Volume 15, Number 1 ISSN 1078-4950

JOURNAL OF THE INTERNATIONAL ACADEMY FOR CASE STUDIES

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

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Whitney Press, Inc.

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

The *Journal of the International Academy for Case Studies* is owned and published by the DreamCatchers Group, LLC, PO Box 2689, 145 Travis Road, Cullowhee, NC 28723. Those interested in subscribing to the *Journal*, advertising in the *Journal*, submitting manuscripts to the Journal, or otherwise communicating with the *Journal,* should contact the Executive Director at info@alliedacademies.org.

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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

McDOLLAR'S IN MOTHERLAND

Linda L. Barkacs, University of San Diego
Craig B. Barkacs, University of San Diego

CASE DESCRIPTION

The purpose of this case is to provide an international negotiation exercise, derived from a specific setting adapted from a real situation, that tests the ability of students to overcome narrow thinking and cultural obstacles and structure an integrative and mutually beneficial agreement. The case is appropriate for junior or senior undergraduate students or first year graduate students, depending upon the depth with which the instructor wishes to explore the case and the instructor's comfort level with the issues included in the case. The negotiation exercise is designed to take about two hours (including the debrief), although more time may be spent on it. The case requires that students devote approximately one hour to preparation of the case, but this time can be spent outside class if necessary.

CASE SYNOPSIS

This case is based in a very general way on the circumstances surrounding McDonald's efforts to begin operations in the former Soviet Union. As George Cohen, the McDonald's executive charged with trying to gain a foothold in the Soviet Union, stated:

> We learned to treat frustration and delay like natures force of gravity. Remember, this was the height of the Cold War. It was 1976. Brezhnev was in power. It was the "Evil Empire." It was Karl Marx in one corner and Adam Smith in another corner, squaring off. There was no happiness, everything was gloomy. And here we were, wading in. We, the epitome of capitalism, mother and apple pie, were trying to get into the Soviet Union during the height of the Cold War (Moon and Herman, 1982).

This negotiation exercise is set in the fictitious nation of Motherland. Motherland certainly resembles Russia, but the use of the country's name directly in the case is avoided to reduce student tendencies to stereotype real people and to avoid potential errors introduced by students who have knowledge of Russian culture. Thus, Motherlandian culture is intended bear some similarity to Russian culture (and in fact may be portrayed, for purposes of this exercise, as what some may regard as stereotypical Russian culture - fairly or not - on steroids!), but Motherlandian culture can only be truly explained by the materials in this exercise.

The negotiation helps students learn to negotiate in a more integrative fashion. Because the exercise is not scored quantitatively based on outcomes, the situation can lead to the use of creative *collaboration in an unexpected venue. The Cohen quote above illustrates a common perception of Cold War relations with Russia before the fall of the Soviet Union. The marriage of McDollar's, which is the metaphoric embodiment of capitalism, to a struggling post-communist state seems counter-intuitive by its very nature. The odd-couple dynamic in this negotiation exercise, however, actually creates possibilities that can be beneficial to both parties. In the case of McDonald's, these possibilities were beneficial to both parties. Thus, this negotiation puts students in an adversarial mind set, which they must work beyond to reap the collective benefits of an agreement. We hope that the students will be drawn toward this understanding through analyses of their own best alternative to a negotiated agreement (BATNA) because both sides lose if the parties fail to reach an agreement.*

In addition to testing students' understanding of BATNAs, the McDollar's negotiation challenges students to decide between two drastic extremes. On the one hand, they will be tempted by profit motives and corporate advancement. On the other, they have the chance to promote social welfare among an impoverished people. This is an internal conflict that those on the McDollar's side of the negotiation are especially likely to encounter because, as Americans, it is remarkably easy and culturally predictable to lapse into greed-driven competition. This universal tension between public good and private gain is played out at both the individual level and the broader societal level in this negotiation exercise, given the situational conflict between communism and capitalism, collectivism and individualism, and every other difference between Soviet and U.S. culture. This case is built on a bargaining position template developed by Barkacs and Barkacs (2004).

McDOLLAR'S IN MOTHERLAND

Role for Taylor Dunn, Founder and Senior Chairperson of McDollar's Motherland

General Information

This case takes place in fictional foreign nation of Motherland, which for purposes of this case will be regarded as a former Soviet republic. One may properly infer that the fictitious Motherland strongly resembles Russia, but Russia specifically is not used in order to avoid stereotyping real people and to avoid potential mistakes regarding Russian culture. Thus, while Motherlandian culture is intended bear some similarity to Russian culture (and in fact may be portrayed, for purposes of this exercise, as what some may regard - fairly or not - as stereotypical Russian culture), Motherlandian culture nevertheless exists exclusively within the confines of this exercise.

In terms of setting the stage for this exercise, the Cold War is history and political and economic change is underway in the former communist regimes of Eastern Europe. Currently in Motherland, capitalism is emerging - providing a more enticing landscape for foreign direct investment. With the Motherlandian economy still struggling and in transition, and with some of its citizens starving and freezing, Motherland has gradually begun to westernize. The concepts of glasnost and perestroika (meaning "openness" and "economic restructuring," respectively) are prominent features of the political and economic reform in Motherland. To the Motherlandians, who were behind the Iron Curtain for almost a century, such concepts are quite understandably extraordinary and revolutionary.

Soviet propaganda and enculturation, however, have created a lasting negative image of Capitalists, specifically Americans, as greedy, power hungry beasts. A major problem for American investors is trying to overcome this perception. With a culture dominated by Socialist sentiment, which promises food and heat for all its citizens, the Motherlandian general public is wary of western business infiltration, and its emphasis on personal gain and wealth.

The Motherlandian government has begrudgingly agreed to allow some Western firms to do business in the Motherland. While such a shift in policy offers potentially lucrative business ventures for Western firms, the political and economic risks are substantial, creating tension and conflict between prospective foreign business investors and the Motherlandian government.

One particular investment possibility involves McDollar's, a world renowned fast food establishment based in the United States. McDollar's ascended to the top tier of fast food chains when the owners streamlined the hamburger serving process, and redefined the restaurant industry forever. Since then the company has been wildly successful in its ventures, with tens of thousands of locations on six continents. The corporation employs over three million people, netted revenues in the billions last year, and has become an American branding icon with the likes of Coca-Cola and Nike. Their classic symbol, the green dollar sign ($) is universally recognized as an eating establishment of the highest quality and a beacon of profit for franchisees everywhere.

A meeting is scheduled between Taylor Dunn, the founder and Senior Chairperson of the so far only conceptual "McDollar's Motherland," and Alex Kasiminov, the current Motherlandian Minister of Commerce. With no current fast-food competition in Motherland, Dunn is interested in the expansion of McDollar's into the Russian market, believing that he/she will enter into it unopposed, allowing him/her to reap an incredible profit. On the other hand, Kasiminov is entering the negotiation with the best interests of his/her country and those he/she represents in mind. While each side has apprehensions about the other, and in light of the substantial cultural differences, Dunn and Kasiminov nevertheless hope to meet civilly and productively.

Confidential Information for Taylor Dunn

NOTE: This exercise can easily be conducted as a team negotiation. In fact, the exercise works very well with having a team with anywhere from three to five negotiators on each side. Moreover, the teams do not have to be evenly matched. If negotiation teams are used, each additional team member can create his or her own name and title, or that can be generated and assigned by the instructor. Possible titles might include any of the following:

VP of Sales
VP of Marketing
Public Relations Representative
Motherlandian Economics Specialist

Background

You are the founder and Senior Chairperson of McDollar's Motherland. The only problem is that McDollar's Motherland exists merely as a concept, inasmuch as you have yet to open a single fast food restaurant in Motherland. Your relationship with the McDollar's corporation, however, is no recent development. You first met Jay Brock, the company's mastermind, shortly after you graduated from law school, and two years later you abandoned your career in law to open your first McDollar's in Eastern Canada. With remarkable speed you turned McDollar's into the largest food service organization in Canada.

Even though you have yet to open a McDollar's restaurant anywhere in the former Soviet Union, you have already invested 14 years of blood, sweat and tears into the cause. Years ago you first realized the potential - a region with hundreds of millions of people with a diet very similar to an Americans. Since then you have been traveling to Motherland five to six times each year to meet with government officials and trying to cut through all of the bureaucratic red tape. This process began during the Cold War, so such excursions were not vacations, but rather arduous business trips half way around the world. Little progress had been made until recently, when you finally received tentative approval to actually build a McDollar's Motherland in the capital city of Mosberg.

Since then you have been working out the details of the agreement with government officials. Your plan is to build and operate twenty restaurants within Mosberg, but you still need to work out a few matters before you can actually finalize the deal. While you had previously met and worked primarily with local officials of Mosberg, a meeting has been arranged for you to speak directly with the Minister of Commerce, Alex Kasiminov. While you have made much progress over the years, you realize that Kasiminov may make various demands and insist on numerous concessions before being willing to give final approval of the project. Because he/she is the Minister of Commerce, you realize that he/she can walk away at any time if dissatisfied and, accordingly, leave you empty handed and with nothing to show for 14 years of effort and all the associated costs. You have always enjoyed the full confidence and support of Jay Brock, but you also know that he is obsessed with penetrating the Motherlandian market at any cost. Losing this contract would deal a powerful blow to your self esteem and would cripple your heretofore excellent relationship with Jay Brock. You have heard rumors from corporate that failing to finalize a deal would, at the very least, result in a demotion and, at worst, lead to your forced early retirement.

Given that your corporate career hangs in the balance, you should take considerable time to thoroughly review the issues. Whether the twenty prospective restaurants within Mosberg become a reality depends on your reaching agreement on following issues:

The Menu

The McDollar's menu is central to its identity, and has always stayed true to its basic fare of burgers, fries and McParts. No new restaurant has ever deviated from the same staple menu, and to do so would be seen within the corporation as blasphemous to McDollar's name. The menu has come under the scrutiny of the Motherlandians, and you anticipate that Kasiminov will want to change it somehow to make it more Motherlandian. Changes to the menu would be against everything that is McDollar's, and would certainly arouse the ire of the corporate headquarters. Do you really want your brand name to be associated with cabbage soup?

Source Locally?

As is often the case with foreign direct investment ventures, one of the main decisions to be made is whether to source locally, or to import needed ingredients and supplies. While sourcing locally is normally the low-cost answer within developing countries, Motherland is in a class of its own. Sourcing locally would almost certainly be beneficial for the company over the long run, but you are concerned that up front costs may seem steep to corporate, even though Jay Brock has never said any such thing.

The supply chain - to the extent you can call it that - in most of Motherland is antiquated, fragmented, and in many cases, non-existent. Farming is very low-tech and inefficient, and roads desperately need repair. Moreover, there is nowhere to process the local products in order to maintain the consistency required by corporate McDollar's back home.

In order to even consider sourcing locally, a number of improvements would have to be made. For example, McDollar's would have to bring in agricultural specialists from all over the world to educate the Motherlandian farmers on how to grow the products they needed (most Motherlandians do not even know of the existence of the larger Idaho potato). Somehow these specialists would have to transform old-world farms into efficient modern day agri-businesses. Given the nightmare logistical constraints in Motherland, McDollar's would also have to invest in infrastructure, such as roads to transport local goods. Finally, McDollar's would have to build the behemoth McComplex, a 100,000 square foot processing plant, in a nearby suburb of Mosberg in order to maintain food consistency. This complex would be a way to ensure quality control, and would include a self-contained bakery, dairy, and meat-cutting operation facility, while employing over 400 people.

All of these projects would cost in the neighborhood of $50 million up front, making the projects significant initial investments. While these costs would easily be recouped over the years if McDollar's Motherland is a success, they might be very difficult to explain to corporate back home. After 14 years of your failure to deliver in Motherland, however, Jay Brock's patience is wearing thin, and you know he wants a deal made sooner rather than later. You could ask Kasiminov to help finance these investments in infrastructure, but with Motherland's current economic situation, you doubt Kasiminov will be of much help.

The alternative, importing the inputs from existing European suppliers, would be at slightly higher unit costs, but would require no startup investments. The problem with this approach, however, is that it would do nothing to build up the necessary internal infrastructure in Motherland, which both you and Jay Brock regard as crucial to the long term success of McDollar's in Motherland.

Hire Locally?

While most typical workers in your restaurants are likely to be Motherlandian, just who will hold management positions is something that still has not been resolved. If you hire local managers, they will not be as in tune with the McDollar's corporate culture. This worries you and some at corporate headquarters because McDollar's has a strong image that must always be maintained. As the first restaurant in a large new market, the Mosberg McDollar's must epitomize the McDollar's image and values. In fact, in the United States, all managers must pass a rigorous training program at Hamburger University located at corporate headquarters. For you, American managers, at least to open the first restaurant, seem better suited for the task.

If left with no other recourse, you might consider Motherlandian managers, as long as they first attend Hamburger University, although their transportation and housing are additional costs that you would probably be asked to incur by the Motherlandians.

Ownership

Attempting to do business in a country with a history of communism can be awkward and cumbersome because in communist countries most business enterprises are owned by the state. All of the countries in which you have done business previously have allowed you to maintain complete ownership of your restaurants, but in Motherland you anticipate that will not be the case. You doubt that the Motherlandians will allow you to maintain 100% control of the venture, but you are still interested in keeping as much ownership as possible. Allowing the Motherlandian government to control too much of the restaurant could set a dangerous and unheard of precedent, which might also be poorly received by the corporate office.

Conversely, having the government as business partner could have its advantages. The Motherlandian government's political clout could certainly help with - and in fact be of crucial importance to - certain matters, such as accessing utilities, improving infrastructure, and acquiring real estate. Besides, the more the Motherlandian government is involved the greater interest it has in making the McDollar's Motherland a success.

Location

Location will be one of the most important points of your discussion with Minister Kasiminov, as it will greatly affect the performance of your business. You have heard rumors that three possible sites are being considered for the first McDollar's. The first site is a prime real estate, located right smack in Pushpin Square, just one block from Motherland's Lenin Memorial. This site would gain lots of attention and pedestrian traffic, allowing McDollar's to prosper and, for that reason, you regard this specific location as ideal for your inaugural restaurant. Given that it is such valuable space in such a central location, however, you know that Kasiminov will demand a number of concessions to accommodate your strong preference for this location.

The other two locations are less appealing. One is located in a popular business district...popular before the Bolshevik revolution at least. Now it is mostly abandoned. The other is in a very well trafficked part of town, situated right between the Red Light District and a very historic site, an old Stalinist Gulag.

Currency

Currency in the republics of the former Soviet Union is always a big topic of discussion because it is seen as little more than just colored paper exchanged for goods; currency defines the social class of the carrier as well. The local currency, the Ruble, is nontransferable money widely circulated amongst the commoners of Motherland. The aristocracy and foreigners, however, use hard currency, such as dollars or euros. It is illegal for common people to hold any form of hard currency, and in fact, many of the nicer shops are hard currency only, and do not permit peasantry entrance.

Beyond the class warfare issue, currency selection is also a big decision for McDollar's because of the risks of the Ruble. The Motherlandian economy has been known for periods of hyperinflation, which then trigger super devaluation. Apart from the risk that the Ruble may be severely devalued, the Ruble is also a blocked currency (i.e., nontransferable), so any profit made must be kept within Motherland.

Hard currency alienates a vast majority of the population so many stores have started having separate lines, one for hard currency and one for Rubles. The Ruble lines are always long and slow-moving while the hard currency lines are typically quick and easy. A dual currency has its merits, as some profits could be counted on and repatriated. Even so, the separate line system is deeply resented by the common Motherlandians, and would almost certainly keep them from viewing McDollar's Motherland as a truly Motherlandian enterprise, which would lead to depressed sales, if not outright boycotts. Conversely, corporate McDollar's will not like to hear that your subsidiary will not be sending any profits home, and that investments are being put at economic risk.

Your Task

Represent the McDollar's corporation in drafting the final agreement with Minister of Commerce Kasiminov on each of the listed issues.

For McDollar's Negotiators

Some things an American should know before negotiating in Motherland:

Most Motherlandian business people have high expectations of Western business people. You will be judged immediately by the way you dress and deport yourself. Dress conservatively and well. During cold seasons, dress in layers. Also note these suggestions:

- Always be on time, it is very important to the Motherlandians.
- Shake everyone's hand firmly when you greet them, do not expect friendly smiles.
- Defer to the senior official to lead the meeting and wait to be given the floor before engaging Motherlandians.
- Be firm and polite at all times; do not be pushed.
- Accept cookies and tea when offered.
- Motherlandians drink lots of vodka and smoke profusely. If you smoke as well, make sure to offer cigarettes generously. Not doing so is considered incredibly rude.
- Business cards are handed out liberally in Motherland and are always exchanged at business meetings. The ceremony of presenting and receiving business cards is important. Don't treat it lightly.
- Your company should be represented as a specialized team of experts. Presentations should be thoroughly prepared, detailed, factual and short on "salesmanship."
- Motherlandians usually negotiate technical issues very competently, directly and clearly but, being newcomers to capitalism, often do not fully understand Western business practices and objectives. It may be necessary to explain the reasoning behind some of your demands.
- Business negotiations in Motherland are lengthy and may test your patience. Plan to be in for the long haul.

- ♦ Personal relationships play a crucial role in Motherlandian business. It is a collectivist culture.
- ♦ No agreement is final until a contract has been signed.

The Motherlandians are generally VERY superstitious, so note these points:

- ♦ Never shake hands over a threshold: it will lead to an argument.
- ♦ Always bring flowers or wine when invited to a Motherlandians home. Do not bring Vodka, as the Motherlandians will already have an ample supply which they believe is of higher quality.
- ♦ Never put your feet up on furniture or show the soles of your feet when sitting: it is considered very rude.
- ♦ Be careful complimenting something in a host's home: they may try to give it to you.

Adapted From: Bosrock, M. (2005) and Saratov (2005).

FOR McDOLLAR'S NEGOTIATORS

"WINNING AT ALL COSTS...SOVIET STYLE"

How do you recognize the Soviet style? You distinguish it by the specific behavior of the other side. All "Soviets," whether from Moscow or from Memphis, use the same six steps in the negotiation dance:

1.	Extreme initial positions.	They always start with tough demands or ridiculous offers that affect the other side's expectation level.
2.	Limited authority.	The negotiators themselves have little or no authority to make any concessions.
3.	Emotional Tactics.	They get red faced, raise their voices, and act exasperated - horrified that they are being taken advantage of. Occasionally they walk out of a meeting in huff.
4.	Adversary concessions viewed as weakness.	Should you give in and concede something, they are unlikely to reciprocate.
5.	Stingy in their concessions.	They delay making any concession and when they finally do, it reflects only a minuscule change in their position.

6.	Ignore deadlines.	They tend to be patient and act as though time is of no significance to them.

Adapted From: Cohen, H. (1980, p. 121).

MCDOLLAR'S MOVES TO MOTHERLAND

Role for Alex Kasiminov, Minister of Commerce of for Motherland

General Information

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Soviet propaganda and enculturation, however, have created a lasting negative image of Capitalists, specifically Americans, as greedy, power hungry beasts. A major problem for American investors is trying to overcome this perception. With a culture dominated by Socialist sentiment, which promises food and heat for all its citizens, the Motherlandian general public is wary of western business infiltration, and its emphasis on personal gain and wealth.

The Motherlandian government has begrudgingly agreed to allow some Western firms to do business in Motherland. While such a shift in policy offers potentially lucrative business ventures for Western firms, the political and economic risks are substantial, creating tension and conflict between prospective foreign business investors and the Motherlandian government.

One particular investment possibility involves McDollar's, a world renowned fast food establishment based in the United States. McDollar's ascended to the top tier of fast food chains when the owners streamlined the hamburger serving process, and redefined the restaurant industry forever. Since then the company has been wildly successful in its ventures, with tens of thousands of locations on six continents. The corporation employs over three million people, netted revenues in the billions last year, and has become an American branding icon with the likes of Coca-Cola and Nike. Their classic symbol, the green dollar sign ($) is universally recognized as an eating establishment of the highest quality and a beacon of profit for franchisees everywhere.

A meeting is scheduled between Taylor Dunn, the founder and Senior Chairperson of the so far only conceptual "McDollar's Motherland," and Alex Kasiminov, the current Motherlandian Minister of Commerce. With no current fast-food competition in Motherland, Dunn is interested in the expansion of McDollar's into the Russian market, believing that he/she will enter into it unopposed, allowing him/her to reap an incredible profit. On the other hand, Kasiminov is entering the negotiation with the best interests of his/her country and those he/she represents in mind. While each side has apprehensions about the other, and in light of the substantial cultural differences, Dunn and Kasiminov nevertheless hope to meet civilly and productively.

Confidential Information for Minister Alex Kasiminov

NOTE: This exercise can easily be conducted as a team negotiation. In fact, the exercise works very well with having a team with anywhere from three to five negotiators on each side. Moreover, the teams do not have to be evenly matched. If negotiation teams are used, each additional team member can create his or her own name and title, or that can be generated and assigned by the instructor. Possible titles might include any of the following;

Department of Agriculture
Economic Advisor
Foreign Affairs Advisor
Department of the Interior

Background

You are Alex Kasiminov, the Minister of Commerce for the former Soviet republic Motherland. You take great pride and honor in your mother country and love her people. You are a true public servant and believe that the people should be helped and honestly represented by their government. You have been in government for all of your adult life, and have seen the devastating effects of the Cold War on Motherland and its people throughout your life. You were a Communist, but your views have moderated over time; you have witnessed the advantages and benefits enjoyed in the West, and realize that Motherland must do something to stimulate her troubled economy. After all, it is the Motherlandian people who are struggling to survive, with many of them close to starving to death in the notoriously cold winters. You are also a pragmatist and are painfully aware of the problems with the economy, unemployment, hunger, and dissatisfaction among the population. Yet you have great faith in yourself and your leadership abilities, as well as your government colleagues, and believe that you are the public official who will solve the problems of your country. While you are somewhat wary of the West and of capitalist culture, as most Motherlandians are, you hope that by allowing some foreign investments and business ventures into the Motherlandian market, the nation will greatly benefit.

You have heard good things about McDollar's and their corporation. They have been extremely successful in their operations and have been able to generate amazing profits while expanding all over the world. McDollar's has never expanded into Motherland, however; in fact, there are no "fast food" restaurants in your country and you wonder how your people would respond to this phenomenon that is so popular in the West, especially in America, whose cultural imperialism you find somewhat threatening.

You understand that beyond the first ever McDollar's restaurant in Motherland, McDollar's ultimately wants to establish twenty restaurants in the Mosberg area, and is eager to meet with you to discuss the plans. You are, however, somewhat worried about McDollar's representative in Motherland, Taylor Dunn. You know that Dunn is an excellent business person who has built McDollar's from the ground up into a widely profitable organization. Yet, you believe that Dunn may not always have the best motives behind his/her actions. You are concerned that Dunn is often solely profit-driven and does not take into account any other factors in establishing and promoting his/her business interests. You are unsure whether Dunn will understand and accommodate Russian culture and societal concerns, or whether Dunn will only be looking out for his/her own personal interests, i.e., the bottom line.

Nevertheless, reaching such a deal with such a successful foreign corporation would be extremely beneficial for your country, and your are convinced it will initiate tremendous momentum for starting down the path of improving the standard of living for all Motherlandians. Striking a deal would also result in a considerable boost to your troubled economy by stimulating it with an enormous sum of foreign capital and by creating employment opportunities for the general population. Moreover, agriculture production could receive a boost, existing industries could be redeveloped, and new ones could be launched.

Most importantly, McDollar's could serve as a model for other foreign companies to do the same. This might open the door to more direct foreign investment, which you know would mean more money still for the Motherlandian economy. While you are personally secure in your career and finances, and even though you will not lose anything if McDollar's does not open a franchise in Mosberg, you are acutely aware of how is at stake for the future of Motherland and what an unambiguous and unmitigated disaster it will be if an agreement cannot be reached.

Given that the future economic well-being of Motherland hangs in the balance, you should take considerable time to thoroughly review the issues. Whether the twenty prospective restaurants within Mosberg become a reality depends on your reaching agreement on following issues:

Menu

Culturally, Motherlandians have had little to no concept of fast food. In fact, there have historically only been two kinds of restaurant facilities in Mosberg, the first type being formal dining rooms operated by local governments, which are very strict. They are very formal, with white table cloths and cutlery, and no one would ever consider eating food with their hands. The service has always been horrible, with patrons often sitting for many hours before being served bland Russian food by impolite waiters. The second type of restaurant is the small, informal café variety, where patrons stand while eating pelmini, a ravioli-like pastry, with biscuits and coffee.

You feel that there is a great need for more diverse food and restaurant options in Motherland, and that the McDollar's foods will be liked by the people. You also wonder, however, if there will be some wariness by the people toward trying such options as Chicken McParts, and Mega Macs. Accordingly, you would like to see the menu changed or augmented slightly to better accommodate Motherlandian culture and tastes. You favor such popular Motherlandian items such as grilled cheese sandwiches, cabbage salads, burgers with pork patties, and chicken or mushroom soups, and would very much like to see them added to the menu. You want what is best for Motherland and her people, and you are confident these foods should be included as options for the Motherlandian population. Moreover, these popular foods are inexpensive and, better still, could easily be produced and sourced locally, which is very important to you.

Sourced Locally?

You would like to see the food and the ingredients used by McDollar's in Motherland to be sourced locally. For you, the issue of Motherlandian inputs is crucially important, and you want your country to have a strong hand in the operations of such a massive venture in your own backyard. To your way of thinking, the ideal situation would be for everything to be produced and sourced on a local level, with McDollar's financing much needed infrastructure and logistical improvements out of their deep capitalist pocketbooks. You would be insulted, outraged, and humiliated if the company had to import from other countries (especially the gluttonous United States), as this would deprive Motherland of valuable and critically important employment and economic development opportunities.

You understand that the U.S. corporation will most likely want to train Motherlandian producers and farmers in the latest and most efficient techniques in order to increase their productivity. You see this as beneficial and you want it to occur as well; however, you realize that such training comes at a cost, and you paying for it would be very difficult for your government.

Local production and sourcing will require a substantial facility in which to store and generate the food and drink to be served. The McDollar's corporation has long had a company motto of keeping their products "consistently the best," no matter where in the world they are operating. The burgers sold in New York would need to be the same burger sold in Mosberg; therefore, the ingredients and food processes must be the same. One of the ways in which to achieve this is to construct in or around Mosberg one of McDollar's large food production facilities, lovingly called the McComplex by its originators. This complex is the best way to ensure quality control, and would include a self-contained bakery, dairy, and meat-cutting operation facility, while employing over 400 people. While it would cost over McDollar's $50 million to build it, its construction is an imperative, and another great opportunity to boost your economy. You are confident that McDollar's plans to build the McComplex, and that Dunn will offer to pay for it. You do know as an absolute certainty that your government does not have sufficient funds to pay for such a project, nor do you even have the authority to agree to such an expenditure.

Hire Locally?

With the make-up of the workforce, one pressing issue is whether McDollar's will hire and employ locally or will instead want to bring in outside managers. You of course will insist that McDollar's hire local Motherlandians, as your economy has been experiencing unprecedented unemployment levels and desperately needs the job opportunities made available by the venture. Skeptics point out that Motherlandian employees, particularly those working in the food services industries, have a reputation for being unfriendly and unmotivated. You do not believe this is an entirely fair assessment, but you do realize that McDollar's holds, as one of its key values, its cheerful and friendly customer service. You are confident that Motherlandian workers have much to offer. Many are very well-educated and intelligent, and have backgrounds in such fields as rocket science, health care, and other areas requiring higher education. It would therefore be possible to hire very well educated persons from these sectors who could staff and represent the restaurants extraordinarily well.

You would dread seeing the venture in Mosberg dominated by American managers, who you feel would be only profit-driven and would not understand the needs and culture of Motherlandian employees and customers. Therefore, you must insist that all employees (managers and floor workers) of McDollar's in Motherland be Motherlandian citizens. You do realize that once you get your way on this, Dunn may require Motherlandian Managers to be trained at Hamburger University, the American training center for the McDollar's corporation. If Dunn does require such training, however, it only makes sense that McDollar's should pay the costs for any such training, the transportation involved, and the housing necessary for these managers.

Ownership

During this time of Motherland's transition economy, the Motherlandian government has taken upon itself the role of undertaking transactions with foreign firms, instead of allowing individual Motherlandian companies to create joint ventures on their own. Motherlandian law stipulates that government still controls all services in the city, including restaurants, utilities, and real estate. As a result of this, you want to retain as much ownership of the McDollar's Motherlandian venture as possible, but you cannot go lower than 51% and, in fact, you have no authority to go any lower. If you did have such authority (which you don't), you would never be able to take less than this figure as you would seem weak in the eyes of the Motherlandian people, and you cannot be considered weak. Such public opinion would ruin you politically and your future prospects. You sincerely expect that McDollar's will accept such an arrangement, given that is it they who are guests in your homeland. You also know that your government can truly help assist the venture if you are given the majority share of the ownership. If McDollar's needs land, you will be able to get them land. If they need electricity, you can get your powerful military to put in power lines and utilities.

