family values? You could start with the employment of parolees, which instilled long-term employee dedication that Dixon's reciprocated over the decades. There was also Vergne's initial pass-down of Dixon's at a reduced cost that set the precedent for future successions. Dedication to family and friends, while flawed, can be viewed as a strength to many; however, it is important to point out to students why this is flawed even though such patronage goes on today in both the family business world, political appointments and pop culture icons. Terri's dedication to her father's memory and to Dixon's is also a powerful example of the strength of family values in motivating future generations.

3. How did others corrupt these values and what was the result? The employment and partnering with unqualified friends and family was mentioned above, but is helpful again here when discussing the long-term results. The key person to discuss here is Steve and his almost Machiavellian manipulation of his mother-in-law. While the story sounds like a movie of the week, the effect was very real and had long-term implications for Dixon's, the employees and Terri and her family. Then, out of this tragic event and the chaos that followed, Terri was able to create a new Dixon's, built upon long established family values, that has succeeded dramatically given where she started.

SUCCESSION WHEN NOT PLANNED

Many family firms are not prepared for succession when faced with the issue due to sudden death, disability, family rupture, or divorce. Terri's divorce situation, on the surface, would seem to be especially problematic. No business experience, a business in shambles, three young children and no other means of support. Doubtful any student will not see this as a stressful situation.

Succession When Not Planned Discussion

1. Would the presence of children hinder or support Terri's efforts? The presence of children in small business divorce cases has actually been shown to increase business survival (Galbraith, 2003). Terri's situation supports this conclusion and Terri stated how she really only had two things to work for, her children and her father's business.
2. Which gender is more likely to be more negatively impacted by a divorce, the man or woman? Interestingly enough, there is no significant difference. No matter which partner ends up with the business, the odds are the same on the business surviving (Galbraith, 2003). However, ask the students which spouse they believe would carry Dixon's out of trouble. Most likely they see neither spouse as qualified to lead Dixon's. Yet, hindsight is 20/20 and it is obvious that Terri's internal drive and mother's survival instinct played a pivotal role in her overcoming what Steve had left her. In Terri's advantage was the quickness and ease of

her divorce. If there had been a lengthy trial with resultant expenses and the business held in limbo, the likelihood of the business surviving is greatly reduced (Galbraith, 2003).

3. How will the children be impacted from this experience? For the most part, the children will not view the business or their mothering in a negative way for the experience they have been through. Granted, the situation is disruptive, but the bond between child and mother is no weaker than a non-entrepreneurial mother. However, when looking back, the mother tends to view the past in a more negative light than the children (Schindehutte et al, 2003). This was true in Terri's case where the children view their childhood as fairly normal or at least not bizarre. Terri, having been older and probably a little guilt ridden, does not view the past in a positive way and regrets to some degree that she was not able to provide for her children during those formative years like she would have preferred.

A SUCCESSION MODEL

The model below is based upon a literature search of over 40 articles and 7 books over the last 30 years regarding family business succession (Breton-Miller et al, 2002). The model is presented in a preliminary format and then further developed as an integrative model regarding family owned business succession. The preliminary model is sufficient for undergraduates, but the entire article is worth requiring for advanced undergraduates or graduate students. The development of a model, which Le Breton-Miller et al (2004) detail nicely, is excellent reading for aspiring scholars of entrepreneurship.

The preliminary model is included for this discussion and is sufficient for class discussion around Dixon's and other family owned business.

<table>
<tr><td colspan="3">Incumbent
Quality relationship with successor, motivation, personality</td><td colspan="3">Successor
Quality relationship with incumbent, motivation, abilities</td></tr>
<tr><td colspan="2">Ground rules and 1st steps

Shared vision for the future to establish succession planning</td><td colspan="2">Nurturing/development of successor

Formal education
Training program
Transfer of knowledge
Career development
Outside work experience</td><td colspan="2">Hands-off/Transition Process/Installation

Incumbent phase out/transition and new role
Successor phase in.</td></tr>
<tr><td colspan="6">Family Context
Family dynamics of collaboration, quality of relationships, trust, openness</td></tr>
</table>

Incumbent and successor interact during the succession process of ground rules, nurturing/development and hands-off/transition, all the while, acting within the family context. All the above headings and components were found to be the variables most often mentioned in the literature review. These are detailed below. Class discussion can flow from Dixon's as well as other family owned businesses the students are familiar with.

- Incumbent
  - Quality relationship – the more positive this relationship from any angle, the better the transition; mutual respect leading to trust leading to feedback which cycles back into the relationship.
  - Motivation – how does the incumbent view leaving the firm; as losing control and a death sentence and psychologically difficult or is the motivation one of the natural process, a positive letting go for the family legacy.
  - Personality – delegating vital for the successor to make own mistakes and successes while still being guided; the opposite is a micro manager hanging on too long causing resentment
- Successor
  - Quality relationship - as above, positive is vital.
  - Motivation - positive self-image; their time as arrived; enthusiastic without being overbearing.
  - Abilities – proven management skills backed up by experience; legitimacy; interpersonal skills.
- Ground rules – weakest area in the literature having to do with succession guidelines.
  - Succession plan – known throughout the family for long time.
  - Shared vision – overall family business goals firm, supported by all and known by all.
- Nurturing/development of successor – training of the successor
  - Formal education – college degreed successors have smoother transitions than high school degreed successors.
  - Training program – the more formalized the better; demonstrates focus and increased successor profile, grows involvement in the firm.
  - Transfer of knowledge – begins at home but increased to the firm as a growing involvement; relationship with incumbent pivotal.
  - Career development – exposure to the business so the earlier the better for credibility, experience and interpersonal contacts.
  - Outside work experience – working outside the firm to establish an independent reputation; often one of the strongest criteria for success.
- Hands-off/Transition Process/Installation
  - Incumbent phase out/transition and new role – mentoring relationship to ease the transition can be positive if handled well by both sides. Having a new

"job" or plan ready in the outside world can satisfy incumbents need for purpose.

- Successor phase in – clear responsibilities and time frame for each to occur very helpful is smoothing the transition. Well-defined boundaries for incumbent creating successor independence.

Given that Le Breton-Miller et al (2004) review the gaps in the literature, the article is an excellent source for major research projects regarding family business succession issues and how these issues impact succession.

FAMILY BUSINESSES PART 1

Family businesses play a prominent economic role in virtually all economies worldwide and have a significant impact on the North American economies of Canada, Mexico and the U.S (Kelly et al, 2000). However, literature and research on family owned businesses, and family women owned businesses in particular, has been dramatically lacking relative to their overall economic impact (Birley, 2001; Kelly et al, 2002). Birley (2002) offers an interesting classification system that should stir class discussion. She breaks family owned businesses into three clusters; family out, family in, family jugglers.

1. Family out businesses, 18% of surveyed US family owned businesses, believe that:
   - Children should not be introduced to the business at an early age.
   - Children's education should not be focused on the family business.
   - Management successors should be the best qualified, family or not.
   - Family is neutral regarding vocational choices of children.
   - Business shares should be earned, not handed out.
   - Founder or older generation should eventually move aside.
   - Business is not necessarily stronger with family members involved
   - Shares can be transferred to whomever, family member or not.

2. Family in businesses, 32% of surveyed US family owned businesses, believe that:
   - Oppose all the views of the family out businesses.
   - Children receive business shares equally.
   - Pay may differ between family members and non-family members.
   - Benefits are provided to all family members.

3. Family juggler, 50% of surveyed U.S. family owned businesses, are neutral, for the most part, on all the above issues.

FAMILY BUSINESS DISCUSSION PART 1

1. What do students think of these classifications?
2. Experience with any of these?
3. Given what you know about Terri, what type of family business is Dixon's?
4. What do you think is most important for a family owned firm; profit maximization or family harmony? Research is increasingly showing that family owned firms, unlike other businesses, have a tenuous balancing act they must strike between what will make the most money and what will create or destroy family harmony (Chrisman, 2003). Many family-owned business decisions are not based strictly upon money, which again makes the operation and study of family-owned firms unique from profit driven firms. This is discussed further below.

FAMILY BUSINESS PART 2

In a continuation of the above, theories are emerging that view family-owned businesses as a unique focus of study. One of those is a resource-based view of entrepreneurship and the exclusive characteristics of family-owned firms. Five of these are (Sirmon and Hitt, 2003):

1. Human capital – can be both a negative and a positive encompassing the knowledge and skills of each family member in regards to the business. As seen by Leonard's example, the negative is when family membership eclipses knowledge and skill that can be brought to the business. The positive exemplified by Terri via the stronger dedication and servitude a family member brings to a family legacy business that an outsider would rarely feel.
2. Social capital – human capital is focused on the individual, social capital is focused on the relationships between individuals. Supplier, resource and finance ties to outside stakeholders are a few examples. Strong social capital ties have been shown to be invaluable in training subsequent generations in operating the family firm.
3. Survivability capital – resources the extended family is willing to expend in support of the business; for example, loans, gifts, and labor. In other words, a family safety net.
4. Patient capital – family firms are not interested in quarterly reporting nearly as much as they are interested in generational advancement. While family-owned firms may be limited in the capital they can raise, they are usually not limited to short term financial thinking.
5. Governance structure –cost of monitoring, controlling and punishing those who manage the firm. Family responsibility, and let's be honest, family guilt, keep these costs relatively low compared to non-family owned firms.

FAMILY BUSINESS DISCUSSION PART 2

A resource-based view of entrepreneurship is an interesting theory to discuss and often makes logical sense to most students, but theoretical discussions are not always incorporated into undergraduate or entry-level course, so depending on the level of class you are teaching, you may or may not want to lecture on the theory itself.

However, by bringing up the five issue areas above, you can begin to present the resource-based view of entrepreneurship and make students aware of how theory can be applied to real world businesses.

1. Human capital – how can the human capital aspect of a family business be accentuated? By educating the children and creating their buy-in of the family business and legacy at an early age.
2. Social capital – Terri's ability to create social capital after her divorce may have been her key skill in saving Dixon's.
3. Survivability capital – limited by family size and the human and social capital the family has developed. In Dixon's case, survivability capital would be regarded as quite low, but increasing.
4. Patient capital – Uncle Vergne thought this way and Terri is quickly becoming a patient capitalist herself; however, the franchise issue may be an example of conflicting patient capital ideals. Terri views franchising as a long-term risk threatening Stephen and Julie's ability to pass on the firm, while Stephen sees franchising a long-term investment in the family's future.
5. Governance structure – the trust between Terri and her children and their ease of communication can actually create a competitive advantage when you essentially have three people thinking as one on most issues and always with the family and the family business uppermost in their decision making.

