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JOURNAL OF THE INTERNATIONAL ACADEMY FOR CASE STUDIES

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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).

INSTRUCTORS' NOTES

This negotiation is best done as a team versus team simulation between members of the Motherlandian Government and members of McDollar's corporate Motherlandian board. As it is an international negotiation with the American team engaging in conversation with individuals of a radically different culture, they should be knowledgeable about Motherlandian society and business practices. There will undoubtedly be some uncomfortable periods during the simulation as both sides get accustomed to the other side's culture. Students should be well aware of the Motherlandian cultural practices and superstitions that are listed on the provided cultural sheets.

When the students begin to get into negotiation issues, there are a number of issues that each side may approach in an integrative manner. Let's look at each issue to see the possibilities.

Issue 1 - Menu Changes:

Menu consistency is the cornerstone of the McDollar's dining experience, and is crucial to Dunn and his/her board. While Kasiminov may prefer that some slight changes be made or food selections added, this issue is not all that important to the Motherlandian government. This issue was basically created as ammunition for the Motherlandian side to give as a concession to the American side. A win-lose situation would be if both sides solely accepted one menu or the other; the

American menu or the Motherlandian menu. Students have the opportunity to be creative in menu changes so that both sides can be pleased.

Issue 2 - Local Sourcing:

This is one of the issues that offers the most possibilities for an integrative deal. It is incredibly important to Kasiminov that all of the capital and infrastructure improvements are made to his/her country in order to benefit his people. Likewise, sourcing locally can be very beneficial to Dunn in the long run. Dunn, however, will have to see past the hurdle of the high start-up costs associated with this.

In the actual case, all of these improvements were in fact made, with a cost of around $45 million American dollars (which included roads, the McComplex, and farmer education, etc.), all which have been incredibly effective. Students can also be very creative here in the ways in which they choose to train farmers and construct infrastructure. The American briefing warns Dunn that Jay Brock will be angered by delays, but he has already incurred fourteen years of waiting; Jay Brock is not about to lose this deal over simple start-up costs, which he probably expects.

In actuality, corporate McDonald's flew in European supply specialists including a Dutch cucumber specialist for making pickles, a German meat expert, and their European potato supplier. The benefits of local sourcing kept costs low and consistency and quality high for McDonald's in the long run, maintaining the excellence of their products. Likewise, the farmer training and infrastructure built Russian farms around Moscow not only into steady suppliers for McDonald's, but into incredibly profitable business which helped to feed the starving masses (which is mutually-beneficial pie expansion).

Issue 3 - Hire Locally:

This is an important issue for both sides, but one that we do not feel should be difficult to resolve. Kasiminov obviously desires Motherlandian employees and management to boost his economy, and Dunn will want to maintain autonomy with American managers. The training costs are thrown out as a red herring, but truly are largely insignificant. An optimal outcome for both sides would be to train well educated locals at Hamburger University, with McDollar's picking up the tab, which will be a small expense when tacked on to the McComplex costs. The issue of financing the training can be used by the American side as a potential bargaining fodder for other, more important issues. In reality, all Russian employees were used, and made up the most amazingly competent and over-educated staff of any McDonald's in the world (e.g., McDonald's employed a top-level rocket scientist to run the Dunn).

Issue 4 - Ownership

This issue is non-negotiable for Kasiminov and the Motherlandian side. They will not be able to take lower than 51% ownership, and would like more. This will be a strong conflict. We have included this issue so that the Americans will actually feel all of the sacrifices that are sometimes necessary to avoid a terrible BATNA. In reality, the Russians and the city of Moscow ended up owning 51% of the ownership of the venture; in 1998, however, McDonald's had renegotiated their stake back up to around 80% ownership.

Issue 5 - Location:

It will be easy and clear to both sides that location one, in Pushpin Square, is the best area to locate the venture for both parties. It will be expensive for the Americans to obtain the site, but well worth it; it will be a good site for the Motherlandians as well, but much more difficult to acquire by Kasiminov. The Minister of Commerce, however, will be able to use this as leverage to get more out of the American side on other issues; if he is able to obtain the real-estate.

Issue 6 - Currency:

Using Rubles only is a substantial risk to the Americans with the fears of devaluation and the impossibility of repatriation. So they will and should do everything in their power to fight for dual lines and dual use of Rubles and hard currency. On the other hand, Kasiminov will be a staunch supporter of Rubles only for the McDollar's venture, as will the general Motherlandian populace, who will be the main customers. This is a very important issue, and it is somewhat of a lose-lose situation for the American side. But as long as the company can operate self-sufficiently with Motherland (which forcefully implicates the need for the McComplex), repatriation will not be necessary and choosing Rubles only will show good faith on the part of the Americans, which will gain the respect of Kasiminov and the Motherlandian commoners. In reality, McDonald's Russia accepted Rubles only, which gained them the respect of the Russian people, but was faced with economic crisis with the devaluation of 1998.

Cultural Issue - A Cultural Trap for U.S. (McDollar) Negotiators.

Herb Cohen's book, *You Can Negotiate Anything*, contains a chapter titled "Winning at all costs...Soviet style," which lists and describes six particularly hard bargaining - and incredibly unproductive - negotiating techniques.

The summary version of those techniques has been adapted and included in the negotiation packet for U.S. (McDollar) negotiators. The expectation is that McDollar negotiators will stereotype their counterparts and wrongly impute to them Soviet style negotiating techniques. The reason this is false attribution on the part of U.S. (McDollar) negotiators is because Motherlandian negotiators are being given the same information, except they are explicitly told that the Soviet style is by no means necessarily the Motherlandian style and, in fact, because of the horrible Motherlandian BATNA (no deal, economic stagnation or decline) Motherlandians should be particularly motivated to bargain in good faith (as they are explicitly told to do) in order to strike a deal.

The intentionally constructed irony in this exercise is that on issues on which Motherlandian negotiators may state they have no authority, for example not being able to pay for McComplex or not being able to go below 51% ownership, the truth is they really do have no authority - and their role information packet says exactly that. U.S. (McDollar) negotiators, however, are likely to convince themselves that any reference to "authority" by the Motherlandian negotiators is nothing but a Soviet style tactic and they may wrongly become cynical and distrustful, i.e., a self-fulfilling prophecy will take place. Some of the Motherlandian positions may strike U.S. (McDollar) negotiators as extreme, but they really are not extreme given the weak state in which Motherland finds itself.

If the parties lose sight of their BATNAs, become too competitive, and forget where they are in the negotiation process - it's been going on for fourteen years - they will reach an impasse, which both parties should understand is a disaster. Given that we have the real world case to fall back on during the debrief, it can credibly be explained that in the real world McDonald's satisfied almost all of the Soviets' needs not because the U.S. was weak during the negotiations, but because McDonald's fully understood that accommodating legitimate Soviet needs was the only way the deal could work - and, as history has borne out, the agreement was a success in the real world for both sides.

NEGOTIATION TERMS (FOR INSTRUCTOR'S USE IN DEBRIEF)

BARGAINING ZONE: The bargaining zone is also known as the "settlement zone."

BATNA: A negotiator must determine his/her Best Alternative to a Negotiated Agreement. This is so important that it has been made into an acronym. A BATNA is the point at which a negotiator is prepared to walk away from the negotiation table. A negotiator should be willing to accept any set of terms superior to their BATNA. Moreover, a negotiator should reject any set of terms that are worse than their BATNA (Fisher, et al. (1991), Thompson, 2001).

EXPANDING THE PIE: Expanding the pie is a method used to create integrative agreements through the use of integrative negotiation. It is the opposite of Pie Slicing, also known as Distributive Negotiation or Fixed Pie Negotiation, a faulty perception that the parties' interests are completely opposed. Expanding the pie means identifying trade-offs and avoiding compromise (Thompson, 2001).

INTEGRATIVE NEGOTIATION: Integrative negotiation is also known as "win-win" negotiation. Common misperceptions are that win-win negotiation means compromise, an even split, feeling good or building relationships. What win-win really means is that both parties are better off than if there were no agreement. The very best integrative outcome -- an optimal agreement – means all creative opportunities are exploited and no resources are left on the table. (Thompson, 2001).

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AUTHORS' NOTE

This case was inspired by and is a modification and expansion of a case entitled "McDollars in Mother Russka," a case originated by former University of San Diego undergraduate students Nicholas M. DeWeese and Zachary G. Puca. The case is based loosely based on the actual case study of McDonald's in Russia and was structured based on the bargaining template (Smart Growth for St. James) produced by Linda L. Barkacs and Craig B. Barkacs.

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.

INSTRUCTORS' NOTES

Learning Objectives

This case is intended to teach and reinforce various aspects of strategic analysis and choice including internal and external analysis, strategic choice as a function of SWOT analysis, implementation of a Low Cost Leadership generic strategy, utilization of Financial Ratio Analysis and modification of strategy as time unfolds. The case can also be used to examine the potential benefits and risks of overseas expansion for a domestic concern.

Teaching the Case

We suggest that a practical starting point for this case analysis is a discussion in class of mission, vision and SWOT analysis. This case illustrates how a Low Cost leadership generic strategy can be extremely successful in a very competitive industry – passenger airlines. Southwest has enjoyed profitability and continued growth for thirty five years. It should be noted that as of the date of the case (February, 2008) that Southwest Airlines' market cap was $9.42 billion while American Airlines, United, Delta, Northwest and Continental had substantially lower market caps.

When assigning this case for classroom discussion, we recommend that the instructor require the students to read the case, review a selection of the references and jot down answers to the discussion questions before class. Then, in class, we suggest that individual students assemble themselves into teams of three to four students and prepare consensus answers to the five discussion questions. The answers should be presented by a team representative. This allows about ten minutes for presentation of each team answer and works well in a traditional seventy five minute class.

Incase the instructor wants to make this a two-day discussion, other topics and questions can be included:

1. How can Southwest Airlines accommodate the rapid, recent increases in fuel costs? A recent technology advance is the addition of Boeing winglets (vertical fins) to the ends of the wings on roughly one-third of Southwest's fleet. See http://www.b737.org.uk/winglets.htm

2. What can any airline do about the implicit threat of shoulder-fired Stinger missiles? See http://business.timesonline.co.uk/tol/business/industry_sectors/transport/article3025938.ece

3. Beyond modified seating and boarding arrangements, what can Southwest do to attract larger numbers of business travelers? Consider the "bundle" of service surrounding the flight alone.

4. Can Southwest (today) incorporate elements of Guerrilla Marketing as Lamar Muse did in the airline's early history? See: http://www.gmarketing.com/

We recommend and use Kantola Productions' Stanford Executive Briefing Videos in class. One that is particularly relevant to this case is "Colleen Barrett: What Drives Phenomenal Success?" Colleen Barrett has been with Southwest since its beginnings and is today President and Corporate Secretary. Her video, in addition to enriching the discussion of Southwest Airlines, can also be used as a "bridge" device into a discussion of female executive leadership in modern organizations.

DISCUSSION QUESTIONS

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

A SWOT Analysis is a procedure used to identify the important characteristics of the firm's internal environment and the salient characteristics of the external environment. **S**trengths are those things that a firm has (like human and physical resources) that can provide a competitive advantage. For Southwest, strengths would include its culture and people together with its systems and operating results. **W**eaknesses are just the reverse of Strengths and it is difficult to identify any significant weaknesses at this time. **O**pportunities and **T**hreats are those things external to the firm that represent real opportunities for enhanced growth and profitability or threats to enhanced growth and profitability. Opportunities for Southwest would include the possibility of a route map expansion to include the Caribbean, Mexico and Canada. Threats obviously include competition from other low cost airlines and fuel costs.

Interpretation of a SWOT analysis means more than compiling a list of strengths, weaknesses, opportunities and threats. It means combining these factors in combinations that will lead to the creation of competitive advantages. For example, Southwest's fuel hedging procedures (a strength) combined with the current cost of aviation fuel (a threat) suggests that continued, active fuel hedging programs now is the time will be a major source of competitive advantages for the foreseeable future.

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?

It is true that most introductory accounting texts recommend a Current Ratio of 2.0 or above. However, it is also true that some industries commonly exhibit Current Ratios of 1.0 or slightly less. This is true of both airlines and utilities. The logic here is that both of these industries have a steady, daily inflow of cash (revenues) and are thus able to manage their Current Liabilities easily. Two points are worth noting. Southwest's Current Ratio did decline from 2005 to 2006 and this is not a positive sign. Also, in order to interpret any financial ratio, we should consider changes over time and the specific ratios for the industry in which it participates. We recommend that students consult http://finance.yahoo.com for current financial ratios.

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

The most commonly-heard complaint about Southwest Airlines has historically been its boarding procedures. Southwest has boarded customers in groups of thirty on a first-come, first-served basis. There were no assigned seats and many people commonly lined up at the gate an hour before departure time to get a chance for a preferred seat. The reason for this boarding procedure was that it minimized the cost of boarding and facilitated quick gate turnarounds.

Beginning in late 2007, Southwest began offering Business Select seating on many flights which entailed an additional charge of $10-$30 each way and guaranteed those customers paying the additional ticket price the opportunity to be in the first group of customers boarded. Additional inducements for the extra fare include a free drink, more frequent flyer rewards and refundable, reusable tickets. Southwest estimates that Business Select will increase annual revenues by $100 million. Since Southwest flew roughly 1.1 million flights in 2006 this means that earning an additional $100 million in revenue would only be roughly $100 per flight. With an average load factor of 73%, this means about 5 people per flight would need to utilize business select to realize the revenue goal. On this basis the expected incremental revenue looks conservative.

The larger question though is "Will this reduce the complaints about boarding, in general?" One must realize that many passengers flying Southwest do so because of their historic low ticket prices. It is unlikely that many of these passengers would select business select and so the complaints may not be resolved.

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?"

On the "plus" side of the question would be the opportunity to increase the number of flights but there are several potential "minuses." Flying to some airports in the Caribbean, Mexico and Canada would include the added complexity and cost of working with foreign governments. Access to gates at the airports can be a considerable expense and easy access to maintenance services adds an additional dimension.

In general, adding to the route map with destinations outside the United State would be a clear departure from Southwest's traditional business model and, obviously, needs to be carefully considered. In additions to the concerns above, it would be appropriate to consider the distances involved and the passenger traffic volume that currently exists. For instance, travel is quite heavy between New York City and San Juan, Puerto Rico. The distance is approximately 1650 miles and well within the range of a 737-800. Other popular destinations in the Caribbean such as Nassau, the Virgin Islands and Jamaica are within the "reach" of a 737. One interesting potential route is the possibility that the United States government will relax travel restrictions to Cuba since Fidel Castro stepped down as President and there are more than 1.2 million Cuban Americans living in the United States with relatives and friends still in Cuba.

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

Southwest Airlines has been profitable since its inception – 35 years ago – and continues that amazing track record today. No other major airline has matched this consistent performance and that is probably reflected in the market cap for the majors. At $9.5 billion, Southwest is more than double the other major carriers. It could be argued that Southwest's profitability reflects their Low Cost Leadership strategy but the real answer goes much deeper than that. Southwest has a business model that others have attempted to copy with limited success.

Important elements of the business model include the corporate culture, the dedicated, hard-working workforce and the ability to react quickly to new opportunities and challenges. Most important, perhaps, is the belief that Southwest is a fun place to work and the employee stock ownership program builds wealth quickly for those who stay with the airline.

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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.

INSTRUCTORS' NOTES

Traditional college students, unless they have had some amount of experience in the work force, are usually quite surprised to learn that even in these so called enlightened times that discrimination is alive and unfortunately quite well in corporate America.

There has been undeniable progress in many areas. Nevertheless, the evidence is overwhelming that the problems affirmative action seeks to address -- widespread discrimination and exclusion and their ripple effects -- continue to exist.

Minorities and women remain economically disadvantaged: the black unemployment rate remains over twice the white unemployment rate; 97 percent of senior managers in Fortune 1000 corporations are white males; (28) in 1992, 33.3 percent of blacks and 29.3 percent of Hispanics lived in poverty, compared to 11.6 percent of whites. (29) In 1993, Hispanic men were half as likely as white men to be managers or professionals; (30) only 0.4 percent of senior management positions in Fortune 1000 industrial and Fortune 500 service industries are Hispanic. (31)

Blatant discrimination is a continuing problem in the labor market. Perhaps the most convincing evidence comes from "audit" studies, in which white and minority (or male and female) job seekers are given similar resumes and sent to the same set of firms to apply for a job. These studies often find that employers are less likely to interview or offer a job to minority applicants and to female applicants. (32)

Less direct evidence on discrimination comes from comparisons of earnings of blacks and whites, or males and females. (33) Even after adjusting for characteristics that affect earnings (such as years of education and work experience), these studies typically find that blacks and women are paid less than their white male counterparts. The average income for Hispanic women with college degrees is less than the average for white men with high school degrees. (34)[1]

Discrimination also occurs in many forms and with various nuances. "Title VII of the Civil Rights Act of 1964 protects workers from employment discrimination based on their race, color, religion, sex, national origin, opposition to practices made unlawful by Title VII, or participation in Title VII proceedings."[2] The Office of the High Commissioner for Human Rights of the United Nations noted that discrimination included discrimination based upon HIV/AIDS, religious intolerance, people with disabilities, migrant workers, xeophobia, and racial discrimination.[3] The International Labour Office concurs with the United Nations and noted that many people suffer from multiple discrimination.[4]

The overriding mission of this case is to present to students several situations within a firm where discrimination is not only present but seems to be nurtured by higher levels of management and unchecked by human resource personnel. It is also a cautionary tale. A company may espouse equality, empowerment and management, but failure to train, execute and enforce these discrimination policies may have substantial repercussions, including major lawsuits.

RESEARCH METHODOLOGY AND DATA COLLECTION

The first author in this case interviewed one of the case characters (although not the subject of the discrimination) hence this research is subjective and phenomenological in nature.[5] The writing style of the case therefore reflects a more colloquial style then one might find in a typical business case and tries to capture the points of view of the case characters. The information for this case was collected by the first author through personal reflection, observations, e-mails, and discussions with the key characters in the case as well as through secondary research. The quotes presented in this case are paraphrases of actual conversations between the case characters.

INTENDED INSTRUCTIONAL AUDIENCE AND PLACEMENT IN COURSE INSTRUCTION

This case was primarily developed for upper level undergraduates taking an introductory course in human resource management since the focus of the case requires students to make a determination as to not only whether racial discrimination occurred in the workplace but what if any actions could have been taken by management to prevent it. Specifically, the students would need to analyze the firms' employee's recent promotions relative to the Civil Rights Act of 1991. The case may also be employed in an introductory undergraduate management course (perhaps after the section on staffing), and a business ethics course.

The case should be introduced after students have read material on racial discrimination, employee recruitment, and the processing of employee complaints. Since the case covers numerous chapters in a typical HRM textbook, and has many confounding elements, it is recommended that the case be employed as a sectional or comprehensive case rather than an end-of-chapter case.[6]

In its secondary uses, the case could serve as an end of chapter case dealing with HRM issues in an introductory management course or could serve as a introductory or end of chapter case dealing with employer-employee relations in a business ethics course.[7]

LEARNING OBJECTIVES

The overall purpose of this case is to introduce students to the nuances associated with discrimination and affirmative action laws as they apply to employee promotion and superior-subordinate interactions. Students obtain a "real-world" feel of the situation through character dialogue and tacitly experience some of the difficulties that the characters encountered when trying to progress at the firm and report discrimination violations. Specific learning objectives are as follows:

- For students to obtain a basic understanding of the antidiscrimination laws as they apply to the work environment.

- For students to understand the idiosyncratic nature of being managed in a firm that is not proactive about discrimination violations
- For students to discern what actions Rogers, Young, and Ford could have taken in light of the firms' inaction to their discrimination complaints.
- For students to make a judgment (based upon the facts case and the presiding laws on discrimination) whether Rogers, Young, and Ford had a prima facie case.
- For students to decide, assuming Rogers, Young, and Ford do have a prima facie case, whether or they should win their case and what would be an acceptable remedy.
- What actions the firm can take in the future to prevent discriminatory actions from occurring.

TEACHING STRATEGIES

Preparing the Student Prior to Case Analysis

There are several approaches, none of which are mutually exclusive, that an instructor may employ in terms of utilizing this case. It is strongly recommended that, regardless of which course this case is to be employed with, students should have some exposure to antidiscrimination law. Some background information can be gleaned from such websites as http://www.eeoc.gov/types/race.html (EEOC's definition of race discrimination), http://www.eeoc.gov/facts/qanda.html (discriminatory practices), http://www.usdoj.gov/crt/emp/faq.html (the justice department's site on frequently asked questions) and http://www.lawzilla.com/content/fed-emp-300.shtml (facts about EEOC mediation).

Secondly, it is also recommended that students have some grounding in employee standard employee hiring and promotion practices. This information can be obtained from a typical HRM textbook as well as from recommendations from The European Community Regional Development Fund (http://www.equality-online.org.uk/ equality _advice/recruitment_selection.html) and EEOC's Best Practices of Private Sector Employers (http://govinfo.library.unt.edu/npr/library/Best-Practices.htm).

The above information may be delivered prior to assigning the case by using at least one (1) of the follow methods:

- *a short lecture, student presentation, discussion session, and/or reading assignments on aforementioned topics.*
- *a guest lecturer from a human resource manager and/or EEOC compliance officer.*

Role-Playing (80 minutes)

Role-playing enacts a case and allows the students to explore the human, social, and political dynamics of a case situation. This case lends itself quite well to a role playing exercise since the filing of discrimination charges can be enacted through a confrontational venue; a mock court.

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

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

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

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

The class as a whole should be employed for this exercise. Given the class, the instructor can determine how many jurists will be needed, whether a student will play the role of the judge (although this role is suggested for the instructor), and how many witnesses will be available to testify in court. At least three students will be needed to play the role of the plaintiffs (Rogers, Young and Ford), one student to represent the defendant (the firm), and two students will need to role play their respective attorneys. Witnesses from the case should include Kevin Simmons, Vice President of the Financial Administration Department, Laura Hertz and Mary Connors, who worked for the Accounts Receivable Department, Tom Mathers, Credit Manager, and Linda Evans, a secretary. Other students may be assigned to be witnesses, as needed.

Step 2: Enactment (50 minutes).

The instructor or the student playing the role of the judge should start the court hearing by summarizing the situation and then asking each attorney to make an opening statement. The instructions to the students playing the attorneys is that they need to "win at all cost" and therefore: a) a settlement is out of the question; b) they will conduct a very aggressive cross examination. The instructions to the students playing Simmons and Mathers is to absolutely deny race, age, or gender impacted their treatment of their employees and certainly did not play any role in the most recent promotion decisions.

Step 3: Debriefing (20 minutes).

The instructor might want to ask the following questions:

Did the jury reach a verdict?
If in favor of the Plaintiff, what was the settlement?
Did you agree with the jury's verdict? Why or Why not?
Evaluate each attorney – did they do a good job in making their case?
Evaluate the Plaintiffs and the Defendants – were they believable?
Evaluate the witnesses - were they believable?

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

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

The debriefing session should produce closure for students by connecting HRM practices and EEOC laws with case specifics and the results of the role-playing exercise.

Suggested Case Questions

Discerning the real problem in the case could serve as an introductory question (i.e. discuss the problem posed in the case), however, this question should be separated from the other case-specific questions dealing with race discrimination since it is evident that the latter questions would bias the answer to the first question. We suggest that, at most, students be given only the question dealing with discussing the case problem as a take home assignment and that the remainder of the questions be employed as in-class discussion questions.

1. What are the antidiscrimination laws concerning the workplace that applies to this case?

This question requires that students recognize that the focus of the case is on the discrimination claim by do some reading and research on race discrimination.

The below average student will answer this question by referring to discrimination in general rather than to race discrimination as discussed in the case. This student might cite Title VII of the Civil Rights Act of 1964 which "prohibits discrimination based on the protected classifications of race, color, religion, national origin, and sex."[8]

The average student will probably cite the more recent Civil Rights Act of 1991 noting that this act was passed in order to make it easier for employees to substantiate their claims and by addressing mixed-motive cases (those cases where other performance-related factors also motivated the employment practice).