Location

Another important issue for you is the location of the restaurant venture in your capital city of Mosberg. Location is important to you, as it can increase profitability. Profitability, however, is not the only consideration. Motherlandian sentiment - how the people regard a specific location - is also a major factor.

You have heard rumors that three possible sites are being considered for the first McDollar's. The first site is prime real estate, located directly in Pushpin Square, just one block from the Lenin Memorial. There is a hotel going out of business there, and you could pull some strings to allow McDollar's to take over the site. Locating at that site would attract a great deal of attention and pedestrian traffic, allowing McDollar's to take off financially. Critics believe, however, that having such a Western influence so near to the great Communist icon of Lenin will be problematic. Given the vocal opposition, you would be required to expend considerable political capital to secure this site.

One other complicating factor for this particular site is that the funds needed to renovate the hotel would make it impossible for you to contribute to training costs at Hamburger University for local management, if McDollar's ends up insisting on such training and further suggests that the Motherlandian government would be expected to help pay for it.

The other two locations under consideration are less than optimal. One is located in a popular business district...popular before the Bolshevik revolution at least. Now it is mostly abandoned. The other is in a very well trafficked part of town, situated right between the Red Light District and a very historic site, an old Stalinist Gulag.

Currency

Whether to transact business in Rubles or hard currency is another important issue. The historical legacy of Motherland's currency is very important to you and to the Motherlandian people. It helps to define who the Motherlandians are and it is a reflection of their culture. The local currency, the Ruble, is a blocked currency (nontransferable money) widely circulated amongst the commoners of Motherland. Motherland has had a history of hyper-inflation, however, which has led the aristocracy and foreigners to use hard currency, such as dollars or euros. It is illegal for commoners to hold any form of hard currency, and in fact, many of the nicer shops are hard currency only, and do not permit entry by peasants.

Not surprisingly, hard currency alienates a vast majority of the population so many stores have started having separate lines for hard currency and Rubles, with the Ruble line always being out the door and slow moving and the hard currency line being short and fast moving. The separate line system is deeply resented by the majority of Motherlandian people, and may keep them from viewing McDollar's Motherland as a truly Motherlandian enterprise. You are looking out for the average Motherlandian, and feel that they would best be represented by the Rubles system, and would be more willing to accept McDollar's if it operated solely with Rubles. Better still, having a non-transferable (or blocked) currency seals the profits in Motherland, which will benefit your economy further.

Your Task

To conscientiously and in good faith represent the Motherlandian Government and the Motherlandian people in attempting to reach a final agreement with Taylor Dunn and the Americans on each of the listed issues.

Motherlandian Business Practices and Culture
(For Motherlandian Negotiators)

Most Motherlandian business people have high expectations of Western business people. They judge Western business people immediately by the way they dress and deport themselves, which means Western business people should dress conservatively and well. During cold seasons, dress is expected to be in layers. That which follows reflects general tendencies of the Motherlandian people:

- Being on time is very important.
- Shaking everyone's hand firmly when greeting them, without offering friendly smiles.
- Deferring to the ranking senior official to lead meetings, and waiting to be given the floor before engaging in a conversation.
- Being firm and polite at all times; but not being afraid to push hard.
- Offering cookies and tea, expecting that they will be accepted and received gracefully.
- Drinking lots of vodka and smoking profusely. If other guests present smoke as well, such guests are expected to offer cigarettes generously. Not doing so is considered incredibly rude.
- Business cards are handed out liberally in Motherland and are always exchanged at business meetings. The ceremony of presenting and receiving business cards is important. It is not to be treated it lightly.
- Negotiating teams should be represented as a specialized team of experts. Presentations should be thoroughly prepared, detailed, factual and short on "salesmanship."
- Motherlandians usually negotiate technical issues very competently, directly and clearly but, being newcomers to capitalism, often do not fully understand Western business practices and objectives. You may require Western business people to explain the reasoning behind some of their demands.
- Business negotiations in Motherland are lengthy, and Motherlandians have no qualms whatsoever about testing the patience of their negotiating counterparts. Being in negotiations for the long haul does not faze Motherlandians in the least.
- Personal relationships play a crucial role in Motherlandian business. It is a collectivist culture.
- No agreement is final until a contract has been signed.

The Motherlandians are generally VERY superstitious, so note these points:

- Never shake hands over a threshold: it will lead to an argument.
- Always bring flowers or wine when invited to a Motherlandians home. Do not bring Vodka, as the Motherlandians will already have an ample supply that they believe is of higher quality.
- Putting ones feet up on furniture or showing the soles of ones feet when sitting is considered very rude.

- If someone compliments something in a Motherlandian hosts home, the Motherlandian may try to give it to whoever made the compliment.

Adapted From: Bosrock, M. (2005) and Saratov (2005).

FOR MOTHERLANDIAN NEGOTIATORS

"WINNING AT ALL COSTS...SOVIET STYLE"

How do your recognize the Soviet style? You distinguish it by the specific behavior of the other side. All "Soviets," whether from Moscow or from Memphis, use the same six steps in the negotiation dance:

1.	Extreme initial positions.	They always start with tough demands or ridiculous offers that affect the other side's expectation level.
2.	Limited authority.	The negotiators themselves have little or no authority to make any concessions.
3.	Emotional Tactics.	They get red faced, raise their voices, and act exasperated - horrified that they are being taken advantage of. Occasionally they walk out of a meeting in a huff.
4.	Adversary concessions viewed as weakness.	Should you give in and concede something, they are unlikely to reciprocate.
5.	Stingy in their concessions.	They delay making any concession and when they finally do, it reflects only a minuscule change in their position.
6.	Ignore deadlines.	They tend to be patient and act as though time is of no significance to them.

Adapted From: Cohen, H. (1980)

NOTE TO MOTHERLANDIANS:

Although you might be familiar with Herb Cohen's book and what it says about so-called Soviet style negotiating techniques, you should remember that the so-called Soviet style of negotiating is not necessarily the Motherlandian style of negotiating.

McDollar's Negotiation Results

Real Names / McDollar's

>____________________________________

>____________________________________

>____________________________________

____

Real Names / Motherland

>____________________________________

>____________________________________

>____________________________________

____

Issues:

Change the Menu / Do Not Change the Menu

If changing the menu, what changes will be made? ____________________________

____

____

____

Produce Locally / Import Needed Ingredients and Supplies

American Management / Motherlandian Management

Will Motherlandians be attending Hamburger University? __________________________

If so, who will pay for housing/transportation? ________________________________

What are the ownership percentages? McDollar's______% Motherland______%

Pushpin Square / Business District / Red Light District

Rubles / Hard Currency / Both

Was your agreement good for your interested parties (Corporate Reps for McDollar's, Motherlandian Government or Motherlandian people)? Explain your reasoning.

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SOUTHWEST AIRLINES 2007

Thomas M. Box, Pittsburg State University
Kent Byus, Texas A&M University – Corpus Christi

CASE DESCRIPTION

The primary subject matter of this case concerns Southwest Airlines. A secondary issue concerns the appropriateness of modifying a Generic Strategy that has lead to thirty five years of uninterrupted growth and profitability. The case has a difficulty level of four (senior-level undergraduates). The case is designed to be taught in one fifty minute class period and is expected to require about two hours of outside preparation by students.

CASE SYNOPSIS

Southwest Airlines has long been cited in Business Strategy classes as an exemplar of Porter's Low Cost Leadership strategy. Through fiscal year 2006, they have enjoyed thirty five years of uninterrupted profitability. In 2007, they began considering several fundamental changes in their long-term business model to address the realities of increased competition, rapidly-escalating fuel costs and the threats of world-wide terrorism.

New competition – particularly JetBlue and ATA have modeled their operations on the original "Southwest model." Interestingly, David Neeleman –founder of JetBlue in 2001-- was a former southwest Airlines executive and Michael O'Leary – CEO of Ryanair (Dublin, Ireland) –spent several weeks in 1991 at Southwest Airlines headquarters in Dallas, Texas learning the Southwest model. Ryanair is the lowest cost major airline in Europe at this time.

Fuel prices – the second largest component of operating cost for airlines—has increased dramatically (about 50%) in the last three years. As a result, airline profits in 2008 will be lower than originally forecast in early 2007.

The most common complaint about Southwest Airlines has been its boarding policy. For many years, passengers were assigned to groups of thirty with those arriving early at the gate getting into the first group of thirty and, thus, the first choice of seats. In 2007, Southwest began two experiments in seating – the first in San Diego—with assigned seats and later a differential pricing scheme whereby those willing to pay $10 - $30 more per ticket were allowed to board first.

Southwest is also considering the possibility of extending its route map to include large cities in Canada, Mexico and the Caribbean. An additional consideration is the possibility of buying smaller regional jets to serve smaller markets in the United States.

INTRODUCTION

Rollin King, a San Antonio entrepreneur, convinced Herb Kelleher in 1966 that a commuter airline serving Houston, Dallas and San Antonio was a feasible business proposition. King, at that time owned a small commuter air service and Kelleher, an attorney, had done legal work for King. Houston, Dallas and San Antonio were the Golden Triangle of Texas with rapid economic and population growth. The distance between these three cities was long enough that travel by bus and automobile was somewhat inconvenient.

On March 15, 1967, Kelleher incorporated Air Southwest Company (later Southwest Airlines) and on November 27, 1967 filed an application with the Texas Aeronautics Commission (TAC) to fly between Houston, Dallas and San Antonio. TAC approved the application on February 20, 1968 and the next day Braniff, Trans Texas and Continental filed a restraining order to prohibit Southwest from beginning to fly in the summer of 1968. After a series of legal challenges including a Supreme Court appeal, Southwest won the right to commence operations in late 1970.

H. Lamar Muse was hired as Southwest Airline's first president in January 1971 and quickly assembled a group of experienced airline executives that came to be known as 'the Over the Hill Gang." Despite a series of legal challenges, Muse was able to secure financing, buy three new Boeing 737-200s and commence flight operations on June 18, 1971. Because they were an in-state airline, Southwest had considerably more latitude in terms of operations than the flagship carriers (intrastate carriers). Muse came to be known as the master of the gimmick but what he was really doing was to employ Guerrilla Marketing techniques that were notably successful. Muse created the "LUV" culture at Southwest that continues to this day. He emphasized fun and created very dedicated and loyal customers.

By 1973, Southwest Airlines was operating at a profit and that has continued every year since. No other airline in the world has been able to match Southwest's track record of consistent profitability and growth. Southwest has employed Low Cost Leadership as its generic strategy and it has been able to offer some of the lowest ticket prices in the airline industry for the last thirty four years.

Southwest has implemented its Low Cost Leadership strategy in a number of ways. It flies a route map that is basically point to point as opposed to other carriers who fly a hub and spoke route map. Southwest also flies only one type of aircraft – Boeing 737s and generates industry-high utilization rates by achieving very quick gate turnarounds – less than thirty minutes. They do not serve meals and were known for many years for only serving peanuts as snacks. Southwest is also unusual in that all employees are expected to "pitch in" when necessary to solve problems and speed gate turnarounds.

ABBREVIATED TIMELINE

1974: Southwest carries its one millionth passenger and remodels the terminal at Houston's Hobby Airport.

1977: Southwest carries its five millionth passenger and its stock is listed on the New York Stock Exchange as "LUV."

1982: Herb Kelleher is named President, CEO and Chairman of the Board.

1992: Southwest wins the first annual "Triple Crown" in aviation. This award reflects on time service, baggage handling and the level of customer complaints.

1997: Jacksonville, Florida is added as Southwest's 50th city and the airline takes delivery of its first 737-700. The Shelby Amendment modifies the Wright Amendment and permits nonstop service from Dallas Love Field to Mississippi, Alabama and Kansas.

2001: Colleen Barrett becomes President of Southwest and Jim Parker becomes CEO. Terrorists attack the World Trade Center and the Pentagon. The airline industry is decimated by these attacks. At the end of the year, Southwest has 29,274 employees and 344 aircraft.

2004: Southwest Airlines announces its 31st consecutive year of profitability. Southwest announces service to Philadelphia – its 60th airport. Gary Kelly replaces the retiring Jim Parker as CEO.

2005: Southwest announces its code share agreement with ATA, substantially increasing the number of connecting flights including flights to Hawaii. This agreement increases revenue by about $50 million, annually.

2006: Southwest reported record revenues and net profits despite the impact of rapidly escalating fuel costs. At the end of the year, Southwest had 481 airplanes (all Boeing 737s) and 33,000 employees.

SOUTHWEST CULTURE

An axiom of business that many of us learned early was that the primary responsibility of executives was to maximize shareholder wealth. That nostrum gets dumped on its head at Southwest Airlines where the primary responsibility of executives is to take care of employees first which will lead to employees taking good care of the airline's customers and that will, finally, result in appropriate rewards for the shareholders. More than anything else Southwest has been a fun place to work since its inception. This fact is illustrated by a display in the boardroom. At the initial meeting, over cocktails, between Rollin King and Herb Kelleher, King sketched the triangular route map (Dallas, San Antonio and Houston) on a cocktail napkin with the note, "Herb, let's start an airline." Kelleher replied, "Rollin, you are crazy. Let's do it." This "can do" and somewhat irreverent attitude pervades the entire organization.

Lamar Muse (the first president) was also a bit of a maverick that shaped the Southwest culture in many ways. For example it was Muse's idea to foster the LUV philosophy by flying out of Love Field in Dallas and hiring very attractive stewardesses who were outfitted in hot pants designed by his wife. Another time, a competing carrier decided to offer $13 tickets for flights from Dallas to Houston to compete with Southwest's $26 ticket price. Muse (in a famous ad) offered to match the competing carrier's price or to price the ticket at the original $26 with a free bottle of Chivas, Crown Royal or Smirnoff vodka. The tag line for the ad was "Nobody's going to shoot Southwest Airlines out of the sky for a lousy $13." The ad worked and the media loved every minute of it. It is believed that for a two-month period, Southwest was the largest distributor of Chivas, Crown Royal and Smirnoff vodka in Texas.

Employees are hired at Southwest, in many cases, on the basis of attitude. People who do get hired are screened by a group of future peers and must demonstrate a sense of humor to get an offer. The basic philosophy is that "you hire for attitude and train for skills." Despite its attitude about having fun, the airline emphasizes that hard work is expected (and rewarded.) This has not curtailed the applicant list for Southwest employment. In 1995, they accepted 124,000 external applications, interviewed 38,000 people and actually hired 5,473.

Regular parties, picnics and other ways to celebrate employees are all part of the Southwest culture. In the headquarters at Love Field are hundreds of employee photographs on the walls. In addition, employees are encouraged to donate free time to a multitude of charities including Ronald McDonald House and Habitat for Humanity. The result of these activities (and many others) is that Southwest employees feel a "kinship" with the organization. They find it relatively easy to align their personal goals with the organization's goals.

Summarizing the Southwest Airlines cultural attributes, one finds:

- An egalitarian attitude that extends from top management to the newly-hired hourly worker.
- A serious concern for the wellbeing of customers.
- A very strong work ethic throughout the organization.
- A dedication to issues of social responsibility.
- A "fun" orientation throughout the organization.
- A creative approach to maintaining the lowest cost per seat mile metric in the airline industry.

FISCAL YEAR 2006 PERFORMANCE

Table 1: Financial Data

	2006	2005	2004
Operating Revenues ($)	9,086	7,584	6,530
Operating Expenses ($)	8,152	6859	6126
Operating Income ($)	934	725	404
Other Expenses (net) ($)	144	(54)	65
Income Tax ($)	291	295	124
Net Profit After Tax ($)	499	484	215
Total Assets ($)	13,460	14,003	11,137
Long Term Debt ($)	1,567	1,394	1,700
Equity ($)	6,449	6,675	5,527
Net Income per Share	$.63	$.61	$.27
Dividends per Share	$.018	$.018	$.018

Note: All $ amounts are millions (except per share data)
Source: Southwest Airlines 10K Report – January 31, 2007

Table 2: Operating Data

	2006	2005	2004
Passengers Carried	83,814,823	77,693,875	70,902,773
Trips Flown	1,092,331	1,028,639	981,591
Load Factor (Utilization)	73.1%	70.7%	69.5%
Fuel Cost per Gallon	$1.53	$1.03	$.83
Number of Employees	32,664	31,729	31,011
Number of Planes	481	445	417

Source: Southwest Airlines 10K Report – January 31, 2007

A NEW BUSINESS MODEL

Southwest Airlines has been, since its inception, an example of Porter's (1980) Low Cost Leadership strategy. They have achieved a low cost leadership position in their industry by emphasizing such things as faster than average gate turnarounds to yield higher utilization rates, one class of seating and no meals on board, one type of airplane – Boeing 737, no hub and spoke routes, the ability to move very quickly when establishing a new city presence, and a very successful fuel hedging program that began in 2000.

Gate turnaround times are a key performance metric in the airline industry. Southwest Airlines has historically had the quickest turnarounds in the industry – averaging about 20 minutes. They recognized early on that airlines only generate revenue and profits when they are flying. They achieve better than average turnaround times as a result of superb communications and coordination. It is not unusual to see flight attendants and pilots working with the provisioning and ramp crews to pick up trash and load bags. It is worth noting that if Southwest in 1995 had the same turnaround times as others in the industry, they would have needed an additional 25 airplanes in the fleet.

For many years Southwest used plastic boarding cards and assembled passengers in groups of thirty to board the plane. There were no assigned seats and only one class of service. This was done to simplify boarding and speed up the gate turnaround time. Since there were no assigned seats, passengers frequently arrived at the gate an hour before the scheduled departure so as to be one of the first to board the plane. This "cattle call" approach to boarding created dissatisfaction for some passengers and, as a matter of fact, was the leading passenger complaint about Southwest Airlines. Quite recently, Southwest has experimented with assigned seat boarding in San Diego and has also just initiated what amounts to a group of three classes of service. By paying an extra $50 for a Business Select ticket (one way) passengers can be among the first 15 to board and thus able to get the preferred aisle or window seat. This is a recent innovation and it is too soon to measure results. CEO Gary Kelly expects the Business Select ticketing option to add $100 million in additional revenue in 2008.

Southwest is a point-to-point airline. It does not have a hub and spoke route map like most of the other major carriers. Two additional possible changes to the Southwest business model is the possibility of extending their route map to include large cities in Mexico, Canada and the Caribbean. CEO Kelly remarked recently that this was a change that was when, not if.
Kelly is also intrigued by the possibility of flying to smaller city pairs in the United States in regional (100 passenger) jets.

Fuel costs are the second largest item on a list of operating expenses. Personnel costs are the largest. The cost per barrel of crude oil has doubled in the last year and this increased cost has dramatically affected the price of jet fuel. Southwest owns long term contracts to buy most of its fuel at the equivalent of $51 a barrel through 2009. This active fuel hedging program produced gains for

Southwest of $892 million in 2005, $675 million in 2006 and $439 million for the first 9 months of 2007.

DISCUSSION QUESTIONS

1 Do a SWOT analysis for Southwest Airlines and interpret your findings.

2. At the end of 2006, Southwest had a Current Ratio of 0.90. At the end of 2005, it was 0.94. Most introductory accounting texts suggest that the appropriate ratio is 2.0. Does Southwest have a serious problem with working capital management?

3. Southwest revised its boarding procedure in 2007 with the introduction of Business Select seating (and boarding). Will this new introduction generate expected revenue increases and resolve complaints about boarding policies?

4. Southwest is considering the possibility of adding Canadian, Mexican and Caribbean destinations to its route map. Comment on this possibility. Does it make sense? What are the "plusses and minuses"?

5. Is Southwest more or less profitable than other major US airlines? Why?

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Southwest Airlines 2006 Annual Report

Southwest Airlines (October 19, 2007) 10Q Report

THE BIG STINK AT DARIUS D'AMORE'S FRAGRANCES, INC.

Barry Armandi (deceased), SUNY-Old Westbury
Herbert Sherman, Brooklyn Campus – Long Island University
Daniel J. Rowley, University of Northern Colorado

CASE DESCRIPTION

This is a field-based disguised case which describes treatment of employees within Darius D'Amore's Financial Administration Division. The case describes a brief history of several employees who filed a lawsuit against the firm claiming racial, disability and gender discrimination after they were overlooked for promotion, or were poorly treated, and eventually terminated.

The case has a difficulty level appropriate for a junior level course in human resource management, business ethics, or principles of management. The case is designed to be taught in one class periods (may vary from fifty-five minutes to eighty minutes depending upon the course structure and the instructional approach employed) and is expected to require between four to six hours of outside preparation by students.

CASE SYNOPSIS

Derived from observation and field interviews, the case describes the plight of several workers within Darius D'Amore's Financial Administration Division and what incidents lead to their eventually filing a lawsuit against the firm. Rich Rogers, 43, had been with the company as a supervisor in the Corporate Credit Department since 1997. Mr. Rogers, a white male, had his Bachelor's degree in management and was enrolled in an MBA program at a local University. Rogers was fighting stage 4-lung cancer since 1996. His condition was not revealed to the Company or his co-workers until 1998. He made his condition known at that time because he needed to take a two-month leave to have bilateral lung surgery. Mr. Rogers, on several occasions, felt that he was passed over for promotion because of his illness and questioned why he was training his supervisors if he wasn't qualified for the job. When Rogers brought up several racial incidents to the head of the Division, Kevin Simmons, he was told to mind his own business and that no matter how hard you work, you will never be promoted. Several other racial and discriminatory incidents occurred that impacted and/or were observed by Les Ford, a 44 year old African American employee, and Jasmine Young, a 25 year old African American female. Their complaints to both management and *human resource management went unheeded and eventually Rogers and Young were fired while Ford quit. The case ends with the three of them bringing a lawsuit against the firm.*

INTRODUCTION

"The Job Position Opening Policy is to first post the job internally and if no qualified candidate is found, then the open position will be announced to the general public," stated Jeff Juda, Chief Financial Officer of Darius D'Amore, at a Finance Department meeting. "Likewise," he continued, "we fully abide by and support all laws and rules governing employment, especially those from the EEOC."

"What a load of bull!" whispered Rich Rogers to Les Ford. "Juda probably doesn't know what the hell's been going on in his own Department! But he will soon," responded Les.

BACKGROUND

The Darius D'Amore Company was one of the world's leading manufacturers and marketers of quality skin care, makeup, fragrance and hair care products. Darius and Dante D'Amore founded the Company in New York City in 1945. Its products were sold in over 120 countries and territories under the following brand names: Darius D'Amore, Darius, Dante, Beginnings, Inferno, Heaven, Cleanique, Zodiac, Avalon, *Madeline* and Seasons. Each division had its own specific and unique image, advertising and merchandising strategy.

The Company was headquartered in New York City, with manufacturing facilities located in the United States, Belgium, Switzerland, the United Kingdom and Canada. The Company went international in London in 1960 and established a presence in Hong Kong in 1961. There were approximately 20,000 full-time employees worldwide. The Company was publicly traded since November 1990, with members of the D'Amore family owning a majority of stock.

The Darius D'Amore Company sold its products through limited distribution channels, consisting mainly of upscale department stores (i.e. Macy's, Lord and Taylor), specialty retailers (i.e. Nieman-Marcus, Nordstrom's), international perfumeries and pharmacies and, to a lesser extent, freestanding company stores, spas and duty-free shops. Upon acquiring *Madeline* and Avalon, the Company entered two new channels of distribution: self-select retail (i.e. Wal-Mart) and professional hair salons. In November 1998, the Company began to sell certain products over the Internet.

Darius D'Amore, the flagship brand of the Company was founded in 1945. It marketed women's makeup, fragrance and skincare products, as well as men's fragrances and grooming products. The Darius D'Amore brand was known for the high quality, innovative and technologically advanced products it provided its customers. Darius D'Amore was sold in over 14,000 stores in more than 120 countries and territories and had nine full-service day spas in cities across the United States and in Toronto, Canada. In addition, it owned and operated two free-standing stores, one in Las Vegas and one in Youngtown, New York.

In fiscal year 2004, net sales for the Company were $5.2 billion. Net earnings were $428 million. The Darius D'Amore Company had more than 48 years of consecutive annual sales increases. The Darius D'Amore brand alone had global net sales of $2.5 billion. Net earnings were $282.4 million. A note for fiscal year 2003 reads, "Information includes the effect of a special charge of $22.0 million ($13.5 million after-tax)…related to the proposed settlement of a legal action."

ORGANIZATIONAL STRUCTURE

Darius D'Amore owned or was the licensee to 21 companies. Each company or brand acted as a separate and distinguishable entity with their own laboratories and staff. However, all companies abided by the same standards of Darius D'Amore. Even though each company was under the D'Amore organizational umbrella, they competed with each other for market share.

All brands reported their financial information to corporate headquarters in New York City. Some of the corporate executives and departments were located in Huntington, Long Island. The Finance Division was run by the CFO, Jeffery Juda. Under Mr. Juda there were eight departments. Each department was structured slightly different but all had a Vice President, Staff Vice President, Executive Director(s), directors, managers, supervisors and the low-level employees. (See Appendices A and B for the organization charts.)

The Financial Administration Division had a total of 75 employees as of 2005. The Division was broken down into five departments: accounts receivable, accounts payable, credits and collections, payroll, and salary and commissions. Many of the employees were in the same department and position their entire Darius D'Amore career.

POSTING OPEN POSITIONS

When a job position became available, the policy of Darius D'Amore was to first post the job internally and if there was no qualified candidate, the position would be advertised to the public. Many low level positions were filled in this manner. However, when it came to management positions, there were some deviations.

Rich Rogers, 43, had been with the company as a supervisor in the Corporate Credit Department since 1997. Mr. Rogers, a white male, had his Bachelor's degree in management and was enrolled in an MBA program at a local University. Rogers was fighting stage 4-lung cancer since 1996. His condition was not revealed to the Company or his co-workers until 1998. He made his condition known at that time because he needed to take a two-month leave to have bilateral lung surgery.

Prior to his leave, two people had resigned from the positions of Manager of Credit Returns and Director of Credit Returns. Rogers let Al Savarino, Executive Director for Accounts Receivable and Credit & Collections, know he was interested in both. Both positions were a level up in management and meant more money, responsibility, and status. While on leave, Rogers received a call from Savarino who indicated that the positions had been filled with two people from outside the Department. Tony Miceli was the new Director and Tom Mathers was now Rogers' manager. When Rogers mentioned that he felt he was qualified, at least for the manager's position, Savarino told him that in his estimation he was not qualified and, therefore, would not post the position internally.

According to Laura Hertz, who works in the Accounts Receivable Department and a close associate of Rogers, "[Rogers] was devastated because if he was not qualified, why was it his responsibility to train both Miceli and Mathers?" To add fuel to the fire, Hertz had heard that Mathers told Rogers that Rogers did not get the position because Kevin Simmons, Vice President of the Financial Administration Department, said "He (Rogers) is a dead man and wouldn't return to work."

Kevin Simmons, a white male in his early fifties, had been with the Company for eight years. He was esteemed by upper management and his peers because of the dramatic changes he made to improve both the Department and the Company's profitability. Mary Connors, a black female who has worked in the Accounts Receivable Department for over twenty years, spoke of how, "Kevin came to the Department and made many improvements."

THE TAPE

Mary Connors revealed that in May 2001 Rogers taped a conversation with Mathers, who was unaware of the recording. On the tape, Mathers talked about certain employees, including Simmons and minorities. Some of Mathers' remarks regarding black employees were:

> I can't talk with Christine cause she's a moron. She's on a different planet. She's not for real. Or she'll start talking about things that aren't even words. I think she's one of them uh…she's related to those Jamaican ones, that they drain the chicken blood and they start fires and stuff. You know the kind. Voodoo. Blow the white powder. You ever see that? How they blow the white powder? If it hits you, it puts you to sleep, you go into a voodoo trance. Hell yeah. She blows the white powder. She's one crazy n****r. She looks like a man, doesn't she? One ugly bitch…She's a jungle bunny. Are you fascinated with this fat old coon?

Alongside one of his attorneys, Rich Rogers brought the tape to Kevin Simmons. Just a few minutes into the tape, Simmons made him shut it off and asked both of them to leave. Before he left, Simmons asked Rogers how he could continue to work for the Company if he was going around taping conversations. Rogers was surprised at the comment and also that Simmons didn't investigate the contents of the tape.

PERSONNEL CHANGES

Sometime during February 2000, Miceli transferred to the Director of Payroll position. His replacement, Christine Wines, was hired from outside the Company without the position being posted internally. Two years later in May 2002, both Wines and Mathers were terminated. As his supervisor, Kevin Simmons, noted, "Mathers was let go because he lacked consideration of others in his interpersonal skills." While Mathers was still the manager, Rogers interviewed a Puerto Rican female for an associate's position. Mathers told Rogers not to hire "the big fat Puerto Rican s**c pig." The female was not hired because Mathers' felt "she was unqualified", although Rogers thought differently.