You can close this discussion by asking students that if we have two firms, all things being equal, one family owned and one non-family owned, which firm is more competitive? If, and this can be a big if, the family owned firm has a successful organizational culture supporting and uniting the family to businesses and business to family, a competitive advantage is created by a family owned firm over a non-family owned firm (Zahra et al, 2004).

REFERENCES

Beckhard, R. & Dyer, W.G. (1983). Managing change in the family firm. *Sloan Management Review*, 24, 59-65.

Birley, S. (2001). Owner-manager attitudes to family and business issues: A 16 county study. *Entrepreneurship Theory and Practice*, 26(2), 63-76.

Birley, S. (2003). Attitudes of owner-managers' children towards family and business issues. *Entrepreneurship Theory and Practice,* 26(3), 5-19.

Bygrave, W. (1996). Jack Sprat's restaurant teaching note. *European Case Clearing House*, Babson College, www.ecchatbabson.org.

Chrisman, J.J., Chua J.H. & Zahra, S.A. (2003). Creating wealth in family firms through managing resources: Comments and extensions. *Entrepreneurship Theory and Practice*, 27(4), 359-65.

Galbraith, C.S. (2003). Divorce and the financial performance of small family businesses: An exploratory study. *Journal of Small Business Management,* 41(3), 296-309.

Gallo, M.A. (2002). Preparing the next generation for a career in the family business. *European Case Clearing House*, Babson College, www.ecchatbabson.org.

Goldberg, A.I., Cohen, G. & Fiegenbaum, A. (2003). Reputation building: Small business strategies for successful venture development. *Journal of Small Business Management,* 41(2) 168-86.

Green, L.C. (2002). Beard case teaching note. *European Case Clearing House*, Babson College, www.ecchatbabson.org.

Kellermanns, F.W.& Eddleston, K.A. (2004). Feuding families: When conflict does a family firm good. *Entrepreneurship Theory and Practice*, 28(3) 209-28.

Kelly, L.M., Athanassiou, N. & Crittendon, W.F. (2000). Founder centrality and strategic behavior in the family-owned firm. *Entrepreneurship Theory and Practice*, 25(2), 27-42.

Le Breton-Miller, I., Miller, D. & Steier, L.P. (2004). Toward an integrative model of effective family owned business succession. *Entrepreneurship Theory and Practice*, 28(4), 305-28.

Lerner, M. & Amor, R. (2002). Relationships among strategic capabilities and the performance of women-owned small ventures. *Journal of Small Business Management,* 40(2), 109-25.

Schindehutte, M., Morris, M. & Brennan, C. (2003). Entrepreneurs and motherhood: Impacts on their children in South Africa and the United States. *Journal of Small Business Management,* 41(1), 94-107.

Sirmon, D.G. & Hitt, M.A. (2003). Managing resources: Linking unique resources, management, and wealth creation in family firms. *Entrepreneurship Theory and Practice*, 27(4), 339-58.

Stinchcombe, A.L. (1965). Social structure and organizations. *Handbook of Organizations*. Ed. J.G. March, Chicago, IL: Rand McNally, 142-93.

Ward, J.L. (1987). *Keeping the family business healthy: How to plan for continuing growth*. San Francisco: Jossey-Bass.

Zahra, S. A., Hayton, J.C. & Salvato, C. (2004). Entrepreneurship in family vs. non-family firms: A resource based analysis of the effect of organizational culture. *Entrepreneurship Theory and Practice*, 28(4), 363-79.

MARITIME ENTERPRISES AND REGULATED COMPETITION

Gary A. Lombardo, United States Merchant Marine Academy
Robert F. Mulligan, Western Carolina University

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.

INSTRUCTORS' NOTES

Learning Outcomes

Students will understand the:

- microeconomic framework for price and capacity competition;
- implications of government regulation on the strategic decision making of enterprises;
- strategic interrelatedness of firms within an industry sector that accounts for the majority of the market share;
- implications of price competition;
- implications of capacity competition; and

- the strict dichotomy between an enterprise's strategic short-run and long-run imperatives.

Appropriate Case Context

This case can be used to provide a "real-world" scenario for strategic decisions within the context of the microeconomic framework of price and capacity considerations in a government regulated industry sector. Two competing firms are faced with price and capacity decisions that are critical to their future operations. Although, the context is the marine transportation sector; the issues are faced by senior management teams in many industry sectors that are typical of a small number of producers enjoying a collective high market share; e.g., ethical pharmaceutical and telephone enterprises on the national level and banking and electrical power generating enterprises on a regional level.

Students are assigned roles as the advisors to the Chief Strategy Officer of each company as they formulate and justify their recommendations for a strategy regarding price and capacity competition for their assigned enterprise and assess the competitor's strategic response.

Theoretical Considerations

Earlier research has been helpful in understanding liner shipping competition with respect to pricing and shipping capacity. Bergantino and Veenstra (2002) researched liner shipping competition in terms of network theory. Panayides and Cullinane (2002) investigated competitive advantage and Fusillo (2003) examined the role of excess capacity in deterring entry. Song and Panayides (2002) researched cooperative game theory and Brooks (2002) analyzed regulation in North America from a Canadian perspective. Frankel (2004) estimates that U.S. Cabotage Laws, by shielding U.S. firms from lower-cost international competitors, impose direct costs of $3 billion on the U.S. economy, and indirect costs of $6 billion. In the United States, the Jones Act requires all vessels operating between U.S. ports to be domestically built, owned, operated, and staffed (Lombardo, 2004) thus increasing freight costs.

This section reviews the basic microeconomic theory relevant to understanding the competitive nature of maritime firm behavior. Maritime firms maximize profit rather than revenue. It appears most widely applicable to assume that firms face conventional u-shaped short-run marginal cost functions determined by either fleet purchase and building decisions, or alternatively, by fleet leasing decisions. The fleet size is fixed in the short run and determines the volume of shipping at which marginal cost (cost per additional TEU (twenty-foot equivalent units) container) will be minimized. Firms attempt to match fleet size with expected demand to ensure they generally operate at or near the minimum of their short-run marginal cost curve, but because future demand is never perfectly known in advance, to a greater or lesser extent, firms generally operate out of cost-minimizing equilibrium. Firms desire and plan for a certain level of excess capacity, affording the opportunity to profit from unplanned (and usually temporary) increases in demand. Without excess capacity, firms forego profit opportunities afforded by exceptional demand. However, it is a well-known feature of maritime business planning that excess capacity is kept very low due to low profit margins. When firm capacity greatly exceeds current demand beyond the need for excess capacity, firms have to assess whether the shortfall in demand is temporary or permanent. In response to a demand shortfall that is expected to be permanent, firms could either cancel or reduce planned shipbuilding or ship purchase programs, and lease out part of their current fleet to non-competing firms. Because firms can lease their ships for use in other trade routes, they generally have a revenue-generating alternative to maintain significant unused excess capacity. In addition, because a firm can generally lease additional ships, the need for excess capacity is minimized. Thus, for simplicity, we assume zero excess capacity.

The cost structure of a typical maritime firm is illustrated in case Appendix 3. A similar approach is presented by Haralambides (2001) to describe pricing of port services. Short-run marginal cost curves are based on resource constraints which are binding in the short run but not in the long run. Fleet size is one example of such a constraint. In the short run the firm is constrained by the size of its current fleet, but in the long run it can adjust fleet size to any desired level, through sales, leases, or building new ships.

Firms should always operate in the region of output where short-run marginal cost is upward-sloping, represented by the dotted lines in the figure. In the long run, average cost may be increasing, decreasing, or flat. However, long-run average cost, even if it is decreasing, never does so rapidly enough to offset the steeper increase in short-run marginal costs. Marginal cost necessarily rises faster in the short run than in the long run because the distinction between long-run and short-run costs is based on flexibility and reallocation of resources. Some resources are fixed in the short run, guaranteeing that short-run marginal costs rise faster than long-run marginal costs, which result from fewer constraints. Constraints which may be binding in the short run include fixed-term ship-leasing and labor contracts. Because these are periodically renegotiated, they are always less binding over the long run. The long-run average-cost curve is depicted as downward-sloping because with significantly greater volume the firm can benefit from scale economies and over the long run technology improves, lowering costs.

INFORMATION PROVIDED IN THE CASE

Case Appendices 1 and 2 provide financial information as it pertains to the two competitors; CSX Lines and Matson. Case Appendix 3 presents information concerning the long-run and short-run cost structure for maritime enterprises.

Case Appendix 4 depicts the strategic outcome possibilities based on price competition while holding shipping capacity constant. These outcomes are explained as follows:

- If A raises price, B may respond by raising, maintaining, or lowering price. If B raises price in response, neither firm loses or gains market share, and both firms gain revenue and profits. Although neither firm gains strategic advantage, both firms benefit. The only loser would be the customers. If B maintains price in response, A gains strategic advantage. If B lowers price, A gains an even greater strategic advantage.
- If A maintains price, B may respond by raising, maintaining, or lowering price. If B raises price, B gains strategic advantage because with the assumption of fixed capacity there is no scope for transfer of freight from one carrier to the other thus the firm with the higher price earns higher revenues without facing higher costs or the loss of its customers. If B maintains price, neither gain advantage. If B lowers price, A gains strategic advantage.
- If A lowers price, B may respond by raising, maintaining, or lowering price. If B raises price it would gain additional revenues while A is losing revenue due to its lower price; thus B gains strategic advantage. If B maintains price it would maintain revenue while A is losing revenue; thus B gains strategic advantage. If B lowers price, both firms lose profits.
- Case Appendix 5 depicts the strategic outcome possibilities based on shipping capacity while holding price constant. These outcomes are explained as follows:
- If A increases capacity, B may respond by raising, maintaining, or lowering capacity. If B increases capacity, both firms lose profits by raising costs. Although both firms lower minimum SRAC by increasing capacity, thus moving down the LRAC, they have both imposed the cost of carrying unused capacity, because the total freight volume in the market is limited. If B maintains capacity, B gains strategic advantage because its costs are unchanged, but A's rise with its expanded, unused capacity. If B lowers capacity, this forces a transfer of demand to A, which benefits from lowered unit costs and increased freight carriage.
- If A maintains capacity and B increases capacity, A gains strategic advantage. If B maintains capacity, neither gains advantage. If B lowers capacity, A gains strategic advantage, because though A's profits are unchanged, B imposes higher unit costs on itself, as well as losing revenue along with volume.
- If A reduces capacity and B increases capacity, B gains strategic advantage due to its increased customer contracts and lower unit costs. If B maintains capacity, B gains strategic advantage. If B reduces capacity, both firms lose profits.