The above average student will also note that "in *Wards Cove Packing Co*. v. *Atonio* (1989), a five-member Court majority implicitly overturned its earlier interpretation of Title VII of the 1964 Civil Rights Act in *Griggs* v. *Duke Power Co.* (1971) and held that the burden of proving that a defendant company's employment practice discriminates against a protected group always remains with the plaintiff and does not shift to the defendant. In this act [P.L. 102-166], Congress rejects the Court's holding in Wards Cove and places the burden of proving that its employment practices do not discriminate squarely on the defendant."[9]

The exceptional student will further denote that "in the most important affirmative action decision since the 1978 Bakke case, the Supreme Court (5–4) upheld the University of Michigan Law School's policy, ruling that race can be one of many factors considered by colleges when selecting their students because it furthers 'a compelling interest in obtaining the educational benefits that flow from a diverse student body.'"[10]

This student might also indicate that states also have their own civil rights laws. For example, New York's Executive Law Article 15 Section 296 (Unlawful discriminatory practices) states that "It shall be an unlawful discriminatory practice: (a) For an employer or licensing agency, because of the age, race, creed, color, national origin, sexual orientation, military status, sex, disability, genetic predisposition or carrier status, or marital status of any individual, to refuse to hire or employ or to bar or to discharge from employment such individual or to discriminate against such individual in compensation or in terms, conditions or privileges of employment."[11]

2. In your opinion, do the plaintiffs have a prima facie case for discrimination?

This question has two purposes; one, to determine if students understand the concept of making a prima facie case; two, to see if students can apply the requirements for a prima facie case to this case.

The below average student will answer this question without referring to the law regarding prima facie cases and discrimination. This student will then offer a personal opinion based upon the facts of the case (without reference to said laws).

The average student will most probably answer this question by first defining what a prima facie case is. "A prima-facie case is a lawsuit that alleges facts adequate to prove the underlying conduct supporting the cause of action and thereby prevail. …
A plaintiff can establish a prima facie case of race discrimination under Title VII by establishing that (1) he or she belongs to a racial minority; (2) he or she applied and was qualified for a job for which the employer was seeking applicants; (3) he or she was rejected for the position despite his or her qualifications; and (4) the position remained open after his or her rejection and the employer continued to seek applications from other people with similar qualifications to the plaintiff. McDonnell Douglas v. Green, 411 U.S. 792, 802 (1973). In Texas Dept. of Community Affairs v. Burdine, 450 U.S. 248, 253 (1981), the Supreme Court stated that '[t]he burden of establishing a prima facie case of disparate treatment is not onerous.'"[12]

This student would then indicate that at all of the plaintiffs were in fact member of minority groups, at least one was eligible for a promotion which did not receive although others filled the position, and his performance seemed to equal those who in fact received promotions.

The above average student would continue by noting that there are two types of discrimination, intentional and unintentional. Intentional discrimination is when employees are treated unfairly or receive disparate treatment while unintentional discrimination is when employment practices **that is not job related** results in a disparate impact. A prima facie case can be made for intentional discrimination if there are restrictive company policies, discriminatory remarks, or by applying the McDonnell-Douglas test. An unintentional discrimination case can be made by applying the four-fifths rule (the hiring rate of new employees for a minority group may not be lower than 80% of the majority group). This student would note that by employing the four-fifths rule for promotional purposes, it is clear that the other three employees promoted were members of an advantaged group.

The exceptional student would probably continue to cite some of the legal issues surrounding prima facie cases as it affects the defendants. "After the plaintiff has established a prima facie case, the burden of production shifts to the employer to articulate a legitimate, non-discriminatory reason for the plaintiff's rejection. Id. If the employer sustains the burden, the plaintiff then has the opportunity to present evidence showing that the employer's stated reason for the rejection was merely pretextual. Id.; see also McDonnell Douglas, 411 U.S. at 807; Lindahl, 930 F.2d at 1437 ('The defendant's articulation of a legitimate nondiscriminatory reason serves . . . to shift the burden back to the plaintiff to raise a genuine factual question as to whether the proffered reason is pretextual.') (quoting Lowe, 775 F.2d at 1008).

... Under McDonnell Douglas, to establish his prima facie case, the plaintiff need not prove that discrimination was the motivating factor in his dismissal. All he must do is raise an inference that such misconduct occurred.

A plaintiff can also establish a prima facie case by "offering evidence adequate to create an inference that an employment decision was based on a discriminatory criteria illegal under [Title VII].' Mitchell v. Office of the Los Angeles County Superintendent of Schools, 805 F.2d 844, 846 (9th Cir. 1986) (quoting Teamsters v. United States, 431 U.S. 324, 358 (1977)); see Lowe v. City of Monrovia, 775 F.2d 998, 1006 (9th Cir. 1985) (plaintiff can establish prima facie case of disparate treatment without satisfying McDonnell Douglas test if he or she provides evidence suggesting rejection was based on discriminatory criteria), amended, 784 F.2d 1407 (1986). …

Although 'the mere existence of a prima facie case, based on the minimum evidence necessary to raise a McDonnell Douglas presumption, … the plaintiff [who has established a prima facie case] need produce very little evidence of discriminatory motive to raise a genuine issue of fact' as to pretext. Lindahl, 930 F.2d at 1437. In fact, any indication of discriminatory motive . . . may suffice to raise a question that can only be resolved by a factfinder."[13]

This student might then note that in order for the defendant to rebut a prima facie case, intentional or unintentional, he or she may employ the bon fide occupational qualification defense (BFOQ defense) (1. that all or nearly all members of this group are incapable of performing the job in question; 2. to be "authentic", the employer must limit its employees to a specific group; 3. that it would be socially and morally improper to hire a specific minority for the job; and 4. employment of an older worker would place people in jeopardy), indicate that any perceived discriminatory remarks made were not really of a derogatory nature, that hiring and/or promotional standards employed were legitimate, and that the decision made was of a business necessity (the criteria must directly relate to the employee's ability to perform the job effectively).

This student would denote that the plaintiffs' log of preferential treatment and perceived discriminatory behavior would be difficult to disprove since the BFOQ defense does not seem to apply. There is also no information in the case that would indicate that their performance was lower than their colleagues, what exactly the promotional standards were, and what selection criteria were employed for promotion. This student would probably conclude that a prima facie case could be made.

3. Assuming you were the judge in the case and you had already allowed this case to go forward based upon the prima facie evidence, what would be your verdict and what would be an acceptable remedy to the complaint?

The purpose of this question is to allow students to express their opinion about this case and to propose a solution strategy for rectifying the problem based upon the main provisions of the Civil Rights Act of 1991.

The below average student, regardless of their ruling for or against the defendants, would not reference the Civil Rights Act of 1991 in terms of either burden of proof or awarding of damages. This student's final judgment and award will therefore be unbound by legal limitations and be totally based upon personal interpretation of the facts of the case.

The average student would note that damages in cases of intentional discrimination include compensatory damages and punitive damages. "Compensatory damages are awarded for [current and] future financial losses, emotional pain, suffering, inconvenience, mental anguish, and loss of enjoyment of life"[14] while punitive damages could be awarded if the jury perceived there was malice or reckless indifference exhibited by the defendants. The limitations on the totals damages would be $300,000 (500+ employees). If this student indicates that there was in fact discrimination in the practices of the firm the student might suggest that the plaintiffs be reimbursed punitive damages and be placed in a position of equivalent authority, responsibility, and compensation as their former co-workers who did receive promotions.

The above average student, when describing his or her final judgment, would indicate if they found for the plaintiff whether or not their finding was of intentional or unintentional discrimination. In either case, they would also explain how the jury came to that conclusion given the facts of the case (i.e. since burden of proof is more difficult in disparate impact cases, this student would indicate how the company might fail to prove that their employment practices "is job related and consistent with business necessity").[15]

The exceptional student might deem this case far more complex in that perhaps mixed-motives were in play. For example, it is quite possible that Kevin and Tom would argue that they in no way intentionally discriminated against the plaintiffs' working behavior and promotion in that they would have treated the plaintiffs the exact same way, regardless of their race, gender, or disability. If this defense held up, the award could be merely a return to the job for the plaintiffs and promotion (and any related back pay) and the reimbursement of attorney fees and court costs.

4. What actions should Rogers, Young, and Ford could have taken in light of the firms' inaction to their discrimination complaints?

This question requires students to address the obligations that employees have to protect their own interests and acknowledges a proactive approach to problem solving. It also requires students to apply their knowledge of general human resource management policies dealing with employee complaints.

The *poor student* will either denote that these employees were powerless to do anything and that they had no alternative but to seek a legal remedy or would acknowledge that these employees could have taken some action but would only provide their opinions as to what alternatives were available to them.

A *fair student* would acknowledge that most organizations have several standard procedures for registering work-related complaints. The complaint model[16] would require that the manager and/or human resource manager: 1) listen to the complaint and paraphrase it; 2) have the complainer recommend a solution; 3) schedule time to get all of the facts and/or make a decision; and 4) develop and implement a plan, and follow up.

If the resolution to the complaint was not satisfactory to the complainant then most organizations would have a formal grievance procedure for formally addressing complaints. These procedures usually include: notifying the individuals involved in the grievance, optional mediation, a written grievance (a formal document), a grievance hearing (hire experts, plan the investigation, interview witnesses, search for evidence, and the hearing), and binding arbitration (selection process of arbitrator, the decision, and handling the cost of proceedings).[17]

An *average student* would provide more detail about the grievance process as well as provide more recommendations. For example, there are legal considerations one must address in the grievance process including adequate notice, a fair remedy, respecting privacy and dignity, and preventing physical and emotional injury. Other details might include the "Ten Tips for Handling Grievances" (Let people know whom to approach with service-related concerns or problems; allow people to fully explain their views before jumping to conclusions; get the facts and listen carefully; investigate carefully; be tactful; be deliberate; communicate throughout the process; consider all the consequences; admit mistakes; and sell the decision) or "Minimizing the Likelihood of Litigation" (establish realistic expectations; good communication is your first defense; give legitimate grounds for actions and refrain from mentioning irrelevant considerations; follow the organization's written procedure; take the time to do it right; limit the number of people involved and protect privacy; and consult a lawyer when establishing your grievance policy and procedure).[18]

An *above average student* would indicate that whistle blowing was another option for these individuals to consider, perhaps if, after they filed a formal grievance, no action was taken. "Whistle Blowing is when an employee tells on an employer who is breaking the law. Employees who blow the whistle on their employers are protected by law. If they are fired or otherwise retaliated against for whistle blowing, they can sue. … To actually "Whistle Blow", the employee must tell of the illegal act to someone outside the company. It must be a government or law enforcement agency.

If the employee just complains to someone inside the company, that is not whistle blowing, and the employee is not protected by the whisteblower laws. However, the employee may be protected under other laws. For example, it is illegal to fire someone for complaining of sexual harassment or discrimination. …

If the employee has reported the allegedly illegal activity to a government or law enforcement agency, he or she is protected. The employer cannot retaliate against the employee. The employer cannot fire the employee for the whistle blowing. The employer cannot mistreat the employee for whistle blowing. This does not mean that after whistle blowing, the employee cannot be fired for any reason. The employer can continue to treat the employee like any other employee. But the employer cannot treat the employee differently because of the whistle blowing."[19]

The *exceptional student* would further add that whistle blowing has numerous consequences. "A study by Joyce Rothschild and Terrance Miethe reported on the dire personal consequences to whistle-blowers when they raise a red flag. Many suffered retaliatory behavior from their employers. They lost their jobs or were forced to retire (69 percent of study respondents), received negative job performance evaluations (64 percent), were monitored more closely by their supervisors (68 percent), criticized or avoided by co-workers (69 percent), or black listed from getting another job in their field (64 percent). These retaliatory consequences were more severe if the whistle blower reported company violations to an external rather than internal authority. …

The new Sarbanes-Oxley Corporate Reform Law includes significant requirements for publicly traded corporations to protect whistle blowers. It's illegal to "discharge, demote, suspend, threaten, harass or in any way discriminate against" the whistle blower. If executives retaliate against whistle blowers, they can be levied up to $500,000 in fines or jailed for up to 10 years. Board audit committees must publicize direct and insulated communication channels for use by whistle blowers. The Department of Labor can order companies to rehire a whistle blower, bypassing the courts, and whistle blowers can request immediate jury trials to accelerate resolution of their cases.

Sarbanes-Oxley won't protect whistle blowers in private corporations, and it won't provide adequate compensation for the years of emotional turmoil, job harassment, and social isolation that many experience. The National Whistle Blowers Center in Washington asserts that about 50 percent of whistle blowers are fired after making allegations against their company."[20]

5. What actions the firm can take in the future to prevent discriminatory actions from occurring?

This question goes to the heart of the case – how can management prevent or at least minimize discriminatory behavior. Students must apply their knowledge of diversity management, prejudice and discrimination and apply that knowledge so as to develop a solution strategy.

A poor student will answer this question without referencing any secondary sources, providing only opinion, in a brief, list-like manner.

A fair student will start by defining prejudice and discrimination. Prejudice is "the prejudgment of a person or situation based on attitudes"[21] while discrimination is "behavior for or against a person or situation"[22] based upon prejudice. Common areas of employment discrimination include recruitment, selection, compensation, upward mobility, and evaluation.

This student might recommend that the most effective method for dealing with discriminatory actions is to provide diversity training – to teach employees to understand why they should value employee differences and be aware of their own biases and prejudices. Most diversity training programs have the following objectives: to understand the changing socio-demographic make up of the workforce; to see the business in the larger context of competing in a global, diverse competitive environment; to show how discriminatory behavior hinders business success; and to show the value of recruit from targeted multicultural markets so that the firm could better reach those targeted markets.[23]

A good student would add that not only must employees receive continuous training on diversity management, there must be internal monitoring systems (such as procedures for handling complaints and grievances – see question 4) that would allow employees to safely report, without fear of reprisal, any activities that they thought were discriminatory in nature. Furthermore, managers must be trained on how to use these procedures. There also must be a compensation system that rewards whistle blowing so that there is incentive for the employees to risk the potential negative consequences that many associate with this activity.

A very good student would also add that training techniques such as using videos, role playing, case studies, and computer simulations would provide a deeper level of understand as well as lead to behavioral changes if the firm has a culture that supports diversity.

An excellent student would indicate that the nature of discriminatory behavior is such that the firm's entire HRM process, starting with recruitment and selection, must orient the potential new employees to the values espoused by the firm, presumably that the firm values diversity and will not tolerate discrimination in any form. This student would also note that it is the overriding culture that will determine whether the firm's complaint and grievance procedures are merely legal shells for compliance purposes or whether these systems are in place to support employee rights. This student might challenge the firm's ability to change employees' preconceived notions (prejudices) and therefore the firm must focus not on what employees think (their attitudes but what they do (their behavior) relative to other employees. The message must be loud and clear that discriminatory behavior will not be tolerated in any form and the firm must be very clear in defining those behaviors, communicating and educating their workforce, and then enforcing those rules.

EPILOGUE

While the lawsuit was still being decided in the judicial system, Darius D'Amore did an entire restructuring of the managers included in the suit. When Linda Evans asked her supervisor why they were moving people around, she was told that the Company wanted upper management to be more diverse. The truth about the restructuring may never be known but all of the managers included are still with the Company, except Mathers and Wines, who were both terminated in May 2002.

No known actions were taken against the managers who did nothing, and at times they discouraged employees from going to Human Resources. Mary Connors noted that Kevin Simmons was highly looked upon by his peers for his hard work. She remarked "So instead of taking disciplinary actions against him, they transferred him to a Vice President position in a different department and gave him a raise." Mary Connors and Linda Evans were most disturbed by the transfer of Cathy to Retail Accounting. Based on her record of dealing with minorities, she was not let go, but transferred to a position created for her and not posted for others to apply. Viola and Price are still in their same positions. Mike Bonn, along with other managers who were slightly involved, were moved to other departments. No one will know for sure if it was due to the lawsuit, but the timing makes it seem that way. The case was settled out of court within six months of the filing, but because of a confidentiality clause, Rogers, Ford and Young would not give any comments with regards to the outcome or how it has affected their lives. The dollar amount to be paid to the three Victims is confidential but there is a footnote on the financial statements for fiscal year 2003 that reads "a special charge of $22.0 million ($13.5 million after tax)…[is] related to the proposed settlement of legal action."

Soon after the lawsuit was filed, the President, Anthony D'Amore, sent out a letter restating the company's policy on discrimination and harassment. Along with the letter was a questionnaire asking how the Company can better itself in handling employee related situations and complaints.

A Human Resources employee, who wished to remain anonymous, said that the number one complaint from the questionnaire was that some managers handled similar situations differently and punishment was not equal. He also mentioned a major concern was that friendships and favoritism sometimes played a role in determining disciplinary action. Many employees felt that the incident ended with the manager and never made it into the employee's file. It is now mandatory that all employee complaints be reported to Human Resources. Human Resources has the sole responsibility to investigate the claim, interview all parties involved in the incident and hand down disciplinary actions, if needed. If a problem is brought to management, regardless of the severity, it needs to be forwarded to Human Resources. It is not management's duty to look into the situation. The policy was instituted so a central department, which makes sure discipline is equally handed out for similar situations, would deal with the each problem. It ensures employment files will be noted accordingly and his/her manager will award no special treatment to employees.

Many training classes were provided after the lawsuit, but on a volunteer basis. A Department called "Company Strategy Management" that existed before the lawsuit offered about 50 different courses. Each class included participation from the attendees and when possible, used real life situations from Darius D'Amore. The classes ranged from ½ day to three days in length. They gave details on the Company, motivation, how to handle stress, proper communication skills, etc. Some of the classes touched on discrimination and how to deal with peoples' differences, but there was no single class that talked solely about those issues.

After the lawsuit, new classes emerged with titles such as, "Discrimination: How to Stop It Before It Begins", "Dealing With Others", and "How To Cope With Differences." These new classes tried to alleviate any problems with regards to discrimination before they began.

The most recent solution was a distribution of the newly revised Company's "Code of Conduct, as of September 15, 2004." The title of page 4 and 5 was "How To Raise Concern." It provided a confidential toll-free hotline for "every employee…to promptly report any violation or suspected violation of this Code of Conduct, any other Company policy or applicable law or regulation." It also highlighted a "No Retaliation" policy for those employees that raise "good faith" concerns. (See Appendix C for a copy of these pages.) The last section "A Safe and Fair Workplace" talked primarily about "Equal Employment Opportunity" and "Prohibition Against Harassment." (See Appendix C for a copy of the related sections.) The section was a summary of the laws of the EEOC. It again stated the procedure for reporting an incident and the "No Retaliation" policy. The procedure gave the employee the option to report the situation to "your supervisor or your supervisor's supervisor (bypassing the chain of command), or if you feel more comfortable, you may contact Human Resources." If the employee didn't already do so, it was the supervisor's responsibility to advise Human Resources.

ENDNOTES

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

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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 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.

INSTRUCTORS' NOTES

This case focuses on ethical dilemmas that may arise when choosing estimates in accounting for and reporting of defined benefit pensions and other postretirement benefit plans consistent with the new requirements of Statement of Financial Accounting Standards No. 158 (SFAS 158). The case describes a situation where key executives may be using the estimates to manage financial statement results. The case explores the effects of estimate choices on amounts reported on the financial statements and on stakeholders, accountants' ethical and professional responsibilities, and possible solutions to the ethical dilemmas. The case includes ethical, conceptual, analytical, as well as research components. Written and oral communication skills can be enhanced utilizing this case.

This case can be utilized in intermediate accounting as part of the coverage of pensions and other postretirement plans, or in a more advanced graduate class focusing primarily on underlying conceptual issues and the case's research components. Two sets of questions are included. The first set can be answered from the case information and subject knowledge; the second set requires some research. The research questions include questions about a) the effect of SFAS 158 on a real life company, b) the disclosure requirements for pensions and other postretirement plans, and c) authoritative guidance regarding choices of estimates and the issue of financial statement materiality. These questions are particularly pertinent for a graduate accounting class, but can also be assigned as an individual or group research project in intermediate accounting.

The case can be solved in groups during class time, or it can be assigned as a group or individual homework project. In either case, students should review the case prior to discussion in class. The research components can be utilized as an extra credit assignment or as a regular assignment. The case has been tested in a graduate accounting class and was well received by the students. Approximately two hours of outside preparation is needed if the case is completed solely as an assignment. If the research components are assigned at the same time as the company/case specific questions, additional time may be needed. Detailed in-class discussion will require about 45 minutes.

Students should be encouraged to focus not only on the financial statement effects, but also and importantly on the ethical consequences of accounting estimates and changes in these estimates. The instructor may wish to emphasize that objective, unbiased estimates help enhance the reliability and thus the usefulness of the information.

In discussing the case in class, particular emphasis on the importance of integrity, competence, and objectivity is recommended. Reference to professional ethical standards, such as those of the American Institute of Certified Public Accountants or the Institute of Management Accountants would be useful.

SUGGESTED ANSWERS TO 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?**

    Both SFAS 87 and SFAS 158 require that a liability be accrued for underfunded defined benefit pension plans. However, the calculation to determine underfunding differs between the two standards. Consistent with SFAS 87, a minimum liability had to be recognized on the sponsoring entity's balance sheet if the fair market value of the pension plan assets was less than the present value of the accumulated pension obligation (ABO). Consistent with SFAS 158, a pension plan is deemed to be underfunded if the fair value of the pension plan assets is less than the projected benefit obligation (PBO). Since the PBO incorporates future salary increases, while the ABO only incorporates current salary levels, the PBO typically is larger than the ABO. This tends to increase the need for the accrual of a liability under SFAS 158. This is what occurred at Mottins Corporation.

    Consistent with SFAS 106, underfunded postretirement benefit plans did not require liability accrual (salary levels do not affect these types of plans). However, consistent with SFAS 158, a liability must be accrued for underfunded plans to the extent that the ABO exceeds the plan assets. This is what occurred at Mottins Corporation.

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?

Companies must recognize a liability and accumulated other comprehensive income (loss) for any underfunded pensions and other postretirement benefit obligations on their balance sheets. The liability typically tends to be classified as a long-term liability. For underfunded plans, the accumulated other comprehensive income account is classified as a contra equity account, thus decreasing total stockholders' equity. When Mottins adopted SFAS 158 at the end of the fiscal year 2006, its total liabilities increased by $223,000 and its total stockholders equity decreased by the same amount.

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?

Increasing the discount rate assumption decreases both the accumulated and the projected benefit obligations. If a pension or other postretirement benefit plan (e.g., a retiree health care plan) is underfunded, increasing the discount rate decreases the accrual needed for the underfunded portion, or may even eliminate the need for an accrual. This improves the financial position of the company, increasing equity and decreasing liabilities.

The effect of the additional increase of the discount rate by 0.25 percent on the projected and accumulated benefit obligations would be to decrease or even eliminate the underfunded portion of Mottins' retirement plans. A higher discount rate also affects the company's pension and retiree health care plan expenses through the calculation of the expenses' interest components. The interest components would tend to be lower if a higher discount rate is used, thus decreasing the total expense recognized in Mottins' income statement.

A higher rate of return estimate would lower the pension and retiree health care expense recognized in the income statement. However, any net loss arising during the period from a difference between the actual and estimated return has to be recognized in other comprehensive income during the period.

The requested rate changes do not appear to be reasonable. The company changed the discount rate assumptions during the prior period (2006); at the same time long-term market rates and conditions have not changed significantly. Reasons other than market changes appear to be influencing the executives' desire to change rates.

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?

If Mottins had not increased its discount rate by 0.5%, its total liabilities associated with the pension and retiree health care plans would have been $1,069,000 (846,000 higher than the $223,000 that were recognized). In addition, other comprehensive income associated with pensions and the retiree health plan (a contra equity account) also would have been $1,069,000. This increase in total liabilities and decrease in total equity would have affected key financial statement ratios such as the debt/equity ratio. Furthermore, the previously used lower discount rate would also have affected pension and health care cost expense, most likely resulting in higher expense. This effect on expense would occur because in calculating the interest component of the expense, the discount rate would have been applied to a higher present value of the ABO and PBO.