After both Wines and Mathers were terminated, Rogers again let Simmons know he was interested in at least the manager's position (Mathers' job). Simmons did not post the positions internally and Rogers indicated again he was denied the opportunity to apply. Mary Connors remembered clearly that Rogers was crying hysterically when he came out of Simmons's office. While consoling him, Rogers was angry that the "a**hole Kevin Simmons told him no matter how hard you work, you will never be promoted. It is probably a good idea if you look for another job!" Mary was in shock but was even more disturbed by what Rogers' said Simmons told him in December 2002. Repeating word for word what Rogers told her with tears coming down his cheeks, "Simmons has the nerve to tell me that I am using my cancer to f**k the system."

LES FORD'S TURNDOWN

Les Ford, a 44 year old African American employee, worked in the Product Demonstration Department from August 1999 – December 2002. His Department oversaw the payment of salaries and commissions to the cosmetic personnel. Ford was with the company for a few years making lateral moves from position to position.

Jasmine Young, a 25 year old African American female, was hired as a temporary employee in March 2001 to work in Salary and Commissions Department, with Les Ford.

Les Ford and Jasmine Young worked in a different department than Rich Rogers and neither of them had cancer. Even though they were from different departments, they were both on the same floor and reported to the same Vice President, Kevin Simmons. Vic Viola was the Executive Director.

Linda Evans, a secretary, and Mary Connors both agreed that Les Ford was liked by many of his co-workers. His supervisor, Deborah Jones, was leaving for another position and felt that he was the most qualified for her position. After Ford expressed interest in applying for the promotion, Jones took it upon herself to delegate some of her responsibilities to Ford. After applying for the position in December 2000, he was told by Vic Viola that the position was not going to be filled at the moment, but two new coordinator positions were being created. Ford felt cheated but took one of the positions in order to remain motivated.

One month after Ford began his new position, a white female from the customer service department was named the supervisor. Once again, upper management did not post the position. This was the same position that Ford was told was not being filled. The new hire was Cathy Richards, a white female who had been with the Company for over twenty-four years. According to Linda Evans and Mary Connors, she was the one who created most of the trouble for minority employees. An unnamed source from the Human Resource Department stated that Cathy was written up on a number of occasions for name calling, especially to those she supervised. Another minority, Elvin Shane, backed the claim found in the report. He worked in the same department as Ford and Young. Edward indicate that "Cheryl, along with other coworkers, would use derogatory slurs, such as 'jungle-bunny', 'voodoo bitch' and worse of all 'n****r'." The racial and sexual slurs went on even after people complained to Vic Viola and Kevin Simmons. Mary Connors described an incident where a black pregnant female employee under Rich Rogers reported to him that she was tripped and called a "n****r" by Cathy Richards. Rogers reported it to the people above him, including Kevin Simmons, but nothing was ever done.

Rogers and Young complained to their manager Mike Bonn and the director Mitch Henning about the verbal and non-verbal abuse by Cathy Richards. Only after numerous complaints did Henning decide to bring the issue to John Price, a human resources manager. Rogers and Young were stunned when Price told them " to let things slide." Linda Evans remembered a human resources secretary, Janice Lawrence, told Young "I know that there are people upstairs that do not like certain people, but you just have to ignore it."

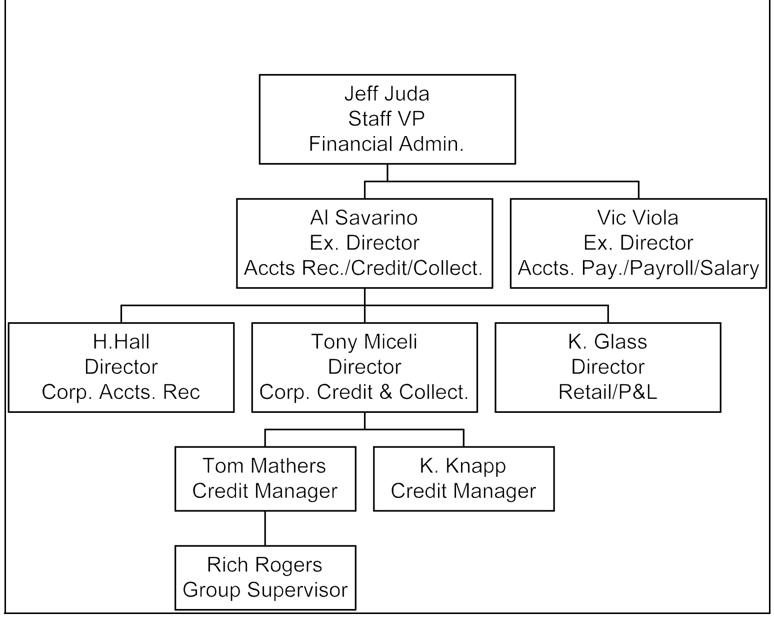
Regarding Rogers and Ford, Mary Connors said "people in the Department started to believe that it was malicious intent by management to keep certain people from moving upward in the Company." She continued by saying that it is sad that no one, including herself, took it upon himself or herself to bring the situation to the correct authorities.

ENOUGH IS ENOUGH

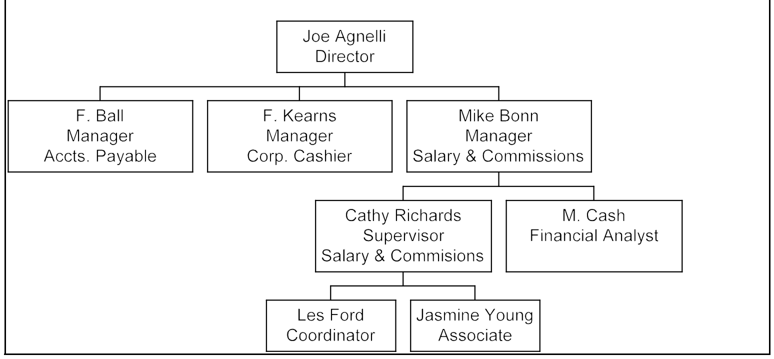
Rogers was fired in December 2002 because of his "refusal to cooperate". Rogers claimed the firing was unjust because he had a great record and in fact his 2002 bonus was his largest in the 5 years with the company.

Young was laid off as a temp during May 2002. Mary Connors remembered Young telling her she wanted to quit the entire time but she needed the money to support her family. She kept telling herself that her treatment would get better; but it only got worse.

Out of frustration, Ford quit in April 2003. In May 2003, Rich Rogers, Les Ford and Jasmine Young, filed a $70 million lawsuit claiming racial, disability and gender discrimination.



Appendix A
Organization Chart for
Financial Administration Division
Darius D'Amore, Inc.
March, 2001



Appendix B
Organization Chart for
Accounts Payable/ Salary & Commisions Department
Darius D'Amore
March, 2001

Appendix C
Excerpts from Code of Conduct, Darius D'Amore, 2004

From Pages 4-5.

How to Raise Concerns

Every employee Has the responsibility to promptly report any violation or suspected violation of this Code of Conduct, any other Company policy or applicable law or regulation, in order to protect the Company, its stockholders, its employees and its customers.

If you have information regarding any such violation or suspected violation you should report such information to your supervisor or bring the matter to the attention of:

The General Counsel,
The Senior Vice President, Global Human Resources, or
The Chief Internal Control Officer

You may also call the confidential, toll-free hotline at (877) XXX-XXXX or use the post office box cited below. Callers from outside the United States or Canada must first dial their country's access number, which may be found at http://www.usa.att.com/traveler/codes/index.jsp.

All such submissions will be treated confidentially to the extent possible. To assist and encourage the prompt reporting of suspected violations, we will accept reports made on an anonymous basis.

Questionable Accounting or Auditing Matters

If you have concerns regarding questionable accounting or auditing matters or internal accounting controls, you may also submit your concerns directly to the Audit Committee of the Board of Directors by writing to:

Darius D'Amore, Inc.
Attn: Audit Committee
P.O.Box XXXX
New York, New York XXXXX

You may also call the confidential, toll-free hotline at (877) XXX-XXXX. Callers from outside the United States or Canada must first dial their country's access number, which may be found at http://www.usa.att.com/traveler/codes/index.jsp.

All such submissions will be treated confidentially, to the extent possible. To assist and encourage the prompt reporting of suspected violations, we will accept reports made on an anonymous basis.

No Retaliation

The Company will not retaliate against any employee who in good faith raises concerns or makes a report about a possible violation of the Code of Conduct. It will not discharge, suspend or discriminate against an employee because such employee in good faith reports or otherwise provides information regarding a possible violation of this Code of Conduct or of any questionable business practice, accounting or auditing matter.

From Pages 25-27.

Our Workplace

A Safe and Fair Workplace

The continued success of the Company's businesses depends on a safe and equitable workplace in which all employees can perform to the best of their ability.

Equal Employment Opportunity. It is the policy and practice of this Company to provide all employees and applicants for employment with equal employment opportunities without regard to race, color, religion, gender, age, national origin, sexual orientation, disability, or veteran status or any other characteristic protected by law. This policy applies to all Company activities, including, but not limited to, recruitment, hiring, compensation, assignment, training, promotion, discipline and discharge.

The Company will provide reasonable accommodation consistent with the law to otherwise qualified employees and prospective employees with a disability and to employees and prospective employees with needs related to their religious observance or practices. What constitutes a reasonable accommodation depends on the circumstances and thus will be addressed by the Company on a case-by-case basis.

The Senior Vice President, Global Human Resources is the Equal Opportunity Director for the Company and is responsible for implementing this policy. Questions regarding this policy should be directed to that office (212-XXX-XXXX).

Prohibition Against Harassment. The Company endeavors to maintain a working environment in which all employees treat each other with respect. Accordingly, the Company strictly prohibits conduct that constitutes or that could lead or contribute to harassment based on gender (whether or not of a sexual nature), race, color, national origin, religion, age, disability, sexual orientation, or any other characteristics protected by law. Harassment does not require an intent to offend. Thus, inappropriate conduct meant as a joke, a prank, or even a compliment can lead or contribute to harassment.

Examples of prohibited conduct are: racial or ethnic slurs; threatening or intimidating acts directed at an individual because of his or her gender or sexual orientation; the posting or distribution of hostile written or graphic materials aimed at a particular sex or religion; the use of computers (including via the Internet) or the e-mail system to view or distribute racially or sexually offensive communications; and the use of an employee's home computer to send racially or sexually offensive communications to another employee at work.

Sexual Harassment. Sexual harassment is a particular type of discrimination. Sexual harassment includes unwelcomed sexual advances, requests for sexual favors, and other verbal or physical conduct of a sexual nature when:

Submission to such conduct is made a term or condition of employment, either explicitly or implicitly;
Submission to or rejection of such conduct is used as the basis for employment decisions affecting and individual; or
Such conduct unreasonably interferes with an individual's work performance or creates an intimidating, hostile or offensive work environment.

The Company prohibits conduct that constitutes, or could lead or contribute to, sexual harassment. Examples of such conduct are: unwelcomed sexual flirtations, advances or propositions; inappropriate touching of an individual's body; comments about an individual's body or appearance; sexually degrading words used to describe an individual; and the use of computers (including the Internet or e-mail) to display or distribute images, messages or cartoons with a sexual content.

Additional rules apply to individuals with supervisory authority at the Company. No one with a supervisory role may at any time: (1) threaten or imply that an individual's submission to or rejection of a sexual advance will in any way influence any decision regarding the individual's employment, performance evaluation, advancement, compensation, assignments, discipline, discharge or any other term or condition of employment; or (2) make any employment decision concerning an individual on such an basis.

Procedures

If you believe that you have been subjected to prohibited conduct, you are urged and expected to report the relevant facts promptly. You may speak to your supervisor or your supervisor's supervisor (bypassing the chain of command), or, if you feel more comfortable, you may contact your Human Resources Manager, the Senior Vice President, Global Human Resources or the General Counsel. Individuals who have information about inappropriate conduct directed towards others also are expected to report the relevant facts promptly.

Your prompt reporting is very important so that the Company can take action to stop the conduct before it is repeated. All reports will be followed up on promptly, with further investigation conducted where needed to confirm the relevant facts. In conducting it investigations, the Company will strive to keep the identity of individuals making reports as confidential as possible.

Any employee or member of the Board of Directors of the Company found to have violated this policy will be subject to disciplinary action, including termination of employment. Individuals who violate this policy also may be subject to legal and financial liability.

No Retaliation

Threats or acts of retaliation against an individual who in good faith reports inappropriate conduct pursuant to these policies are prohibited. In the event you feel you have been retaliated against for having made such a report, you should report the retaliation as described above.

ACCOUNTING FOR PENSIONS AND OTHER POSTRETIREMENT BENEFIT PLANS AND THE USE OF ACCOUNTING ESTIMATES AND CHANGES IN ESTIMATES: AN ETHICAL PERSPECTIVE

Marianne L. James, California State University, Los Angeles

CASE DESCRIPTION

The primary subject matter of this case concerns ethical dilemmas accountants and other executives may face when selecting required estimates in accounting for and reporting of defined benefit pensions and other postretirement benefit plans and complying with the requirements of Statement of Financial Accounting Standards No. 158, the new accounting standard. Accountants' professional and ethical responsibilities and resolutions of the ethical dilemmas are explored. Secondary, yet important issues are the effects of the choice of estimates on financial statement results and on the usefulness and integrity of the financial statements. 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 issues and the research components of this case. The case has ethical, conceptual, analytical, and research components. Utilizing this case can enhance students' oral and written communication skills.

This is an illustrative case. Any similarities with real companies, individuals, and situations are solely coincidental.

CASE SYNOPSIS

Examples of unethical behavior by financial executives and accounting frauds, such as those at Enron, WorldCom, and Adelphia Cable have renewed the public's as well as the business community's attention on the importance of truthful and ethical financial reporting. Legislation, particularly the Sarbanes-Oxley Act of 2002 has supported this renewed emphasis.

Ethical financial reporting not only requires the absence of fraudulent behavior but also that entities and their accountants choose estimates that best reflect the underlying economic events. When accounting issues involve extensive estimates over a long time horizon, ethical dilemmas may arise if individuals with competing interests attempt to influence the estimates chosen. Accounting *for pensions and other postretirement benefit plans requires extensive estimates over a long time horizon.*

The Financial Accounting Standards Board (FASB) recently issued Statement of Financial Accounting Standards No. 158 "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans," which requires that companies with underfunded plans recognize the underfunded portion on their balance sheets (FASB, 2006). For some entities the effect of this provision is quite significant. Estimates chosen for the plans' discount rates and rates of return on plan assets can significantly affect the funding status and can be used to manage financial statement results.

The primary focus of this case is to examine the ethical dilemmas accountants may face when executives utilize estimates to manipulate financial statements. The case explores the effects on financial statements and their causes, effects on stakeholders, motivation of key personnel, professional and ethical responsibilities of accountants, and potential resolutions to the ethical dilemmas. 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 and the case's research components. The case has ethical, analytical, conceptual, communication, and research components.

INTRODUCTION

The primary purpose of financial accounting and reporting is to provide information that is useful to decision makers (FASB, 1978). Information is considered useful if it is reliable, relevant, consistent, and comparable (FASB, 1980). Generally Accepted Accounting Principles (GAAP) provide guidance and rules for accounting for economic events and transactions to help entities achieve this purpose. Ethical behavior by accountants and financial executives is essential to preserving the usefulness of financial reporting and to support the purpose of new and existing accounting standards.

Because of the complexity of financial transactions, inherent uncertainties, and the need for extensive estimates, financial information may be manipulated or "managed," thus decreasing its usefulness. Accounting standards and rules which intent to enhance the reliability, relevance, and comparability of financial statements are not static. New standards are issued to meet changes in the business and financial environment and to further enhance the usefulness of financial statements. Accounting for defined benefit pensions and other postretirement plans is complex, involves long-term horizons with inherent uncertainties, and requires extensive estimates and assumptions, such as estimates of employee turn over rates, longevity, health care and salary trends, and discount and plan asset return rates.

Historically, defined benefit pensions, which promise employees a specific amount of retirement income, represented the most common employer-sponsored plans. Although this is changing, with some major companies (e.g., IBM and Verizon) discontinuing defined benefit pension plans, they still play an important role for many employees, comprising about 38% of employer-sponsored plans (Clements, 2006).

Accounting for pensions and other postretirement benefit plans has evolved over time. On September 29, 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" (FASB, 2006). This standard amends but does not supercede SFAS No. 87, "Employers' Accounting for Defined Benefit Pensions," and SFAS 106, "Employers' Accounting for Postretirement Benefits Other than Pensions" (FASB, 1985, 1990). SFAS 158 represents phase one of FASB's ongoing comprehensive pension and other postretirement benefit project. Additional changes, which may include changes in the calculation of expense are expected as FASB continues to examine accounting and disclosure for these defined benefit plans.

One of the major provisions of this new standard affects the methods in which pension and other postretirement liabilities are calculated and recognized on sponsoring entities' balance sheets. SFAS 158 requires that entities accrue a liability to the extent that their pension and other postretirement obligations exceed the plan assets (FASB, 2006).

The provisions of SFAS 158, which was effective for fiscal periods ending after December 15, 2006 most significantly affect companies with underfunded pension and other postretirement benefit plans. A recent estimate (prior to the issuance of SFAS 158) suggests that large companies carried approximately 300 billion dollars in pension and other postretirement obligations off their balance sheets (Byrnes & Welch, 2006). Companies may influence the funding status of the benefit plans and thus the amount recognized on their balance sheets through their choice of the discount rate. This potential tool for manipulation may create ethical dilemmas for those involved in the financial reporting process.

ILLUSTRATIVE EXAMPLE

Katie Schmaltz, CPA, CIA, has just been promoted to assistant controller of Mottins Corporation, a publically traded company that manufactures component parts for consumer electronics. For the past four years, she worked for Mottins as their internal auditor. She enjoyed her work as internal auditor, but she is excited about becoming the company's assistant controller. Katie is very proud of being an accounting professional and believes that professional ethics are of paramount importance. She considers Cynthia Cooper, the internal audit director who together with two colleagues discovered and the reported the WorldCom fraud, a role model. The company recently and unexpectedly lost its controller to early retirement. The new controller, Jim Kariton, will be joining the company in a few days. Meanwhile, Katie familiarizes herself with the financial reporting process, the general ledger, and the most recent financial statements.

Mottins Corporation has been growing and prospering during the past five years. As part of its growth and expansion project, the company recently purchased the patent for a new innovative parts manufacturing process that the company hopes will increase its sales by 100 percent over the next five years.

Mottins Corporation sponsors a defined benefit pension plan, as well as a postretirement health care plan. Virtually all of the company's employees are covered by these plans. Both plans are underfunded; the pension plan is slightly underfunded, while the other postretirement benefit plan is significantly underfunded. Consistent with the requirements of SFAS 87 and SFAS 106, no liability had to be accrued on the company's 2005 balance sheet for its retirement benefit plans.

Katie reviews the note disclosures for the defined benefit pension and retiree health care plans and notices that for the fiscal year ended December 31, 2006, the company properly adopted SFAS 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans," which amends both SFAS 87 and SFAS 106. The following are selected disclosures from the Mottins Corporation's 2006 financial statements.

SELECTED INFORMATION FROM THE 2006 FINANCIAL STATEMENT NOTES

Financial Statement Note No. 9: Retirement Plans

Effective fiscal year 2006, the Company properly adopted Statement of Financial Accounting Standards No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans." Consistent with the requirements of SFAS 158, the funding statuses of the Company's defined benefit retirement plans must be disclosed and are as follows:

Funding Status of Defined Benefit Pension Plan	December 31, 2006 (in thousands)
Projected benefit obligation	$ 6,855
Plan assets at fair market value	6,790
Funding Status	$ (65)
Items not yet recognized as components of net periodic pension cost (expense)	
Prior service cost	$ 39
Unrecognized net loss	26

Funding Status of Retiree Health Care Plan	December 31, 2006 (in thousands)
Accumulated benefit obligation	$ 1,010
Plan assets at fair market value	852
Funding Status	$ (158)
Items not yet recognized as components of net periodic health care cost (expense)	
Transition Obligation	$ 40
Prior service cost	100
Unrecognized net loss	18

The Company utilized the following rate assumption in accounting for its defined benefit retirement plans:

Rate Assumptions - Pension Plan	2006 (in percent)	2005 (in percent)
Discount rate	6	5.5
Return on plan assets	9	9
Salary trend rate	3	3
Rate Assumptions - Retiree Health Care Plan	2006 (in percent)	2005 (in percent)
Discount rate	6	5.5
Return on plan assets	9	9
Health care trend rate	7	7

While reviewing the financial statement disclosures, Katie notices that Mottins recognized $223,000 in long-term pension and other postretirement benefit liabilities. Katie, who had read in the financial press that some companies that sponsored underfunded employee retirement plans were quite adversely affected by the provisions of the new standards, is pleased to learn of this relatively small impact of SFAS 158 on her company's financial statements.

Upon further review of the financial statement notes regarding the pension and postretirement health care plans, she notices that the company increased its discount rate assumptions from 5.5 percent to 6 percent for the year 2006. She recalculates the projected pension and accumulated postretirement benefit obligations utilizing the 2005 discount rate assumptions and realizes that the total effect of the 0.5 percent increase in the discount rate was a reduction of $846,000 in total liabilities. She calls the actuary who provides actuarial assumptions and estimates for the company's plans and learns that the change was within reasonable limits and had been specifically requested by the former controller.

Two weeks later, Jim Kariton, the new controller discusses a number of forthcoming financial reporting issues with Katie. Katie is pleasantly impressed by the new controller's qualifications, personality, and interpersonal skills. She is looking forward to a collegial and rewarding professional relationship with her new superior.

At the end of their conversation, Jim instructs Katie to contact the company's actuary and request his support for increasing the discount rate by 0.25 percent in 2007 and the long-term expected rate of return on plan assets by 0.25 percent for both the pension and retiree health care plans. Katie states that she noticed that the discount rate had already been increased by 0.5 percent for 2006. Jim indicates that a further increase is warranted by overall increases in interest rates, and that the long-term expected rate of return on plan assets should be increased to 9.25 percent due to an enhanced outlook for the plans' investments. Katie can't help wondering about the motivation for this newest increase.

A week later, while visiting Chief Financial Officer (CFO) Mike Johans' office to drop off a report, she overhears him speaking with the pension fund manager, asking for a change in the investment mix to increase the percentage of higher-yield, lower-rated securities in the plan assets. During the phone conversation, he impresses on the fund manager that the equity markets are expected to flourish. Katie has heard that the fund manager is a good friend of the CFO and that they play golf together on a weekly basis.

Katie talks to her friend in Human Resources and learns that the CFO has apprised the Director of Human Resources about a potential change in the retirement plan to a 401(k) plan for new employees and the elimination of the retirement health care plan. Katie, who also is covered under the current plans, is concerned for her and her colleagues' welfare.

Katie is unaware that meanwhile, the Chief Executive Officer (CEO), John Ballon, has been meeting with individual board members for lunch and other outside activities, utilizing the opportunity to encourage them to vote for a curtailment of employee retirement benefit plans. John Ballon knows that the company will need to decrease its expenses to continue meeting or beating its earnings trends and targets. John's and other executives' bonuses are directly contingent on meeting earnings forecasts. In addition, John holds a large number of stock options, currently valued at 1.4 million dollars. He plans to meet earnings forecasts for each year until his planned retirement in three years.

A few weeks later, one of Katie's colleagues casually mentions that her boss, CEO John Ballon has been meeting with several board members, some of whom are also on the company's audit committee. She also mentions that she overheard a reference to employee retirement plans. After considering this new information, Katie begins to suspect that the CEO may be trying to influence board members' votes regarding the retirement plans.

Later that day, Jim Kariton asks Katie to review the financial statement notes and disclosures relating to the company's property, plant, equipment, and intangible assets. Katie notices that the notes describe the useful life of the patent as 17 years. She asks Jim Kariton whether this represents an appropriate estimate given the rapid change in technology. He immediately responds with the statement that "This is not a concern; we are amortizing the cost over the legal protection of the patent remaining at time of purchase." Katie doubts that this technology really will be useful for 17 years and offers to ask the engineering department to provide an updated estimate of the usefulness of the patent. Jim Kariton states that this not necessary and that any change in the useful life likely would be immaterial.

Katie decides to again mention her concerns regarding the planned increases in the discount rate and rate of return assumptions for the retirement benefit plans; the controller states that the increases are justified and that the CFO recommended them. Katie asks him whether the company is planning any future changes in the retirement plans. The controller indicates that he knows of no such plans and again asks her not to concern herself about these issues. He also hints that if financial results are favorable for the company he will recommend that she receive a bonus for all her hard work.

Katie decides to call the company's former controller at home to inform him of her promotion to assistant controller and perhaps gain some insights into the prior year discount rate change. After a few minutes of pleasant conversation, she asks him about the increase in the discount rate for 2006. The former controller tells her that "top management requested the change." He also says that he is enjoying retirement and his part-time teaching position at the State University. At the end of the conversation he advises her to be diligent about her new position and to always remember what the "CPA" and "CIA" certifications stand for. Katie feels that she has been subtlety warned. Katie is uncertain about what she should do.

REQUIRED

Answer the questions listed in the Assignments/Questions section of this case as assigned by your instructor. Provide concise answers and support all your statements.

ASSIGNMENTS/QUESTIONS:

Company-Case Specific Questions:

1. SFAS 158 changed how liabilities for pensions and other postretirement benefits must be calculated; as a result, some entities - including Mottins - that did not have to recognize related liabilities on their balance sheets under SFAS 87 and SFAS 106 must now do so under SFAS 158. What factor(s) account(s) for this difference?

2. How are underfunded pensions and other postretirement benefit obligations recognized on the balance sheet after adoption of SFAS 158? What was the effect on Mottins' balance sheet?

3. Why would increasing the discount rate assumptions affect the pension plan and health care plan liabilities recognized on the balance sheet? How would the planned increase in the rate of return on plan assets likely affect Mottins' financial statements? Do you believe that the changes in the rates requested by the controller and CFO are reasonable?

4. If Mottins Corporation had not increased its discount rate during 2006, how would its financial statements have differed? How did the change affect the company's stakeholders?

5. Review the authoritative literature regarding accounting changes and relate it to the discount rate and rate of return changes for pensions and other postretirement benefits. Under what circumstances are changes in estimates justifiable? Does the situation in this case meet the criteria?

6. Review the authoritative guidance regarding the amortization of intangible assets. What are the criteria for selecting the useful life of an intangible asset, such as a patent? Do you agree with Mottins' accounting treatment for its patent?

7. Evaluate the behavior of the individuals involved in this case from an ethical perspective. What are their ethical and professional responsibilities? What may be the motivation for their behavior?

8. Katie apparently feels uncomfortable with some of the accounting estimates and changes in estimates. What options does she have to address these issues and potentially solve her dilemma? What are Katie's professional responsibilities in this case?

9. What would you do if you were in Katie's position?

Researchable Questions:

1. Identify a large company that has been affected significantly by the implementation of SFAS 158. Briefly summarize the effect on the company's balance sheet.

2. What changes are expected under phase two of FASB's pension and other postretirement benefit project? How would these potential changes affect entities' financial statements?

3. What types of disclosures have to be made by the company regarding its benefit plans. List and briefly describe the types of disclosures required under SFAS 158, SFAS 106, and SFAS 87. Do you believe that these disclosures enhance the usefulness of the financial statements?

4. Can an error or "inaccurate" accounting estimate be ignored if the amount or change in the amount are immaterial? Refer to the authoritative guidance in your answer. Also relate your findings to Mottins' estimates.

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HDTV SYSTEMS

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CASE DESCRIPTION

The primary subject matter of HDTV Systems is capital budgeting within a mid-size electronics firm, and analysis of a possible merger with a large firm of international scale. HDTV Systems is recommended for students who have already had exposure to capital budgeting, cost of capital, and valuation techniques; thus, it is most appropriate for upper-level undergraduate students and second year graduate students. The case can be taught in two class hours, and student preparation should require no more than two hours.

CASE SYNOPSIS

This case involves both quantitative and qualitative aspects of capital budgeting in a firm whose principal owner desires growth and new products but finds constraints primarily due to the size of the company. The case begins with a description of HDTV Systems as a closely-held company with limitations to growth. It presents limitations to funding and shortfalls in analytical processes. Cash flow estimates for a new consumer television product are presented as well as the project's internal rate of return and payback period. The student will learn that capital budgeting is a complex process going beyond calculations of investment worth.

As the analysis of the capital expenditure is carried out, HDTV Systems entertains being acquired by Global Electronics. The combination is seen as perhaps offering a more realistic setting for the large capital expenditure for manufacturing the new television project. The case draws out financial motivations for the potential merger, as well as projections of free cash flow for HDTV Systems as a division of Global.

INTRODUCTION

Capital budgeting constitutes one of the most critical processes in any business enterprise that seeks to take advantage of market opportunities while meeting the needs of its customers and shareholders. The accuracy of the estimation of revenues and operating costs will impact the reliability of actual cash flows, and the comparison of projected cash flows with the cash flows that ultimately result casts a picture of financial health for the organization. Management has the responsibility to consider the challenges faced by the company to deliver profitable growth and cash generation in the midst of intense competition and increasing cost pressures.