Case Appendix 6 presents the conditions for strategic advantage based on the four strategic decision rules offered in the case study. This schematic is constructed from the perspective of firm A, but applies equally well to firm B. A gains strategic advantage, the final and desired outcome, by accomplishing one of the following: increasing its own profits, or decreasing B's profits. A can increase its profits by increasing revenue, decreasing cost, or both. A can increase revenue by increasing price, increasing volume carried, or both. A can decrease cost only by increasing capacity, and this works only if the added capacity is fully utilized. A gains strategic advantage as long as B loses, so A gains advantage if B's profits diminish. This occurs if B's revenue falls, or if B's costs rise. B's revenue falls if B lowers price, or if B loses shipping volume, or both. B's cost rise whenever B carries substantial unused capacity, which can only occur when A draws volume from B.

Case Appendix 7 depicts the strategic outcome possibilities based on both price competition and shipping capacity. These outcomes are explained as follows:

- In each row there is at least one column in which firm B is the unambiguous gainer of strategic advantage. Thus firm A never receives a guaranteed strategic advantage from initiating change if B selects the appropriate response. Consequently, change should never be initiated by either firm. It is more advantageous to wait for the other firm to initiate change, and then respond in such a way that the responding firm (here designated firm B) gains strategic advantage.
- The only conceivable motive a firm could have to initiate change would be the hope of engaging in a cooperative game with the rival. It is clear that there are only two outcomes where both firms benefit -- where A increases price and either maintains or lowers capacity, and where B makes exactly the same changes. If A makes one of these two moves as the first stage of a cooperative game, and if -- and only if -- B responds appropriately, that is, by matching A's changes, then both firms can increase profits. It is also clear that one of these potentially cooperative outcomes is preferable to the other -- where both firms raise price and maintain capacity.
- Regulators must be vigilant against this kind of cooperative gaming, because firms face clear incentives to raise price without limit, as long as both firms cooperate. Economic theory suggests that two firms in this scenario face incentives to collude, thus effectively acting as a single business unit. The analysis presented here goes beyond the conventional view. Because the regulatory authority protects the enterprises from competition from additional domestic, and particularly from international entrants, it seems more logical to view the regulator, together with the firms it regulates, as a single business unit. Then it becomes apparent that the regulatory authority faces inconsistent incentives. The regulatory mission encompasses maximizing both the consumer surplus, which implies both minimizing profits in the regulated sector and encouraging entry by new competitors, and simultaneously ensuring that competing firms remain profitable, which implies the contrasting conditions of maximizing firm profits and discouraging entry of new firms into the regulated market.

SUMMARY DISCUSSION BY THE INSTRUCTOR TO THE CLASS AT THE CONCLUSION OF THE CASE ANALYSIS

The only conceivable motive a firm could have to initiate change would be the hope of engaging in a cooperative game. Case Appendix 7 provides a clear indication that the firm initiating a strategic action is not guaranteed a resultant competitive advantage. It may only gain a competitive advantage if the responding firm fails to select the appropriate strategic response. This observation confirms the substantial body of management literature suggesting that established firms tend to be less innovative (Hannan and Freeman, 1984; Geroski, 1995; Almeida and Kogut, 1997; Almeida, 1999; Lombardo and Mulligan, 2003). Consequently, change should rarely be initiated by either firm. It is more advantageous to wait for the other firm to initiate change, and then respond in such a way that the responding firm gains strategic advantage. This condition leads to the temptation of cooperative behaviour. Firms function best in this context by understanding the limitations and opportunities this business environment affords.

REFERENCES

Almeida, P. (1999). Semiconductor startups and the exploration of new technological territory. In Z. Acs (ed.), *Are Small Firms Important? Their Role and Impact* (pp 39-50). Dordrecht: Kluwer.

Almeida, P., & B. Kogut (1997). The exploration of technological diversity and geographical localization in innovation. *Small Business Economics,* 9(1), 21-31.

Bergantino, A.S., & A.W. Veenstra (2002). Interconnection and co-ordination: an application of network theory to liner shipping. *International Journal of Maritime Economics,* 4, 231-248.

Brooks, M.R. (2002). Liner shipping regulation in North America: A Canadian perspective. *International Journal of Maritime Economics,* 4, 281-300.

Frankel, E. (2004). Rules and economic impact of U.S. Cabotage (Jones Act) Laws. Presented to the *International Association of Maritime Economists (IAME) Conference*. Izmir, Turkey. 30 June - 2 July.

Fusillo, M. (2003). Excess capacity and entry deterrence: The case of ocean liner shipping markets. *Maritime Economics and Logistics*, 5(2), 100-115.

Geroski, P. (1995). What do we know about entry? *International Journal of Industrial Organisation*, 13(4), 421-440.

Hannan, M., & J. Freeman (1984). Structural inertia and organizational change. *American Sociological Review,* 49, 149-164.

Haralambides, H.E. (2002). Competition, excess capacity, and the pricing of port infrastructure. *International Journal of Maritime Economics*, 4, 323-347.

Lombardo, G.A. (2004). Short sea shipping: Practices, opportunities and challenges. TransportGistics, Inc. Retrieved November 1, 2004 from www.insourceaudit.com/WhitePapers/Short_Sea_Shipping.asp (May 24).

Lombardo, G.A., & R.F. Mulligan (2003). Resource allocation: A Hayekian paradigm for maritime conglomerates. *Quarterly Journal of Austrian Economics*, 6(1), 3-21.

Panayides, P.M., & K. Cullinane (2002). Competitive advantage in liner shipping: A review and research agenda. *International Journal of Maritime Economics*, 4, 189-209.

Song, D.W. & P.M. Panayides (2002). A conceptual application of cooperative game theory to liner shipping strategic alliances. *Maritime Policy & Management*, 29(3), 285-301.

NOVACO: THE CHALLENGE OF INTERNATIONAL ENTREPRENEURSHIP OF A NEW FIRM

William Brent, Howard University
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.*

INSTRUCTORS' NOTES

PROBLEM STATEMENT

J. P. Morgan Chase Inc. and Wachovia Securities, Inc. are the underwriters for the IPO of Novaco Corporation, who want to issue 5,000,000 shares of common stock to finance its future growth and financial needs. The company has granted the underwriters the option of purchasing up to 750,000 additional shares from the firm to cover over-allotments, should they occur. In light of the foregoing, the case reviewer is being asked to assess the corporate value of Novaco and determine the appropriate offering price for the issue and also determine whether or not the firms and private investors 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 valuation methods, specifically from an international perspective, with consideration of the strategic and financial needs of a multinational firm.

ALTERNATIVE SOLUTIONS

Book Value Method

Determine the firm's book value and use that value as a basis for determination of a fair market (offering) price for the firm's initial shares.

Price-to-Earnings Method

Compute the firm's estimated price-to-earnings rate times its estimated EPS and use the figure to determine the IPO price as an acceptable valuation method for price determination,

Free Cash Flow Analysis

Analyze the firm's projected discounted cash flows as a valuation methodology and determinant of the firm's current market value and an appropriate market clearing price.

ANALYSIS OF THE ALTERNATIVES AND RECOMMENDATIONS FOR TEACHING APPROACHES

Book Value Method

Determine the firm's book value and use this value to determine a fair market price for the offering. Novaco's current book value per share is $0.50. It follows that, if the company issues 5,000,000 shares, the total book value will be approximately $2,500,000. The industry average for 2002 (computed by and cited in the Standard and Poor's industry surveys) produced or yielded a book value per share of $0.64. If the industry average is used, the total value of Novaco's shares would be nearly $3,200,000.

In a pure-play analysis, using one of Novaco's most formidable competitors as a basis for comparison, Microsoft Corporation's value was determined to be $3.83 per share for the same period. Given Microsoft's established record of superior performance in the market as the largest software manufacturer, the low share price of $39 is used as a comparative test base for the inexperienced Novaco. The computed book-to-market value ratio was 9.8%, and, using this rate, Novaco's per share market value approaches a price of $5.10. If Microsoft's high market price of $61.125 were used instead, the book-to-market value would be 0.059. Based on this figure, Novaco's per share market price for the 5,000,000 shares would be $55.15 per share ($61.125-9.8%=$55.15) Using Microsoft to estimate Novaco's market price does produce a rather wide range of prices (between $5.10 and $55.15), thus making the accuracy of the outcome of the method somewhat questionable. Moreover, it is difficult to make relative comparisons of Microsoft and Novaco on any level given the vast differences in size, experience, market share, and years of operation. The comparison parameters become quite distended in the process.

If the underwriters choose to use either of these prices to set the price of Novaco's IPO, they will run the risk that is most common with initial offerings -- either underpricing or over- pricing the issue. As noted by Roger Ibbotson, Jody Sindelar, and Jay Ritter in their seminal articles on IPOs (Chew, 1998), if the price is too low, the issuer's potential to raise the needed capital is undermined and the reputation of the underwriter is damaged. On the other hand, if the price is set too high, the firm commitment underwriters, as in this case, will incur a loss, because they must lower the selling price in order to sell the entire issue.

In most valuation case problems, evidence can be obtained about the capital market's assessment of the company itself. In the case of the IPO, however, the market price or a current assessment of the firm is usually not available. Further, securities regulations prevent dissemination of cash-flow forecasts, and, although internal forecasts are possible, they often fall wide of the mark because of market cyclicality or lack of knowledge in the particular new business segment of the firm. Because of the level of uncertainty that surrounds the new issue, and Novaco was no exception, it would be necessary for the firm and the underwriters to disclose as much information as possible to potential investors about the firm to enhance sales of the issue. This would hopefully allay some of the many concerns about the issue and the firm and dispel much of the uncertainty that often occurs prior to an IPO issue.