Financial statement manipulation and management of estimates generally decrease the usefulness of the information provided and in the long-run negatively affect stakeholders. If Mottins' increase in the discount rate during 2006 was motivated by a desire to manipulate financial statement numbers and/or by a desire to enhance the executives' self-interest, the resulting financial statements were less useful. In the long-run, the interests of the company's stakeholders are best served by unbiased information; this includes pension and retiree health care liabilities that are based on unbiased discount rate estimates.

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?

Changes in estimates are very common. Currently, SFAS No. 154, "Accounting Changes and Error Corrections - a replacement of APB Opinion No. 20 and FASB Statement No. 3" (FASB, 2005) governs changes in accounting estimates. Changes in estimates are treated prospectively and should be made if new information becomes available that justifies the change and enhances the relevance and reliability of the financial statement information. Based on the information provided in this case, these conditions/criteria do not appear to have been met.

SFAS 87 and SFAS 106 currently govern choice of the pension and other postretirement benefit rate estimates, including the discount rate and rate of return on plan assets. The standards provide guidance, but do not prescribe specific rates to be used in accounting for these plans. Consistent with SFAS 87 "Each significant assumption used shall reflect the best estimate . . . " (FASB, 1985, par. 43). For example, "the expected long-term rate of return on plan assets shall reflect the average rate of earnings expected on the funds invested or to be invested to provide for the benefits included in the projected benefit obligation. In estimating that rate, appropriate consideration should be given to the returns being earned by the plan assets in the fund and the rates of return expected to be available for reinvestment" (FASB, 1985, par 45). SFAS 106 (FASB, 2000) has similar requirements for other postretirement benefit plans, such as retiree health care plans. Again, Mottins' desired change does not appear justified given the case situation.

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?

Currently, SFAS 142 "Goodwill and Other Intangible Assets" governs amortization of intangible assets (FASB, 2001). Intangible assets (except for goodwill) that have a determinable life are amortized over their useful life. Consistent with SFAS 142 "The useful life of an intangible asset to an entity is the period over which the asset is expected to contribute directly or indirectly to the future cash flow of that entity" (FASB, 2001, 11). If an intangible asset is protected by a legal life (e.g., patent), the asset must be amortized over the lesser of the useful or the legal life. The amortization period currently utilized by Mottins may be too long given potential changes in technology. Further investigation and potential revision of the useful life are warranted.

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?

The Company's executives and particularly the CFO and the CEO are required to act in the best interest of the company's stockholders as well as that of other stakeholders. Their actions should reflect a long-run view that includes maximizing shareholders' returns. Earnings management and financial statement manipulation are inconsistent with the executives' ethical, professional, and fiduciary responsibilities. The controllers, assistant controllers, CFO, and all those involved in the financial reporting process must act with competence and integrity to produce financial reports that are relevant, reliable, unbiased, and truthful.

The individuals' motivation may be inferred from their behaviors and attitudes outlined in the case:

The CFO and CEO: It appears that the CFO and the CEO want to maximize the company's income and improve its financial position not solely through positive economic performance, but also by "managing" accounting estimates. The desire to enhance their bonuses and the value of their stock options may at least in part motivate their behavior.

The Controller:	It appears that the controller wants to please his superior and comply with the CFO's wishes. His actions also may be influenced by a desire to earn a bonus.
Katie:	Katie is facing an ethical dilemma. Katie wants to succeed in her new position; she takes her professional responsibilities very seriously and wants to act with integrity, competence, and objectivity. She also appears to consider the well-being of the company's employees, as well as her own. She also must comply with the ethical standards of the state board of accountancy of the state that issued her CPA licence and the Institute of Internal Auditors, as well as those of other professional organizations such as the AICPA.
The former controller:	The former controller's early retirement may have been influenced by an uneasiness about pressures to manage accounting estimates.

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?

Katie should first research the authoritative literature to ascertain that her judgment was appropriate and then prepare a summary that supports her view points with reference to that authoritative guidance. She should then speak again with the controller and try to convince him with the support of her prepared summary. If she is unsuccessful, she also could speak with the CFO. If she is still unsuccessful, she could speak to the audit committee of the board of directors and the financial statement auditors.

Katie should consider the possibility that other earnings and financial management practices currently may be used by the company. If that were the case, it could indicate that management tends to try to achieve positive financial results through earnings and financial statement manipulation. This would be a disturbing situation that could cause additional and future ethical dilemmas for Katie.

Katie's professional responsibilities as an accountant are compatible with as well as complementary to her ethical responsibilities. Her professional responsibilities are to act in a manner that is consistent with a high level of integrity, competence, and objectivity. She must also comply with the ethical standards of the state board of accountancy in the state that issued her CPA licence, and the Institute of Internal Auditors, as well as those of any professional organization (e.g., the AICPA) of which she is a member.

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

Answers will vary. All answers should be supported. Hopefully students will recognize the importance of professionalism, integrity, objectivity, and competence and the importance of relevant and reliable financial information.

Researchable Questions:

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

The answers will vary depending on the company chosen by the students. Many students may choose General Motors (GM) because of the highly publicized effect on its financial statements. A review of GM's 2006 financial statements and financial statement notes (www.gm.com) reveals that as a result of adopting the provisions of SFAS 158, GM's total liabilities increased by $10.738 billion. In addition, GM's accumulated other comprehensive loss increased by $16.946 billion and its total stockholders equity decreased by the same amount. As a result of the application of SFAS 158, GM's total stockholders' equity became negative, its total liabilities exceeding its total assets.

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?

The FASB has not yet reached any decisions under phase two of its project. This will change as time passes; the status of the project, and any decisions, including exposure drafts and final rules can be found at www.fasb.org/project/postretirement_benefits.shtml. The SFAS website lists a number of common criticisms of the existing pension and other postretirement benefit accounting standards, which may be addressed during phase two of its project. Among those criticisms that are expected to be addressed is a change in the rate of return used to calculate pension and other postretirement expense. Currently, the estimated rate of return is utilized, allowing companies to smooth the earnings effect. In the future, companies may have to utilize the actual rate, which could increase earnings fluctuations. In addition, less latitude in the choice of estimates for the discount and rate of return rates may be allowed under phase two of the project. These changes would likely decrease the potential for manipulations and increase the information's decision usefulness.

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?

SFAS 158 requires the following disclosures:

For each income statement year presented, the company must disclose a) " . . . the amounts recognized in other comprehensive income, showing separately the net gain or loss and net prior service cost or credit." (The company must differentiate between other comprehensive income arising from the current, year and those arising from prior years), b) " . . . the net transition asset or obligation recognized as a reclassification adjustment of other comprehensive income as a result of being recognized as a component of net periodic benefit cost for the period," c) "the amounts in accumulated other comprehensive income that have not yet been recognized as components of net periodic benefit cost, showing separately the net gain or loss, net prior service cost or credit, and net transition asset or obligation," and d) "The amount of other comprehensive income expected to be recognized as components of net periodic benefit cost over the fiscal year that follows the most recent annual statement of financial position presented, showing separately the net gain or loss, net prior service cost or credit, and net transition asset or obligation." (FASB, 2006, paragraph 7).

Consistent with SFAS 87 and SFAS 106, the company also must disclose detailed information about its pension and retiree health care plans, including a description of plan assets, types of assets held, the benefit formulas, all significant actuarial assumptions (e.g., employee turn over, service life, etc.), and significant estimates made (e.g., discount rate, rate of return, etc.) (FASB, 1985, 1990). In addition, for each year presented and each benefit plan, companies must show reconciliations of the beginning and ending balances of the plan assets and the projected benefit obligation, as well as detail of the calculation of the benefit expenses. Furthermore, the company must show the amounts of the vested, accumulated, and projected benefit obligations.

The information required to be disclosed enhances the usefulness of the financial statements. Stakeholders gain insights that will help them judge the obligations of the company and the future compensation benefits for the employees.

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.**

Neither FASB, nor the Securities and Exchange Commission (SEC), or any other authoritative entity have defined materiality in definite quantitative terms. SFAC No. 2 defined material omissions or misstatements as those that could have changed or influenced the decision of a reasonable individual (FASB, 1980). In August 1999, the SEC issued Staff Accounting Bulletin No. 99 - Materiality (SAB 99), which supports the FASB's stance on materiality and specifically asserts that "...misstatements are not immaterial simply because they fall beneath a numerical threshold." (SEC, 1999). SAB 99 also lists a number of examples of circumstances that may cause a quantitatively small amount to become material. These include a misstatement that may hide a failure to meet earnings forecasts and misstatements that affect executive compensation, such as bonuses (SEC, 1999).

In the case of Mottins, even if the change in the rate estimates for the pension and retirement health care plans and the effects of the relatively long useful life for the patent were quantitatively immaterial, the effect still may be considered material. For example, the estimates and changes in estimates may help the company reach its earnings forecasts and affect the bonuses earned by its executives. In addition, intentional misstatements and earnings management that in quantitative terms are relatively small, may still reflect a management attitude that is inconsistent with the objective of ethical and truthful financial reporting. Thus, such misstatements should not be ignored.

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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.

INSTRUCTORS' NOTES

Teaching Suggestions

The case allows instructors to demonstrate both acceptable and weak capital budgeting criteria, i.e., the IRR and Payback Period methods, respectively. Instructors can bring in other methods such as Net Present Value, and correct the Payback Period to reflect present value of cash flows.

The case also addresses the "post audit" process in which actual cash flows from past capital expenditures are compared to those originally forecasted. Instructors may also want to bring in underlying causes for shortfalls in cash flows such as missed predictions about consumer acceptance of company products, and in that way demonstrate the importance of marketing research upon financial decisions.

HDTV Systems highlights the advantages of merger with a larger, more sophisticated parent firm. Yet, as a target is brought into a larger parent, its results may not automatically improve. The case provides comprehensive data for use in evaluating the value of HDTV Systems as a potential target acquisition for Global. Instructors can emphasize the similarities of valuing a fixed asset acquisition (the production facilities and equipment for the high definition television considered by HDTV Systems) and valuing an entire target company (HDTV Systems as an acquisition target of Global).

HDTV Systems is considering moving into the production of a high-end electronic product. If the macro economy drops, so will the degree of luxury spending. Firms operating in this environment are required to develop insight into the demand for future products, and there will inevitably be a mix of hits and misses. The key is to be successful most of the time in product development design and sales, so that profitability and shareholder wealth increase on balance across the product offerings.

The case further allows instructors to present a realistic capital request through Exhibit 1 in the case. In this numerical example, the development of periodic cash flows is presented, and the resulting IRR and Payback are presented. Instructors can point out the flaw in assuming a fixed product price over time, as well as the importance of upfront start-up expenses, working capital requirements, and salvage value. Instructors may also address the shortfalls of the payback period.

DISCUSSION QUESTIONS

1. **George believed that as long as the IRR of a project more than covered the cost of capital, the firm should benefit. He also felt that the payback period indicated how long HDTV Systems' investment was at risk. Evaluate these investment criteria generally, as well as the specific interpretation George made of the IRR and payback period.**

The IRR measure of investment worth is reliable in this case because the cash flows are normal with one sign change, and because the reinvestment rate assumption at 13.5% is reasonable to meet. However, the use of the firm's cost of capital without adjusting for project-specific risk can be challenged. Suppliers of new capital make an assessment of the risk of the firm's growth opportunities, but may or may not have specific information about the risk of HDTV Systems potential, new investment(s) compared to the risk of the firm's existing assets.

The payback period as calculated in the case ignores time value of money, and it ignores cash flows beyond the payback. Additionally, the payback period requires a subjective hurdle, i.e. a maximum acceptable payback is needed and it is subjectively determined.

Many potential asset acquisitions are of a replacement nature, and the risk of such investments is less than for equipment for new product offerings. In the case of the UHDTV project, there is contemplation of a new television model within a company that already manufactures televisions and other electronic products; thus, there is less risk than in alternative projects that might take the company into an entirely new direction.

2. Discuss the effects on the net income of HDTV Systems if the majority of projects undertaken, especially those with large capital outlays, result in actual cash flows below cash flows originally estimated. What are the implications if the expected return is not achieved and the company has to absorb the depreciation expense associated with weak projects undertaken in the past?

Future net income will definitely be lower if cash flows from capital expenditures are lower than forecasted. However, if a firm calculates a high IRR for a particular project with strong projected cash flows, actual cash flows can be lower than projected and net income can still increase.

Depreciation continues under the original schedule even though revenues and/or do not meet projections. Project abandonment must be considered if weak performance results, and depreciation write-off will likely result even if a company finds a buyer for the fixed assets.

3. Discuss some steps that could be taken to allow HDTV Systems to recover market share.

The company could identify production cost reduction opportunities and then perhaps lower product price; it could also enhance product features and/or quality, find more effective promotional methods, offer innovative new products, and additional distribution channels.

4. How could selling HDTV Systems to another firm lead to improvement of its financial performance and to enhanced shareholder returns?

There should be synergies derived from Global's acquisition of HDTV Systems; the larger parent firm may have more effective management and better and less expensive access to capital, and it may have more flexibility to enter new markets. However, large firms may become lethargic, suffer from poor coordination of the firm's activities, and exhibit agency problems.

5. **Comment on the stable price assumption underlying the IRR and payback period results for the potential UHDTV project.**

The consumer electronics industry has long been characterized by declining product price after an introductory period, and the assumption about constant price over eight years is unrealistic.

6. **Verify the accuracy of the 13.5% IRR result for the UHDTV, as well as the six year payback period.**

The IRR and payback period shown in Exhibit 1 to the case can be verified using a calculator or Excel.

7. **Describe the underlying reason(s) for the trend over time in both cost per unit and operating margin, as shown in the supplemental data in Exhibit 1.**

The general decline in cost per unit occurs because of the level of depreciation. Then, as cost per unit declines, operating margin increases.

8. **Evaluate the uncertainty of Global actually realizing the cost savings assumed through synergies.**

The value of HDTV Systems as perceived by Global may not be fully realized if Global finds that it needs to hire additional management to operate the acquisition. The possibility exists that Global could overestimate administrative synergies, leading to higher costs than originally projected.

9. **Discuss the realism of the assumption that the HDTV division will use non-union workers in its operations.**

It is a tenuous assumption that the HDTV division will be able to remain non-union, while the remainder of Global's hourly plant workers are unionized. Perhaps this disparity can remain for a period of time, but at some point one can foresee higher wages at the HDTV division.

10. Name and discuss other valuation techniques that could have been used in connection with Global's assessment of acquiring HDTV Systems.

Global could have used multiples of earnings or cash flow. The multiple approach requires obtaining multiples of companies in the public market, and applying those multiples to HDTV's earnings and/or cash flow. Adjustments would need to be made for the smaller size and likely greater risk of HDTV Systems compared to the public companies from which the multiples were obtained. Another approach that could be used, at least as a reality check for the discounted cash flow and multiple methods, is the net assets approach; here, the target's liabilities are subtracted from the book and/or market value of the assets.

11. One objective to acquisition of a target in the same industry as the acquiring firm is to "take out the competition". What are the basic advantages to doing so?

The acquiring firm acquires market share and greater control over product pricing. In this way, the acquiring firm's revenues should increase.

12. Discuss other synergies that Global might achieve beyond savings in administrative costs.

Global should be able to leverage its relationships with suppliers of materials. The company should be able to achieve economies through purchasing in larger volume. The fact that both companies are in the same line of business will enhance the likelihood of achieving these savings.

INDIAN MOTORCYCLE COMPANY: STRATEGY FOR MARKET REENTRY

Scott Droege, Western Kentucky University

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.

INSTRUCTORS' NOTES

Recommendation for Teaching Approaches

The following five questions with potential answers are specifically mentioned in the case. These questions would be appropriate for student case prep prior to case discussion. Following this are theoretical perspectives professors may want to use for case discussion allowing the discussion to move from specific case issues to more generalized theoretical implications.

1. No doubt there is a consumer base that desires premium motorcycles, but will Indian be able to take market share from established incumbents such as Harley-Davidson?

The three previous failures in Indian's history argue against the ability of the Indian brand to be successful. In addition, Stellican Limited is a British private equity firm and even though they have established manufacturing in North Carolina, biker purists will certainly recall Indian's checkered history when the British private equity firm, Brockhouse Limited, purchased rights to the Indian name and simply rebranded its Royal Enfield bikes as Indian Motorcycles during the 1955-1985 era.

However, Stellican Limited is the venture capital firm that now owns Indian Motorcyele. Stellican is experienced in reviving failing brands and has carefully studied Indian's past. In addition, Stellican has a vested interest in Indian's success and is willing to back up this interest with capital injections. In addition, Indian's top-management team views this as a long-term commitment rather than an overnight story. Combined with Stellican's capital backing, this argues in favor of success.

2. 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?

Indian has put together a world-class engineering team. Also, top management is well aware of negative consumer sentiment from the most recent 1999-2004 failure. Together with Stellican's long-term commitment, Indian should be able to manufacture a quality motorcycle. On the downside, however, Indian's mall size will not allow scale advantages that can quickly translate into cost savings. Thus, although Indian may be able to build a quality motorcycle, this will likely come at a cost higher than those for incumbents. It is therefore likely that pricing for introductory models will be above competitors' prices for similarly featured motorcycles.

3. 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?

Students may have a hard time with this question. The argument against Indian's ability to convince customers and distributors that Indian has staying power is its three past failures. Students who look deeper, however, will realize that the Indian Chief, as the most recognized model among Indian motorcycle aficionados, is the most logical choice for initial reintroduction. Thus, bringing back the Indian Chief is a smart way for the new Indian Motorcycle to begin restoring the authenticity of the brand among biker purists who have a substantial influence over product perceptions.

4. Will the financial backing of Stellican Limited provide Indian Motorcycle Company with enough time and resources to pierce the American cruiser market?

This question is a bit tricky but astute students will reframe the question. The answer to this question revolves around Stellican's expected return on equity. Stellican has a long time horizon, but as a private equity firm it will certainly be accustomed to cutting its losses if the reintroduction of Indian does not have at least marginal success. Thus, students should recognize that the market, not Stellican per se, will determine whether Stellican will be willing to provide the time and resources needed to make the brand a success.

5. Why has Stellican Limited chosen Indian when there are numerous other investment alternatives?

Stellican has a strategy of reviving failing brands by unlocking brand equity. The unique focus of this strategy is dependent on the path Stellican has taken in previous private equity decisions. Stellican's managers have climbed the experience curve and now have the expertise to unlock the potential in the Indian brand. (See below for an explanation of how to expand this topic to the path-dependant nature of strategic choice).

Theoretical Perspectives

1. Resource-Based View

Indian's unique place in the history of the American motorcycle market is imperfectly imitable. The social complexity of developing a brand with such recognition among Indian's target market has potential value if the new Indian Motorcycle Company can leverage it in a way to capture the nostalgia of the brand.

A point to make with students is that competitive advantage arises from a combination of all factors of the resource-based view—value, rarity, inimitability, and nonsubstitutability. One classroom approach would be to outline each factor and have students derive a table from this. For example, a table might look similar to the following:

The point of this exercise is to help students see that the RBV requires a combination of factors to garner competitive advantage. It does not appear from this standpoint that Indian is likely to generate a competitive advantage at least in the near term.

RBV Factor	Indian Motorcycle Company
Value	The value of Indian's resources is derived from the nostalgia of the brand although the market leader, Harley-Davidson, also has the same sense of nostalgia having begun in 1903 (only two years after Indian began).
Rarity	Indian's resources include the Indian brand, the top management team with experience in reviving failed brands, and a world-class R&D/engineering team.
Inimitability	The unique historical path makes imitability unlikely. Victory, as a fairly recent new entrant, is a long way from approaching Indian's history. Still, other brands such as BMW and Triumph have historical uniqueness of their own. And of course the main competitor—Harley-Davidson—will be a constant threat to inimitability based on historical authenticity and nostalgia.
Nonsubstitutability	Indian plans on mass production. Substitutes include custom builders such as Orange County Cycles and Mad Dog. Clearly, custom builders will be considerably higher priced. Substitutes also include smaller, more fuel-efficient, motorcycles. The most obvious substitute, of course, is other modes of transportation (autos, buses, cabs, etc.). Substitutability could also be premised on the fact that because the U.S. cruiser market is primarily discretionary, purchase of a motorcycle is simply a substitute for other ways to spend leisure time. Thus, a raft of potential substitutes (movies, fishing, football, etc.) could potentially dampen demand.

However, competitive advantage—performance above industry averages—is not necessary for success (a point students sometimes overlook). Instructors may want to point out that Stellican Limited will be looking for a return on investment similar to other investments with similar risk. Whether or not Indian becomes an industry leader with a competitive advantage relative to the industry average is in some ways irrelevant as long as Stellican's ROI hurdle rate is achieved. In other words, whether other firms outperform Indian is not the most relevant question, but rather the question is whether Stellican can obtain its desired risk-adjusted ROI.

2. Alliances

A way to bring alliances into the discussion is to compare Indian to Victory Motorcycles. Victory was a new market entrant in 1998 as a division of Polaris, an established manufacturer of snowmobiles and all-terrain vehicles (ATVs). Victory competes directly with Harley-Davidson and had a difficult time gaining acceptance in the market. After sluggish initial sales, Victory aligned with Arlen Ness, a firm with a long history of designing custom motorcycles and custom motorcycle parts. Victory developed an alliance with Arlen Ness in which Arlen Ness handles the design work on a select group of Victory's models known as the Arlen Ness Signature Series. In addition to Victory's other product lines, this has created additional sales to those who prefer a "factory custom" motorcycle—a mass produced motorcycle with a custom look with the Arlen Ness special edition name attached.

It would be interesting to ask students if a similar alliance would benefit Indian Motorcycle Company. Indian Larry Legacy is a well-known boutique firm among custom motorcyclists that designs one-of-a-kind motorcycles. The namesake of the firm known as Indian Larry passed away in 2004, but this only increases the distinction. The name "Indian Larry" is especially appropriate to the Indian Motorcycle Company brand. Questions to interject to spur class discussion for comparison might be: Would Indian benefit from an alliance with the Indian Larry Legacy at the outset in the same way that Victory has benefited from its alliance with Arlen Ness, or would it be better for Indian to establish itself on its own merits before considering such alliances?

3. The Threat of New Entrants

The threat of new entrants can be examined from the perspective of incumbent firms. Does Indian represent a viable challenge? Instructors teaching this case can divide the U.S. cruiser market into four groups (as discussed in industry segment of the case): (1) Harley-Davidson as the incumbent with historical similarities to Indian but with a huge market lead and an established distribution network, (2) Victory Motorcycles, the 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 (an American country of origin tends to have consumer appeal in the U.S. cruiser market segment), (3) non-U.S. firms that target the motorcycle cruiser market such as Honda, Yamaha, Kawasaki, and Suzuki and (4) boutique firms that make custom motorcycles such as Orange County Choppers and Mad Dog.

Students' analysis should reveal that boutique firms will be the least concerned about Indian's market reentry. In fact, sales of Indians will likely spur new demand for the boutiques as Indian owners customize their bikes; i.e., chopper forks and other fairly expensive customizations. Non-U.S. firms face the largest threat; even though they have operations in the U.S., foreign countries of origin tend to matter to at least a segment of cruiser buyers. Victory and Harley-Davidson are in the middle of this risk continuum; both can claim to be American bikes although Harley-Davidson has the edge over Victory given Harley's establishment as a brand dating back to 1903 (versus Victory's beginning in 1998).

Instructors may wish to use the above information in class to draw a risk continuum based on the threat of Indian's market reentry. The continuum would look similar to the following:

Potential Threat of New Entry by Indian

Strong Threat------------		------------	------------Weak Threat
Non-U.S. firms (Yamaha, etc.)	Victory	Harley-Davidson	Custom boutiques (This segment may actually benefit from Indian's reentry).

4. Private Equity Acquisition

Stellican Limited is a private equity firm specializing in three areas: distressed situations, value situations, and special situations. Part of Stellican's philosophy is that "superior management is the largest and most controllable source of value creation." Stellican typically gains a controlling interest in a firm then works closely with the firm's management to unlock potential value. But with Indian Motorcycle Company, two of the four Stellican partners (Steve Heese and Stephen Julius) have taken on management roles with Heese as president and Julius as chairman. Clearly, this was necessary given that Stellican simply bought the trademark of a defunct company that had no management team.