BACKGROUND

HDTV Systems, an electronics company, has been in business for the past 25 years. Its founder, David Carlson, recognized an opportunity for a regional television manufacturing company to satisfy the growing needs of an emerging middle class in the U.S. Early product designs were simple but adequate and the firm prospered as limited competition existed at the time. But as technology became more advanced and consumer income rose, consumer demand included more features and better quality, and new firms entered the market to compete for a share of the expanding business.

To stay ahead of competition, HDTV Systems undertook an ambitious expansion of the business by designing new models in response to changing customer needs. The Company also increased production capacity in order to maintain its market share in the region. Following these years of heavy investing activity, David Carlson placed his eldest son George in charge of a special assignment to review all recent capital expenditures of the firm. George was asked to evaluate all the major capital proposals presented by the managers of the organization and determine, in retrospect, which ones had truly merited implementation on the basis of the analysis provided and the projected versus actual cash flows. These capital expenditures were made based on the internal rate of return (IRR) measure, as well as the payback period. He felt that the IRR addressed the revenues and operating costs, and if a project's IRR covered the cost of capital and had something left over, the firm should benefit. George viewed the payback period as an indication of how long the firm's investment was at risk; however, he was uncertain about how quickly a payback should be.

George's evaluation of prior capital expenditures indicated that the majority of the projects underperformed relative to projections. Worse yet, all of the projects with large dollar investment were producing cash flows below projections. Similarly, the majority of projects were not on target to achieve their originally estimated payback periods. George began to wonder how the Company's future profitability would look given the disappointing actual cash flows from recent capital expenditures.

In the summer of 2005, George and his father held a meeting to review the performance of the business to discuss which direction the firm should take going forward. It appeared to David that the competition seemed to be gaining a larger share of the market. In turn, his company needed to aim for even higher thresholds of return in each decision it entertained or else it would find itself an average performer amidst increasingly superior competition. David, who had worked so hard to build the company, was unsure that his son appreciated the seriousness of the situation following their review of actual results.

As a means to revive the company's financial performance, David and George began to explore the possibility of offering a new type of high definition television. They considered which components to make within the company, which to out-source, how to exploit the company's existing marketing/distribution channels, and product pricing. They estimated the following capital budgeting inputs:

- The project would have a total plant and equipment cost of $22 million, and one-time start-up costs of 5% of the plant and equipment costs.
- The estimated life of cash generation by the project was eight years.
- Expenses were estimated at 89% of revenues.
- MACRS seven year depreciation was used; a 37% marginal, blended federal and state income tax rate was used.
- Investment in working capital was projected at 20% of the change in revenues.
- Product price was $900, with expected unit sales as shown in Exhibit 1 below.

The high definition project was projected to earn a 13.5% IRR, which was very close to HDTV Systems 13% weighted average cost of capital. Also, the payback period was slightly over six years. While David wanted to move the company toward new products and becoming more profitable, he knew the analysis indicated the capital expenditure was only marginally feasible. He was also concerned that the actual cash flows from the project might fall short of predictions as other large projects had in the past. Last, he was concerned about the magnitude of funds that would have to be raised externally, and whether the cost of capital could turn out to be higher than 13% once the funds were sought and obtained. Ultimately, David decided to hold off on the project.

After long consideration, David decided to search for an outside buyer for the company which would have the resources and knowledge to insure the continued growth and prosperity of the organization after he was gone. He reasoned that a larger company could carry out his high definition television project more profitably through scale economies and access to lower cost capital. Along with a team of financial advisors, David began negotiating with a leading company in consumer electronics called Global Electronics.

From an operating point of view, there were a number of strengths that HDTV could bring to Global. First, HDTV Systems offered an opportunity to increase Global's business activity in a market where it has had a marginal presence. Global wanted to grow in various markets, and acquisitions appeared to be a cheaper and faster way to do so. HDTV has a product line similar to that of Global and had a distribution network in place as well as suppliers of long-standing. In addition, HDTV Systems' factories were filled with non-union workers, who were "cheaper" than its own workforce.

EXHIBIT 1 - Analysis of Capital Expenditure for Television Product by HDTV Systems

IRR (Internal Rate of Return) Inputs and Calculation (in millions)	
Inputs:	
Project Capital, 100% at Year 0	$22
Revenues are Estimated over Eight Years	
Expenses as a % of Revenues	89%
One-time up-front expenses as % of project costs	5%
Depreciation based on MACRS Seven Year Depreciable Life	
Working Capital based on Change in Revenues	20%
Tax Rate	37%
Salvage Value is included in Net Cash Flow on an after-tax basis	

Annual NCF = (Change in Rev. - Change in Exp. - Change in Deprec.) * (1 - Tax Rate) + Change in Deprec. - Change in Work. Cap.

Year	Change in Revenue	Change in Expenses	Change in Deprec.	Subtotal	Subtotal After Tax	Change in Deprec	Change in Work. Cap.	Salvage Value	Annual NCF	SUPPLEMENTAL DATA Year	Product Price	Expected Quantity	Cost per Unit[1]	Operating Margin[2]	Total Rev. (Millions)
0									-22.0						
1	31.5	29.1	3.1	-0.7	-0.5	3.1	6.3		-3.7	1	900.00	35,000	579.87	0.36	31.5
2	67.5	60.1	5.5	1.9	1.2	5.5	7.2		-0.5	2	900.00	75,000	550.83	0.39	67.5
3	109.5	97.5	3.7	8.3	5.2	3.7	8.4		0.6	3	900.00	121,667	524.00	0.42	109.5
4	123.0	109.5	2.9	10.7	6.7	2.9	2.7		6.9	4	900.00	136,667	517.81	0.42	123.0
5	180.0	160.2	2.0	17.8	11.2	2.0	11.4		1.8	5	900.00	200,000	510.87	0.43	180.0
6	163.5	145.5	2.0	16.0	10.1	2.0	-3.3		15.4	6	900.00	181,667	511.50	0.43	163.5
7	120.0	106.8	2.0	11.2	7.1	2.0	-8.7		17.7	7	900.00	133,333	513.99	0.43	120.0
8	82.5	73.4	0.9	8.2	5.2	0.9	-7.5	3.0	15.4	8	900.00	91,667	510.68	0.43	82.5

IRR = 13.5%

PAYBACK PERIOD INPUTS AND CALCULATION (in millions)

Payback = Year before Full Cost Recovery + (Unrecovered Cost at Beginning of Year / NCF Flow During Year)

Year	Annual NCF	Cumulative NCF
1	-3.7	-3.7
2	-0.5	-4.2
3	0.6	-3.6
4	6.9	3.3
5	1.8	5.1
6	15.4	20.5
7	17.7	38.2

Payback = 6.09 Y=years

Full cost recovery occurs just after the beginning of the sixth year.

Notes:

1. Cost per unit is based on the change in expenses including depreciation, on an after tax basis.
2. Operating Margin is based on product price and cost per unit.

In addition, acquiring HDTV meant one less competitor out of the picture and although it was a horizontal merger, it did not appear that there would be any antitrust issues raised given the size of HDTV relative to the total industry. HDTV management had good connections with the existing customers of the firm as well as suppliers, and thus, the operations of the division would not be disrupted by the acquisition.

Furthermore, HDTV had already begun exploring the possibility of introducing a new product on the market similar to the one that Global was thinking about, but HDTV was further ahead in its market analysis and engineering design. Global had enough debt capacity (including available lines of credit) and cash reserves on hand to pay for its acquisition and thus financing costs would be brought to a minimum.

As Global management began to analyze the value of HDTV Systems, financial statements of HDTV were obtained. Based on these statements and other analyses, Global management developed the necessary inputs to a discounted cash flow (DCF) approach to the valuation. Importantly, certain synergies were identified primarily involving reduction in administrative costs; however, from the viewpoint of an acquiring firm, these potential savings would be excluded from the initial offering price it is willing to pay for the target.

Global management used the following assumptions and estimates in developing a DCF-based value of HDTV Systems:

1. Base year sales (2005) of $250 million,
2. Growth rate in sales of 11.5% in the first forecasted year, and 5% per year thereafter,
3. Cost of goods sold at 51.8% of revenues based on historical cost of goods sold; this implies a gross profit of 48.2%,
4. Operating and administrative expenses at 42.5% of revenues,
5. Non-operating expenses at .2% of revenues,
6. Blended federal and state tax rate of 37%,
    - ♦ Depreciation at 2% of revenues,
    - ♦ Working capital at 3% of the change in revenues,
    - ♦ Capital expenditures for replacements at 3% of revenues,
    - ♦ A discount rate of 14%, and
    - ♦ Interest-bearing debt of $15 million.

Using this input data, a value calculation of the target was made based on discounted cash flows as shown below as Exhibit 2. The analysis indicates an equity value of HDTV Systems of $86,453,000.

Exhibit 2: Valuation Analysis of HDTV SYSTEMS Discounted Cash Flow Method Valuation

					(Dollar amounts are in thousands)					
Description	Basis for Forecast		Base Year Amount		Year 1	Year 2	Year 3	Year 4	Year 5	
Net Sales Revenue, growing annually	See Note		$250,000		$ 278,750	$ 292,688	$ 307,322	$ 322,688	$ 338,822	
Less: Cost of Goods Sold	51.8%	Revenue			144,393	151,612	159,193	167,152	175,510	
Gross Profit	48.2%				134,357	141,076	148,129	155,536	163,312	
Less: Operating & Admin. Expenses	42.5%	Revenue			118,469	124,392	130,612	137,142	143,999	
Less: Non-operating Expenses	0.2%				558	585	615	645	678	
EBIT					15,331	17,269	18,132	19,039	19,991	
Less: Blended Income Tax	37%	EBIT			5,672	6,390	6,709	7,045	7,397	
Subtotal					9,659	10,879	11,423	11,994	12,594	
Plus: Depreciation	2.0%	Revenue			5,575	5,854	6,146	6,454	6,776	
Less: Working Cap.	3.0%	Change in Rev.			863	418	439	461	484	
Subtotal					14,371	16,315	17,130	17,987	18,886	Residual
Less: Capital Expenditures, Replacements	3.00%	Revenue			8,363	8,781	9,220	9,681	10,165	Value
Free Cash Flow					$ 6,008	$ 7,535	$ 7,910	$ 8,307	$ 8,721	$ 130,815
Times: Discount Factor	12.0%				0.8929	0.7972	0.7118	0.6355	0.5674	0.5674
Discounted Cash Flow					$ 5,365	$ 6,007	$ 5,630	$ 5,279	$ 4,948	$ 74,224
Sum of Discounted Cash Flows					$ 101,453					
Less: Interest-bearing Debt					15,000					
Total Equity Value Indication					$ 86,453					

Note: Estimated growth rate of sales is 11.5% in year 1, and 5% annually in all subsequest years.

In late 2006, the firm was purchased for $79 million by Global Electronics. Global wanted the complementary products that HDTV Systems produced and also benefited from the well-established distribution network that HDTV Systems enjoyed. This new acquisition became known as the HDTV Division of Global Electronics. Global was also highly interested in the high definition television project that HDTV Systems had developed recently, but had postponed thus far.

INDIAN MOTORCYCLE COMPANY: STRATEGY FOR MARKET REENTRY

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CASE DESCRIPTION

The primary subject matter of this case concerns strategic management. Secondary issues examined include entrepreneurship. The case has a difficulty level of four, appropriate for senior level courses. The case is designed to be taught in two class hours and is expected to require two hours of outside preparation by students.

CASE SYNOPSIS

This case presents a an iconic U.S. firm, Indian Motorcycle Company, with a rich history that has ceased production three times in the past century and compromised the authenticity upon which the brand is based through a variety of ownership changes and market challenges. Indian Motorcycle Company most recently disillusioned consumers and distributors in 2004 by suddenly ceasing production, leaving distributors without products to sell, and leaving customers with unenforceable warranties. But currently, the British private equity firm, Stellican Limited, is attempting to restore the brand. Two of Stellican's partners, Steve Heese and Stephen Julius, have taken active management roles in the new Indian Motorcycle Company. Both have experience in reviving struggling brands. Indian will soon begin production of a motorcycle model, the Indian Chief, which hearkens back to the 1930s. Yet with three failures in its past, it is uncertain whether Stellican can bring the Indian brand back to life. Students must decide whether the reentry of this nostalgic brand will be successful in the highly competitive heavyweight cruiser segment of the U.S. motorcycle industry.

INTRODUCTION

Steve Heese and Stephen Julius, partners in the venture capital firm Stellican Limited, have faced similar challenges before but their current challenge is among the most difficult. They intend to resurrect Indian Motorcycle, a failed brand with a rich history. Despite a recent botched endeavor to regain its place among the motorcycle "cruiser" market, Indian Motorcycle once again will attempt to capture the market's attention.

Stellican Limited has purchased the rights to the Indian Motorcycle name. Stellican is not new to brand revival; the firm previously brought back to life other firms with bleak outlooks. Riva is an Italian yacht manufacturer with a 160-year history that nearly failed until Stellican acquired it. Chris Craft is an American boat manufacturer that Stellican revitalized. Even a dying Italian soccer franchise, Vicenza Calcia, found its footing after Stellican injected it with capital and took an active management role in rejuvenating the franchise. Still, will this collective experience be enough to challenge entrenched and emerging competitors in the American motorcycle industry? Julian believes he and Heese can accomplish this:

> "Great brands, if you do the right things with them, if you manage to fulfill a promise to the brand by creating a beautiful product, then the brand equity will come flooding to the surface very, very quickly. What Indian needs is to be treated right. Its past needs to be respected but its future needs to be recognized. If you can produce a blend of contemporary products which hark back and takes cues from the past, then you'll have a winning product."

LEGENDS AND STORIES

Factors setting Indian Motorcycle apart are the legends and stories embedded in its past. For example, its first corporate sale was to the New York City Department of Police. Police in New York had a recurring need to capture horses that had gotten away from their owners; Indian motorcycles provided the solution with motorcycles that were quick enough to round up the horses.

As the U.S. entered World War I, the military had a dire need for reliable and agile transportation. Indian Motorcycle agreed to suspend its production of consumer motorcycles to supply the defense department with over 41,000 motorcycles to meet the need. This sparked the firm's reputation as a company committed to patriotism and sacrifice (even though they profited greatly from the military contract). Indian Motorcycle again received a Department of Defense contract in World War II, further reinforcing this image.

A competency Indian Motorcycle gained during World War I was the ability to make extremely nimble and responsive cycles despite the reputation it later gained as a heavy, lethargic cruising motorcycle. Among its early models, however, the Indian Scout was noted for excellent handling. Stunt riders frequently chose the Scout as the preferred model for wall-of-death stunts where riders would ride horizontally in a large enclosed wooden cylinder. This wall-of-death stunt is still performed today at the Sturgis Motorcycle Rally in South Dakota, the largest annual motorcycle rally in the U.S.

Much later, Indian Motorcycle gained attention when its bikes were used in Hollywood productions such as *Terminaor 3*, *Cat in the Hat*, and *Scooby Doo 2*. Recently, *The World's Fastest*

Indian recounted the life of Burt Munro of New Zealand who set the motorcycle world speed record in 1967 on a 1920 Indian Motorcycle he had rebuilt over a number of years.

A CHECKERED PAST OF THREE FAILURES

The First Ending, 1901-1953

Indian Motorcycle was the first company to mass produce motorcycles in the United States beginning in 1901, two years before current market leader Harley-Davidson Motor Company. Two bicycle racers, George Hendee and Oscar Hedström, founded the firm and in just three years Indian Motorcycle received the Gold Medal for Mechanical Excellence just as Harley-Davidson was getting off the ground. This was the same year Indian Motorcycle came out as the leader of Great Britain's Reliability Trial, a 1,000-mile endurance race.

By 1914, the firm had 3,000 employees producing over 32,000 motorcycles annually at its Massachusetts seven-mile long assembly plant commonly referred to as "the wigwam." Although the original name of the firm was the Hendee Manufacturing Company, as model lines were expanded and eventually included motorcycles such as the Indian Chief, the Scout, the Warrior, and the Arrow, the firm took on the Indian Motorcycle name. While the firm had no direct connection to American Indian tribes, each new model name was an effort to be emblematic of U.S. heritage.

In 1938, Hap Alzina, owner of an Indian Motorcycle distributor, narrowly missed beating Harley-Davidson's land speed record at the Bonneville Salt Flats in Utah by only 1 mph (although Burt Munro set the record on an Indian in 1967). This slight miss in 1938 became prescient of Indian Motorcycle's future. The firm's profitability and liquidity began to unravel as competition from Harley-Davidson and other motorcycle manufacturers, together with the substitution threat from Henry Ford's Model T automobile, resulted in pricing pressure within the industry. In addition, the Great Depression followed later by World War II hurt American consumers' discretionary income reducing sales of nonessential consumer purchases. This combination of competition, substitute products, and reduction in consumer discretionary income magnified Indian Motorcycle's liquidity and profitability problems.

At the end of the Great Depression, E. Paul DuPont acquired Indian Motorcycle and saved it from bankruptcy. This coincided with the latter part of the art deco period in American history and influenced DuPont's motorcycle styling concerns. Indian Motorcycle under DuPont's direction incorporated art deco styling with its now-classic deep fender skirts, seat fringe, and the look that became associated with historical biker traditions.

In 1945, Torque Engineering Company acquired Indian Motorcycle from DuPont. Increases in consumer spending after World War II were not enough to buoy sagging motorcycle sales forcing Torque to divide the firm into the Atlas Corporation as the manufacturer and Indian Sales

Corporation as distributor. However, this restructuring initiative was unable to restore the company to its former profitability. Production in the Massachusetts plant was discontinued in 1953.

The Second Ending, 1954-1985

The private British firm, Brockhouse Limited, bought the rights to the Indian Motorcycle name and its remaining assets in 1954 after U.S. production ceased. Brockhouse ran an ad in the U.S. stating: “After many moons…a brand new Indian.” This ad was intentionally designed to capture the Indian Motorcycle tradition and continue the trust American motorcycle enthusiasts had placed in the firm.

Brockhouse maintained Indian Motorcycle’s U.S. distribution network but moved production to England through a joint venture with Royal Enfield, a British motorcycle manufacturer (now located in India). Rather than producing “a brand new Indian” as promised, Brockhouse simply rebranded Royal Enfield motorcycles. Royal Enfields that were shipped to U.S. distributors bore the classic Indian Motorcycle badge with Indian script on the gas tank. This was an attempt to capitalize on the Indian Motorcycle heritage while also leveraging the market popularity of British motorcycle manufacturers such as Triumph, BSA, and Norton. These firms were gaining market share in the U.S.; Brockhouse believed that branding its motorcycles to link the past with the present was key to increasing sales among American bikers. Brockhouse’s Royal Enfields continued the tradition of purloining Native American history by introducing new models with names such as the Tomahawk, Apache, and Fire Arrow.

However, U.S. bikers quickly recognized that the new Indians were not traditional American motorcycles but rather British bikes with different names. Although other British bikes had a loyal following in the U.S., the Royal Enfield Indians soon became known as a “knock-off” brand. Among U.S. bikers, authenticity was among the most important features. A British motorcycle feigning an American tradition had difficulty penetrating this core biker market.

Toward the end of the 1960s, Brockhouse realized its strategy was failing. The Indian brand had mostly disappeared as the distribution network dried up from lack of sales. At this time, Floyd Clymer, a wealthy American who had been an Indian Motorcycle distributor, a motorcycle racer sponsored by Harley-Davidson, and owner of the renowned *Cycle* trade magazine, attempted to save the brand. Clymer valued the traditions set by Indian Motorcycle in its pre-1954 era and attempted to restore the authenticity by reviving the Indian Scout model. Clymer wanted to improve the quality as well as restore the brand to its roots and this, paradoxically, led to its downfall. Clymer utilized a German-built frame that was state-of-the-art at the time but combined this with an older model engine. This attempt to link the old with the new, although advertised heavily, never gained the momentum to even make it to production.

Clymer then took a different approach and targeted the sport bike market composed of motorcyclists who were less steeped in loyalty to American motorcycle brands and instead were more impressed with performance regardless of country of manufacture or origin. Clymer put together an Italian high-performance frame sourced from Italjet with a top-of-the-line engine sourced from Royal Enfield. Additional parts were sourced from other German, Italian and, and British firms. After producing less than 100 of these motorcycles, Clymer died, leaving the vision of an Indian-branded high-performance sport bike unfulfilled.

Clymer's attorney, Alan Newman, took over where Clymer left off. But rather than aiming for the large-bore cruiser market, Newman saw more potential in the minibike and small transportation market. He opened a factory in Taiwan and sold 20,000 bikes in the 1972-1973 model year. While not near Indian's peak during its glory days—its single year record sales were set in 1913 at 32,000 units—this was still a profitable venture. Newman cashed out in 1977 by selling the rights and assets to American Moped Associates, a firm that continued production in Taiwan until selling in 1982.

By this time, the original concept that had gained such popularity in the first half of the century was far removed from the then-current production model. Indian Motorcycle had lost its authenticity and now was just another small bike producer competing with Honda, Kawasaki, Yamaha, Suzuki and other mass producers. What was left of the Indian Motorcycle brand folded in 1985 as competition compressed profit margins and contracted market share.

The Third Ending, 1998-2004

Murray Smith, backed by $22 million in venture capital funding, bought the Indian Motorcycle trademark in 1998. Production began promptly in 1999 with the Indian Chief, a large cruiser model designed to replicate the famed model of the art deco era. The board of directors, however, fired Smith after only one year when the board and Smith clashed over the strategic direction of the new venture. Smith wanted to leverage the Indian Motorcycle brand into a restaurant franchise and develop a line of Indian-branded cologne and other merchandise. The board believed the most promising approach was to focus initially on the motorcycle itself rather than diversification into other product and service lines.

In 2000, the company achieved sales of $90 million. In 2001, Frank O'Connell, formerly a top management member at both Reebok and then Gibson Greetings, bought private equity firm Audux Group and subsequently injected $45 million into Indian Motorcycle Company thereby acquiring a controlling interest in the firm. Smith told *Fortune* magazine, "To bring back a legend is the sexiest thing in the world."

Also in 2001, Indian Motorcycle Company reintroduced the Indian Scout and the Indian Spirit, both smaller than the Chief but still targeting the cruiser market. The company believed the best strategy was to get production up quickly by assembling outsourced components with intentions to subsequently produce major components such as a proprietary engine as the firm developed. Engines were originally sourced from S&S Cycle, an American manufacturer, while Indian's R&D

engineers were designing a motor. The new proprietary engine was introduced in the 2002 model year.

"To bring back a legend is the sexiest thing in the world" but it may also be the impossible dream, at least at this point in Indian's evolution. During the 2004 model year, Indian produced only 40 motorcycles then suddenly announced it was discontinuing business. This left bikers who had purchased Indian motorcycles since 1999 with no authorized service dealers and warranties that no longer had any backing. Distributors were left with no bikes to sell. Once again the reputation of Indian Motorcycle was tarnished.

THE CRUISER SEGMENT OF THE U.S. MOTORCYCLE INDUSTRY

The new Indian Motorcycle Company is now thinking carefully about segmentation within the cruiser niche of the U.S. motorcycle market. Harley-Davidson is the incumbent with historical similarities to Indian but with a huge market lead and a very established distribution network. Harley-Davidson—among the most recognizable brands in the world—currently has 49% of the heavyweight, or cruiser, segment of U.S. motorcycle sales. Victory Motorcycles is a division of Polaris started in 1998 that can, along with Indian and Harley-Davidson, claim that it is an American motorcycle company with headquarters in Minnesota (this tends to have consumer appeal in the cruiser market segment). Non-U.S. firms that target the motorcycle cruiser market such as Honda, Yamaha, Kawasaki, and Suzuki have established a strong following among cruiser buyers. These firms have taken styling cues from Harley-Davidson and combined them with distribution and manufacturing scale to drive cost reductions. Still, these manufacturers' motorcycles tend not to have the esteem of the market leader, Harley-Davidson, within the cruiser segment of the market. Boutique firms such as Orange County Choppers and Mad Dog make custom, one-of-a-kind motorcycles. For example, Orange County Choppers recently built a chopper with a built in guitar amplifier for Hartley Peavey, founder and CEO of the acoustic industry specialty firm Peavey Electronics. These custom motorcycles tend to have considerable esteem and status among bikers; however, the one-off custom manufacturing process eliminates the scale efficiencies of the mass producers. Prices can be more than ten times as much as a top-of-the-line Harley-Davidson or Victory motorcycle. Thus, the boutique firms aim for the upscale market within the cruiser segment of the motorcycle industry.

The cruiser segment of the U.S. motorcycle industry is growing by about 5%. Higher growth areas are overseas. The European cruiser segment, for example, is expanding at a 14% rate although analysts predict this will slow over the next few years. All manufacturers except the boutique firms are taking advantage of this disparity by enlarging overseas distribution networks. Still, U.S. personal discretionary income is high relative to many other parts of the world; U.S. sales currently generate 30% of total motorcycle manufacturer revenues even though the U.S. accounts for only 7% of global motorcycle unit volume. The new Indian Motorcycle Company has future plans to expand into international markets, but the near-term strategy is to focus reintroduction in the U.S. This is as much a practical concern as a market concern; a driving priority for Indian is development of a network of dealers in the U.S.

Several factors are likely to affect the U.S. cruiser market. Consumer confidence is a key economic driver of sales. If personal income rates stagnate and unemployment rates increase, discretionary purchases such as motorcycles will be hit hard. Some analysts believe an aging baby boomer population will dampen demand for future U.S. motorcycle sales as health problems prohibit the ability of some among this demographic group to ride motorcycles (the average age of motorcyclists is currently 42-years-old). On the other hand, as baby boomers retire they also gain increased free time to ride motorcycles. In either case, only 1.1% of U.S. bikers ride their motorcycles to work providing support that, for many individuals, motorcycle purchases are discretionary rather than necessary. Economic and demographic factors that can constrain discretionary income thus can have a heavy impact on motorcycle demand.

PREPARING FOR REINTRODUCTION

After Indian Motorcycle Company failed for the third time in 2004, Steve Heese, president, and Stephen Julius, chairman, purchased the rights to the Indian brand name through the venture capital firm Stellican Limited. However, they realize it will take much more than simply leveraging the brand of the past to build a successful company for the future. Both executives are well aware of Indian's past successes and failures. Still, they are firmly committed to bringing back the iconic legacy. Stellican has recently backed up this commitment with $30 million of additional funding beyond that paid for the initial brand name rights. Julius states:

> "This capital increase is a clear demonstration of our significant commitment to the successful future of Indian Motorcycle. It ensures that the Company has the proper financial foundation. However, the success of Indian Motorcycle will not be based on capital alone. Recruiting a world-class management team and following the appropriate business strategy are paramount."

Currently, Indian has a 40,000 square foot manufacturing plant in Kings Mountain, North Carolina with room for expansion of up to 125,000 square feet.

Steve Heese, as Indian's current president, brings substantial experience in reviving deteriorated brands. He is a partner with Stellican Limited and also president of Chris Craft, a formerly struggling boat manufacturer Heese was able to reposition Chris Craft as a stable manufacturer in the boating industry. Stephen Julius is chairman of Chris Craft. The combined talent of the Heese-Julius management team makes Indian Motorcycles a formidable competitor if they can overcome the mistakes of the past. Both Hees eand Julius were involved when Stellican Limited turned around the Italian yacht manufacturer Riva and the Italian soccer franchise Vicenza Calcia. Together, Heese and Julius bring decades of cumulative experience to successful brand reentry.

Yet, it will take more than these two executives to successfully bring the Indian back to life. Heese and Julius were successful in recruiting Geoff Burgess as Vice President of Product Development and Engineering. Burgess, ironically, was previously Director of Product Development at S&S Cycle from whom Indian sourced its engines in 1999 and 2000. Getting Burgess to join Indian was a major win. In addition to his work at S&S Cycle, Burgess has held product development posts at Victory Motorcycles, Global Motorsports Group, and others. As of May 2007, Indian had employed only 14 engineers but plans to increase this to 200 in the near future. Recently, Indian hired Nick Glaja, a 27 year veteran in the motorcycle industry, as Vice-President of Engineering.

Indian will begin with only once model line, the Indian Chief. The Chief may have a few product variations, but near-term plans include only this single model. Future plans are not yet definitive but will likely include other model lines such as the Scout.

Indian has been marketing its introduction rather quietly. The top management team realizes that Indian's most recent failure in 2004 was in part due to over-promising and under-delivering. The current team is attempting to avoid making promises that seem too ambitious, worrying that potential consumers, and especially distributors who remember when the former Indian Motorcycle Company left them hanging, will see the new Indian Motorcycle Company as just a specter of the past. Instead of aggressive advertising, the new Indian has utilized a grass roots model. The company has been catering to current Indian owners groups such as the Iron Indian Riders Association. Indian has also taken the unusual step of promising availability of a new 2009 Indian Chief for a $1,000 deposit made through the company website. The uniqueness of this is that potential buyers will not know the final price, motorcycle specifications, or any other details until production begins even though they must pay their $1,000 deposit upfront.

FUTURE CHALLENGES

The company claims in a recent press release:

> "There is a considerable consumer base for a premium line of motorcycles under the Indian Motorcycle brand, which has an almost cult-like status amongst many consumers. The company will focus on supplying genuine, American made, motorcycles which are beautifully designed, made of the highest quality materials, reliable and supported by a qualified dealer network."

This presents some assumptions, however. Those who remember first hand the "cult-like" status of the original Indian Motorcycles are well into their 60s or beyond given that the last of the "authentic" Indians were produced in 1953. No doubt there is a consumer base that desires premium motorcycles, but will Indian be able to penetrate markets with established incumbents such as Harley-Davidson? The recent rebranding by Yamaha of its Star motorcycle line competes in this same market space. A relative newcomer to the cruiser market, Victory (owned by Polaris) has also established a strong foothold in this same target market with excellent quality ratings by J.D. Power and Associates. Will another newcomer such as Indian be able to achieve quality levels at the outset necessary to win over consumers and distributors who were burned by Indian's sudden closure in 2004? And will a single model line in the near term, the Indian Chief, be enough to convince potential customers and distributors that Indian is here to stay?

Stephen Julius has promised that "this is a 10, 15, 20-year project, this is not a 12-month project…There's no magic to this. We've just got to do it right, slowly, carefully, take our time and not think that it's going to happen overnight." Julius points out that the problem with the most recent Indian Motorcycle during the 1999-2004 period was that "they just felt that it could be done instantly and it can't." Given this history, why has Stellican Limited chosen Indian when there are numerous other investment alternatives?

Indian has failed on numerous occasions in the past, yet the top management team of Steve Heese and Stephen Julius has succeeded in similar situations just as often. Combined with the motorcycle product development expertise of Geoff Burgess and the engineering expertise of Nick Glaja, Indian has a highly competent group leading its strategic initiatives. With the financial backing of Stellican Limited, Indian may once again have a chance to pierce the American cruiser market segment. Still, is this enough? Heese and Julius now face the combined challenges of moving from design to development, creating a distribution network, and regaining the confidence of the American cruiser market despite past failures.

Stephen Julius recently reported to potential customers: "We are honored and inspired by your patience and continued commitment to the resurgence of Indian Motorcycle. We feel certain that we will surpass your expectations with our world-class staff, sound engineering platform and selection of dealers committed to premium service." Time will tell.

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BETTER FACTORIES CAMBODIA: BUILDING A COUNTRY VOID OF SWEATSHOPS

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CASE DESCRIPTION

The primary subject matter of this case concerns overseas manufacturing and the conditions under which employees work. Secondary issues examined include economic development, social responsibility, and strategic management. The case has a difficulty level of three, appropriate for junior level students. The case is designed to be taught in one class hour and is expected to require three hours of outside preparation by students.

CASE SYNOPSIS

Better Factories Cambodia is an organization that seeks to increase employment in Cambodia by certifying that products produced in registered manufacturing companies meet minimum employment standards. The organization has certified over 200 manufacturing firms and presents itself as a model for other developing countries. Questions remain concerning the legitimacy of the certification process and the perceived value that foreign companies and their customers place on socially responsible manufacturing.

BETTER FACTORIES CAMBODIA

Many of the employees who work in Cambodian factories do not earn enough money to afford the goods they produce. The young women in Cambodia who work in the garment industry sewing Disney characters onto pajamas cannot afford the products they are making. Many do not even know much about the likes of Mickey Mouse, Cinderella, or the other treasured Disney characters. Working long hours for low pay, under less than ideal working conditions, is common in Cambodia. Even though government imposed minimum wage levels and working conditions are very low by Western standards, getting employers to honor those standards has been difficult. International companies that contract with manufacturers in developing countries have increasingly come under scrutiny by consumer groups because of the poor working conditions and employment practices of those local manufacturers. One country which is trying to improve the working conditions of its citizens and improver its image is Cambodia.

Cambodia is located in Southeast Asia and borders Vietnam to the east, Thailand to the west, and Laos to the north (Figures 1 and 2 in Appendix). Cambodia's 14 million inhabitants are some of the poorest people in the region, and have suffered some of the worst experiences in recent human history. Cambodia gained its independence from France in 1953 and experienced war and major political upheaval until free elections were conducted in 1993. Cambodia was an unwilling participant in the military conflict between Vietnam and the United States, and for a time, was occupied by Vietnamese forces. Under the regime of the Khmer Rouge and its leader Pol Pot, Cambodia experienced the horrors of genocide and the starvation of its people. Cities were evacuated and educated people were considered enemies of the state. Mass executions and starvation resulted in the deaths of an estimated 1.7 million to 3 million people. With a peace accord signed in 1991, and elections held in 1993, Cambodia began the long process of rebuilding itself. The garment industry of Cambodia is a major export for the country and employs hundreds of thousands of Cambodians. Cambodia, with a per capita GDP of only $450 seeks to become a competitive location for low wage manufacturing. One of the areas in which Cambodian leaders see promise for improved economic conditions in their country is in low-skilled manufacturing. Wage levels are very low in Cambodia (minimum wage of $45 per month for a 48 hour work week) and government leaders feel this advantage can attract foreign contract manufacturing opportunities. One concern, however, is the perception that Cambodian factories are little more than sweatshop operations in which workers are exploited due to their desperate economic situation.

Better Factories Cambodia was established as a result of a trade agreement between the United States and Cambodia. Under the agreement, the United States agreed to increased market access for Cambodian goods if these goods would be produced under better working conditions. Better Factories Cambodia became a project of the International Labour Organization (ILO), a specialized agency of the United Nations (UN) which seeks to promote social justice, human rights, and better working conditions. The ILO, headquartered in Geneva, sets minimum standards for employment such as freedom of association and the right to unionize, equal employment opportunity, and humane working conditions and pay. One of the core beliefs of the ILO is that "poverty anywhere constitutes a danger to prosperity everywhere." The ILO has been working to improve the living conditions of workers in developing countries, and partners with other organizations to implement and enforce generally agreed upon employment standards. While wage levels in Cambodia are low, the country is in a less competitive position overall in terms of being a desirable manufacturing environment. Cambodia, with its recent political past has a poor image in the minds of many foreign companies. The country's infrastructure is less than ideal and worker productivity, while reasonable by developing country standards, is lower than China and Vietnam. Better Factories Cambodia seeks to increase the competitiveness of the country by focusing on the issue of image and making the country competitive with its neighbors through good employment standards.

Better Factories Cambodia is managed by the ILO and supported by the government of Cambodia. The organization monitors the employment practices of manufacturing firms in the country and has certified over 200 companies, meaning that they meet the basic international standards for humane employment practices. An incentive for company participation is the requirement of certification in order to gain an export license from the government. Participating companies sign a memorandum of understanding in which they agree to abide by certain employment standards and open their factories to inspection. Better Factories Cambodia conducts unannounced factory inspections and uses a 500 item checklist in its inspections. The audit covers issues such as wages, hours, child labor, and worker safety. Auditors, who have been trained in Cambodian and international employment standards, inspect the factories and conduct interviews with employees both on and away from the worksite. The results of the audits are available for public inspection through the website of Better Factories Cambodia. The estimated cost of the program is less than $3 per employee per year and the program is supported by the government of Cambodia and a number of international companies such as Disney, Nike, Adidas, and Levi Strauss. Better Factories Cambodia competes with other auditing agencies such as Social Accountability International (SAI) which certifies companies with its SA 8000 designation, and with the auditing processes of separate international companies such as Wal-Mart who conduct their own audits of companies that make the products they sell.

One area of concern is the reliability and credibility of the auditing process. In China, where more attention has been directed recently to labor conditions and social auditing, a number of cases of corruption in the auditing process have been uncovered. It appears that manufacturers keep separate records concerning wages and working conditions and regularly instruct their employees on how to respond to the questions posed by the auditors. In some cases much of the work is subcontracted to other firms that are hidden from the auditing process. Few workers in developing countries are inclined to speak honestly to outsiders if they feel that such action will result in possible job loss. Many of the workers have little opportunity for other employment. In many developing countries factory workers come from rural parts of the country and are willing to endure long work hours with low pay due to the lack of better opportunities. Some producers complain that the standards increase their costs which they are not able to pass on to their international buyers. One such contractor, Ron Chang of Shoetown Footwear states, "We can't ask Nike to increase our price. How can we afford to pay the higher salary?" Some critics of the system argue that companies such as Wal-Mart and Nike continue to demand lower prices from their suppliers and this increases the likelihood that manufacturers will find ways of cheating the auditing system. Factories owned and directly controlled by international companies operating in developing countries seem to experience fewer problems with unethical and illegal employment practices.

Better Factories Cambodia is on a mission - to rid Cambodia of sweatshops and to be the model country in terms of socially responsible manufacturing. The organization hopes that by creating an image of a sweatshop free country, Cambodia will be able to effectively compete for international manufacturing contracts.

DISCUSSION QUESTIONS

1. Do consumers care how the goods they purchase were produced? Should they care?
2. Rank the following participants in terms of responsibility for insuring humane working conditions in foreign manufacturing operations: consumers, local manufacturing management, multinational firms who contract the production, local governments.
3. Do you think Better Factories Cambodia will be successful? What can the organization do to insure the completion of its mission?

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APPENDIX

Figure 1

Figure 2
Southeast Asia

Source: U.S. State Department

GOING TO MARKET WITH A NEW PRODUCT: ST. LAWRENCE ISLAND, ALASKA

Wayne A. Roberts, Jr., Southern Utah University

CASE DESCRIPTION

The primary subject matter of this case concerns the evaluation of alternative channels of distribution for a proposed new business. Secondary issues that can be examined include pricing through channels, the marketing concept and real world considerations, and information collection and analysis. The case has a difficulty level of 3 to 4. The case is designed to be taught in 1/2 to 1 class hour and is expected to require anywhere from no outside preparation to 1 hour of outside preparation by students, depending on how the case is presented. If desired, the case can easily be expanded to cover logistics issues.

CASE SYNOPSIS

St. Lawrence Island, Alaska, located in the Bering Sea, is actually closer to Russia than Alaska. There is very little economic activity on the island, and the native villages of Savoonga and Gambell are very interested in finding opportunities to generate much-needed cash and employment opportunities for their children.

One resource the island has is seaweed. A market study done on behalf of St. Lawrence Island indicates the health food market has been growing over 15%/year and that 30% of health food consumers purchased seaweed vegetables within the past year. One popular seaweed product, kombu, comes from a seaweed available in abundance around St. Lawrence Island.

This case describes the channels of distribution associated with this market, along with representative pricing, and asks students to evaluate three channel alternatives open to the St. Lawrence Islanders. The proposed alternatives can be evaluated by a number of criteria, such as economic (cash flow levels and risk), adaptability, and control. Important aspects of channel and buyer behavior uncovered during the market study are available, and may be given during the discussion regarding the alternatives.

The case may be introduced verbally and evaluated through the lecture format, or if desired, students may be required to read the case and respond to questions prior to class.

This interesting, simple case clearly demonstrates channel members perform functions that someone has to perform, and if a level is cut the functions need to be shifted to someone else.

Further, the best channel choice for an organization hinges on the relative strengths and weaknesses of the organization.

INTRODUCTION

St. Lawrence Island (SLI) is located more than 100 miles off the mainland of Alaska in the Bering Sea, less than 40 miles from Siberia. Temperature extremes vary from less than 30 degrees below zero to a record 67 degrees Fahrenheit. From mid-November to May the island is locked in Bering Sea ice, and the winds average over 15 mph. Mammals on the island include fox and a large unmanaged reindeer herd. The reindeer were introduced to the island in 1900. There are no docks on the island, and any materials brought in have to be either off-loaded the occasional barge via small boats or flown into one of the two small airstrips.

There are two villages, Gambell and Savoonga, on this isolated island. Interestingly, the distance between the two settlements is greater than the distance between Gambell and Siberia. Fewer than 700 Yup'ik Eskimos live in each village. The people predominantly follow a subsistence lifestyle, hunting and living off of walrus, seal, whales and fish. A very few people hold commercial fishing permits, and there is a small fish processing facility in Savoonga. Cash is derived from selling ivory carvings, archaeological artifacts, and from a few seasonal bird watchers. While most homes in Gambell now are tied into a water and sewer system, at the time of the case a sizable proportion of homes in Savoonga still relied on hauling water and on honey buckets, which are nothing more than sewage pails which must be hauled out and emptied.

The residents of St. Lawrence Island need cash for electricity, snowmobiles, rifles, and many other goods. Further, villagers are concerned about the lack of opportunities for the younger people. Young adults often migrate to larger cities on the mainland in the search for employment, and without viable opportunities on the island the communities might wither. Therefore there is a high degree of interest in finding suitable economic opportunities.

NEW BUSINESS OPPORTUNITY

An entrepreneurial-minded individual from Fairbanks, Alaska, noted the quantities of seaweed that grew around the island, and suggested that the St. Lawrence Islanders explore the opportunity to harvest and market them. Following up on this suggestion, the Islanders, through the Alaska Department of Community and Regional Affairs, issued a request for proposals. A team was hired to do two things: first, to inventory the types and quantities of seaweed that grow around the island, and second, to explore market opportunities for the seaweed species that occurred in large enough quantities.

As it turns out, a very common type of seaweed in the area, genus Laminaria, is used commercially in several ways: for extractives (which is used in beer, frostings, dental material, toothpaste), as fertilizer, as fodder, and for food (kombu). The highest value use is as a food. The Japanese use it to flavor soups and casseroles, have kombu candy, and eat it plain. Koreans, Chinese, and other Asian nations also eat kombu. It should be noted that for Asian kombu consumers a little amount went a long ways; most packaged kombu was in approximately 8 ounce packages.

With regard to the food market, a number of options were examined. The possibility of exporting the seaweed to Japan was rejected, given that Japan already has a mature kombu industry and is tightly controlled; one bureaucrat could decide to disallow the importing of St. Lawrence Island kombu at any time. Further, discussions with Japanese industry participants led the research team to believe that the fact that the seaweed came from pristine Alaskan waters harvested by natives would not bestow any differential advantages to St. Lawrence Island kombu: Industry representatives believe that taste was the most important product attribute, and their assessment of the taste of St. Lawrence Island seaweed was that it was not exceptional, or even above average.

Selling to Asians in America, and to Japanese restaurants in the U. S., was also considered. However, this did not appear to be promising. Japanese restaurants bought supplies from wholesalers that already had adequate supplies and were not interested. Visits to ethnic grocery stores were likewise not encouraging; Korean stores stocked Korean kombu, and Japanese stores stocked Japanese kombu. Uwajimaya, a rather large Asian foods grocery store in Seattle, stocked Japanese kombu in a Japanese products aisle, Korean kombu in a Korean products aisle, and Chinese kombu in a Chinese products aisle. Store personnel said that customers bought products from their home country.

One market that appeared to be promising was the U.S. health food market. Health food sales were increasing over 15% per year, health food stores were increasing in number and sophistication, and seaweed products were beginning to be retailed through health food stores. Prices were higher than for Asian-produced kombu, the products came from U. S. companies targeting health conscious consumers, and the field did not appear to be saturated with competitors. Significantly, it was estimated that 30% of health food consumers had purchased seaweed products within the previous year. It appeared that health food kombu was in the introductory, or perhaps the beginnings of the growth stage, of its product life cycle.

Based on personal interviews and observations, the typical channel of distribution for health food products is as follows: Raw materials, such as seaweed, go from harvesters/growers to manufacturers, who package, label and sell a final product to wholesalers/distributors, which in turn is sold and distributed to retailers, who sell to final consumers. For an item that retails for $10.00, health food stores typically pay wholesalers/distributors between $6.00 and $7.00. The wholesalers/distributors would typically pay manufacturers between $4.50 and $5.25 for the item. The raw materials costs manufacturers pay to suppliers would run between $2.25 and $3.95.

ALTERNATIVES

With this information, a group got together to discuss what the tentative scope of the new business should be. Three alternative models were raised for consideration:

Alternative 1

The first model called for St. Lawrence Islanders to simply harvest, dry, and bundle the kombu for sale to one or more health food manufacturers.

Alternative 2

The second alternative entailed turning the bulk kombu into a final packaged product, which would then be sold directly to retailers. The thought was that St. Lawrence Islanders could cut out the manufacturers and wholesalers, and keep more of the revenue and profit for themselves.

Alternative 3

The third alternative called for selling the final packaged product directly to consumers. In this model, the St. Lawrence Islanders could keep all the revenue for themselves.

CASE QUESTIONS

1. For the first alternative, consisting of focusing on harvesting and selling bulk seaweed to manufacturers, what exactly would the St. Lawrence Island business have to do with regard to the product, pricing, and promotion? Assuming pursuing this would be successful, how many channel relationships would have to be maintained? Success, under this alternative, would depend on what?

2. For the second alternative, which consists of selling a finished product to retailers, what additional tasks and activities have to be done with regard to the product, pricing, and promotion? Assuming pursuing this would be successful, how many channel relationships would have to be maintained? Success, if this alternative is pursued, would depend on what?

3. For the third alternative, which consists of cutting out the retailer and selling the final packaged product directly to consumers, what tasks and activities would have to be done beyond what would be required under the second alternative with regard to the product, pricing, and promotion? Success, if this alternative is pursued, would depend on what?

4. Roughly, what could the new firm expect with regard to sales and costs in the short term, and the long term, under each alternative? Why? What sort of investments in people, equipment, and systems are associated with each alternative? What are the risks under each alternative?

5. What sort of investments in people, equipment, and systems are associated with each alternative? What are the risks under each alternative?

6. Recognizing that additional research is required, which alternative do you think represents the best bet for the islanders? Why?

ACME ELECTRONICS

Carol Docan, California State University, Northridge
Richard Gunther, California State University Northridge
Leonard Rymsza, California State University Northridge

CASE DESCRIPTION

The primary subject matter of this case concerns business law and statistical analysis. Secondary issues examine negligence vs. negligence per se; cause in fact; contributory vs. comparative negligence; statute of limitations; and statistical analysis involving proportions and expected value. The case also presents strategic thinking and ethical issues related to business conduct and their affects on consumers.

The case has a difficulty of level three, appropriate for junior level courses. The case is intended to be taught in three class hours, including a class presentation by student teams. The case is expected to require a minimum of three hours of outside preparation by student teams that present a report.

This case is designed for use in an upper division inter-disciplinary business course. The purpose of the course is to enable students to utilize knowledge they have gained in their lower division core business courses that include one business law course and one statistics course. However, the case can be easily modified for use as an in class or take-home assignment in an introductory business law course by eliminating the Case B Questions on statistics.

CASE SYNOPSIS

Students are presented with a factual setting that they can identify with quickly. A consumer's computer hard drive "crashes" presenting immediate concerns. Can the computer be repaired and the hard drive replaced? Will the repairs be covered under warranty? Can the data be retrieved? If so, at what cost?

The consumer takes his computer to the repair department of the retailer where he originally purchased the computer. He learns that the "crashed" hard drive (defective drive) can be easily replaced with a new hard drive. However, the repair department is not equipped to retrieve data from the defective drive. The consumer is assured that the defective drive will be returned to him and he is given the name and telephone number of an individual who specializes in the retrieval of data from crashed hard drives.

After the repairs have been completed, the consumer picks up his computer and what he believes to be the defective drive from his computer. The consumer takes the defective drive to the data retrieval specialist who is able to retrieve about 90% of the data from the defective drive. The consumer is excited. He pays the specialist for his services and returns home to view the retrieved data. The excitement of retrieval quickly turns to disappointment when the consumer discovers that the data retrieved from the defective drive is not his data.

The consumer is able to trace the problem to a mix-up at the computer repair department. Apparently the hard drive the consumer received was not from his computer. By the time the mix-up was discovered it was impossible to trace the whereabouts of the consumer's drive and he is resigned to the fact that the data is lost.

The consumer has spent $800 to recover data from a defective drive that was not his. In addition, he is faced with the cost of reconstructing the data that is lost. Following an exchange of letters with the consumer, Acme Electronics contemplates settling the case. However, before this step is taken, several questions must be answered. The case can be divided into three major parts. The first part requires students to analyze a possible negligence claim against Acme with respect to its failure to return the appropriate defective drive to the consumer. Students are required to address the following negligence concepts – negligence per se; actual (cause in fact) causation; damages; and defenses to negligence (i.e., contributory vs. comparative negligence).

The second part of the case requires students to utilize their understanding of several statistical issues. They are required to recognize a proportion, calculate the appropriate sample size for estimating it, and calculate a confidence interval for the estimate. Students will also be asked to apply the concept of expected value as it relates to a statistical variable in the damage estimate.

The last part of the case enables the students to propose strategies regarding settlement and ethical issues raised by Acme's refusal to assume responsibility for its actions.

It is interesting to note that the principal facts in this case are based upon a real life experience of one of the authors.

ACME ELECTRONICS

Leonard J. Fontz, Service Department Manager for the Hometown, Gould store of Acme Electronics (Acme), sat at his desk contemplating his next move. Acme Electronics is a subsidiary of Gooney Tunes Enterprises, Inc., a large media conglomerate. Acme owns more than 200 stores throughout the world. Fontz has been assigned to handle a negligence matter involving Otto Gunter, a customer at the local store. Fontz looked over several letters from Gunter that told his story.

In January of 2005, Gunter purchased a Gatekeeper Computer (Nimbus 2005) system from Acme. The computer performed extremely well until October of 2007 when the hard drive "crashed." Gunter took the unit to the repair department at the Acme store in Hometown. Gunter explained that he thought the hard drive in the computer was defective and sought to have it repaired. In addition, Gunter asked the service technician if he could have his old hard drive back after the repairs were made on the computer. The technician assured Gunter that the service department would return to Gunter any computer parts that would be replaced.

The hard drive was defective and was replaced at no charge to Gunter. When Gunter picked up the repaired computer he was also given what was presumed to be the original hard drive that was removed from the unit. Gunter told the repair manager that he was interested in attempting to retrieve the contents of the old hard drive. Gunter asked if Acme could provide this service. The manager indicated that Acme did not provide such a service. However, he provided Gunter with the telephone number of Ron Retriever. The manager indicated that Retriever might be able to help Gunter. Gunter left the store with his repaired computer and the old hard drive and went directly home because he was anxious to contact Retriever.

Gunter contacted Retriever and was told that it would cost $800 to attempt to recover the contents of the hard drive and that there were no guarantees as to the extent of the recovery, if any.

After several days of deliberation, Gunter decided to spend the $800 and hope for the best. Retriever went to work on the hard drive and was very successful. Retriever was able to recover about 90% of the contents of the hard drive. Retriever phoned Gunter with the good news. Gunter immediately drove to Retriever's shop, reclaimed the hard drive and the recovered contents, and paid the $800. Gunter then rushed home and viewed the recovered materials. To Gunter's amazement the recovered materials were not his.

What had happened? Gunter concluded that Acme's repair department had not returned to him his "crashed" hard drive. Instead, he surmised, he was given someone else's hard drive. In reviewing the recovered materials, Gunter was able to discover the name and telephone number of the true owner of the hard drive he had been mistakenly given. Gunter called the owner, Aaron Gottmilk, and related what he thought had happened. As a result of the conversation, Gunter discovered that he and Gottmilk both had the same computer, that each had experienced a crash of the hard drive, that both had purchased their computers from Acme and had, on the same day, returned the computers to Acme for repair. Gunter also learned that Gottmilk had asked for and received from Acme what he, Gottmilk, thought was his original hard drive. Lastly, Gunter, hoping that their respective hard drives had merely been switched between the two of them, asked Gottmilk if he still had the hard drive. Gottmilk indicated that he had discarded the hard drive.

What could Gunter do? He had spent $800 to retrieve materials from a hard drive that was not his. The owner did not need the materials and was not interested in paying Gunter $800 for the retrieved information. In addition, Gottmilk had discarded the "crashed" hard drive he had been given by the repair department at Acme. Thus, even if Gottmilk had received Gunter's hard drive, that hard drive was no longer available to Gunter because it had been thrown out by Gottmilk. What a mess. Gunter had been through the rollercoaster of emotions. Down when his hard drive had crashed, up when he learned that Retriever had been successful in recovering information, and back down upon discovering the information was not his and that Gottmilk had discarded the hard drive that was, presumably, from Gunter's unit.

On December 1, 2007 Otto Gunter wrote a letter to Acme describing his situation and requesting reimbursement of the $800 that was wasted on the recovery of information from a hard drive that was not his. Fontz, the service manager, wrote the reply shown in Exhibit 1.

After reading the letter from Fontz , Gunter responded by sending the letter shown in Exhibit 2 below.

After receiving the second letter from Gunter, Fontz contacted Jipsy Jetson, the director of the risk management department at corporate headquarters. Following their short conversation, she said that she would look into the matter. Jetson was aware of the results of a recent survey of 600 past negligence cases in the State of Gould. In 80% of these cases the plaintiff was awarded damages. On average the amount awarded was approximately 50% of the amount requested by the plaintiff, excluding punitive damages, which were not included in the study.

Jetson, on behalf of Acme, is contemplating settling this case out of court and has asked your legal team to write a report. She is seeking your legal and statistical evaluation of the problems facing Acme.

EXHIBIT 1

(Exhibit 1 is a copy of a letter from Leonard J. Fontz to Otto Gunter denying responsibility for Gunter's expenses but proposing an offer to settle the dispute.)

December 21, 2007

Mr. Otto Gunter
987 Spring Road
Hometown, Gould 00086

Dear Mr. Gunter:

Your letter of December 1, 2007 has been received. After careful consideration, it has been determined that Acme Electronics has no responsibility for any expenses that you may have incurred as a result of this unfortunate situation.

Normally, every effort is made to keep track of parts that are replaced on computers that are being repaired. However, during the first two weeks of October 2007, our service department experienced a large volume of hard drive replacements to the Nimbus 2005. Due to the large number of hard drive replacements, the service department was unable to maintain its procedure for keeping track of replaced computer parts.

It is also noted that computer owners are continually reminded of the necessity to "back up" a copy of the hard drive on their computers. Your failure to take this easy and painless precaution has been the primary contributor to your loss. However, Acme Electronics is happy to offer you a $100 gift certificate towards the purchase of any merchandise in the store.

Sincerely,

Leonard J. Fontz

Leonard J. Fontz
Manager, Service Department
Acme Electronics

EXHIBIT 2

(Exhibit 2 is a letter from Otto Gunter to Leonard J. Fontz declining Fontz's previous offer of settlement and making a counter settlement proposal.)

December 26, 2007

Acme Electronics, Inc.
c/o Mr. Leonard J. Fontz
Electronic Repair Department
2345 Elm Avenue
Hometown, Gould 00048

Dear Mr. Fontz:

I understand your position regarding backing up my computer hard drive. I had instructed my son numerous times to do this for me and he would tell me "sure Dad, no problem, I will do that first thing tomorrow." Unfortunately, first thing tomorrow never came for my son or me. Nevertheless, I am confident that, if you had returned my "crashed" hard drive to me, Mr. Retriever would have been able to recover the materials from my hard drive.

Your offer of a $100 gift certificate is appreciated but is wholly inadequate as a settlement in this case. I would make the following proposal to Acme Electronics:

♦ A payment of $800 as reimbursement for the unnecessary expenditure to Mr. Retriever;

♦ A payment of $5,000 to cover the cost of my time to reconstruct lost materials used in my consulting job;

♦ A payment of $10,000 in the form of punitive damages for your behavior in the handling of this matter.

Sincerely,

Otto Gunter

Otto Gunter

Case A Questions – Legal Issues - Negligence

1. Has Acme been negligent in its actions regarding keeping track of replaced computer components and failing to return the parts to Gunter?

2. Assuming Acme has been negligent, what defense(s) may be available to Acme to lessen or eliminate any liability on its part?

Case B Questions – Statistical

3. Consider the sample of 600 past negligence cases. Suppose you are willing to let the 80% estimate be within .03 (3%) of the true proportion. You are willing to assume a 90% confidence. . (Hint: You may wish to review the concept of *confidence intervals*. Check any business statistics textbook, or go to http://www.davidmlane.com/hyperstat and check topics 8 and 10.)

    a) Is 600 an adequate sample size for the estimate of 80%? Show why or why not.

    b) Construct a 90% confidence interval on the estimate of 80%. How would you interpret it?

4. Determine the expected value of the amount that could be paid to Gunter in a settlement. Use the 80% probability figure. Also determine a maximum and minimum expected value for the settlement figure based on the confidence interval above. Be sure to include all of the damages Gunter will be able to recover. How would you interpret your expected values? (Hint: You may wish to review the concept of *expected value* in a business statistics text. In this case the expected value is found by multiplying the probability of each possible event by the monetary consequence of that event. Then the results for all events that can occur are summed.)

Case C Question – Ethical & Strategic Issues

5. Should Jetson attempt to settle the matter with Gunter before he files a lawsuit? If so, what would be the recommended monetary amount of the settlement? Be sure to include all of the statistical and legal issues involved as well as any ethical and strategic issues.

ACME ELECTRONICS LIBRARY

Article appearing in local Hometown newspaper:

DAILY TRIBUNE / FRIDAY, January 7, 2008

Court to Consider Changing Contributory Negligence Doctrine

Today the state Supreme Court heard oral arguments regarding a change in the long-standing common law rule regarding contributory negligence. Contributory negligence is the plaintiff's failure to exercise reasonable care in attending to his or her own safety. Under a contributory negligence standard, presently followed by the courts in the state, a plaintiff is unable to recover any damages he or she may have sustained as a result of a defendant's malfeasance if the plaintiff has contributed in any way to the damages he or she has sustained. Consequently, despite a finding that the defendant was negligent and caused the plaintiff to suffer damages as a result of that negligence, the doctrine of contributory negligence results in a complete bar to recovery by the plaintiff. In any case, if the defendant can establish that the plaintiff is to blame, in the slightest degree, for contributing to his or her damages, then the plaintiff recovers nothing from the defendant. For example, suppose the evidence shows that a defendant was speeding and ran through a red traffic light and that the plaintiff was only two percent at fault for failing to swerve or brake quickly enough to avoid the collision. Under the doctrine of contributory negligence, even though the defendant is 98% at fault, the plaintiff will recover nothing.

This rule has been criticized as oppressive and unfair. In response many states have adopted comparative negligence systems either by statute or judicial decision. These comparative negligence systems vary among the states, however, there are basically two different applications. One form is described as "pure" and the other as "mixed" or "limited."

Under the "pure" version of comparative negligence, the award of damages to the plaintiff will be reduced in direct proportion to the plaintiff's percentage of fault, regardless of the ratio. For instance, in the above example, the plaintiff was found to be two percent at fault. Thus the plaintiff could recover 98% of his or her damages. Further, even if the plaintiff was found to be 51% at fault, he or she would still be able to recover at least 49% of his or her damages. Finally, even if the plaintiff was found to be 99% at fault, the plaintiff would be entitled to recover, from the defendant, 1% of the damages suffered. Under the "pure" comparative system it is evident that the harshness of the contributory negligence doctrine is significantly softened.

Under the "mixed" or "limited" version of comparative negligence, in order for the plaintiff to receive any damage recovery, the plaintiff must be no more than 50% at fault for the injury. Thus in the above examples the plaintiff would not recover any damages if the plaintiff was found to be at fault 51% in the one instance and 99% in the other instance.

A secondary issue facing the court will be whether any change in the contributory negligence doctrine will be retroactive and, if so, what cases will be affected.

In light of the questions asked by the Supreme Court justices, it is not possible to predict what decision the Court will make in this matter. A decision is expected by early August.

Recently, the Supreme Courts of the neighboring states of Confusion and Grace adopted comparative negligence systems for their respective jurisdictions. These courts also considered questions regarding retroactivity.

Gould Codes AnnotatedBusiness and Professions Code
Division 18. Professions and Vocations Generally
Chapter 16.6 Computer Repair

§ 8984.10 Return of replaced parts to customer

Upon request of the customer at the time the work order is taken, the computer repair dealer shall return replaced computer parts to the customer at the time of the completion of the work excepting such parts as the computer repair dealer is required to return to the manufacturer or distributor under a warranty arrangement. If such parts must be returned to the manufacturer or distributor, the dealer at the time the work order is taken shall inform the customer of this requirement. In such instance, the dealer shall offer to show, and upon acceptance of such offer or request shall show, such parts to the customer upon completion of the work.

Gould Codes Annotated
Code of Civil Procedure
Part 3 Of Civil Actions
Title 4 Of The Time Of Commencing Civil actions
Chapter 2, §§ 212 - 245

§212. Civil actions, without exception, can only be commenced within the periods prescribed in this title, after the cause of action shall have accrued, unless where, in special cases, a different limitation is prescribed by statute.

§235. The periods prescribed for the commencement of actions other than for the recovery of real property, are as follows:

§235.1 Within one year: An action for assault, battery, or negligence.

SMITH'S ALL-NEEDS CONVENIENCE STORES, INC.

D.K. "Skip" Smith, Southeast Missouri State University

CASE OVERVIEW

This case challenges students to consider how Jamie Taylor, a recent university graduate and now the new manager of the Smith's All-Needs Convenience Store in Abilene, Noklohoma, can increase the revenues generated by his store and (in so doing) increase his own compensation. The case is based on field research conducted by the author. It seems worth noting that in our area, there appear to be a number of convenience store management opportunities available for recent university graduates. Because they should find it very easy to relate to Taylor and the challenge he faces, the case is especially appropriate for senior-level undergraduates as well as recent university graduates currently enrolled in full-time MBA programs. It is designed to be taught in a class session of 1.5 hours, and is likely to require a couple of hours of preparation by students.

CASE SYNOPSIS

This case can be used to stimulate discussion on at least three interesting and important issues: (1) Identification of characteristics of (and sources of data for) the convenience store industry in the U.S., that is, one of the very dynamic segments of the retail sector; (2) What are the options available to managers of retail stores who are eager to grow their business; and (3) Will the model or conceptual framework or data analysis tool utilized by decision makers affect the data on which they focus their attention and/or the alternatives they are likely to consider? Data in the case include: (1) Description of the challenge faced by Jamie Taylor; (2) Data on (and sources for that data) the convenience store industry in the United States; (3) Background information on the company for which Taylor is working (that is, Smith's All-Needs Convenience Stores, Inc.); and (4) Descriptive information on the store which Taylor manages and the market it serves.

THE SITUATION

Jamie Taylor is the new manager of the Smith's All-Needs Convenience Store in Abilene, Noklohoma. The previous manager was transferred to a brand-new Smith's All-Needs Convenience Store located a couple of miles west of Abilene. The Smith's All-Needs Convenience Store District Manager (i.e., the man who hired Taylor to manage the Abilene store) indicates that he believes the market has changed, and that the Abilene store needs to review and update its approach to the market. The manager has also indicated to Taylor that the Abilene store should be increasing its revenues 10 percent per year. Taylor believes this sort of increase plus good performance on the mystery shopper surveys used by Smith's All-Needs Convenience Stores could increase his compensation considerably; Taylor is very eager to increase his compensation.

THE INDUSTRY

The National Association of Convenience Stores(NACS) indicates that convenience stores must meet the following criteria: "a broad merchandise mix and a minimum of 500 Stock-keeping units (SKUs). NACS identifies six alternative convenience store formats: (1) Kiosk; (2) Mini-Convenience; (3) Limited Selection Convenience; (4) Traditional Convenience; (5) Expanded Convenience; and (6) Hyper Convenience. For additional information on each of these six convenience store formats, see Appendix 1. As indicated there, a traditional convenience store tends to be approximately 2,400–2,500 square feet, that is, about the size of a 2-bay service station. For this format, it is typical that both gasoline and store sales are important. Simple foodstuffs (for example, popcorn, nachos, etc.) may also be sold. Striped parking and extended hours are common.

The U.S. Census has information on the number of convenience stores by state (data from 2003), the number and percentage of convenience stores in each state which sell gas, and the number and percentage of convenience stores in each state which are one-store operations. That information can be found in Appendix 2. With more than 12.5 thousand stores, Texas is the convenience store leader. California, with slightly more than 9,000 stores, and Florida, with slightly less than 9,000 stores, are also leaders; these three states account for nearly ¼ of all convenience stores in the United States. At the opposite extreme, the District of Columbia and Alaska each have less than 200 convenience stores.

NACS indicates that the top 10 categories of products sold by convenience stores (not including gasoline) are: (1) Cigarettes; (2) Packaged non-alcoholic beverages; (3) Foodservice; (4) Beer; (5) Other tobacco; (6) Candy; (7) Salty snacks; (8) General Merchandise; (9) Fluid milk products; and (10) Packaged sweet snacks. As for gasoline, NACS estimates that convenience stores sell ¾ of all gasoline sold in the United States; this amounted to nearly $350 billion dollars in 2005. Nationwide, NACS reports that gross margins on fuel were (in 2005) 6.9 percent. As for the gross margins on in-store purchases, NACS reports that these are approximately 29.5 percent. According to NACS, 60 percent of convenience stores in the U.S. are single store operations.

THE COMPANY

The company now known as Smith's All-Needs Convenience Stores was started by R.J. Smith in 1958. That year, R.J. became an oil jobber for Standard Oil Corporation. In other words, the initial business of Smith's Oil Companies was to deliver fuel to local retail service stations and farmers.

In the late 1960s, Smith's Oil Companies won a contract to be the sole provider of fuel and motor oil for Thruway Construction Company (TCC), the firm which had won the contract to construct most of the Noklahoma section of Interstate Highway 89. During this period, the amount of revenue generated by Smith's Oil Companies increased dramatically.

In the early 1970s, Standard Oil Corporation discontinued its operations in Noklahoma. At this time, R.J.Smith purchased several of the former Standard service stations and then launched a small chain of self-service gas stations called "Smith's Pump-Ur-Own." The chain did well, and to increase both his coverage of the market area and revenues as well, Smith began building additional gas stations.

In 1975 Smith expanded the scope of its operations by purchasing a bait and tackle shop in Ft. Jones, a small nearby city. This store did well, and through the mid-1980s, the primary growth strategy for Smith's Oil Companies was to acquire additional bait and tackle shops located near Smith's Pump-Ur-Own gas stations. By 1985, this concept (that is, bait and tackle shops next to gas stations) had been utilized by Smith's Oil Companies in a dozen locations. The product line at these outlets included: gasoline, oil, beer, cigarettes, bait, and tackle.

In 1985, Smith's Oil Companies acquired its first convenience store, that is, a retail store with a product line which included not only the items being sold through the bait and tackle shops but also an assortment of deli items, snack foods, and beverages. Over a relatively short period, several of the old Smith's Pump-Ur-Own locations were converted to the new expanded product line format, and a few new stores featuring the new format were opened as well. At this time, because the expanded product line provided so many reasons for customers to shop, the name of the chain was changed to Smith's All-Needs Convenience Stores.

Through the 1990s and on into the 21st century, Smith's All-Needs Convenience Stores has continued to innovate and grow. Today, all of its refurbished stores feature a drive-up window, and many of its 30+ stores offer (through a partnership with a couple of food vendors) a line of branded foodstuffs. In 2002, a group of employees developed the mission statement and the set of core values set forth below:

MISSION STATEMENT

Our mission is to be a superior convenience store business, committed to excellence and creating a valuable experience for every guest and team member.

Core Values

Respect & trust our team and guests.
Honesty to self and others.
Outstanding experience for every guest.

Do what we say we will do, every time.
Empower all well-trained team members.
Service + execution = success.

The mission and core values set forth above apply to all stores. On a few other dimensions as well, the 30+ stores are all quite similar; examples include:

1. Many Smith's All-Needs Convenience Stores have large numbers of part time employees. Many employees only work one or two evenings per week, and Smith's All-Needs Convenience Stores employ lots of people already working a full-time job somewhere else.

2. Smith's All-Needs Convenience Stores strive everyday, all day, to provide superior customer service. Customers should be greeted at the door, employees are expected to help customers find what they need, employees are expected to wear a smile, service is expected to be quick and convenient, and so on. Smith's All-Needs Convenience Stores compete on service, not on price.

3. All fountain drinks in Smith's All-Needs Convenience Stores are Coca Cola products. Similarly, all potato chips and pretzel snacks are provided by Lay's.

4. As part of its efforts to ensure superior customer service, Smith's All-Needs Convenience Stores uses mystery shoppers. After purchasing products at a store, the mystery shopper fills out a form indicating what they purchased, the quality of service they received, the quality of the food purchased (if any), the cleanliness of the store, whether they experienced the "5 phrases" which Smith's All-Needs Convenience Store employees are supposed to use (greet the customer, ask if they can help, ask if they found everything they needed, ask for their suggestions, and thank them for their business plus wish them a nice day). For their store to qualify for a bonus, managers must receive 90 percent or higher from the mystery shoppers.

While all Smith's All-Needs Convenience Stores are similar on the above dimensions, on other dimensions there can be considerable differences between the various stores. These differences could include:

1. There is a mix of small and larger stores. In small stores, the number of cooler doors and amount of shelf space is considerably less than in the newer, larger stores. While the product categories carried by the large and small stores are very similar, the number of items in the product line of a big store can be considerably greater than in a small store. A small store might have 15 employees; larger stores could have many more employees.

2. Some (but not all) stores are open 24 hours. The newest store will (when it opens) be one of the stores which will be open 24 hours.

THE ABILENE STORE AND MARKET

As is the case for many convenience stores, the primary source of revenue for the Abilene store (70–80% of total revenues) is gasoline. Other product categories which contribute significantly (that is, double-digit percentage of total store revenue) include cigarettes and food service (that is, pizzas, breakfasts, etc.). Soft drinks and beer, while they contribute single-digit percentages of total revenue, are also important contributors to store revenue.

While gas provides a very large percentage of total revenue for most convenience stores, margins on gasoline tend to be low. Because of competitive pressures, this is particularly true for the Smith's All-Needs Convenience Store in Abilene. While gasoline prices at a competing convenience store diagonally across the highway may be slightly cheaper than the Abilene Smith's All-Needs Convenience Store, within a couple miles of the Abilene store are two gasoline outlets which are likely to offer substantially lower prices on gas. Nonetheless, Taylor estimates that 50 percent of his customers do purchase gasoline at his store. Of the customers who purchase gasoline, Taylor estimates that 10–15 percent use a credit card at the pump to purchase gas, and then leave without ever coming inside his store. In other words, most (but not all) of the 1,000 or so customers each day who make a purchase at his store do actually enter the store.

The Smith's All-Needs Convenience Store in Abilene is open 24 hours. Over the last four months, Taylor has observed the following patterns business patterns:

1. The period from 11pm-4am is often very slow.
2. There is a massive flow of customers at 5am weekday mornings; Taylor believes that this surge is due to the fact that the day shift for one of the area's major employers starts work at 6am. A number of these customers will purchase breakfast.
3. A bit before and after 8am, there will be a steady flow of customers coming to purchase gas and a cup of coffee and/or a donut.
4. On weekdays, starting about 11am, there is a steady flow of students on their lunch hour from Abilene's Senior High School. Abilene Senior High School has nearly 1,200 students. Because they have little time for lunch and little money, orders of breadsticks ($1.29) and 32 ounce cups of soda ($.85) are popular with students. Because students always seem to be running late, and because traffic in this area is very heavy at this time, there is very little early morning business from students. Besides the high school cafeteria, other places close to the high school where students go for food include Price Chopper (a supermarket with a deli section), Hardee's, Abilene Sports Grill (a local fast-food outlet), Pizza Hut, and Subway. In

addition to the high school students, Taylor gets some lunchtime business from workers at three industrial plants (Steelco has about 50 employees; Plastico has about 400 employees; Airco has about 90 employees) located very near his store. For factory workers, popular lunches include barbeque sandwiches, chicken sandwiches, pizza, etc.

5. About 4pm weekdays there is a surge of business. Taylor believes it is due to a shift change at one of the local factories.
6. About 5pm weekdays (i.e., the end of the working day) there is likely to be a surge of business from people stopping in to buy gas and a cup of coffee.
7. About 11pm weekdays there is another surge of business; Taylor believes this surge is due to workers at one of the local factories taking their lunch breaks.
8. On weekends, the pattern and volume of patronage is quite different. One of the nearby factories (Airco) operates only four days per week; furthermore, high school is not in session on Saturday or Sunday.

STRATEGY FOR THE ABILENE STORE

As indicated earlier, the target market includes employees of nearby factories, students at the Abilene Senior High School, and (more generally) people traveling past the Abilene location of Smith's All-Needs Convenience Store as they drive to work and/or other activities. The products offered by the Abilene store include those offered by most convenience stores, i.e.,: (1) Cigarettes; (2) Packaged non-alcoholic beverages; (3) Foodservice; (4) Beer; (5) Other tobacco; (6) Candy; (7) Salty snacks; (8) General Merchandise; (9) Fluid milk products; and (10) Packaged sweet snacks. As indicated earlier, the categories contributing the most revenue include: gas, cigarettes, food service, soft drinks, and beer. Regarding cigarettes, Taylor has discovered that demand is strongest for low-to-medium brands; expensive up-market brands do not sell well in Abilene.

Smith's All-Needs Convenience Stores believe that customer service impacts powerfully and positively on customers' perceptions and buying behaviors. For that reason, Taylor's employees (and in fact, all Smith's All-Needs Convenience Store employees) are trained to greet every entering customer with the following five behaviors: (1) As they enter the store, say good morning; (2) Make eye contact; (3) Ask if the customer found what they needed; (4) Ask if they made a fuel purchase; and (5) As they exit the store, wish them a nice day. Another element of the Smith's All-Needs Convenience Store customer service effort is that all employees (including Taylor's) wear uniforms, so as to make sure that they are obvious to customers. A recent market research project conducted by Coca-Cola indicates that the fact that employees are easily identifiable can be a competitive advantage; interestingly, none of Taylor's major competitors use uniforms.

Like many Smith's All-Needs Convenience Stores, Taylor does not do a lot of print and/or television advertising. However, his store does get involved in promotional efforts with local radio stations. Often, these involve opportunities for radio listeners to win free sandwiches and/or pizzas from Smith's All-Needs Convenience Stores. Of course, Taylor's store does engage in Point-of-Purchase (that is, POP) promotions, where customers entering his store find promotional offers on various products.

Most of the pricing for all Smith's All-Needs Convenience Stores (including the Abilene store) is set at the same level, for the entire chain, by staff at corporate headquarters. On tobacco products and gasoline, however, corporate staff often adjusts prices to take account of local market conditions. On other products, store managers (including Taylor) may request that a price be changed. For example, if Taylor wanted to offer a special price on a barbeque sandwich meal purchased at the Abilene store, he would present his proposal to his district manager. After (but only after) the district manager approves, Taylor would be able to offer the sandwich at the special price.

At Smith's All-Needs Convenience Stores (including Taylor's store), there can be interactions between pricing and promotions. For example, customers who buy a plastic 24-ounce re-usable Smith's coffee mug for $3.00 can fill that mug every day that they bring their mug to the store, for the price of a 12-ounce coffee. As for soda, Smith's All-Needs Convenience Stores (again, including Taylor's store) often run a "soda card" promotion where any purchaser with seven prior 44 ounce soda punches (that is, one punch for each 44-ounce soda purchase made) receives one free 44-ounce soda.

THE COMPETITIVE ENVIRONMENT

As indicated earlier, the market in which Taylor's Smith's convenience store is located (that is, Abilene, Noklahoma) is quite competitive. There is a convenience store competitor located diagonally across the street from Taylor's store. Six months ago, this competitor refurbished and upgraded their Abilene store. The upgraded store sells beer, cigarettes, gas, liquor, snacks, and soda; however, they do not provide any on-premise food service. Prices tend to be a little lower than at the Smith's All-Needs Convenience Store. This competitor has a total of three stores: Two in a small nearby city, and the one in Abilene. Operating hours for this competing convenience store are 5am-midnight. As indicated earlier, there are two large and lower-cost gasoline outlets located within a couple miles of Taylor's store. As for food, as already indicated, there are several nearby competitors.

THE MANAGER AND HIS BACKGROUND

Jamie Taylor grew up in Kansas City. After graduating from high school in June 2000, Taylor enrolled in Noklahoma State University in a small city very close to Abilene. Abilene is a bit more than 100 miles south of Kansas City; Taylor knew the town well from visits with his grandmother, who had lived there all her life.

At Noklahoma State University, Taylor was a solid student. During his student days, Taylor worked part-time at a couple of different jobs; one of those jobs was as a part-time employee for a manager named "Leslie" at the Smith's All-Needs Convenience Store she managed, which was located very near the university. At this Smith's All-Needs Convenience Store, Taylor's duties included calculating totals and collecting money from customers, cleaning and straightening up the store, running the machines which made coffee and iced tea, keeping the ice dispensers full, checking in shipments of products, and so on. Because his classes kept him quite busy during the week, Taylor limited his working time at this Smith's All-Needs Convenience Store to Friday night, Saturday, and Sunday.

At the end of four years, Taylor graduated with an undergraduate degree in marketing. After graduating, Taylor moved back to Kansas City and lived for three months with his parents. During this time, Taylor worked for a credit union and tried to decide whether he wanted to go back to school, either in law or in an MBA program.

One weekend, while visiting Abilene to link up with friends from his university days, Taylor stopped in at the Smith's All-Needs Convenience Store to talk with Leslie. At the end of their conversation, Taylor told Leslie that he was interested in moving back to Abilene and going to work full-time for Smith's All-Needs Convenience Stores. Because Taylor had been a very good worker, Leslie contacted her district manager and gave Taylor a very favorable recommendation. Shortly afterwards, Smith's All-Needs Convenience Stores offered Taylor a position in their management training program.

In his first assignment, Taylor spent two weeks training in Lincoln, Noklahoma, a small town located approximately 30 miles north of Abilene. Next, he spent a month working at a Smith's All-Needs Convenience Store in a small city very near Abilene; after that, Taylor spent a month working at another Smith's All-Needs Convenience Store in that same city. After these assignments, because his former manager (that is, Leslie) needed an assistant manager, Taylor was sent back to the same Smith's All-Needs Convenience Store where he had worked as a student.

A little more than a year later, the manager of the Smith's All-Needs Convenience Store in Abilene was promoted to the position of store manager of a brand-new Smith's All-Needs Convenience Store located slightly west of Abilene. This meant that the Smith's All-Needs Convenience Store in Abilene needed a manager. Taylor had mentioned to Leslie and to his district manager that he was interested in moving up; in June 2006, Taylor was offered the job of manager of the Smith's All-Needs Convenience Store in Abilene.

THE CHALLENGE

Assume you are Jamie Taylor. How will you increase revenues at your store, so as to improve the performance of the store and increase the amount of money you are making as well?

APPENDIX 1

CONVENIENCE STORE TYPOLOGY

What is a Convenience Store?

In the not too distant past, every convenience store looked about the same – 2,400 square feet of packaged consumer items. Today, companies in the industry are approaching markets with different types of stores and different product offerings. There are mini-convenience stores under canopies, conventional size stores with expanded foodservice, and even hyper-convenience stores with the extensive variety of product offerings and in-store seating for foodservice. The fastest growing segments of the convenience store market are considered by many to be "nontraditional" stores. That is, store formats other than 2,400 square feet, either larger or smaller.

The changes in store formats have implications for all elements of the industry. Retailing executives are concerned with competitive impact and their marketing strategies and niches. Product suppliers want to be aware of format variations as they dictate requirements for appropriate product packaging, promotion, and distribution for the stores. Equipment and systems vendors want to design their equipment and systems to fit the various types of store formats. Investors and financial analysts want to understand the economics of the changes taking place and the likely impact on the convenience store industry. Finally, the various governmental agencies – local, state and federal – need to understand the various store formats.

Based on this research, six formats were identified as representing trends in the convenience store industry. The six convenience store formats are:

Kiosk;
Mini Convenience Store;
Limited Selection Convenience Store;
Traditional Convenience Store;
Expanded Convenience Store; and
Hyper Convenience Store.

A general description of each type is provided below.

Kiosk

This format is less than 800 square feet and is intended to provide some additional revenue beyond gasoline sales. Gasoline is always the focus of this operation with the owner usually being an oil company or petroleum marketer. The store sells only the fast-moving items found in traditional convenience stores (tobacco, beverages, snacks, and confectioneries). Grocery items are conspicuously absent, as is any sort of foodservice. Store sales may be only about ten percent of revenues in such locations. Parking is usually only at the pumps. Hours vary widely depending on the location and the inclinations of the owner. Typical customers are transients and locals stopping in to buy gasoline.

Mini Convenience Store

This store format, usually 800 to 1,200 square feet in size is extremely popular with the oil companies and the emphasis is on gasoline sales. However, in such locations, the owners view store sales as an important part of the revenue and margin picture. Grocery selection is usually very thin and foodservice beyond prepared sandwiches. There usually is not any parking other than that at the pumps, although some locations do have modest striped parking. Open hours usually range from 18 to 24 hours. Customers are usually people buying gasoline. However, there are stores of this size in urban areas which may or may not sell gasoline.

Limited Selection Convenience Store

These stores, which range from 1,500 to 2,200 square feet, are becoming more numerous. They are often affiliated with oil companies and are in the size range of a converted two-bay service station. Both gasoline and store sales are generally important parts of profitability. They differ from the "mini convenience store" in a broader product mix and grocery offering (although still somewhat limited by traditional convenience store standards). Also, simple foodservice (hot dogs, nachos, popcorn, etc.) may be offered. Although gasoline buyers are normally still the main part of the customer base, traditional convenience store patrons are important. Striped parking and extended hours are common.

Traditional Convenience Store

Most of the original convenience stores fall into this category. They are about 2,400 to 2,500 square feet in size and offer a product mix which includes dairy, bakery, snack foods, beverages, tobacco, grocery, health and beauty aids, confectionery, and perhaps prepared foods to go, fresh or frozen meats, gasoline, various services, and limited produce items. Most stores of this size have 6 to 12 striped parking spaces or some form of convenient pedestrian access. Hours are extended compared to average retailers with a large percentage open 24 hours per day. Such operations are normally owned by convenience store chains, but oil companies have also built or acquired stores of this size.

Expanded Convenience Store

Growth is occurring in the number of stores in the 2,800 to 3,600 square feet range. Such stores can accommodate more shelving for additional grocery products or room for significant fast food operations and seating. Stores using the space for more grocery items are taking advantage of the niche which has developed as supermarkets increasingly move above the 40,000 square foot range. A few large chains are using this "superette" approach. A greater percentage are using the space to take advantage of the high profit margins in fast foods. As the number of smaller operations proliferates (largely as a result of the oil companies), many convenience store chains apparently view the move toward increased fast foods as essential. In terms of other products and services, such stores usually carry the traditional convenience store items. Parking is important with most having about 10 to 20 marked spaces. Hours are extended. Such operations not only attract the typical convenience store customer but also more families, women, and senior citizens.

Hyper Convenience Store

These very large stores (4,000 to 5,000 square feet) usually offer an array of products and services arranged in departments. For example, such stores may offer variations such as a bakery, a sit-down restaurant area, or a pharmacy. Many of these locations do sell gasoline. The number of employees per shift can be large, particularly if a small restaurant is present. The number of parking spaces is substantial, especially since the amount of time the average customer spends in such an establishment can be significant. Hours are extended. Here again, as in the case of the Expanded Convenience Store, families and senior citizens as well as traditional convenience store customers are patrons. In some locations, such stores are mini-truck stops which obviously affects product mix and the customer base.

According to NACS Constitution and Bylaws, the NACS Definition of a Convenience Store is:

> *". . . a retail business with primary emphasis placed on providing the public a convenient location to quickly purchase from a wide array of consumable products (predominantly food or food and gasoline) and services."*

While such operating features are not a required condition of membership, convenience stores have the following characteristics:

> *While building size may vary significantly, typically the size will be less than 5,000 square feet;*
> *Off-street parking and/or convenient pedestrian access;*

Extended hours of operation with many open 24 hours, seven days a week;
Convenience stores stock at least 500 SKUs; and
Product mix includes grocery type items, and also includes items from the following groups: beverages, snacks (including confectionery) and tobacco.

For more information on "what is a convenience store," please contact NACS.

Source: National Association of Convenience Stores webpage [http://www.nacsonline.com].

APPENDIX 2

CONVENIENCE STORES BY STATE

Industry Resources

PR Toolkit

U.S. Convenience Stores – State-by-State Count 2003
(Fact Sheet)

The total number of convenience stores in the U.S. stands at 132,424 stores, according to the 2003 National Association of Convenience Stores (NACS)/TDLinx Official Industry Store Count, as of December 31, 2002. The count is based on TDLinx data that tracks convenience stores as defined by TDLinx and endorsed by NACS.

NACS' definition of a convenience store includes requirements that stores that have a broad merchandise mix and a minimum of 500 stock-keeping units (SKUs).

Ten years ago, the official industry store count stood at 100,800; 20 years ago there were 76,200 stores; and 30 years ago there were 24,300.

Below is a chart, organized by U.S. Census regions, showing official store count for each state, including the total number and percentage that sell motor fuels, as well as the total number and percentage that are owned and operated as one-store companies. (Figures as of Dec. 31, 2002.)

Table: Convenience Stores by Region					
New England	Total stores	Stores with gas	(% of all stores)	One-store operators	(% of all stores)
Connecticut	1,322	787	59.3	953	72.1
Maine	1,038	728	70.1	733	70.6
Massachusetts	2,621	1,075	41.0	1,867	71.2
New Hampshire	764	534	69.9	523	68.5
Rhode Island	451	261	57.9	317	70.3
Vermont	537	410	76.4	378	70.4
Middle Atlantic	Total stores	Stores with gas	(% of all stores)	One-store operators	(% of all stores)
New York	5,969	3,103	52.0	4,041	67.7
New Jersey	2,309	596	25.8	1,651	71.5
Pennsylvania	4,168	2,845	68.3	2,015	48.3
E. North Central	Total stores	Stores with gas	(% of all stores)	One-store operators	(% of all stores)
Indiana	2,668	2,366	88.7	1,031	38.6
Illinois	4,214	3,128	74.2	2,272	53.9
Ohio	4,907	3,435	70.0	2,222	45.3
Michigan	4,397	3,110	70.7	2,658	60.5
Wisconsin	2,380	2,181	91.6	1,410	59.2
W. North Central	Total stores	Stores with gas	(% of all stores)	One-store operators	(% of all stores)
Iowa	1,772	1,698	95.8	709	40.0
Kansas	1,239	1,178	95.0	561	45.3
Minnesota	2,371	2,162	91.2	1,235	52.1
Missouri	2,936	2,644	90.1	1,451	49.4
Nebraska	916	855	93.3	435	47.5
North Dakota	353	335	94.9	235	66.6
South Dakota	507	489	96.4	292	57.6
South Atlantic	Total stores	Stores with gas	(% of all stores)	One-store operators	(% of all stores)
Delaware	339	233	68.7	171	50.4
District of Columbia	181	47	26.0	180	99.4
Florida	8,984	6,470	72.0	5,017	55.8
Georgia	5,439	4,917	90.4	3,346	61.5
Maryland	1,699	901	53.0	869	51.1
North Carolina	5,674	5,047	88.9	3,294	58.1
South Carolina	2,945	2,568	87.2	1,557	52.9
Virginia	4,000	2,945	73.6	2,131	53.3

Table: Convenience Stores by Region					
West Virginia	1,308	1,009	77.1	778	59.4
E. South Central	Total stores	Stores with gas	(% of all stores)	One-store operators	(% of all stores)
Alabama	3,650	3,435	94.1	2,546	69.8
Kentucky	2,572	2,276	88.5	1,505	58.5
Mississippi	2,245	2,069	92.2	1,508	67.2
Tennessee	3,726	3,335	89.5	2,136	57.3
W. South Central	Total stores	Stores with gas	(% of all stores)	One-store operators	(% of all stores)
Arkansas	1,858	1,742	93.8	1,207	65.0
Louisiana	2,934	2,453	83.6	1,923	65.5
Oklahoma	2,505	2,331	93.1	1,470	58.7
Texas	12,688	10,884	85.8	7,281	57.4
Mountain	Total stores	Stores with gas	(% of all stores)	One-store operators	(% of all stores)
Arizona	2,087	1,663	79.7	982	47.1
Colorado	1,762	1,572	89.2	638	36.2
Idaho	708	656	92.7	448	63.3
Montana	523	481	92.0	299	57.2
Nevada	918	691	75.3	640	69.7
New Mexico	884	817	92.4	320	36.2
Utah	905	836	92.4	385	42.5
Wyoming	313	298	95.2	139	44.4
Pacific	Total stores	Stores with gas	(% of all stores)	One-store operators	(% of all stores)
Alaska	187	163	87.2	109	58.3
California	9,149	5,311	58.1	7,061	77.2
Hawaii	374	180	48.1	173	46.3
Oregon	1,418	665	46.9	1,111	78.3
Washington	2,610	1,908	73.1	2,140	82.0
UNITED STATES	Total stores	Stores with gas	(% of all stores)	One-store operators	(% of all stores)
	132,424	101,823	76.9	78,353	59.2
Source: National Association of Convenience Stores webpage: [http://www.nacsonline.com].					

DEVELOPING A PERFORMANCE MANAGEMENT SYSTEM AT THE COMMUNITY OUTREACH AGENCY: A CASE STUDY

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CASE DESCRIPTION

The primary subject matter of this case concerns developing, implementing, and making operational a performance management system at a small non-profit public agency. This includes the role that strategic management, the management process, and job analysis plays in this process. The case depicts a mid-level manager's attempt to design a performance management system to be used throughout the organization. This case has a difficulty level of four. It is designed to be taught in one class hour and is expected to take approximately three hours of student preparation time.

CASE SYNOPSIS

Students are provided with a management scenario describing top management's request to develop and implement a system of performance management in the organization. Students are asked to review the scenario and develop and describe a system of performance management that will lead to enhancing long-term organizational effectiveness. Students should consider both operational and strategic issues, problems, and concerns associated with completing the assignment. To facilitate their analysis, students are provided with brief definitions/explanations/descriptions of performance management, performance appraisal, job analysis, and job descriptions.

PERFORMANCE MANAGEMENT CASE

Anne Forrest is the director of the Lead Off program at the Community Outreach Agency (COA), a non-profit organization in a small southern town. The Community Outreach Agency is an umbrella organization that specializes in administering, leading, and managing a number of social programs including Lead Off. Depending on the specific program, funding is provided by federal, state, and/or local governments as well as by private donations. The essential purpose of the agency is to effectively manage the process of the delivery and utilization of funds to and by qualified recipients through the various Agency programs.

The Lead Off program is one of many administered by the Community Outreach Agency. Anne Forrest, as well as all other program directors, reports directly to the Executive Director of COA, Wilbur Jackson. Mr. Jackson has been at the Agency for ten years and reports directly to the Board of Directors, a five-member group consisting of local and area community leaders. Mr. Jackson personally selected three of the five board members.

Anne Forrest has been at the agency for three years, and she has managed the Lead Off program for the past year. Her job consists of leading, administering, and supervising all aspects of Lead Off. She received her undergraduate degree in management five years ago, but this is her first management position. While a college degree was not a specific requirement for the job, Anne feels that it played an instrumental role in her being selected to head the Lead Off program. Anne is the only Agency director with his/her degree, and Mr. Jackson has referred to this fact on a number of occasions—particularly when he has needed to assign someone to special projects beyond their director duties. Though Anne was proud of her degree, she often joked with herself that, at least for now, it just created a lot more work.

"Anne. Can I talk to you for a second?" It was midmorning on a Monday, and the last thing Anne needed or expected today was a visit from her boss. Though Mr. Jackson was a nice enough man, Anne had very little respect for the way he directed COA. He refused to be innovative or creative, and, in Anne's opinion, he knew virtually nothing about management or leadership. The former music teacher was appointed by the previous board of directors, one of whom had been a colleague for several years. Since a number of agency programs were designed to assist school age children, the Board thought a former educator would be a good choice for executive director. Unfortunately, during Mr. Jackson's tenure, the organization had experienced no growth, private donations had become stagnant, and client services had declined. Also, it seemed to Anne that the only time Mr. Jackson left his office was to pile more work on one of the program directors—usually her.

"You're the college girl with the business degree. What do you know about performance appraisals?"

"I'm familiar with the topic," said Anne. "We talked about it in school, but I'm far, far from an expert. I do know that the way we do them around here doesn't make a lot of sense to me."

"I'm starting to think you might be right," Jackson replied. "I've never had so many complaints about anything as I've had lately over these damn evaluations. Two directors refused to sign theirs, and three other directors just left my office complaining about them being useless and unfair. And you mentioned the other day that you saw no point in even bothering since they just got stuck in a drawer and were never used for anything." Anne remembered that comment, and she was not at all surprised to find out that others were pretty unhappy with the whole appraisal process at COA. She knew that she never took appraisals seriously, either hers or the ones that she did for the people that reported directly to her. As far as she knew, appraisals had never been used to make any managerial decisions and, based on her conversations with other directors, each tended to give everyone that he or she evaluated essentially the same rating: a little above average. "So maybe it's time we changed the way we do them," said Mr. Jackson.

"Here it comes," thought Anne. And it did.

"Here's what I'd like you to do, Anne. I want you to develop us a new performance evaluation system. I'm tired of all these complaints; plus, if we are going to spend this much time on the things every year, maybe we really should get something out of it. Start from scratch, and let's do it right. If you need anything from me, let me know—but I really don't think I can be much help on this one."

Anne was very surprised to hear Mr. Jackson saying this. Normally he appeared to let most complaints, suggestions, or ideas from the directors go in one ear and out the other. "He must be getting a little flack from above. Maybe someone went straight to a board member," Anne thought. And while she was totally swamped at work with a million things to do, she had to admit that she would love to see major changes in the way COA conducted performance appraisals—regardless of Mr. Jackson's motives. She also had to admit that even though her knowledge of the subject was limited, she had been exposed to the topic in school and was probably the person at the agency most qualified to handle the assignment.

"You know I'm snowed under here. When would you want me to have it done," Anne asked? "And are we really going to implement it and use it after I develop it? I would hate to spend tons of time putting this thing together and nothing ever come of it. Remember the employee handbook, and the policy manual, and the marketing brochure—should I go on?! I worked so hard on each of those projects, but yet we have NO employee handbook, NO policy manual, and NO marketing brochure. All the work was a total waste of time."

Her comments stung the director, but he had to admit she was making a point. "You have my word," said Mr. Jackson. "You develop the system, from top to bottom, and I'll make sure it gets put in place." For some reason, Anne took little comfort in that promise.

As Mr. Jackson turned to leave, Anne yelled, "When do you need it?"

"Oh, about that. I promised the Board we'd present our new performance evaluation program at the end-of- the-month meeting," he replied.

"Wonderful."

Anne's first thought was that she had a lot of work to do. She remembered discussing performance appraisals in her management classes, but the details were sketchy at best. She decided that she would use the rest of the day to re-familiarize herself with the topic. She closed her door and started researching.

After reviewing her class notes, calling a couple of former professors, and spending several hours on the Internet, two things began to stand out in Anne's mind. The first thing she discovered was that most managers hate doing performance appraisals and most employees hate having them done—so, it was not surprising to find out that complaints were pretty rampant. The second thing she found out was that professionally managed, cutting-edged organizations no longer just conduct performance appraisals. These companies include performance appraisals as part of a complete performance management system. Therefore, she quickly recognized that the first thing she needed to do was to learn everything she could about performance management. Anne began making notes, and by the end of the day had developed the following definition/ description/explanation of performance management that she felt was suitable for her purposes:

> *Performance management is a strategic process designed to ensure that employees' activities, behaviors, and outputs are aligned with the mission, objectives, and strategies of the organization. The primary purpose of performance management is to make certain that employee performance contributes to the accomplishment of the organization's objectives and the achievement of its mission. Performance management specifies which aspects of performance are relevant to the effectiveness of the organization (as determined through job analysis), measures those aspects through performance appraisal, and provides feedback to employees through performance feedback sessions.*

"Well, now I know what performance management is!" said Anne to nobody in particular. "And it ain't us." She knew that employees at COA had no measurable goals upon which they were evaluated. She also recognized that most items on the evaluation forms were outdated and did not appear related to the essential elements of the jobs—and certainly had no relation to the critical elements of making the organization effective. Anne was also concerned that employee evaluation meetings tended to last only long enough to sign the form. As far as she knew, no constructive feedback was ever provided, no rewards were ever distributed, no additional training was ever suggested or prescribed, and no discipline was ever administered based on these formal performance evaluations.

Anne also learned that performance appraisals, job analysis, and job descriptions all were critical aspects of performance management—and this alarmed her as well. She had never even seen a job description for her position, and, after several phone calls, she quickly determined that the only employees who had ever seen job descriptions for their positions had been at the agency since its inception 15 years ago. Also, performance appraisal forms were merely checklists of items ("gets to work on time"; "dedicated"; "good attitude"; "dresses appropriately"; etc.) to rate between 1 (poor) and 5 (excellent)—and in her opinion the items had little to do with the critical aspects of the jobs, the ones that would ultimately enable the organization to be successful. "Anyway," thought Anne "we all just give everybody a 4 on everything anyway—so what's the point? Plus, there aren't even any job descriptions to tell us what we are supposed to be evaluating people on anyway." She began to feel very frustrated

As six p.m. rolled around, Anne was exhausted and a bit frustrated; but as she got ready to leave the office, she still managed to tell herself "not bad for the first day." In fact, though she was rather reluctant initially about the entire assignment, she already was beginning to see how implementing a performance management system could really impact the effectiveness of the agency—but she also knew that the agency would have to eliminate everything they were doing now and start from scratch. Also, today's crash course had revealed two huge concerns. First of all, Anne was completely convinced that, for performance management to work, top management must be totally committed to the idea—and she suspected that the director wanted this done for the wrong reasons. Second of all, performance management is tied directly to the strategic plan of the company, linked directly to the mission, objectives, and strategies of the organization. She has never seen a mission statement for the agency--and as far as she knows, nobody at COA had ever even used the term strategic plan and had certainly never been involved in strategic planning.

As she turns off her light and heads to her car, she can't seem to get the project out of her head. She begins to make mental notes of what she should do next and the problems she might encounter while attempting to complete this assignment by the next board of directors meeting. "And that's just the beginning," she thought. "Then we have to figure out how to make this thing really work." She still had a lot of work to do.

INSTRUCTIONS TO STUDENTS

You are Anne Forrest. Prepare your report to the Board of Directors. Be sure that your report addresses both strategic and operational issues.

USE OF A JOB COST SIMULATION TO ENGAGE GEN Y STUDENTS

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CASE DESCRIPTION

Meeting the educational needs of the current generation of students, referred to as Gen Y students, is a pedagogical challenge. Research suggests that Gen Y students learn most effectively in environments where they are actively engaged and in control of their learning. The in-class learning simulation described in this paper is designed to appeal to the more active learning style of Gen Y students. The simulation focuses on the process flow and accounting for products in a job cost environment.

The simulation requires students to actively perform three different job functions in a manufacturing environment. First, they assume the role of inventory manager in which they receive and inventory raw materials. Second, they assume production roles, in which they analyze prototypes, order materials, build products, and accumulate production costs. Third, they assume the role of cost accountant. In this role, they account for the accumulation and application of product costs. By completing this simulation, students build a frame of reference for manufacturing production processes that should deepen their understanding of accounting in a production cost environment.

This simulation has a difficulty level appropriate for freshman and sophomores but can be easily adapted for upper level accounting classes. Several options for adaptability of content are presented in the instructor's notes. The simulation is designed to follow lectures on the text material and takes approximately one hour of class time. It does not require any outside preparation by students. Prior students have rated this simulation as a very helpful hands-on learning experience that greatly enhanced their understanding of the job cost process.

CASE SYNOPSIS

Introductory accounting courses are generally taught to undergraduate business majors as part of the required basic business core. Many of the students are non-accounting majors and may lack the motivation to study accounting. Most have little work experience and may also lack a frame of reference for the concepts taught in class. While these demographics have made accounting *education challenging in the past, meeting the educational needs of the current generation of students, Gen Y students, is proving to be even more of a challenge.*

Gen Y students (1984 to present) grew up with computers, the Internet, beepers, cell phones, MTV, and a proliferation of computer games. Learning styles of this generation are more active and visual than verbal (Eisner, 2004), causing traditional teaching methods to be less effective. For these students to learn, they must be actively engaged and in control of their learning (Arhin & Johnson-Mallard, 2003).

The use of non-traditional teaching aids has been shown to be beneficial to the learning process and is becoming more common (Gupta, Elson, & Ostapski, 2006; Hoffjan, 2005; Albrecht, 1995). The use of games and simulations to teach managerial accounting concepts engages students in the process, helps them relate the concepts to real-world situations, and enhances their ability to retain the knowledge without memorization. Goman (2006) refers to this style of learning as "edutainment", an environment where students want to be entertained to induce learning.

This simulation embodies these strategies by allowing students to design and build products in a manufacturing environment following the product from design through completion and sale using a job costing methodology. Students are actively engaged in both the manufacturing process and accounting for the manufacturing processes as they complete the exercise. Student feedback indicates that the simulation was perceived as an effective learning strategy.

THE SIMULATION

The simulation materials include simulation instructions, ©Legos, product prototypes, inventory lists, and forms. The forms consist of a job cost sheet, material requisition forms, time sheets, raw material inventory cards, and receiving reports (see Exhibit 1 in instructors' notes for all simulation forms). The simulation mimics a job cost environment. The classroom is divided into a raw materials inventory area, a production area, and a finished goods area. Students are divided into groups and simulation instructions are distributed and reviewed. Students are required to perform three separate functions in the simulation, assuming different "player" roles, beginning with inventory management. The instructor assumes the role of factory supervisor assisting in all areas as needed.

Inventory Management

The first assignment, presented in Table 1, requires students to perform inventory management functions. Students performing this function are required to receive, count, and store inventory in the raw material inventory warehouse. The goal of this function is for students to understand that raw materials inventory is made up of different types of material which, in the aggregate, make up the general ledger balance in raw materials inventory. The subsidiary ledgers are the inventory cards, which can be actual cards as they are in this simulation or electronic records that record the same information.

Raw materials used in production consist of thirteen different ©Lego shape-color combinations. An inventory list of each item, description, and price is provided to each student (See Exhibit 1 of instructors' notes). Each individual inventory item is delivered to the company packaged in a large ©Ziploc bag with an inventory label attached to the outside of the bag. Students perform the procedures outlined in the simulation instructions for the inventory management position and create receiving reports and inventory cards for received materials.

Table 1

Inventory Manager: *In this assignment, you will perform the tasks of an inventory manager in a manufacturing environment.*

The steps to complete the assignment are as follows:

Receipt of raw materials:

1. *Count and fill out a receiving report for each unique raw material delivered and forward complete receiving reports to the cost accountant*

2. *Record the purchase of raw materials on inventory cards, one for each type of raw material. Use the inventory list to aid you in inventory costing.*

Issuance of raw materials to production:

1. *Receive material requisitions from production teams.*
2. *Issue material to teams, complete and sign the material requisition slips, and update the inventory cards.*
3. *Forward signed material requisitions to cost accounting.*

Introduction Processing

The production processing assignment, presented in Table 2, requires the students to perform the production functions in a job cost manufacturing environment. The objective in the production process procedures is for students to understand how direct material and direct labor are assigned to jobs as the actual tasks are performed. They should also understand that overhead, the factory supervisor, the facilities surrounding them, etc., are not directly associated with their particular job. This should enhance their understanding of the need to allocate overhead since it cannot be directly charged. A final objective is for them to understand that costs accumulate by job. They should gain this understanding by summarizing the production cost on their job cost sheet.

Students are assigned to groups. Each group is to produce a unique product. "Jobs" consist of product prototypes built from ©Legos by the instructor in advance of the class or the instructor can elect to allow students to design their own product prototypes. Suggested designs are included in each Lego kit if students wish to use these as a basis for their unique product design. Team members should pick one of the job team roles as described in the procedures and performs their functions.

Table 2

Job Teams:

Job Coordinator
Designer
Production Staff
Team Accountant

Production Processing: *In this assignment, you will perform the tasks of a job team that builds the Product on the shop floor.*

The steps to complete the assignment are as follows:

1. *The designer reviews the production steps, analyzes the prototype, and identifies the material needs.*
2. *The job coordinator issues material requisitions and receives material.*
3. *Production staff builds the product.*
4. *All members keep track of time on times sheets as work begins by job.*
5. *All members submit time sheets weekly to cost accounting.*
6. *The team accountant completes the job cost sheet, using material requisition forms, time tickets, and predetermined factory overhead rates. The predetermined overhead rate is $150 per direct labor hour, which is based on a total of 20 estimated direct labor hours.*
7. *Job coordinator ships the completed job to finished goods and forwards completed job cost sheets to cost accounting.*

Cost Accounting

The objective for this function is for students to understand how to account for the tasks they just performed and for the movement of materials and jobs throughout the production process. Team accountants summarize job costs in T accounts on the board. The T account represents the job cost sheet prepared by the team during production. As a class, students now assume the role of cost accountant, described in Table 3, using the professor as their "scribe". Students direct the professor to record the accumulation of manufacturing costs using the source documents prepared by the teams and the summary of job costs on the board. These functions are performed as group to allow students to synthesize their individual group activities into a single set of summary journal entries. Students propose the appropriate entries to record the application of job costs to production, the movement of completed jobs out of production, and the sale of a job. The final objective is for students to dispose of any remaining overhead balances and to reconcile subsidiary job accounts to general ledger inventory control accounts.

Table 3

Cost Accounting: In this assignment, you will perform the tasks of a cost accountant in a job cost manufacturing environment.

The steps to complete the assignment are as follows:

Journalize the following transactions and post the entries to T accounts:

1. From inventory receiving reports, record the receipt of raw material inventory.
2. From time cards and from salaried payroll, record the payroll. Salaried employees consist of the inventory manager ($500), and the factory supervisor ($2,500). Payroll taxes are 8% of gross wages.
3. Record overhead costs. Overhead costs consist of:
    a. Purchasing and storage of raw materials $100
    b. Insurance $200
    c. Fuel surcharge for delivery of materials $200
4. From duplicate copies of material requisitions forms, record application of material to work-in-process and manufacturing overhead.
5. Apply labor to jobs and overhead.
6. Apply overhead to work-in-process.
7. Receive job cost sheets and record the transfer of completed jobs to finished goods inventory.

Assume that one of the jobs has now been sold and do the following:

1. Choose the job that is sold.
2. Calculate a selling price equal to cost plus a 20% markup for profit.
3. Record the sale of the job.

Complete the accounting process by :

1. Analyze the inventory account.
2. Prepare the journal entry to dispose of any over or under applied overhead.
3. Reconcile the T accounts to the subsidiary job accounts that support their balances (Raw material inventory, Work-in-Process, Finished goods inventory)

The simulation has been used in ten sections of undergraduate managerial accounting courses. Student feedback indicates that students felt it enhanced their understanding of job costing and accounting for job costing and was much better than reading the text, hearing a lecture, or preparing homework answers. Students also reported that visualizing the process really enhanced their learning and kept them from just memorizing the steps.

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HEDGING WITH FOREIGN CURRENCY OPTIONS AT PEARSON INC

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CASE DESCRIPTION

The primary subject matter of this case is hedging foreign currency exchange rate risk using foreign currency options. Secondary issues examined include evaluating financial risk 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 4-5 hours of preparation time from the students.

CASE SYNOPSIS

Pearson Inc is a US based company specializing in corporate travel services. Recent product line additions have exposed the company to more significant foreign currency exchange rate risk. In addition, the unique structure of Pearson's business model has led the company president, Mike Pearson, to consider currency options in addition to traditional forward currency hedges. Pearson would like an evaluation of the company's increased foreign currency exposure and a proposed strategy for eliminating unwanted exchange rate risk before the next product catalog is published.

BACKGROUND

Employees engaged in corporate sales make up approximately 12% of the fulltime workforce in the United States. Corporations spend over one trillion dollars annually on sales force expenditures, more than they spend on any other promotional method. Given the high cost and importance of the personal selling function, a key managerial concern is about motivating people to achieve higher levels of performance. Incentives like sales contests are generally seen as an important tool to motivate sales people to achieve goals that surpass those associated with normal compensation, enhance job satisfaction, and increase corporate profits. Sales incentives promotion is an industry that exceeds $127 billion annually. Awards associated with sales contests generally fall into one of three categories -- cash, merchandise, and travel.

Growth in travel awards exploded during the1990's, only to drop off as the technology industry fell apart in 2000 and the 9/11 terrorist attacks of 2001 made travel as a reward less appealing. However, the all-expense paid vacation for employees achieving specific benchmarks is making a comeback as a popular incentive award recently. The Incentive Marketing Association estimates that corporate America spent about $30 billion on travel rewards alone in 2006. In addition, there has been a significant change in the destinations and type of activities people are doing with incentive travel. The trend in this industry is shifting to a desire for more exotic international travel options.

Pearson Inc is an Atlanta based company specializing in corporate travel services. Their focus is primarily on incentive initiatives, customer loyalty programs, and meetings and event management. Founded in 1986 by Mike Pearson, Pearson Inc has two main divisions. The corporate event group is a higher volume/lower margin division that specializes in large group travel outings, such as training seminars, conferences, and annual meetings. The incentive travel group is a lower volume/higher margin division that provides travel packages mostly associated with sales contests, customer loyalty programs, and other reward based promotions. In a typical sales contest, a company may set a specific goal for its sales force. Possible objectives may be to increase sales, generate new accounts, launch new products, liquidate inventory or expand into new territories. The company will then define precisely what the sales force needs to accomplish, whether its percentages, number of units, profits or some other concrete measurement and employees who achieve stated goals will earn rewards such as travel packages.

THE SITUATION

By and large, the incentive travel division at Pearson works off a catalog business. The main catalog is published twice a year (January and July) and allows customers to choose from a variety of travel rewards associated with employee incentive programs. Destination trips are grouped into tier levels and vouchers for tier levels are sold from the catalog at a guaranteed price. For example, Tier One vouchers are currently priced at $1000 per person and included popular domestic destinations such as Orlando, Las Vegas, and San Diego and usually incorporate activities such as spa treatments or rounds of golf. Higher tier levels, offered at higher prices, include both domestic and international travel destinations such as New York, Hawaii, Europe and Asia. Between the various destinations offered at each tier level, the current catalog contains over 60 destination options.

A typical client of Pearson might design a sales incentive program where points are awarded for achieving specific sales goals. The more points an employee earns, the higher the tier voucher the employee is eligible for. For example, a Pearson client might have a sales force of 100 employees. It is possible that 20 out of 100 may earn enough points to be eligible for a Tier One voucher award, 10 out of 100 might earn a Tier Two voucher, and 5 out of 100 may be eligible for Tier Three vouchers. The company would then purchase 35 travel vouchers (20 Tier One, 10 Tier Two, and 5 Tier Three) from Pearson. Eligible employees awarded vouchers would later redeem them for their preferred destination within a year.

When a new catalog is printed, the travel division does not know exactly how many vouchers will ultimately be sold nor do they know which trips offered within tier levels will ultimately be chosen. However, Pearson meets regularly with marketing and operations managers to discuss sales forecasts and events that might affect sales. In addition, these managers are responsible for weekly sales forecasts, which provided good estimates of expected volume.

Mike Pearson, CEO of Pearson Inc, talked almost daily with Amanda Martin, vice president of the incentive travel division. Most of their recent discussions had dealt with properly managing the newer foreign travel package options among the higher tier levels in the company's upcoming July 2007 catalog. Martin had been working for the last 2 months on adding unique destination mostly concentrated in Spain and Portugal. One of the main concerns Pearson had centered on foreign currency exchange rate risk. If award recipients ending up choosing international destinations, Pearson would receive revenues in US dollars from the sale of the voucher, but later incur costs in other currencies. If the Spain and Portugal trips turned out to be as popular as Martin envisioned, Pearson would need to purchase a significant number of Euros during 2008.

Foreign currency exchange rate risk itself did not worry Pearson, as he had been familiar with hedging techniques frequently used by the corporate event division. For example, the corporate division had organized a 400 participant annual meeting for a client in Paris last year. Although the client paid Pearson in US dollars and expenses incurred by Pearson were in Euros, the corporate division simply purchased Euros forward equivalent to 90% of projected expenses once the contract was signed. Because the timing and approximate amount of Euros needed was known 14 months in advance, the forward contract eliminated a majority of exchange rate risk that would arise if the Euro strengthened over the exposed time period. Unfortunately, in offering international destinations through the incentive travel division catalog, the volume of actual international packages (and hence amount of foreign currency needed) was not known until a later date. Pearson explained the difference to Martin using a few simplifying assumptions.

> *Our next catalog will be published on July 1, 2007. You have included additional international destination offerings in appropriate tiers based on current exchange rates. Your team will sell travel vouchers out of the catalog over the next few months. However, the final volume of vouchers sold will not be known until December. All vouchers sold are priced in US dollars. However, eligible employees will redeem their vouchers for various travel destinations over the course of year beginning January 2008. The earliest we would need to cover any Euro expenses*

would be January 1, 2008. However, we would likely need to be purchasing Euros at different intervals throughout all of 2008.

```
                                   Eligible Employees Choose Travel Destinations
                         1-1-08    Euros needed to cover Intl travel costs          12-31-08
I------------------------------I-------------------------------------------------------------------I
7-1-07                  12-31-07
Catalog                 Vouchers sold
Distributed             US$ revenues
Prices guaranteed       received
Through Dec. 31, 07
```

Pearson explained further:

If we look at just the new Tier Three packages for simplicity, it includes options of New York, San Francisco, Portugal, or Spain. We sold about 2,000 Tier Three (priced at $3,000) vouchers over the last 6 months out of the January 07 catalog. Go ahead and assume the same level of sales for the July 07 catalog. Our costs are about $2,500 per domestic trip and about 1,800 Euros for the Spain and Portugal trips. Given the current exchange rate of about $1.34 per Euro, profit margins are actually slightly higher on the international offerings. If your marketing research is correct and about half of the vouchers sold end up with eligible employees selecting the Portugal or Spain option, we are going to need to buy about 1.8 million Euros beginning in January 2008. Of course, at the extreme, if no one chooses the international trips then we won't need any Euros. If you don't think that is possible, just remember what happened to the popularity of international travel after 9/11. Conversely, if everyone selects international trips, we will need 3.6 million Euros. In reality, actual foreign trip sales may be higher (lower) than forecasted due to more (less) Tier Three vouchers purchased, a larger (smaller) international selection rate than what you predict, or some combination of the two. Add in uncertainly regarding costs in purchasing Euros and we have a recipe for potential disaster. Following a simple forward contract hedge does not provide much comfort either.

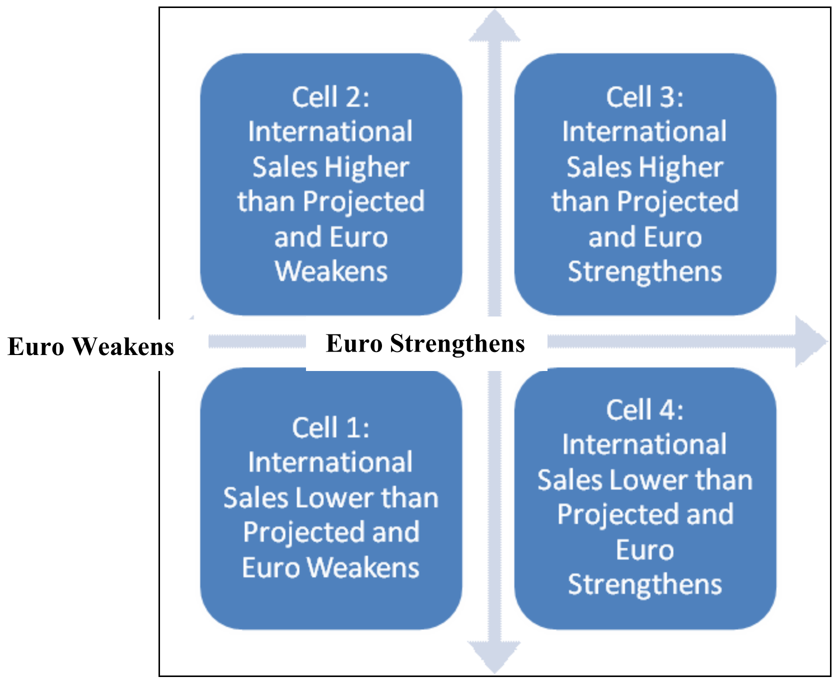
Pearson continued his explanation using a two-by-two matrix reflecting actual volume and currency fluctuations (see Figure 1):

Suppose our Tier Three forecasts indicate a need to purchase 1.8 million Euros beginning 6 months from now. If we hedge expected currency exposure with *a long position in a 6 month forward contract for 1.8 million Euros, we know exactly how much 1.8 million Euros will cost. However, consider the problems that arise in Cell 1 and Cell 3. Cell 1 represents a scenario where volume is lower than forecasted and the Euro has weakened. We purchased more Euros forward than was needed and have to sell the surplus Euros for a loss. Cell 3 represents a scenario where volume is higher than expected, but we didn't buy enough Euros to cover our costs. The additional Euros needed will have to be purchased at a higher price thereby eroding profits. Of course risk contains a positive as well as negative component. Cell 2 represents a scenario where volume is higher than forecasted but the Euro is weaker. Even though we will need to purchase additional Euros, we can do so at a lower cost. Cell 4 represents a scenario where we purchase more Euros forward than was needed and end up selling surplus Euros for a profit. In the long run, no matter if you hedge or not, about half the time you win and half the time you lose. It is the short run that can really hurt. We use forward contracts in the corporate outing division more to stabilize earnings. However, hedging with forwards doesn't seem to work as well in this case, but is probably better than leaving it un-hedged. Out of the 60 or so packages we have among the different tiers, about 25 of them are international. Compare that with about 10 trips from the 2006 catalogs. I didn't bring it up last year because the volume of international trips in the past wasn't large enough to warrant expending resources resolving it. However, as international destinations appear to be gaining momentum, we are going to have to address these issues.*

I would suggest that we first assess our potential foreign exchange rate exposure. Let's begin with an analysis of Tier Three vouchers. Once we get a handle on potential Tier Three exchange rate exposure, we can begin to formulate a more comprehensive hedging strategy. We have a preliminary forecast for Tier Three sales volume (See Table 1). What we don't know is how many of the Tier Three vouchers sold will ultimately end up being international trips. If we look at three simple scenarios in which we assume a low international redemption rate of say 10%, a base redemption rate of 50% based on your initial research, and a high international redemption rate of 70%, we might get a clearer picture of how many Euros we may need during 2008. Based on experience, I would suggest the probability of a low redemption rate at 20%, the probability of a base redemption rate at 60%, and probability of a high redemption rate at 20% (See Table 2). This will allow us to better quantify the impact of exchange rate movements on our dollar costs in purchasing Euros.

Figure 1: Two by Two Matrix (Sales Volume versus Currency Movement)

Actual versus ForecastedVolume



After the meeting was over, Martin went back to her office to consider her options. She had spent a lot of time putting together the Portugal and Spain packages and her instincts led her to believe the international additions would almost certainly boost catalog sales. She wasn't about to drop them all from the new catalog. Moreover, she knew her compensation was linked with bottom line profits not top line sales. Therefore, even if volume was higher than expected over the next 6 months, she also needed foreign currencies to remain stable or weaken relative to the dollar before any major year-end bonus could be expected. Although Martin was comfortable with the estimates regarding the total number of vouchers sold (See Table 1), she was less certain about how many how many Euros would need to be purchased in the future. Martin's research data led her to believe half of the eligible employees would choose the international option among the Tier Three grouping. However, Pearson had mentioned the possibility of an outside event like a terrorist attack altering attitudes regarding international travel very quickly. She reasoned that Pearson's suggestion for a probability distribution regarding the percentage of international trips selected would help account for variation regarding international redemption rates (See Table 2). The resulting joint probability distribution between total number of trips and international selection rates would allow her to better estimate the range and likelihood of Euros needed in 2008. If the range of Euros needed was small enough maybe the forward contracts would work after all. If not, maybe there was an option to purchase Euros only if she needed them.

Table 1: July 2007 Tier 3 Catalog Sales Forecast

	Actual Sales	# of Units Sold	Probability of Occurrence
Below Average		1500	30.0%
Average		2000	40.0%
Above Average		2500	30.0%

Table 2: Probability Distribution for International Trip Selection Rate

Redemption Rate	% of International Trips Selected	Probability of Occurrence
Low	10%	20%
Base	50%	60%
High	70%	20%

THE TASK

1. Determine a probability distribution for the total number of international trips selected from the July 2007 catalog by filling in the Joint Probability Distribution Table (Table 3) below. Calculate the corresponding number of international trips selected for each potential outcome.

Table 3: Joint Probability Distribution for International Trips Selected			
Acceptance Rate\Actual Sales	Low	Base	High
Below Average	6.0%		
(Intl. Trips Selected)	(150)		
Average			8.0%
(Intl. Trips Selected)			(1400)
Above Average		18.0%	
(Intl. Trips Selected)		(1250)	

2. Calculate the expected number of Euros needed in 2008 to support the number of International trips selected from the July 2007 catalog based on the joint probability table above (The average cost per international trip s 1800 Euros). What is the minimum number of Euros needed? What is the maximum number of Euros needed?

Table 4: Calculation of Euros Needed to Support Tier 3 International Trips					
Actual Sales		Acceptance Rate	Probability of Occurring	Intl. Trips Selected	Euros Needed
Below Average	and	Low	6%	150	
Average	and	Low			
Above Average	and	Low			
Below Average	and	Base			
Average	and	Base			
Above Average	and	Base	18%	1250	
Below Average	and	High			
Average	and	High	8%	1400	
Above Average	and	High			
			Expected Euros Needed =		1,656,000

Minimum number of Euros needed = ___________

Maximum number of Euros needed = ___________

3. Use the probability distribution of Euros needed from question 2 to determine the US dollar cost impact of purchasing Euros in the spot market under different exchange rate scenarios. The three exchange rate scenarios to be considered are defined as "Strong Dollar", "Stable Dollar" and "Weak Dollar". Calculate the expected US dollar cost impact and the minimum and maximum US dollar cost impact under each exchange rate scenario. Assume a "Strong Dollar" scenario would imply an average exchange rate of $1.25/1Euro. A "Stable Dollar" scenario would imply an average exchange rate of $1.34/1 Euro. A "Weak Dollar" scenario would imply an average exchange rate of $1.45/1 Euro. For example, if the dollar remains stable and Euros needed during 2008 are purchased at an average cost of $1.34 there would be "no impact" on costs as anticipated costs were also $1.34. If the average cost for Euros needed during 2008 are $1.45 ("Weak Dollar" scenario), the impact on costs would be $0.11 higher per Euro purchased.

Table 5: US Dollar Cost Impact from Exchange Rate Movements (No Hedge)

		US Dollar Cost Impact		
Probability	**Euros**	Exchange Rate Scenarios		
of Occurring	**Needed**	$1.25/EUR	$1.34/EUR	$1.45/EUR
6%	270,000	$ (24,300)	$ -	
			$ -	
			$ -	
			$ -	
			$ -	
18%	2,250,000		$ -	
			$ -	
8%	2,520,000		$ -	
			$ -	$ 346,500
Exp ($ Impact)		$ (149,040)	$ -	$ 182,160
Min $ Impact			$ -	
Max $ Impact			$ -	

4. Calculate the US dollar cost impact under the given exchange rate scenarios of buying 1.8 million Euros six months forward on July 1, 2007. Compare the cost impact of hedging with forwards versus the assumed cost of $1.34 per Euro. For simplicity assume the six month

forward rate is also $1.34 per Euro. For example, if actual sales are below average and a low acceptance rate is realized, then Pearson will need to purchase 270,000 Euros. Their basis is an anticipated cost of $1.34 per Euro. If they decide to hedge by buying 1.8 million Euros six months forward at a price of $1.34, they will have purchased 1.53 million Euros more than they needed. If the "Strong Dollar" scenario occurs, they will sell the 1.53 million excess Euros at an average rate of $1.25. The 1.53 million excess Euros purchased for $1.34 and later sold for $1.25 represents a loss of $0.09 per excess Euro sold for a total of $137,700 (1.53 million * $0.09). Therefore, the dollar cost impact of implementing a forward hedge results in higher than anticipated costs of $137,700 under a "Strong Dollar" scenario assuming below average actual sales and a low acceptance rate.

Table 6: US Dollar Cost Impact from Exchange Rate Movements (Forward Hedge)
Forward Hedge Assumptions: 1.8 million Euros six months forward at $1.34 per Euro

		US Dollar Cost Impact		
Probability	**Euros**	Exchange Rate Scenarios		
of Occurring	**Needed**	$1.25/EUR	$1.34/EUR	$1.45/EUR
6%	270,000	$ 137,700	$ -	$ (168,300)
			$ -	
			$ -	
			$ -	
			$ -	
18%	2,250,000		$ -	
			$ -	
8%	2,520,000		$ -	
		$ (121,500)	$ -	$ 148,500
Exp ($ Impact)		$ 12,960	$ -	$ (15,840)
Min ($ Impact)		$ (121,500)	$ -	$ (168,300)
Max ($ Impact)		$ 137,700	$ -	$ 148,500

5. Calculate the US dollar cost impact under the given exchange rate scenarios of taking a long position in 1.8 million Euro Call options with an exercise price of $1.34 and a 6 month maturity date. Compare the cost impact of hedging with call options versus an assumed cost of $1.34 per Euro under the different exchange rate scenarios. Assume the premium on the call options is 2% of the notional value of the contract. (The contract is for 1.8 million Euros

with an exercise price of $1.34. The notional value of the contract is $2.412 million. The premium paid is $48,240)

Table 7: US Dollar Cost Impact from Exchange Rate Movements (Option Hedge)
Option Hedge Assumptions: Long position in 1.8 million Euro Call options with an exercise price of $1.34 and a 6 month maturity date.

		US Dollar Cost Impact Exchange Rate Scenarios		
Probability of Occurring	**Euros Needed**	$1.25/EUR	$1.34/EUR	$1.45/EUR
6%	270,000	$ 23,940	$ 48,240	$ (120,060)
			$ 48,240	
			$ 48,240	
			$ 48,240	
			$ 48,240	
18%	2,250,000		$ 48,240	
			$ 48,240	
8%	2,520,000	$ (178,560)	$ 48,240	$ 127,440
			$ 48,240	
Exp ($ Impact)		$ (100,800)	$ 48,240	$ 32,400
Min ($ Impact)		$ (235,260)	$ 48,240	$ (120,060)
Max ($ Impact)			$ 48,240	

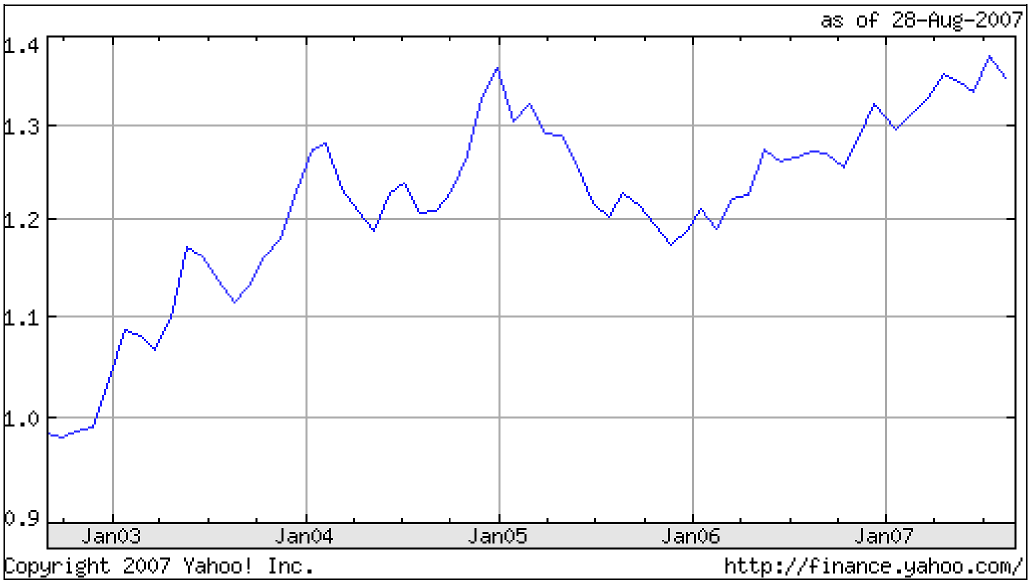
6. What conditions represent the greatest risk to Pearson if he chooses to leave the exchange rate exposure un-hedged?

7. What conditions represent the greatest risk to Pearson if he chooses to implement a forward hedge?

8. What conditions represent the greatest risk to Pearson if he chooses to implement an options hedge?

9. Make a recommendation to Pearson regarding the advantages of an option hedge in terms the general impact on profitability, not just costs.

Exhibit 1: Historical Exchange Rate: Number of US Dollars / 1 Euro



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E-TAILING OFFICE FURNITURE: TOO MANY CLAIMS AT OFC

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CASE DESCRIPTION

The primary subject matter of this case concerns an audit of claims processing for an on-line retailer. Secondary issues examined include process analysis, database analysis, and statistical quality control. The case has a difficulty level of six, appropriate for first year graduate level students. The case is designed to be taught in two class hours and is expected to require 6 – 8 hours of outside preparation by students.

CASE SYNOPSIS

In this claims processing case, evidence is presented to support a critical analysis of claims processing problems. Currently claims are not processed in an efficient manner. Students need to critically analyze the current claims handling process and present a revised version in their solution. Data is provided regarding the number of claims, types of claims, claims processing error rates, catalog information, database sources, and database updates. The data is sufficient to give clues as to the sources and variations of claims. While multiple solution approaches will satisfy the case requirements, solutions should be similar in their general form and conclusions.

INTRODUCTION

OFC is an on-line retailer selling bulk office furniture made of laminated materials: tables, file cabinets, and cases. OFC sells suites, sets, and individual pieces. Suites consist of pre-planned sets of furniture for offices, conference rooms, etc. Sets consist of two or more individual pieces, but are less then suites. OFC hosts a website consisting of an online catalog and an order processing system. As of late the general manager has noticed an unacceptable increase in the number of claims. Claims take various forms including: damaged goods, purchase order errors, manufacturing errors, and packaging errors among others. The claims-processing department, staffed by a supervisor and two clerks, has always been pressed. Claims are usually backlogged for at least twenty days. OFC operates 360 days per year.

Chris Scan, OFC's general manager is fed up with the frequent emails, calls, crises, and just general turmoil in claims processing. He forms a team to study the situation, and tells the team leader he wants results ASAP, with weekly reports. The first report is due in one week.

Report 1- Claims-Processing (CP) Description

The Claims Supervisor receives a claim (arriving by email or traditional mail). A paper file of the claim is created, logged in, and forwarded along at each step as the claim investigation process. The file contains information on the customer, product, dates shipped and received, and a description of the claim. Additions are made to the file at each step in the process, indicating what was investigated and what was found. Only the Product Manager and General Manager can approve restitution on a claim. The Claim Processing Supervisor forwards the claim file to the appropriate Sales Representative, who confirms a sale, and verifies various aspects of the sale (amount, dates, etc.). The file is then forwarded to Shipping, which confirms the shipment status (dates, condition), and then to the Business Office, which confirms billing and payment information. The verified claim is returned to the Claims Supervisor, with any discrepancies noted. The Claims Supervisor determines the resolution of the claim, and forwards it to the Product Manager for approval.

Approved resolutions are returned to the Claim Processing Supervisor for communication to the customer. If the Product Manager cannot approve a claim, it is forwarded to the General Manager for approval. General Manager approval is needed in cases where it is not entirely clear as to the cause of the claim and the fulfillment of the claim is considered a judgment call. The General Manager resolves the claim on the basis of the information in the file, company policy, and judgment, and returns it to the Claim Processing Supervisor for communication with the customer. The General Manager's resolution is final. On the average, approximately 15% of the backlog is with the Claim Processing Supervisor, 35% with the Sales Representative, 20% with Shipping, 10% with the Business Office, 15% with the Sales Manager, and 5% with the General Manager. Approximately 20% of the claims reach the General Manager.

To Chris, it was no wonder he was fed up. The claims process looked like a cumbersome, redundant mess. He instructed the team leader to get him some information on the type and frequency of claims. These results are summarized in report 2.

Report 2 – Type and Frequency of Claims

A comprehensive survey of the 2,027 claims submitted in the last 5 years was conducted and is summarized in Table 1 below.

Table 1: Summary of claims in 5-year survey			
Shipping		Business Office	
Claim	**Frequency**	**Claim**	**Frequency**
Shortage/overage	321	Pricing	373
Delamination	291	PO error	180
Invoicing	188	Trans. Fees	112
Wrong order	81	Discounts	107
Mfg. error	74	Other	47
Loading error	71	**Total**	**819**
Tare error	55		
Damage	51		
Packaging	47		
Late	23		
Other	12		
Total	**1,214**		

A further breakdown of the major claims in each category above is shown in table 2.

Table 2: Breakdown of claims in top categories from Table 1			
Shortage/Overage (321 claims)P		Pricing (373 claims)	
Suite shipments	254	Suite sales	269
Set shipments	56	Set sales	92
Individual pieces	11	Individual pieces	12

Suites and sets comprised the bulk of shortage/overage and pricing claims. A more detailed investigation of Suite and Set documentation revealed the following information:

Number of Suites offered (average, 5-year period):	5
Number of Sets offered (average, 5-year period):	12
Changes in definition (number, type and quality of pieces included) in 5-year period:	27
Frequency of documentation updating:	quarterly
Number of discrepancies between reference databases (Sales Department, Shipping, Business Office) currently:	
Definitions:	5
Prices:	8

In the business office the majority of claims result from pricing errors (almost half). Two clerks are responsible for handling all business office claims. To gain a detailed understanding of how the clerks handle work volume and complexity (and resulting error rates) sample data was collected and is presented in table 3. Volume is measured as claims per week, and complexity is items per claim.

Table 3: Sample data by pricing clerk					
Clerk 1			**Clerk 2**		
Volume	Complexity	Error rate	Volume	Complexity	Error rate
171.04	3.46	0.034	225.47	3.83	0.041
162.28	3.78	0.035	198.34	4.21	0.040
168.19	2.89	0.031	234.21	2.99	0.038
189.53	3.55	0.036	214.00	4.42	0.043
168.00	3.24	0.032	204.97	3.50	0.037
161.03	2.99	0.031	162.50	3.96	0.035
218.94	2.30	0.033	236.43	3.08	0.038
186.05	2.60	0.031	180.98	4.79	0.041
199.57	2.60	0.032	200.47	3.77	0.038
176.51	2.97	0.032	218.75	4.86	0.045
155.89	3.75	0.034	211.80	3.80	0.039
202.09	3.12	0.035	203.48	4.45	0.042
209.92	2.78	0.034	206.00	4.01	0.040
226.37	3.18	0.038	199.07	3.90	0.039
191.07	3.83	0.038	170.12	3.80	0.035
199.56	2.78	0.033	198.01	3.81	0.038
193.82	2.97	0.034	206.30	3.47	0.037
177.54	3.16	0.033	225.15	3.65	0.040
183.35	2.75	0.032	218.11	3.53	0.039
173.93	2.93	0.032	194.46	3.77	0.038
Means					
185.73	3.08	0.033	205.43	3.88	0.039
Standard Deviations					
19.58	0.42	0.002	19.22	0.49	0.002

Table 4 presents the sampled clerk data in summary format.

Table 4: Pricing error rates and related data		
Employee	**Clerk 1**	**Clerk 2**
Error rate (%)	3.34	3.92
Work volume (mean) (Claims per week)	185.7	205.4
Work complexity (mean) (Items per claim)	3.1	3.9
Overall error rate: 3.63%		

In addition, Chris required an additional report regarding the state of and types of databases involved in the ordering process.

Report 3 – State of Databases for Sales, Billing, Delivery, and Products

Four separate databases are maintained for the company. When a sale is made entries are committed to a sales database regarding customer information and products bought. After an order is placed in the sales database corresponding payment, and shipping and delivery information is entered into payment and delivery databases respectively.

The payment database is maintained by the billing department. After an order is placed with the sales people they forward the order to billing who then arranges and tracks payments.

The delivery database only tracks shipment dates and order numbers. When deliveries are made, drivers have an order report generated from the sales database, they then reconcile the order report with the delivery report from the delivery database. As a note, the sales database does not track whether an order was successfully delivered.

In addition, a fourth database is maintained regarding product information. As stated above this database is only updated quarterly. OFC's website contains an online product catalog generated from information maintained in this database.

ASSIGNMENT

Analyze OFC's claims processing problem. Make any reasonable assumptions you believe necessary to analyze the problem. Recommend an improved Claims Processing process: Specify goals and objectives, critical processes, measures, procedures, and controls.
Specifically address the following questions:

1. What are the claims, and how many are there?
2. How are claims processed?
3. Is the current process efficient?
4. What can be said about the workload/quality of the business office clerks? Is the business office over or under staffed?
5. Is the current database design sufficient?

WHAT IS THE RIGHT THING TO DO? THE CASE OF RURAL BANKING

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CASE DESCRIPTION

The primary subject matter of this case concerns some of the real-world difficulties associated with overinvestment in negative NPV projects (or underinvestment in positive NPV projects) when capital budgeting valuation is close to $0.00 NPV. It also focuses on identification of marginal cash flows in a capital budgeting problem, the importance of customer service, conduct of business in a rural environment, and the influence that the press can have on business decisions. It also speaks to the importance of considering qualitative and intangible issues in the sensitivity analysis that accompanies capital budgeting problems. The case has a difficulty level appropriate for junior or senior level finance majors – either in their first or second course of corporate finance. The case could also be used in a class of first-year MBA students. The case is designed to be taught in a single sixty (60) or eighty (80) minute class period and should require approximately one or two hours of outside preparation by students.

CASE SYNOPSIS

The student assumes the role of the CEO of City State Bank who must decide whether to ignore a large number of customer complaints at a local branch, close the branch in question, or take action to alleviate the problems that customers are experiencing. The CEO has made some preliminary projections associated with addressing the customer concerns, but he needs to consider the advantages and disadvantages of each alternative in great detail. Analysis of the problem is more qualitative in nature and requires only one simple computation by the student; however, discussion of the situation should be rich in the areas of overinvestment, identification of marginal cash flows, and spillover effects. Although the case is derived from an existing bank and a real decision, City State Bank is a fictitious entity. Other information in the case has also been altered to provide confidentiality.

PROBLEMS AT THE DRIVE-UP WINDOW

For many years, being the only banking facility in the city of Jones, Mississippi, a community of 1,500 residents, was a distinct advantage to City State Bank ("CSB"). CSB's main banking office is located in Jackson – approximately 30 miles from Jones. In 2001, the Jones branch was robbed twice within a six-month period. Other than the local excitement at the time, the event went unnoticed for about two years until CSB announced that they were closing the bank lobby and customers would have to conduct their banking business through a single drive-up window. Pedestrian traffic is now greeted with a sign that reads:

Figure 1. Lobby Window Sign

LOBBY
CLOSED
Please Use
The Drive-Up
Window

Knock for
Safe Deposit Service

Customers suspected that the lobby was closed because of the two robberies. Since 2003, there have been a number of customers who have taken their banking business to other out of town banks – about twenty to thirty minutes down the road. The local weekly newspaper called Bill Franks, President and CEO of CSB to determine why the lobby had been closed. He noted that he joined the bank after the lobby closure so he would not speculate as to why it had been closed. Franks did point out that security and customer safety was very important.

Frustrations with the lobby closure came to a boil recently when Larry Smith sat in line at the drive-up window for over an hour waiting to cash a check made payable to his mother who had endorsed the check over to Larry. When he got to the teller, she stated that his mother would have to accompany him to cash the check. He went home and got his mother to accompany him to the bank. They waited in line for another 45 minutes before reaching the teller window.

With this bad experience fresh on his mind, Larry decided to solicit signatures on a petition demanding that lobby operations be reestablished. Over 900 residents signed the petition demanding that CSB either open the Jones branch lobby for full service banking or sell the branch to another bank that would.

Larry delivered the petition to Bill Franks – whose office was in Jackson. Mr. Franks was alarmed that so many Jones residents expressed their concern with his bank's treatment of customers. He told Larry that he would examine the issues raised in the petition and would meet with the board of directors to determine CSB's course of action. Adding to his disappointment, the statewide daily newspaper in Jackson had picked up on the story and featured CSB's poor level of service in an article the very next day. Needless to say, the article was far from flattering. Even the mayor of Jones was quoted in the article as saying he wasn't happy with the current situation. He was concerned about the impact of the long car line on the city's traffic safety – not to mention his concerns about how the town could attract more business without adequate banking facilities.

THE CEO'S OPTIONS

As he prepared information for the board, Mr. Franks examined all the data upon which he could get his hands. His Jones branch was certainly losing customers. The branch had fewer accounts than the number of folks who signed the petition! Given the competitive nature of the rural banking markets in Mississippi, he could not justify selling the branch to a competitor. Besides, the press would have a field day with CSB if another bank came in to "clean up" their mess. He felt he had three options:

1. close the branch,
2. ignore the petition and continue operating the drive-up only facility, or
3. improve the lobby with some added security features and open the branch for full banking services.

Closing the branch would mean a serious blow to the local economy of Jones and the efforts of the city to attract any new businesses. Businesses were leaving Jones already! Could he contribute to the city's failure? Operating bank branches in rural communities is CSB's core business, and a closure would have many other indirect effects.

Ignoring the petition would lead to the eventual demise of the branch – not to mention the continuing bad press.

Bill's most difficult task is determining whether or not it is in the best interest of his shareholders to open the lobby. If he were to open the lobby for service, how many members of the community could he lure back to the bank? Commercial accounts of local merchants had all but gone away. He was left with fewer than 520 accounts – almost all of which were personal. Advertising would help CSB regain many lost customers, but was their reputation too far gone to fully repair? Shear convenience would bring some folks back – but how many? Bill's best estimates of net cash flows are reported in Exhibit 1.

With regard to his cost of capital, Bill collected several pieces of information. First, he examined CSB's balance sheet and noted that the bank was financed with 80% debt and 20% common equity (the bank had no preferred shares outstanding). From the bank's perspective, interest rates were pretty good and the bank could borrow at 5.0%, and their marginal tax rate was 35%. The current stock price was $30.00, and next year's annualized dividend was anticipated to be $2.26. The bank has five analysts following their performance, and their long-term (5 year) estimates of CSB's earnings growth are 2.3%, 2.6%, 2.5%, 2.8% and 2.3% respectively. With this information, Bill was confident that he could come up with CSB's cost of capital.

Bill wasn't excited about any of his options. Were his projections accurate? At best, he could offer very little support for his numbers if the board were to grill him on them. He was at a loss about what to do.

Table 1: Projections for Reinstituted Lobby Operations

Year	Number of Net New Accounts	Net Cash Flows per New Account	Lobby Improvements	Total Net Cash Flows
2008	450	120.00	-100,000	-46,000
2009	200	123.60	0	24,720
2010	100	127.31	0	12,731
2011	50	131.13	0	6,556
2012	25	135.06	0	3,377