Price-to-Earnings Method

Compute the firm's price-to-earnings rate (and forecasted eps) and use it as a valuation methodology and determinant of the firm's market clearing price. The underlying assumption of this method is that the market value of the firm is directly related to the company's share price. The average price-to-earnings ratio for the industry was computed to be 24.2 times (Exhibit 5). This is applied to Novaco's earnings figures to determine the appropriate market value; however, we are unable to apply this method directly because the firm incurred a loss in 2002. In examining another similar company that had a recent IPO issue, Thompson Financial appears to be a more closely aligned pure-play firm for Novaco, including the fact that Thompson had a recent history of losses at or near the time of its IPO issue (see case Exhibits 6 and 7). This would also have precluded the use of the P/E method valuation for that firm also. Within a virtually untapped international technological market, it appears that early in their histories, the investor/lenders had little confidence in the real potential of these two firms, and, therefore, as the market quite often does, the new unknown firms incur heavy losses in order to exploit the market's vast opportunities.

The losses incurred by the firms coupled with the fact that they are operating in a high tech industry generally creates a feeling of distrust among investors who are wary of the potential for serious losses to occur. The perplexing issue for the managers of Novaco was the decision of go to the market at that moment or wait. If the company had gone immediately to the market, the credibility of the firm would have been a serious concern. The firm might have been wiser to wait for a more opportune time, say a year or two, with the help of a shelf registration until the firm had a more stable, secure foundation of credible market performance. Conversely, waiting could also have been problematic in that it would have kept or not allowed the firm its needed capital and strategically inhibited it from the international market, reduced the firm's growth and internet market development, and caused the firm to lose its potential advantage as a new international entrant and competitor to Microsoft and others. Additionally, after posting a loss for the year, Novaco had to demonstrate to its potential investors, customers, and creditors that it had sufficient strength to be taken as a serious market contender. One best means of accomplishing this was through the issue of the IPO, even if the firm had to accept a deep discount in the trading value (and price) of its shares.

Free Cash Flow Analysis

Analyze the firm's projected discounted cash flows as a valuation methodology and determinant of the firm's current market value and an appropriate market clearing price. The

Discounted Cash Flow (DCF) Methodology of stock price determination rests heavily on the forecast of the firm's future cash flow projections. As noted in Case Exhibit 1, the firm's revenues increased from $695,871 in December 2002 to $16,625,391 in June 2003 (2100% growth rate), which was additionally matched by the firm's operational costs. Forecasting the future growth rate is a requirement of the DCF method, which for Novaco was a difficult matter because of its limited operating history-April 2002. Although high rates of growth are not uncommon in the high tech industry for growth firms, this rate of growth was rather large to be used in the financial valuation because it would be difficult, at best, for the firm to sustain that growth rate. A forecast of the company's cash flows based on the sustained growth model is presented in Exhibit B. The forecast was conducted based upon the fact that a pure-play company had to be chosen from the industry to determine an appropriate (more realistic) growth rate.

As noted in case Exhibit 6, Thompson Financial seemed to provide a very good basis for comparison (i.e., the same industry, product, a recent IPO, and current losses). Consequently, Thompson's average growth rate of 33.2% was used, together with the growth rate of America Online (AOL) to forecast Novaco's short-term growth rate for a 5-year period of 51.4% (33.2%+18.2%). This rate is estimated to remain in duration for 5 years, with a subsequent long-term sustainable rate of 10%. Based on Value-Line's predictions, the market rate of growth was predicted between Microsoft's sustained rate of 23% and the 51% prediction made by the case model for short-term growth. In the long-term, however, a conservative approach was taken for Novaco's future growth at 10 percent because it was felt that the large initial growth could not be sustained with the addition of competition, arbitrage of Novaco's product mix and other market growth leveling transactions.

Financial cash flows (net income and depreciation) were calculated as a percentage of sales using industry averages. These calculations are displayed in the case solution exhibits B & D. As a means of forecasting the capital expenditures for 2003, the increase that the firm experienced from December 2002 to June 2003 was assumed to double for the remaining six months of the year. Therefore, the capital expenditures for 2003 were projected to be $8,627,894(Exhibit B), Based on the industry average growth rate in capital expenditures, the firm's capital expenditure rate was forecasted at a constant rate of 5.6% between 2003-2007. This assumption might have been understated in light of the firm's expansion plans, international marketing and perhaps not, considering recent developments.

However, as a proxy, Thompson provided only a partial solution to the problem. Thus, Novaco's free cash flows were considered as an adjunct to the above analysis. To accomplish the valuation, the firm's discount rate had to be estimated for discounting cash flows to 2004. The firm's cost of equity (capital) was calculated using a Capital Asset Pricing Model (CAPM-WACC combination), which produced a rate of 40% (see solution Exhibit C). A Weighted Average Cost of Capital computation was also conducted to more closely approximate a real world application, and it was 35.94%, especially considering the international risk-adjusted nature of the rate. The CAPM elements used were a market return of 22.8%, risk-free rate of 5.57% for 90-day treasury bills, and the beta selected was 2.0 because of the firm's given high risk characteristics. The WACC elements included a cost of debt equal to a Baa debt offering of 8%, but this was discarded as too low for the firm, and the prime rate of 9% was chosen. The WACC rate was chosen to discount the firm's cash flows, producing a present value of the firm of $93,385,631, and a per share value of $18.68.

FINAL RECOMMENDATIONS

Based on the foregoing discussion, the underwriters should have valued the firm using the discount cash flow method of analysis, because it more closely accounts for many of the idiosyncrasies of IPO offering and international firms, while addressing the problem of recognizing the fledgling firm's earnings potential. Additionally, the DCF method lends a greater degree of authenticity to the value derived than other methods employed. The true potential of the firm may have been viewed from a rather conservative basis; however, with all other factors present in the case with the company, risk avoidance was the key. Although, as indicated below in the epilogue, the firm might take off following the IPO or later experience what most rising stars encounter periodically, i.e. a period of down-turn due to competition with competitors like Microsoft.

Moreover, based on the traditional inclination to underprice IPOs, investors should and quite often do carefully evaluate the worth of the growth opportunities that could positively impact the value of the shares upon entry into the market. IPOs are quite often severely underpriced in terms of their real potential, but in the case of Novaco, meteoric growth should have been considered as a key element to its competitive edge in the market and the Internet (World Wide Web) system.

EPILOGUE

On August 12, 2003, after two years of business, Novaco Corporation issued 5,000,000 shares in an initial public offering. The underwriters originally anticipated an offering at around $14 a share, but, because of a strong demand at that price, the offering price was raised to $30.

The price of the shares skyrocketed from their $50 per share issue price to over $70.00 in the initial trading, before closing at $58.25 per share, implying a total value of over $2.0 billion. However, within months of the original offering, the price again doubled. At those prices, the shares retained by the company's cofounders – Jim Olson, a 24-year-old programming whiz; Chuck Martin, and the firm's CEO, Greg Martin – would have been worth hundreds of millions of dollars if Novaco were a real firm. Each party would have held millions of shares and become instant billionaires at Novaco's highs, which occurred within a few months following the offering. Novaco was projected to become a successful international internet firm. Its revenues were projected to grow steadily at a rapid pace and it was to realize a constant profit until the realities of that kind of market trend come to fruition and revenues plateau, sales and market share also level off largely due to industry giants such as Microsoft and their market strategy of total market dominance.

EXHIBITS

EXHIBIT A
ANALYSIS OF THOMPSON'S GROWTH

THOMPSON Financial's Rate of Growth

	1999	2000	2001	2002	2003
Revenues					
Internet Services	4979	7054	10019	16860	71521
Software	9201	13342	13980	16278	22940
Total	14180	20396	24019	33138	94461
Change in Revenues		0.44	0.18	0.38	1.85
Average Change in revenues from 1999-2003		0.332			
Net Income as % of Sales (Industry)	0.1909	0.2556	0.2615	0.2856	
Change in Net Income as % of sales		0.338921	0.023083	0.092161	

EXHIBIT B
FORECASTED NOVACO CASH FLOWS
(SUSTAINED GROWTH MODEL)

Industry Averages and Estimated Changes for Cash Flows

	2002	2003	2004	2005	2006	2007
Depreciation	2.35	2.01	2.42	2.67	2.39	
Revenues (Industry)	45.21	34.98	41.41	49.48	43.07	57.53
Depreciation as a % of sales	0.052	0.0575	0.0584	0.054	0.0555	
Average Depreciation as a %		0.0555				
Capital Expenditures @ a rate of growth of 5.6%						
Jun-02	$4,313,947					
	Dec-02	2003	2004	2005	2006	2007
	$8,627,894	$9,111,056.06	$9,621,275.20	$10,160,066.61	$10,729,030.35	$11,329,856.04
Working Capital @ a rate of growth of 4%						
Dec-02	2002	2003	2004	2005	2006	2007
$1,808,928	$1,881,285.12	$1,956,536.52	$2,034,797.99	$2,116,189.91	$2,200,837.50	$2,288,871.00
Change in Working Capital	$72,357.12	$75,251.40	$78,261.46	$81,391.92	$84,647.60	$88,033.50

EXHIBIT C WACC CALCULATIONS
Cost of Equity – Risk Adjusted for International inclusion
The CAPM Model = $R_f + (R_m - R_f)$Beta
where: Beta = 2.0
R_f = 5.57%
R_m = 22.8%
K_e = 5.57 + (22.8- 5.57)2.0
K_e = 40.03
Cost of Debt assumed to be at prime rate of 9%
Weighted Average Cost of Capital (WACC)
= $W_dK_d (1 - T) + W_{ce}K_e$
WACC = 9%(1 - 0.34) 0.12 + 40.03 (0.88) = 0.359392 or 35.94%

EXHIBIT D
FORECASTED FREE CASH FLOWS FOR 2003-2007 ($000s}

	2002	2003	2004	2005	2006	2007
Revenues	80,700,000	122,179,800	184,980,217	280,060,049	424,010,914	641,952,524
Net Income	7,424,400	11,240,542	17,018,180	25,765,524	39,009,004	59,059,632
Add Depreciation	4,478,850	6,780,979	10,266,402	15,543,333	23,532,606	35,628,365
Less Cap. Exp.	14,848,800	15,680,333	16,558,431	17,485,704	18,464,903	19,498,938
Less Change in Working Capital	72,357	75,251	78,261	81,392	84,648	88,034
Free Cash Flow	($3,017,907)	$2,265,936	$10,647,889	$23,741,762	$43,992,059	$75,101,026

EXHIBIT E DISCOUNTED CASH FLOW ANALYSIS						
	2002	2003	2004	2005	2006	2007
Free Cash Flow	($3,017,907)	2,265,936	10,647,889	23,741,762	43,992,059	75,101,026
Discount Rate	35.94%					
	(3,017,907.12)	1,666,865.01	5,761,943.424	9,450,855.97	12,882,057.37	16,177,430.52
Total Present Value		42,921,245.17				
Present Value of Cash Flows from 2003 onwards 318,470,041.6				75,101, 026(1.10)/(.3594-.10) =		
Discounted back to 2003						50,464,385.72
Value of NOVACO = sum of present values						$93,385,631
Market Value per share based on issue of 5,000,000 shares of common stock					$93,385,631.00/5,000,000 =$18.68	

REFERENCES

Chew, D. (1998). *The New Corporate Finance: Where Theory Meets Practice, first edition*. New York: Irwin/McGraw-Hill.

Copeland, T. E. & J. F. Weston (1988). *Financial Theory and Corporate Policy, third edition*. Reading, MA: Addison-Wesley.

Hof, R. D. (1997). Netspeed at Netscape *Business Week*, February 10.

MicroSoft Prospectus (2002).

Hewlett-Packard Prospectus (2002).

Kuemmerle, W. (2005). C*ase Studies in International Entrepreneurship: Managing and Financing Ventures in the Global Economy, first edition*, New York: Irwin/McGraw-Hill.

O'Hara, M. (1995). *Market Microstructure Theory*. Cambridge, MA: Blackwell Publishing, Ltd.

Ross, S.A., R.W. Westerfield, and J. F. Jaffe. (2003). *Corporate Finance, fifth edition*. New York: Irwin/McGraw-Hill

Standard and Poor's Industry Surveys (2002).

Standard and Poor's Stock Reports (February, 2002).

Value-Line (March, 2003)

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.

INSTRUCTORS' NOTES

RECOMMENDATION FOR TEACHING APPROACHES

I have often found that students do not clearly understand the concept of environmental sexual harassment, without seeing specific examples. This case was designed to help clarify this particular issue, in specific, those instances of sexual harassment by third parties, in a manner that allows insightful discussion of the topic.

Generally, the approach I take is to divide the class up into small groups, and assign them each one or more of the cases to discuss. Then each group will present their determinations to the class, and we will discuss, as a whole, whether the analysis picked up the important facets of the case. Each of these cases is based on a specific real situation, and have been decided in a court of law. The specifics of each case follow:

GENERAL DISCUSSION POINTS

Employer liability for workplace environmental discrimination under Title VII is usually based upon traditional notions of agency law which ordinarily poses no difficulty in resulting employer liability because the vast majority of environmental discrimination complaints are founded upon the actions of the company's employees both co-workers and supervisors (Faragher v. City of Boca Raton, 1998). However, imposing liability upon the employer for the discriminatory acts of non-employees is problematic (Berry v. Delta Airlines, 2001). Third party non-employees typically cannot be considered an agent of the employer and consequently the employer cannot be held liable for environmental discrimination because of the acts of non-employees upon an agency theory (Burlington Industries, Inc. v. Ellerth, 1998). The courts, however, have ruled that employers are liable for harassing conduct by non-employees "where the employer either ratifies or acquiesces in the harassment by not taking immediate and/or corrective actions when it knew or should have known of the conduct" (Folkerson v. Circus Circus, 1997). The EEOC guidelines on the subject are in accord and recite: "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" (29 CFR §1604.11 (e), 1980). The courts, then, have applied a negligence theory of liability to impose legal responsibility upon the employer of the victim of discrimination as a result of the harassing acts of non-employees (Little v. Windermere Relocation, Inc., 2001). "Thus, employers may be held liable in these circumstances if they 'fail to remedy or prevent a hostile or offensive work environment of which management-level employees knew, or in the exercise of reasonable care should have known" (Lockard v. Pizza Hut, Inc., 1998).

THE CASES

Complaint 1- The employee sales rep and a customer.

In Galdamez v. Potter, Galdamez, a US postal service employee, alleged that she was subjected to a hostile work environment, due to her Honduran ancestry and strong accent. She claimed harassment and unwarranted discipline by supervisors, customers and community members. While the initial court decision ruled against Galdamez, an appeals court held that an employer may be liable for actionable harassment of an employee by third parties if it failed to investigate and remedy the harassment after learning of it. This decision creates a stand-alone claim under Title VII for an employer's failure to investigate and remedy harassment of its employees by third parties, such as customers and community members. Galdamez v. Potter, 415 F.3d 1015 (9th Cir 2005).

While the Galdamez case involves race and national origin discrimination, the extension of Title VII to include harassment by customers, applies in sexual harassment cases as well. Since Susan has reported this to her supervisor, and it has happened repeatedly, the company should have taken reasonable steps to rectify the issue. Their failure to do so may make them liable under the "negligence theory of liability" highlighted above.

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?

The behavior is extreme and repeated. This would be likely to satisfy the requirements for a hostile work environment.

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

The employee has given notice to the company supervisor, providing sufficient information to indicate that a hostile work environment exists.

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

Companies should have a clear set of guidelines regarding hostile work environments. The EEOC sexual harassment guidelines state that:

> *The employer should investigate promptly and thoroughly. The employer should take immediate and appropriate corrective action by doing whatever is necessary to end the harassment, make the victim whole by restoring lost employment benefits or opportunities, and prevent the misconduct from recurring.* (Policy Guidance, 1990)

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

This scenario is based on Hicks v. Sheahan, 2004 U.S. Dist. Lexis 26791 (N.D. Ill. 2004), wherein the employer argued that it could not be liable for the actions of a person who is employed by an independent contractor. The U.S. Supreme Court has thrown into question whether an employer can be vicariously liable for I.K. harassment because of the lack of agency relationship but the court in Hicks dodged the issue by holding that courts have applied the EEOC standard of negligence liability to situations involving harassment by a non-employee and distinguished this case from a vicarious liability agency theory to one involving negligence by the employer in failing to address the sexual harassment by Wilson. The court said, "Even assuming that the employer is correct that it did not have the authority to control an Aramark employee, Defendant has offered no reason that it should not have at least tried to address the problem when "Sam" was repeatedly complaining of the harassment. The employer could have notified Aramark of Sam's allegations and asked it to investigate so Wilson's status as a non-employee does not preclude liability by the employer if it is otherwise negligent.

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?**

Yes. The courts look to the frequency and severity of the harassment to determine whether it is sufficiently severe or pervasive to alter the terms of the worker's employment. Here, the acts of the independent contractor were subjectively and objectively frequent and severe because of the overt sexual content and because the worker perceived the acts to be unwelcome and offensive.

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

Yes. The key to the employer's liability here is that the worker repeatedly reported the harassment and the employer was negligent in responding to his complaints.

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

The company SHOULD have fully investigated the claims, and contacted Aramark about the harassment.

Complaint 3- Employee receptionist encounters a supplier.

This case was inspired by Fulmore v. Home Depot, 2006 U.S. Dist. Lexis 22906 (S.D. Ind, 2006). The court reasoned that no matter how severe this conduct the incident did not support a hostile environment claim because the conduct could not be attributed to Home Depot. The EEOC Guidelines regulating sexual harassment state that an employer may be responsible for harassment by an non-employee where the employer knows (or should have known) of the conduct and fails to take immediate and appropriate corrective action, depending on the control and other legal responsibility the employer may have over the non-employee. Several courts have held that discriminatory harassment by a customer or patron can be evidence of a hostile environment claim where the employer ratified or condoned the conduct by failing to investigate and remedy it after learning of the conduct. Under circumstances where an employer ratifies or otherwise condones discriminatory conduct there can be a basis for employer liability. Here, however, no reasonable jury could find that Home Depot ratified the conduct, ignored the complaint of abuse or otherwise forced Mary to endure discrimination by suppliers. Home Depot had no control over this supplier with whom it had no business or other relationship and where the harassing behavior had ceased Mary has failed to raise an issue as to whether Home Depot had either the ability or the duty to do anything further. This court has not imposed upon employers the obligation to reprimand or otherwise punish persons over whom they have no control for harassing behavior when the employee is no longer being subjected to the harassment.

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?**

This is a very close question and the answer is mixed. Usually one incident of harassment will not be deemed sufficiently severe or pervasive to affect the conditions of the worker's employment. The single remark of one of the salesmen will not be sufficient to create an abusive working environment. However, a single incident of an offensive and un-consented touching can constitute a basis for environmental sexual harassment. A single incident of harassment must be exceedingly severe to be actionable and the act of touching the worker's breast just once will probably not constitute environmental sexual harassment.

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

No. The general rule is that an employer may be liable for discriminatory harassment by a non-employee where the employer ratified or condoned the conduct by failing to investigate and remedy it after learning of the conduct. Here, however, there is no evidence that the employer ratified the conduct, ignored complaints of abusive treatment or otherwise forced the employee to endure discrimination by third parties in the reception area. The employer had no control over the conduct of the visitors and where the harassing behavior had ceased there was no evidence that the employer had the ability to do anything. The courts have not imposed upon an employer an obligation to reprimand or otherwise punish third parties over whom they have no control from harassing behavior when the employee is on longer being subjected to the harassment.

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

Nothing. The harassment having ceased and the third parties having no relationship to the employer then the employer is under no duty to act.

Complaint 4- Public Relations Employee Raped by Client.

The facts for this case were derived from Little v. Windermere Relocation, 301 F.3d 958 (9th Cir. 2001). The issue in the case was not whether the employer created a hostile work environment but whether the employer's reaction to the rape created environmental sexual harassment. Here, the employer's actions after the rape were insufficient and negligent. The employer's failure to take immediate and effective corrective action allowed the effects of the rape to permeate the Public Relations employee's work environment and alter it irrevocably.

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?

Yes. Rape is unquestionably among the most severe forms of sexual harassment and being raped by a business associate while on the job irrevocably alters the conditions of the employee's work environment.

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

Yes. An employer's reaction to a single serious episode may form the basis for an environmental sexual harassment claim. Again, an employer can be liable for harassing conduct by non-employees where the employer either ratifies or acquiesces in the harassment by not taking immediate and corrective actions when it knew or should have known of the conduct.

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

Make an unequivocal response to the complaint and the wrongful behavior. Here, the employer's reaction to the rape was equivocal at best. The employee was encouraged to get the account; when she reported the incident she was not effectively removed from the account and when she finally reported the incident to the President she was demoted. The employer failed to prevent contact between the employee and Guerrero such as effectively removing the employee from the account or informing Starbucks that it must replace the contact it used with the employer. In short, the employer failed to take appropriate remedial measures so that its inaction can be deemed to be a ratification or acquiescence in the rape such that it is liable for creating an abusive and hostile work environment.

REFERENCES

Allen v. Tyson Foods, 121 f.3d 642 (11th Cir. 1997).

Berry v. Delta Airlines, 260 F.3d 803 (7th Cir. 2001).

Breda v. Wolf Camera & Video, 222 F.3d 886 (11th Cir. 2000).

Burlington Industries, Inc. v. Ellerth, 524 U.S. 742 (1998).

EEOC Sexual Harassment Guidelines (2006). Retrieved June 28, 2006, from www.eeoc.gov/types/sexual_harassment.html

EEOC Policy Guidance on Current Issues of Sexual Harassment (1990). Retrieved July 3, 2006, www.eeoc.gov/policy/docs/currentissues.html

Faragher v. City of Boca Raton, 524 U.S. 775 (1998).

Folkerson v. Circus Circus Enterprises, Inc., 107 F.3d 754 (9th Cir. 1997).

Fulmore v. Home Depot, 2006 U.S. Dist. Lexis 22906 (S.D. Ind, 2006).

Galdamez v. Potter, 415 F.3d 1015 (9th Cir. 2005).

Guidelines on Discrimination Because of Sex, 29 C.F.R. Section 1604.11(a).

Guidelines on Discrimination Because of Sex, 29 C.F.R. Section 1604.11(e).

Harris v. Forklift Systems, Inc., 510 U.S. 17 (1993).

Hicks v. Sheahan, 2004 U.S. Dist. Lexis 26791 (N.D. Ill. 2004).

Johnson v. Booker T. Washington Broadcasting Service, Inc., 234 F.3d 501 (11th Cir. 2000).

Little v. Windermere Relocation, 301 F.3d 958 (9th Cir. 2001).

Lockard v. Pizza Hut, Inc., 162 F.3d 1062 (10th Cir. 1998).

Mendoza v. Borden, Inc., 195 F.3d 1238 (11th Cir. 1999).

Meritor Savings Bank v. Vinson, 477 U.S. 57 (1986).

Oncale v. Sundowner Offshore Servs. Inc., 523 U.S. 75 (1998).

Title VII of the Civil Rights Act of 1964, 42 U.S.C. 2000e-2 (1964).

INVESTING IN ARKETIA

James Dow, California State University, Northridge
Gordon Johnson, California State University, Northridge

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?"

INSTRUCTORS' NOTES

RECOMMENDATION FOR TEACHING APPROACHES

We schedule a 40 minute coaching session to review needed concepts from our freshman business statistics class: interpretation of standard deviation, normal area table, hypothesis testing (mean and proportion). Less time is needed for freshman macroeconomics and ethics.

On the day students present the case, most of the class discussion is about ethical issues since the statistics is cut and dried.

1. **Statistics provided by developing countries are not always reliable. Data can be hard to gather and is sometimes reported incorrectly. From your 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. (5 pts.)**

   This question uses the distribution of the sample mean, and students use sample data to make inferences.

   H_0: μ (population mean) = (or $\geq$) 1100 (the East Arketia claim)
   H_A or H_1: $\mu < 1100$ (the West Arketia claim)

   This is a "one tail" test since West Arketia wins the debate only if the mean for East Arketia is less than \$1100. If the mean for East Arketia were more than \$1100, East Arketia would win.

   It is acceptable to use either the Z table (normal table) or the t table. Some texts insist that you must use the t table when you do not know the population standard deviation, but most texts allow the normal approximation when n is greater than 30. The Z table will be used here. With a one tail test, the Z table shows a critical Z = 2.33, with 1% significance. We will make the mistake of agreeing with West Arketia when East Arketia is truthful only 1% of the time.

   The test statistic is: Sample Z = (Sample mean – population mean)/standard error of the mean.

The sample mean = \$923.62, the hypothesis gave us population mean = \$1100; and the standard error of the mean = (standard deviation/square root of sample size) = 84.64/10 = 8.464. The Sample Z = (923.62-1100)/8.464 = *-20.8*. Since the absolute value or *+20.8 > 2.33*, one *rejects the null hypothesis*. The population mean of East Arketia is significantly less than \$1100, so it is reasonable to conclude that average East Arketia income is less than average West Arketia income.

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." (10 pts.)**

      Since the standard deviation of West Arketia = \$350, while the standard deviation of East Arketia = \$70, it can be concluded that West Arketia has more variation in income than East Arketia, hence a bigger 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**

      i. **West Arketia**
      ii. **East Arketia**

      Does it seem reasonable to assume a normal distribution? Is income symmetric or skewed? (10 pts.)

      This question uses population data; unlike Q1, there are no sample statistics. Q1 and Q2 are intentionally in reverse sequence from the table of contents of most statistics text books. This simulates real-world applications.

      (i) Probability that income is less than poverty level = P(income < 800) = P(Z < (800-1100)/350) = P(Z< -0.86) = .1949 from the normal table, so about 20% are below poverty level in West Arketia.
      (ii) For East Arketia, P(Z < (800-925)/70) = P(Z < -1.79) = .0367, so about 4% are below the poverty level.

It is usually NOT the case that income is normally distributed because income is typically positively skewed to the right, that is the very wealthy create a right tail. In other words, mean > median because the mean is more likely to be affected by extreme values (the rich).

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 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? (20 pts.)**

H_0: p (population proportion) = (or $\geq$) 1/3 (the Amnesty International hypothesis)
H_A or H_1: p < 1/3 (the Minister of Commerce hypothesis)

If p is equal to or more than one third, that would support Amnesty International, so we have a one-tail test. At the .10 significance level, the critical Z = 1.28, using the normal approximation to the binomial. The test statistic is: Sample Z = (sample proportion – population proportion)/standard error of proportion. The sample proportion is 100/500 = .20, and the population proportion is 1/3 = 0.33, if the null hypothesis (H_o) is true. The standard error of the proportion is the square root of (.33)(1-.33)/500, which is the square root of .00044, namely .021. Hence Sample Z = (.20-.33)/.021 = -6.3. Since 6.3 is greater than 1.28, we reject the null hypothesis that one third of the prisoners are political prisoners. This supports the Minister of Commerce since 20% is significantly less than 33%.

The final part of this question is open-ended and is designed to get students to think about the context of the data. Unlike the income measure, which was objective, the classification of political vs. non-political is subjective. What is free speech to one person could be inciting a riot to the government. Another prisoner might be in jail for bank robbery, while critics of the government claim the prisoner is innocent and framed by prosecutors because of his political activity. Furthermore, the sample of prisoners might have been determined by the government, which has an incentive to provide a biased sample.

4. Based on the economic and statistical issues, evaluate the potential for growth in the two countries. (20 pts.)

Factors that determine Gross Domestic Product per capita include the level of physical capital, human capital, technology, and efficiency. Rapid economic growth requires investment in plant and equipment, an educated work force, recent technological innovations, and a government which does not delay development with bureaucratic hurdles,
The output of a country is determined by the technology available, the amount of inputs used in production and how efficiently the inputs are used. Economic institutions, such as a legal system that enforces property rights and a government that is not too corrupt, are major factors in determining efficiency.

East Arketia has had relatively low investment in physical capital and human capital (the education of the work force) and has an inefficiently run government with a mixed record of enforcing property rights.

West Arketia has been better record in terms of policies that encourage economic efficiency and accumulation of inputs and so is likely to grow faster. In terms of return to the company, West Arketia would be a better choice.

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 poverty problem, 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?

Let A: growth, B: poverty, P(A)=6/20=.30, P(B) = 8/20= .40, P(A and B) = 1/20=.05.P(B/A) = P(A and B)/P(A) = .05/.30 = .17

b. Are the two events independent? Justify your answer.

P(B/A) not equal to P(B), so A and B are NOT independent.

c. If you are concerned about poverty, would prospects of economic growth affect your concern? How might this relate to the Arketia region?

Economic growth should reduce poverty, which is an argument for West Arketia. With economic growth, probability of poverty drops from .40 to .17. Students with more advanced training or interest in economics could discuss the possible connections between growth, poverty, and income distribution.

6. **Some managers at Westman were concerned about arbitrary definitions of "rapid" growth and "major" poverty problem. A new sample was taken from 6 countries which 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 and Y = percentage households below the poverty line.

a. **Find the regression equation to estimate Y given X**

Y = 35.52 – 3.12X

b. **If a country has a 3% growth rate, estimate the percentage below the poverty line.**

Y = 35.52 –3.12(3) = 26, so 26% below the poverty line.

c. **How does this affect your decision regarding the Arketia region?**
As the growth rate increases, poverty decreases. Each additional one per cent increase in growth reduces the per cent below the poverty line by 3.12 percentage points. This supports the case for West Arketia.

7. **If it is found 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? (20 pts.)**

Some ethical considerations include:

1. Who benefits and who loses from Westman's decision?

2. Who does Westman have a responsibility to? Only the shareholders? Other stakeholders?
3. What are those responsibilities?

Faculty teaching this case have reported that today's business majors have difficulty looking beyond the shareholders. Questions about historical business ethics issues, such as the boycott of South Africa, are met with bewilderment. This case is designed to reintroduce some of these issues.

The case was set up so that there was a stark contrast between the countries. West Arketia provides the better prospects for investment but has a worse record on human rights, while East Arketia is the reverse.

There is no right or wrong answer to this question independent of the ethical framework held by the student. A good answer would tie the decision to the student's belief about the responsibilities of companies.

STONEBRIDGE COUNTRY CLUB: CASH…IS THERE ENOUGH?

David A. Kunz, Southeast Missouri State University
Benjamin L. Dow III, Southeast Missouri State University

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.

INSTRUCTORS' NOTES

Case Overview

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.

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 interest loan 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 are provided. 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.

DISCUSSION 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.

The complete cash budget is provided in Table One. A summary of the budget is as follows: (based on 100 new members)

	Cash Inflows	Cash Out Flows	Net Cash	Beginning Cash	Ending Cash Before Borrowing	Required Borrowing *	Cum. Borrowing
	$	$	$	$	$	$	$
							123,000
Jan	48,596	17,294	31,302	50,000	81,302	(51,302)	130,238
Feb	59,738	118,278	(58,540)	30,000	(28,540)	58,540	132,238
Mar	81,211	83,260	(2,049)	30,000	27,951	2,049	132,288
Apr	106,695	183,362	(76,667)	30,000	(46,667)	76,667	208,955
May	105,944	168,748	(62,804)	30,000	(32,804)	62,804	271,758
Jun	122,402	112,528	9,874	30,000	39,874	(9,874)	261,885
Jul	118,175	102,041	16,134	30,000	46,134	(16,134)	245,751
Aug	107,388	70,520	36,868	30,000	66,868	(36,868)	208,882

	Cash Inflows	Cash Out Flows	Net Cash	Beginning Cash	Ending Cash Before Borrowing	Required Borrowing *	Cum. Borrowing
	$	$	$	$	$	$	$
Sep	98,148	98,272	(124)	30,000	29,876	124	209,006
Oct	95,199	79,507	15,692	30,000	45,692	(15,692)	193,314
Nov	77,390	30,095	47,295	30,000	77,295	(47,295)	146,018
Dec	62,390	60,692	1,698	30,000	31,698	(1,698)	144,320
*To maintain a $30,000 cash balance							

The cash budget indicates that Stonebridge will exceed the $200,000 revolving credit agreement during the months of April (borrowing required $208,955) through September (borrowing required $209,006). Based on the assumptions used to prepare the cash budget, the requested $200,000 revolving credit agreement will not be sufficient to meet the needs of Stonebridge.

The cash budget confirms the bank's concern regarding the cash requirements for year one of operation.

Note: Students answers may vary by a few dollars due to spreadsheet rounding.

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.**

Cash outflows result from expenditures (capital investments, course maintenance, marketing expenses, general and administrative expenses and interest expense) controlled by Stonebridge thus are likely to have a higher degree of accuracy (both the amount and timing of the outflow) than the inflows. Inflows depend upon the number of members, member golfing activity and member spending (food and beverage and merchandise). Stonebridge has less control over the amount and the timing of the inflows, thus they are likely to be less accurate than the outflows.

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
September	0	0	1
October	0	0	0
November	0	0	0
December	0	0	0

125 Members

The complete cash budget is provided in Table Two. A summary of the budget is as follows: (based on 125 new members)

	Cash Inflows	Cash Out Flows	Net Cash	Beginning Cash	Ending Cash Before Borrowing	Required Borrowing *	Cum Borrowing
	$	$	$	$	$	$	$
							123,000
Jan	48,589	17,295	31,294	50,000	81,294	(51,294)	71,706
Feb	68,229	118,308	(50,079)	30,000	(20,079)	50,079	121,785
Mar	90,756	83,551	7,205	30,000	37,205	(7,205)	114,580
Apr	117,850	193,558	(75,708)	30,000	(45,708)	75,708	190,288
May	118,979	170,063	(51,084)	30,000	(21,084)	51,084	**241,372**
Jun	137,824	114,484	23,340	30,000	53,340	(23,340)	**218,032**
Jul	127,503	113,721	13,781	30,000	43,781	(13,781)	**224,501**
Aug	115,650	72,713	42,937	30,000	72,937	(42,937)	161,314
Sep	106,222	100,168	6,054	30,000	36,054	(6,054)	155,260
Oct	103,080	90,460	12,620	30,000	42,620	(12,620)	142,640
Nov	83,829	30,965	52,864	30,000	82,864	(52,864)	89,776
Dec	67,579	61,111	6,468	30,000	36,468	(6,468)	83,308
*To maintain a $30,000 cash balance							

The cash budget based on 125 new members reflects an improved cash position, but the $200,000 revolving credit agreement is still not sufficient to meet the needs of Stonebridge.

75 Members

The complete cash budget is provided in Table Tree. A summary of the budget is as follows: (based on 75 new members)

	Cash Inflows	Cash Out Flows	Net Cash	Beginning Cash	Ending Cash Before Borrowing	Required Borrowing *	Cum. Borrowing
	$	$	$	$	$	$	$
							123,000
Jan	43,501	17,285	26,216	50,000	76,216	(46,216)	76,784
Feb	59,128	118,255	(59,127)	30,000	(29,127)	59,127	135,911
Mar	72,103	83,025	(10,922)	30,000	19,078	10,922	146,833
Apr	87,560	173,163	(85,603)	30,000	(55,603)	85,603	**232,436**
May	100,513	167,515	(67,002)	30,000	(37,002)	67,002	**299,438**
Jun	107,677	110,625	(2,949)	30,000	27,051	2,949	**302,387**
Jul	109,598	90,606	18,992	30,000	48,992	(18,992)	**283,395**
Aug	94,674	68,402	26,272	30,000	56,272	(26,272)	**257,123**
Sep	91,447	96,419	(4,972)	30,000	25,028	4,972	**262,095**
Oct	87,316	68,588	18,728	30,000	48,728	(18,728)	**243,366**
Nov	70,951	29,227	41,724	30,000	71,724	(41,724)	**201,642**
Dec	57,201	60,274	(3,073)	30,000	26,927	3,073	**204,715**

*To maintain a $30,000 cash balance

Not surprisingly, the cash budget based on 75 new members reflects a deteriorating cash position. Stonebridge's use of the revolving credit agreement exceeds the $200,000 limit in April ($232,436) and peaks in June when $302,387 is needed. Stonebridge's borrowing requirements exceed the $200,000 limit during the months of April through December. With this scenario the $200,000 revolving credit agreement is not sufficient to meet the needs of Stonebridge.

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.).

Cash inflows will be delayed if new members join later in the year. This will cause the cash shortfall to be even larger than forecasted in Table One. The annual cash inflows will be unchanged but the during the first half of the year cash inflows will be lower and the opposite will be true for the second half of the year.

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

Depreciation is a non-cash expense, thus it is not explicitly included in the cash budget. Depreciation expense does reduce a firm's income tax payments thus it does have an indirect impact on 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?**

If outflows were mostly at the beginning of the month and inflows mostly at end, the monthly net would remain the same but the cash deficit during the month would be larger than indicted by the monthly balance. The cash deficit during the month can be identified by preparing a weekly or daily cash budget for the month.

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

If the bank fails to extend the requested credit, Stonebridge has two basic options, find another source of credit or reduce or delay internal cash requirements. Approaching another bank for the short-term credit would represent an external source. If an external source is not an option then the firm may reduce cash outflows by reducing or postponing expenditures (course maintenance, capital expenditures, etc). Another option would be to negotiate extended credit terms with suppliers or delay payments to suppliers without negotiations. Either of these options would be receive additional vendor credit. Options to accelerate cash inflows would be to eliminate the extended payment terms offered to new members or increase the frequency of billing (from monthly to semi-monthly).

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.

Cash is a non-earning asset. Marketable securities are short-term (maturities less than a year) debt instruments which have low-risk and are highly liquid and are held in lieu of cash. Given the characteristics of low-risk and high liquidity, the expected return on marketable securities is low but it is greater than the zero return on cash. Treasury bills, bank certificates of deposits (CDs) and money market mutual funds are marketable securities.

If the forecasts showed surpluses indefinitely, the firm would want to evaluate how to best use the surplus. They could consider reducing debt, paying or increasing dividends or repurchasing stock.

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.

There is no correct answer but it should be apparent to the students at this point that the proposed $200,000 credit agreement is not sufficient. Students may argue that the new member assumptions, which have a large influence on cash inflow, appear to be overly optimistic. The consequences of insufficient cash (delaying payment to vendors, employees, and the bank) are much greater than having excess cash (higher interest expense). It is better to error on the side of conservatism; by having too much cash, than risk an unexpected cash shortfall. The cash budget based on 75 new members indicates a maximum cash requirement of $302,387. A revolving credit agreement of $600,000 would not be excessive.

Table One: Stonebridge Country Club - Cash Budget (Based on 100 new members)												
Cash Budget	Jan.	Feb.	Mar.	April	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
	$	$	$	$	$	$	$	$	$	$	$	$
Cash Inflows												
Dues	40,000	43,000	47,000	52,000	55,000	58,000	59,000	60,000	60,000	60,000	60,000	60,000
Initiation Fees	7,500	15,000	30,000	37,500	22,500	22,500	7,500	7,500	0	0	0	0
Green Fees	0	0	0	0	5,200	11,000	17,400	11,800	12,000	12,000	6,000	0
F&B	0	820	1,720	8,460	11,440	15,400	17,400	14,160	13,200	12,000	6,000	1,200
Merchandise	0	718	1,505	7,402	10,010	13,475	15,225	12,390	11,550	10,500	5,250	1,050
Miscellaneous	96	200	986	1,333	1,794	2,027	1,650	1,538	1,398	699	140	140
Total Inflows	**48,596**	**59,738**	**81,211**	**106,695**	**105,944**	**122,402**	**118,175**	**107,388**	**98,148**	**95,199**	**77,390**	**62,390**
Cash Outflows												
F&B Supplies	0	295	619	3,045	4,118	5,544	6,264	5,098	4,752	4,320	2,160	432
Merchandise	0	0	502	1,053	5,182	7,007	9,433	10,658	8,673	8,085	7,350	3,675
Pro Shop	1,000	1,000	2,000	2,000	2,000	3,000	3,000	2,000	2,000	2,000	2,000	2,000
Course Maintenance	5,000	5,000	25,000	25,000	30,000	35,000	35,000	35,000	30,000	25,000	10,000	10,000
Carts	307	645	3,173	4,290	5,775	6,524	5,310	4,949	4,500	2,250	450	450
F&B Labor	320	671	3,299	4,462	6,006	6,786	5,522	5,148	4,680	2,340	468	468
Marketing	3,000	3,000	5,000	8,000	8,000	5,000	2,000	0	0	0	0	0
G&A	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500
Other	167	167	167	167	167	167	167	167	167	167	167	167
Capital Expenditures	0	100,000	0	100,000	100,000	0	0	0	0	0	0	0
Interest Expense	0	0	36,000	0	0	36,000	0	0	36,000	0	0	36,000
Income Taxes	0	0	0	27,845	0	0	27,845	0	0	27,845	0	0
Total Outflows	**17,294**	**118,278**	**83,260**	**183,362**	**168,748**	**112,528**	**102,041**	**70,520**	**98,272**	**79,507**	**30,095**	**60,692**
Net Cash Flow	**31,302**	**(58,540)**	**(2,049)**	**(76,667)**	**(62,804)**	**9,874**	**16,134**	**36,868**	**(124)**	**15,692**	**47,295**	**1,698**
Beginning Cash*	50,000	81,302	22,762	20,712	(55,955)	(118,758)	(108,885)	(92,751)	(55,882)	(56,006)	(40,314)	(6,982)
Ending Cash*	81,302	22,762	20,712	(55,955)	(118,758)	(108,885)	(92,751)	(55,882)	(56,006)	(40,314)	(6,982)	(8,680)
* Before borrowing adjustments												

Table One: Stonebridge Country Club - Cash Budget (Based on 100 new members) Continued												
	Jan.	Feb.	Mar.	April	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
	$	$	$	$	$	$	$	$	$	$	$	
Beginning Cash	50,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000
Net Cash Flow	31,302	(58,540)	(2,049)	(76,667)	(62,804)	9,874	16,134	36,868	(124)	15,692	47,295	1,698
Ending Balance Before Borrowing	81,302	(28,540)	27,951	(46,667)	(32,804)	39,874	46,134	66,868	29,876	45,692	77,295	31,698
Required Balance	***30,000***	***30,000***	***30,000***	***30,000***	***30,000***	***30,000***	***30,000***	***30,000***	***30,000***	***30,000***	***30,000***	***30,000***
Borrowing Required	(51,302)	58,540	2,049	76,667	62,804	(9,874)	(16,134)	(36,868)	124	(15,692)	(47,295)	(1,698)
Ending Balance After Borrowing	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000
Cumulative Balance	**71,698***	**130,238**	**132,288**	**208,955**	**271,758**	**261,885**	**245,751**	**208,882**	**209,006**	**193,314**	**146,018**	**144,320**
* Reflects beginning borrowing of $123,000 less $51,302.												

Table Two: Stonebridge Country Club - Cash Budget (Based on 125 new members												
Cash Budget	Jan.	Feb.	Mar.	April	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
Cash Inflows												
Dues	41,000	44,000	49,000	55,000	59,000	63,000	64,000	65,000	65,000	65,000	65,000	65,000
Initiation Fees	7,500	22,500	37,500	45,000	30,000	30,000	7,500	7,500	0	0	0	0
Green Fees	0	0	0	0	5,500	11,800	18,900	12,800	13,000	13,000	6,500	0
F&B	0	820	1,760	8,820	12,100	16,520	18,900	15,360	14,300	13,000	6,500	1,300
Merchandise	0	718	1,540	7,718	10,588	14,455	16,538	13,440	12,513	11,375	5,688	1,138
Miscellaneous	89	191	956	1,312	1,791	2,049	1,665	1,550	1,409	705	141	141
Total Inflows	**48,589**	**68,229**	**90,756**	**111,850**	**118,979**	**137,824**	**127,503**	**115,650**	**106,222**	**103,080**	**83,829**	**67,579**
Cash Outflows												
F&B Supplies	0	295	634	3,175	4,356	5,947	6,804	5,530	5,148	4,680	2,340	468
Merchandise	0	0	502	1,078	5,402	7,411	10,119	11,567	9,408	8,759	7,963	3,981
Pro Shop	1,000	1,000	2,000	2,000	2,000	3,000	3,000	2,000	2,000	2,000	2,000	2,000
Course Maintenance	5,000	5,000	25,000	25,000	30,000	35,000	35,000	35,000	30,000	25,000	10,000	10,000
Carts	308	660	3,308	4,538	6,195	7,088	5,760	5,363	4,875	2,438	488	488
F&B Labor	320	686	3,440	4,719	6,443	7,371	5,990	5,577	5,070	2,535	507	507
Marketing	3,000	3,000	5,000	8,000	8,000	5,000	2,000	0	0	0	0	0
G&A	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500
Other	167	167	167	167	167	167	167	167	167	167	167	167
Capital Expenditures	0	100,000	0	100,000	100,000	0	0	0	0	0	0	0
Interest Expense	0	0	36,000	0	0	36,000	0	0	36,000	0	0	36,000
Income Taxes	0	0	0	37,381	0	0	37,381	0	0	37,381	0	0
Total Outflows	**17,295**	**118,308**	**83,551**	**193,558**	**170,063**	**114,484**	**113,721**	**72,713**	**100,168**	**90,460**	**30,965**	**61,111**
Net Cash Flow	**31,294**	**(50,079)**	**7,205**	**(75,708)**	**(51,084)**	**23,340**	**13,781**	**42,937**	**6,054**	**12,620**	**52,864**	**6,468**
Beginning Cash*	50,000	81,294	31,215	38,420	(37,288)	(88,372)	(65,032)	(51,251)	(8,314)	(2,260)	10,360	63,224
Ending Cash*	81,294	31,215	38,420	(37,288)	(88,372)	(65,032)	(51,251)	(8,314)	(2,260)	10,360	63,224	69,692
* Before borrowing adjustments												

Table Two: Stonebridge Country Club - Cash Budget (Based on 125 new members)												
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
	$	$	$	$	$	$	$	$	$	$	$	
Beginning Cash	50,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000
Net Cash Flow	31,294	(50,079)	7,205	(75,708)	(51,084)	23,340	13,781	42,937	6,054	12,620	52,864	6,468
Ending Cash Before Borrowing	81,294	(20,079)	37,205	(45,708)	(21,084)	53,340	43,781	72,937	36,054	42,620	82,864	36,468
Required Cash Balance	***30,000***	***30,000***	***30,000***	***30,000***	***30,000***	***30,000***	***30,000***	***30,000***	***30,000***	***30,000***	***30,000***	***30,000***
Borrowing Required	(51,294)	50,079	(7,205)	75,708	51,084	(23,340)	(13,781)	(42,937)	(6,054)	(12,620)	(52,864)	(6,468)
Ending Cash	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000
Cumulative Balance	**71,706***	**121,785**	**114,580**	**190,288**	**241,372**	**218,032**	**224,501**	**161,314**	**155,260**	**142,640**	**89,776**	**83,308**

* Reflects beginning borrowing of $123,000 less $51,294.

Table Three: Stonebridge Country Club - Cash Budget (Based on 75 new members)												
Cash Budget	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug	Sep.	Oct.	Nov.	Dec.
Cash Inflows												
Dues	40,400	42,400	45,400	48,400	51,400	53,400	54,400	54,800	55,000	55,000	55,000	55,000
Initiation Fees	3,000	15,000	22,500	22,500	22,500	15,000	7,500	3,000	1,500	0	0	0
Green Fees	0	0	0	0	4,840	10,280	16,020	10,880	10,960	11,000	5,500	0
F&B		808	1,696	8,172	10,648	14,392	16,020	13,056	12,056	11,000	5,500	1,100
Merchandise		707	1,484	7,151	9,317	12,593	14,018	11,424	10,549	9,625	4,813	963
Miscellaneous	101	213	1,023	1,337	1,808	2,012	1,640	1,514	1,382	691	138	138
Total Inflows	**43,501**	**59,128**	**72,103**	**87,560**	**100,513**	**107,677**	**109,598**	**94,674**	**91,447**	**87,316**	**70,951**	**57,201**
Cash Outflows												
F&B Supplies		291	611	2,942	3,833	5,181	5,767	4,700	4,340	3,960	1,980	396
Merchandise			495	1,039	5,005	6,522	8,815	9,812	7,997	7,384	6,738	3,369
Pro Shop	1,000	1,000	2,000	2,000	2,000	3,000	3,000	2,000	2,000	2,000	2,000	2,000
Course Maintenance	5,000	5,000	25,000	25,000	30,000	35,000	35,000	35,000	30,000	25,000	10,000	10,000
Carts	303	636	3,065	3,993	5,397	6,008	4,896	4,521	4,125	2,063	413	413
F&B Labor	315	661	3,187	4,153	5,613	6,248	5,092	4,702	4,290	2,145	429	429
Marketing	3,000	3,000	5,000	8,000	8,000	5,000	2,000	0	0	0	0	0
G&A	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500
Other	167	167	167	167	167	167	167	167	167	167	167	167
Capital Expenditures		100,000		100,000	100,000							
Interest Expense			36,000			36,000			36,000			36,000
Income Taxes				18,369			18,369			18,369		
Total Outflows	**17,285**	**118,255**	**83,025**	**173,163**	**167,515**	**110,626**	**90,606**	**68,402**	**96,419**	**68,588**	**29,227**	**60,274**
Net Cash Flow	**26,216**	**(59,127)**	**(10,922)**	**(85,603)**	**(67,002)**	**(2,949)**	**18,992**	**26,272**	**(4,972)**	**18,728**	**41,724**	**(3,073)**
Beginning Cash*	50,000	76,216	17,089	6,167	(79,436)	(146,438)	(149,387)	(130,395)	(104,123)	(109,095)	(90,366)	(48,642)
Ending Cash*	76,216	17,089	6,167	(79,436)	(146,438)	(149,387)	(130,395)	(104,123)	(109,095)	(90,366)	(48,642)	(51,715)
*Before borrowing adjustments												

Table Three: Stonebridge Country Club - Cash Budget (Based on 75 new members)												
	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug	Sep.	Oct.	Nov.	Dec.
	$	$	$	$	$	$	$	$	$	$	$	$
Beginning Cash	50,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000
Net Cash Flow	26,216	(59,127)	(10,922)	(85,603)	(67,002)	(2,949)	18,992	26,272	(4,972)	18,728	41,724	(3,073)
Ending Balance Before Borrowing	76,216	(29,127)	19,078	(55,603)	(37,002)	27,051	48,992	56,272	25,028	48,728	71,724	26,927
Required Balance	***30,000***	***30,000***	***30,000***	***30,000***	***30,000***	***30,000***	***30,000***	***30,000***	***30,000***	***30,000***	***30,000***	***30,000***
Borrowing Required	(46,216)	59,127	10,922	85,603	67,002	2,949	(18,992)	(26,272)	4,972	(18,728)	(41,724)	3,073
Ending Balance After Borrowing	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000	30,000
Cumulative Balance	**76,784***	**135,911**	**146,833**	**232,436**	**299,438**	**302,387**	**283,395**	**257,123**	**262,095**	**243,366**	**201,642**	**204,715**

*Reflects beginning borrowing of $123,000 less $46,216.