This brings up two questions typically asked about corporate acquisitions but also apply here: (1) Is the acquired company better off and (2) is this the best alternative? Students will easily see that question 1 doesn't apply given that there was nothing more than a trademark at stake before Stellican intervened. However, question 2 may provide some debate. The instructor could frame the debate around the issue of whether Heese and Julius are the appropriate persons to head Indian. Both are full-time partners in Stellican and both are on the top management team of Chris Craft, the boating firm Stellican previously revived. Thus, given that both of these executives cannot give their full attention to Indian, is Stellican's ownership of Indian the best alternative? Would Indian be better off with a management team devoted solely to this single firm and its outcomes rather than splitting its partners time between Indian and these partners (Heese and Julius) other responsibilities?

At this point, professors may wish to bring up the path-dependent nature of strategy. That is, future strategic options are to some extent limited by past strategic choices. As a private equity firm, Stellican could conceivably invest in any number of struggling businesses but Heese and Julius' experience has been reviving iconic, although struggling, brands. Their cumulative experience thus steers them toward strategic situations in which they have some prior, applicable knowledge. The goal of this is to show students that sometimes it is helpful to break the frames—the assumed logic—of a strategic path. Once professors make the point that Stellican may have difficulty recognizing opportunity outside their relatively narrow frame of reference, professors could then encourage students to think of other situations in which a firm may have been better off to pursue "frame-breaking" rather than obvious strategic alternatives. (A classic example is Kodak's hesitancy to move into digital cameras early in the digital camera product life cycle, preferring instead to incrementally improve its film technology—a strategic mistake that nearly cost Kodak its viability).

Their active involvement with Stellican and Chris Craft ensure that Heese and Julius have less at stake than a typical management team; their employment is diversified. If Indian turns out to be another failure once again, Heese and Julius can walk away with Indian (as it has done before) leaving customers and distributors hanging. On the other hand, both Heese and Julius have a vested interest in Indian's success through Stellican's large investment in restoring Indian. In addition, both executives have experience in turnaround situations. Thus, the debate comes down to how much confidence customers and potential distributors can place in a top management team that has a stake in the outcome but who can also walk away. In other words, is the stake large enough to inspire confidence? There are no clear answers at the present time; the fact there are no clear answers should help stimulate class debate.

Ethics

For those wishing to bring up ethical issues, a recent interview by MotorcycleUSA would be a good starting point. MotorcycleUSA asked Indian Motorcycle Chairman Stephen Julius:

"There have been stories in the media where Native Americans have protested using their likeness in a manner they perceive as offensive. They even tried to have the professional baseball team, the Atlanta Braves, change their name. Have you had any negative feedback from Native American groups over the use of the word 'Indian' and 'Chief' and 'Scout'?"

Julius responded:

"Well, let me make two comments. First, anything we will do will certainly not be in any way disparaging to the Native American population here. We are proud to be associated with them. Secondly, these issues were raised in the past and they were dealt with, actually, after quite long and expensive legal cases in the courts and they've all been resolved, so that's not something that is of concern to us."

Instructors might begin by asking students if they agree that using the Indian brand name might be offensive. For instance, is it ethical to use a group that has historically suffered discrimination and prejudice to advance a commercial brand? As students discuss this point, additional debate can be injected by asking whether students would support a brand called “African American” if that brand name would increase sales. The larger point to discuss is at what point do commercial interests cross the line when using historical situations involving minority groups?

As students debate this issue, it is worth considering whether endorsements might help overcome any negative reaction to the Indian brand. For example, Indian Motorcycle could perhaps ask Native American tribes to endorse the Indian brand name as emblematic of the historical struggle of Native Americans. This would turn the tables and allow a potentially damaging brand name from the perspective of insulting a minority group to become an asset rather than a liability

BETTER FACTORIES CAMBODIA: BUILDING A COUNTRY VOID OF SWEATSHOPS

Charles A. Rarick, Purdue University - Calumet
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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.

INSTRUCTORS' NOTES

Target Audience and Teaching Strategy

This case is written primarily for undergraduate students taking a course in international business, however, it can be used in a number of other courses as well. It could be effectively used in a basic marketing or international marketing course, as well as a course in economics, or an introduction to business course. Since the case deals with social responsibility and ethics, it could also be used a courses devoted to these topics. Since the case is short and focused, it can easily be incorporated into many courses in the business curriculum.

The purpose of the case is to generate a discussion on the topic of contract manufacturing in developing countries. Often contract manufacturing has been mentioned in the media when a sweatshop is uncovered and a major company is embarrassed. Nike, Wal-Mart, Disney, and others have all had to deal with negative publicity surrounding their arrangements for foreign manufacturing at one time or another. The case should be of interest to students as they are consumers of many of the products produced under these conditions.

The case can be used in a number of different ways. The case is perhaps best used for general class discussion, however, an argument can be made for its assignment as a group project. Students can visit the websites of the various parties involved in the case to gather further information if desired. In particular, students can learn more about SA 8000 and how it compares with the work of Better factories Cambodia. The website for Better Factories Cambodia has a number of newsletters available for evaluation.

ANALYSIS

While suggested answers to the discussion questions follow, the case isn't written for definitive answers to those questions. The case is written for a class discussion and critical thinking on the part of students and some opinions will be expressed in response to these questions.

Discussion Questions:

1. Do consumers care how the goods they purchase were produced? Should they care?

The importance of this question is that without a niche, Cambodia will have a hard time competing with China in the garment industry. Cambodia has chosen to gain its competitive advantage via a sweatshop-free environment. If consumers really don't care about the working conditions of the factories in which their goods are produced, this advantage will not result in many gains for Cambodia, in the long run. While some attention has been paid to these issues, it seems to be quickly forgotten by consumers. In some cases, such as in the fur industry, a campaign against unethical treatment of animals seemed to have produced a long-term consumer backlash. Overall, it appears that consumers for the most part are not aware of any sourcing issues for the products they purchase and it is questionable as to how much they really care. One advantage for Cambodia in this area, however, is that it is not the ultimate consumer who may need to be catered to as much as the middlemen. For example, while a customer at Wal-Mart may not care that a tee shirt he/she is buying was produced in a sweatshop, Wal-Mart's management is concerned. Even if social responsibility isn't driven by the ultimate consumer, it is possible that corporate responsibility will make Cambodian factories prosper with their approach. The question concerning whether a consumer should care is subject to some opinion. Many students will argue that it is important, however, their actions may indicate a less thoughtful and caring orientation.

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

This question can generate a good discussion on the topic of responsibility. A good case can be made for the main responsibility being placed on local manufacturers or the governments of where the countries the factories are located. A discussion of the merits of such manufacturing jobs and the options available to workers in those countries can have a useful purpose as well. While few people from developed countries would want to work in these factories, the jobs are better than the other employment options available in those countries. The workers willingly work in those conditions for the wage level offered. If factories follow the legal rules established by local government then it could be argued that social responsibility is being met. This line of reasoning assumes that all interested parties are doing what is in their own best interests. Consumers get lower priced merchandise and may buy more of it, retailers stay competitive, and contract manufacturers make a profit and can employ people who need jobs. The other line of reasoning is that there is a huge power difference among the participants and that factories do not always follow the rules established by local governments. Child labor, unsafe working conditions, and below minimum wage pay all occur in developing countries and local government may not have the resources to stop these practices. This line of reasoning argues that it is more effective for consumers to place pressure on companies to act responsibly in order to insure that factory workers are treated properly. The ranking that are generated should produce a rich discussion, however, there isn't a right answer to this question. Students should be able to provide the reasoning behind their rankings.

3. Do you think Better Factories Cambodia will be successful? What can the organization do to insure the completion of its mission?

It is difficult to say if this approach will be successful. One factor that must be addressed is corruption. If the auditing process is undermined by corrupt factory owners then it legitimacy will be questioned. Better Factories Cambodia competes with the auditing processes of individual international companies who, like Wal-Mart do their own investigations. Better Factories Cambodia can offer the advantages of knowing the local culture, language, and practices of the country. At least in theory, Better Factory Cambodia can do a better job of insuring that employment practices meet the international standards. It is imperative that the process be carried out in an honest and forthright manner. Increased support from international buyers would help Better Factories Cambodia achieve its mission. If the buyers continue to push for lower prices, the incentive to cheat the system increases. Working closely with international buyers to reduce costs and to increase productivity will be helpful. The realization that adherence to the standards may increase costs must be recognized by the international buyers. In the end, higher productivity in China and Vietnam may doom the venture. Unless Better Factories Cambodia can increase the importance of ethical sourcing, and/or increase productivity in the country's garment industry, the organization may not be able to achieve its mission.

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

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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.

INSTRUCTORS' NOTES

Recommendations for Teaching

I usually assign this case in the introductory principles of marketing course immediately after a lecture regarding channels of distribution. However, I have also used it successfully in the graduate marketing management class. The case is not long, and need not be complicated, but it generates substantial discussion, and students find it interesting. There are St. Lawrence Island photographs and maps on the Internet, and I usually share these prior to our class discussion (for example, see http://www.tsuru-bird.net/gambell/).

In the version of the case presented here three alternatives are presented, and students are guided by a series of questions which guide them through some important considerations. However, I have successfully used this case without providing students with either the three alternatives or specific questions. Instead, I ask students to generate some alternative ways that the St. Lawrence Islanders can get their product to their target market, and ask them to think about what it means for the business, and what they believe would be best in this situation. Simply eliminating the last section of the case makes this possible.

I do not usually ask students to write down their answers. Instead, I use the case to generate a class discussion. As the alternatives are discussed, I put the channel of distribution for each alternative on the board, and I build up a matrix with the alternatives in rows, and various characteristics and criteria as columns (e.g., number of relationships and transactions, number of tasks required, prices/unit, costs, and risks).

I have found that with a relatively small investment of course time this short engaging case makes it clear that cutting out the middleman does not necessarily cut costs, and may not be the wisest course of action for a firm.

Covering the case in class can take anywhere from 15-20 minutes to a full hour. Usually I allocate about 30 class minutes to the case.

DISCUSSION QUESTIONS AND ANSWERS

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?**

The first alternative calls for the St. Lawrence Islanders to harvest, dry, and bundle the kombu for sale to one or more manufacturers. Under this alternative, the product would be bulk kombu. There would be no labeling, no breaking of bulk into small packages, and no branding. Managing the inventory would be straightforward and simple. The price would be modest on a per pound basis, and would be a function of whatever they could negotiate with the manufacturer(s). Promotion would consist of finding one or more manufacturers who could see some value in buying St. Lawrence kombu. Presumably this would be through personal sales calls, and at most a few long-term relationships would be the consequence of the manufacturers finding value in this uniquely-sourced product. Managing channels of distribution would consist of simply getting the bulk product to their one or two customers.

Success under this model would be a function of finding one or more manufacturers interested in buying and using the product, and in developing the expertise to harvest, dry and transport the seaweed to the buyer(s). In Japan the kombu is sold in bulk at central auctions, and this would not be feasible here. There would have to be some reason for the manufacturer to want to work with the islanders. It would most likely have to be because the source of the seaweed will be valued by some consumers. Further, success would hinge on the talents and ability of the manufacturer(s) to effectively compete in the kombu market.

It is important to note that while the price/pound would be low under this alternative, so would the costs. Operationally they would need some people and facilities to harvest, dry and bundle the bulk product, and they would only have to deal with one or, at most, a few customers. The business would be a relatively simple operation.

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?**

Under this alternative, with regard to the product decisions about the sizes, packaging, labels and labeling, and branding would have to be made. Then, of course, they would have to develop processes and learn how to package and label the products. More supplies would be involved, and managing the inventory would be a little more complicated. Since the islanders have no experience in any of these areas, either time and/or money spent on consultants, or both, would be required at startup. The price to retailers would have to determined, including terms and allowances (e.g., quantity discounts, promotional allowances). With regard to promotion, the islanders would be responsible for finding and convincing retailers to stock the product, and they should actively consider how to promote the product to consumers. If successful, the islanders would have to manage a fairly large number of relationships with retailers of different sizes in different locations and with different operational idiosyncrasies.

Success under this alternative would be a function of being able to do all of these tasks efficiently and effectively. A very big hurdle and expense would be in contacting and convincing retailers to carry the product. Retailers usually rely on wholesalers, and may be hesitant to buy one fairly insignificant product from one supplier. Students can appreciate how complicated a retailer's life would be if each item stocked was purchased from a different manufacturer.

With regard to this alternative discussions of selling the product through catalogs could be discussed. It might be possible to find catalogers that might be interested in adding such a product to their offerings.

As the discussion unfolds, I tell students about the results of some marketing research. Personal interviews were undertaken with retailers and wholesalers. As expected, retailers revealed that they were not interested in buying a relatively minor product directly from a manufacturer: they indicated they wanted to buy such a product from their wholesalers. Interestingly, Puget Consumers Coop in Seattle started an independent wholesale company, Nutrasource, so that Puget Consumers Coop could focus on the retail business and leave the problem of finding and managing relationships with manufacturers to others. Personal interviews with wholesalers likewise revealed that they were not interested in adding a seaweed product manufacturer to their sources, especially one that had only one or two products that were equivalent to those they were obtaining from established manufacturers. Thus, retailers were not interested in single-item producers (at least at the level of sales expected in this case), and second, wholesalers appeared to be reluctant to add new manufacturers of a single, relatively low sales volume product.

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?**

Under this alternative consumers would have to be found and convinced to buy the product. Possible ways to do this would be through direct mail, telemarketing, and/or the Internet. The packaged product might not be any different. With regard to pricing, the St. Lawrence Islanders would be responsible for setting the final price to the consumer and setting any terms. Compared to selling to wholesalers or retailers, the quantities purchased per transaction would be smaller and much more variable, and this would influence the costs and tasks involved in managing relationships with customers and in shipping the product. Compared to the previously discussed alternatives, the complexity of managing relationships and tasks would be considerably greater.

Success, under this alternative, would be a function of efficiently and effectively finding and communicating with final users of the product, in convincing to buy the product direct, and in being able to handle the large number of small transactions that require shipping. Either here or later students could be asked how interested they think potential customers would be in ordering small quantities of a product they may have never tried or only use a few ounces per year. Would current users even think about looking for sources of kombu on the Internet? Would they respond to an unsolicited email about the product?

At least one person suggested that the St. Lawrence Islanders could sell packages of kombu from carts at tourist destinations (e.g., Portage Glacier near Anchorage or Mendenhall Glacier near Juneau). Even if this would be permitted, students should think through what the reaction of tourists would be as they passed a cart selling packages of seaweed.

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?

In the short term revenue would be greatest if they could find an interested manufacturer with established relationships with downstream channel members. Costs would also be modest on a per unit basis. Short term sales would likely be lowest if they decided to sell directly to consumers, unless they couldn't find any retailers to carry the product under the second alternative. The investment and costs associated with selling direct to consumers would be highest, as well. Short term sales to retailers would require a fair amount of personal sales work, and sales would initially be slow, or maybe even zero. Costs would be relatively high, although not likely as great as they would be if they were to sell direct to consumers. Even though the selling price/pound would be highest when selling direct to consumers, and lowest when selling to a manufacturer, volume and cost considerations suggest that profitability would be maximized (or losses minimized) by selling to a manufacturer.

In the long term there is more uncertainty about where the most sales and profits are, but given only one or two products, it is likely that the most profitable, and the alternative with the greatest sales volume, will likely be through selling it to a manufacturer or two. This is because of the reluctance of conventional retailers to buy directly from single-item, lower sales volume products. However, if they can find a retailer chain (or a wholesaler) that will carry the product then perhaps it might be different. In particular, if health food catalog retailers can be interested in such a product, then maybe sales and/or profits might be highest when selling directly through them. Given the low usage rate of the product among consumers, and the fact that for most potential users it is an unsought product, it is likely that selling directly to consumers is not feasible.

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

When selling to a manufacturer the St. Lawrence Islanders will need people and equipment for harvesting, transporting, washing and drying the seaweed, and bulk storage. They will need to invest in systems and people for keeping basic records and managing the process. Someone will need to be responsible for finding and maintaining the relationship(s) with the manufacturer(s).

If they decide to sell directly to retailers, they will need to acquire information about labeling and packaging, and they should have information that will facilitate decisions about branding, packaging size, pricing, shipping and some logistics. Hence some market research should be conducted by someone. They will need people to package the product, and the supplies to do it. They will need to store both the bulk and the final packaged seaweed. In the main office they will need systems and people to maintain relationships and paperwork with the retailers. Most likely a sales force will be required to find and convince retailers to buy from them, and this will entail other activities and expenses.

Bypassing retailers and selling directly to consumers would entail everything above, with the possible exception of less invested in a sales force, plus more activity and expense associated with finding and communicating and selling to final consumers through advertising and other promotional activities, and in maintaining records associated with individual consumers. More people, perhaps, and more facilities might be required for customized packing.

As one moves from selling to manufacturers to selling to individuals the amount of resources at risk would generally increase, and the business gets more complex. In addition to possibly having more invested as one moves from being a supplier to manufacturers to selling directly to consumers, the increased complexity suggests that the risks associated with operations and marketing get greater. More relationships may mean less variability from period to period, for example, but it also means that there are more chances to make mistakes.

One consideration that can be broached is that the more complicated the business, everything else being equal, the more employees are required. One of the goals of the St. Lawrence Islanders is to provide employment to residents, particularly younger residents, so giving up profits in exchange for employment opportunities may be desirable. Note that they are not compelled to strive to maximize shareholder value.

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

Given the inexperience of the St. Lawrence Islanders in manufacturing and marketing, the conservative approach would be to try to sell bulk seaweed to manufacturers. If this can be done, the business would be simple and not require a lot of operational and marketing knowledge, and the business could get up on step quickly. The sales, profits, and cash flows would be fairly easy to forecast. With either of the other two options the costs may outrun revenue for a long time, and the operation may never be profitable.

The main lesson to be learned by this analysis is that if you cut out the middlemen, you need to take over their functions, and to the extent you don't have their expertise and contacts and experience, you will likely not make more.

EPILOGUE

One manufacturer was interested in working with the St. Lawrence Islanders. Not only would the manufacturer buy the bulk product, but the manufacturer was willing to hire St. Lawrence Islanders to package the finished product on the island. In return he wanted their assurance that they would not try to cut him out in the future. The manufacturer sold a large number of products, and indicated that the expected returns associated with another kombu product were not large enough to warrant putting a lot at risk in such a project.

The last I heard, the project never went forward because of organizational complications. There were individuals that could have pursued this, but there was an agreement that there had to be a consensus of the people from Savoonga and Gambell before this could go forward, and this was, and is, a significant barrier.

ACME ELECTRONICS

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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.

INSTRUCTORS' NOTES

Recommendations for Teaching Approaches

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. In addition, the course also aims to improve a student's communication, written and oral, and teamwork skills. Student teams prepare the answers to questions presented in the case with coaching from faculty. The faculty coaching is intended to provide answers to team questions. All teams submit a formal written business report containing an analysis of the issues presented in the case. One team of students formally presents their case solution to the class. A second team of students acts as a "discussion team" by asking the presenting team for further explanation or clarification of its case solution. Following the discussion team's exchange with the presenters, the entire class is welcome to participate in an active question and answer session.

Although this case is designed to be used in an upper division inter-disciplinary business course, 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 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?

In order to prevail in a claim for negligence, Gunter must establish several points. These elements combined are referred to as the prima facie case. The prima facie case in negligence consists of the following: (1) conduct; (2) duty; (3) breach of duty; (4) actual cause; (5) proximate cause; and (6) damage. (Note: some textbooks do not include conduct as a specific point in the prima facie case.)

In Gunter's case against Acme some of the elements (conduct, duty, breach of duty and proximate cause) can be easily established, while other elements (actual cause and damages) are more difficult to establish. Remember, in order for Gunter to prove that Acme was negligent, he must establish each of the six elements of the prima facie case.

THE PRIMA FACIE CASE FOR NEGLIGENCE

Conduct

Conduct refers to acting affirmatively (doing something) or failing to act (an omission). What is Acme's conduct? Certainly there was affirmative conduct in the repair of the computer, including the removal of the defective hard drive and returning a hard drive that was not the one that was removed from Gunter's computer. However, the conduct leading to the claim of negligence is a failure to act, an omission on the part of the repair department - failure to properly identify the hard drive once it was removed from the computer. This failure to properly tag the hard drive is the reason why Acme is unable to return to Gunter the defective hard drive that was replaced in his computer.

Duty

The next two elements of the prima facie case (duty and breach of duty) can be established by a traditional determination of how a reasonable computer repair dealer should act under the same or similar circumstances or by application of the doctrine of negligence per se.

Duty requires an analysis of two issues. The first issue relates to the standard of care that Acme must exercise in this case. The second issue requires a decision as to whom Acme owes a duty.

Standard of Care – Traditional Approach

With respect to the standard of care, in very general terms one must act in such a way as to not expose another to an unreasonable risk of injury. Stated differently, one must act as a reasonable person of ordinary prudence would act under the same or similar circumstances. In this particular case it can be said that Acme must act in a way that we would expect a repairer of computers to act under the circumstances.

Does the standard of care require identification or marking of defective computer hard drives when removed from a computer so that the hard drive can be returned to the owner of the computer? The standard of care to be exercised may be determined several different ways. For example, custom in the computer repair business may be an indication of how one should act under the circumstances. Without specific custom or usage evidence, students may merely arrive at a conclusion that they would feel is reasonable under the circumstances.

To Whom is The Duty Owed?

Does Acme owe a duty to Gunter? Generally, a defendant owes a duty of care to those who the defendant would foresee to be at risk of harm as a result of the defendant's conduct. Students may explain this part of the prima facie case in terms of "foreseeable plaintiffs" or plaintiffs who are within a certain "zone of danger" as defined by the nature of the defendant's conduct. There is little doubt that Gunter, as a customer of Acme's, is a foreseeable plaintiff.

Breach of Duty

The next point of the case requires a determination of whether Acme has breached the duty of care that it owes to Gunter. The usual approach to determining a breach of duty is to "calculate the risk" that the plaintiff is exposed to by the defendant's conduct. This approach requires weighing the chances of harm occurring and its severity against the cost of preventing the harm and the value assigned to the defendant's conduct. One may look at this approach as similar to a cost-benefit analysis. If the chances of harm occurring and severity of the harm outweigh the cost of prevention and the value assigned to the defendant's conduct, then the duty has been breached. The question presented here is whether Acme has failed to act as a reasonable computer repair dealer in failing to return Gunter's replaced hard drive. On the one side of the calculus of risk scale, the chances or likelihood of harm under these circumstances would be high and the extent of the harm could also be high depending upon the nature of the information contained on the hard drive that was not returned. The risk of confusing the hard drives was high as evident from Acme's letter indicating that it had "experienced a large volume of replacements," and admitted being "unable" to keep track of defective parts. The severity of the harm would be any and all information held by the hard drive.

On the other side of the scale one must consider the cost of preventing the harm and the value attributed to Acme's conduct. The cost of preventing the harm is arguably low. How much would it cost to place a tag on the hard drive to identify it as belonging to Gunter? A high value, however, might be placed on providing computer repair services. However, it might be argued that Acme would not have a valid reason for attempting to repair more computers than it could repair in the exercise of ordinary care.

In the final weighing, a likely conclusion is that the chances of harm and the severity of the harm would outweigh the cost of prevention and the value of Acme's conduct. Thus the duty of reasonable care would be breached by Acme.

If, however, the reverse is determined, that the cost of preventing the harm and the value placed on providing computer repair services would outweigh the chances of harm and the severity of harm, then the duty would not be breached.

Negligence Per Se

Before moving on to the actual cause element of the prima facie case, it would be helpful to look at the concept of *negligence per se*. This concept provides a way to establish two elements of the prima facie case of negligence (duty and breach of duty) in light of a statute. There are a number of cases that the instructor may choose from to illustrate the concept. One case that serves multiple purposes for this assignment is *Haft v. Lone Palm Hotel*, 3 Cal. 3d 756, 478 P.2d 465 (1970). The *Haft* case addresses, in depth, two issues that arise in Gunter's negligence cause of action - *negligence per se* and actual cause.

Statutes can clearly specify how a person should behave. Proof of a statutory violation can create a presumption of negligence. The common law doctrine of *negligence per se*, presumes the failure of a person to exercise ordinary care if: (1) He violated a state statute or regulation of a public entity; (2) Death or injury results from an occurrence of the nature which the state statute or regulation was designed to prevent; and (3) The person suffering the death or the injury to his person or property was one of the class of persons for whose protection the state statute or regulation was adopted.

Statute – Standard of Care Owed to the Customer

It is at this point that the report may analyze duty and breach of duty with reference to the *negligence per se* doctrine. Gould Business and Professions Code section 8984.10 reveals that a computer repair dealer is required to "return replaced computer parts to the customer at the time of the completion of the repair" if the customer made that request at the time of the order. The statute clearly specifies the standard of care that must be exercised. Presumably the purpose of the law is to protect the customer. When the hard drive is returned the customer is reassured that the part was actually replaced (as opposed to just being repaired) and gives the customer an opportunity to retrieve the information on the drive. In addition the statute clearly indicates that the duty is owed “to the customer.” Gunter, being a customer, is certainly within the class of persons that the statute was designed to protect.

Statute – Breach of Duty

If the element of breach of duty is analyzed from the standpoint of the statute and *negligence per se*, a conclusion of breach of duty is easily reached. The statute does not specify exactly how the dealer may fulfill the duty to “return replaced computer parts to the customer.” Presumably the dealer will develop procedures whereby the replaced parts can be identified for return to the owner. The statute merely requires the dealer to return replaced parts to the customer. However, merely returning to the customer a hard drive would not appear to satisfy the requirements of the statute. The dealer's standard of care would logically require that the hard drive that is returned to Gunter must be the hard drive that was specifically replaced in Gunter's computer. The statute, arguably, is intended to assure the customer that the hard drive had in fact been replaced. In addition, however, it is also likely that the statute also required the return of the hard drive so as to enable the customer to retrieve the contents of the defective/replaced hard drive. The harm that was caused (the loss of information on the drive) may be precisely what the statute was intended to prevent. Nevertheless, without question, the facts clearly indicate that Acme failed to return to Gunter the defective hard drive that was replaced in his computer.

However, proof of the statutory violation does not establish that a defendant’s negligent conduct is the actual cause of the plaintiff’s harm. Thus, the analysis must move on to the next element of the prima facie case – actual causation.

Actual (Direct) Cause

Of the six points of the prima facie case, this point is the most difficult to establish in this case. Actual cause requires that there be a direct link between the conduct of the defendant and the harm suffered by the plaintiff. In this case Acme's failure to return the hard drive to Gunter must be the cause of Gunter's loss. Generally the issue of actual cause is analyzed using a "but for" question. “But for” the defendant's conduct plaintiff would not have suffered a loss. Stated differently, the defendant’s conduct led to the plaintiff loss.

Since actual cause is part of the prima facie case of negligence, the burden of establishing the causal connection is on the plaintiff. So what is the difficulty facing Gunter in this case? The difficulty is that the hard drive that was replaced in Gunter's computer is not available. Thus Gunter is unable to establish that had he been given his defective hard drive he would have been able to recover the information from the hard drive and thus would not have been injured. It is impossible for Gunter to establish the link between Acme's conduct and Gunter's loss because he does not have his replaced hard drive. Although Gunter might argue that since Retriever was able to recover Gottmilk's materials from Gottmilk's defective/replaced hard drive and since his hard drive was the same as Gottmilk's, therefore, presumably, Retriever would have been able to recover Gunter's materials from Gunter's defective hard drive. Acme's position would most certainly be that Gunter would not have been able to recover any information from the hard drive even if Acme had returned it to him.

Given that it is impossible for Gunter to establish the causal link between his loss and Acme's conduct, is Gunter's negligence cause of action defeated? The answer to this question is not necessarily YES. In some instances, the courts will assume that the casual connection exists and shift the burden to the defendant to establish that his conduct was NOT the actual cause of the plaintiff's loss. Although the presentation of evidence regarding actual causation is normally one of the burdens that must be undertaken by a plaintiff in proving his case, if the lack of evidence in a case results directly from the defendant's conduct the court will shift the burden of proof on the issue of actual causation to the defendant to absolve himself if he can**.** This shifting of the burden of proof rarely occurs. However, in the present case, Gunter may be successful in arguing that because of Acme's failure to return to Gunter his hard drive it is impossible for him to establish that he would have been able to recover the data from his hard drive because Acme no longer has the drive. Thus, the burden should be shifted to Acme to prove that that failure was NOT the actual cause of Gunter's loss. The inability of Acme to provide such proof will result in the "actual cause" of the loss being established as a matter of law. (*Haft v. Lone Palm Hotel*, 3 Cal. 3d 756, 478 P.2d 465 (1970), provides a discussion of the circumstances under which the court shifted to the defendant the burden of proof on the issue of actual causation.)

Proximate Cause

This point of the prima facie case is easily met. It is important to note that proximate cause has nothing to do with proximity or closeness of the loss to defendant's conduct. Proximate cause is a concept that will enable a limitation of the extent or scope of a defendant's liability for conduct, on the part of the defendant, that has actually (in fact) resulted in a loss to the plaintiff.

Some courts discuss proximate cause as the natural and probable consequences of a defendant's conduct. Cases dealing with difficulties relating to proximate cause are those where the plaintiff's loss arises as a result of a series of connected, weird and unforeseeable events.

In this case what would be the natural and probable consequences of Acme's actions? Stated differently, are the damages suffered by Gunter the natural and probable consequences of Acme's failure to return to Gunter his replaced hard drive? The answer is most certainly yes. The events leading to the loss are not weird or unforeseeable. There are not a lot of intervening forces at work here. There is no need to explain this concept in further detail since its existence is rather obvious.

Damages

Compensatory Damages

Has Gunter been damaged by Acme's conduct? If so, what are the damages? Clearly Gunter has expended $800 to retrieve data from a hard drive that was not his. The retrieved data was of no value to Gunter. Thus, Acme's failure to return the proper hard drive to Gunter resulted in his needlessly spending $800 to retrieve information from Gottmilk's hard drive that was of no value to Gunter.

Gunter has indicated that he wants Acme to pay him $5,000 to cover the cost of his time to reconstruct lost materials that he used in his consulting work. Here, Gunter must provide some evidence as to the nature of the data that was lost and the efforts he would need to expend in order to reconstruct that data. There are probably not enough facts given in the case to evaluate the validity of Gunter's $5,000 claim. A conclusion that an award of $5,000 should be made would not appear to be out of the realm of possibility. However, an opposite conclusion is also reasonable since the facts of the case are vague on the costs of reconstructing the lost data.

Punitive Damages

In addition Gunter is seeking $10,000 in punitive damages because of the way Acme has handled the entire matter. Students might explain the difference between intentional tort cases and negligence and the possible recovery of punitive damages in these cases. The rational for awarding punitive damages in intentional tort cases (e.g. assault, battery, false imprisonment, defamation, infliction of emotional distress) is two fold. First, the intentional nature of one's conduct is viewed as reprehensible and should therefore be punished. Second, punishing the defendant for conduct specifically aimed at causing harm provides a deterrent affect with respect to the behavior of others.

Generally, punitive damages are not recoverable in a case of negligence. In this case Gunter would not be able to recover any amount for punitive damages. Acme did not act with the specific intent to damage Gunter, but merely failed to exercise ordinary care. The conduct here is not reprehensible, was unintentional, and a deterrent message for others is not appropriate.

Conclusion - Negligence

Student reports will, more than likely, conclude that Acme's conduct amounted to negligence and that its conduct caused harm to Gunter. The extent of the harm would certainly include the $800 spent on recovering useless data. It is likely that students would also conclude that the request for $5,000 to cover the cost of recreating the lost data is reasonable. However, a conclusion that Acme would be liable for punitive damages would be clearly erroneous.

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

DEFENSES TO NEGLIGENCE

Contributory Negligence

In lawsuits based upon a negligence cause of action there are several defenses that may be available to the defendant. If successful, a defense is usually a complete bar to recovery by the plaintiff in spite of having established that the defendant was negligent. This is the result of a successful defense of contributory negligence. If the plaintiff contributes to his loss to any degree, then the plaintiff will recover nothing for the damages suffered as a result of the defendant's negligence. The "Daily Tribune" article states that the State of Gould currently recognizes contributory negligence as a defense. Thus, if Gunter is responsible for bringing about his loss, to any degree, Gunter will recover nothing from Acme.

Did Gunter contribute in any way to the harm that he suffered? The analysis here regarding Gunter's behavior is the same prima facie case that was used in evaluating Acme's behavior, i.e., conduct – duty – breach of duty – actual cause – proximate cause – damage. Reports may not include an in-depth analysis of Gunter's behavior and will provide a superficial coverage of Gunter's possible negligence. Gunter owed a DUTY to HIMSELF to avoid any harm he would suffer if the hard drive crashed. He clearly BREACHED this duty by failing to back up the hard drive. That failure ACTUALLY CAUSED the DAMAGE.

A more thorough discussion of Gunter's conduct is most desirable. Gunter's conduct in this case is an omission – he failed to make a back-up copy of his hard drive. Gunter certainly owes a duty to himself to act as a reasonable person would act under the same or similar circumstances. (This covers the points of duty and to whom the duty is owed.) The interesting question presented here is whether the standard of care would include backing up the hard drive. This is a critical decision. If the standard of care would include backing up the hard drive then the next issue, i.e., has Gunter breached the duty that he owes to himself, is easily determined. If the duty includes backing up the hard drive, Gunter has failed to do this; therefore he has breached the duty. The failure to back-up has caused the harm (actual cause established). The "but for" question would be answered in the affirmative. If Gunter had backed-up the hard drive he would not have been harmed. If the hard drive crashes, Gunter would have a back-up copy and therefore any harm that might have occurred is avoided. The degree of contributory negligence on Gunter's part is not relevant. Contributory negligence, to any degree, results in a complete bar to recovery from Acme.

On the other hand, if the duty does not include making a back-up copy of the hard drive, then the duty is not breached because of that failure. If the duty to oneself is not breached then one element of the prima facie case of negligence is missing and Gunter was not negligent (contributorily). If Gunter was not negligent then the defense of contributory negligence is unsuccessful and Gunter's recovery of damages from Acme will not be affected.

Comparative Negligence

The "Daily Tribune" article indicates that the Gould Supreme Court is considering changing the contributory negligence doctrine to a comparative negligence standard. The article provides the students with an explanation of comparative negligence (both pure and mixed). The pertinent part of that article is:

> 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 were 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 were 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 where the plaintiff was found to be at fault 51% in the one instance and 99% in the other instance.

In addition to the "Daily Tribune" article, the instructor may assign textual material or a specific legal case; or conduct class discussion that will assist the students in analyzing the comparative negligence issue. There are numerous legal cases that an instructor might choose from. One case is *Li. v. Yellow Cab Co. of Californian*, 13 Cal. 3d 804, 532 P.2d 1226 (1975). The *Li* case discusses contributory and comparative negligence. The case also addresses the issue of retroactivity once the court decides to abandon the contributory negligence standard and adopts in its place a "pure" comparative negligence standard.

Gunter Not Comparatively Negligent – Full Recovery

The determination of whether Gunter has acted negligently in failing to exercise reasonable care is the same prima facie case we have discussed above. If Gunter has not been negligent then he would be entitled to full recovery of damages from Acme. The result in this instance is the same regardless of whether the defense is based on contributory negligence or comparative negligence.

Gunter Comparatively Negligent – Recovery Differs

If Gunter is negligent, then the percentage of his contribution to his own loss must be determined. The analysis can only make statements based upon certain assumptions. If the Supreme Court of Gould adopts a pure comparative negligence standard then Gunter's recovery would be reduced by the percentage of his contribution to his own loss. Suppose Gunter contributed 60% to his own loss. Under the pure form of contributory negligence Gunter would be able to recover 40% of his damages from Acme.

If the Court adopts a mixed comparative negligence standard, then Gunter would be able to recover damages from Acme if the percentage contribution to his own loss is less than 50%. Thus, if Gunter were determined to have contributed 49% to his own loss, he would be able to recover 51% of his damages from Acme. However, if Gunter were determined to have contributed 50% or more to his own loss, he would be barred from recovering anything from Acme.

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.**

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

It has been estimated that 80% of the time the plaintiff is awarded damages (let p =. 8). Several assumptions with respect to risk are made. (1) It is desired that our estimate of 80% is within 3%, up or down, of the true proportion (let B = .03). Recall that we do not know the true proportion; we can only estimate it. One might be familiar with similar risks used in political polling. (2) The confidence of 90% is the proportion of times that a confidence interval based on the 80% contains the true proportion. This *confidence interval* contains an upper value, higher than 80%, and a lower value, lower than 80%. We can be 90% certain that this interval contains the true percent the plaintiff is awarded damages. (Hint: You may wish to review the concept of confidence intervals. Go to http://www.davidmlane.com/hyperstat and check topic 8 and then 10.) The calculation of this confidence interval is shown in part b below. Let confidence or $(1-\alpha) = .90$ so that $\alpha = .10$.

The 80% proportion follows a binomial probability distribution. However, the sample sizes in this problem are large enough to use the normal approximation to the binomial. The probabilities of various percentages occurring can be described by the *normal distribution* or *bell-shaped curve*. (See http://www.davidmlane.com/hyperstat and check topic 5.) Errors can either be up or down, so this problem involves two tails, each with a probability of $\alpha/2$ or .05. From a normal table $Z_{\alpha/2\,(.05)} = 1.645$.

The sample size $n = [Z_{\alpha/2} \sqrt{p(1-p)} / B]^2 = [(1.645)(.4) / .03]^2 \approx 481 < 600$.

Therefore, a sample of 600 is large enough given our assumptions.

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

Again, using the normal approximation to the binomial distribution, the confidence interval is $p \pm Z_{\alpha/2} \sqrt{p(1-p)/n}$ or $.8 \pm (1.645) \sqrt{(.8)(.2) / 600}$. The actual sample size is 600 so n = 600. The formula gives an upper bound of .8 + .027 = .827 and a lower bound of .8 - .027 = .773.

It is important that students correctly define this confidence interval. There are several ways to state it. One way is to state that one can be 90% confident that the interval (.773-.827) contains the true percent the plaintiff is awarded damages. Another is that 90% of all confidence Intervals will include the true percent. However, it is NOT correct to say that the probability the true percent is in the interval (.773-.827) is 90%.

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?

The *expected value* is the weighted average of a set of values where the weights are the probabilities of the values. In this problem the values are all costs so the expected value can be called *expected cost*. Here the expected value is found by multiplying the probability of each possible event by the monetary consequence (cost) of that event. Then the results for all events that can occur are summed.

Acme's conduct in this case does not appear to meet the egregiousness standard for purposes of awarding punitive damages. It did not appear to deliberately act with knowledge of a high probability of harm and reckless indifference to the consequences of its actions. Thus, *no* punitive damages are considered.

The negligence claims that can be considered are (1) the payment of $800 as reimbursement for the expenditure to Mr. Retriever and (2) the payment of $5,000 to cover the cost of time to reconstruct lost materials. Your students may rationalize different values; give them credit if their answers are well thought out.

The expected value (or expected cost) = (.8)(.5)($5800) + (.2)($0) = $2320. The expected value based on the upper bound of the confidence interval of .827 is $2398. The expected value based on the lower bound of .773 is $2242. If there were many cases with similar costs, the mean settlement would be $2320, assuming the 80% figure. Even if the 80% varies (and assuming the 50% is correct), the interval $2242 - $2398 is relatively small. $2320 appears to be a reasonable estimate.

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 strategic and ethical issues.

The expected value of $2320 could be used as the basis for a settlement. This amount is much less than Gunter's claims. If Jetson can convince Gunter to settle for something approximating this amount, both parties would save lengthy and expensive litigation costs. (Settling would be particularly beneficial to Acme if the Gould Supreme Court adopts the pure comparative negligence standard). A settlement appears to be in the best interests to the stakeholders involved and appears to be fair and ethical.

Please note that is an open-ended question. A number of good answers are possible. Some of your best students may mention the following ethical and legal issues.

ETHICAL ISSUES

One ethical issue that the case presents is Acme's response to Gunter's request to be reimbursed the $800 out of pocket expense for recovery of data from Gottmilk's defective hard drive. The facts clearly indicate that Acme did not return Gunter's defective hard drive to him. Legally Acme may or may not have to compensate Gunter. However, Acme has already acknowledged that it failed to tag the hard drive due "to the large number of hard drive replacements" it was making during the first two weeks of October 2007. The right thing to do, one might argue, is to assume responsibility for one's actions. The $100 gift certificate settlement offer does not accomplish this. The student reports should look at this issue and make some attempt to apply at least one approach to ethical decision-making.

There are numerous approaches that are used to determine if one's actions are ethical. The most common of these approaches is the Stakeholder/Utilitarian Theory (maximize the net benefits to society as a whole, i.e., the greatest good to the greatest number). Other theories include the Rights Theory (respecting and protecting individual rights); Justice Theory (fair distribution of benefits and burdens); Categorical Imperative Theory (looking at the results if everyone acted in the same manner); and the Front Page Test (reaction if the decision is reported on the front page of the local newspaper). In order to answer this question instructors must provide students with a framework whereby they can analyze Acme's behavior from an ethical standpoint.

STRATEGY

The strategy involving the legal case revolves around the one-year statute of limitations, the possible change in the contributory negligence defense in the State of Gould, and if there is a change to a comparative negligence standard will the standard be applied retroactively.

Gunter's Dilemma

If the Gould Supreme Court retains the contributory negligence defense, then Gunter should settle. It is likely that if the case were to go to trial, Gunter would be found to have been contributorily negligent and would be barred from recovering any damages from Acme. Acme would appear to have the upper hand at this point and may not have any interest in settling the matter quickly.

If the Gould Supreme Court adopts the "pure" comparative negligence standard then Gunter may wish to take his chances in court and try to establish his claim for $5800. Even if he is found to have contributed to his own loss, his recovery would only be reduced by the percentage of his contribution to his loss. Under these circumstances, Acme may want to settle the case with Gunter. Acme, of course would try to settle for as small an amount as possible.

If the Gould Supreme Court adopts the "mixed" comparative negligence standard, Gunter faces the possibility of being barred from recovering damages from Acme if the jury determines that he was at least 50% responsible for causing his loss. In this instance, Acme would again have the upper hand and may not have any interest in settling the matter.

The one-year statute of limitations will soon bar any lawsuit that Gunter may file. The one-year period of time within which to file the lawsuit would begin to run from the time Gunter knew or should have known that he was injured. From the facts stated in the case it is not clear on what precise date Gunter knew he had not been given his replaced hard drive. However, the date is somewhere between the middle of October and December 1, 2007 when Gunter wrote his first letter to Acme. If Gunter does not file the lawsuit in a timely manner he will lose the opportunity to have a court hear his case. The dilemma here is that if the Court adopts the new standard, will that standard be applied retroactively and, if so, how? A reading of the "Daily Tribune" article should raise this dilemma. If Gunter files his case before the Court adopts the new comparative negligence standard, that standard may not be available to him in his lawsuit. The court may retroactively apply the new standard only to those cases that are filed after it changes the law from the contributory to a comparative negligence standard. (As mentioned earlier in the comparative negligence discussion, Li v. Yellow Cab Co. of California may provide the students with some guidance with respect to the issue of retroactive application of the comparative negligence defense.)

Acme's strategy, in light of the statute of limitations and the retroactivity issues, would depend upon decisions reached by the Supreme Court of Gould in the case before it relating to changing the law of contributory negligence. If the Court does not change the law, (the retroactivity issue is not raised) Acme has the advantage and is not concerned with settling. If Gunter does not file his suit within the one-year time period, Acme would escape liability. If the Court changes the law to a "pure" comparative standard and determines that the new standard will apply retroactively to only those cases that are filed after the Court's decision, then Acme may want to settle the case as soon as possible.

AUTHORS' NOTE

Dates are extremely important when a statute of limitations issue is presented in a case. The dates currently included in the case are appropriate if the case is assigned in a Spring 2008 class. If the class is assigned in a subsequent term see the table that follows for suggested dates for the events in the case.

Event	Spring 2008	Fall 2008	Spring 2009	Fall 2009	Spring 2010
Computer Purchased	January, 2005 (Nimbus 2005)	January, 2005 (Nimbus 2005)	January, 2006 (Nimbus 2006)	January, 2006 (Nimbus 2006)	January, 2007 (Nimbus 2007)
Hard Drive Crash	October, 2007	April, 2008	October, 2008	April, 2009	October, 2009
Gunter's First Letter to Acme	December 1, 2007	June 1, 2008	December 1, 2008	June 1, 2009	December 1, 2009
Fontz's Response	December 21, 2007	June 21, 2008	December 21, 2008	June 21, 2009	December 21, 2009
Gunter's Response	December 26, 2007	June 26, 2008	December 26, 2008	June 26, 2009	December 26, 2009
Daily Tribune Article	January 7, 2008	July 7, 2008	January 7, 2009	July 7, 2009	January 7. 2010
Court Decision Expected	August, 2008	February, 2009	August, 2009	February, 2010	August, 2010

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.

INSTRUCTORS' NOTE

As indicated in the case, store manager Jamie Taylor faces the following situation: 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.

As regards lessons and/or information which students should learn from this case, at least three points can be made:

1. Exposure to data (and sources of data) on the convenience store industry in the U.S., a segment of the total retail market in the U.S. which is not only dynamic but also accounts for (in certain product categories including gasoline) a very substantial percentage of total U.S. retail sales. As suggested earlier, it seems worth noting that in our area, there appear to be a number of convenience store management opportunities available for recent university graduates.
2. Identification of a large set of options available to convenience store managers who are eager to grow their business.
3. Discussion of the question of the extent to which the model or conceptual framework or data analysis tool utilized by the decision makers affects the data on which they focus their attention and/or the alternatives they are likely to consider.

DISCUSSION QUESTIONS

I often select one student to lead the discussion. Another approach would be to solicit input from various students at various stages of the analysis. Either way, my usual approach to this case is threefold:

1. Solicit from many students the details of the situation faced by Jamie Taylor. Usually, I write much of the information which students come up with on the board, so that if questions on "facts of the case" arise, we will have that information in front of us.
2. Ask an individual student or the class as a whole to address a very specific series of questions. Those questions, and comments relating to two possible solutions to the case, are as listed below:

1, What is the main problem?

Students usually conclude that Jamie Taylor needs to develop a plan to increase (by 10% or more) the sales of his store.

2. What kind of problem is this?

Instructors should not be surprised if there are as many answers to this question as there are students in the class. Clearly, there is no one "right" answer. However, three alternative approaches, each of which seems quite relevant to the situation, are as indicated below:

1. A need to improve the performance of the organization.
2. A need to review and revise the retail strategy being utilized.
3. A need to grow the business.

3. For this kind of problem, what are the key variables which decision-makers must consider, and who is the expert who says so?

For students concluding that the main problem is the need to "grow the business," Ansoff (1957) indicates that there are four (and only four) options: (1) Market penetration; (2) Market development; (3) Product development; and (4) Diversification.

For students concluding that the main problem is the need to review and revise the retail strategy, Lamb, Hair, and McDaniel (2006) indicate that the key elements of a retail strategy are a firm's target market(s) and its retail mix of presentation (that is, layout and atmosphere), personnel, price, place, product, and promotion.

Students concluding that the main problem is the need to improve the performance of the organization may find useful the model of King (1964) for the variables affecting the performance of organizations: (1) Characteristics of the firm's macro environment (for example, interest rates, exchange rates, etc.); (2) Characteristics of the firm's industry environment (for example, the textile industry is labor-intensive, manufacturing of aluminum is energy-intensive, etc.); (3) Characteristics of the "environment" (this consists of characteristics of the firm, characteristics of the firm's competitors, and characteristics of the firm's customers); 4) Characteristics of the firm's strategy (as indicated above, the key elements of a retail strategy are a firm's target market(s) and the retail mix, that is, presentation (i.e., layout and atmosphere), personnel, price, place, product, and promotion; and 5) Characteristics of the firm's tactics and/or the extent to which the firm is able to implement the strategy it has adopted.

4. What data from the case relate to the key variables?

As implied above (and this is one of the key learning points of the case), the data students present will depend on the main problem they identify. Students believing the main problem relates to the need to "grow the business" will focus on the four options identified by Ansoff (1957); Appendix 1 provides descriptions of each alternative and identifies data from the case which relate to each of them. Students believing the main problem relates to the need to review and revise the store's retail strategy will focus on the seven elements of retail strategy identified above; Appendix 2 identifies data from the case which relate to each of those variables. Students believing the main problem is performance-related will focus on the five elements of the performance model identified above; Appendix 3 identifies data from the case which relate to each of them.

5. What alternative solutions can be identified?

Because research suggests we make better decisions if we identify alternatives and then chose one, I require students to identify at least two alternatives. Of course, students having difficulties coming up with a second alternative can be reminded that one possible solution is to "change nothing."

6. Which one alternative does the class/student recommend, and why?

"Changing nothing" is not an option for Jamie Taylor, if he wishes to improve the performance of his store and (in so doing) improve his compensation as well. Students believing that the best definition of the generic problem faced by Taylor involves the need to "grow the business" will need to present an analysis which touches on each of the growth options identified by Ansoff (1957). Students believing that the best definition of the generic problem faced by Taylor involves the need to review and revise the retail strategy will need to present an analysis which touches on each of the seven elements of retail strategy identified by Lamb, Hair, and McDaniel (2006). Finally, students believing that the best definition of the generic problem faced by Taylor involves the need to improve the performance of his store will need to present an analysis which touches on each of the five elements of the performance model identified above.

In discussions and analyses of this case conducted by the author, students chose to focus intensively on the alternative involving the need for Taylor to improve the performance of his store. For additional information on what happened, please see the epilogue.

7. What negatives are associated with the alternative selected by the class leader and/or other members of the class?

Very few solutions are risk and/or problem-free. Negatives associated with the solution proposed by the class leader and/or other members of the class could include the following: The chosen alternative could be expensive both in terms of time and money. Also, because the case probably doesn't provide all the data a decision-maker would need (in other words, it is likely that some important data is missing), it is possible that some assumptions made by the class leader regarding the actual situation faced by Taylor are incorrect. If so, the proposed solution might be inappropriate.

EPILOGUE

In their discussion of the challenge faced by Jamie Taylor, students presented arguments which focused on the performance model suggested by King (1964). Specific suggestions made by the students included:

1. Characteristics of the macro environment

In the long run, the stronger the local economy in Abilene, the more likely it is that Taylor's store will do well. In other words, if any one of a number of macro-level developments takes place (for example, if the traffic count going past his location increases, and/or if additional firms open up near his store, and/or if enrollment at the local high school increases), the performance of Taylor's store is likely to improve. One implication of all this is that (for long term considerations) Taylor should join the local Chamber of Commerce and contribute (with other business leaders) in any way he can to the growth and development of Abilene's economy.

2. Characteristics of the industry

The case indicates that convenience stores account for approximately 75 percent of all gasoline sales in the U.S. and that gasoline accounts for 70–80 percent of the total revenues of Taylor's store. One implication of this fact is that Taylor should consider implementing some sort of customer rewards program to encourage customers who purchase gas from him on a regular basis to continue doing so, and to encourage customers who do purchase gasoline from him to fill their tanks. Perhaps Taylor could implement a program which rewards customers (free food and/or drinks, for example) every time they present a set of receipts indicating that they have purchased at least 50 gallons of gas. Another advantage of such a program is that it should increase the probability that from time to time, each of these gasoline customers (including the 10–15% of his gasoline customers who currently do not enter the store) will enter Taylor's store and be exposed to the Point of Purchase (POP) promotions which Taylor will be running inside the store.

3. Environment

Regarding characteristics of the company, the case indicates that Smith's All-Needs Convenience Stores (including Taylor's store) compete on customer service, not on price. One implication of this fact is that Taylor needs to ensure that his customers do perceive that they receive high quality service from his employees. To this end, Taylor needs to ensure that his employees pay attention to the following five components of service quality: (1) Assurance (that is, employees need to be knowledgeable and courteous, and they need also to convey trust and confidence); (2) Empathy (that is, they need to make each and every customer feel as if they have received caring and individualized attention); (3) Reliability (that is, employees must be able to provide customer service dependably and accurately); (4) Responsiveness (that is, employees must be able to provide customer service in a very timely fashion); and (5) Tangibles (that is, employees must themselves look neat and clean and keep the store and its equipment looking neat and clean as well). Obviously, providing consistently high levels of customer service will require Taylor to provide service-related training not only for new employees but also (on a reminder basis) to existing employees as well. Furthermore, to help motivate his employees to focus on these issues, Taylor might want to implement a monthly employee recognition program, in which customers who feel an employee has provided them with especially good service are provided a way (filling out a card, for example) to call attention to that fact. One approach Taylor could use here is to have a drawing or some other reward program in which every employee recognized within the last 30 days by a customer can participate. In any case, both training employees (so that they are able to deliver high levels of customer service), and motivating employees (so that they are eager to deliver high levels of customer service) will be very important. Whether it will be possible for Taylor to do this with a set of most part-time employees is of course an interesting question; it is possible that properly training and motivating his staff will require an increase in the number of full-time employees on his staff.

Regarding competitor characteristics, the case indicates that the convenience store competitor across the street is characterized by slightly lower gasoline prices and an assortment of products which does not include on-premise food service but which otherwise is similar to the product assortment at Taylor's store. Unlike Taylor's store, the nearby convenience store competitor is open substantially less than 24/7 operating hours. One implication of all this is that in his promotional efforts (radio, posters and/or flyers at local companies, posters and/or flyers at the high school, etc.), Taylor might want to highlight the message that customers at his store are able (any time of the day or night) not only to fuel their vehicles but to fuel themselves (snacks, hot sandwiches, fresh pizza, etc.) as well.

Regarding customer characteristics, the case indicates identifies several groups of customers for Taylor's store, including the following: (1)Workers from nearby factories; (2) students attending the high school at Abilene; and (3) Businesspersons and others traveling the highway past his store. As regards the factory workers, the case indicates that there are surges of workers at 5am (this is a breakfast crowd), 4pm (that is, an "end of shift" crowd), and 11pm (that is, a lunchtime crowd) on weekdays. Implications flowing from these patronage patterns include the following: (1) Taylor needs to ensure that he is well-staffed at 5am, when the surge of workers looking for breakfast arrives; (2) For the homeward-bound workers at 4pm, Taylor might want to consider running short "end-of-day" specials on beer and/or other snack items; and (3) Again at 11pm, Taylor needs to ensure that he is well-staffed, so as to be able to get the "lunch crowd" fed during the time they have available. A related implication is that developing a portfolio of lunch offerings that can be prepared very quickly should help capture (and then retain) the business of the "factory workers on lunch break" group.

Regarding high school students, the case indicates that this group begins arriving about 11am and is short not only of time but also of money. The case indicates that the lunches students purchase tend toward breadsticks and soda; as one step toward identifying alternatives for students, Taylor might want to have a look at what students are can get for lunch (for approximately the same amount of money) from other local food outlets. Of course, to ensure that students are able to get in and out quickly, Taylor needs to ensure that on weekdays his store is well-staffed (starting about 11am) and well-trained.

Regarding businesspersons and others driving past his store, the case indicates that there is a surge of these types of customers a bit before and after 8am and a bit before and after 5pm as well. As indicated in the case, these customers tend to purchase coffee, gas, and a donut (in the morning) and gas and a cup of coffee in the evening. Taylor may wish to systematically observe the behaviors of people in this group, to see if there are additional products which members of this group tend to purchase; if so, having beginning and end of day specials on those additional products might be a way to develop additional business from members of this group. As already mentioned, a customer loyalty program with rewards for every 50 gallons of gasoline purchased might be a way for Taylor to motivate persons driving past his store to come in and make initial and/or additional purchases of gasoline.

4. Retail strategy

As already indicated, the needs of the three key groups of customers patronizing Taylor's store are somewhat different. It appears that key products for the factory workers might include (for the breakfast crowd) an assortment of different hot breakfasts and snacks to take with them for consumption during the working day, promotional prices on beer and snacks for the end of day crowd, and (for the 11pm lunchtime crowd) an assortment of quickly and easily-prepared sandwiches. For this group, price may not be as important as making sure that service is very very prompt, especially for the 11pm lunchtime crowd; certainly, Taylor must ensure that he has plenty of staff on duty during this busy period. Furthermore, and especially for this group, anything Taylor can do to speed up service to customers by adjusting products and/or the layout of the store and/or payment procedures and/or other presentation-related variables should certainly be done. For the factory worker group, it seems likely that posters and/or flyers in the workplace plus reward programs (for example, a card to be punched each time a customer makes a purchase) should be highly effective and efficient.

As regards product offerings to high school students, Taylor could have a look at what other local food outlets are offering and then work toward creating an assortment of very inexpensive ready-to-eat snacks. For this group, both price and prompt service are very very important, especially for the 11am lunchtime crowd. Again, anything Taylor can do to speed up service to customers by adjusting products and/or the layout of the store and/or payment procedures and/or other presentation-related variables should certainly be done; certainly, Taylor must ensure that he has plenty of staff on duty during that very busy period. For the high school group, it seems likely that posters and/or flyers (if allowed by the school) plus reward programs (for example, a card to be punched each time a customer makes a purchase) should be highly effective and efficient.

As for the businesspersons and others traveling the road in from of his store, Taylor may wish to do some depth interviews and/or closely observe members of this group, with the objective of trying to find additional products (beside coffee, gasoline, and donuts) they would be interested in purchasing. Once Taylor identifies other products of interest to this group (either as they drive off to work in the morning, or as they drive home from work in the late afternoon), he may wish to use small outdoor advertisements or banners to advertise promotions available inside his store on these items. As in the case of the factory workers and the high school students, it seems likely that reward programs (that is, a card punched each time a customer makes a purchase) would be another effective and efficient approach to encouraging ongoing patronage.

5. Implementation/tactics

As mentioned earlier, the strategy for Smith's All Needs Convenience Stores (including Taylor's store) is to compete not on price but rather on customer service. As already noted, however, with a high percentage of his staff being part-time employees, it may be difficult for Taylor (and/or other Smith's managers) to compete on customer service. Increasing the number of full-time employees may make it easier for Taylor and his fellow managers to implement the customer service-based strategy which Smith's All Needs Convenience Stores has adopted.

There are two additional issues which need to be addressed:

1. Many of the suggestions made so far are short-term in nature. In the longer-term, it appears that Taylor should invest additional time and energy in developing deeper knowledge of the attitudes and behaviors of members of his three primary customer groups: (1) Workers in nearby factories; (2) High school students; and (3) Businesspersons and others driving past his store. As he develops deeper knowledge of the attitudes and behaviors of members of these groups, Taylor may discover that there are additional products and/or services which members of these groups would be eager to purchase from him.
2. So far, the suggestions to improve the performance of Taylor's store have focused on the weekday trade, that is, the groups of customers (primarily, the workers at nearby factories, the high school students, and the businesspeople and others who drive past Taylor's location) who patronize the store Monday through Friday. It appears that Taylor should do an in-depth analysis of his weekend business, to see if there are groups of prospects (that is, additional potential target markets) in the market for the sorts of products he already offers and/or could easily add to his

product line. For example, at various times during the weekend, there may be groups of churchgoers who could be offered meals either before or after church.

APPENDIX 1
CASE DATA RELATING TO THE "GROW THE BUSINESS" MODEL

1. Market penetration.

Ansoff indicates that this option involves increasing one's own market share of existing products and/or services being sold to existing customers. The case indicates that Taylor's store currently serves three primary groups of customers: (1) Workers in nearby factories; (2) High school students; and (3) Businesspersons and others driving past Taylor's store. The case also indicates the products purchased by these groups; workers tend to purchase meals (breakfast or lunch), high school students tend to purchase lunch, and businesspersons and others driving past Taylor's store tend to purchase gasoline, coffee, and donuts. To grow his business through market penetration, Taylor needs to consider two issues: (1) How to increase the percentage of people in each of the three groups of historic customers (that is, workers in nearby factories, high school students, and businesspersons and/or others who drive past his store) who become customers of his store; and (2) How to motivate members of these groups to increase their purchases of gasoline, coffee, donuts, meals, and the other products his store already offers.

2 Market development.

Ansoff indicates that this option involves selling existing products and/or services to new customers. To increase his sales through market development, Taylor needs to consider what other groups of customers he might be able to interest in purchasing from him gasoline, coffee, donuts, meals and the other products he already stocks.

3 Product development.

Ansoff indicates that this option involves selling new products and/or services to existing customers. To grow his business through product development, Taylor needs to consider what products beyond those he already sells might be of interest to his traditional customers, that is, workers in nearby factories, high school students, and businesspersons and others driving past his store.

4. Diversification.

Ansoff indicates that this option involves selling new products and/or services to new customers. To grow his business through diversification, Taylor needs to consider both the product-related and the market development-related issues mentioned earlier. In other words, are there products and/or services his store does not currently sell which, if he started selling them, might attract entirely new groups of customers.

APPENDIX 2

CASE DATA RELATING TO THE RETAIL STRATEGY MODEL

TARGET MARKET(S)

The case indicates that Taylor has three primary target markets: (1) Workers in nearby factories; (2) High school students; and (3) Businesspersons and others who drive past his store.

PRODUCT(S)

The case indicates that gasoline accounts for 75 percent of convenience store revenues, and that other products which account for substantial portion of convenience store revenues include cigarettes, packaged non-alcoholic beverages, food service, beer, other tobacco products, candy, salty snacks, general merchandise, fluid milk products, and packaged sweet snacks. The case also indicates that Taylor's three primary target markets are heavy purchasers of the following products:

a. Workers in nearby factories: Purchase breakfasts, lunches, snacks, and gasoline.
b. High school students purchase ready-to-eat snack lunches.
c. Businesspersons and others driving past his store purchase gasoline, coffee, and donuts.

PRICING

It appears that high school students are very price sensitive; the case indicates that breadsticks ($1.29) and a 32-ounce cup of soda ($0.85) are very popular. As for his other customers, it appears they may be slightly less price sensitive; the case indicates that although gasoline prices are a bit cheaper across the road and cheaper still two miles down the road, Taylor estimates that 50 percent of his customers do purchase gasoline from him. The case indicates that most prices at Smith's All Needs Convenience Stores are the same in all 30+ stores in the chain; however, the case also indicates that price for gasoline and tobacco products are adjusted by corporate staff to take account of local market conditions. The case also indicates that Smith's All Needs Convenience Stores strive to compete on customer service, not on price.

PROMOTION

With regards to media, the case indicates that Smith's All Needs Convenience Stores (including Taylor's store) do not do much print or television advertising. The stores do however engage in promotional activities with local radio stations; the case indicates that often these efforts involve opportunities for radio listeners to win free sandwiches and/or pizza. As for possible messages or campaign themes, the case indicates that one point of difference between Taylor's store and the nearby convenience store competitor is that while the competitor closes from midnight to 5am, Taylor's store is open all day and all night.

PLACE

The case indicates that there are now more than 30 stores in the Smith's All Needs Convenience Stores chain.

PERSONNEL

Many employees at the 30+ Smith's All Needs Convenience Stores locations are part-time employees. In fact, the case indicates that many employees work only one or two evenings a week, and that the stores employ lots of people who are also working a full-time job somewhere else. With a workforce which is heavily part-time, it is possible that improving the quality of customer service could be difficult. Given the importance which Smith's All Needs Convenience Stores places on customer service (managers wishing to receive bonuses need scores of 90% or higher from mystery shoppers), managers including Taylor may wish to consider increasing the number of employees who are full-time. In the meantime, it appears that both new and existing employees need to be exposed on a regular basis to service quality-related training.

PRESENTATION

The case does not provide much information about either of the two key presentation-related variables, that is, store layout and store atmosphere. The case does indicate that there are several times each day (5am breakfast for factory workers, 11am lunch for high school students, 11pm lunch for factory workers) when being able to be served quickly is likely to be very important to certain customers. At these times, being able (through appropriate layout, having the right number of employees, making sure that employees are properly trained, etc.) to provide quick and easy service to customers will be very important to Taylor and to other Smith's All Needs Convenience Store managers as well.

APPENDIX 3

CASE DATA RELATING TO THE PERFORMANCE MODEL

MACRO FACTORS

The case provides very little information about the local environment within which Taylor operates.

INDUSTRY FACTORS

The case indicates that gasoline accounts for 75 percent of convenience store revenues, and that other products which account for substantial portion of convenience store revenues include cigarettes, packaged non-alcoholic beverages, food service, beer, other tobacco products, candy, salty snacks, general merchandise, fluid milk products, and packaged sweet snacks. The case also indicates that convenience stores are a very dynamic segment of the retail industry, and that (at least in Taylor's local environment) the industry offers a considerable number of job opportunities for recent university graduates.

ENVIRONMENTAL FACTORS

Regarding characteristics of the company, the case indicates that Smith's All-Needs Convenience Stores (including Taylor's store) is a chain of 30+ convenience stores located in Noklahoma. Some of these stores are large, some are smaller, some are older and some are newer, but all compete on customer service, not price. It is interesting that the company uses large numbers of part-time employees; whether it will be possible for Taylor's store to provide a consistently high quality of customer service using most part-time employees is of course an interesting question. Given the fact that his store needs to receive at least a 90 percent mystery shopper score before Taylor receives a bonus, it appears training and motivating his staff will be a very critical issue for Taylor.

Regarding competitor characteristics, the case indicates that the convenience store competitor across the street is characterized by slightly lower gasoline prices and an assortment of products which does not include on-premise food service but which otherwise is similar to the product assortment at Taylor's store. Unlike Taylor's store, the nearby convenience store competitor is open substantially less than 24/7 operating hours. The case indicates that cheaper gasoline is available from outlets a couple of miles up the road. The case also indicates that Taylor's store faces a variety of food product competitors, including a supermarket with a deli section, Hardee's, Pizza Hut, Subway, and a local fast food outlet called Abilene Sports Grill.

Regarding customer characteristics, the case indicates identifies several groups of customers for Taylor's store, including the following: (1)Workers from nearby factories; (2) students attending the high school at Abilene; and (3) Businesspersons and others traveling the highway past his store. As regards the factory workers, the case indicates that there are surges of workers at 5am (this is a breakfast crowd), 4pm (that is, an "end of shift" crowd), and 11pm (that is, a lunchtime crowd) on weekdays. Regarding high school students, the case indicates that this group begins arriving about 11am and is short not only of time but also of money. The case indicates that the lunches students purchase tend toward breadsticks and soda. Regarding businesspersons and others driving past his store, the case indicates that there is a surge of these types of customers a bit before and after 8am and a bit before and after 5pm as well. As indicated in the case, these customers tend to purchase coffee, gas, and a donut (in the morning) and gas and a cup of coffee in the evening.

STRATEGY FACTORS: See Appendix 2.

IMPLEMENTATION/TACTICS

The case indicates that many of the employees at the 30+ Smith's All Needs Convenience Stores locations are part-time. In fact, the case indicates that many employees work only one or two evenings a week, and that the stores employ lots of people who are also working a full-time job somewhere else. With a workforce which is heavily part-time, it is possible that improving the quality of customer service could be difficult. Given the importance which Smith's All Needs Convenience Stores places on customer service (managers wishing to receive bonuses need scores of 90 percent or higher from mystery shoppers), managers including Taylor may wish to consider increasing the number of employees who are full-time. In the meantime, it appears that both new and existing employees need to be exposed on a regular basis to service quality-related training.

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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.

INSTRUCTORS' NOTES

Recommendation for a General Teaching Approach

This case has been successfully used to specifically reinforce the performance management function for senior level management and human resource management students. This case forces the student to explore all aspects of performance management including potential problems, development, implementation, and requirements for long term effectiveness.

A general instruction approach includes a thorough discussion of performance management, performance appraisals, job analysis, and job descriptions. A review of the tasks of strategic management and the management process would also be appropriate. This review and discussion should take approximately two in-class hours. The case instructs students to develop a comprehensive report based upon information in the case. Individual instructors may require each student to submit a written report or he/she may prefer to require teams of students to make formal presentations as if presenting to the board of directors of the firm. Reports would be graded primarily for content with specific attention being paid to students' ability to address both strategic and operational issues while effectively describing a performance system for the organization. If instructors decide to make the case a team presentation assignment, grading could also include an oral communication skills and/or a teamwork component. A general in-class discussion of the case may be appropriate after assignments are submitted or presented. The instructor may choose to highlight specific items from the case that offer significant concerns or challenges and ask students to identify the actions to address these items.

THE REPORT

Students are asked to develop a comprehensive report to present to the board of directors that describes a proposed performance management system for the agency. Students are instructed to address both strategic and operational issues.

Strategic issues

Students should recognize the strategic nature of performance management. Performance management is linked directly to the mission, objectives, and strategies of the organization. Job analysis gathers information that determines the elements of each job that are essential to organizational effectiveness. Job descriptions reflect this information and are critical management tools for effectively appraising an employee's performance. Reward and development decisions for employees should flow directly from these appraisals.

COA has no mission statement and no stated long-term or short-term objectives. There are no job descriptions. Performance appraisal criteria are not linked to job descriptions—since job descriptions don't exist. No evidence indicates that job analysis ever takes place at COA. There are no decisions concerning employees based on performance appraisals. Since job descriptions are developed from information gathered in job analysis, it could be deduced that job analysis activities do not take place at the agency--at least not effectively.

Based on the information provided, students should not be expected to actually create COA's mission, its mission statement, its objectives, individual job descriptions, or employee appraisal criteria; however, students' reports should describe the processes that will lead to the development of these items. Particular attention should be given to identifying implementation responsibilities within the suggested processes. Specific approaches may vary among students, but students should provide appropriate support for all recommendations. From a strategic perspective, reports should be evaluated based on whether the proposal will result in a well-articulated mission statement that is regularly reviewed and revised; organizational objectives that flow directly from the mission statement; current job descriptions that reflect the elements of the job that are critical for organizational effectiveness; performance criteria based on these essential elements; and individual employee reward and development decisions based on his/her appraisals.

Operational issues

The primary operational issue concerns making sure individual managers incorporate performance management into the operational management process. Briefly stated, this process involves managers ensuring that subordinates understand their goals, are provided resources and support to accomplish these goals, and are rewarded and developed based on the accomplishment of these goals. If effective strategic processes (as discussed in the previous section) are developed, individual supervisors should have the necessary tools to ensure that the individual goals are appropriate in terms of enabling the agency to achieve its mission; however, supervisors must be diligent in modifying these goals as the organization revises its mission and changes its objectives. Supervisors must also ensure that performance criteria are regularly revised to reflect these changes. In addition, supervisors must make certain that individual reward and additional training and development decisions are based on individual employee appraisals.

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.

INSTRUCTORS' NOTES

Recommendations for Teaching Approaches

Objectives

The primary objective of the case is to develop students' understanding of job cost processes and accounting for those processes. To complete the simulation successfully, students must possess a basic understanding of job cost accounting. This simulation may be used to supplement or illustrate classroom lectures or alternatively, may be assigned as a class project. The learning objectives for the simulation are to develop students' ability to:

1.	Understand the flow of costs in a job cost production environment.
2.	Understand and apply accounting for costs in a job cost production environment.

Implementation Guidelines

This simulation was designed to be used in introductory managerial accounting courses to facilitate student understanding and accounting for production flows in a job costing environment. The simulation can be easily modified to be used in upper level accounting classes by changing the simulation requirements. Suggested changes to modify the simulation are included in a later section of the notes. Our experience indicates that the simulation should be done after job costing has been covered in class. The simulation materials include ©Legos, inventory lists, forms, and instructions. The simulation can be used with pre-built prototypes, or students can build their own prototypes if time permits. Each set of ©Legos is packaged with pictures of possible "product designs" that can be used for this purpose.

The simulation was designed to mimic a real production environment, complete with an inventory manager, job teams, and a cost accountant. Our experience, however, has shown that if students perform only one function they become isolated from the rest of the simulation. We discuss this further in the teaching notes below.

TEACHING NOTES

The first step in the simulation is to pass out and review the simulation instructions with the students. Instructors should stress that the exercise is meant to simulate a manufacturing environment and the processes that occur in that environment. Instructors then designate areas within the classroom to represent the stores warehouse, the production area, and the finished goods warehouse. Instructors should also point out that although inventory management, production, and cost accounting are normally done by unique individuals within an organization, students will perform all three functions to gain experience and understanding of the manufacturing process. Once students are comfortable with the procedures, instructors direct students to begin the simulation by performing the first three procedures in the inventory management instructions.

Inventory Management – Material Receiving

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.

There are thirteen different types of raw materials. 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. The inventory label contains the raw material item number that corresponds to the inventory list. Students count and record the amount of inventory on receiving reports and on an inventory cards. They use the inventory list (Exhibit 1) to obtain unit costs and then extend the inventory on the cards. Cards are placed with the inventory item in the stores warehouse. As noted above, we suggest that all students perform this function. Instructors can elect to have the students propose the entry to record the receipt of inventory upon completion of the receiving function or wait until production is complete and do all journal entries at that time. Exhibit 2 contains examples of completed receiving reports and inventory cards for a sample inventory item.

Production Processing – Material Needs

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 also need to 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.

Operationally, instructors begin by assigning students to teams. Each team is issued a job cost sheet, two material requisition forms, and a time card for each member of the team. Each team should either pick a prototype for their product or build one if instructors elect to allow students to create their own product. (For instructional purposes the completed forms for production of a prototype are provided in Exhibit 3). Teams enter job cost information (the job name, product description) on the job cost sheet. Each team member selects one of the job team roles as described in the procedures. Teams now perform the first two instructions as follows.

The team designer analyzes the prototype to determine the material requisition needs. Once material needs are determined, the team fills out the material requisition form, in duplicate, and forwards both copies to the materials storeroom requesting their materials.

Inventory Management – Issuance of Material

Students now "switch" from production to inventory management and complete instructions for issuance of raw materials to production. It is helpful to assign at least two person teams to each raw material and to designate one student from each team as the recipient of the issued material. Instructors direct half the raw material team to issue material based on the material requisitions and the other half to update the inventory cards as material is issued. The recipient can move through the stores warehouse, item by item, until their requisition is complete. Instructors can provide an empty ©Ziploc bag with which to package the requested materials. Once all requisitions are filled, the materials manager signs both copies of the material requisition. Operationally, instructors may direct the team that fills the last item on the requisition form to sign the form and forward a signed copy to cost accounting. The remaining copy returns to production with the material, where it is used as the source document to record raw materials on the job cost sheet.

Production Processing – Actual Production

Students rejoin their teams in production bringing their raw materials and signed material requisition with them. The job coordinator receives the issued material and the team accountant enters the receipt of raw materials on the job cost sheet. Job teams build their product and keep track of their time on individual time tickets. When production is complete, team members total their time and the job accountant records it on the job cost sheet. Time tickets are forwarded to the cost accountant so that payroll can be recorded.

Overhead is applied on the basis of direct labor hours. Direct labor hours are accumulated on the time tickets and are used to calculate the applied overhead for each job. Students compute the amount and record overhead on their job cost sheet. Job coordinators for teams who complete production ship the finished good to the finished goods warehouse and forward the completed job cost sheet, with supporting documentation, to cost accounting.

This process has gone very well in the classroom environment and students really seem to have fun building their products. However, our experience with the simulation resulted in a number of suggestions for more effective implementation of this process. We suggest that once the designer identifies the material needs that instructors send the entire team to pull inventory from the stores warehouse. Assigning this function to one student per team creates a bottleneck in the stores warehouse and leaves other team members sitting and waiting for their materials. We have also found that students do not like setting their own labor rates and times. They prefer a more structured approach in which they are told the hourly rate of pay and how much total labor should be used to build their product. In response to their suggestions, we suggest that instructors assign the number of hours that each product should use and then allow students to allocate the hours among the team members. Instructors can elect to assign twenty labor hours among the teams, which results in allocated overhead equal to actual overhead, or can change the amount of actual labor hours so that overhead is under or over applied at the end of the period.

To enhance understanding of how individual jobs make up the work-in-process and finished goods inventory balances, instructors can direct one or more teams to stop production prior to completion. This results in one or more jobs that remain in work-in-process while the rest of the jobs move to finished goods. After the teams record the movement of the jobs from production, students can visually see the jobs supporting the general ledger balance for each type of inventory.

The professor, acting as the factory supervisor, provides help to groups as needed. Students have done well with the material requisitions, building the product, and accumulating material and labor costs on job cost sheets, but sometimes need help with the overhead allocation.

Cost Accountant

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 their job cost sheet in a T account on the board, labeling direct material, direct labor, and overhead. As a class, students now assume the role of cost accountant and use the professor as their “scribe”. Students direct the professor to record the transactions described in Table 3 of the instructions. (Sample journal entries appear in Exhibit 3). These functions are performed as a group to allow students to synthesize their individual group activities into a single set of summary journal entries. Instructors begin by recording the receipt of raw material, unless previously recorded during the initial receipt of inventory. Labor is recorded for both hourly workers, from the time tickets, and for salaried personnel, found in instruction 2 of Table 3. Overhead costs are recorded based on the information in time 3 of Table 3. These first three instructions represent the accumulation of product costs.

Instructions 4 through 7 of Table 3 involve recording the application of product costs to production. Instructors start with raw materials using material requisitions as the source documents and also refer to the T accounts summarizing the jobs that the team accountants previously recorded on the board. This helps students to visually see that the summary entry is the sum of all the individual amounts applied to each job. The application of labor involves both direct time from time tickets and indirect time recorded with the payroll. Direct time is charged directly to work-in-process, while indirect time is charged to manufacturing overhead. Overhead is applied on the basis of direct labor hours, the allocation base used in the predetermined overhead rate. Finally, students direct the professor to record the movement of any completed jobs out of work-in-process into finished goods. As the entries are prepared, instructors post them to T accounts and then have the students compute the balances. Students identify which jobs support which balances at the end of the exercise.

At this point, instructors direct students to select a job for sale and to compute a selling price equal to cost plus a 20% markup. Students propose the journal entries to record the sale. Finally, students analyze the manufacturing overhead account and dispose of any over or under applied amounts.

Students sometimes struggle with journalizing the processes they have just completed. Instructors may have to prompt students with questions to get them to visualize what occurred. For example, if students cannot record the application of materials to production, instructors should ask questions about where they got the materials and what they did with them. Students will remember that they got them from the "raw materials section of the classroom" and that they took them to the "production area of the classroom". This helps them logically derive the entry.

Experiential Classroom Use

The case has been used in ten sections of undergraduate managerial accounting courses. The simulation takes approximately forty-five minutes to an hour to complete. The simulation was first performed in two sections of managerial accounting from which the authors solicited verbal feedback to help perfect the implementation. In subsequent semesters, adjustments were made and an assessment questionnaire was administered to the students. The ratings for the specific questions were as follows (n = 48):

Did this project help you understand a job cost environment?

It received a rating of 4.15/5.00 where a 5 is "quite a bit" and a 1 is "not at all" (SD = .61849).

Did this project help you understand accounting in a job order cost environment?

It received a 3.98/5.00 where a 5 is "quite a bit" and a 1 is "not at all" (SD = .60105).

How did this project compare to learning about job order costing by reading the book?

It received a 4.50/5.00 where a 5 is "quite a bit" and a 1 is "not at all" (SD = .79894).

How did the project compare to learning about job costing by hearing a lecture?

It received a 4.50/5.00 where a 5 is "quite a bit" and a 1 is "not at all" (SD = .71459).

How did this project compare to learning about job order costing by doing homework problems?

It received a 4.20/5.00 where a 5 is "quite a bit" and a 1 is "not at all" (SD = .87418).

The student comments were very positive (summarized in Exhibit 4).

Student feedback indicates that students felt the simulation 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.

Simulation modifications

The simulation can be modified for use in upper level accounting classes. Suggested modifications include (1) assigning the simulation after covering classroom material on job costing, process costing, and activity-based-costing; have the students design the costing system or alternatively, critique and suggest improvements to the production processes and/or the accounting procedures, (2) assign an additional module in which students must identify indirect production costs and design a system for application of overhead to production; have students calculate the rate or rates and apply overhead based on their system design, (3) delete the forms from the simulation and have students design the forms necessary to document to flow of costs, and/or (4) expand the disposition of overhead section by including the assumption that over or under applied overhead is material. This elevates the disposition of overhead to upper level accounting in which students must prorate the over or under applied overhead among inventory and cost of goods sold.

CONCLUSION

This simulation attempts to engage Gen Y students in the learning process by using a hands-on approach to manufacturing and accounting for production in a job cost environment. It takes less than one class period and seems to give students a frame of reference for production processes. Post-implementation survey responses indicate that students liked the simulation, felt that it enhanced their understanding of production processes and accounting for production in a job cost environment. They preferred this method over lectures, reading the text, and doing homework. The simulation is appropriate for use in managerial accounting courses and in upper level accounting courses, with modification.

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Exhibit 1: Inventory List and Simulation Forms			
Inventory Item	Item Number	Colors Available	Price
8 x 2's	8 x 2	Yellow, orange, red, light blue, dark blue, lime green	$2.50 each
Supports	Supports	Dark blue	$.90 each
8 x 1's	8 x 1	Dark blue, lime green, dark green, yellow, orange, red, and light blue	$1.75 each
Eyes	Eyes	Yellow, green	$.50 each
Bases	Bases	Yellow, red, green, and dark blue	$1.00 each
16 x 2	16 x 2	Red and blue	$5.00 each
Squares	SQ – DG	Dark green	$.50 each
Squares	SQ – O	Orange	$.50 each
Squares	SQ – LB	Light blue	$.50 each
Squares	SQ – R	Red	$.50 each
Squares	SQ – LG	Lime green	$.50 each
Squares	SQ – Y	Yellow	$.50 each
Squares	SQ – DB	Dark blue	$.50 each

Job Cost Sheet
Job No: ______________ Quantity: ______________
Item _________________ Date Requested: _________
For __________________ Date Completed: _________

Date	Direct Materials	Direct Labor	Overhead	Total
	Cost of Completed Job			
	Direct Materials			
	Ciredt Labor			
	Overhead			
	Total			
	Unit Cost (Total /Quantity)			

Material Requisition Form
Deliver to: ______________________________ Req No. _______
Charge to Job No. ________________________ Date: _________

Date	Description	Quantity	Price	Total
			Total	

Requested by: _________________ Received by: _______________

Approved by: _________________ Costed by: _______________

Time Card
Employee ____________________ Date ___________

Job	Rate of Pay	Time	Overtime Rate	Overtime Spent	Total
				Total	

Inventory Card

Item: ________________________   Part No: __________

	Receipts			Issues			Balance		
Date	Units	Cost	Total	Units	Cost	Total	Units	Cost	Total
								Total	

Receiving Report

Purchase Order Number _______________________________

Vendor Name _______________________________________

Item #	Description	Qty	Condition Acceptable Unless Indicated Otherwise

____

Receiving Clerk Name

Instructions:

Please staple the packing slip to
the receiving report and
forward both to the Business Office.

____

Receiving Clerk Signature

Exhibit 2: Sample Inventory Management Forms

Receiving Report
Purchase Order Number ______5878_____________________
Vendor Name ______________Legos Internatinal___________

Item #	Description	Qty	Condition Acceptable Unless Indicated Otherwise
8 x 2	Module; 8 holes; 2 stories high	28	
Supports	Supports	3	
8 x 1	Module; 8 holes; 1 story high	19	
Eyes	Module with painted eye	4	
Bases	Module; base building block	10	
16 x 2	Module: 16 holes; 2 stories high	2	
Squares	Dark green	15	
Squares	Orange	24	
Squares	Light blue	24	
Squares	Red	24	
Squares	Light green	26	
Squares	Yellow	24	
Squares	Dark blue	24	

________T. Pergola_____________
Receiving Clerk Name

________T. Pergola_____________
Receiving Clerk Signature

Instructions:
Please staple the packing slip to
the receiving report and
forward both to the Business Office.

Inventory Card
Item: ______Module: 8x2__________________ Part No: ____8x2______

	Receipts			Issues			Balance		
Date	Units	Cost	Total	Units	Cost	Total	Units	Cost	Total
6/1	28	2.50	70.00				28	2.50	70.00
6/2				3	2.50	7.50	25	2.50	62.50

Exhibit 3: Sample Production Forms

Material Requisition Form
Deliver to: _____Production______________ Req No. __5____
Charge to Job No. _Ship__________________ Date: _6/2/07_

Date	Description	Quantity	Price	Total
6/2	16x2	1	5.00	5.00
	8x2	3	2.50	7.50
	SQ – dark green	6	.50	3.00
	Support	1	.90	.90
	SQ – Red	2	.50	1.00
	SQ – light blue	2	.50	1.00
			Total	$18.40

Requested by: ___TMP______Received by: ____DLH______

Approved by:___HAL______Costed by: ____TAC______

Time Card
Employee ____TMP_____________ Date __6/2/07__

Job	Rate of Pay	Time	Overtime Rate	Overtime Spent	Total
Ship	10.00	2.50	15.00	0	25.00
				Total	25.00

Job Cost Sheet
Job No: ___6572___ Quantity: ______1______
Item ______Ship______ Date Requested: __6/1______
For ___Toys R Us___________ Date Completed: __6/4______

Date	Direct Materials	Direct Labor	Overhead	Total
6/2	18.40	75.00*	1,125.00*	1,218.40
	Cost of Completed Job			1,218.40
	Direct Materials			18.40
	Direct Labor			75.00
	Overhead			1,125.00
	Total			1,218.40
	Unit Cost (Total /Quantity)		1	1,218.40

* Represents the sum of all team members direct labor from time tickets
* Computed as: 7.5 direct labor hours x $150 predetermined overhead rate

Sample Journal Entries:

Assume production of 4 jobs with the following costs:

Job	Ship	Flower	Dragon	Fish	Total
DM	18.40	25.00	24.50	11.50	79.40
DL	75.00	60.00	45.00	80.00	260.00
OH	1,125.00	1500.00	675.00	1,200.00	4,500.00
Total	1,218.40	1,585.00	744.50	1,291.50	4,839.40

The ship, flower, and dragon are completed; the dragon is sold at a 20% on cost.

JE	Account Title	Debit	Credit
1	Raw Materials Inventory	258.45	
	Accounts payable		258.45
	Record receipt of all raw materials		
2	Factory labor	3,260.00	
	Wages payable		2,999.20
	Taxes payable		260.80
	To record payroll; direct 260.00; indirect 3,000.00; employee payroll taxes withheld of 8%		
3	Manufacturing overhead	500.00	
	Accounts payable		500.00
	To record overhead bills		
4	Work-in-process Inventory	79.40	
	Raw materials inventory		79.40
	To record the application of direct materials to production		
5	Work-in-process Inventory	260.00	
	Manufacturing overhead	3,000.00	
	Factory labor		3,260.00
	To record the application of direct labor to production		
6	Work-in-process inventory	4,500.00	
	Manufacturing overhead		4,500.00
	To record the application of overhead to production based on 30 total direct labor hours		
7	Finished goods inventory	3,547.90	
	Work-in-process inventory		3,547.90

JE	Account Title	Debit	Credit
	To record the completion of production jobs		
8	Accounts receivable	893.40	
	Sales		893.40
9	Cost of goods sold	744.50	
	Finished goods inventory		744.50
	To record the sale of the dragon.		
10	Manufacturing overhead	1,000.00	
	Cost of goods sold		1,000.00
	To dispose of overapplied overhead		

Raw Materials Inventory

JE Ref	Debit	Credit
1	258.45	
4		79.40
Balance	179.05	

Work-in-Process Inventory

JE Ref	Debit	Credit
4	79.40	
5	260.00	
6	4500.00	
7		3547.90
Balance	1291.50	

WIP ending balance is equal to the costs in “fish”.

Finished Goods Inventory

JE Ref	Debit	Credit
7	3547.90	
9		744.50
Balance	2803.40	

Finished goods ending balance is equal to the costs in “ship” and “flower”.

Exhibit 4: Student Comments
Summary of Student Comments:
• Learn better from hands-on situation rather than reading or listening • Learned the process well • It really helped me connect all the steps • A fun activity overall • Understand the process more after this exercise • As a visual learner, I can better understand the process from an exercise like this • Good visual to complement other ways of learning • I had a really hard time understanding from the book and the lecture; the simulation was very helpful • Experience teaches people better than reading and listening • It helped a great deal to see the breakdown of the process • It was nice change and helped me to understand some of the more difficult aspects of job costing • It helps to walk through each step; I'll be able to visualize the process better and not just memorize the steps
Suggestions for Improvement:
• More time spent • When assigned as an inventory manager, I felt isolated from the rest of the project • Be more specific about labor hours and rates so they will be more alike between groups • Assign set labor rates

HEDGING WITH FOREIGN CURRENCY OPTIONS AT PEARSON INC

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

CASE DESCRIPTION

The primary subject matter of this case is hedging foreign currency exchange rate risk 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.

INSTRUCTORS' NOTES

Tasks to Be Performed

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%	18.0%	6.0%
(Intl. Trips Selected)	(150)	(750)	(1050)
Average	8.0%	24.0%	8.0%
(Intl. Trips Selected)	(200)	(1000)	(1400)
Above Average	6.0%	18.0%	6.0%
(Intl. Trips Selected)	(250)	(1250)	(1750)

Given the information from Table 1 and Table 2, there are 9 possible outcomes. For example, the probability of below average sales and a low acceptance rate is 6% (The Joint Probability of A and B is equal to the Probability of A * Probability of B). The corresponding level of international trips taken is 150 (If below average sales occurs only 1500 Tier Three vouchers will be sold and if the acceptance rate is low (10%), then only 150 international trips will ultimately be selected).

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	270,000
Average	and	Low	8%	200	360,000
Above Average	and	Low	6%	250	450,000
Below Average	and	Base	18%	750	1,350,000
Average	and	Base	24%	1000	1,800,000
Above Average	and	Base	18%	1250	2,250,000
Below Average	and	High	6%	1050	1,890,000
Average	and	High	8%	1400	2,520,000
Above Average	and	High	6%	1750	3,150,000
			Expected Euros Needed =		1,656,000

Minimum number of Euros needed = _*270,000*___

Maximum number of Euros needed = *3,150,000*__

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)	$ -	$ 29,700
8%	360,000	$ (32,400)	$ -	$ 39,600
6%	450,000	$ (40,500)	$ -	$ 49,500
18%	1,350,000	$ (121,500)	$ -	$ 148,500
24%	1,800,000	$ (162,000)	$ -	$ 198,000
18%	2,250,000	$ (202,500)	$ -	$ 247,500
6%	1,890,000	$ (170,100)	$ -	$ 207,900
8%	2,520,000	$ (226,800)	$ -	$ 277,200
6%	3,150,000	$ (283,500)	$ -	$ 346,500
Exp ($ Impact)		$ (149,040)	$ -	$ 182,160
Min $ Impact		$ (283,500)	$ -	$ 29,700
Max $ Impact		$ (24,300)	$ -	$ 346,500

If the dollar weakens and the average cost of Euros purchased increases to $1.45/1 Euro, the total US dollar cost impact would be $0.11 higher per Euro purchased. If the dollar strengthens and the average cost of Euros purchased decreases to $1.25, the total US dollar impact would be \$0.09 less per Euro purchased (i.e. Pearson's cost per trip is lower than originally expected).

4. **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 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)
8%	360,000	\$ 129,600	\$ -	\$ (158,400)
6%	450,000	\$ 121,500	\$ -	\$ (148,500)
18%	1,350,000	\$ 40,500	\$ -	\$ (49,500)
24%	1,800,000	\$ -	\$ -	\$ -
18%	2,250,000	\$ (40,500)	\$ -	\$ 49,500
6%	1,890,000	\$ (8,100)	\$ -	\$ 9,900
8%	2,520,000	\$ (64,800)	\$ -	\$ 79,200
6%	3,150,000	\$ (121,500)	\$ -	\$ 148,500
Exp (\$ Impact)		\$ 12,960	\$ -	\$ (15,840)
Min (\$ Impact)		\$ (121,500)	\$ -	\$ (168,300)
Max (\$ Impact)		\$ 137,700	\$ -	\$ 148,500

The US dollar cost impact of the forward hedge is a function of Euros purchased versus the number Euros needed and the exchange rate movements between the forward rate and spot rate in the future. In cases where the spot rate in the future is less than the forward rate ("Strong Dollar" scenario), actual costs may be higher if too many Euros are purchased and must be later sold at a loss, or actual costs may be less than anticipated if more Euros are needed than purchased forward and the difference is purchased in the spot market at a lower cost. At the extreme, consider the outcome that requires 3.15 million Euros (above average sales and a higher than anticipated acceptance rate). Pearson's basis is $1.34 per Euro. If 3.15 million Euros are needed and the forward hedge is use to purchase 1.8 million Euros, then an additional 1.35 million Euros are needed. Under the "Strong Dollar" scenario, the additional Euros needed are purchased in the spot market for $1.25 ($0.09 less than the basis). This represents a case where costs are $121,500 ($0.09 * 1.35 million Euros) *less* than anticipated. However, if the scenario is one where the average exchange rate is $1.45 ("Weak Dollar") then the additional 1.35 million Euros must be purchased at $0.11 more than the basis, representing a higher than anticipated cost of $148,500 ($0.11 * 1.35 million Euros).

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)
8%	360,000	$ 15,840	$ 48,240	$ (110,160)
6%	450,000	$ 7,740	$ 48,240	$ (100,260)
18%	1,350,000	$ (73,260)	$ 48,240	$ (1,260)
24%	1,800,000	$ (113,760)	$ 48,240	$ 48,240
18%	2,250,000	$ (154,260)	$ 48,240	$ 97,740
6%	1,890,000	$ (121,860)	$ 48,240	$ 58,140
8%	2,520,000	$ (178,560)	$ 48,240	$ 127,440
6%	3,150,000	$ (235,260)	$ 48,240	$ 196,740
Exp ($ Impact)		$ (100,800)	$ 48,240	$ 32,400
Min ($ Impact)		$ (235,260)	$ 48,240	$ (120,060)
Max ($ Impact)		$ 23,940	$ 48,240	$ 196,740

Currency options allow the buyer the right, but not the obligation, to purchase (a call option) or sell (a put option) a currency at an agreed exchange rate (exercise price). For this right without obligation, the buyer of the option pays a premium, making currency options a more expensive alternative to forward contracts. If there was an adverse movement in the exchange rate compared to the exercise price, the option holder would allow the option to expire unexercised. The holder could then buy or sell directly in the spot market at more favorable rates.

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 call options with an exercise price of $1.34, they have the option, but not the obligation, of purchasing 1.8 million Euros at $1.34. The premium associated with the option is assumed to be 2% of notional value of the contract and is paid in advance. The notional value of 1.8 million Euros at an exercise price of $1.34 is $2.412 million. The premium is calculated as 2% of $2.412 million or $48,240. If the "Strong Dollar" scenario occurs, Pearson will choose to let the options expire and purchase the 270,000 Euros needed in the spot market at a price of $1.25/Euro. However, the actual cost of the Euro is $0.09 less than anticipated. The impact on Pearson's anticipated costs are $48,240 higher for the call premium but $24,300 ($0.09 * 270,000) less for the 270,000 Euros actually needed. The total impact on anticipated costs would be $23,940 ($48,240-$24,300) more than anticipated assuming below average actual sales and a low acceptance rate. Under the "Weak Dollar" scenario, the average exchange rate is $1.45/Euro. Having purchased the right to buy 1.8 million Euros at $1.34, Pearson will exercise the call options and purchase 1.8 million Euros even though only 270,000 Euros are needed. The excess 1.53 million Euros will be sold in the spot market for $1.45. The total impact on anticipated costs will be the premium paid for the call options ($48,240) minus the profit from the sale of excess Euros ($0.11*1.53 million Euros) of $168,300. The total impact on costs under the "Weak Dollar" scenario will be a negative $120,060 (costs will be less than anticipated).

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

The biggest impact on costs occurs solely from exchange rate movements. If the Euro weakens ("Strong Dollar" scenario) then Pearson's costs will be much lower than anticipated and profitability will increase. If the Euro strengthens ("Weak Dollar" scenario) then Pearson's costs will be much higher than anticipated and profitability will decrease. The more Euros needed, either from higher than anticipated international acceptance rates or above average sales, the larger the impact. This is precisely the risk Pearson is hoping to avoid.

7. **What conditions represent the greatest risk to Pearson if he chooses to implement a forward hedge *of 1.8 million Euros?***

The forward hedge shifts the impact of exchange rate movements but does not eliminate them. The two by two matrix used by Pearson in the case clearly demonstrates the conditions that unfavorably impact costs. Fewer than expected international trips combined with a weakening of the Euro as well as larger than expected international trips combined with a strengthening of the Euro will both adversely impact costs.

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

Pearson pays $48,240 upfront (Call premium) for the right, but not obligation to purchase Euros at $1.34. This cost is somewhat similar to an insurance policy premium. If the Euro weakens, then Pearson is still able to take advantage of favorable exchange rate movements by purchasing Euros in the spot market at a lower price and the insurance is not needed. The option hedge provides the largest benefit over the forward hedge under the "Strong Dollar" scenario. However, if the "Weak Dollar" scenario occurs, Pearson's call options (a claim is filed) allow for 1.8 million Euros to be purchased at the exercise price of $1.34. If less than 1.8 million Euros are needed, the excess Euros can be sold for a profit. If more than 1.8 million Euros are needed, Pearson would have to purchase the additional Euros needed at the higher price. For the cost of the premium, exchange rate risk is reduced or eliminated for most of the possible outcomes. The biggest risk occurs under the "Weak Dollar" scenario only if Euros needed exceed what is expected.

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

The option hedge provides a number of desirable results, albeit for an initial upfront premium of $48,240. Call options shift most of the risk to situations when there is a greater than anticipated number of Euros needed and the Euro has strengthened. In situations where vouchers sold exceed the forecast, revenues will be better than projected. Larger initial margins on international trips will also defray some of the impact on costs for situations where the selection rate is high. If Pearson decides to utilize the call option hedging strategy, he should realize that paying an upfront premium does not remove all of the risk, but shifts downside exposure to situations under which Pearson is best able to financially absorb it.

E-TAILING OFFICE FURNITURE: TOO MANY CLAIMS AT OFC

Michael J. Douglas, University of Arkansas at Little Rock
Eric S. Kyper, Lynchburg College

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.

INSTRUCTORS' NOTES

The case context is claims processing for an on-line retailer. A general knowledge of database concepts, statistics, and general business knowledge is sufficient to solve the case. Students should:

- Define the problem.
- Outline possible causes of the problem.
- Recommend solutions to reduce claim rates.

Problem definition: OFC is receiving a large number of claims; claims take a long time to resolve.

CASE SOLUTION

1: What are the claims, and how many are there?

There are two general types of claims. Shipping claims and Business Office claims. First, graph the shipping claims for the given case data.

Figure 1: Pareto Diagram of Shipping Claims

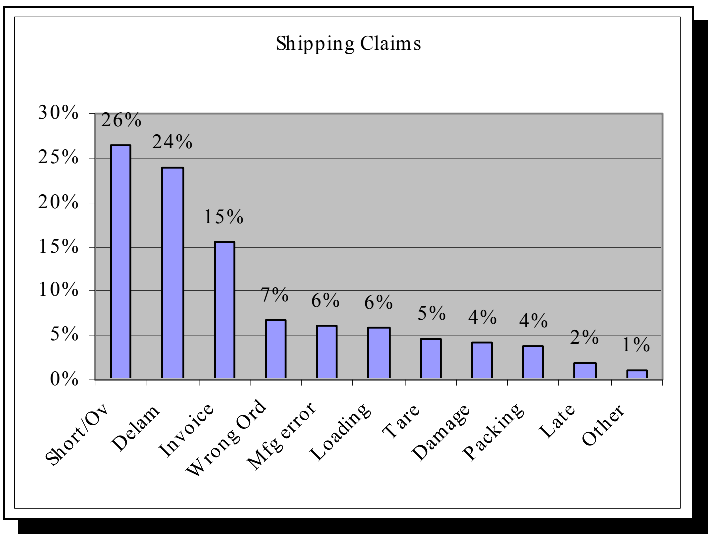
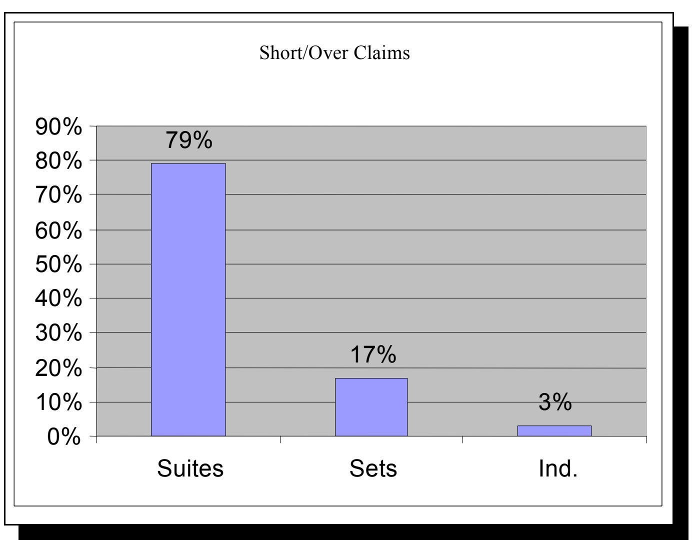


Figure 2: Details of Short/Over Claims



Observations from Figures 1 and 2: Highest numbers of shipping claims are in the short/over category (26%). Within the short/over category the majority of claims arise from problems with suites (79%).

Next graph the business office claims.

Figure 3: Pareto Diagram of Business Office Claims

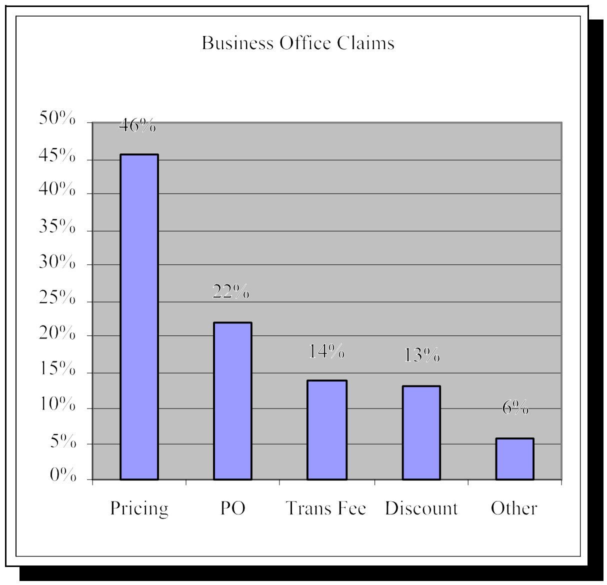
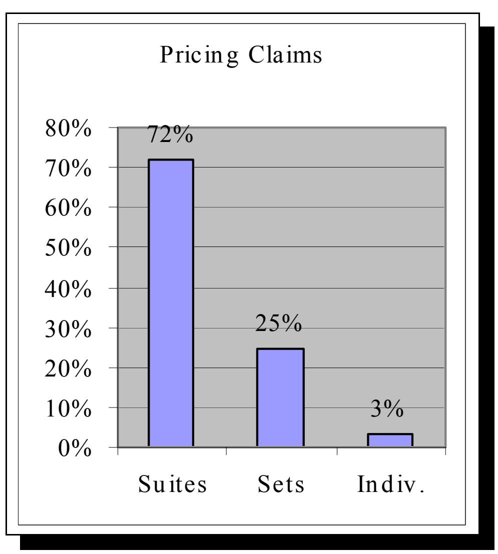


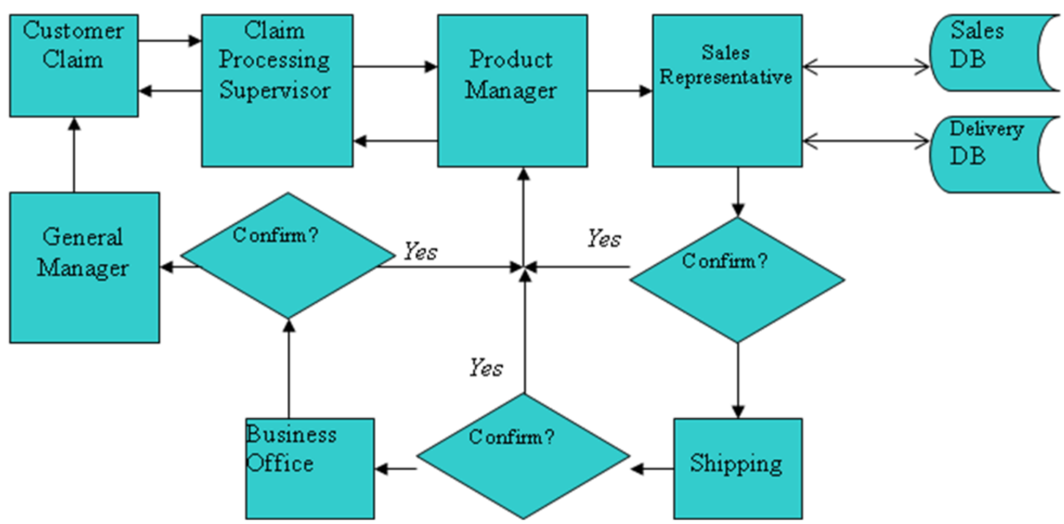
Figure 4: Details of Short/Over Claims



2: How are claims processed?

Construct a process diagram to better observe the process (see figure 5).

Figure 5: process analysis of a claim



3: Is the current process efficient?

The current process is not efficient. The process is rife with redundancy (i.e. claims are forwarded to three separate offices and then back to claims supervisor, then possibly to general manager, etc.). This results in no precise accountability, and too many people involved.

4: What can be said about the workload/quality of the business office clerks? Is the business office over or under staffed?

Next identify the critical processes, relationships between processes, and potential causal factors.

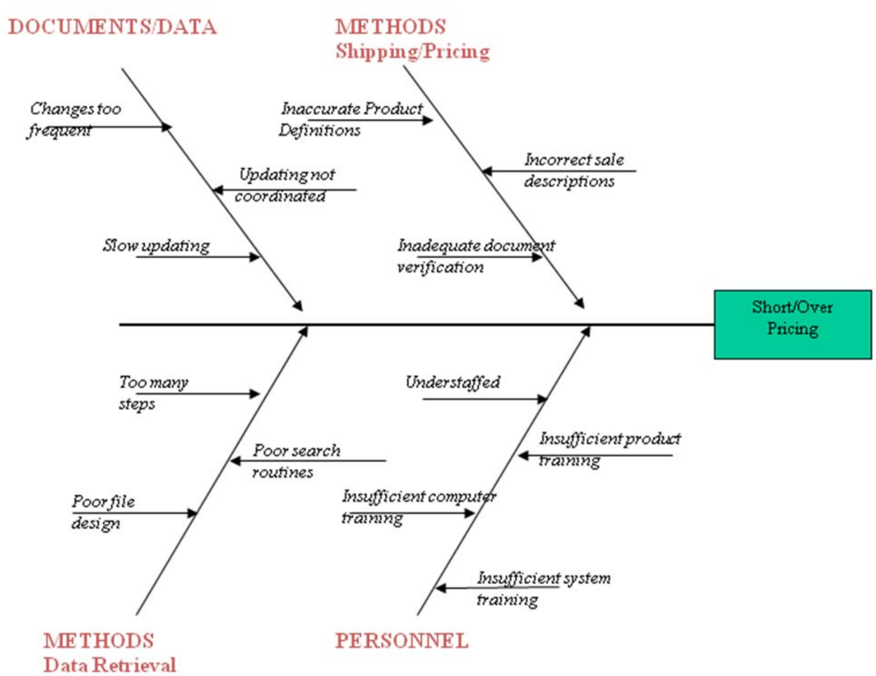
Suite and set data	
Number of Suites offered (average, 5-year period):	5
Number of Sets offered (average, 5-year period):	12
Changes in definition (number, type and quality of pieces included) in 5-year period:	27
Frequency of documentation/database updating:	quarterly
Number of discrepancies between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

Table 1: Pricing error rates and related data

Overall error rate: 3.63%		
Employee	Clerk 1	Clerk 2
Error rate (%)	3.34	3.92
Work Volume (mean)	185.70	205.40(claims per week)
Work complexity (mean)	3.10	3.90(Items per claim)

Analysis (one per claim type)

Figure 6: Cause & effect (fishbone) diagram of pricing claims



Analysis of Processing loads and relationships in Pricing

Figure 7: Work volume vs. Error rate

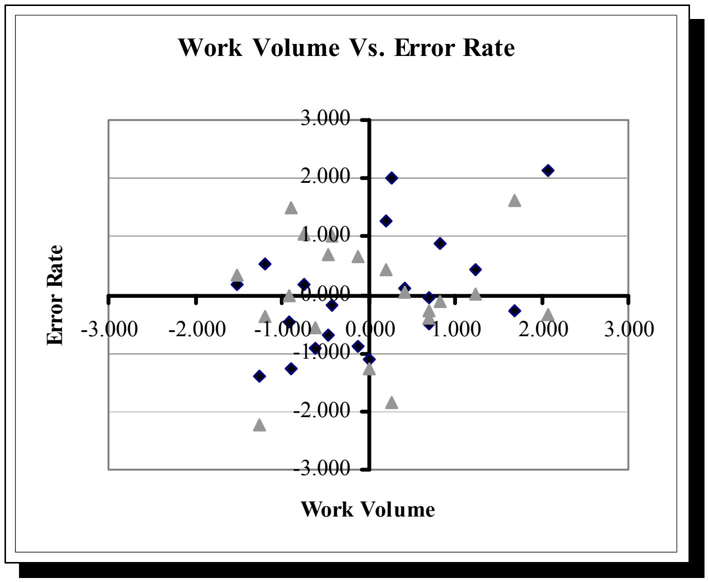
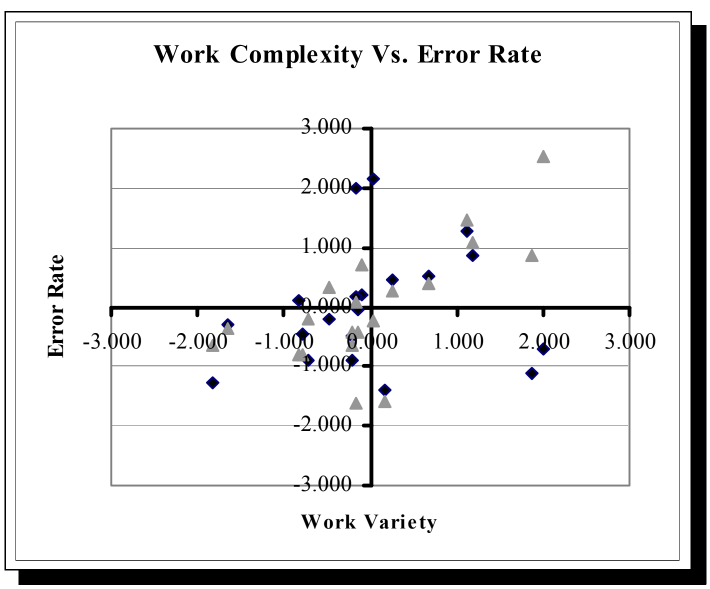


Figure 8: Work complexity vs. Error rate



The scatterplots suggest that the pricing error rate is related to both work volume and work complexity. This may help explain the higher error rate of Clerk 2, who also has a higher workload and a higher level of complexity. This also suggests that reducing individual work rate and/or complexity by increasing the number of personnel may lower the error rate.

5: Is the current database design sufficient?

The current database design in not sufficient because of the following problems:

- Large number of errors
- Poor claims-resolution process
- Frequent product changes
- Poor product documentation
- Uneven processing loads

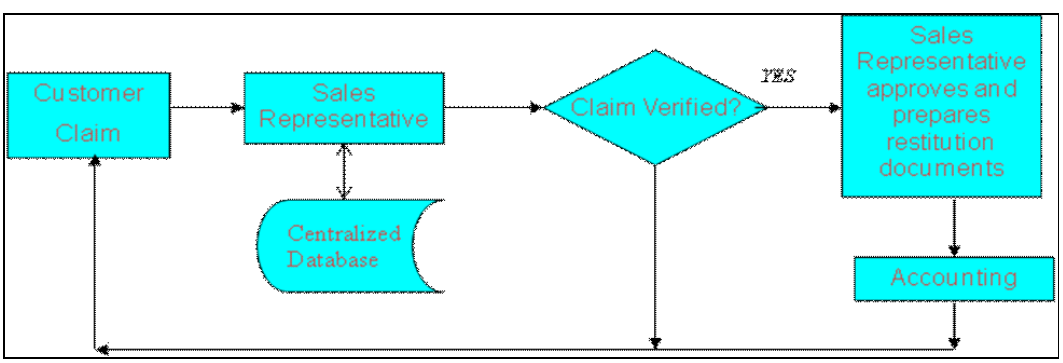
IDENTIFICATION

Critical processes:	Claims Processing, Product Definition, Product Documentation
Relationships:	Shortage/Overage and Pricing Errors (possibly also Invoicing, Wrong Order, PO, and Discount)
Potential Causal Factors (Shortage/Over, Pricing):	Fishbone Diagram

Potential solutions include:

1. Redesign the claims-resolution process. Simplify the process and consolidate databases.

Figure 9: Simplified claim process



2. Formalize and control the product definition and pricing *processes*. Implement clear product definitions, clear and structured pricing procedures, and reduced frequency of product/price changes.

3. Formalize and control the product definition and pricing *documentation*. Update databases as part of the definition/pricing processes. Implement a central database to help eliminate update anomalies.

4. Equalize the workload and complexity of claims process by clerks.

5. Consider hiring an additional pricing clerk.

6. Training of claims processing personnel in product/pricing definitions, data retrieval, and document verification.

7. Evaluation and monitoring of:

   x control charts on number of claims (major categories) and claim-processing times.
   p control charts on Shipping and Pricing error rates.
   Project control schedules on document updating and verification.

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

Jonathan Breazeale, Sam Houston State University
Jim Bexley, Sam Houston State University

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.

INSTRUCTORS' NOTES

Suggested Questions for Students

The suggested approach to presenting this case is to provide students with questions at the beginning of the class period that help guide their thinking and class discussion with regard to the decision at hand. If these questions are not presented to the students prior to class, it is interesting to poll the class (prior to any discussions) on their opinion as to whether or not the CEO should accept the negative NPV project. Poll the class again at the end of the period to determine who may or may not have changed their mind. Suggested questions and the discussion points most likely to arise are now presented:

1. **Given the information that Bill collected, what is an appropriate weighted average cost of capital (WACC) for City State Bank?**

Of course, the formula for calculating the WACC is

$$WACC = w_d r_d (1-t) + w_e r_e$$

where w_d is the percentage of debt going forward to finance new assets, r_d is the current cost of borrowing the firm would pay to loan money or issue bonds, t is the firm's marginal tax rate, w_e is the percentage of equity used to finance any new asset, and r_e is the cost of equity capital. The student must first assume that the firm will finance the security improvements with debt/equity in a manner consistent with its current capital structure (80/20 respectively). Under that assumption, w_d is .8 and w_e is .2. The borrowing rate given in the case is 5.0% (r_d), and the marginal tax rate (t) is 35.0%. The main emphasis of this calculation is to have the student calculate the cost of equity capital (r_e) using the rearranged dividend growth model

$$r_e = Div/P_0 + g$$

where *Div* is the anticipated dividend payment over the next year, P_0 is the current price of the firm's common shares, and g is the expected infinite dividend growth rate. Assuming that dividends will be adjusted upward at the same rate as CSB's earnings, the average of the provided analyst earnings growth estimates would be a reasonable (although probably inflated somewhat) value for g. Given the assumptions contained herein and the information provided in the case, $r_e = 2.26/30 + .025 = .10033$.

Substituting in the WACC formula:

$$WACC = .8(.05)(.65) + .2(.10033) = .046 = \underline{\underline{4.6\%}}$$

2. Given the forecasted cash flows presented in the case, what is the NPV of the proposed lobby renovations?

Year	Number of Net New Accounts	Net Cash Flows per New Account	Lobby Improvements	Total Net Cash Flows	PV (at 4.6%) of Net Cash Flows
2008	450	120.00	(100,000)	(46,000)	(46,000.00)
2009	200	123.60	-	24,720	23,632.89
2010	100	127.31	-	12,731	11,635.69
2011	50	131.13	-	6,556	5,728.86
2012	25	135.06	-	3,377	2,820.61
Net Present Value					(2,181.95)

3. What are the benefits of closing the branch? What are the ramifications?

The benefit of closing the branch is analogous to "ripping the band-aid off". The branch is barely on the verge of profitability. If the decision is to ignore the petition, CSB might be better off riding the wave of bad press now rather than later. A ramification is that CSB is going to be the target of a lot of bad publicity. The press is going to ask them why they closed a rural branch that was once profitable and open for business. Isn't that the core of what CSB is all about? Additionally, CSB is sealing the economic fate of an entire community – which will now be unable to attract new business to the area.

4. What are the benefits of ignoring the petition? What are the ramifications?

The main benefit of ignoring the petition is that this is the option that is in the best interest of the shareholders. The ramifications include continued bad press. While this is the "status quo" option, there may still be spillover effects from such bad publicity in other markets in which CSB operates.

5. What are the benefits of opening the branch again for lobby operations? What are the ramifications?

The benefit of opening the doors is that CSB comes across looking like "the good guy." CSB's predecessor closed the lobby, and they are correcting that mistake. It may have taken them a while to do it, but they made a commitment to the town of Jones, its residents, and its businesses. They will have given Jones and second chance to grow economically. However, this option is not in the best interest of CSB's shareholders. It is not easy to abandon the fiduciary responsibility of being a good steward of investor dollars. Is this a noble enough cause? The tsunami and hurricane Katrina seemed to have been. Contributions to those causes were negative NPV, yet firms gave billions in shareholder dollars. Firms give money to the United Way, Salvation Army, the Red Cross and other organizations as well. Where is the line between being a good steward and "doing the right thing?"

6. Which option should the CEO embrace? Why?

Answers to this question will vary.

7. What is the most difficult part of the capital budgeting calculation for the CEO?

The most difficult part of the capital budgeting calculation is forecasting the marginal cash flows from the competing spillover effects, damaged reputation, bad press, etc. The CEO really would have no support for these projections when standing in front of the board.

LEARNING POINTS

- ♦ It's not always easy to know the "right thing to do". It's much harder than simply applying a rule from a textbook.
- ♦ It is difficult to estimate future cash flows! In fact, it is the most difficult (and important) part of the capital budgeting process.
- ♦ Rural operations are not always analogous to the "typical" Wall Street case. Here, CSB effectively gets to decide whether an entire community lives or dies.
- ♦ The press can have an impact on decisions that affect shareholders. Specifically, in the case of CSB, the press can create unanticipated spillover effects that are not account for in the valuation calculations.
- ♦ Input from local managers vs. the ivory tower of centralized management – listening to folks in the field is important. Shouldn't the CEO have asked the folks who worked at the branch for their input?
- ♦ Repairing goodwill with customers – can marketing make up this gap?
- ♦ Overall influence on the town's economy – Is the town going to make it…even with CSB's investment in the lobby operation?

EPILOGUE

It is rare to have an epilogue in a fictitious case, but as of the date of this article, the course of action the CEO of the actual bank has chosen is to open the bank lobby one day a week. This does not fully accept the terms of the petition, but the small commitment to the community may provide some temporary insights into the validity of the CEOs projections. CSB will not attract as many customers back to the branch under this strategy as they would have had they opened full-time; however, this decision will provide a lot of information to CSB's management team on whether or not they should open the branch continually for regulation operations.