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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, Purdue University - Calumet

CASES

YOURPRODUCTSUCKS.COM: INTERNET GRIPE SITES AT THE CROSSROADS OF TRADEMARKS AND FREE SPEECH

Leonard Rymsza, California State University, Northridge
Kurt M. Saunders, California State University, Northridge

CASE DESCRIPTION

The primary subject matter of this case concerns trademark law. Secondary issues examine trademark infringement, dilution, cybersquatting, commercial disparagement, and freedom of expression.

The case has a difficulty of level four, appropriate for senior level courses. The case is designed to be taught in three class hours and is expected to require a minimum of six hours of outside preparation. The case may be used as an in-class or take home assignment. Also, the case may be assigned as an individual student or student team project.

CASE SYNOPSIS

The Internet has made possible another forum by which dissatisfied consumers can vent their complaints about poor service or purchases of substandard products. In the typical scenario, a disgruntled consumer purchases a domain name and sets up a website, known as a "gripesite," on which to publicize their complaints and criticism about the merchant. In turn, merchants have responded with litigation to protect their trademark rights and silence the consumer. Recent cases arising from this strategy of creating gripesites have pitted the merchant's trademarks and protection of its goodwill against the dissemination of critical information about the merchant and the consumer's freedom of speech.

This case study presents a multifaceted factual setting that raises numerous issues relating to trademark infringement, dilution, cybersquatting, commercial disparagement, and freedom of expression. Consumer decided to have new carpet installed in her living and dining room. She telephoned a nationally recognized home improvement – home furnishing company. Consumer scheduled an appointment for a salesperson to come to her home to measure the floors and provide her with carpet samples. The salesperson did not keep the initial appointment and did not contact consumer to let her know that the appointment would not be kept. Consumer was unhappy with this *behavior but she, nevertheless, scheduled another appointment. The salesperson kept this second appointment but was approximately one hour late. Consumer was frustrated with the appointment mishaps but decided that since the salesperson was at her home she may as well have the rooms measured and look at the carpet samples. Consumer found a sample that was the perfect color and nap. The cost estimate for the carpet was also comparable to estimates that consumer had received from other retailers. Consumer ordered the carpet and made arrangements to have the carpet installed the next day.*

The installation of the carpet went smoothly except that a silver runner was installed instead of a gold runner as specified in the work order. Consumer paid for the carpet and installation with installers promise to return the next day and install the proper runner. The installer failed to return the next day as promised. Within a few days of the installation, consumer noticed several seams in the carpet had become visible and that un-even surfaces had begun to appear. Following several frustrating attempts to schedule the return of an installer and failed attempts to correct the problems, consumer sent a letter rescinding the carpet contract and requesting the return of the $3,000 she had paid for the carpet. Consumer's request was denied and attempts to settle the matter proved fruitless.

Consumer decided to take several courses of action. One strategy resulted in consumer registering seven different internet domain names. The domain names included the name of the home improvement company in varying forms. Consumer began using one of the internet sites. The site contained a statement summarizing consumer's entire dealings with the improvement company and her dissatisfaction with the company's actions. Consumer was contacted several times by legal representatives of the improvement company and was asked that she cease and desist from using the company's name in any domain names. Consumer refused to discuss the matter and the improvement company eventually brought suit against consumer alleging, trademark infringement, dilution, false designation, unfair competition, cybersquatting, various state law claims, and libel. Consumer countered that she was merely exercising her first amendment right of free speech.

This case study explores the intersection of electronic commerce, trademark law, and freedom of speech. As a pedagogical tool, the case can facilitate student appreciation and understanding of the complexity of arguments presented for the protection of trademarks and domain names while at the same time considering the right of consumers to freely express their opinions and views. Moreover, the case can serve as a means to promote awareness of legal risk in business decisions and to enhance the development of legal reasoning skills in business law students.

The first part of the case requires students to evaluate trademark infringement, trademark dilution, cybersquatting, and commercial disparagement claims. The second part of the case requires students to evaluate the improvement company's claims in light of consumer's freedom of speech rights.

YOURPRODUCTSUCKS.COM

Wahl to Wahl Today, LLC (Wahl) is a nationally recognized home improvement and home furnishing company. Wahl's has been in business for over fifty years. Wahl was founded by twin brothers, Bric and Stone Wahl. The small family business was very successful and over the span of many years expanded to a company with over 1,000 employees providing services to over 25 major metropolitan cities in the United States and Canada. It is also the owner of two federally registered trademarks, "Wahl to Wahl Today" and "Wahl to Wahl."

In its early business days, Wahl specialized in the sale of carpeting. Over the years, Wahl expanded from carpet service to flooring and window treatments, exterior rain gutters, interior bath liners, custom windows and vinyl siding. Wahl has become widely know within that last several years because of its extensive radio and TV advertising campaigns. The advertising has focused on convenient shop-at-home service (carpet samples being brought right to the consumer's home), immediate installation, and low warehouse direct pricing. Wahl's advertising developed a catchy Wahl jingle associated with its toll free 877 telephone number. The jingle has resulted in Wahl's telephone number being among the 5 most recognized telephone numbers in the country.

On Wednesday, January 11th, Ms. Flora Behr called the toll free number and requested an appointment to have her living and dining room floors measured and look at some carpet samples. The appointment was set for Friday, January 13th between 4:00 pm and 6:00 pm. No representative from Wahl showed for the appointment. In addition, no one called Flora to inform her that the appointment would not be kept. The following day, Flora called the toll free number to inquire as to what had happened. Flora was told that the salesman had had a problem with his car and was unable to keep any of his Friday appointments. She was informed that, if she wished, she could reschedule for Monday, January 16th during the same time frame as the original appointment. Although Flora was reluctant to re-schedule because she had not been informed of the problems on Friday and because of what she felt was a "poor attitude" on the part of Wahl's customer service employee, she, nevertheless, rescheduled the appointment.

On Monday evening, as time was approaching 6:30pm, it appeared to Flora that no representative from Wahl was going to keep the appointment. Frustrated, she called Wahl's toll free number and after a series of transfers from one representative to another she was told that the salesman was delayed because his appointments were running longer than expected. Flora was assured that someone from Wahl would be at her home by 7:30pm. Flora consented to the change in time but was becoming frustrated with Wahl's lack of good business practices. At 7:15pm, Wahl's salesman appeared at Flora's front door. Frustrated with the appointment mishaps, Flora was tempted to cancel the appointment. However, since the sales representative was there, she decided to have her living and dining rooms measured for the carpet and look at the carpet samples that he had brought with him. Flora chose a carpet that was similar to samples she had at her home from other carpet vendors. She was given an immediate quote that was $300 less than the quotes of $3,300 she had received from two other companies. After considerable deliberation, Flora decided to purchase the carpet from Wahl, primarily based upon the salesman's promise that the carpet would be installed the very next day. Flora signed a contract, paid a deposit of $1,000, and set the installation time for 11:00 am the following morning.

The following morning, the installers arrived on time and installed the carpet. All went well except a silver runner was installed instead of the gold runner that Flora had specified. She pointed out the mistake to the installer who indicated that he was out of gold runner and would return the next day to replace the silver runner with the specified gold runner. Flora agreed and paid by check the balance due on the carpet. Much to Flora's disappointment, the installer did not return the next day to replace the runner as promised. She telephoned Wahl's customer service department. She was told that the installer had forgotten to return to complete the job and that his schedule would prevent him from returning to her home for two weeks. Flora was not happy with this information but felt that she had no other choice but to agree to the delay. She attempted to set a date and time for the work to be completed but was informed that, since installer's schedule was not entirely certain, a Wahl representative would telephone her in about a week to schedule an appointment.

Within the next several days, Flora noticed that several seams in her carpet had become visible and that un-even surfaces began to appear. She called Wahl's customer service and informed a representative of the problems she had discovered in the carpet. She was told that the installer would correct the problems when he returned to replace the runner. Flora, once again inquired as to when the installer would be able to return to her home. Again, she was told that she would be contacted once installer's schedule was finalized.

Two weeks passed and Flora had not heard from any representative from Wahl's. Becoming more frustrated with the entire matter, Flora again called Wahl's customer service department and asked to speak to the customer service manager. She retold her entire saga to the manager who guaranteed her that the installer would be at her home the next day. To her surprise, the installer came to her home the next day and replaced the runner and attempted to correct the seam and un-even surface problems with the carpet. Unfortunately, the installer was unable to correct the problems. Subsequent to the initial attempt to resolve the problems, two more attempts to make things right were performed by other Wahl installers. The problems with the carpet remained.

On April 1st, disgusted with the entire matter, Flora sent a letter to Wahl that stated that she was rescinding the contract, instructed Wahl to send someone to remove the carpet from her home and requested that Wahl refund her the $3,000 she had paid for the carpet. A copy of Flora's letter follows.

Ms. Flora Behr
6414 Wysteria Lane
Hometown, Grace 22044 U.S.A.

April 1

Wahl to Wahl Today, LLC
c/o Mr. Stone Wahl, President
1237 W. 64 th Street
Hometown, Grace 22045

Dear Mr. Wahl:

This letter is notice to you of my rescission of a contract that I entered into with your company on January 16th. Under the terms of that contract, a copy which is attached to this letter, I was to pay a total of $3,000 for carpet and installation of carpet in the living and dining rooms of my home. I have paid the full $3,000 to your company as required under the terms of the contract. However, as a result of several factors, primarily your installers' inability to correct seam imperfections and un-even surfaces in the carpet, I request that your company remove the carpet from my home and refund to me the amount of $3,000.

Sincerely,

/s/ Flora Behr

Ms. Flora Behr

On May 5, Flora received a reply to her letter of April 1. A copy of that letter follows.

Wahl to Wahl Today, LLC
Customer Issue Resolution Center
9801 Carpet Center Drive
Hometown, Grace 22006 U.S.A.
On the Web at:www.wahl-to-wahl-today.com
Email at: wahl@throw.biz

May 1

Ms. Flora Behr
6414 Wysteria Lane
Hometown, Grace 22044

Dear Ms. Behr:

Your April 1 letter to Mr. Wahl has been referred to Wahl's Customer Issue Resolution Center. Wahl to Wahl Today, LLC takes pride in serving its customers and ensuring that all of its customers have a satisfactory experience with Wahl to Wahl Today, LLC.

I am sorry that you feel that you have had an unsatisfactory experience with the installation of carpet in your home. However, I have spoken to the installers who have been to your home in an attempt to correct the problems with the carpet installation. The installers have indicated to me that they have done all that can be done to resolve this matter. They have further indicated to me that the problem with the carpet seams is caused by the Doric XR2006 Vacuum Cleaner that you use to vacuum your carpet. In addition, I have been told that the sub-floor in your living and dinning room is warped. This warping is the cause of the un-even surface appearance of the carpet.

Wahl to Wahl Today, LLC has done all that can be done under the circumstances.

If you have further questions, you may contact me at the following toll free number: 877-RESOLVE

Sincerely,

/s/ Clarence Shagg

Clarence Shagg
Supervising Manager
Customer Issue Resolution Center
Wahl to Wahl Today, LLC

Dissatisfied with Shagg's letter, Flora carefully considered the next steps that she would take. Her first action was to file a complaint with the Better Business Bureau of Hometown. Subsequent to filing the complaint, Flora registered the following domain names: www.wahltowahl.com; www.whaltowhaltoday.com; www.walltowall.com; www.walltowalltoday.com; www.wahltowahltodaysucks.com; www.wahl-to-wahl-sucks.com; and www.wahl-to-wahl-today-sucks.com. Two weeks after registering the domain names, Flora went to Wahl's Hometown office and left a three-page letter for the Wahl brothers, Bric and Stone. In part the first page of the letter read:

> If you would like to discuss this matter, let me know. News spreads fast on the Internet. Once the ball starts rolling it will be too late to do anything. I can be reached by telephone at 555-382-5968.
>
> P.S. – I am known as a person who keeps her promises

The second page of the letter was entitled "List of Complaints Against Wahl to Wahl Today, LLC." The third page of the letter was entitled: "Actions Taken Against Wahl to Wahl Today, LLC" and listed eight items. The first item on the list was the following: "1. Internet web sites that disclose the truth about how Wahl really operates." The letter did not mention domain names or make any references to the Internet other than indicated above.

Flora began using www.wahltowahltoday.com several months after registering the domain name. The site contained a statement summarizing Flora's entire dealings with Wahl. The site did not generate any revenue. In addition, no goods or services were sold on the website. Flora was contacted several times by representatives from Wahl's legal department requesting that she cease and desist from using www.whalltowahltoday.com or any other variation of the Wahl name. