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CONTENTS

LETTER FROM THE EDITORS

Welcome to the *Journal of the International Academy for Case Studies.* The editorial content of this journal is under the control 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 *JIACS* is to encourage the development and use of cases and the case method of teaching throughout higher education. Its editorial mission is to publish cases in a wide variety of disciplines which are of educational, pedagogic, and practical value to educators.

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

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

We intend 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

CASES

DHR PATIO HOMES, LLC: "FOR THE SAKE OF A NAIL, THE KINGDOM WAS LOST!"[1]

Herbert Sherman, Southampton College – Long Island University
Daniel J. Rowley, University of Northern Colorado

CASE DESCRIPTION

This is a field-based, disguised case which describes the attempts of a small residential construction company to close on a large land deal, a deal that would net them over four million dollars in 12-16 months. The problem for the characters in question is how to raise the $2.5 million dollars needed to purchase the property. Every time the protagonists believed they have resolved the situation, another problem with the loan is introduced. Several factors complicate the transaction: the lending institution changed the loan down payment from 10% to 20%, the protagonists had transactional difficulties in terms of physically acquiring their down payment, and one of the lenders at the last minute insisted on a $50,000 set aside to be placed in an escrow account. The case has a difficulty level appropriate for a sophomore or junior level course. The case is designed to be taught in one to two class periods (may vary from fifty to one hundred minutes depending upon instructional approach employed, see instructor's note) and is expected to require between four to eight hours of outside preparation by students (again, depending upon instructor's choice of class preparation method).

CASE SYNOPSIS

Derived from observation and field interviews, the case describes how two college professors operating a home construction LLC are trying to close on a major land deal ($2.5 million dollars) that would net them over $4 million dollars in estimated profits in a 12-16 month time period. These professors have no experience in raising funds but luckily have the assistance of Justin Martin, the President of the Snowy Mountains, the firm that they will be purchasing their subdivision from (Mountain Trails). Through Justin Martin's connections Stephen Hodgetts and Richard Davis meet with Benefit Bank and arrange for the loan. Davis was under the impression that the bank required a 10% down payment ($250,000) which Davis and Hodgetts finally raise by borrowing on their retirement accounts and liquidating Hodgetts' stock holdings. However, the bank actually required a 20% down payment since Davis and Hodgetts were new customers. Justin Martin promised to lend Davis and Hodgetts this amount ($250,000) as a same day loan to be paid back by them from the proceedings of their closing on Justin Martin's mother-in-law's house. At the last minute, however, Justin Martin insisted that Davis and Hodgetts deposit $50,000 in an escrow account;

$50,000 that Davis and Hodgetts did not have access to for at least a few days after the closing date. The case ends with Davis wondering how he is going to raise $50,000 in one day.

INTRODUCTION

"They did it again" moaned Richard Davis to his wife Adrienne. "@!X#$@*^!@, they did it again." He repeated more vehemently. "Just when I thought I had this land contract sewn up and had raised enough collateral to purchase the Mountain Trails subdivision they pull another fast one on me. It was tough enough raising the first $250,000, and then having to scramble last week to raise another quarter million when the bank suddenly wanted 20% rather than 10% collateral. BUT now Justin Martin's lawyer wants us to put $50,000 into an escrow account for a one day loan of $250,000; that's crazy! Given the numerous problems that we've already had trying to close, God only knows if Snowy Mountains will give us another closing date. If we lose this deal it means forgoing over $4,000,000 in profits. Where am I going to dig up another $50k in one day so we can close on this land deal tomorrow?"

COMPANY BACKGROUND AND HISTORY

DHR Construction LLC was formed in April, 2003 by two college professors (Stephen Hodgetts, 50% owner; and Richard Davis, 50% owner) as an offshoot of their real estate management firm, D & H Management, LLC. The construction company was started as a money-saving venture for finishing off the basements of their rental homes. The success of this little construction company lead Davis and Hodgetts to backward integrate their operation; they were going to build homes not only to be purchased by D & H as possible rental units but also for public consumption. DHR's mission was as follows:

> DHR is a locally-based semi-custom home builder. D H R believes in building homes of quality, style and distinction. No detail is too small and no consideration is too great. DHR builds homes as if we were building them for ourselves. In a spirit of wanting our home buyers to feel the same way, DHR designers, builders, and customer service personnel look forward to working directly with our perspective home buyers to assure that each customer gets just what they want. The result: homes of beauty and elegance that also reflect each owner's taste, personality, and sense of style.

DHR developed a simple business model. Homes would be priced at 20% above cost with Richard Davis acting as the architect and head of operations of construction. His job was to work with the subcontractors to ensure that their work met schedule and building code requirements and to make sure that subcontractors' bills coincided with the work provided.

The designs for DHR's new homes included some added features that differentiated these homes from other houses in a similar price range (i.e. more windows, including a garage window, nicer lighting fixtures, upgraded appliances, nicer counters, cabinets, and flooring), including a distinctive California design (i.e. oversized master bathroom with archways, high ceilings, and unique fireplaces). Davis and Hodgetts agreed with their real estate agent that many of these upgrades added minimal cost to the overall price of the homes and accentuated customer value.

Davis also became the principal owner/manager of the firm and handled the back office functions of the business with his wife Adrienne (hiring an accountant, pricing out homes, bidding out work to subcontractors, working with real estate agents, and mortgage companies) while Hodgetts played creditor and bankrolled the company's upfront expenses.

In May, 2003 DHR broke ground on their first construction project in the St. Andrews development and by January 2004 had completed three homes. They then shifted their building site to another location, the Florence Development, which they felt had a more up-scaled look and would allow them to build nicer and more expensive homes. By April of 2004 they had built three homes in Florence, were in the process of building four more in that area, and were looking at other developments for future growth and expansion. Their plans to continue to build in Florence on their four vacant lots stopped short in June of 2004 when a third party lien against their properties made it virtually impossible to close on their homes. A decision in court was pending as to how to resolve the liens.

THE IDYLLIC PROJECT – SNOWY MOUNTAINS

Davis and Hodgetts were putting together what Davis jokingly referred to as "the deal of the century." Davis in June of 2004 had located a brand new development about 10 miles east of where they currently were building several private homes (the Florence Development), in an area called Snowy Mountains. Snowy Mountains was a unique project for the area since the developers had built lakes, a golf course, and a club house (including a three star restaurant) and had very specific designs for community development. The housing currently in the development (phase one) ran the gamut of homes, from two bedroom condominiums (that started around $140,000) to million dollar estate homes on the lake. Every member of the community was given access to the club house (which included a pool and a play ground), the several lakes dotting the development, and a discount at the restaurant and golf course. The developers also sponsored fishing, golfing, boating, and concert events and even had an island that could be rented out for weddings and other parties and included fully equipped restrooms with showers, electricity and a kitchen service cabana.

Davis and Hodgetts were most impressed with the management team of Snowy Mountains, especially the CEO, Justin Martin. Justin Martin, a retired celebrity who bankrolled the operation, wanted first class builders who bought into his vision of an up-scaled community and could produce homes that fit the theme of the development, a mountain motif. (Exhibits 1 and 3 are available from the authors. Exhibit 2 for general description of the community including amenities.) He had already put together plans for developing not only the other side of the lake (phase two), but for a development on the bluff overlooking the lake, as well as an additional development farther up toward the mountain ranges. He had a ten year plan for this area and wanted builders who would stick with him throughout the development process.

Davis and his wife toured the development several times with their management team (real estate broker, mortgage specialist, and construction foreman), as well as with family members, and everyone agreed that these homes would sell themselves. Everyone who had toured the site wanted a home in the community (including Davis's son, Davis, and Hodgetts) and Davis had quickly gathered a list of eight buyers just waiting for DHR to take over the project. With eight pre-sold homes, Davis and Hodgetts knew that this construction project would be a winner.

OPPORTUNITY KNOCKS – MOUNTAIN TRAILS AT SNOWY MOUNTAINS

Timing is everything, and Davis and Hodgetts felt that this new undertaking was just in time. They had decided to no longer build any more homes in Florence until the lien issue was resolved and therefore they had expected to finish up the homes they were completing in Florence by October of 2004. No other projects were in the works and their work crew (although subcontracted rather than employed by the firm) would then be idle; something that Davis in particular wanted to avoid since this would negatively impact morale and his relationship with his work crews.

Davis believed that he and Hodgetts lucked out in that one of the home construction companies in the Snowy Mountains development pulled out of their project, Mountain Trails, after a disagreement with the developers. The company had built approximately ten patio homes[2] starting in 2002 in a forty-five lot area, leaving the remaining lots vacant. Thirty-three of the lots had been sold back to Snowy Mountains; the other two lots were in foreclosure and held by two different banks. This was the last remaining section of Phase One which needed to be completed before Phase Two could be developed. Justin Martin was reluctant to open Phase Two without a commitment from a home builder for the rest of Phase One since he was afraid that the property would remain dormant. Homeowners in this section of the development were getting quite upset that no action had been taken to complete their part of Snowy Mountains and clearly a solution was needed before the developer faced possible legal action. After several discussions with the local residents, Davis and Hodgetts felt that they were like white knights coming to the rescue of both the developer and the neighborhood.

THE PROCESS MOVES AHEAD

After several meetings with Justin Martin's staff at Snowy Mountains, Mr. Martin asked two of his senior staff members to examine the homes that Davis and Hodgetts had built, specifically the newest homes in the Florence Development. This was a major hurdle for DHR Construction to overcome since Mr. Martin wanted his development to feature quality custom builders; distinctive homes that would add beauty to the picturesque scenery. The senior staff toured several of the homes that had been completed, as well as those still under construction. The homes ranged in size from approximately 1600 to 2400 square feet with the price range starting at slightly under $200,000. Mr. Martin's staff concluded that the homes where of high enough quality to warrant further discussion with DHR Construction.

In the interim, Davis and Hodgetts formed a new corporation, D H R Patio Homes, LLC, in order to separate their current construction projects in Florence from their new project, Mountain Trails. Davis and Hodgetts split the ownership 50/50 and decided that Davis should receive a 2% commission on each home constructed as senior partner and head of the business's operations.

Adrienne, Davis's wife, continued her activity in the businesses and became the information hub for the subcontractors and prospective home purchasers. Davis's son, Robert, got a part-time weekend job working at Snowy Mountains showing real-estate properties in Phase Two and became a natural link between DHR and Snowy Mountains. Davis had even managed to work out a deal with Snowy Mountains that for every DHR site that Snowy Mountains closed on, they would receive a $1000 commission; a much lower fee than any real estate broker would have charged.

PUTTING THE PACKAGE TOGETHER FOR MOUNTAIN TRAILS

One of the key stipulations that Snowy Mountains required prior to the signing of the land contract was for DHR to put together a portfolio of home designs with floor plans together with a price list. Davis spent numerous hours with his wife Adrienne looking through home design magazines as well as purchased a CAD/CAM program that would allow them to design homes on the fly on their home computer. Davis thought that the best way to price out the homes was not to separate the prices of the homes from the property but to sell them as a packaged deal; prices for interior lots would sell at a far lower price than those with lakefront property. The models, prices, square footage, and style are listed in Table 1, below. More specific descriptions are available in Exhibit Four.

Snowy Mountains approved the designs, as well as the home price ranges, and felt that these homes and their pricing would blend well with the homes that already existed within the Mountain Trails subdivision. Davis and Hodgetts also showed the designs to the existing residents at Mountain Trails to make sure that they also liked the designs. Davis and Hodgetts understood the delicacy of the situation with the current home owners and wanted their support and cooperation. Furthermore, since DHR was to be the majority land owner in the development, Davis became President of the Homeowners Association and started to work with the residents on landscaping designs for the entrance to Mountain Trails and its green areas.

Table 1: Models for Mountain Trails			
Model	Square Feet*	Style	Price^
Pine	1400	Ranch	$ 339,900
Spruce	1620	Ranch	$ 354,900
Cedar	1680	Ranch	$ 369,900
Elm	1680	Ranch	$ 369,900
Sierra	2275	Ranch	$ 449,500
Olympia	2030	Two Story	$ 385,900
Aspen	2321	Two Story	$ 434,900
Vail I (no bonus room)	2577	Two Story	$ 469,000
Vail II	3104	Two Story	$ 494,900

* Does not include finished basement.
^ Interior lot – For Lakeside Lot add $165,000.

WHAT'S FOUL IS FAIR AND WHAT'S FAIR IS FOUL

It was the 3[rd] weekend in June of 2004 and Davis and Hodgetts were having their usual weekly meeting to go over business matters which Adrienne normally did not attend since she was usually actively engaged with real estate agents, potential renters, and home buyers.

"Hodgetts, I have good news and I have bad news" started Davis. "Go on" beckoned Hodgetts "you've perked my fancy. But let's get the bad news out of the way first." ""Well" Davis's voice cracked a bit from nervousness "you know that we had talked about working on a pay as you go plan with Snowy Mountains; that we would sign a contract to purchase all thirty-three lots but pay for the lots only once we broke ground on them." "Yes" muttered Hodgetts. With a moment's hesitation Davis blurted out " Well, that deal is dead."

Hodgetts looked stunned, as if he had been hit by a bullet from a 44 magnum at point blank range. "Dead, you say?' replied Hodgetts. "Dead? As in finished? Gone? Over? Wasted? Mortem? Cooked?" Hodgetts' face turned from a vibrant red to an ashen gray since he realized that if this project was dead the firm would have no other projects to work on and no homes to build.

"Hear me out," Davis cried. "I said that that particular deal was dead, not that the total deal was dead!" "Oh?" countered Hodgetts. "Yes, yes my friend" Davis responded. "The good news is that we still do have a deal, however, the deal is that we must purchase all thirty-three lots at once." "All at once?" Hodgetts exclaimed. "Ok," Hodgetts sarcastically spoke, "and how much are these thirty-three lots going to cost us, all at once?" "Why," retorted Davis. "The cost will only be about $76,000 per lot. A very reasonable price given the fact that individually they were going to charge us $ 70,000 for the inside lots and $ 205,000 for a lakeside lot. Given the mix of lakeside lots to interior lots we're getting at least a 10% break."

Hodgetts was getting angry. "Yes we're getting a break alright, a break in our necks! At approximately $76,000 per lot you're telling me that we're going to have to raise approximately $2.5 million dollars. I've already leant the company over $250,000 and I have about the same in reserve. Where in God's name do you think I can get this amount of money from? I am not a bank you know!"

FOOLS GOLD?

"Wait a minute, wait a minute – let's get this train back on track. I have yet to give you the really good news." Davis was trying to calm Hodgetts down and at the same time finish his line of reasoning. If he failed to convince Hodgetts of the efficacy of the deal right now, the deal was as good as dead. "I have calculated what our cash flow and profits would be from the sales of these homes and I must admit that they're impressive." Hodgetts harrumphed in the background, crossed his arms, but allowed Davis to resume. Davis then handed Hodgetts a sheet of paper and the asked him to take a few minutes to peruse the fact sheet. See Table 2, below.

Table 2: Estimated Profits from Mountain Trails Subdivision

Models	Price	Building Cost Per Sq. Ft.*	Property Cost	Total Cost	Profit
Pine	$ 339,900	$140,000	$76,000	$216,000	$123,900
Spruce	$ 354,900	$162,000	$76,000	$238,000	$116,900
Cedar	$ 369,900	$168,000	$76,000	$244,000	$125,900
Elm	$ 369,900	$168,000	$76,000	$244,000	$125,900
Sierra	$ 449,500	$227,500	$76,000	$303,500	$146,000
Olympia	$ 385,900	$203,000	$76,000	$279,000	$106,900
Aspen	$ 434,900	$232,100	$76,000	$308,100	$126,800
Vail I (no bonus room)	$ 469,000	$257,700	$76,000	$333,700	$135,300
Vail II	$ 494,900	$310,400	$76,000	$386,400	$108,500

* $100/square foot; profit for a lakeside lot is an additional $89,000.
Minimum profit = 33 lots ($106,900/per lot) + 7 lakeside lots ($89,000) = $3,527,700 + $623,000 = $4,150,700

Hodgetts kept looking and looking at the numbers until they were nothing but a blur. "How did you get these numbers?" he asked Davis incredulously. "Well" Davis began "I took our historic building costs per square foot, which have been around $85, and figured in a fudge factor of $15 a square foot given our need to produce a high quality product as well as to have some contingency funds. I then added the average lot cost in order derive our total cost. Lakeside homes sell at a premium price so I added the profit margin on these lots, the additional sales price minus the average property costs, for the seven lakeside properties to obtain the total profit for this building project. Over four million dollars even if we sold only the least profitable model; not a bad piece of change I might say!"

Dollar signs started dancing in Hodgetts' head and all that a now jubilant Hodgetts could fathom was that he and his excellent friend Davis were going to be rich enough to retire at an early age. Davis gave Hodgetts a few moments to gather his composure so that they could move onto the more pressing issue, the raising of the purchase price of the land, $2.5 million dollars. It was evident that neither he nor Hodgetts had the where-with-all to raise this type of capital on their own and he knew that they would have to go to either banks or venture capitalists to raise the funds they would need. He and Hodgetts knew very little about raising capital and decided that they should do some research before they tackled such a critical issue.

JUSTIN MARTIN TO THE RESCUE

Davis and Hodgetts could not meet the following week to discuss what research they both had come up with. Davis however e-mailed Hodgetts the following message:

> I got a call yesterday from Justin Martin that apparently he has arranged a $2 million+ loan for us to take down all the properties for the patio homes and another $1 million from Benefit Bank for construction.[3] I have also found several investors who would be willing to buy patio homes, rent them back to us as show homes for a year, and then sell the homes on their own. Furthermore, our [own] mortgage lender is willing to offer mortgages based upon the retail value of our patio homes to qualified buyers and close on these mortgages prior to actual construction. This gives us lots and lots of resources to cover the cost of the property and have solid operating capital with minimal "out-of-pocket" expenses. I'll look into this further and get back to you.

How the Loans Would Work

The Davis's arranged a meeting with the bank president and it went just as planned. The Davis's showed off their approved home designs, their price list, Richard's cost estimates, as well as Adrienne's list of all of their subcontractors and support personnel. The bank president and the senior loan officer, good friends of Justin Martin, were quite impressed with what they deemed as a superior presentation; they had worked with many home builders before but none who had such a good command of the situation, especially the numbers. The Davis's and Stephen Hodgetts' credit check came back quite positive, supported by their rental and construction businesses.

The Benefit Bank loan seemed straight forward enough but dealt with only the land purchase. Hodgetts and Davis would have to go through their own mortgage lender for the construction loans, thereby providing cash flow throughout the building of the home. The construction loan, would be paid out as a percentage of the work completed, and would in the end cover a total of 80% of the assessed value of the home. The construction loan could be taken over by the home owner and converted to a permanent loan at minimal expense.

Davis and Hodgetts felt that they had their cash flow covered. For example, once Davis and Hodgetts started to build on a property, with a construction loan they could immediately recover 80% of the retail value of the property (calculated as a percentage of the value of the home). Since the property, if it was an inside lot, was worth approximately 1/3 of the value of the home (see Table 2 above), Davis and Hodgetts could expect to receive at a minimum around $ 90,000 (assuming they sold the least expensive home) or as much as $ 131,000 (for the most expensive home).[4]

Davis and Hodgetts estimated that it would take approximately three months to build each home and therefore they felt that this construction loan would actually provide them not only cash to pay the bank loan on the land back but also additional funds beyond their construction costs (their profit margins were over 20% per home) to pay off the interest on the construction loan (at 6%).

Benefit Bank would loan Davis and Hodgetts the amount requested to purchase the land ($2.5 million dollars) at 6% (2 points over the prime lending rate) which they would be responsible to pay back over the life of the development (approximately 12-16 months). The amount of each monthly payment could be as low as interest only or as much as the entire loan amount; the amount was left up to DHR's discretion. In order to make the loan happen, however, Davis understood that DHR would have to come up with 10% of the requested loan amount as a down payment ($250,000) and both DHR Patio Homes and Davis and Hodgetts personally would guarantee the loans.[5] Before they left the bank, Richard Davis, as senior partner of DHR Patio Homes, LLC, made sure to sign the loan agreement on behalf of the corporation.

PLANS OF MICE AND MEN

That night Davis and Hodgetts got together to figure out exactly how they were going to raise the $ 250,000. Hodgetts still had the ability to lend the firm $ 250,000 but both he and Davis agreed that they would prefer not to touch this money unless they absolutely had to since this would involve Hodgetts liquidating some of his assets (selling stocks and bonds). Davis's first idea was to form an investment group.

"We really do need investor help getting our $250,000 together" explained Richard Davis. "I met with David our mortgage broker yesterday about forming an investor group that could raise that money. I'm not sure what their incentive is yet, but I'm working on it. One thing we talked about before was to sell them spec homes and let them earn a profit." "A good idea" replied Hodgetts "but that doesn't help us with the down payment for the loan – you can't sell a home on property you don't yet own!"

"That's true" Davis countered. "My second idea was to form a real estate investment trust (REIT).[6] We could find, let's say ten individuals, excluding ourselves, who would purchase certificates of ownership in the trust, each unit being worth $25,000, which would in turn use the money for our loan collateral. The investment trust would then get paid for lending us the money and distribute a minimum of 90% of their income to the investors free of corporate income tax." (http://www.reitnet.com/reits101/index.html, August 12, 2004). "And what type of return on investment might these REIT investors look for?" slyly answered Hodgetts. "Well" retorted Davis. "If the average dividend yield on REITs is 7.3%, then I would expect that our investors might want a slightly higher return since, unlike publicly traded REITs, their units would be much harder to liquidate. I'd figure that they'd want at least an 8% return on their investment."

"OK" Hodgetts agreed "they'd certainly want a very good return, I know that I would! However, who is going to find these ten wise investors and how long would it take to establish a REIT?" Davis quickly responded. "In terms of the investors, one or two of our colleagues have shown an interest in our real estate ventures, however, their interest has been mainly in buying homes for rental purposes. I know that we are precluded from investing in the REIT but that does not stop our family members. In terms of how long it would take to form a REIT, I would assume that the paperwork would be similar to forming a LLC; we would need to gather all of the investors in order to form the trust. Let me make a note on this to call our lawyer and verify what I've told you."

"OK" Hodgetts continued. "Let's assume that we could neither get enough investors together nor could form this REIT in time, what is our other backup plan?" Davis had to clear his throat for his upcoming answer since he knew that Hodgetts would not be at all happy with their remaining options. "We have several choices. First, we both have retirement plans with TIAA-CREF through our college. We are allowed to borrow against our retirement plans up to $50,000, assuming we move enough funds out of stock accounts and into their basic annuity account to cover the loan; that raises $100,000. Secondly, we both could apply for second mortgages. Our mortgage broker tells me that between our two homes we could get another $150,000; and there you have it, $250,000 dollars!"

Davis was about to repeat his last sentence when Hodgetts finally broke out of his daze and asked Davis how quickly they could implement the latter solution. Davis went over the procedure for applying for a loan on-line from TIAA-CREF as well as what paperwork would need to be completed for the home equity loans. Hodgetts seemed satisfied with the process and expressed his thanks for Davis's good work.

THE FIRST FEW TWISTS OF FATE

The next day Hodgetts decided that he needed to learn about REITs so he could understand what they were and how they worked. A little on-line surfing informed Hodgetts that the REIT must have a minimum of 100 shareholders. (http://www.private-placement-attorney. com/reit.htm, August 13, 2004.) Certainly they could form an investor group as a LLC but the LLC, unlike a REIT, would be taxed by the IRS as either a partnership (profits and losses are passed through to the members of the LLC) or a corporation. (Mancuso, 2004) Several discussions with potential investors quickly lead Hodgetts and Davis to conclude that they could not wait for an investor group to form and decided to move ahead with their alternative plan; borrowing from their retirement funds and getting a 2nd mortgage on their homes (equity lines of credit). In the interim, Justin Martin was pressing for a closing date on the properties and they settled on July 15th. He FAX'ed over the land contract and asked Davis to get back to him if he had any questions (See Exhibit 5). That gave them two weeks to get both their credit lines and loans, a difficult but not impossible task.

It was July 4th weekend and Hodgetts was at his home when he received the following e-mail from Davis:

> Mountain Trails is getting closer. I'm having to send additional figures to Benefit Bank to show that we are making profits on our homes (what they have seen is our analysis using cost per square foot – they now want statements that shows each home's profit margin based upon actual labor and material costs given our architectural designs). Plus, their figures did not show the income we get from our rental homes nor the amount of depreciation we have realized. With all these in hand, they think they will be able to close within 10 day to 2 weeks.
>
> They did give me a bit of a shock in that since we are new[7] and not super strong financially, they are now only willing to finance 80% of the loan which means that we need to come up with $500,000 instead of $250,000. After the initial shock, I did start to do some figuring and I think we may be alright.
>
> Also, the Florence development is still a problem in terms of the liens, but I am hopeful we'll be out of the houses there within 6 weeks (we only getting stuck with four lots of land). Our mortgage broker says he may have a buyer or two for the homes there and that he is trying to put together his own investment group to purchase the other homes for rental purposes. He wants a 10% discount, not a real problem since we save 6% on real estate brokerage fees.
>
> I'm putting together numbers and you and I will have to scheme in terms of timing, but I think I've got a handle on most of the beast.

Hodgetts' face nearly hit the floor. Where were they going to come up with another $250,000 in less than two weeks? Davis's answer of selling homes prior to the closing made no sense; how could you sell homes when you didn't even own the property they were going to be built upon? Also, was Davis hoping that the liens on the Florence development would be resolved in the next two weeks so that these homes could be sold and the profit used as part of this additional down payment? Hodgetts called Davis to discuss the matter and to develop an alternative plan for raising another quarter of a million dollars. They always had Hodgetts' stock portfolio but Hodgetts was quite loathe to liquidate these funds given he'd have to pay capital gains taxes and also he and Davis would be left with no backup resources.

THE HERO RETURNS BUT DHR IS NOT OUT OF THE WOODS YET

Hodgetts and Davis, after a long talk, agreed that they should discuss the issue of needing an additional ¼ million dollars with Justin Martin and see what advice he would give them. They thought perhaps that he could talk with his friends at Benefit Bank and get the bank to rethink their position. Worst case scenario, they would have to put the closing off until they could raise the money. Davis told Justin Martin everything, including their problems in the Florence Development. Justin Martin, to Davis's amazement, offered to loan Davis and Hodgetts the money as a short bridge loan to be paid back as soon as possible so they could close on the deal. Justin Martin for the second time had acted as DHR's guardian angel and Davis immediately agreed to this deal.

While Justin Martin bailed out DHR for the 2nd $250,000, Davis and Hodgetts were having real problems getting their first ¼ million dollars together in a timely fashion. First TIAA-CREF, rather than wiring $ 50,000 to Davis's savings account, decided to send him a check instead. Davis received the check 5 days before the closing, not in enough time to cash the check (his bank's policy was that checks over $5,000 would take seven business days to clear). Secondly, TIAA-CREF did wire the money to Hodgetts' savings account, however, they wired him $ 100,000 instead of $ 50,000. It seemed that two wires were sent on different days, each for $ 50,000. When Hodgetts' bank went to correct the error, TIAA-CREF voided both transactions. Every time Hodgetts' bank would credit his account for $ 50,000, TIAA-CREF would withdraw the amount. The bank froze Hodgetts' account until they could clarify the situation with TIAA-CREF.

The news was no better from Davis and Hodgetts' mortgage company. Between the two of them, neither Davis and Hodgetts could not obtain a second mortgage even though they had a positive net worth of approximately $ 5 million dollars. Given the fact that both Davis and Hodgetts were both heavily leveraged through their other companies which they had personally signed for (the rental firm had property debts of nearly $ 1.5 million dollars), the mortgage company was reluctant to extend them any credit, even unsecured loans, since they did not believe that Davis and Hodgetts would have the cash flow to pay back the loans. Their analysis of the situation excluded the Snowy Mountains deal.

The problem was that most of Davis and Hodgetts' assets were tied up in either real estate or in retirement accounts; the real estate could not be liquidated quickly (and those in the Florence Development had liens placed upon them and could not be liquidated at all) and the retirement accounts had highly restrictive clauses for liquidating accounts and large penalties (not to mention the tax implications and Hodgetts' bank problems). Simply stated, Davis and Hodgetts were asset rich but cash poor. Hodgetts reluctantly agreed to liquidate his stock holdings, and on July 12th Davis and Hodgetts had just enough funds to go to closing.

AND IN THE END

It was July 14th and Richard Davis was verifying the paperwork on the pre-construction sale of several of the patio homes to be built in Mountain Trails, when he received a call from Justin Martin's lawyer to verify the closing date as the 15th and to make sure that all the details had been covered. It had been verified that Hodgetts' funds had been wired to Benefit Bank and that Justin Martin's funds were also at the bank.

All the bases seemed to have been covered when the lawyer started discussing the establishment of an escrow account. Davis was quite confused and asked the lawyer what was the escrow account for. The lawyer explained that the loan that Justin Martin was making to DHR required that $50,000 be put up as collateral for the loan – the escrow account would retain those funds until the loan was paid back. Davis insisted that there was never any mention of collateral and that it made no sense for DHR to borrow $250,000 while putting $50,000 in escrow, leaving them $50,000 short of the funds they needed for the closing. Although the lawyer agreed with Hodgetts that the loan amount should have then been for $300,000 if Justin Martin wanted to have $ 50,000 set aside in an escrow account, Justin Martin's orders to the lawyer were quite explicit – no escrow account, no loan.

Davis was dumb struck and felt that he had just been run over by a Bradley tank. Hodgetts was tapped out of funds and his bank account was frozen while Davis's TIAA-CREF check for $50,000 would not clear until at least Monday, the 19th. Where was he going to get $50,000 in one day? More importantly, how could he tell Justin Martin that DHR could not go through with the land deal because Justin Martin, the man who not only arranged for the bank loan but also personally leant DHR money, the man who would make him and Hodgetts rich beyond both their wildest imaginations, screwed up the deal by his own requirement of a $ 50,000 set aside escrow account?

Davis discussed the situation with Adrienne and then picked up the phone to call Hodgetts to see if the two of them could work their way out of this mess.

REFERENCES

Mancuso, A. (2004). *Your Limited Liability Company: An Operating Manual*. 3rd Edition. Berkeley, CA.: Nolo

http://www.private-placement-attorney. com/reit.htm, August 13, 2004.

http://www.reitnet.com/reits101/index.html, August 12, 2004.

ENDNOTES

1 All information in this case is factual in nature. The names of the company and the characters in the case have been changed at the request of the owners.

[2] A patio home is a detached form of condominium. The homeowners association performs all exterior maintenance and collects fees from the individual homeowners.

[3] Single-close Construction-To-Permanent Loan: "This is the most common and cost-efficient construction loan option. The single-close allows homeowners to qualify and close with one application - one set of fees - one closing - one loan. This loan provides funds that are disbursed as needed during the construction phase and then converts to a permanent, fully-amortized mortgage at time of completion. The loan requires 'interest-only' payments be made on the monies disbursed during the construction phase." http://www.rehabhome.com/newhomeconstruction loan_loans.htm, January 15, 2005.

[4] To calculate the construction loan payment, take 80% of 1/3 the sales price of the home

[5] Davis and Hodgetts' combined total net worth at that time, approximately $ 5 million dollars, was deemed adequate by the bank to cover the loan.

[6] A corporation or trust that uses the pooled capital of many investors to purchase and manage income property (equity REIT) and/or mortgage loans (mortgage REIT).

[7] Benefit Banks' policy on first-time corporate loans was to finance only 80% of the total loan. This was not disclosed to Davis at his first meeting with the bank although it was in the paperwork associated with the loan agreement.

Exhibit 1: Mountain Style Homes – The Club House at Snowy Mountains

Exhibit 1 is a picture of the Club House at Snowy Mountains and may be obtained from the authors.

Exhibit 2: Development Description – Snowy Mountains

Snowy Mountains is a premier lake front community, featuring superior master-planning and a full complement of amenities for today's active western lifestyle. With 700 acres of planned lakes and open space, living at Snowy Mountains makes everyday a vacation.

Snowy Mountains has continually placed a great importance on creating and maintaining a quality, environmentally-friendly, enjoyable marine environment. The abundant wildlife includes the pelican, eagles, several varieties of herons, deer and foxes. Incorporating the mature natural character of the local lakes with professionally-engineered real estate development,

Beaches

The designers placed sand throughout the subdivision in areas where grass would traditionally be installed in non-lake front real estate. The sand is 3-4 feet deep and was a by-product of the sand and gravel operation that at one time occupied the site. Sand curbs delineate property lines for those homes situated on beach front property. The sand gives the homeowners the opportunity to enjoy their own private beach and allows them to walk down to the water's edge from the back of their lots.

Lakes

The lakes are man-made bodies of water. Like the beaches, they were made as a result of the sand and gravel mining operation which previously occupied the site. The State has classified the lakes as certified water storage reservoirs which will insure their integrity over the years. The lake shores have been sculpted to a gradual, aesthetically pleasing incline to allow for recreational activities in the lakes, and the sand on the beaches descends past the water line to emulate natural beach front settings.

The depth of water in the lakes is in the 20-25 foot depth range and Snowy Mountains operates a continuous water quality system to assure enjoyable, clean conditions. Included in the water quality control system are several oxygenation systems, similar to the air pumps used in aquariums. This maximizes living conditions for aquatic life as well as aesthetically pleasing water quality.

Exhibit 2: Development Description – Snowy Mountains

Jogging Trails

Snowy Mountains boasts over 7.5 miles of on-site recreational trails. The trails are designed for activities such as jogging, biking, roller blading, walking or simply the enjoyment of the area's natural character.

Snowy Mountains is a unique setting for discriminating homeowners who wish to purchase a home with enduring, quality-of-life prerequisites. Homes are available in a variety of sizes and shapes to fit every income and lifestyle. Biking, boating, golfing, tennis, swimming, fishing, and of course.... relaxing. Prices range from $150,000 to $750,000.

Exhibit Three: Site Plan for Mountain Trail At Snowy Mountains

Exhibit 3 is a picture of the Site Plan for Mountain Trail and may be obtained from the authors.

Exhibit Four: Mountain Trail Models

The Pine

- 1400 Square Feet of total finished space
- 2 bedrooms
- Dining room with tray ceiling
- Large kitchen with breakfast nook and butler's pantry
- Large 5 piece master bath
- Master bedroom walk in closet
- Gas log fireplace with wood mantle
- Large spacious rear covered porch
- 420 foot garage with garage door opener
- Full unfinished basement with rough-in
- Prices begin at $339,900 (interior lot)

The Spruce

- Ranch with 1620 Square Feet of total finished space
- 2 bedrooms, 2 1/2 baths
- Dining room with tray ceiling
- Large kitchen with breakfast nook
- Large 5 piece master bath

- Master bedroom walk in closet
- Gas log fireplace with wood mantle
- Large spacious rear covered porch
- 420 foot garage with garage door opener
- Full unfinished basement with rough-in
- Prices begin at $354,900 (interior lot)

The Cedar

- Ranch with 1680 Square Feet of total finished space
- 3 bedrooms, 2 baths
- Dining room with tray ceiling
- Large kitchen with breakfast nook
- Large 5 piece master bath
- Master bedroom walk in closet
- Gas log fireplace with wood mantle
- Large spacious rear covered porch
- 420 foot garage with garage door opener
- Full unfinished basement with rough-in
- Prices begin at $369,900 (interior lot)

The Oak

- Ranch with 1680 Square Feet of total finished space
- 2 bedrooms, 2 baths
- Den (or 3rd. bedrom)
- Dining room with tray ceiling
- Large kitchen with breakfast nook
- Large 5 piece master bath
- Master bedroom walk in closet
- Gas log fireplace with wood mantle
- Large spacious rear covered porch
- 420 foot garage with garage door opener
- Full unfinished basement with rough-in
- Prices begin at $369,900 (interior lot)

The Sierra

- Ranch with 2275 Square Feet of total finished space
- 3 bedroom, 3 1/2 baths
- Dining room with tray ceiling
- Large kitchen with breakfast nook
- Large 5 piece master bath
- Master bedroom walk in closet
- Gas log fireplace with wood mantle
- Large spacious rear covered porch
- 420 foot garage with garage door opener
- Full unfinished basement with rough-in
- Prices begin at $449,500 (interior lot)

Exhibit Four: Mountain Trail Models

The Olympia

- 2-Story with 2030 Square 2275 Square Feet of total finished space
- 3 bedroom, 3 baths
- Beamed study
- Dining room with tray ceiling
- Large kitchen with breakfast nook
- Large 5 piece master bath
- Master bedroom walk in closet
- Gas log fireplace with wood mantle
- Large spacious rear covered porch
- 420 foot garage with garage door opener
- Full unfinished basement with rough-in
- Prices begin at $385,000 (interior lot)

The Aspen

- 2-story with 2324 Square Feet of total finished space
- 3 bedrooms, 3 baths
- Den with beamed ceiling
- Dining room with tray ceiling
- Large kitchen with breakfast nook
- Large 5 piece master bath
- Master bedroom walk in closet
- Gas log fireplace with wood mantle
- Large spacious rear covered porch
- 420 foot garage with garage door opener
- Full unfinished basement with rough-in
- Prices begin at $434,900 (interior lot)

Vail

- 2-story with 2577 Square Feet of total finished space
- 3 bedrooms, 2 1/2 baths
- Prices begin at $469,900 (interior lot)

Vail II

- 2-story with 3104 Square Feet of total finished pace
- 3 bedrooms, 3 1/2 baths
- Paneled den with beamed ceiling
- Dining room with tray ceiling
- Large kitchen with breakfast nook with granite slab island
- Large 6 piece master bath
- Master bedroom walk in closet
- 266 sq ft bonus room
- Gas log fireplace with wood mantle
- Large spacious rear covered porch
- 420 foot garage with garage door opener
- Full unfinished basement with rough-in
- Prices begin at $494,900 (interior lot)

Exhibit Five: Land Contract – Mountain Trails Subdivision of Snowy Mountains

VACANT LAND/FARM AND RANCH
CONTRACT TO BUY AND SELL REAL ESTATE
(FINANCING SECTIONS OMITTED)

_____________, 2004

1. **PARTIES AND PROPERTY.** D H R Patio Homes, LLC, ("Buyer"), agrees to buy, and Snowy Mountains, LLC, ("Seller"), agrees to sell on the terms and conditions set forth in this contract, the following described real estate, to wit:

   Lots 1, 2, 6 through 10, 12, 13, 19 through 26, 28 through 35 and 38 through 45,
   Snowy Mountains Subdivision Sixth Filing also known as Vacant Land____

   (Insert Addresses)

   together with all interest of Seller in all easements and other appurtenances thereto, except as herein excluded (collectively the "**Property**").

2. **EXCLUSIONS.** **N/A**

3. **PURCHASE PRICE AND TERMS. See attached Addendum**

4. **FINANCING CONDITIONS AND OBLIGATIONS. Intentionally deleted.**

5. **APPRAISAL PROVISION. Intentionally deleted.**

6. **COST OF APPRAISAL. Intentionally deleted.**

7. **ASSIGNABLE.** This contract may be assigned by Buyer.
8. **EVIDENCE OF TITLE.** Seller shall furnish to Buyer, at Seller's expense, a current commitment for owner's title insurance policy issued by Weld County Title Company ("**Title Company**") in an amount equal to the purchase price, **within five (5) days from the Effective Date of this Contract, as such term is defined on the attached Addendum** ("**Title Deadline**"). Upon delivery of the title insurance commitment, Seller will provide legible copies of instruments listed in the schedule of exceptions ("**Exceptions**") to the title insurance commitment to Buyer, at Seller's expense. This requirement shall pertain only to instruments shown of record in the office of the clerk and recorder of the designated county or counties. The title insurance commitment, together with any copies or abstracts of instruments furnished pursuant to this Section 8, constitute the title documents ("**Title Documents**"). Seller will pay the premium for the title insurance policy at closing and have the title insurance policy delivered to Buyer as soon as practicable after closing.

9. **TITLE.**
   (a) **Title Review**. Buyer shall have the right to inspect the Title Documents or abstract. Written notice by Buyer of unmerchantability of title or of any other unsatisfactory title condition shown by the Title Documents or abstract shall be signed by or on behalf of Buyer and given to Seller on or before **ten days (10) days after the Effective Date of this Contract** (as such term is defined on the attached Addendum) (the "**Title Deadline**"). If Seller does not receive Buyer's notice by the date(s) specified above, Buyer accepts the condition of title as disclosed by the Title Documents as satisfactory.
   (b) **Matters Not Shown by the Public Records**. Seller shall deliver to Buyer, on or before the Title Deadline set forth in Section 8, true copies of all lease(s) and survey(s) in Seller's possession pertaining to the Property and shall disclose to Buyer all easements, liens or other title matters not shown by the public records of which Seller has actual knowledge. Buyer shall have the right to inspect the Property to determine if any third party(s) has any right in the Property not shown

by the public records (such as an unrecorded easement, unrecorded lease, or boundary line discrepancy). Written notice of any unsatisfactory condition(s) disclosed by Seller or revealed by such inspection shall be signed by or on behalf of Buyer and given to Seller on or before **five (5) calendar days after the Title Deadline**. If Seller does not receive Buyer's notice by said date, Buyer accepts title subject to such rights, if any, of third parties of which Buyer has actual knowledge.

(c) **Special Taxing Districts**. Special taxing districts may be subject to general obligation indebtedness that is paid by revenues produced from annual tax levies on the taxable property within such districts. Property owners in such districts may be placed at risk for increased mill levies and excessive tax burdens to support the servicing of such debt where circumstances arise resulting in the inability of such a district to discharge such indebtedness without such an increase in mill levies. Buyer should investigate the debt financing requirements of the authorized general obligation indebtedness of such districts, existing mill levies of such district servicing such indebtedness, and the potential for an increase in such mill levies.

In the event the Property is located within a special taxing district and Buyer desires to terminate this contract as a result, if written notice is given to Seller on or before the date set forth in Subsection 9(b), this contract shall then terminate. If Seller does not receive Buyer's notice by the date specified above, Buyer accepts the effect of the Property's inclusion in such special taxing district(s) and waives the right to so terminate.

(d) **Right to Cure**. If Seller receives notice of unmerchantability of title or any other unsatisfactory title condition(s) as provided in subsection (a) or (b) above, Seller shall use reasonable effort to correct said title condition(s) prior to the date of closing. If Seller fails to correct said unsatisfactory title condition(s) on or before the date of closing, this contract shall then terminate; provided, however, Buyer may, by written notice received by Seller, on or before closing, waive objection to said unsatisfactory title condition(s).

10. **INSPECTION. See attached Addendum**

11. **DATE OF CLOSING**. The date of closing shall be held **14 days after the Effective Date (as such term as defined in the attached addendum).**

12 **TRANSFER OF TITLE**. Subject to tender or payment at closing as required herein and compliance by Buyer with the other terms and provisions hereof, Seller shall execute and deliver a good and sufficient **general warranty** deed to Buyer, on closing, conveying the Property free and clear of all taxes except the general taxes for the year of closing, and except **N/A** Title shall be conveyed free and clear of all liens for special improvements installed as of the date of Buyer's signature hereon, whether assessed or not; except (i) distribution utility easements (including cable TV), (ii) those matters reflected by the Title Documents accepted by Buyer in accordance with subsection 9(a), (iii) those rights, if any, of third parties in the Property not shown by the public records in accordance with subsection 9(b), (iv) inclusion of the Property within any special taxing district, and (v) subject to building and zoning regulations.

13. **PAYMENT OF ENCUMBRANCES.** Any encumbrance required to be paid shall be paid at or before closing from the proceeds of this transaction or from any other source.

14. **CLOSING COSTS, DOCUMENTS AND SERVICES**. Buyer and Seller shall pay, in Good Funds, their respective closing costs and all other items required to be paid at closing, except as otherwise provided herein. Buyer and Seller shall sign and complete all customary or required documents at or before closing. Fees for real estate closing services shall not exceed **$300.00** and shall be paid at closing by **one-half by Buyer and one-half by Seller.** The local transfer tax of **N/A** % of the purchase price shall be paid at closing by **N/A** Any sales and use tax that may accrue because of this transaction shall be paid when due by **Buyer**.

15. **PRORATIONS**. General taxes for the year of closing, based on the taxes for the calendar year immediately preceding closing, rents, water and sewer charges, owner's association dues, and interest on continuing loan(s), if any, and **N/A** shall be prorated to date of closing.

16. **POSSESSION.** Possession of the Property shall be delivered to Buyer as follows: **date of closing**, subject to the following lease(s) or tenancy(s): **N/A**. If Seller, after closing fails to deliver possession on the date herein specified, Seller

shall be subject to eviction and shall be additionally liable to Buyer for payment of **$_______** per day from the date of agreed possession until possession is delivered.

17. **CONDITION OF AND DAMAGE TO PROPERTY** . Except as otherwise provided in this contract, the Property and Inclusions shall be delivered in the condition existing as of the date of this contract, ordinary wear and tear excepted. In the event the Property shall be damaged by fire or other casualty prior to time of closing, in an amount of not more than ten percent of the total purchase price, Seller shall be obligated to repair the same before the date of closing. In the event such damage is not repaired within said time or if the damages exceed such sum, this contract may be terminated at the option of Buyer. Should Buyer elect to carry out this contract despite such damage, Buyer shall be entitled to credit for all the insurance proceeds resulting from such damage to the Property and Inclusions, not exceeding, however, the total purchase price. Should any Inclusion(s) or service(s) fail or be damaged between the date of this contract and the date of closing or the date of possession, whichever shall be earlier, then Seller shall be liable for the repair or replacement of such Inclusion(s) or service(s) with a unit of similar size, age and quality, or an equivalent credit, less any insurance proceeds received by Buyer covering such repair or replacement. The risk of loss for any damage to growing crops, by fire or other casualty, shall be borne by the party entitled to the growing crops, if any, as provided in Section 2 and such party shall be entitled to such insurance proceeds or benefits for the growing crops, if any.

18. **TIME OF ESSENCE/REMEDIES**. Time is of the essence hereof. If any note or check received as earnest money hereunder or any other payment due hereunder is not paid, honored or tendered when due, or if any other obligation hereunder is not performed or waived as herein provided, there shall be the following remedies:

    (a) **IF BUYER IS IN DEFAULT:**
    Seller may elect to treat this contract as cancelled, in which case all payments and things of value received hereunder shall be forfeited and retained on behalf of Seller, and Seller may recover such damages as may be proper, or Seller may elect to treat this contract as being in full force and effect and Seller shall have the right to specific performance or damages, or both.

    (b) **IF SELLER IS IN DEFAULT:**
    Buyer may elect to treat this contract as cancelled, in which case all payments and things of value received hereunder shall be returned and Buyer may recover such damages as may be proper, or Buyer may elect to treat this contract as being in full force and effect and Buyer shall have the right to specific performance or damages, or both.

    (c) **COSTS AND EXPENSES:**
    Anything to the contrary herein notwithstanding, in the event of any arbitration or litigation arising out of this contract, the arbitrator or court shall award to the prevailing party all reasonable costs and expenses, including attorney fees.

19. **EARNEST MONEY DISPUTE**. Notwithstanding any termination of this contract, Buyer and Seller agree that, in the event of any controversy regarding the earnest money and things of value held by broker or closing agent, unless mutual written instructions are received by the holder of the earnest money and things of value, broker or closing agent shall not be required to take any action but may await any proceeding, or at broker's or closing agent's option and sole discretion, may interplead all parties and deposit any moneys or things of value into a court of competent jurisdiction and shall recover court costs and reasonable attorney fees.

20. **ALTERNATIVE DISPUTE RESOLUTION: MEDIATION.** **N/A**

21. **ADDITIONAL PROVISIONS:** (The language of these additional provisions has not been approved by the Colorado Real Estate Commission.) **See attached Addendum**

22. **RECOMMENDATION OF LEGAL COUNSEL**. By signing this document, Buyer and Seller acknowledge that this document has important legal consequences and had recommended the examination of title and consultation with legal and tax or other counsel before signing this contract.

23. **TERMINATION**. In the event this contract is terminated, all payments and things of value received hereunder shall be returned and the parties shall be relieved of all obligations hereunder, subject to Section 19.

24. **SELLING COMPANY BROKER RELATIONSHIP**. **N/A**

25. **NOTICE TO BUYER**. **See attached Addendum**

26. **NOTICE TO SELLER**. **See attached Addendum.**

27. **MODIFICATION OF THIS CONTRACT.** No subsequent modification of any of the terms of this contract shall be valid, binding upon the parties, or enforceable unless made in writing and signed by the parties.

28. **ENTIRE AGREEMENT**. This contract and the attached Addendum and **Exhibit A**, the terms of which are incorporated herein by reference constitutes the entire contract between the parties relating to the subject hereof, and any prior agreements pertaining thereto, whether oral or written, have been merged and integrated into this contract.

29. **COUNTERPARTS**. A copy of this document may be executed by each party, separately, and when each party has executed a copy thereof, such copies taken together shall be deemed to be a full and complete contract between the parties.

BUYER:
D H R Patio Homes , LLC.

By: ______________________________
Its: ______________________________
SELLER:
Snowy Mountains, LLC.

By:____
Its: _______________________________________

DAVID WALENTAS' TWO TREES MANAGEMENT COMPANY: A CASE OF DELIBERATE ENTREPRENEURSHIP

Noushi Rahman, Pace University
Fabiha Naumi, Katalyst, Bangladesh

CASE DESCRIPTION

This is an entrepreneurship case in the real estate industry (in a New York neighborhood called DUMBO). DUMBO is one of the most chic neighborhoods of New York City, specifically Brooklyn, and the revitalization has been a "planned gentrification" as opposed to a "natural gentrification" process. This case primarily focuses on (a) entrepreneurial traits and behaviors in the context of real estate development and (b) relevant corporate strategies—horizontal and vertical integration—for the entrepreneurial firm. The secondary focus is on the resource based view. This is a complex case and it requires some prior understanding of strategy concepts. It will be appropriate as a business policy case for senior undergraduate as well as graduate students. Also, it may be used exclusively as an entrepreneurship case with junior and senior undergraduate students. Considering the length of the case, it needs to be pre-assigned; students must have read the case before coming to the class. Questions about the case should also be pre-assigned to point students' thinking in the desired direction. Actual analytical discussion should take roughly 10 minutes per question discussed, and another 5 to 10 minutes would be enough to provide a case summary in class.

CASE SYNOPSIS

Real estate entrepreneur-turned-mogul David Walentas has deliberately transformed Brooklyn's DUMBO neighborhood, where he holds about 3 million square feet of building space. Walentas has worked methodically to give the deserted area of DUMBO a neighborhood feel. Initially, he allowed artists to move in for very low rent. As artists moved in, so did culture, sophistication, and the need for art-related things. This gave rise to multiple galleries, design studios, and printing services firms in DUMBO. With an increasing population in the neighborhood, the government was more willing to invest in redeveloping State-owned properties in the area. This had strong positive spill over for Walentas' Two Trees Management Company.

At an estimated current going price of $700 per square foot, Walentas' 3 million square feet real estate holdings are worth about $2.1 billion. With development work in DUMBO factory buildings going full-steam, however, Walentas now faces a dilemma concerning his growth strategy.

Once these buildings are all leased out or sold, the growth of his company Two Trees Management will stagnate. Thus, despite tremendous success, what the future holds for Two Trees is anyone's guess.

SITUATION

By 2001, DUMBO (acronym for Down Under the Manhattan Bridge Overpass) was dubbed the most chic and up-and-coming neighborhood of Brooklyn. Comparing DUMBO's chic-ness to the most art-focused neighborhoods of Manhattan, *New York Times* quipped, "DUMBO is the new SoHo." Under the careful strategizing of real estate entrepreneur David Walentas, DUMBO has changed from a dilapidated graveyard of desolate buildings to a vibrant and happening residential-commercial hotspot.

Gentrification of DUMBO has been focused and quick. While urban scholars recognize gentrification as a gradual and slow process of neighborhood reversal through a variety of contributions from developers, real estate businesspeople, landlords, and the upper-middle class (Smith, 1982), such has not occurred in DUMBO. Control of a large portion of the DUMBO real estate allowed David Walentas the ability to act as a catalyst to speed up the gentrification of the neighborhood.

Through his company Two Trees Management, Walentas has reaped returns of almost one-hundred times that of his initial investments! As great as it sounds, Walentas is faced with a major dilemma among sell-now, sell-later, and rent-now options.

Walentas is converting his third building to condominiums this year. He currently owns 15 buildings in DUMBO. Prices keep increasing in the area, with the latest offering being in the range of $700-900 per square foot. So, converting all of the buildings now would mean making less money than is possible (assuming prices will increase further). However, the price keeps increasing partly because of the record-low interest rates that have enabled many people to afford homes that they previously could not. Industry experts keep warning that the mortgage interest rates will start going up (this has already started, although very modestly). So, when the mortgage interest rates go up, few buyers will be able to afford Walentas' highly priced luxury condos. Waiting for the economic cycle to come around 360 degrees (i.e., back to low interest rates) to sell his remaining housing stock at high prices is a huge gamble!

So what comes next for Walentas? His core competence is in real estate development and that is what he does best. There are, however, several tight spots to be aware of. Walentas can start working on another dilapidated neighborhood (perhaps Red Hook, which looks eerily similar to what DUMBO looked like 25 years ago). Or should he consider interior design, cleaning and maintenance, and other lines of businesses that will give him greater control over the real estate development business? He can continue to cater to the needs of his customers. Bringing in dry cleaning, bookstores, salons, spas, and a sports arcade could all add tremendous value to DUMBO.

Walentas is divided between the two options he is facing – starting full-fledged real estate development in some other area or starting other lines of business that will complement his existing DUMBO project. Looking out the window of his office, Walentas saw two iconic bridges (i.e., Brooklyn and Manhattan winged out) symbolically showing him the different paths to the future. A mistake here would seriously jeopardize his greatest achievement thus far. What should be his strategic path from here on?

BACKGROUND

Walentas grew up amidst poverty in Rochester; he describes himself as “an indentured orphan.” He went to the University of Virginia and while there he decided he wanted to be a developer. Determined and confident, Walentas got established as a developer relatively early in his life (Finn, 2003). It was, however, his project in DUMBO that turned him from an established developer to a real estate legend. It all started in 1979 when Walentas drove through the Fulton Ferry Landings, a several square block river-side area between the Brooklyn Bridge and the Manhattan Bridge. With the greatest skyline of the world as the background scenery, Walentas envisioned tremendous investment potentials in DUMBO.

Walentas himself described his career as being constantly “on the edge.” His shirt sleeves have the embroidered phrase: “No guts, no glory.” His philosophy complements two of Winston Churchill’s much renowned quotes that Walentas deeply believes in – “Fortune favors the brave” and “Never, never, never give up.” While growing up, Walentas was always a smart straight-talker – never hesitant to pursue what he believed in. Walentas describes his younger-self as ‘fresh.’ Reinforced with his spectacular success in DUMBO, he proclaimed that “perseverance beats inspiration any day” and one should “never take ‘no’ for an answer” (Schmid, 2004).

In 1982, Two Trees Management Co. purchased 9 buildings from Harry Helmsley for $16.5 million (Beyer Blinder Belle, 1990). The purchase price of some 2.5 million square feet of space was at the rate of $6.6 per square foot (Schmid, 2004). Two Trees later acquired other buildings, thus increasing its holdings to roughly 3 million square feet of space.

Soon after the purchase of these factory buildings in a completely dilapidated neighborhood, Walentas applied to the City government for a rezoning of the area. In 1984, the City and State governments conditionally designated Two Trees Management to develop the Empire Stores along with a number of city-owned sites in DUMBO (Beyer Blinder Belle, 1990). Walentas saw tremendous prospects in DUMBO and ‘seized the opportunity’ to bring about his plans. He proposed an elaborate rejuvenation plan for DUMBO. Suffice to say, such a grand plan was ‘too heavy’ to fly and needed revision.

Prior to his DUMBO investment, Walentas’ strategy has been simple: buy space, add value, and sell at high margin. The DUMBO investment, being Walentas’ largest holdings, did not fit into this traditional mold. Adding value to DUMBO seemed like an extremely challenging task. First, Walentas' proposed long-term plans of rejuvenation were plagued by political problems. The deputy Mayor of that time, Kenneth Lipper put many obstacles in Walentas' way with the DUMBO project for what have been described as some personal reasons (Finn, 2003). Then, in 1987, the stock market crashed. This had trickling effects on the real estate market. During 1989-1993, the New York real estate market was a total buyers market. So, one decade after acquiring roughly 3 million square feet of space, Walentas realized no gain. Worse yet, a significant portion of Walentas' wealth remained stuck in the gutters. At times, he even wanted to sell the properties; but could not do so as there was not a single buyer who would buy his vast building space.

During his continued financial hard-times, Walentas was patient. He survived through his other businesses—other revenue generating activities. However, amidst all the financial woes, Walentas was unwavering about his vision. He sent his son to the University of Pennsylvania. His son, Jed Walentas, apprenticed under Donald Trump (successfully, without being fired). And, the real estate boom beginning in the late 1990s set the stage for Walentas to realize his vision. Jed Walentas' solid education and excellent training made him his father's most reliable partner. Two Trees Management got a break in 1997 when the State Office of Parks, Recreation, and Historic Preservation solicited proposals for the redevelopment of the Empire-Fulton Ferry State Park. It was 'carpe diem' for Walentas, who was the only one to submit a proposal (on behalf of Two Trees). The State Office of Parks, Recreation, and Historic Preservation granted the proposal in 1998.

With great hopes and high spirits, Walentas engaged in detailed planning for the Fulton Ferry Park. The park was on the far-west side of DUMBO, just by the East River. Walentas' development plans of the State Park would provide a much needed green recreation area for DUMBO residents. The proposed redevelopment plan was very grand and expensive, costing the government $300 million. By 2000, the government withdrew its support for redeveloping the Park.

THE FUNCTIONING OF TWO TREES MANAGEMENT CORPORATION

Two Trees adds value to the properties it owns by converting factory buildings to posh offices and residential apartments. These offices and apartments have new fittings, large windows, and concealed electric, phone, and cable wirings. An excited Walentas exclaims: "We are thrilled to offer the finest move-in ready office suites in Brooklyn. DUMBO has Manhattan quality at one-tenth of the price" (Hagerdon Publication, 2001). Surely, Walentas is keen to bring new businesses to DUMBO.

Two Trees Management caters to businesses that are looking for a great deal of convenience in their daily operations. To facilitate in-coming business tenants, Two Trees offers four steps: visit space, sign lease, move-in, and get-to-work. In other words, all amenities, such as electrical wirings, telephone connections, and internet facilities are inclusive in the lease package.

The City and State governments' actions have had mixed effects on Two Trees. On the positive side, the rerouting of Bus 25 through DUMBO has added convenience for the residents.

In contrast, the State and City governments' on-and-off approach toward Empire-Fulton Ferry Park has caused much grief for Two Trees Management.

Governmental tax-breaks have made leasing prices in DUMBO and other Brooklyn neighborhoods relatively attractive. For example, through the Relocation and Employment Assistance Program (REAP) program, businesses moving to Brooklyn can potentially save $13-15 per square foot over the price in Manhattan. Another tax-break is in the form of annual tax credits. Small businesses meeting certain specifications become eligible for $3000 per employee tax credits. Also, real estate tax abatement of up to $2.50 per square foot is available to these new business tenants (Grassi, 2001). Lastly, many businesses qualify for reduced energy rates. Two Trees Management has definitely benefited from these government-induced benefits, for these benefits have made DUMBO office space even more attractive than what Two Trees can claim credit for.

BEYOND REAL ESTATE – THE MAKING OF A NEIGHBORHOOD

Two Trees' approach to DUMBO has largely been way beyond real estate development. Walentas has always given much attention to bringing in businesses of 'certain types,' particularly businesses that add cultural character to the neighborhood (see Table 1). In the 1980s, Walentas offered a great deal of space for zero or very little rent to artists who would come and make DUMBO their workplace and home. It is not surprising that over the years many galleries, printing services, design studios, and software businesses have leased offices in DUMBO. Boutique galleries include M3 Projects, 5 + 5 Gallery, Metaphor Contemporary Art, Howard Schickler Fine Art, Paint Gallery, Gale Gates et al., Smack Mellon Studios, and d.u.m.b.o. Arts Center (DAC). More than a dozen printing services firms are also DUMBO tenants. Design studios, such as Four Eyes Production and Sceptre Consulting have added to the artistic or cultural character of the neighborhood. In recent months, several software firms and a couple of business consulting firms have also moved into the neighborhood.

Table 1: Esteemed Artists and Arts Organizations Working in DUMBO

Artists and Arts Organization	Genre	Critical Acclaim
Vito Acconci	Film, video, photographs, & sculptures	MoMA
Art at St. Anns	Concert, music theater, puppet theater	
Brooklyn Front	Miscellaneous (art gallery)	
Creative Time	Miscellaneous (public arts projects)	Installations: "Consuming Places"
DUMBO Arts Center	Miscellaneous (annual d.u.m.b.o. art under the bridge festival)	
Tom Fruin	Sculptures (made of 'found objects')	
GAle GAtes et al.	Theater	

Table 1: Esteemed Artists and Arts Organizations Working in DUMBO		
Artists and Arts Organization	**Genre**	**Critical Acclaim**
Howard Schickler Fine Art	Photographs, paintings, drawings, and rare books (19th and 20th century)	
J. Mandle Performance	Miscellaneous (experimental arts using performances and installations)	
Lunatarium	Music, dance, film, video, installation, and performance art	
Mastel + Mastel	Digital art	
Sheila Metzner	Fine art, photography	Metropolitan Museum of Art; International Center for Photography; MoMA
One Arm Red	Meeting place for artists to mingle, establishing a sense of community	
Source: http://www.dumbolofts.com		

Bringing in culturally linked firms as business tenants, Walentas has created an environment that facilitates trade. The design studios can get access to the best and most competitively priced printing facilities. The galleries serve as an important channel to display and sell artworks and new designs to the public. Business consulting and software firms may contribute to all of these businesses in more specialized and/or technical ways. Overall, Walentas' neighborhood design has converted DUMBO into a trade-friendly neighborhood.

Walentas's goal is not merely to facilitate his business tenants. The primary goal is to make DUMBO a vibrant and lively community where employment and entertainment create a synergy. He has been actively involved in organizing a variety of festive events, such as the Egg Hung & Spring Fling, BARGEMUSIC, Summer Film Series, and It's My Park Day (see Table 2). Since DUMBO's buildings are mostly old factory-buildings, adding a residential feeling to the neighborhood is critical. Besides various festive events, developing the Empire-Fulton Ferry Park would go a long way in fulfilling this mission. Attracting gourmet shops also adds an upper-middle class aura to the neighborhood.

Another telling example comes from Walentas' search for a bakery. When some 2400 square feet of store space became available at 85 Water Street, Walentas decided to find a specific baker. While various businesses wanted to rent the space, Walentas would only rent the space to a baker. This choice prevented Two Trees Management from securing several confirmed tenants for the space, but it enabled Walentas to add a critical neighborhood-element to DUMBO. After much searching, Walentas found Almondine—a French-style bakery with surprisingly affordable fancy delicacies (Croghan, 2004). This was a significant step in DUMBO's transformation, because, as home improvement guru Bob Vila says, "what's a neighborhood without a bakery" (Croghan, 2004).

As DUMBO picks up momentum as a neighborhood, both residential and business tenants keep flocking in to get some space of their own. Upper-middle class buying power, coupled with a degree of sophistication, has attracted fine restaurants to the neighborhood. DUMBO residents can now go to *Pete's Downtown* for Italian, *Superfine* for Mediterranean, *Grimaldis* for Pizza, *Rice* for eclectic dishes, *Bubby's* for traditional American food, and *Five Front* and *River Café* for new American dishes (Zagat Survey, 2005). All of these restaurants are medium to high end. Grimaldis' coal oven pizzas are the highest rated New York pizzas by Zagat (food score 27 out of 30) (Zagat Survey, 2005). The River Café, which is very expensive, is one of the foremost all-round restaurants of greater New York City (food score 25, decoration score 28, service score 24—each score is out of 30) (Zagat Survey, 2005).

Table 2: Organized Cultural Events in DUMBO, April 2002 – October 2004

Dates	Events
April 10, 2002	Egg Hunt & Spring Fling at Brooklyn Bridge Park
September 2002 - May 2003	BARGEMUSIC
November 2003 - December 2003	Snapshot Fashions: Dressing in the 20th Century Exhibition at the MF Adams Gallery
January 29, 2004	Brooklyn Underground's Moonshine Theater presentation: "The Holy Mountain"
January 2004 - March 2004	MULTIPLEX at Smack Mellon
March 2004 - April 2004	MULTIPLEX at Smack Mellon
March 2004 – May 2004	Ricoh Gerbl and Robert Taplin and Smack Mellon
April 1, 2004	Jen Ferguson April Fool's Day at Superfine
July 2004 – August 2004	The Brooklyn Bridge Park Summer Film Series
August 2004 – August 2005	Family Concert – The Persuasions
October 2004	Good Samaritans
October 23, 2004	"It's My Park" Day

Source: http://www.dumbo-newyork.com

FINANCIAL STATUS AND THE FUTURE

The real estate development project of DUMBO has been extremely profitable for Walentas. From $6.6 per square foot to an average of $700 per square foot is indeed a long stretch. Nevertheless, now is a crucial time for Walentas because once his renovated buildings are leased out and/or sold, the growth of Two Trees will stand still. Anticipating this impending slowdown, Walentas has been trying hard to construct new high-rise buildings in DUMBO. However, political opposition has made such vertical expansion remote. Growing in other neighborhoods in a manner similar to DUMBO remains another alternative for Walentas' Two Trees. Besides growth through real estate development, Two Trees Management may consider going into other supporting businesses. For example, a household appliance store, a grocery, a salon and a barber shop can contribute to completing the neighborhood feel and convenience. Whatever path Walentas chooses to pursue now will be crucial to the continued success (or failure) of Two Trees Management Corporation.

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PEARL BEER

Henry ("Rod") Elrod, University of the Incarnate Word

CASE DESCRIPTION

Pearl Beer is purposefully written in an easy-going style intended to appeal to students, and is designed to stimulate classroom discussion. The case can be used in and management policy strategy classes or marketing classes. There is no intention to cast odious reflections on particular people or companies, Coors Beer and Pearl Beer included, nor to suggest a better way of management. The things Wayne says are just his opinions, and no one knows if they are true or not.

Students should prepare an analysis of what is going wrong at the company, and what they are going to do about it. The case does not include data for the students to analyze because the problems in the case, and their solutions, have their genesis in behavioral issues which are not affected by the application of statistical approaches or by the tools of managerial accounting. The case presents no technical difficulty, but requires the logical thought and clarity of expression typical of seniors and graduate students. It can be taught in a single class if the students prepare ahead of time, and students should spend perhaps an hour in a discussion group to prepare.

SYNOPSIS

Pearl Beer describes Wayne, a delivery truck driver for a beer distributor, as its central character. The company calls Wayne an outside salesperson. Wayne calls himself a truck driver. This dichotomy is the central theme of the case, which should be approached as an exercise in organizational behavior and employee motivation. Through Wayne's experiences students get an inside look at the organization and operation of the company, and a first hand view of the problems faced by management.

The manager, Jan Williamson, has a big problem. Relentless competition and the day-to-day battle for the minds of the company's employees are paramount. How can she capture the imagination of her employees and gain their spirited contribution to the efficient marketing of the company's products? How can she compete, and yet retain her integrity? How can we be competitive, and yet hold up our end of the bargain a company has with its employees and society? These are the questions raised by the case.

Pearl Beer reflects the reality that in business one never has enough time, resources or information upon which sound decisions may be based. Yet, management must analyze, develop plans and strategies and act. Students should prepare an analysis of what is wrong at the company, and develop a plan for what to do about it.

BACKGROUND

The Pearl Brewing Company, of San Antonio, Texas, was a regional brewer of the pale lager beer that replaced the dark bitters brewed in America until after the end of Prohibition in 1933 (Hennech, 2002). According to the *Handbook of Texas Online* Pearl was founded in 1881 by German immigrants to the San Antonio area, and after 100 year the successor organization was selling 1.8 million barrels of beer annually, in 45 states (Hennech, 2002).

Wholesale beer operations are often franchises authorized by the brewery and state licenses to deliver warm beer in cans, bottles and kegs to retails from distribution warehouses geographically scattered across the brewer's trade area. While laws and customs vary by state, in many jurisdictions, like Texas, local distributors compete based on advertising assistance to the local retail outlets as well as brand advertising, delivery service and consumer demand for the products. One-on-one sales contacts by the driver/salespeople are the companies' most important marketing tool.

Pearl Beer deals with a distributor in the Dallas-Fort Worth, Texas market struggling with declining sales and the relationship of the company (the local distributor for Pearl Brewing Company) with driver Wayne Johnson, and manager Jan Williamson.

WAYNE JOHNSON

Wayne is a complex character who appears to be simple. He is slim and muscular from hard work, and lots of it. Wayne never got out of the eighth grade, but he knows more than he lets on.

Wayne is a driver for the Pearl Beer Distributing Company in Fort Worth, Texas. Pearl has a nice facility on the South Freeway, a tilt-up, cement-sided warehouse building, with several motorized forklift machines and a fleet of about a dozen beer delivery trucks. These are 25-ton trucks, on a bobtail chassis, with four slide-up roll-top bin doors on each side. Wayne was glad when the company got those forklifts. It meant he no longer had to come in at five-thirty to load his truck in the mornings, as he had done for the first ten years he drove for Pearl. A forklift operator could do it in a few minutes. All Wayne had to do was drive through the wash rack every morning, and be on the road exactly at seven. The trucks carry only warm beer, not cold, and are never on the road before seven, because to do either is illegal for a Texas beer wholesaler. The truck cabs are not air-conditioned, but they do have AM radios.

The company has the Pearl distribution rights to Tarrant County, the home county for the city of Fort Worth. Wayne's route covers most of the southwest side of town, and includes just enough customers for him to be able to get to all the regulars each day. The route includes every kind of customer: grocery chains like H-E-B, convenience stores, like 7-Eleven, and numerous restaurants, pool halls and bars. Wayne feels there is no use in trying to get too many more customers. If he did, the company would just split his route, since he has all he can service in a day already.

Wayne is paid commission: twenty-five cents a case, no salary and no overtime. Under the Fair Labor Standards Act, Wayne is an "outside salesperson," exempt from the law's overtime requirements. Wayne can make a maximum of about $50,000 per year, if he empties six bays on the truck every day, which does not often happen. He made around $37,500 last year, which is not too bad considering he took an unpaid two-week vacation. Some days his sales are better than others, and he sells more beer in summer than winter.

Wayne drives a 15-year-old Chevrolet (his personal car, not the company truck.) It is a junker. Manual-transmission, six-cylinder-junk. Wayne calls it a "tool car," which means he stores tools in it. The headliner is ripped out, the windshield is cracked and the driver side window does not roll up and down any more. There is no back seat, and the hood is rusted through. It looks like birds may have once lived in it. Wayne has a bumper sticker that says, "Support the Troops."

The company pays half of Wayne's group health insurance cost. There is no pension plan, no IRA account, no 401K plan or SEP (simplified employee pension; see §408-K of the Internal Revenue Code.) They provide some life insurance for employees: one and one half times annual salary face value. In an industry where back injuries are common, there is no safety training, and no disability insurance.

There is a Teamster's local that drivers can join. Texas is an "open shop" state, meaning that even if a union officially represents the workers in a shop, the workers are not obligated to join. Members and non-members alike benefit from whatever the Teamsters are able to negotiate from management. Wayne colonized the Teamster's at Pearl several years ago, by organizing and leading a strike that lasted six months before management caved in. The union paid him some money, but in that six months without a pay check he used up all his savings and eventually lost the house he and his wife were buying. He moved his wife and four kids back to a cheap duplex apartment. The company would have fired him, but of course, that would have violated several Federal laws. Wayne figures they never will fire him, because it would look like retaliation for his union activities. Wayne says the union has not done much since getting the contract that ended the strike.

Wayne has Teamster's experience as an over-the-road driver for one of the national household moving companies. As a single man, Wayne drove all over the country, and he claims to know girls from Atlanta to Albuquerque. An interesting character, to say the least. He has a moon-shaped curved notch missing from the top of his right ear, like the way a peanut butter sandwich looks after you take a bite out of it. He says he got it in a fight when he was caught "kissing the wrong girl."

He is also something of a poor-boy philosopher. He and his wife save money regularly, and talk about getting their kids to go to college. His granddad told him that getting ahead and improving your life is like sitting on the branch of a tree. "Just put you a stob in the limb as far out as you can reach, and then scoot out to it. When you get there, do it again."

That is as serious as Wayne ever gets. Otherwise, he is a cheerful, happy-go-lucky sort. He was once asked how long he would stop if it rained during the workday. He just laughed and shook his head. If it rains, Wayne gets wet.

Wayne is in good physical shape for a person of his age, but there are limits to how many years people can do hard physical work. Some time try backing up a flight of stairs with a two-wheel dolly stacked with 11 cases of beer. You will get the idea. He also drinks a lot of beer. He takes a break at about half past ten in the morning, and again about four in the afternoon, and drinks two beers on each break; never more, never less. He usually drinks a beer at lunch, too. Of course, he always drinks Pearl, and the bars give it to him, like a tip. On a hot day, say 100 degrees or so, working on the truck all day, a cold Pearl tastes pretty good.

Even though he has all the business he can handle, the company expects him to do some marketing. They hold a driver's meeting, about 15 minutes worth, every Monday before the trucks go out. Management tells the drivers to wear their blue Pearl shirts, keep the trucks clean, call on new customers and try to get them to become regulars. Sometimes Wayne stops and leaves a couple of free cases at the bars on the route that do not regularly serve Pearl, but he rarely picks up any of them as new customers. If he does get a new bar added to the route it usually turns out they do not attract many Pearl drinkers. There is great brand loyalty among regular beer drinkers. According to Wayne, they almost never change brands or try a new brand. The only exception is that customers will drink a different brand if their bar runs out of their regular brand, or they go to a new bar that does not sell their brand. If they like the new one, they will switch, and be just as loyal to the new brand as they were to the old one.

The main marketing task is rotating and restocking the product on the grocery shelves, and in the glass-front coolers in the convenience stores. This means putting the oldest beer toward the front of the shelves, so it will sell before the newer beer. Beer has a limited shelf life before it goes bad or "skunky." Wayne rotates each individual can or bottle in the glass cases so that the label faces the front. Look at the labels on cans and boxes in the grocery store sometime—most products are turned so the labels face the front.

The company also has a driver with a panel truck or delivery van to deliver kegs to catered events. This driver also delivers clocks, signs and advertising posters to the various bars around town.

Sometimes Wayne has to wait for a bar to collect from a couple of customers before they can pay him. By law, the bars are not extended credit. They pay cash money, and Wayne carries the currency, usually around $700 or $800, in a big wad in his shirt pocket. Some of the other companies provide a cement safe on the truck with a slot to stuff money into, which the driver cannot open, and which is too heavy to carry off. Wayne agrees with the company's idea that if a robber or highwayman is armed with a knife or a gun, the driver should just give up the money. He thinks the idea of the safe would just make a bandit mad, and harm might come to driver and crew.

Before Coors was introduced in Texas, Pearl was the leading selling beer in the state. The main competition is Schlitz, Jax, Lone Star and Coors. Budweiser and Miller's are in the market, but they are not big sellers. You can also buy Carling's Black Label, Ham's, something called Texas Pride and some import beers from Mexico. Wayne's main competition comes from Coors, which is just entering the Fort Worth market.

Coors is popular with college students. The Dallas-Fort Worth area is geographically close to Oklahoma, where Coors is available, and students sometimes drive to state operated liquor stores in Turner Falls, Oklahoma, just across the Texas border, to buy Coors in cases. In the Fort Worth market, the Coors drivers and assistant drivers wear neckties (Wayne usually wears a Pearl patch on a blue work shirt) and they have their shoes shined. They are constantly calling on Wayne's customers, giving them advertising materials like neon Coors signs, posters and coasters. Wayne has all that material too, but believes his customers who want it already have it. Wayne thinks the Coors drivers also give "bonus" cases to customers that buy their beer, perhaps a free case for every ten they buy. This is strictly illegal, and neither Wayne nor Pearl will do it. Some say the competitors actually pay cash back to the bar tenders who buy extra beer. Wayne also thinks the Coors drivers take Pearl off the shelves in the grocery stores, and replace it with their beer, and might even turn the Pearl labels the wrong way. What ever they are doing, Wayne is losing business to them and his route is shrinking.

JAN WILLIAMSON

Jan Williamson is the manager of the operation. Her title is Executive Vice President, and she is the person the owners have hired to restore their distributing company's profits and market position to what they think is their rightful place. Jan is about 35, and has a marketing degree from the University of Texas at Arlington, right there in the Fort Worth/Dallas area. Jan, who is a slender five feet-three inches tall, combs her black hair straight back and clips it together in the back. She wears white shirts and slacks to work, and drives a flashy black Chrysler, a four-door model. She thinks the car makes her look successful, but it is just a used car. Before taking the job at Pearl, Jan had been a salesperson for a textbook publisher, for a year. Before that, she sold cars for a local Dodge dealer.

Sales declined last year (Jan's first year), for the third year in a row, and the fourth out of the last five. Unless things change in the remaining four months of this year, sales will be about the same this year as last. Jan has had several indications from the owners that she needs to start showing some results, and fairly soon. Thus the Friday sales meetings and the new emphasis on cleaning the trucks, wearing the uniforms, and so on.

REQUIRED

You are Jan Williamson. What are you going to do? As support for your answer/plan, please include a detailed report on any analysis or study that you do.

AUTHOR'S NOTE

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

HEDGING FOREIGN CURRENCY TRANSACTION EXPOSURE

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

CASE DESCRIPTION

The primary subject matter of this case is hedging foreign currency exchange rate risk. Secondary issues examined include assessing transaction exposure and comparing hedging techniques to effectively manage unwanted exposure. The case requires students to have an introductory knowledge of accounting, statistics, finance and international business thus the case has a difficulty level of four (senior level) or higher. The case is designed to be taught in one class session of approximately 3 hours and is expected to require 3-4 hours of preparation time from the students.

CASE SYNOPSIS

St. Louis Chemical is a regional chemical distributor, headquartered in St. Louis. Don Williams, the President and primary owner, began St. Louis Chemical ten years ago after a successful career in chemical sales and marketing. The company has gradually expanded it product line and network of manufactures. However, a year-end report had shown shrinking profit margins on product lines that include chemicals purchased from a Canadian manufacturer. Williams has asked for recommendations regarding his firm's exposure to exchange rate risk.

BACKGROUND

St. Louis Chemical is a regional chemical distributor, headquartered in St. Louis. Don Williams, the President and primary owner, began St. Louis Chemical ten years ago after a successful career in chemical sales and marketing. The company reported small losses during it first two years of operation but has since reported eight consecutive years of increasing sales and profits. The growth has required the acquisition of additional land, equipment, expansion of storage capacity and more than tripling the size of the work force. St. Louis Chemical has become the leading distributor in the St. Louis area. Since beginning his career in the chemical distribution industry Williams has developed solid customer contacts in the St. Louis metropolitan area, as well as with major customers in Missouri, Illinois, Iowa, Indiana and Tennessee. He has also developed valuable contacts with key chemical manufacturers.

A chemical distributor is a wholesaler. Operations may vary but a typical distributor purchases chemicals in large quantities (bulk - barge, rail or truckloads) from a number of manufacturers. They store bulk chemicals in "tank farms", a number of tanks surrounded by dikes to prevent pollution in the event of a tank failure. Tanks can receive and ship materials from all modes of transportation. Packaged chemicals are stored in a warehouse. Other distributor activities include blending, repackaging, and shipping in smaller quantities (less than truckload, tote tanks, 55-gallon drums, and other smaller package sizes) to meet the needs of a variety of industrial users. In addition to the tank farm and warehouse, a distributor needs access to specialized delivery equipment (specialized truck transports, and tank rail cars) to meet the handling requirements of different chemicals. A distributor adds value by supplying its customers with the chemicals they need, in the quantities they desire, when they need them. This requires maintaining a sizable inventory and operating efficiently. Distributors usually operate on very thin profit margins. *RMA Annual Statement Studies* (2005-2006) indicates "profit before taxes as a percentage of sales" for Wholesalers - Chemicals and Allied Products, (SIC number 5169) ranges from 1.6 to 3.2% with an average of 2.7%. In addition to operating efficiently, a successful distributor will possess 1) a solid customer base and 2) supplier contacts and contracts which will ensure a complete product line is available at competitive prices.

THE SITUATION

During the first week of 2006, Williams decided to take advantage of the relative calm that usually accompanies the beginning of the year and review matters that had been neglected during the holiday season. One of the more confusing documents involved shrinking profit margins on sales of specialty chemical products. Most of the components making up the specialty chemical line were purchased from Norcand Chemical. However, Williams was not personally familiar with Norcand Chemical. His company had only recently expanded into distributing lines of specialized chemical products and in the past, purchases from Norcand had been relatively small.

Williams walked downstairs to talk with John Young, the purchasing agent in charge of orders from Norcand Chemical, and ask for a recommendation regarding the company's relationship with Norcand. Young noted that the company had been buying specialty chemicals from Norcand for the last two years, however, the growing popularity of the specialty chemical line had resulted in increasing orders from Norcand. In fact, Young had purchased almost $2.5 million dollars worth of products manufactured by Norcand last year.

Young noted that the only major difference between Norcand and US manufacturers was Norcand required payments in Canadian dollars. Once an order was placed, the Canadian manufacturer shipped by truckload and the order was normally received by St. Louis Chemical within 30 days. Payment terms were 60 days from the end of the delivery month. At the time an order is placed, Young converts the price from Canadian dollars to US dollars. Young recalled that

Norcand is consistently at or below many US chemical manufacturers' prices for specialty chemicals. Young said he would prepare a report showing all purchases from Norcand over the last two years but Young recommended the company continue their relationship with Norcand because in his opinion, Norcand was both competitive in terms of price and extremely reliable in regards to shipments compared to other US specialty manufacturers.

Williams walked back upstairs to talk with Gail Packmore, a regional sales manager whose clients purchase the majority of the specialty chemical line. Williams conveyed his concern to Packmore about falling profit margins on the specialty chemical products. Packmore remarked that the specialty chemical line was one of the fasting growing lines at St. Louis Chemical and had been responsible for adding 3 major customers last year alone. In addition, these customers purchased more than just specialty chemicals from St. Louis Chemical. Packmore recited that when she quotes a price on specialty chemicals, the prices are good for 3 months, which is approximately the amount of specialty chemical inventory on hand. Packmore uses the same methodology to determine the mark-up on specialty chemicals that is used for other product lines. All component costs used in pricing come from the purchasing department and are automatically updated via the company's computer network. After orders from customers are received by Packmore, she uses a forecasting model to determine the amount of inventory replenishment needed in the future. Packmore submits a replenish inventory order request back to Young and the cycle continues.

Williams walked back downstairs to the accounting office to talk with Sherri Scott. Scott was responsible for accounts payable at St. Louis Chemical. Williams explained his perplexity over the falling profit margins on specialty chemicals especially those regarding Norcand Chemical. Scott explained that when order from Norcand arrived, the company had 60 days from the end of the delivery month to pay the invoice. Since orders from Norcand had to be paid in Canadian dollars, the 12 PM exchange rate on the last day of the payment month was used for the invoice. Scott noted that the only difference in payments to Norcand versus US manufacturers was that payment was made electronically from an account at the bank denominated in Canadian dollars. At her request, the bank would transfer sufficient money converted to Canadian dollars into the Canadian denominated account used to pay the invoice. Fees charged by the bank in setting up this special account were minimal. Scott promised to deliver a report showing all paid invoices the Norcand Chemical over the last two years.

In passing, Scott mentioned that she had just returned from her annual ski trip to Canada. She had always stayed at the same hotel and the price of the hotel was 100 Canadian dollars per night this year, which had remained unchanged from last year. She didn't know the exact difference, but guessed this year the hotel cost her approximately US$88 per night and only US$79 per night last year even though the listed price of the hotel was the same. Maybe the difference in exchange rates which caused her ski trip to be more expensive this year was also responsible for shrinking profit margins.

Williams walked back upstairs to the office of James Thorton, a newly hired MBA currently working in the finance office, anxious to resolve this matter quickly. Williams recited his recent exploits. He explained to Thorton that barring a complete review of the pricing methodology for specialty chemicals or discontinuing the specialty chemical line, which might cause the eventually loss of some recently acquired customers, he still did not have an answer to the falling profit margins. Thorton promised to look into the matter and prepare a report for Williams in 3 days.

THE TASK

By the end of the day, Thorton had organized the purchasing report from Young (Exhibit 1), collected the payment invoices from Scott (Exhibit 2) and noticed some surprising differences. Young entered the cost of the products purchased from Norcand using the spot exchange rate between the Canadian dollar and the US dollar at the time of the order. Young's cost was automatically sent to Packmore to determine the appropriate mark-up for different product lines. However, the invoice on orders from Norcand was paid by Scott approximately 90 days later. Any exchange rate movement between the time of the order and the time of payment resulted in differences between the cost estimates used by the Packmore to determine the appropriate mark-up and the actual cost of the inventory to St. Louis Chemical. This meant that St. Louis Chemical was exposed to 90 days of exchange rate risk for each Norcand order.

For example, shipments ordered in January would be delivered in February and paid for in April. During certain time periods, the actual cost in US dollars paid by Scott was more than the amount Young entered into the computer and during other time periods, it was less. Looking over the last year, the cost difference was mixed, sometimes working in St. Louis Chemical's favor and other times working against them. Hindsight being 20/20, Thorton concluded the recent weakening of the US dollar relative to the Canadian dollar was the primary cause of shrinking profit margins (See Exhibit 3). However, Thorton had no idea as to the direction of exchange rate movements in the future. While Thorton could explain past Norcand transactions, Williams was certain to ask for a recommendation regarding future transactions involving specialty chemicals orders from Norcand. Thorton compiled a list of tasks that need to be performed before his meeting with Williams. Where applicable, Thorton decided to use the most recent Dec. 2005 order valued at 300,000 Canadian dollars with payment due in March, 2006 as a practical example.

1. Calculate the percentage change in the #CAD/1USD exchange rate between the order month and invoice month for all past transactions. Determine the US dollar cost difference per transaction between the estimate used by Packmore and the invoice paid by Scott. Explain the effect of exchange rate movements on profit margins during 2005.

2. For the C$300,000 December 2005 order, determine a probability distribution of the US$ cost to St. Louis Chemical in March, 2006 incorporating the following assumptions:

   -The December 2005 spot rate (indirect quote) at the time of the order is 1.17CAD / 1USD.
   -The percentage change in the Canadian dollar/US dollar (indirect quote) exchange rate follows a normal distribution.
   -The expected percentage change between the spot rate in 90 days and the current spot rate is 0%, but the 90-day standard deviation in the percentage change between the spot rate in 90 days and the current spot rate is equal to 4% (the annualized standard deviation is 8%).

3. Discuss with Williams the extent of exchange rate risk faced by St. Louis Chemical arising from the C$300,000 Dec. 2005 transaction using a 90-day Value-at-Risk methodology based on a 95% confidence level.

   -The December 2005 spot rate (indirect quote) is 1.17CAD / 1USD.
   -The Dec. 2005 order is expected to cost US$256,410 in 90 days.
   -A Value-at-Risk methodology incorporates the time horizon, confidence level and transaction size to determine a maximum loss on the value of the position at risk.
   -The maximum loss is determined by the lower boundary of the probability distribution and is approximately 1.65 standard deviations away from the mean for a 95% confidence level.
   -The percentage change in the Canadian dollar/US dollar (indirect quote) exchange rate is assumed to follow a normal distribution.
   -The expected percentage change between the spot rate in 90 days and the current spot rate is assumed to be 0%, but the 90-day standard deviation in the percentage change between the spot rate in 90 days and the current spot rate is assumed to be equal to 4%.

4. Discuss the strengths and weaknesses of paying Norcand at the time of delivery rather than waiting 60 days until the invoice is due.

5. Describe a money market hedge that could be used to eliminate the exchange rate risk associated with the Dec. 2005 order valued at C$300,000 incorporating the following assumptions.

   -The December 2005 spot rate (indirect quote) is 1.17CAD / 1USD.
   -According to St. Louis Chemical's banker, the company can currently borrow US dollars for 3-months at an annual rate of 7.25%, but would only earn an annual rate of 2% on a 3-month Canadian dollar time deposit for transactions below $1 million.

6. Describe a Forward Rate Hedge that can be used to eliminate the exchange rate risk associated with the Dec. 2005 order valued at C$300,000.
   -The December 2005 spot rate (indirect quote) is 1.17CAD / 1USD.
   -A 3 month forward rate (indirect quote) at the time of the order is quoted at a bid price of 1.1590 CAD/1USD and an ask price of 1.1600CAD / 1USD for transactions valued at $1 million or more.

7. Describe the specific details of a Canadian dollar futures contract. Propose a Canadian dollar futures contract hedge that can be used to eliminate the exchange rate risk associated with the Dec. 2005 order valued at C$300,000.
   -The Dec. 2005 spot rate is 1.17CAD / 1USD (indirect quote) or 0.8547USD/ 1CAD (direct quote).
   - A March 06 Futures contract is quoted as 0.8620 (direct quote)
   - A June 06 Futures contract is quoted as 0.8641 (direct quote)
   - A September 06 Futures contract is quoted as 0.8659 (direct quote)
   - Information on Futures Contracts can be found at www.cme.com

8. Compare the strengths and weaknesses of a forward rate hedge and a futures contract hedge in terms of the following:
   a) Size of the contract
   b) Delivery date
   c) Transaction costs

9. Describe a currency pair spot transaction. Discuss the strengths and weaknesses of hedging the Dec. 2005 order valued at C$300,000 using a currency pair spot hedge.
   -The Dec. 2005 currency pair quote USD/CAD
   Bid=1.1698 Ask=1.1702
   -Information on Currency spot pair transactions can be found at:
   http://fxtrade.oanda.com/currency_trading/overview.shtml

10. Make a recommendation to Williams regarding the exchange rate risk faced by St. Louis Chemical.

Exhibit 1
Summary by month for purchases by St. Louis Chemical of Norcand Chemcial products

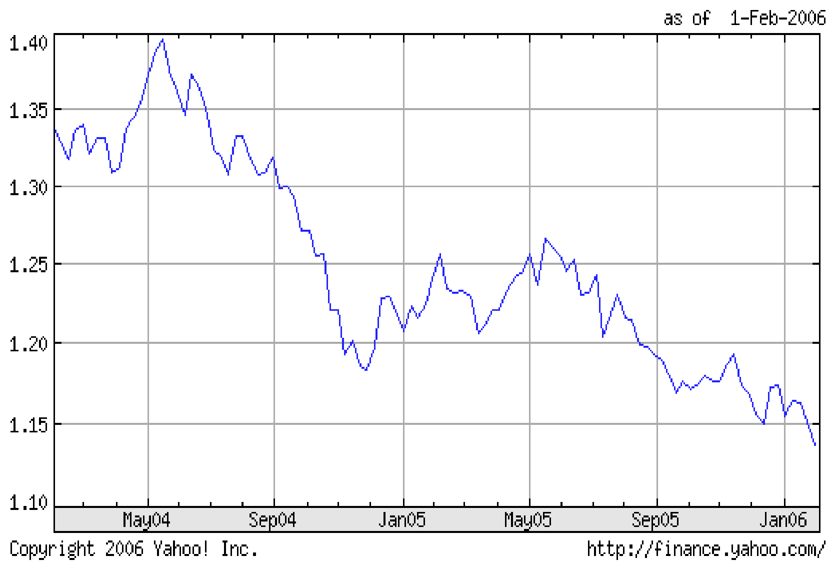
Order Date	Purchase Amount Canadian $ (thousands)	Spot Rate used at time of order #of CAD/ 1 US	Cost Estimate at time of order US $ (thousands)	Delivery and Invoice Month
Jan-04	110.25	1.33	$82.89	Feb-04
Feb-04	85.16	1.34	$63.55	Mar-04
Mar-04	65.33	1.31	$49.87	Apr-04
Apr-04	90.23	1.37	$65.86	May-04
May-04	42.21	1.36	$31.04	Jun-04
Jun-04	75.12	1.35	$55.64	Jul-04
Jul-04	41.34	1.33	$31.08	Aug-04
Aug-04	45.08	1.32	$34.15	Sep-04
Sep-04	85.14	1.27	$67.04	Oct-04
Oct-04	159.34	1.22	$130.61	Nov-04
Nov-04	155.26	1.19	$130.47	Dec-04
Dec-04	175.19	1.20	$145.99	Jan-05
Jan-05	265.23	1.24	$213.90	Feb-05
Feb-05	272.05	1.24	$219.40	Mar-05
Mar-05	241.14	1.22	$197.66	Apr-05
Apr-05	256.32	1.26	$203.43	May-05
May-05	283.45	1.26	$224.96	Jun-05
Jun-05	325.15	1.23	$264.35	Jul-05
Jul-05	310.34	1.22	$254.38	Aug-05
Aug-05	300.21	1.19	$252.28	Sep-05
Sep-05	295.14	1.17	$252.26	Oct-05
Oct-05	286.11	1.18	$242.47	Nov-05
Nov-05	315.21	1.17	$269.41	Dec-05
Dec-05	300.00	1.17	$256.41	Est. Jan-06

Exhibit 2

Summary of Payments to Norcand Chemical

Order Month	Purchase Amount Canadian $ (thousands)	Delivery and Invoice Month	Payment Month	Spot rate used to Pay Invoice #of CAD/1USD	Invoice Paid in US $ (thousands)
Jan-04	110.25	Feb-04	Apr-04	1.37	$80.47
Feb-04	85.16	Mar-04	May-04	1.36	$62.62
Mar-04	65.33	Apr-04	Jun-04	1.35	$48.39
Apr-04	90.23	May-04	Jul-04	1.33	$67.84
May-04	42.21	Jun-04	Aug-04	1.32	$31.98
Jun-04	75.12	Jul-04	Sep-04	1.27	$59.15
Jul-04	41.34	Aug-04	Oct-04	1.22	$33.89
Aug-04	45.08	Sep-04	Nov-04	1.19	$37.88
Sep-04	85.14	Oct-04	Dec-04	1.20	$70.95
Oct-04	159.34	Nov-04	Jan-05	1.24	$128.50
Nov-04	155.26	Dec-04	Feb-05	1.24	$125.21
Dec-04	175.19	Jan-05	Mar-05	1.22	$143.60
Jan-05	265.23	Feb-05	Apr-05	1.26	$210.50
Feb-05	272.05	Mar-05	May-05	1.26	$215.91
Mar-05	241.14	Apr-05	Jun-05	1.23	$196.05
Apr-05	256.32	May-05	Jul-05	1.22	$210.10
May-05	283.45	Jun-05	Aug-05	1.19	$238.19
Jun-05	325.15	Jul-05	Sep-05	1.17	$277.91
Jul-05	310.34	Aug-05	Oct-05	1.18	$263.00
Aug-05	300.21	Sep-05	Nov-05	1.17	$256.59
Sep-05	295.14	Oct-05	Dec-05	1.17	$252.26
Oct-05	286.11	Nov-05	Jan-06	?	?
Nov-05	315.21	Dec-05	Feb-06	?	?
Dec-05	300.00	Est. Jan-06	Mar-06	?	?

Exhibit 3: Historical Foreign Exchange Data (# of Canadian dollars per 1 US dollar)



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THE EFFECT OF CHANGES IN ACCOUNTING FOR DEFINED BENEFIT PENSIONS AND OTHER POSTRETIREMENT BENEFIT PLANS ON COMPANIES' FINANCIAL STATEMENTS AND STAKEHOLDERS

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CASE DESCRIPTION

The primary subject matter of this case concerns changes in accounting for defined benefit pensions and other postretirement benefit plans proposed and promulgated by the Financial Accounting Standards Board (FASB) and their effects on the financial statements of companies that currently sponsor these plans. Secondary, yet important issues are the potential effects of these changes on companies' willingness to offer these plans to their employees, and the resulting potential economic impact on the companies' stakeholders. This case has a difficulty level of three to four and can be taught in about 45 minutes. Approximately two hours of outside preparation is necessary to fully address the issues and concepts. This case can be utilized in intermediate accounting as part of the coverage of pensions, or in a more advanced graduate class focusing more extensively on underlying conceptual and economic issues. The case has conceptual, analytical, and research components. Both oral and written communication skills can be enhanced using this case.

CASE SYNOPSIS

Since the introduction of the first pension plan by American Express in 1875, traditional (defined benefit) pension plans have become an important source of millions of employees' retirement income. At one time, defined benefit pensions, which promise employees a specific amount of retirement income, represented the most common type of employer-sponsored plan. Legislation, especially the ERISA ACT of 1974 and the creation of the Pensions Benefit Guarantee Corporation (PBGC) added security to these benefits. Sadly, these traditional pensions have become less popular. In 1981, 81% of employees who were covered by employer-sponsored retirement plan were covered by a traditional pension plan; by 2003, that percentage decreased to 38% (Clements, 2006). This trend appears to be continuing. For example, recently, several large well-known public companies have decided to freeze their existing pension plans. Reasons for this reduction in traditional pension plans include the financial risk to the employer, and the uncertainty created by *negative or low-performing stock markets. Other postretirement plans (e.g., postretirement health care) also have become less popular, primarily due to rising costs.*

Changes in accounting for traditional pensions and other postretirement benefit plans may sharply increase the liabilities and expenses and decrease the equity shown on companies' financial statements and may further increase the risk and cost of these types of plans. These changes may affect employers' willingness to continue offering these plans.

The primary focus of this case is to examine the potential short-term and long-term effects of recently promulgated and expected accounting changes on companies' (1) financial statements, (2) stakeholders, and (3) willingness to offer these plans. The case can be taught at the same time that retirement benefits are covered in an intermediate accounting class, or in an advanced accounting class focusing primarily on underlying concepts. The case has analytical, communication, and research components.

INTRODUCTION

Accounting for pensions evolved from the "pay-as-you-go" basis to the full accrual basis. The currently pertinent primary accounting standard, Statement of Financial Accounting Standards No. 87 (SFAS 87), "Employers' Accounting for Defined Benefit Pensions," was issued by FASB in December 1985, effective for fiscal year 1987. SFAS 87 requires that a minimum liability is accrued if the present value of the pension obligation at current salary levels (ABO) exceeds pension assets.

The currently pertinent accounting standard for accounting for non-pension retirement plans, (such as retiree health care plans), Statement of Financial Accounting Standards No. 106 (SFAS 106), "Employers' Accounting for Postretirement Benefits Other Than Pensions" was issued December 1990, effective for fiscal year 1993. SFAS 106 requires that companies accrue an annual expense for retiree plans, such as health care, but does not require the recognition of a minimum liability, even if the plan is underfunded.

Recently, FASB decided to reevaluate accounting for both defined benefit pensions and other postretirement benefit plans. In November 2005, FASB officially added a comprehensive two-phase pension and other postretirement benefits project to its agenda (FASB, 2005). On March 31, 2006, FASB issued its first exposure draft as phase one of a two-phase project and on September 29, 2006, FASB issued Statement of Financial Accounting Standards No. 158 (SFAS 158) (FASB, 2006). SFAS 158, "Employers' Accounting for Defined Benefit Pensions and Other Postretirement Plans" amends both SFAS 87 and SFAS 106. Many provisions of SFAS 87 and 106 continue to be effective. FASB has not yet issued an exposure drafts under phase two of its comprehensive project.

The changes promulgated under SFAS 158 may significantly affect companies' balance sheets if their retirement plans are underfunded. In addition, the expected changes from phase two of FASB's project may also affect companies' income statement, particularly if pension and other postretirement plan investment returns are volatile. These changes may lead some companies to curtail their plans and thus potentially adversely affect employees and retirees. The case presented below highlights and examines the effect of accounting changes on financial results and potentially employers' willingness to provide retirement benefits to their employees.

THE SITUATION

On September 27, 2006, Jackie McKiern, Controller of Neuman Corp., an automotive parts supplier, walked into her office to find her new boss, Chief Financial Officer (CFO) John Millern waiting for her. John, who just has joined the company on August 1, 2006 has spent most of the past few weeks familiarizing himself with all financial aspects of the company. While reviewing the company's financial statements, he noticed that pension and other postretirement benefits represented a significant amount of the company's expense. John recalls hearing at the end of the previous year that the FASB has decided to review and revise accounting for defined benefit pensions and other postretirement benefit plans. At that time, he wasn't concerned about this, because his previous firm sponsored a 401(k) plan, which does not fall under the requirements of FASB's defined benefit pension standards. Now, that he has joined a company that sponsors a defined benefit pension and a postretirement health care plan, he feels that he must consider the potential effects of any accounting change on his new company.

John also recalls reading an article about the potentially detrimental effects that a change in the accounting standards could have on General Motors' (GM) financial statements. He quickly researches the original article and finds that on December 29, 2005, the Wall Street Journal reported that the expected change in the accounting rules may virtually eliminate GM's current net worth. He is aware that GM is experiencing financial difficulties. Although Neuman Corp. is financially sound, John now is quite concerned about the potential effect of the expected accounting changes on Neuman Company's financial statements. He is determined that the company preform well under his financial guidance. He first considers what he has learned about the company's retirement plan.

For the past 20 years, Neuman Corp. has sponsored a defined benefit pension plan for its full-time employees. The benefits fully vest after seven years of employment. The majority of the employees who are eligible for future pension benefits have not yet reached retirement age. Double-digit stock market returns during much of the 1990s contributed to a fully funded pension plan during that period. Currently, the plan is somewhat underfunded. A few years after adopting its pension plan, the company also implemented a postretirement benefits plan that provides for health care coverage during its employees' retirement years. That plan currently is unfunded and the company pays only the amount necessary to maintain benefits for its few current retirees.

After considering these facts, John is concerned about both the short and long-term effects of the expected accounting change on the company's financial statements. He asks Jackie to compile information that will help the company plan for the future and allow it to select the most advantageous strategy. John feels that in light of the company's plans to raise additional capital within the next three years by issuing corporate bonds, steps may need to be taken to avoid a negative impact of any accounting change on the company's ability to inexpensively raise capital.

John asks Jackie to find out what the expected changes in accounting for defined benefit pensions and other postretirement benefit plans are, and to answer the following questions regarding the effects on the company's defined benefit pension plan and its retiree health care plan.

ASSIGNMENTS AND QUESTIONS

Company-Specific Questions

1. What would be the short-term impact on Neuman Company's a) balance sheet, b) income statement, and c) statement of cash flows?

2. What would be the long-term impact on Neuman Company's a) balance sheet, b) income statement, and c) statement of cash flows?

3. What options does the company have?

4. How would implementing each of these options affect the company's a) balance sheet, b) income statement, and c) statement of cash flows?

5. Who are the stakeholders? Who would benefit from each option?

6. How would the employees be affected by each of these potential options?

7. What are the ethical issues involved?

8. How would each of these options affect the perceptions of people outside the company?

9. What do you recommend that we, the company's executives should do?

Jackie also decides to research some related questions that may contribute to the decision making process.

Researchable Questions:

1. How have other companies reacted to this proposed change?

2. Is there any historical evidence that new accounting rules and/or proposals may lead to decreases in employee retirement benefits?

3. Are other companies' pension and other retirement plans currently funded?

4. How does recent legislation impact on traditional pension plans?

John expects a briefing on the results of this research in five days. Jackie asks you, her assistant to answer/research these questions for her. You are an accounting major and currently are enrolled in Intermediate Accounting II. You currently are discussing pensions and other deferred employee retirement benefits in class. You are excited about the prospect of applying what you are learning in class to your position of accounting assistant. You are anxious to complete the assignment to the full satisfaction of the company's controller and CFO. Your first step is to review information regarding the expected changes in the accounting rules and the company's financial statements and notes for the year ended December 31, 2005. You also decide to access the FASB website to determine whether any updates are available.

Jackie, a licensed CPA had already familiarized herself with the anticipated changes when FASB's intentions first had been publicized. She had prepared a short summary of the expected changes, which is shown below, and discussed the issues with the prior CFO of the company. The prior CFO, who was very employee-oriented, and Jackie agreed at that time that no change in their retirement plans was warranted. Jackie makes her summary and selected financial statement information available to her assistant. This information is shown below.

SUMMARY OF EXPECTED CHANGES IN ACCOUNTING FOR DEFINED BENEFIT PENSIONS AND OTHER POSTRETIREMENT BENEFITS

(Prepared by Jackie McKiern, Controller, April 8, 2006)

On November 10, 2005, FASB voted to reconsider both SFAS 87 "Employers' Accounting for Defined Benefit Pensions," and SFAS 106 "Employers' Accounting for Postretirement Benefits Other Than Pensions." (FASB, 2005). FASB expects to complete this comprehensive project in two phases, the first to be finalized by the end of 2006. On March 31, 2006, the FASB issued an exposure draft titled, "Employers' Accounting for Defined Benefit Pensions and Other Postretirement Plans," which proposes changes under phase one of the FASB project (FASB, 2006).

Phase One (FASB exposure draft, FASB, 2006):

1. Entities with underfunded pension plans would be required to recognize a liability equal to the unfunded amount of the pension and other postretirement obligations on the sponsoring company's balance sheet. This unfunded pension obligation would be calculated based on the projected benefit obligation (in the case of pensions) and the accumulated benefit obligation (in the case of other postretirement benefits). For pensions, currently, the accumulated benefit obligation, which does not take into consideration future salary levels, is utilized to calculate and recognize an additional minimum liability. The projected pension benefit obligation typically is higher than the accumulated obligation because salaries are expected to increase over time. For other postretirement benefits plans, no minimum liability has to be recognized under current accounting rules; thus, even companies with significantly underfunded or unfunded plans are not required to recognize any minimum liability on their balance sheets. If this changes, the unfunded portion that would have to be recognized on the balance sheet could be quite significant. Benefit plan assets and benefit obligations would be measured at the balance sheet date.

2. Unrecognized actuarial gains and losses and prior service costs arising during the current period would have to be recognized as a component of other comprehensive income. Currently these costs are deferred until amortized and recognized as components of expense. Additional disclosure of the effect of deferred recognition is required.

3. Any unrecognized transition obligation would have to be recognized as an adjustment to the beginning balance of retained earnings. Currently these costs are deferred until recognized in expense.

Phase Two - Expected Changes:

FASB also is planning to further review the recognition and disclosure rules for pensions and other postretirement benefit costs in income and comprehensive income. Furthermore, its guidance on measurement assumptions (e.g., the rate assumptions) and the measurement of the obligations will be reassessed, potentially requiring the use of actual rates of return. This phase is conducted jointly with the International Accounting Standards Board. Thus, within the next few years, companies may have to utilize the actual return on pension plan assets (instead of the estimated return) when calculating pensions and other postretirement cost (expense). This return may well be negative for some of the years, which could increase expenses sharply and contribute to income volatility.

SELECTED INFORMATION FROM THE 2005 FINANCIAL STATEMENT NOTES

Financial Statement Note No. 7: Retirement Plans
Defined Benefit Pension Plan

Effective January 1, 1986, the Company established a defined benefit pension plan covering substantially all of its full-time employees. The pension benefits are based primarily on years of service. The plan's pension plan assets consist primarily of equity investments in U.S. and European blue chip stocks and corporate bonds. All dollar amounts are in thousands.

Net Periodic Pension Cost	**2005 (in thousands)**	**2004 (in thousands)**
Service Cost	$ 70	$ 60
Interest on PBO	120	111
Estimated return on plan assets	(144)	(140)
Amortization of deferred loss	20	20
Amortization of prior service cost	10	10
Net periodic pension cost	$76	$61
Changes in Benefit Obligation (PBO)	**2005(in thousands)**	**2004 (in thousands)**
PBO at the beginning of the year	$2,000	$1,850
Service Cost	70	54
Interest Cost	120	111
Actuarial Loss (gain) on PBO	0	1
Less: Benefit paid to retirees	(20)	(16)
PBO at the end of the year	$2,170	$2,000
Changes in Pension Plan Assets	**2005 (in thousands)**	**2004 (in thousands)**
Market value of assets at beginning of year	$1,800	$1,744
Less: Actual return on assets	7	(3)
Employer contributions	90	75
Benefits paid to retirees	(20)	(16)
Market value of assets at end of year	$1,877	$1,800

Reconciliation of Funded Status	Year ended	Year ended
and Benefit Obligation	**12/31/2005**	**12/31/2004**
Projected benefit obligation	$2,170	$1,800
Fair value of Pension plan assets	1,877	2,000
Underfunded amount	(293)	(200)
Unrecognized prior service cost	145	155
Unrecognized net loss	135	145
Prepaid (accrued) pension cost	$ (13)	0
Additional Minimum Liability Calculation	**Year 2005**	
Accumulated Pension Benefit Obligation, 12/31	$1,900	
Pension plan assets at end of year, 12/31	1,877	
Minimum Liability	23	
Prepaid (Accrued Pension cost)	(13)	
Additional Minimum Liability	$ 10	
Actuarial Present Value of Pension Benefit Obligation as of January 1	**2005**	
Vested benefit	$1,000	
Accumulated benefit	1,800	
Projected benefit obligation	2,000	
Pension plan assets	1,800	
Pension Rate Assumptions	**2005 and 2004**	
Weighted-average discount rate	6%	
Expected weighted-average long-term rate of return	8%	
Salary trend rate	3%	

Postretirement - Health Care Plan

Effective January 1, 1987, the Company established a retirement health care plan that covers substantially all of its full-time employees. The following is selected information relating to the company's retirement health care benefits plan.

Net Periodic Postretirement	2005 (in thousands)	2004 (in thousands)
Health Care Cost		
Service Cost	$15	$14
Interest on ABO	30	28
Estimated return on plan assets	0	0
Amortization of deferred loss	0	0
Amortization of prior service cost	0	0
Amortization of transition obligation	9	9
Net post retirement health care cost	$54	$51
Postretirement Benefits - Rate Assumptions	**2005 and 2004**	
Weighted-average discount rate	6%	
Expected weighted-average long-term rate of return	8%	
Health care trend rate - long-term	3%	

The plan currently is unfunded. The company pays the exact amount necessary to meet the health care premiums for its current retirees. That amount was $26,000 for 2005 and $24,000 for 2004. As of December 31, 2005, the plan's accumulated benefit obligation exceeds the plan assets by $1,100,000; its unrecognized transition obligation was $63,000.

REQUIRED

1. Check FASB's website for any updates (www.fasb.org).
2. Answer the questions listed in the Assignment/Question section of this case as assigned by your instructor. Provide concise answers.

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CREDIT CARDS, DEBIT CARDS AND MONEY DEMAND

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CASE DESCRIPTION

The primary subject matter of this case concerns the effect of the introduction of credit cards and debit cards on money demand. The objective is to allow students to apply the results of the four theories of money demand to the changes that are occurring/have occurred in the financial sector. The case has a difficulty level of 3 or 4 and would be appropriate for use in money and banking, financial economics, or intermediate macroeconomics courses. The case is designed to be taught in 1-2 class hours and is expected to require 3-4 hours of outside preparation by students.

CASE SYNOPSIS

John Williams recently returned from a trip on which he realized that he no longer needed cash—not even at fast food restaurants. Everyone accepts credit and debit cards these days. He becomes concerned that this may mean that money is going away. He begins to look into the idea of a cashless society. Certainly credit and debit cards will play a large role in a cashless society. He quickly realizes that to truly understand the impact of credit and debit cards, he will have to understand their impact on money demand (specifically M1 and M2). He researches the four key theories of money demand—The Quantity Theory of Money, Keynes's Liquidity Preference Theory, Friedman's Modern Quantity Theory of Money, and the Baumol-Tobin Model—and comes up with a list of questions applying the impacts of credit cards and debit cards to the results of the models.

INTRODUCTION

John Williams recently returned from a two week road-trip. On his trip he made an interesting observation. Cash and traveler's checks are no longer a necessary part of a "road-tripper's" travel essentials. These days even fast food restaurants accept credit and debit cards. John has heard people speculate about a cashless society in the past and is beginning to wonder if it is starting. He worries that a "cashless" society means a "moneyless" society. John has taken several economics courses in college and has decided to use what he learned in these classes to help him further investigate the role of credit and debit cards in the economy.

JOHN'S RESEARCH

So far he has found a definition for money. Money is any object or commodity that a society generally uses and accepts as a method of payment. It must also serve as a unit of account and store of value. He is relieved to find that a "cashless" society does not mean the same thing as a "moneyless" society. He has also found that money can be classified or measured in several ways. The Board of Governors of the Federal Reserve System collects data on money and then classifies it as either M1 or M2. John has written down the definitions for M1 and M2 that he found at the Board of Governors website in table H.6 Money Stock and Debt Measures.

M1 consists of (1) currency outside the U.S Treasury, Federal Reserve Banks, and the vaults of depository institutions; (2) traveler's checks of nonbank issuers; (3) demand deposits at commercial banks (excluding those amounts held by depository institutions, the U.S. government, and foreign banks and official institutions) less cash items in the process of collection and Federal Reserve float; and (4) other checkable deposits (OCDs), consisting of negotiable order of withdrawal (NOW) and automatic transfer service (ATS) accounts at depository institutions, credit union share draft accounts, and demand deposits at thrift institutions.

www.federalreserve.gov/releases/h6/Current

M2 consists of M1 plus (1) savings deposits (including money market deposit accounts); (2) small-denomination time deposits (time deposits in amounts of less than $100,000), less individual retirement account (IRA) and Keogh balances at depository institutions; and (3) balances in retail money market mutual funds, less IRA and Keogh balances at money market mutual funds.

www.federalreserve.gov/releases/h6/Current

After a little more searching, John has learned that there are four theories of money demand. At this point he isn't quite sure how these fit into answering his question, but he feels certain they will prove useful. Worst case scenario: he'll call his older sister—a graduate student in economics—and get her opinion. If John has research on theories of money demand and other such topics, his sister will be so impressed she'll have to help him find the answers he is looking for!

John has jotted down some notes on the four theories of money demand. His notes are below:

There are four main theories of money demand These four theories are discussed in detail in Miskin 7th edition and Hubbard 4th edition. Cecchetti's textbook covers 3 of the 4 in its money demand chapter. They are the Quantity Theory of Money, Keynes's Liquidity Preference Theory, Friedman's Modern Quantity Theory of Money, and the Baumol-Tobin Model.

Quantity Theory of Money: Theory introduced by Irving Fisher in 1911.

-Nominal GDP is affected by the quantity of money in the economy and by velocity.

-Velocity is determined by the institutions and technology of the financial sector of the economy. Short-run velocity is constant. This means nominal GDP is determined by changes in the quantity of money.

-Nominal GDP = total income in the economy
-Put these things together and get that money demand is determined by the level of income in the economy and the fixed technology and institutions in the financial sector.

Keynes's Liquidity Preference Theory: Theory introduced by John Maynard Keynes in the 1930s.
-Households hold money balances for three reasons: 1) to make transactions, 2) as a precaution against unexpected purchases, and 3) as a means of storing wealth. -The third reason (the speculative motive) allows the relationship between money demand and interest rates to be explored.

Friedman's Modern Quantity Theory of Money: introduced by Milton Friedman in the 1950s.
-Treats money and the decision to hold money as it would any other asset.
-The theory of asset demand determines the amount of money that a household chooses to hold.
-Treating money in this way allows for multiple interest rates to play a role in the choice of holding money. -Since banks will compete for deposits when returns on other assets rise relative to the rate of return on money, they will increase the services or interest rates offered. This means that relative returns do not fluctuate and therefore interest rates have no impact on money demand.
-This theory also recognizes that inflation concerns will affect the choice of how much money to hold by allowing physical goods and money to be substitutes.

Baumol-Tobin Model: Two similar models were introduced separately by Baumol and Tobin in the 1950s.
-Households want to hold as little of their earnings as cash at any given time.
-Households want to hold the optimal amount of earnings in interest bearing assets at any point in time.
-At the same time the household wants to minimize its number of trips to the bank (these trips represent transactions costs).
-Thus the household must maximize the amount of earnings in bonds while minimizing transactions costs.

Over Thanksgiving break John told his sister about his research efforts. She was quite impressed and decided to help him out by telling him about the background research she had been doing for one of her professors on debit cards and credit cards. She told him that in many respects credit cards and debit cards look like substitutes. Both allow users to make online and mail order purchases and give the consumer a consolidated listing of their purchases in monthly statements. In most cases, both debit and credit cards are accepted at the same locations since they use the same hardware. In one important way, however, they differ. A credit card is a line of credit and a debit card is not. John is not positive, but he thinks that this difference will make a big difference in whether or not the two media are both considered money. He needs to get back to his notes and double check his definition of money.

John's sister has been reading lots of research about how households use credit cards and debit cards and their impact on different aspects of the economy (one being money demand). This makes John feel quite good—he is researching the same thing that economists are thinking about—maybe he'll be an Econ major after all! John's sister says some households are convenience users of credit cards, meaning that they very responsibly pay off their credit card bill each month. John wants to know, "What's the point?" She tells him that by doing this households may be able to prolong paying for their purchases for up to 45 days. At the same time, they can keep more of their earnings in interest bearing assets. Supporting this, Duca and Whitesell (1995) and King (2004) find that households with credit cards tend to have more money in savings accounts and less in checking accounts. John thinks this sounds pretty interesting but he isn't sure he and most of his friends have the self-control to make this work very well. John's sister agrees that some people don't seem to be able to do this (although research suggests that many households can). She then tells him about other research she has come across that tries to explain why households would use debit cards instead of credit cards. Beyond prolonging bill payments, credit cards have several other nice perks that debit cards typically do not. These include many incentive programs such as airline miles and cash back on purchases. Yet debit card usage has been increasing rapidly in the United States. Reasons households may choose to use debit cards include being able to get cash back while making purchases, thus cutting out a trip to the bank after the shopping trip, and most importantly for many households, avoiding falling back into a pattern that led to serious credit card debt while still maintaining the convenience of electronic payment (King 2004; King and King 2005).

After talking with his sister, John is convinced that the information he has already found is going to prove very useful in helping him to understand the impact of credit cards and debit cards on money demand. His sister gave him a list of papers to check out to get more details on credit cards and debit cards. He decided to wait until after finals to really dive into the new research. Over the last few days he has compiled the following data:

-*Debit Card usage increased at an annual rate of 53.3% between 1993 and 1997. (King and King 2005)*
-*The US lags behind other countries in the adoption of electronic payments. (Humphrey, Pulley, and Vesala 2000;Caskey and Sellon 1994)*
-*Between 1983 and 1995 credit card borrowing increased at a real rate of 179%. (King 2004)*
-*People who have had bad experiences with credit cards (i.e. have been in serious debt because of credit cards) tend to have more negative feelings about credit cards. (King and King 2005).*
-*Median credit card debt in 2001 was $1900 based on Survey of Consumer Finances data. (Aizcorbe, Kennickell, and Moore 2003)*

After reading through a mountain of research on credit cards and debit cards, John has had two realizations. First because of the amount of data and research available, he needs to focus his attention very narrowly or he will never get anywhere. Second he feels that he now has plenty of information to tackle the question he initially started with: how will the prevalence of credit and debit cards in the US affect money in the US?

JOHN'S TASK

Several days later, John has decided that the best way to answer his question is by focusing on the four theories of money demand. He has broken his quest down into five questions. The questions are as follows:

1. Typically, economists assume that technological innovations in the banking industry will lead to an increase in the velocity of money.
    a) Is this true for the introduction of credit cards? Explain. Does your answer change if you define money as M2 instead of M1?
    b) Is this true for the introduction of debit cards? Explain. Does your answer change if you define money as M2 instead of M1?
    c) Explain how an increase in velocity would occur for the general case of a technological/financial innovation.
2. Consider the Baumol-Tobin Model.
    a) Given the general assumption that households want to maximize interest earned on "bonds" while minimizing the number of trips made to the bank to switch between bonds and money, which instrument should households use, credit cards or debit cards?
    b) How would the model predict that M1 would be affected if more households began using credit cards to make their daily transactions? How would the model predict that M2 would be affected?
    c) Under this model, would there be any reason to use debit cards? Which would be preferable, debit cards or checks?
    d) If credit cards were used according to this theory, would consumer credit debt levels rise? Why or why not?
3. Keynes's Liquidity Preference Theory asserts that there are three motives for holding money—1) a transactions motive 2) a precautionary motive and 3) a speculative motive.
    a) Which motives would be affected by the introduction of credit cards into the economy? What would be the end result on money demand based on Keynes's Liquidity Preference Theory? Explain.
    b) Which motives would be affected by the introduction of debit cards into the economy? What would be the end result on money demand based on Keynes's Liquidity Preference Theory? Explain.

4. Based on Friedman's Modern Quantity Theory of Money, when would you expect credit card usage to rise, as interest rates in the economy rise or as they fall? When would you expect debit card usage to rise, as interest rates in the economy rise or as they fall?
5. Based on the four theories of money demand, are there any generalizations that can be made about what occurs when credit cards are introduced into the economy? What about when debit cards are introduced into the economy? If there are similarities among the results generated by each model, why do four theories of money demand persist in economics?

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UPHEAVAL IN AN ORGANIZATION: A CASE OF ORGANIZATIONAL MISMANAGEMENT?

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CASE DESCRIPTION

This case has a difficulty level of two (appropriate for sophomore-level students) and is designed to be taught in approximately 1-1/2 hours. It would be most appropriate for discussion and analysis in basic management courses when the topics of leadership, ethics, and managing diversity are covered. The case would also be appropriate for discussion in basic marketing and marketing management courses when the instructor is ready to discuss ethics in marketing. In addition, the case would be appropriate for discussion in separate Human Resources and Ethics courses.

CASE SYNOPSIS

In the wake of numerous recent corporate scandals, there has been renewed interest in the subject of leadership and what makes a true leader. While much of the attention has been focused on high-level executives and the impact their actions have had on the internal and external stakeholders of entire corporations, this very attention has caused some managers at all levels, as well as instructors of management and leadership, to take a closer look at the actions or behaviors of leaders. Of particular interest is how these behaviors are guided by a person's ethical standards. Because the behavior of managers or leaders can affect the organization's performance, and because this performance, especially in a marketing organization, has a direct impact on customer satisfaction, an understanding of these leadership behaviors becomes critical. And if diversity is an added element in the situation, the need for understanding is even greater. The following case relates the actual experiences of a third-level manager of a diverse marketing communications group as she deals with difficulties resulting from the actions of her superiors. The case focuses on the impact the behaviors of her organization's leaders had on her, her department, and at least one group of the organization's customers.

THE RISE—AND BEGINNING FALL—OF SHARON

Sharon, an African-American female, had been the manager of Marketing Communications Planning for a major telecommunications firm, one of the largest such firms in the world, for four years. With the same company for nineteen years, she was professionally recognized as an initiator of creative, effective, award-winning marketing programs aimed at telecommunications service providers and end users. For example, Sharon had created an end-user Corporate Telecommuting Program that was adopted by a major telecommunications equipment provider, Local Exchange Carriers (the telephone service providers to which the equipment was sold), and the U.S. Government. She was also quoted by industry journals as an expert in the area of the effects of telecommuting on the telecommunications industry. Her position as manager of Marketing Communications Planning was the first position in which she had people-reporting responsibilities, but considering the accomplishments of the group she supervised, she seemed to be achieving success in the area of management just as she had in all of her previous assignments. For example, her group developed and implemented a strategic marketing plan for the company's flagship product, successfully positioning the product, including the creation of new marketing images, in the highly competitive telecommunications marketplace.

Sharon's department consisted of eight subordinate Market Planners at three different management levels. These market planners/managers were responsible primarily for creating marketing communications sales ware; developing and implementing customer and customer team training, including a technical, marketing, and professional skills development program for the product marketing organization and training for customers at the annual Users Conference; creating a presence for the business unit at national tradeshows; and most recently, creating a new marketing image that was more in line with the new direction in which upper management wanted to go.

The Marketing Communications Planning Department was one of four departments that made up the larger North America Product Marketing organization of which Donna was vice president. Sharon was one of only three African-American third-level-or-above managers out of 26 in Donna's organization.

Just when everything seemed to be going so well for Sharon, however, her world started falling apart. Her first hint of a problem came when she returned from vacation on January 6, 1998 and learned that her manager, Sam, would be transferring to another organization in another state. Sharon immediately made an appointment with him to discuss the promotions of two of her subordinates. She needed Sam's signature on the promotion packages. Sam, however, would not sign the papers for either candidate; instead, he brought up a different subject altogether. Sharon was completely taken aback when he stated that there were members of her organization who felt that she was prejudiced against the Caucasians in the group. (At the time, her organization was equally divided between Caucasian and African-American females.) Sam's accusation was based on an account that one of the Caucasians had given him indicating that Sharon had allowed one of her African-American subordinates to work at home for a two-week period after her father had undergone emergency brain surgery. Sam also mentioned that he had previously told Sharon that one of her Caucasian subordinates did not like her and that he was aware that this person was transferring out of Sharon's group for fear of retaliation.

At this point, Sharon was visibly shaken by the accusation, because she had worked consistently to overcome discrimination throughout the organization and had always strived to abide by the organization's stated diversity and affirmative-action guidelines. Moreover, it was quite unnerving for her, an African-American female, to be accused of discrimination. When she asked Sam if anyone in his organization or in the overall business unit had ever before accused her of prejudice or practicing discrimination, he replied "No." He repeatedly stated, nonetheless, that the people in Sharon's group were afraid of her and that it was perceived that she discriminated against the Caucasian females. When Sharon suggested that Sam interview the members of her organization himself, he told her that *she* should interview them to find out what their concerns were and then report back to him.

Returning to her office, Sharon immediately called Marge, the one Caucasian member of her group who she felt would be most forthright with her. Marge was one of the people whom Sharon had been working so hard to get promoted again. (Sharon had already succeeded in promoting Marge twice before.) When Sharon learned that Marge was actually the person who had complained to Sam, Sharon could not believe what she was hearing. She reminded Marge of the times that she had allowed Marge to work from home during family emergencies, occasions that Marge seemed to have forgotten. Sharon also learned that Marge's conversation with Sam had occurred following his announcement that he was transferring.

The Attack Continues

Two days later, on January 8, Sam called Sharon to find out if she had contacted the people in her group to set up appointments with them to find out if they had any complaints about her. Sharon replied that she had not done so, other than to have a brief conversation with Marge, because being so upset by the accusation, she wanted to make sure that she approached the topic appropriately with everyone; she did not want to get emotionally out of control during any of the interviews. Sam became very pushy at this point, stating that Sharon was just using this as an excuse not to follow his orders.

After the meeting, Sharon immediately began calling the other members of her organization to set up appointments. When Sam called her again on January 13, Sharon was able to report that she had indeed set up times to meet with all of the members of her group and that her first meeting was scheduled for January 16. On this same date, before her first appointment, Sharon met again with Sam at his request, a meeting that was a repeat of the previous ones, with Sam accusing Sharon of being vindictive, of putting fear in her subordinates, and of being in denial of the truth. Sharon asked Sam why he was trying to destroy her reputation. She stated that she could understand if he simply wanted her to find a new job, but she could not understand why he wanted to destroy her. His only reply was that she should be able to accept and admit that what he was saying was true, that she had hurt people. It was at this time that Sam also told Sharon about a new job that Donna, the vice president would have in the organization and that he was recommending Sharon for it. Because the job would clearly represent a demotion, Sharon indicated that she was not interested in it. The matter was not pursued further at that time.

The Interviews

Over the course of two weeks, beginning on January 16, Sharon met individually with her remaining subordinates. With each one, she approached the subject by saying that some people in the group had expressed concerns about her management style, alleging that she practiced favoritism. With the exception of the following two results, none of the remaining members of the organization expressed any concerns:

> *One of the African Americans stated that she felt she had been rated lower than one of the Caucasian members because Sharon wanted to promote the Caucasian member. This African American also told Sharon in confidence that Sam had been calling different group members into his office to question them about Sharon.*

> *One of the Caucasians indicated that she would like to return to the way the group used to operate, with everyone working on a single project together. She felt that when the members worked on separate projects, they did not feel like a team. She also indicated that she felt Sharon paid more attention to the new people in the organization, two Caucasians and one African American, than to people who had been in the organization longer.*

During the same two-week period in which Sharon was conducting the interviews, she was also reporting the results to Sam, as she had been instructed to do. Sam used some of these occasions to, again, emphasize that he felt Sharon was not only hurting people, but also refusing to accept this truth.

The Meeting with the Ombudsperson

At some point during this two-week period, Sharon also decided that she should contact Don, the campus ombudsman charged with mediating disputes between management and non-management personnel. When making her appointment with him, Sharon explained that two people in her group were charging her with discrimination, and because one of them was transferring out of her group, she felt that an exit interview was necessary. Sharon informed Sam of her appointment with Don. She first went to see Don alone, and the first thing he said to her was that he could not believe that the Sharon he knew should have anyone afraid or her or that she would be accused of discrimination. Sharon and Don agreed to meet with Kate, the member of her group who was transferring.

Finding Kate extremely reluctant to meet, Sharon informed Sam, who called Kate and had her set up the appointment with Don and Sharon. During this meeting, however, Kate had no comments. Sharon reported this result to Sam, who used it as evidence that people were afraid of her. Sam also met with Don to discuss the situation and reiterated the same accusations to him.

In her subsequent meeting with Don, Sharon informed him that she was so worried about the entire situation that she could not sleep and could not think about anything else. He recommended that she contact the Employee Mental Health Department regarding how the situation was affecting her sleep.

Sam's Departing Blow

On January 29, Sharon had what was to be her final meeting with Sam, who announced that they were not going to discuss the complaints anymore. Instead, he proceeded to fill out an evaluation form, supposedly with her agreement. However, whenever she disagreed with his perceptions, he refused to change anything and wrote down only his thoughts. The evaluation, which lasted for two hours, was the worst character evaluation Sharon had ever experienced. At the end of it, Sam instructed her to sign up for coaching classes and also announced that he would help her look for a new job. This was Sharon's first hint that her group might be taken from her.

Shortly after this time, Donna, the vice president, returned to the country, and Sharon made an appointment to meet with her on February 12. This meeting was cancelled, however, so an appointment for a conference call was made for February 20. During this call, Sharon informed Donna that she had signed up for the coaching class as Sam had recommended. She also asked Donna if she could have her job back (she had unofficially been removed from the position, but was remaining as supervisor only until a replacement could be found), to which Donna replied, "No." Sharon was to be transferred to a new job in the organization. Sharon and Donna also discussed the two promotion packages that Sharon had first taken to Sam for signature. Ultimately, Donna signed the papers for both, but later learning that Sam, who by this time was in his new assignment out of state, was very upset about the promotion of the African American, she stopped the promotion papers.

The Death Knell for the Department

Things finally came to a head one Friday afternoon in April 1998 when Sharon called Norma, one of her direct reports, who was African American and her top-rated subordinate, into her office. "Well, Norma," Sharon said, "Starting Monday, you're going to be the new acting manager of the Marketing Communications Planning department." "What do you mean?" Norma asked incredulously. “Where are you going? Did you get a promotion?” Norma found it hard to believe that Sharon was going to a new job, when absolutely nothing had been said previously about Sharon’s leaving. Besides, Norma was in the midst of preparing for the huge Users Conference that would be starting in about three weeks. How could she possibly handle this responsibility, along with all of the others that she had, and at the same time manage the entire department? To Norma, such a situation would be an almost certain recipe for failure. “No,” Sharon explained. “I didn’t get a promotion; I’ve been given a new assignment. As of today, April 1, I’ve been transferred to Lewis’ organization. It has been decided that I’m no longer capable of managing people. I’m not allowed to share the details of this development with anyone at this time. However, since you’ll be taking over the job starting Monday, I’m making the announcement to you first. The rest of the department will be told later today.”

Norma, a friend as well as a subordinate of Sharon’s, could not believe what she was hearing. “Who made this decision, especially that I will be the new department *acting* manager?” she asked. “Lewis and Donna,” Sharon responded. Lewis was the new manager to whom Norma learned Sharon was now reporting, and Donna was the Vice President of the entire business unit. “Well, I’m not taking the job,” Norma declared. “This is the most ridiculous decision I’ve ever heard of! Don’t they realize that we are three weeks away from the biggest customer event of the year?” I am *not* going to be a part of this fiasco!”

Somewhat surprised at Norma’s response, Sharon said, “Then I guess we’ll have to tell Lewis.” “Let’s go see him right now,” Norma declared, as she started walking out the door toward Lewis’ office, with Sharon by her side. If “surprised” described Sharon’s reaction to Norma’s declaration, nothing short of “utter shock” could describe Lewis’ reaction. Unable to persuade Norma to take the new responsibility, Lewis finally stated that he would call Donna, the vice president, and inform her of Norma’s decision.

Over the weekend, Sharon cleaned out her office in preparation for starting her new assignment at the beginning of the next week. On Monday, Lewis asked to see Norma again to find out if she had perhaps had a change of mind about assuming the role of acting department manager. Learning that she had not changed her position, he shared with her some of the discussion he had had with Donna. Norma learned that Donna had directed Lewis to “*make* her (Norma) take the assignment,” to which Lewis had quietly told Donna that he didn’t think it would be wise to try to force a position on someone who was so strongly opposed to taking it. Thus, as of that time, the Marketing Communications Planning department was officially without a manager.

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SLASTYONA CONFECTIONARY (A)

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CASE DESCRIPTION

The primary subject matter of this case is the development of human resources management policies, specifically compensation, in a challenging and changing environment – Russia. Secondary issues are managing organizational change and leadership. Instructors in different disciplines (International Management, Human Resources Management, Change Management, and Leadership) should emphasize different aspects of the case. The case has a difficulty level of four; it is appropriate for senior level and first year graduate students. The case is designed to be taught in 1 1/2 class hours and requires 3 hours of outside preparation by students. The case may be taught with or without the Slastyona (B) case. The case is based on field research. The names of the company and managers have been disguised.

CASE SYNOPSIS

Slastyona was a Russian confectionary firm with the foreign multinational corporation, INTERCHOC, as its majority shareholder. Through explosive growth (80% per year in volume from 2000 to 2003), Slastyona had captured a dominant share of the Russian market. In summer 2004, Slastyona's expatriate president, Jeffrey Walker, and Human Resources Director, Martina Espinosa, in light of the company's plans for further growth, hired an international team of management consultants. The consultants were asked to develop compensation policies including job analysis, job evaluation and grading, and pay scales for Moscow headquarters, the four confectionary factories, and sales offices throughout the country The HR Director's goal was to implement policies that would "attract, retain, and motivate high performing individuals in sales, manufacturing and support staff functions." The influx of MNCs to Russia had distorted pay standards in the country, creating a sellers' market for English speaking managers. Slastyona planned to transform its Factory A in the city of Nizhniy Novgorod into a "flagship" factory by investing in sophisticated, modern plant and equipment. HR and particularly compensation policies were needed to support growth. However, implementation of changes met with resistance by the expatriate General Manager of Factory A, Wilton Winchester.

Given the large investments already made in and planned for Factory A, and given the company's high expectations that it would become the "flagship" factory, the president asked the management consultants what should be done to implement their recommendations.

SLASTYONA CONFECTIONARY (A)

In July 2004, Jeffrey Walker, the expatriate President of Slastyona Confectionary, listened attentively as the team of management consultants from Western Europe concluded their presentation with compensation and benefits recommendations for the company, which they had prepared after a 5 week study. A number of thoughts went through Walker's head; he was especially concerned about the situation in Factory A, in Nizhniy Novgorod. Nizhniy Novgorod (formerly called Gorky) was the Russian Federation's third largest city. (See Exhibit 1, Map of Russia.) When the consultants finished their presentation, Walker thanked them and, for a minute, sat in silence. He was aware that Martina Espinosa, the HR Director for Russia, Ivan Dmitrienkov, the Compensation & Benefits Manager, and the consultants were made nervous by his silence, so he asked the questions that were foremost in his mind. "I think you've done a wonderful job of developing a pay policy for headquarters, in our factories and around the regional sales offices," Walker began.

"I believe that we can - and let me know, Martina, if you disagree - implement your recommendations at HQ. I also believe we can implement what you've recommended, with some minor adjustments, in 3 of the 4 factories. I'm not too worried about the sales offices for now. We have other priorities to deal with, but Gunter will be able to make some use of your study. I'm concerned with the Nizhniy Novgorod factory." (Gunter Wolff was Slastyona's Director of Sales and Marketing).

"You know that we are transforming Factory A into our flagship manufacturing site in this part of the world. We've invested heavily and are willing make the additional investments needed so that Factory A is as modern and efficient as any INTERCHOC factory anywhere in the world. While the upgrades of plant and equipment are proceeding as planned, I'm concerned that recruitment and policies are lagging behind. H.R. policies need to support the infrastructure upgrades, or we won't take full advantage of the investments we're making."

"You were down there; you met Wilton Winchester and his team.... Do you think that we can implement what you recommend for Factory A? Do you think we're ready? What do you think must be done before we can implement an effective pay structure at Factory A?"

INTERCHOC

INTERCHOC, B.V. was a global organization that tended to delegate a high degree of authority to subsidiaries. The MNC's global expertise was in marketing, but it was also considered strong in financial management, sales, logistics, and manufacturing. Although the global product range was immense, only a few leading brands were very well known by consumers worldwide. INTERCHOC's product quality was generally considered to be high by industry experts, and it had products in nearly all price sub-segments of the markets it served. INTERCHOC's regional headquarters for Eastern Europe were located in Vienna, Austria.

SLASTYONA CONFECTIONERY

Slastyona was the leading private confectionery manufacturer/ marketer in Russia. The majority of Slastyona's shares were owned by INTERCHOC, B.V., the international confectionery giant within which Jeffrey Walker, now 59, had made his career. The remaining shares were owned by Russian investors.

Well known international brands as well as locally developed brands of chocolates, sweets and chewing gum had been introduced to the Russian market, backed by sophisticated Western marketing, including extensive media/outdoor advertising, point of sales material and promotions. Slastyona’s national promotion, "Does your sweetheart have a sweet tooth?" was considered to be the most adventuresome marketing campaign ever conducted in the country and had eclipsed competitors' attempts to gain market share at Slastyona’s expense. Growth had been over 80% per year in volume terms from 2000 to 2003. For the moment, there was no sign of abatement. However, the 5-year strategic plan and budget did take into account a more "normal" growth pattern, slowing to 30% per year from 2004 to 2007, then 10% per year thereafter in volume.

Walker believed that the development of a full brand portfolio and aggressive growth in the early years would establish the company in a leading position that would be hard to dismantle 10 to 15 years in the future, despite the nervousness that the Finance and Administration people in INTERCHOC’s Vienna headquarters felt when he presented his strategic plans and long-term view of the market. "In a country like Russia," one of the Regional VPs had said, "you can't plan beyond 2 or 3 years - everything could change."

In the past few years, Walker had been spending a good deal of time on marketing issues, but knew that his top priorities for the next several years would still be distribution, government and shareholder relations, security (of people and assets), organization, and human resources management. In particular, he knew he had to spend more time overseeing the transformation at Factory A. Walker believed that appropriate human resource management systems should be based on best practices from INTERCHOC, but also adapted to “fit” Russian culture and Slastyona’s particular circumstances. Having worked internationally for most of his career, and in Russia for several years, he was well aware that Russian culture was very different from the West. (See culture data in Appendix)

Slastyona's headquarters were in Moscow. The company had four factories in Russia (Nizhniy Novgorod, St. Petersburg, Yekaterinburg, and Vladivostok), and was about to open a fifth in Novosibirsk. (See map of Russia in Exhibit 1.) It also had a large national sales structure with disperse sales offices, depots and warehouses. Factory A was the largest factory, both in terms of volume and capital investment. Slastyona has approximately 2,700 employees, a number considered high (for its volume) by Western standards, even though a large number of jobs had already been outsourced or eliminated outright. (See organizations charts in Exhibits 2 and 3, and a list of management positions and incumbents in Exhibit 4.)

SLASTYONA'S FACTORY IN NIZHNY NOVGOROD

Factory A was intended to become the flagship manufacturing site in Russia, at which product innovation, new process technology, and manufacturing management training and development would be experimented with in the coming years. Significant changes had already been made in plant and equipment and more changes were coming. Factory A was organized functionally with the most significant functions (Production, Engineering & Maintenance, Logistics, Human Resources, Finance & Administration) reporting to the General Manager, Wilton Winchester. The General Manager was not accountable for sales or marketing. These functions were managed nationally by the Director Sales & Marketing in Moscow, Gunter Wolff. Information systems and to some degree finance and administration were also centralized in Moscow. Human Resources policies and procedures were part of the factory's scope of accountability. Nonetheless, the Director Human Resources in Moscow (Martina Espinosa) exerted considerable influence over policies and procedures in all the factories. (See Exhibit 2, Slastyona's organization chart.)

THE CONSULTANT'S REPORT

Martina Espinosa, Director of Human Resources, had hired a prestigious international consulting firm from Western Europe to analyze the compensation and benefits policies and practices at Slastyona. Her goal was to develop policies that would support the business strategy of rapid growth through national distribution and the development of a full brand portfolio. Policies were needed to help Slastyona attract, retain and motivate high performing individuals in sales, manufacturing and support staff functions. She knew that the Russian compensation market was in tremendous flux. English-speaking Russians with a good education and one or two years of experience in a multinational company were commanding from USD 40,000 per year for entry-level management or sales positions, and requesting bonuses and benefits on top of that.

Foreign firms had "upset" the pay market by offering Western European salaries. All firms were forced to compete for a limited number of young, internationally-oriented, English-speaking Russian managers, who were in a seller's market for their services. Capitalism had taken root quickly in Russia, and Martina knew that in order to compete, Slastyona's compensation had to remain competitive at different levels in different markets. Accurate assessments of the many different pay markets in the country was difficult to achieve. For Slastyona, the different pay markets included (1) the Moscow "professionals/managers market," (2) multiple regional sales functions markets -

each one unique and difficult to assess, and (3) distinct pay markets for professionals, managers, and factory workers in five cities.

In Nizhniy Novgorod, like other cities in Russia, managers and professionals (especially finance people with a minimum understanding of Western accounting) were in scarce supply. Martina also knew that the potential managerial and professional labor force was vast; Russia had a 99% literacy rate and approximately 17% of the population had received some university-level education. In percentage terms, Russia's population was educated like that of Europe, although the number of engineering, science and mathematics graduates was disproportionately high (World Bank). Martina had some doubts, however, about the quality of education in Russia. Some of the people Slastyona had hired from universities with good reputations had arrived poorly prepared to analyze data or draw conclusions from information. A few new hires for junior management or sales positions had been let go because they were incapable of acting without close supervision. Because so many government-funded jobs had simply disappeared with the fall of the Soviet Union, scientists and engineers could not find suitable work. Martina knew that many factory workers recently hired for the new factory in Novosibirsk were engineers. Most of the new workers in Factory A had a university degree of some kind. In fact, one newly hired foreman was a nuclear physicist who could not get a job in his field.

Martina’s problem was the time and resources needed to find good people, teach them INTERCHOC's standards of quality, get them trained for their jobs, and retain them. The team of management consultants had facilitated the description and evaluation of jobs, set up a grading structure, and developed pay ranges and merit pay based on performance. Adaptations in the pay scales were made for each region of Russia, in accordance with estimates of each local pay market. The consultants had working with Ivan Dmitrienkov (Compensation & Benefits Manager) and Martina for more than a month. Martina she felt that an extremely professional job had been done of assessing the markets based on the information available, as well as developing compensation and benefits policies and specific recommendations. She was confident that if Jeffrey Walker approved the report, she could plan and budget payroll, and attract and retain qualified employees. Pay market data were plentiful on some Russian cities (Moscow, St. Petersburg), somewhat available for some others like Nizhniy Novgorod, but totally absent for Irkutsk, Yekaterinburg and Vladivostok, and other cities.

Martina had learned that Moscow was the fourth most expensive city in the world to live in, after Tokyo, Osaka, and London (Global/Worldwide), which partially explained why Moscow salaries had skyrocketed. The consultants had estimated local pay markets as proportions of the Moscow market, based on differential cost-of-living indices and other scraps of information. The consultants had identified a large number of pay inequities and had proposed a plan to introduce changes gradually over 3 periods: about one and one-half years. Because of inflation, Martina had a great deal of room to maneuver. The official estimate for inflation from 2003 to 2004 was 10.9% and was rising in 2004 by at least one percentage point (IMF World Economic Outlook). She had learned in Latin America how inflation could be useful when one is attempting to introduce radical changes to a pay structure.

THE CONSULTING PROCESS

The consultants had begun with an exhaustive job analysis. Incumbents had been trained to describe their own jobs. Then the consultants, working with interpreters and translated versions of the documents, acted as facilitators between superiors and subordinates to clarify how accountabilities cascaded down the structure. The process of job description and evaluation had identified some overlapping responsibilities and omissions, and changes were proposed to jobs and the organizational structure to address the issues identified. The process had gone well, and numerous changes to the structure had been introduced. There were, however, issues in Nizhniy Novgorod at Factory A.

After the extensive job analysis, the consultants had facilitated the work of two committees, which evaluated the jobs based on responsibilities and required knowledge, skills and abilities - job requirements, not incumbent abilities or capabilities. After the jobs had been evaluated, the consultants proposed a grading structure with 16 grades, similar to what other INTERCHOC companies used, yet adapted to the distribution of jobs at Slastyona. The proposal was discussed with the committee and approved. For each grade, the consultants proposed base salary values (minimum, maximum and midpoint salary per grade) in a logical structure. Base salary midpoints increased by about 20% consistently, and the increase from the minimum salary and the maximum salary in any grade was exactly 50% (minimum =80% of midpoint salary, maximum =120% of midpoint salary).

Next, each employee's actual pay was compared to the recommended pay structure, and individual adjustments were recommended. The consultants also proposed guidelines for merit pay and promotions. The entire set of recommendations, and budget implications, were presented to the management team in Moscow and now awaited approval.

THE JOB ANALYSIS MEETING IN NIZHNIY NOVGOROD

The Nizhniy Novgorod committee included Sasha Yurchenko (Factory A Production Manager), Galina Paskova (Logistics Manager) and Svetlana Ermakova (HR Manager in Factory A). The three managers were working with a consultant on job analysis, in order to identify possible overlaps / omissions of accountabilities between departments and jobs. The process was going well, but Svetlana Ermakova was concerned that the group didn't really have a grasp of some issues. Because of the heavy investment planned for the factory, the group very much needed a picture of the factory in the foreseeable future.

Svetlana Ermakova wanted to forecast the number of supervisors and managers needed next year, because she knew that it took months to find and train people. She suspected that the current group of supervisors might not be able to deal with the new technology. The new equipment included highly automated, high-speed machinery for both production and packaging, all computerized. Computer control of the process would require very different skills of the supervisors. A six-month training/ internship would be required for maintenance supervisors, and at least 3 weeks for production supervisors - longer if time could be found.

Sasha Yurchenko (Production Manager) agreed with Svetlana. He added that since Factory A was to be the first factory in Russia with equipment at this level of sophistication, it was likely to be the place where supervisors and managers from the other factories would be trained. Factory A's Production Supervisors and Foremen would have significant training responsibilities that should be taken into account in job evaluations.

Galina Paskova (Logistics Manager) commented that it made no sense to train only the production supervisors - obviously the day would come when the workers themselves would run the equipment with very little supervision - she had seen this in factories in Austria. In addition, she commented, the logistics staff should be trained; she hoped that someday the computer control process would be extended to cover fully the control of inventories of raw materials, work in process, finished goods and goods in transit to the sales department's depots and warehouses. "The logical career path for the future supervisors in logistics is from production," she added, "in production they will get the best training on the computer control process. If Logistics Supervisors were to come from production jobs, they would be able to dialogue much better with Production Supervisors about excess levels of stock of raw materials - they would know what they were talking about."

Galina also thought that Slastyona should expect troubles recruiting young supervisors. The State Technical University as well as the secondary schools in Nizhniy Novgorod was having serious budget problems; the best teachers were leaving for other jobs in the private sector (Moscow Tribune). Clearly it was only a matter of time, she remarked, till the quality of graduates dropped and Slastyona would need to do much more remedial training.

Sasha and Galina discussed this issue a bit. Sasha added that the problem was even more severe than it seemed: since the state schools in other cities of Russia were also having budget problems, it was reasonable to assume that they too would graduate potential technicians who would require remedial training. Since it was foreseeable that Factory A would become the "flagship" factory in Russia and the potential source of technicians, supervisors and managers in the other Russian factories, the impact of the troubles at the schools would be felt company-wide. He predicted that the cost of training would skyrocket, and discussed why he thought this was so for several minutes.

Martina, at this point, interrupted their conversation and asked the three managers what additional information they needed. They replied that what was most needed was a description of what the factory would look like several years, say five, in the future, in order to know now what steps should be taken, what type of responsibilities should be designed now to deal as best as possible with this scenario. The meeting then stopped for lunch.

Martina took advantage of the opportunity to eat with Wilton Winchester. She told Wilton what the managers were discussing in the meeting and asked if he could find some time, in the afternoon, to join them and provide a brief description of the future factory - what it would took like, what volume was expected, what mix of products and technology, what kind of workers, etc. Not only would the group like to hear this, so too would Martina. She was surprised by Wilton's reply:

> *"Now that's all well and good, Martina. It's good that these guys are thinking. But really now, you HR people come down and forget that we have a factory to run. My people can't be tied up in meetings all day - couldn't you have finished this stuff this morning? I believe this salary stuff is as important as anything we have to do to get this factory in good shape, I really do. By the same token, our prime objective is to produce chocolates; that's our objective. If we can't produce chocolates then I don't care if the salaries are well organized, it would still be a failure."*

Wilton then went on to talk about working practices: "You know, Martina, I believe my job is to get these guys trained and I'm counting on you to help me. But this stuff doesn't help. These guys are still using communist working practices, as much as I've tried to get them to change. You gotta remember - INTERCHOC working practices aren't like that. The difference between the old style and the new style is night and day, night and day. We don't make some Soviet-style five year plan that nobody is going to achieve anyway."

"We're more realistic, and you've got to tell these guys to be practical. All of these managers are good at the paperwork, the administration side, that's their ability. But we need to focus on our prime objective - making chocolates. I don't think we need to come up with a Soviet-type plan in order to figure out what the salaries should be here, I really don't."

Martina was concerned. Without Wilton's "buy-in" to the process, how would they be able to introduce policy changes? Why was he uninterested? Was the salary structure inappropriate for Factory A? Was the consultants' approach wrong? What could she tell the team and the consultants? What would she tell Jeffrey Walker when she returned with the consultants to report back in Moscow? Above all else, what did she need to do to ensure proper implementation of an effective pay policy for Factory A and the rest of Slastyona?

Exhibit 1
MAP OF RUSSIAN FEDERATION

Exhibit 2
SLASTYONA, PARTIAL ORGANIZATION CHART

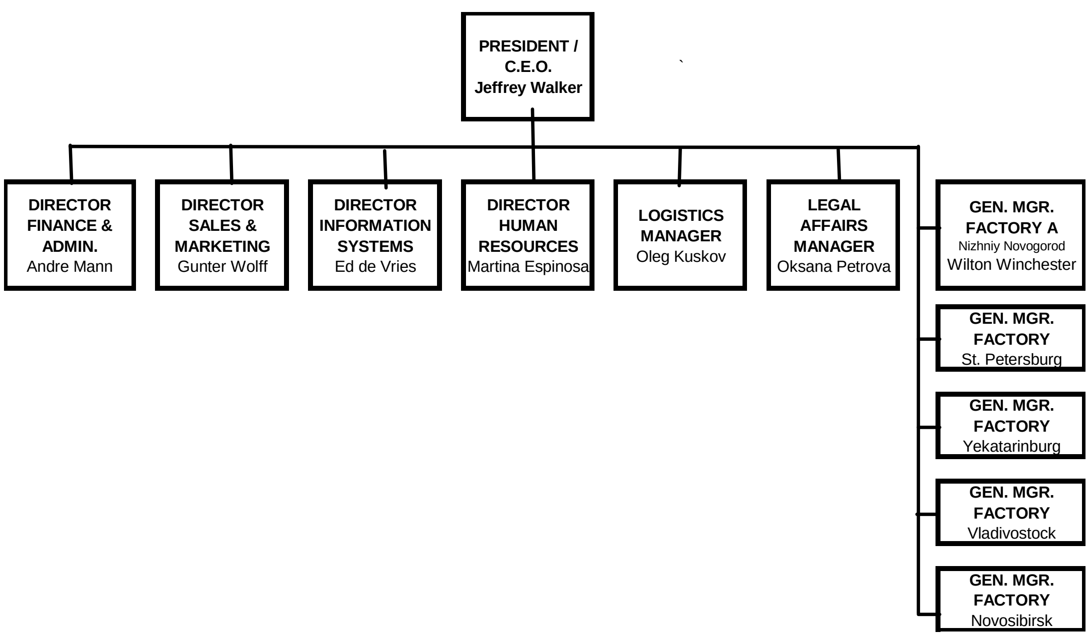

Exhibit 3
FACTORY A, PARTIAL ORGANIZATION CHART

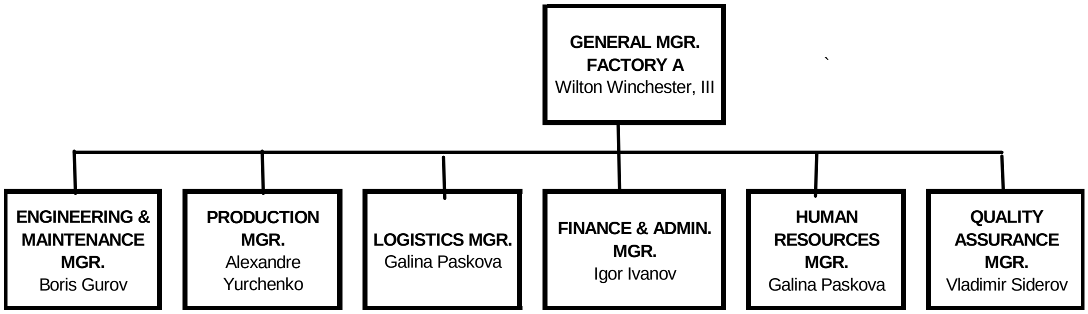

Exhibit 4
MANAGEMENT POSITIONS AND INCUMBENTS AT SLASTYONA (Partial List)

Job	Location	Incumbent	Job Status	Age	Previous Job
President	Moscow	Jeffrey Walker	Expatriate secondee	58	President of another INTERCHOC affiliate
Director Human Resources	Moscow	Martina Espinosa	Expatriate secondee	36	Vice-Director HR & Legal INTERCHOC Latin America
Compensation & Benefits Mgr	Moscow	Ivan Dmitrienkov	Local	32	Hired locally and trained in Vienna
Director Sales & Marketing	Moscow	Gunter Wolff	Expatriate secondee	42	Recruited from a competitor
Director Finance & Administration	Moscow	Andre Mann	Expatriate secondee	47	Transferred from INTERCHOC Vienna
Director Info. Systems	Moscow	Ed de Vries	Expatriate secondee	31	Transferred from a European INTERCHOC affiliate
Logistics Mgr	Moscow	Oleg Kuskov	Local	42	Hired locally
Legal Affairs Mgr	Moscow	Oksana Petrova	Local	28	Hired locally
General Mgr Factory A	Nizhniy Novgorod	Wilton Winchester III	Expatriate secondee	52	Regional Director Manufacturing -INTERCHOC
Engineering & Maintenance Mgr	Nizhniy Novgorod	Boris Gurov	Local	43	Career employee at Slastyona
Production Mgr	Nizhniy Novgorod	Alexander Yurchenko	Local	36	Recruited from another Russian confectionery firm

Exhibit 4
MANAGEMENT POSITIONS AND INCUMBENTS AT SLASTYONA (Partial List)

Job	Location	Incumbent	Job Status	Age	Previous Job
Quality Assurance Mgr	Nizhniy Novgorod	Vladimir Sidorov	Local	38	Career employee at Slastyona
HR Mgr	Nizhniy Novgorod	Svetlana Ermakova	Local	27	Recruited out of university; trained INTERCHOC Vienna
Logistics Mgr	Nizhniy Novgorod	Galina Paskova	Local	33	Recruited locally; trained INTERCHOC Vienna
Finance & Admin. Mgr	Nizhniy Novgorod	Igor lvanov	Local	31	Recruited out of university

APPENDIX
HOFSTEDE'S NATIONAL CULTURE DIMENSIONS

Geert Hofstede identified five dimensions of national culture and collected data from respondents in more than 60 countries. A description of his research can be found at http://feweb.uvt.nl/center/hofstede/, where the following definitions of variables are provided:

POWER DISTANCE is "the extent to which the less powerful members of organizations and institutions (like the family) accept and expect that power is distributed unequally."

INDIVIDUALISM is "the degree to which individuals are integrated into groups. On the individualist side we find societies in which the ties between individuals are loose: everyone is expected to look after him/herself and his/her immediate family. On the collectivist side, we find societies in which people from birth onwards are integrated into strong, cohesive in-groups, often extended families (with uncles, aunts and grandparents) which continue protecting them in exchange for unquestioning loyalty."

MASCULINITY "versus its opposite, femininity, refers to the distribution of roles between the genders ... The assertive pole has been called 'masculine' and the modest, caring pole 'feminine'. The women in feminine countries have the same modest, caring values as the men; in the masculine countries they are somewhat assertive and competitive, but not as much as the men, so that these countries show a gap between men's values and women's values."

UNCERTAINTY AVOIDANCE "deals with a society's tolerance for uncertainty and ambiguity […]. It indicates to what extent a culture programs its members to feel either uncomfortable or comfortable in unstructured situations."

LONG-TERM ORIENTATION is associated with **"**thrift and perseverance" while a short-term orientation is associated with values of "respect for tradition, fulfilling social obligations, and protecting one's 'face'."

Exhibit 5
CULTURAL DIMENSIONS OF RUSSIA AND SELECTED OTHER COUNTRIES (*)

Cultural Dimension	Russia	United States	Austria	China
Power Distance	95 – high	40 – low	11 – low	80 - high
Uncertainty Avoidance	90 – high	46 – low	70 – high	30 - low
Individualism	50 – individ.	41 – individ.	55 – individ.	20 – collectivistic
Masculinity	62 – masculine	40 – masc./fem.	79 – masculine	66 – masculine
Long-term Orientation	10 – short-term	29 – short-term	31 – short-term	118 – long-term

(*) The numerical data in the table were obtained in Hofstede's original study of IBM employees and published in the first and second editions of *Culture's Consequences* (2001); the words "HIGH," "INDIVIDUAL," etc. have been added only for the purpose of providing a "first glance" interpretation of the numerical score. Scores for USA and China are included as reference points.

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SLASTYONA CONFECTIONARY (B): THE FACTORY GENERAL MANAGER

Stephen J.J. McGuire, California State University, Los Angeles

CASE DESCRIPTION

The subject matter of this case is leadership and managerial competence. The case has a difficulty level of four; it is appropriate for senior level and first year graduate students. The case is designed to be taught together with the Slastyona (A) case, or in a follow-up class for approximately 1/2 hour. The B case requires 1 hour of outside preparation by students.

CASE SYNOPSIS

The B case is designed to complement the Slastyona Confectionary (A) case by providing additional information on Wilton Winchester's leadership and competencies by providing a verbatim interview transcript. Winchester is the General Manager of Slastyona's Factory A. A team of management consultants completed a compensation project in the Slastyona A case and was to do a follow-up assignment that included interviews with managers. The B case begins President Jeffrey Walker asking the consultants "what they have learned" after interviewing Winchester. The rest of the case contains a transcript of a semi-structured interview with Winchester, designed to elicit comments that reveal behavior indicative of his leadership and managerial competencies.

SLASTYONA CONFECTIONARY (B) – THE FACTORY GENERAL MANAGER

Jeffrey Walker, President of Slastyona Confectionary, waited in his office for an informal meeting with Martina Espinosa, Director of Human Resources, and the management consultants who had been hired for a follow-up assignment after their recently completed compensation study.

Walker had asked the consultants to think again about what might need to be done at Factory A in Nizhniy Novgorod before changes in the pay structure could be implemented. He was convinced that a number of potential issues needed to be explored. After all, Factory A was intended to be the flagship manufacturing site in Russia, at which product innovation, new process technology, and manufacturing management training and development would be experimented with in the coming years. Whatever happened at Factory A would surely have an impact on the remaining 4 (soon to be 5) factories and throughout the whole firm in Russia.

Following their report with compensation policy recommendations, Walker had asked the consultants to "take another look" at Slastyona, and in particular at Factory A. What potential organizational and staffing issues needed to be planned for? What additional support did Moscow need to provide to Nizhniy Novgorod? What about the leadership and management competence of the people at HQ and in Factory A?

The consultants had begun to address his questions by carrying out a series of long interviews to assess managers at Moscow HQ and in Nizhniy Novgorod. In fact, they had interviewed Walker himself for about 3 hours, with tape recorders to capture every word! Their approach was semi-structured; they asked each manager to tell three "stories" in his or her own words. The first story was supposed to be about a success the interviewee had personally achieved at Slastyona. The second story was about a failure at Slastyona or elsewhere, and the third about either success or failure. Based on these interviews, the consultants would prepare reports about the competencies and cognitive capabilities of the managers, with recommendations for development.

Although the reports were still being prepared, Walker wanted the consultants' "unofficial" view of Wilton Winchester.

APPENDIX: PARTIAL TRANSCRIPT OF WINCHESTER INTERVIEW

Subject: Wilton Winchester, III
Age: 52
Company: Slastyona
Job: General Manager, Factory A
Interviewer: S

[Introductions, background, explanation of the 3-story format.]

S Very good, okay! So, I would like you to tell me three stories, about anything that interests you. Start with a success story, if you can think of one. Please tell me the title of your story before you proceed. About anything that interests you.

W.W. Hmm… right, okay, I find it difficult, I'm sure I can tell quite a few stories.

S That's great.

W.W. A recent positive experience, rather than a story, that I can tell is about the development of the manufacturing operations within the region within the last few years.

S This was in your job at INTERCHOC's regional headquarters?

W.W. Yeah, I was Regional Director for Manufacturing, out of Vienna.

S Okay.

W.W. Okay. So. I took on-board an objective to move away from the normal attitude, how the business had been run from a manufacturing point of view. In the department we had two people who worked for me plus the managers out at the factories. We set fairly strict objectives to improve our customer service, which is something similar to what the Slastyona Board is doing at the moment. And we challenged ourselves to produce and ship [product name omitted] from a recognized fifteen days to do it within eight days.

S Recognized, what do you mean?

W. W. Well, that was a sort of what we were running at. That was seen as a normal, and it was done within the normal process not within the new teamwork - Japanese-type process. And we challenged ourselves to see if it was achievable within our own set-up. It was done through everybody taking it on board as the objective and working together, and we had certain leaders on specifics and we had the factories moving smoothly. Next, we had to look at the quality.

S Right.

W. W. It was handled like in the usual manuals; we had to see what things were dysfunctional. If they were dysfunctional, why? What do we need to do? We started to look at it. We had a lot of heartache, you know getting people to buy-in, getting people to believe, change their minds, but obviously we did it in steps, in slow steps, so people were starting to gain confidence and actually now it is almost like normal. To see their main objective in terms of rapid customer service.

[comments omitted]

S Right, so what about quality?

W. W. As I said with the new process we created, that was the first step and the quality in terms of the unacceptable chocolates was dramatically reduced from the normal between six and seven percent to averaging between two and four percent. Our customer returns dropped quite dramatically. We still had - I am not saying that everything was clean there - we still had the occasional hiccup.

S Right.

W.W. And we had one complete reject in two years, which was on a new product [product name omitted] so, we had; sorry, we had two rejects. We had one in Turkey as well, which as a minor hiccup and it was someone who broke the process, and if these things happen then it's good that they do. It's alarming as well because you use it as an opportunity rather than a negative because you can say to the people, and you can show it to the people that, look, because you deviated from the process that you agreed to, this is the trouble you get.

S Right, right. Could I ask you to tell me: what your role was in the development of manufacturing operations at Slastyona? Tell me about a success you had.

W. W. My role, my main role is setting up the businesses from nothing, which is also a fairly successful story.

W.W. [Several minutes of comments excluded]

S That's super, thank you. Let's do that; let's talk about setting up the business at Slastyona. But could I ask you to be a little more personal, because you say, "we did this" and "we did that" and you know who you mean but I have no idea who the “we's” are?

W. W. Okay! By the way, I think I tried to explain; “we” means the two people who were working for me, and the factory managers and so, the places I was talking about was Ukraine, Turkey and here in Russia - Slastyona.

S Right. You set up Slastyona?

W.W. Of course. Before I came here I was responsible for the capex project. I set up lots of factories in this region! I was responsible for getting these factories going, making sure we were making good chocolates.

[Comments excluded]

W.W. But um, my role initiated in this region in 1987. I joined this region because I felt I needed a challenge and people find it strange that I would come here as a challenge because it was, there were still communists at the time and nobody saw it as development when I was asked if I wanted to come. It was basically, in old technical terms, it was a grade down at that time but I still came.

When I started off in Russia, I was on my own. There was nobody else, I was the one-man department and my job at that time was to set up a factory in Russia. A factory that could make good chocolate.

Well, I wanted to talk about how I developed managers, the development of managers and it has been something that I believed in. But I don't want to talk about Slastyona, let me talk about the Ukraine.

S Take someone specific, you don't have to name him or her, but...

W. W. Okay, but there are so many of them. There are three people who I would say I am very pleased with. Two are the two boys I had originally brought here for different reasons, because; and one is a local, a local national, okay. Taking the expat, then I, I went to my boss and said: this is who I want, I don't really want to post the job. I want this guy. He agreed. But I was told that wiser people doubted the wisdom of my selecting him.

S Why did your boss have doubts? And why did you select this candidate?

W. W. Well, this guy before was an accountant. But I knew he could do more, basically because I knew his ability. I had worked with him for three years. I knew him as an accountant too, but I had sent him on an engineering course so there was all a lot of background that we had already done. In terms of really developing someone in this part of the world, he was my first person. There were a lot of doubters about the guy because he was an accountant and that guy's final achievement has been the last two years, because I left him up in Kiev and he has taken the Ukraine from zero to a huge success in two and a half years, which is an exceptional job.

S What did you do? How did that work?

W.W. I worked with them, we were at the very beginning, we were a team. There was the other gentleman as well who works for me, and we started the business and we were there for six months setting it up, building the foundation. Once the foundation was there, he was left to develop the local managers and develop the business at the same time. But his prime objective was to develop the managers. His objective obviously was to achieve all the business objectives as well, but his main purpose was to develop the locals. As I said to him, if after three years you don't have a manager ready to run that business, you have failed. I said, I don't care if the plant is running successfully, if you don't have a manager ready, it’s a failure.

S Why did you say that?

W.W. Because we didn't want to bring in somebody from outside. We believed that it should be local managers. Our guy was an expatriate and we feel it should be a local manager in that environment, because he would understand the environment better and things, and he’d be better at relating to the people. So, that was one success in terms of developing. The other one was a gentleman who has been with the company a considerable amount of time. He had moved around various jobs, he has never had a settled period. He's been at risk in certain cases, and we brought him in but he was a different type of person.

S What do you mean, we brought him in?

W.W. The other, that gentleman from, who was in the Ukraine, and I. First, we had to agree who we needed, but it is always an agreed decision, because we have all got to work together. So, we brought him in. He found it very difficult to start with; this was a challenge to him coming with his own history and unsure of himself. His strength was quality and engineering, industrial engineering, whereas the other guy's strength was administration and planning, so it was a nice balance. And we gave them objectives that matched their strengths so that they could feel comfortable.

S Who set the objectives?

W. W. I did.

S Okay.

W.W. Okay. With him, we said what he should do. I keep saying what he should do and he took up the challenge, he worked with it. And now he is a very, I find he is a very confident person in his role and totally different from what he was when he came four years ago. Sometimes he's a little bit too confident. But it's good to see. Now, because of that, they are setting up the new factory [in another Russian city] at this very moment, and he is the project leader. I am still controlling him and giving him direction, but he is the project leader. Same as I’d done with the guy in Ukraine.

S Right.

W.W. Now, he's come to the next step, which is the self-satisfaction of managing an overall set-up project. He is going to do the whole thing and that's how much I think he has developed in a short space of time. People are using their skills to the best of their ability and getting tremendous satisfaction.

S Very, very interesting.

W. W. The other one is a local manager, here in Slastyona and it's probably more difficult to relate to, because the person is still, has to come a long way, has a long way to go yet, in terms of my comfort. Full comfort level, full trust. Ah, it's the Logistics Manager, [name omitted] here at the factory; she is a girl, which doesn't make any difference really. But I mean it is very unusual especially in a communist country to have a senior manager being a female. I hired her here and then she spent two years working and being trained in Europe. Still, two years isn't much. She had been brought up in the communist systems and she went to university in East Germany, so she had all the, not the communist beliefs, but the communist work practices.

S Right.

W.W. And, for her to come in a company like INTERCHOC, it's night and day in terms of how we do business. Totally night and day. She didn't start as a manager, she was just selected as one of ten people who had a potential, so she got sent abroad. We went on a couple of weeks training down to Turkey. Took them through a small, it's not so much training but an induction program, get them to understand INTERCHOC. At Slastyona, I left her in charge of the administration because that's where her strength was. She was good at the paperwork. Her university background gave her that ability. I had an elderly man working for me then as Logistics Manager and supposedly Facilities manager. He found it all very, very difficult, but he was good with the girls. He was kind but firm. Most of the factory employees are women.

Most of the factory workers are women; it is more suitable to a female labor and all. There are some males in specific jobs, but generally 95% is female, so he was very good with them, but he was under a great deal of stress when we started to get into paperwork. Because INTERCHOC has a lot of paperwork and analysis and reporting, so we know where our business is going, not just reporting but paperwork that lets you understand the costs, the efficiencies, and things like that. And he had a real problem with it, so we would have to find somebody to take the role and leave him just as a technical adviser. We took a risk, we promoted this the young girl to the job of Manager. Myself and the President of Slastyona.

S Right.

W.W. Okay. It was my objective to train her. Now that self same girl is doing the job and now she can be left alone for a good period of time to tend to the day-to-day running of the Logistics Department. She is very good at looking into how the business is going. She is able to pinpoint the problems. She is still weak on the technical side, but as long as she has strong technicians working for her, it is not a big problem as long as she is able to understand this. And that's what she has to do.

S And have you been working with her?

W. W. I haven't been working with her, no. My time is being spent in running this factory, this business, setting objectives and working and showing how to get it done from my own experiences. From my own background and it's, that's what I keep saying, it's never-ending. I mean, the girl is successful. She'll probably be as successful as 90% of the managers round the world.

S Right.

[Several minutes of comments omitted]

W.W. These people I developed went through development from very, very strange circumstances for them. Also the results that people achieved were with the direction and objectives I gave them. Well, I talked last week with the *Wall Street Journal* discussing how I felt about business in Russia. Because there have been a lot of complaints; people think it's too costly. Efficiencies are too low, absenteeism is a problem, turnover is a problem and I said to the interviewer, I don't agree. I think you have to look deeper than that, because Slastyona is working here and making a good product and a good profit. At this precise moment, we have 4% absence year-to-date which is lower than the average, we have somewhere in the region of under single figures in turnover. We have high quality, high efficiency, and low cost, but the low cost is achieved through management. We pay the people more, but we get less cost because of it.

S Right.

W. W. And I explained to the guy, I said it's okay! I've seen people complaining and we’re talking American Companies. I met with some of these people, I know what they have been doing. I said, now it comes down to management. This is a low cost country if you utilize it.

S Right, right.

W.W. I am talking now blue collar.

S Sure, sure. I've worked in Russia a bit. Hmm, good story, that's super, that's very good. For my purposes, the most useful parts are those where you begin to talk about what you did, what you thought, okay. Some of the stuff about what the other person did, is very interesting but not really what I'm looking for.

W.W. But the trouble is, I'm that type of person, you are not going to get me saying "I".

S I noticed that! It's not your style. I understand that.

W.W. Probably deep down, I know it has been my direction, my drive, my role, my foresight, my experience. I've created all this, because I've seen, I mean I have seen the failures in other places. I take pride in what's been achieved here. As I've said, I have been accused of being a hands-on manager. But the perception of myself as a hands-on manager, not a desk manager, is fine. I am not interested in that. I keep saying to people that it's not right, because also in the same breath, it means I'm not a team player, and I disagree because I couldn't achieve what's been achieved just on my own. Now, I'm hands-on, I'm hands-on in terms of working with people. I'm hands-on in terms of developing managers. I will not ask someone to do something that I don't think I can do myself. I will set objectives, but I also take time to make sure that people know the job. Say for example, the Logistics Manager, a girl with big aspirations, or the Production Manager, who thinks he's ready to take my job. It's okay to have aspirations, but if the people don't have the knowledge to use their aspirations, then you have great difficulty. I believe in giving people their own freedom to make decisions. But there are times when you have to curtail it.

S Can you give me an example of what you were discussing – your management philosophy?

W. W. The example I can give is the two people who joined me. When I gave them their objectives, I left them to go and do it on their own. I only overviewed from a distance and if I felt it wasn't right, I would discuss it, to point them in the right, to what I felt was the right direction, because I still feel it was necessary to have leadership. Sometimes people become bunkered; they still need leadership.

You have to have a straight vision. You don't go over this boundary or that boundary because of your objective. You need someone above who is looking at the broader perspective and giving direction.

[The interview continued for approximately 35 more minutes.]

PROCESS INNOVATION AT THE SANDY LUMBER MILL

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CASE DESCRIPTION

The primary subject matter of this case concerns the value of quality control and continual system improvement. Secondary issues examined include project implementation, and quality management issues. The case has a difficulty level appropriate for undergraduate seniors towards the end of a semester quality management class and for graduate students. The concepts presented in the class are not trivial and several hours during class can easily be used to discuss all issues. A student's degree of understanding of process control issues, financial analysis, and quality management issues dictate the amount of time out of class each will spend to address case issues. Most students will need to spend a minimum of four hours to address all issues.

CASE SYNOPSIS

The Sandy sawmill produced dimensional lumber. The mill had recently completed a $2.6 million process upgrade that had allowed it to improve yields and better match lumber produced to market conditions. Revenues had increased from $29,000,000 to over $40,000,000 as a result. But challenges and opportunities remained. The milling process was theoretically capable of producing closer to specification, and operators still had difficulty identifying where in the process defects originated. Further, the mill manager was somewhat overwhelmed by the amount of data being produced and how best to use this data. The case ends with the mill manager wondering what he should do next to get the most out of the new system. This case was designed for use in a quality management class to facilitate discussion of the design and implementation of a statistical process control systems.

INTRODUCTION

Tony Flagor watched the computer screen display real time information on the boards being processed at the Sandy Saw Mill and marveled at the new control process now in place. He was proud of the changes that he and his team had made. Nevertheless, even though the new control process was vastly superior to the one that had been in place when Tony had first become mill manager, it still did not seem to be adequate. The milling process consisted of many steps, each one representing a unique opportunity for a quality problem. Unfortunately, the control process did not display which task caused an out of specification board, only that a given place on a given board did not meet specifications. Furthermore, the measurement system in place had the potential of creating an unfathomable number of data points per minute, and Tony was unsure how best to use all of that potential data. What Tony did know was that he needed to continuously improve the effectiveness of the mill in order to stay competitive, and he believed that effective real time process control was key.

The US lumber industry in which the Sandy Mill competed was highly competitive, and generating profits had become an increasingly challenging task for everyone in the industry. An 18% increase in lumber imports from 1997 to 2002 (Kelly, 2003) and increased effectiveness of processing technology had created a situation of high supply relative to demand despite diminished supplies of raw material due to closure of many national forests to logging to protect endangered species. From 1997 to 2003, 117 (14%) of the 829 United States softwood lumber mills went out of business (Spelter, 2003) and the number of trees harvested declined by 6.85% (United Nations Economic Commission for Europe, 2003), yet lumber production in the USA was static for the same time period (Kelly, 2003). The surviving operations had to increase effectiveness (extract more boards of higher value from a given log at lower operating costs) and gain economies of scale to stay in business. The Sandy lumber mill was a mill that so far had been successful in increasing lumber production effectiveness.

The mill manager in charge of milling operations and milling improvements at the Sandy mill was Tony Flagor. Tony came to the Sandy mill from a career in the Navy as an electrician where his responsibilities included electrical maintenance and training. After the Navy, Tony earned a BS and MBA from the University of Washington. Tony's first job at the Sandy mill was as maintenance manager after first working for one year as an electrician in an adjacent plywood mill, which was also owned by the company that owned the Sandy mill. The position of maintenance manager was for both the Sandy mill and the plywood mill. Within a year of taking the maintenance manager position, Tony applied for the mill manager position at the Sandy lumber mill. Much to the surprise and anger of some longtime employees of Sandy who had also applied for the same position, Tony became the new manager of Sandy. There were many reasons Tony was selected for the position. His personal work ethic and ability to work with everyone but still make and enforce tough yet fair decisions regarding subordinates enabled Tony to have productive work centers. As important as Tony's human resource ability was in management's decision to make Tony the new manager of Sandy, it was Tony's willingness and ability to incorporate new technology into the milling processes that cinched management's decision.

Under Tony's direction, the Sandy mill undertook and accomplished a massive process redesign, which allowed the mill to increase the level of profits it generated for its parent company. Tony was pleased with the new processes because they were consistent with the strategic direction of the parent company, which involved focusing on those business units that had and could maintain a competitive advantage and that had potential to grow. Despite the success of the new process, Tony knew that the competition was not resting and that he would have to keep improving process effectiveness in the most cost effective manner possible to maintain and strengthen the competitive advantage that the mill currently had. Toward that end, Tony had to decide what the next step was to continue to improve the effectiveness of the mill.

COMPANY BACKGROUND

The parent company of Sandy was founded in the early 1900s. The company was a vertically integrated, diversified forest product company that owned 1.5 million acres of timbered land and operated 15 mills. The mills included lumber mills such as the Sandy mill, paper mills, particleboard mills, oriented strand board mills, and plywood mills.

The Sandy mill was a softwood lumber mill that had been in operation since 1972. It was nonunion, paid above industry average wages (one person year did cost the company an average of $50,000.00), and had the capacity of producing 85,000,000 board feet per year from logs ranging from five inches to 18 inches in diameter and eight to 18 feet long. Unlike many current mills, Sandy was expected to create lumber from multiple species of trees; Douglas, Alpine, and White Fir, Engelmann Spruce, Cedar, and, Lodge Pole Pine. To take advantage of this expected flexibility, the milling process required a greater amount of operator knowledge because mill operators had to understand the peculiarities of production inherent to each species. True flexibility also required a process that had fast, easy setups so that operators could quickly start processing of a different species to meet dynamic market demand. Up until 2002, the mill had an efficiency driven production process where the focus was only on making as much lumber as possible as cheaply as possible. Mill managers paid less attention to what species and dimension was currently in demand in the marketplace, but rather focused on how to get the longest production run for a given species. This efficiency focus was driven by the nature of the process in use at that time.

MILLING PROCESS, PRE-2002

The milling process as of 2002 consisted of a traditional lumber mill process that was labor intensive (Exhibit 1). The mill produced an average of 85,000 million board feet (MMBF) (one MMBF equals1000 board feet) of dimensional lumber per year. A board foot is a metric used in the lumber business measuring 1 inch x 12 inches x 12 inches and dimensional lumber refers to the width and depth of the boards produced. The original mill produced 2” X 4”, 2” X 6”, 1” X 4”, and 1” x 6” dimensional lumber. To simplify calculations, all boards in this case will be assumed to be 2” X 4” where one lineal foot equals .67 board feet and the average board is 14 feet long. The mill operated 202 days per year with two, ten-hour shifts per day. The lumber produced sold at an average selling price of $347 per 1000 board feet (m.bd.ft) or one MMBF.

The start of the process consisted of a sawyer on a log carriage. The sawyer would quickly inspect a log and with partial help from a computer decide how the log should be cut to get the most lumber the quickest. The lumber the sawyer made would proceed by conveyor belt to inspectors who would sort the lumber by dimension, length, width, and depth (see exhibit 1 for a schematic of the process). Seventeen people per shift were involved in the total process; most making many qualitative decisions that would affect the quality and volume of process output. To help make these decisions more accurate and easier, and to keep all workers busy, large batch sizes of uniform logs of one species were the norm. Thus, to produce the volume of output needed, the mill often produced lumber from certain species and in certain dimensions that had lower market value relative to lumber with other dimensions or from other species in the interest of achieving higher milling efficiency and output. This practice created a focus on efficiency, not market effectiveness.

In addition to the focus problem created by the perceived need to produce large batch sizes effectuated by a labor-intensive process, lumber quality and yield per unit of raw material (a log) suffered. Although the process operators were experienced and good at the tasks they performed, the shear number of decisions made daily, tight dimensional market specifications required to meet lumber standards, the physically demanding and tedious nature of the work, and a large number of shifting process variables created a situation where many units of output were out of specification. The same problems also generated faulty decisions regarding the best way to get the most lumber out of a log, which in turn lowered the number of board feet of lumber produced relative to the board feet encompassed within each log. Not only was the board foot yield affected by sawyers' decisions, but the total dollar value per time of operation was also influenced negatively because the sawyer concentrated on dimensions that more easily derived the most volume of lumber the fastest, not the greatest amount of dollars.

The mill's efforts to control quality during the production process consisted of having personnel measure eight boards in eight places within the first 10 minutes of start up to see if production was within specifications. The focus was on whether the process was producing boards within process specification at start up, as opposed to whether the process was in or out of control in real time. Real time process adjustment decisions were seldom made based on the direct output from the QC process after start up. Process decisions made by operators were primarily a function of their tacit knowledge of the inherent variability embedded in the process system, and how that variability affected outcomes.

Required lumber dimensions were determined by industry standards (i.e., a dried two by four needed to be a minimum of 1.50" deep and 3.50" wide), and the mill experienced increased costs as a result of being either under or over these dimensions. The more costly problem was being under specification. Product that was under specifications had to be sold on a secondary market at a significant discount. Tony estimated that being under specification cost $20.00/1000 board feet, which could cost the company up to $8,000.00 per day in lost profit if the entire production for the day was under specification. Because of the high cost of being under specification, the process was routinely set to overcut .350" (Standard deviation (SD) .11) over market specification for width and .210" (SD .075) for depth. Of this overcut, however, .006 inches was necessary for shrinkage during the drying process to reduce the moisture content of the wood to 12-16% and another .015" was necessary to allow for variation in saw kerf (width of the cut made by the saw that is a representation of the output of the saw sharpening process). The remainder of the overcut was to protect against the possibility of producing output that was under specification due to other system variability. With the mean overcut listed above it was felt that the milling process would produce few boards under market specification due to the normal variability of the system. Tony was not sure what the long run average variability of the system was exactly, but knew that the theoretical minimum variability was the variability associated with variation in kerf.

Cutting product that was over specification did not impact the product in the marketplace as any boards that were produced over specification were corrected in the final planing process after the green lumber (the term green here is the term used in the industry to describe lumber that has not yet been dried) had been dried. Cutting the lumber over specifications did waste material, however. Tony estimated that every 1/1000 of an inch cut over market specification on both width and depth dimensions together cost the company $20,302.00 per year in wasted wood. The plant tended to operate with a bias toward avoiding undersized lumber, and oversize system drift was seldom caught or worried about and at times whole shifts would produce boards that exceeded the targeted overcut.

PLANNING FOR CHANGE

When Tony took over as manager the board feet of lumber produced as a percent of the number of true board feet of logs introduced into the production process was 85%. Even though the mill was making money, industry competition was eroding profits. Tony knew he had to create a production process that increased yield by producing more boards per log by reducing the overcut and optimizing the cut decisions based on both number of board feet and market value per board foot for a given log. To accomplish the yield and market value increase, the number of human decisions had to decrease, and an effective QC program had to be implemented. An effective QC program would give operators the necessary ability to manage board dimension in real time given the need for narrower process settings to produce boards closer to market specification.

Tony knew that changing the process would be challenging from a human resource perspective. The mill was located in a small town and was operated by people with little education beyond high school. Up to three generations of some families worked at the mill at any one time, and traditional milling practices were revered. Due to this reverence for traditional practices and the low level of education, workers were going to be particularly suspicious of the new technologies that Tony knew were necessary to keep the mill competitive.

When Tony became sawmill manager he held a meeting with the mill's employees to explain why the traditional milling process was no longer adequate and to explain that the process and the way operators managed the process would have to change if the mill was to remain competitive. Process improvement had to happen in all areas of the milling system or everyone would be out of a job. The targets Tony gave were to reduce the average board overcut by .06" for width and .054" for depth, increase the board feet of lumber recovered to true log board feet bought to 95%, and to increase the per thousand value a minimum of $30/1000 by cutting to market demand. Then Tony did something the employees were not used to – he asked them how they thought they should proceed and promised there would be no lay offs from the company due to process change. After numerous meetings between Tony and his employees and Tony and his managers, everyone agreed that the current processing system was no longer adequate. The process operators were expert, dedicated employees who were limited by the current process in how much product they could produce and the quality of that product. Thus, it was agreed that the mill employees needed to design and implement a completely new, automated process utilizing the latest technology if the Sandy mill was to stay in business for the long term.

NEW MILLING PROCESS

During 2002 and part of 2003, under Tony's leadership, Tony, his employees, and equipment suppliers/consultants installed an automated milling system that they had designed (Exhibit 2). The system consisted of two major components: (i) a full log scanner and the corresponding software and controls to allow computer optimized canter saw cuts; and (ii) new scanners for the board edger and trim saws and the corresponding software and controls to allow for computer optimized trimming of the individual boards produced. The new system also include a new method of saw maintenance that reduced the saw kerf from .135 inches to .115" and the SD of the kerf from .005" to .002". Exhibit 2 provides a process flow diagram of the new system.

This original installation cost $2.6 million and was completed within the time specified, but it was a stressful time for the organization. To help reduce stress and keep employee buy in, management provided extensive training to the process operators so that they could not only operate the new milling system, but also understand the technology that enabled the system. Further, as promised, the management at the Sandy mill did not lay off any employees due to the new system, although one employee was reassigned to another job within the company. Tony made sure he took time to ski, bike, and spend time with his family during this time as a way to cope with the stress, and he encouraged his employees to also maintain balance in their lives.

The new system improved log yield to 95% and helped the mill become more market driven as the decisions on how to cut the logs and boards was transferred from operators to sophisticated computer software. The decision rule the computer followed was based on the size and quality of a log, and the dimensions that were in demand and had the highest prices in the marketplace. While the mill still operated the same number of hours as before, production increased from 85,000 MMBF to 116,500 MMBF. Some of the increased production was due to an increased speed of production (as a result of faster decisions) and some due to less waste (as a result of better decisions). Further, completely automating the sawing task helped reduce setup times and enabled shorter batches by species and made it practical to have a greater mix of log sizes within a species batch and still realize the optimal number of board feet of lumber relative to the board feet in a log. The ability to run smaller batches and to optimize the amount of lumber based on the value of specific dimensions increased the average selling price per thousand by $25/MMBF.

One disappointment that the team experienced with the initial installation was the team's inability to meet its targeted reduction in overcut. The team was able to reduce the overcut by .03 inches (.320" width, .18" depth overcut, SD .099" width, .059" depth), but this was only about half of what was targeted. The primary limitation was that the initial install did not provide a feedback mechanism such that the production system could be monitored for board dimensions on a real time basis. The scanners used at the trim saw and the board edger could have been used for this purpose, but the software was not designed to do so and would have been expensive to convert.

The trim scanner inspected a board to determine the optimal length or lengths to make that board determined by defects within the board and original length of the board. Standard lengths ranged from eight feet to 20 feet in two-foot increments. For example, a 19 foot, defect-free board could be made into an 18 foot board, an eight and ten foot board, or two eight foot boards. Market price would dictate the optimal decision. If there were a defective spot on the board, the algorithm used in the computer software would determine how to cut the spot out and still produce a valuable board or boards. Similarly, the scanner for the edger inspected the rough boards that had round edges to determine the optimal width of the board that would remove the round edges from the board. About 1/3 of production went through the edger and all production ultimately passed through the trimmer operation. Both of these devices essentially took a digitized picture of a board where 95% of the measurement error will range between +/- .008". The scanner software was not designed to capture and consolidate this data, however, so even though the original install did achieve less waste by making better decisions about the width and length of a board to make, it did not include an easy method of determining real time status of the production system.

NEW QUALITY CONTROL PROCESSES

To achieve real time system status so machine settings could be set tighter, Tony immediately had two additional scanners placed in the system shortly after the initial system install. These scanners just monitored board thickness and width, and were accurate to +/- .002" when the lenses were clean. The first scanner was placed in the process just after all the boards from both sets of vertical band saws were cut to the optimal width. The second scanner was placed in the system following the trim task where all boards going through the system were cut to optimal length/s (see Exhibit 2). Each scanner could scan 1000 measures per second on boards that were being conveyed at approximately 700 feet per minute thus, the QC system had the ability to measure all boards in both width and depth dimensions every 1/8 of and inch. This represented an incredible amount of data that Tony was still trying to figure out how best to use. Due to the nature of the current process, however, it was not possible to tell which board came from which band saw on the first scanner, or which board came from the band saws or the gang saws or which saw on the gang saws on the second scanner.

The data from each scanner was graphed in real time against targeted process specifications and was used in an Engineering Process Control (EPC) protocol. When 5 out of 10 boards, 30 out of 100 boards, or 50 out of 300 boards were above or below the process specifications, the computer alerted the operators. Once alerted, the operators determined and fixed the problem that was causing boards to be produced beyond process specification. Because operators had no way to tell how the out of specification board came through the system from the displayed data, the system could not be shut down until the operator determined the problem. There were at least 12 different places in the total system where adjustments could change, and out of specification boards would be produced as a consequence. At the production rate of one board per second, if all 12 areas were producing under size boards, 8333 board feet with a $20 penalty per MMBF could be made in the ten minutes it usually took the operators to find the problem.

In addition to the computer-generated alerts that the operators received from the system, the production supervisors had continuous access to the real time graphical process output that the system generated in the mill's control room. Tony had yet to establish a clear protocol on how supervisors should make use of this graphical output. Sometimes supervisors noticed system drift or patterns evident in the graphical output and took action prior to any alert being generated by the system. Further, sometimes supervisors took action to make a correction when the amount of overcut moved higher than the established overcut target. Other times, Tony was not even sure if supervisors looked at the output except at the end of the shift. Tony also recognized that the data being generated by the system provided the potential to evaluate the effectiveness of a given run or shift. Tony was unsure about the wisdom of using the data for such purposes and how best to understand the causes of the variations he saw in the data within a given shift and between different shifts.

The addition of the two scanners to the system allowed the overcut to be reduced to .290" (SD .09") for width and .156" (SD .05") for depth because of the reduced standard deviations of overcut. The mill continued to follow the EPC protocol described above, and this protocol resulted in the system being shut down at least four times on a typical day to adjust at least two of the 12 adjustable areas each shut down. Unfortunately, the new QC system did not provide a method of determining where the out of specification boards were processed in the system (such a system would cost approximately $10,000.00), nor was the software set to determine what part of the board was out of specification (such software would also cost approximately $10,000.00).

Knowing what route a specific board came through the production system would allow the system to be shut down as soon as a problem was detected because an operator would know which of the 12 areas was creating the problem. Knowing which part or parts of the board was/were out of specification would also provide clues as to what the problem at a specific area might be. Tony knew that the causes of some problems were so certain that automatic adjustments could probably be designed into the system such that the system could make the necessary corrections before the operator was even aware there was a problem. Tony knew of several locations in the process where such automated adjustments could be designed in and assumed that with the help of mill operators, all twelve areas of adjustment could be automated. Tony estimated that it would cost between $5,000 and $15,000 per location for automated adjustments. Tony expected that if these instruments were put in place in conjunction with knowing immediately where an out of specification board came from, the average overcut could be reduced another .06" (SD reduced further to .057") for width and .02" (SD reduced further to .026") for depth.

WHAT NEXT

Tony and the sawmill operators were pleased with many of the outcomes produced by the new process system, but knew they had to keep improving the process. Because operators could not react fast enough when the system started producing product out of specification, the amount of deliberate overcut was still large relative to the lower bound of milling system variation embedded in the flex of the saw blades. The QC system was producing massive amounts of data, but the operators did not seem able to utilize the information to produce boards closer to market specification, nor were the operators able to determine the source of specification problems from data alone. Tony knew that he had to revamp the QC system, preferably so that the milling process system would adjust automatically to information produced from the QC system. However, Tony was worried that upper management might balk at putting more money into the QC system and that the milling process operators might not understand a more sophisticated QC system and not be able to take advantage of all the possibilities for milling system improvement and control. Tony now had to decide whether or not to make further improvements in the QC system, keeping in mind the significant cost of such changes and the capabilities of his operators to utilize a more advanced system effectively.

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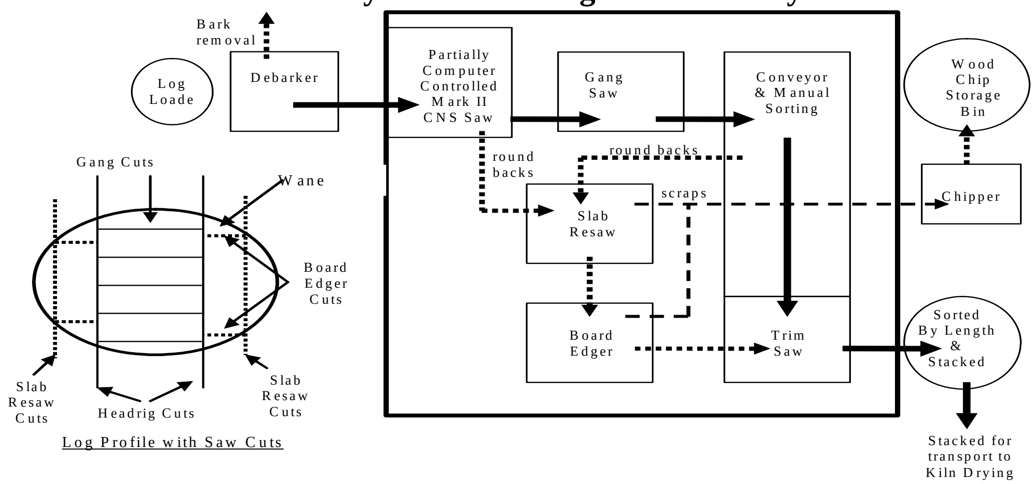
Exhibit 1: Sandy Manufacturing Process & Layout Pre 2002



Task descriptions pre 2002.

Task 1, Debarker: The first step is to remove the bark from the log. The bark is used to generate steam for other milling processes.

Task 2, Mark II Canter Saw: The log is cut into a certain sized rectangle by removing slabs from the log that are a given thickness depending on the dimension of board required and the initial log dimensions. This task is critical in determining the board feet of lumber salvaged from a log. If the first cut is made in the wrong place, fewer usable boards or boards with lower market value will be produced. The decision on how to cut each log is made by the sawyer based on a visual inspection of the log and the help of a decision support system.

Task 3, Gang Saw: The rectangle produced by the Heading Sawyer is automatically cut into individual boards. The Gang Saw consists of up to 13 horizontal circular saws that have to be precisely set to produce boards of equal thickness.

Task 4, Hand Sort: boards are sorted by width, thickness, and approximate length. Boards that are the correct width and thickness are trimmed to an optimal length and stacked by length to go to the Kiln dryer where the lumber is dried to 12% moisture content from a normal green condition of 20 to 40% moisture content. Boards that are not the correct thickness or have too much wane are sent to Task 5.

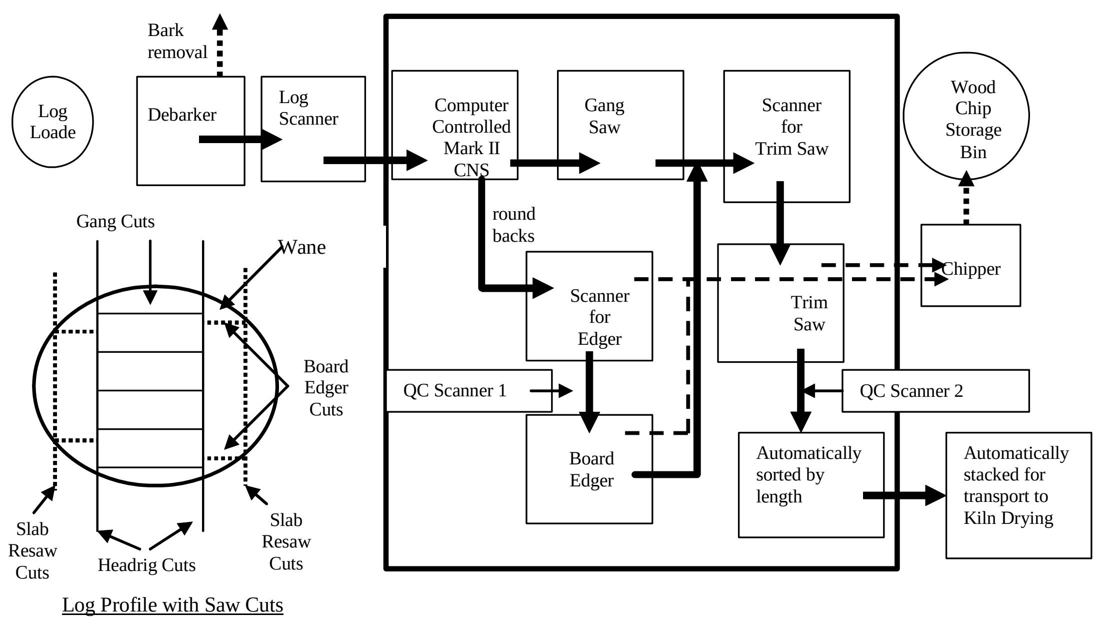
Task 5, Slap Resaw: boards from the Canter Saw that are too thick are adjusted to the correct thickness and sent to Task 6.

Task 6, Board Edger: boards from the Slap Resaw are edged to the correct width and sent to the trim saw.

Task 7, Trim Saw: boards are cut to optimal length and sent to be stacked by hand for transport to the Kiln.

Task 8, Chipper: wood that cannot be made into lumber is ground into chips that will be burned to make steam or be used to make paper.

Exhibit 2: Sandy Manufacturing Process & Layout Post 2002



Task descriptions post 2002 (with new technology/systems shown in bold).

Task 1, **Debarker**: The first step is to remove the bark from the log. The bark is used to generate steam for other milling processes.

Task 2, **Log Scanner**: scans are taken of the log using infrared scanners and the optimal number and thickness of slabs are determined automatically based on the shape of the log and the value of the lumber.

Task 3, **Computer controlled Mark II Canter Saw**: The log is cut into a certain sized rectangle by removing slabs from the log that are a given thickness depending on the dimension of board required and the initial log dimensions. This task is critical in determining the board feet of lumber salvaged from a log. If the first cut is made in the wrong place, fewer usable boards or boards with lower market value will be produced. This task is now controlled by a computer and optimal cuts are made to produce the greatest number of boards with the highest market value from each log.

Task 4, **Gang Saw**: The rectangle produced by the Canter Sawyer is automatically cut into individual boards. The Gang Saw consists of up to 13 horizontal circular says that have to be precisely set to produce boards of equal thickness.

Task 5, **Scanner for Edger**: scans using infrared scanners are taken of the slabs from the Canter Saw to determine automatically what board or boards can be made from the slab and then the boards are sent to Task 6 where they are edged to the proper width.

Task 6, **QC Scanner 1**: slabs are measured using infrared scanners to determine thickness to determine if the Heading Saw blades are set correctly.

Task 7, **Board Edger**: boards are edged to the correct thickness.

Task 8, **Scanner for Trim Saw**: boards are scanned to determine what optimal length of boards can be made, this information is used after Task 8 to determine which stack each board is sent to by length.

Task 9, **Trim Saw**: Boards are cut to optimal lengths and sent to be stacked for transport to the Kiln. A one to three board solution is possible.

Task 10, **QC Scanner 2**: all boards are measured using infrared scanners to determine width, thickness, and length.

Task 11, **Sorting**: boards are sorted automatically from information from Task 8 by length to go to the Kiln dryer where the lumber is dried to 12% moisture content from a normal green condition of 20 to 40% moisture content.

COPING WITH TRANSITION: FROM DOCTORAL RESEARCH TO TEACHING AND FROM CORPORATE TO ENTREPRENEURIAL FINANCE

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CASE DESCRIPTION

The primary subject matter for this case concerns the re-thinking of teaching methods and strategies in shifting from a doctoral research orientation to one of teaching emphasis, and from a typical business school orientation in financial management and business strategy to a more directed approach toward entrepreneurial finance. The case has a difficulty level appropriate for an exercise for business school professors faced with this particular challenge, as well as for PhD graduates coming into an environment where innovative and deeper pedagogical thought is necessary. The case is designed to be used in a seminar setting and should take no more than one hour for a seminar exercise, less if the case is available in advance for reading purposes.

CASE SYNOPSIS

Richard LeMont, a recent graduate of a Midwestern university with a Ph.D degree in Finance with a minor in Strategy/Policy, is faced with teaching a course in entrepreneurial finance at an AACSB-accredited College of Business. His doctoral training, while preparing him to deal with research and typical business school courses, has failed him where the entrepreneurial course is concerned. The reader is tasked with developing solutions to the problems highlighted by his first four weeks of the course.

INTRODUCTION

Richard LeMont glared at the test scores from the first exam of the semester in his entrepreneurial finance course. Not a student had passed. He had set what he believed to be a reasonable standard, and the students had simply failed. Richard reviewed the transcripts to see that all the students enrolled had completed the first two accounting principles courses and a course in corporate finance. All the students had the necessary prerequisites. He then set about reviewing his examination questions. Half of the questions on the exam were taken from the publisher's test bank. The other questions were developed from his lectures. Every student completed the exam within the allocated time of one and one half hours. The first part of the exam focused on financial statement analysis and the interpretation of financial ratios. The second half of the exam was a problem set based on financial information which the students were to use to compute basic financial ratios and then write a short analysis based on their findings. From a very simple financial statement, the students were told to develop a cash flow statement.

Richard had a fairly straightforward approach to class policies. His grading system was based on four exams, all counting equally. He would assign but not collect homework problems (to avoid spending a lot of time grading some 45 papers). The final was not comprehensive unless a student missed an exam. For students missing an exam, he had a comprehensive final which would count double. Richard decided to talk to some students before giving back the disastrous results.

He quickly learned that most students admitted that they did not read the text. "We expect you to tell us what we need to know because we are working and don't have time to read." was the general response. He was also surprised to find that while the students had the two principles of accounting courses, they all claimed to have forgotten most of their accounting. Once these students completed their accounting course, they figured it was best forgotten since they never intended to do bookkeeping or accounting as a career. All the students reported that they sold their accounting text at the end of the semester "...since the course is over. I don't want to teach, so why should I have a textbook?" they would respond. Richard also discovered that these particular students had almost a phobia over computing simple ratios. Decimal errors showed that students were unable to recognize the difference between ratios and percentages! The problems portion of the test, where students were given a simple income statement and balance sheet and told to analyze the company's liquidity, revealed that nearly one quarter of the class confused accounts receivable and accounts payable. "I really like finance," stated one coed, "but I hate accounting because I don't like numbers and don't like worrying about what the accounts mean."

Richard sought advice from his more experienced colleagues. Several noted that the average student learns just enough to "get through a course." Most students sell their textbooks back to the bookstore as soon as they have finished studying for their final. "Once the course is over, I can get some spending money to celebrate the end of the semester." chirped one student. Richard found out that students often work 15-20 or more hours a week and therefore expect a teacher to teach them only what they "need to know."

"Because so many students failed your test, the class will feel quite justified in blaming you for their failure," warned a senior professor. The young professor decided he better spend some time outside of class trying to get to know his entrepreneurial finance students. In casual conversation, Richard learned that most of his students were taking the course to either fulfill an advanced elective toward their major in management or general business. There were only one or two finance students who were taking the course as an elective within their major and they sought out the course because "the text looked less mathematical than other electives like courses in investments, financial analysis, or commodities and futures."

To get a better perspective on his students, Richard designed and conducted a survey which produced some interesting results. His first discovery was that the majority of his students had read less than 50% of the text and a good 20% of the class did not even own a textbook. The average GPA in the class was a 2.0 on a 4.0 scale. Most of the students took the course not for the content, but due to the convenient time it was offered. Most of the students had no idea what they would do after college in terms of what industry they would work in or what job function they would seek. The typical response to the questions over future careers was "How can we know what we want to do if we haven't already done it?" Several students reported that they would be returning home to work in their parent's small business and several students indicated an interest in banking or financial planning. Only one student had a career oriented internship.

Richard then realized that he was dealing with students who were really not upper level finance students, but were 'generalists' who had no appreciation for either accounting or finance! Richard wondered why they were even taking entrepreneurship as a minor. Quite by accident, at lunch in the Student Center, Richard was introduced to retired Professor Don Filbert, the professor that Richard was hired to replace. In addition to corporate finance, Dr. Filbert had taught both entrepreneurship and the entrepreneurial finance course. Dr. Filbert explained that most of his students had not aspired to create vast wealth, nor did they profess to have the ambition of becoming executives in medium to large companies. Some of his students were future heirs to small "mom and pop" operations but most students were merely in college to get a degree and get a job. "Our students" Filbert noted, "are first generation college and their parents either work for a small business or own a small business. They take entrepreneurship thinking it is a program on how to run a small business for the purpose of producing an income for themselves." Filbert used the general course on entrepreneurship to introduce the concepts of wealth creation through going public or selling out to competition, in addition to getting students to write business plans.

After talking to students and Dr. Filbert, Richard felt that he had misunderstood the level of sophistication of his students as he had thought that such a specialized course in finance would attract those individuals expecting to earn a living either as investment bankers, venture capitalists, or entrepreneurs. Instead, his students made no distinction between being an entrepreneur and being self-employed. Required courses to his students were a means to getting a degree and not for attaining an education or for use in the real world.

THE "DOCTORAL CANDIDATE" PERSPECTIVE

Later that afternoon, Richard decided to have a snack at the student center when he was approached by another newly hired professor that he had met during the university’s new faculty orientation program. Dr. Nancy Hernandez had finished her doctorate in accounting. Conversation quickly turned to their respective experiences. "I just don't understand how students expect to learn accounting without doing any homework." She told Richard that while students seemed to like her as a person, the whole tone of the class changed after the first exam results were provided to her students. Nancy told Richard that many students told her they don't have time for "busy work" and that if homework only counted for 20% of the grade, they were better off just "studying the material than doing busy-work for a homework grade." As a result of not doing the homework, my students did ok on the objective, multiple choice questions which focused on vocabulary, but they could not compute depreciation in order to fill out simple depreciation schedules. Two out of 40 students earned over 78 on the first exam with most of the class only scoring in the high 60's. Nancy lamented, "If they had done the homework they would have understood that accounting is recording accounting transactions, making the proper debit-credits and not just memorizing some terms." Nancy also seemed concerned that her students would blame her for their laziness and shortcomings. Nancy understood that worrying about student evaluations was not very conducive to concentration on research, which was a significant requirement at the university.

Richard responded that he was also having troubles. Both reminisced about the faculty orientation program. Various administrators including the Vice President of Academic Affairs and the Dean of the College of Business had talked about the need to grow class enrollments and to improve retention rates while "raising the bar" on academic expectations. Ringing in his ear was the comment that all the administrators made was that "we are here to support you." The Dean mentioned the relatively new AACSB standard of assessing student outcomes and the importance of external assessments. The Dean encouraged faculty to consider using standardized exit tests. He stressed the need to develop other assessment tools and informed them that the Deans office would be working the whole issue of assessment over the coming year. The Associate Dean reported that the entire university was facing external pressure from major stakeholders to justify budgets on the basis of proving student outcomes. Both faculty members concluded that perhaps they had heard mixed messages? Richard gained some comfort that his frustration was not strictly due to the course content or design of his course. He had discovered that Dr. Hernandez was encountering difficulties due to similar student attitudes in her courses in accounting. However, he wondered if her situation was as serious as his.

ALIGNING COURSE CONTENT AND OBJECTIVES WITH STUDENT REALITIES

Turning to his own plight, Richard began reviewing his course materials. The entrepreneurial finance course and its related text covered the elements of a business plan, forms of organization, measuring and evaluating financial performance of a business using some 19 financial statistics. The text had a significant amount of narrative on non-quantitative issues such as the form of business, the selection of a bank, the selection of members of the Board of Directors, and the importance of establishing banking relationships. The text explored financial forecasting, the process of estimating additional financing to support corporate growth, cash burn rates, and the process of cash planning. The text provided examples of small firms and how they would use project and budget future revenue and expenses to determine future cash needs. The additional funds needed formula coupled with various examples of a small business experiencing rapid growth illustrated the problems that can arise for small firms due to sales volatility.

Unlike the corporate finance book, the examples and illustrations described relatively simple service business such as repairing computers or cleaning swimming pools and simple manufacturing businesses such as bakeries. The entrepreneurial finance text dealt with issues like whether to lease or buy equipment, how to estimate cash burn rates, and the importance of managing accounts receivable from a small firm perspective. The text had chapters on the role of angel investors, small banks, and venture capital firms. The text was oriented to address finance from the perspective of either a small family operated businesses or an entrepreneurial venture whose owner/managers were committed to rapid expansion. The entrepreneurial finance text had extensive descriptions of the venture capital industry, how venture capital firms are organized, sources of their funds, and typical investment criteria. The text described three types of equity valuation methods: maximum dividend method, pseudo dividend method, and delayed divided approximation. In addition, the text offered commentary on venture capital valuation methods and typical terms demanded by venture capital investors. He hoped to expose students to the issue of how to properly structure a growing enterprise through common, preferred, convertible debt, warrants and options. A portion of the course would deal with financially distressed companies and operating under Chapter 13 or 11 of the bankruptcy code.

During his doctoral work, Richard had taught the basic corporate finance course and since his current institution used the same book, he felt his students could move quickly through the overlapping topics. Richard made the following chart comparing the content of the two courses:

Comparison of Content **Entrepreneurial Finance versus Corporate Finance**	
Corporate Finance	**Entrepreneurship**
Financial Statements	Financial Statements
- Income Statement	- Income Statement
- Balance Sheet	- Balance Sheet
- Statement of Retained Earnings	- Statement of Retained Earnings
- Cash Flow Statements	- Cash Flow Statements
Analysis of Financial Statements	Analysis of Financial Statements
- Ratio analysis	- Ratio analysis
- Liquidity analysis	- Liquidity analysis
- Asset Management Ratios	- Asset Management Ratios
- Debt Management Ratios	- Debt Management Ratios
- Profitability Ratios	- Profitability Ratios

Comparison of Content Entrepreneurial Finance versus Corporate Finance	
Corporate Finance	**Entrepreneurship**
	Overlapping except examples are Small Business or Entrepreneurial ventures that are not publicly held. - Financial structure of different industries - Obtaining comparative data - Obtaining research - industry surveys and analyses
	Selection of the form of business Selection of Board of Directors Obtaining Professional advice
	Realities of bookkeeping and accounting practices among small business. - Importance of using 'enterprise' software and ability to generate: - Cash flow statements, budget and variance reports, aging reports - Costing systems to measure contribution and pricing of different services and products
	Break Even analysis - by units - NOPAT
Du Pont Equation Management's duty and responsibilities as related to MVA and EVA	
Markets and Institutions	Markets but in the context of IPOs and valuation of new ventures. Role of Venture Capital firms: - Organization - Source of Funds - Investment criteria - Types of VCs - SBICs
	Accounting/Enterprise systems for the small - entrepreneurial firm.
Risk and Rates of Return - Market Risk Premium - Beta and CAPM - Volitility and risk	Interest rates but in the context of lending to small firms.
Time Value of Money Bonds	Implicit in topic of issuing bonds as part of a financing package with an SBIC or venture capital firm. Cost of capital issues.

Comparison of Content Entrepreneurial Finance versus Corporate Finance	
Corporate Finance	**Entrepreneurship**
Stocks and their Valuation	None except for concept of valuation of firms thinking about going public and timing the market for their best price
Weighted average cost of capital. Examples taken from publicly held companies.	Applied to reality of small - entrepreneurial firms.
Cash flow estimation and risk	Cash flow
Distributions to Shareholders	
Working Capital Management - Commercial Paper - Sources of short term financing	Working Capital Management but from a small firm/entrepreneurial venture perspective. Emphasis on banking relationships, role of angels, supplier relationships, strategies to minimize external funding.
Financial Forecasting - AFN formula	Financial Forecasting - Heavy emphasis on AFN formula - Researching local economic factors, industry trends.
Multinational Financial Management	

The above chart reflected that many financial formulas are covered in both courses. The significant difference was in the application of these financial tools and financing options available. The corporate finance course generally provided examples of the application of these formulas to large, publicly-held corporations. The entrepreneurial finance course focused on the environments that small and growing firms face. Small firms and entrepreneurial businesses generally don't issue bonds, play on currency rates, or use hedge funds. They simply don't have the size or expertise to use sophisticated financial strategies. Nor was their budgeting process as sophisticated as in larger organizations. While getting comparative data for large firms is relatively easy, smaller firms must use industry or trade publications which are more difficult for students to obtain to compare their financial performance to other companies.

Small firms are unlikely to have an employee devoted to financial analysis. Realistically, family- owned enterprises expect their general management to be capable of making sound decisions based on their own financial analysis or in consultation with the company's accountant or accounting firm. The traditional corporate finance course focuses on strategic issues facing large, publicly held enterprises that have finance departments. The corporate finance course prepares future employees to work as financial analysts or in a treasury function within a large organization. The entrepreneurial finance course, on the other hand, must be designed to prepare employees who will spend most of their time either producing or selling the product or service. Most small to medium firms do not have the luxury of specialized employees for finance and accounting. These organizations will either have relatively static work forces or are striving to grow quickly to realize a capital gain for their founders and venture capital investors through an initial public offering.

Richard assumed that overlapping topics meant that he could simply assign homework problems and discuss the solutions the following day. Because students did not ask questions about the solutions to the homework exercises, he assumed that they were keeping up. Actually, his students were not doing homework on a consistent basis nor were they reading the text. Richard noted that many students did not even take notes in his class but he inaccurately interpreted this to mean that they were bored because they already understood the concepts. When it came time for the first exam which would count 25% of the course grade, the students actually felt lost and frustrated. Richard's assumptions had obviously been erroneous.

Richard overheard some students talking in the hallway. The student who did the best on the first exam told another student that the test was unfair. "We are not a bunch of graduate students." she said. "He better curve this exam or else we will get him on the faculty evaluations." Later that same day, a colleague told Richard that his first exam was the subject of student comments in his marketing class. As he turned on his laptop and connected it to the computer, he overheard two of his students discussing the entrepreneurial finance course in the hall. The students were complaining that Richard was not teaching and that he was unreasonably expecting them to remember details from other courses. What pricked the marketing professor's attention was the comment that "we'll end his teaching days when the faculty evaluations come around." And one of his better marketing students remarked "These professors are out to lunch 'cause they don't realize we are paying them to teach us and we don't have time to teach ourselves."

Richard was aware that effective teaching and high student evaluations would not result in a positive tenure vote without at least three refereed journal articles within a five year period. Richard rightly feared that low teaching evaluations along with minimal research could also sabotage his tenure. At an AACSB accredited program, Richard knew that publishing in refereed journals was not optional; it was a requirement. He knew he had to allocate substantial resources to his research. Because his institution's mission emphasized teaching, though, his teaching performance was also relevant if he expected to gain tenure. In addition, the university had a merit-based pay system. Faculty evaluations accounted for 50% of the evaluation score used for both merit and for the major (but not exclusive) consideration for tenure and promotion.

Student ratings accounted for half of the teaching score with the department chair's rating accounting for the other half. Research officially counted for 25%, and service counted for the other 25%. In reality, however, he knew that in order to earn tenure it would take student evaluations near the top of his colleagues if he merely met the minimum research standard.

To earn an annual merit pay increase, Richard knew his overall student evaluation score must be in the top half of the faculty. If students bad-mouthed his teaching and his class enrollments dropped, his department chair's teaching evaluation would work against him for both merit pay and tenure. Starting out with no publications and poor teaching evaluations would not be a good position to be in, especially since he had asked to teach the elective in entrepreneurial finance. Richard was clearly justified in being concerned over his reputation as a teacher, the potential impact on his merit pay and the potential impact on his tenure.

Several days later, Richard bumped into the Dean of the Business School who dropped the bomb: “Richard, you need to do what you can to minimize the number of students coming to my office about you and your entrepreneurial finance course.” Unfortunately, another professor interrupted the comment resulting in the Dean walking off to tend to another issue. Richard had a sinking feeling that some of his students had jumped the chain by going directly to the dean.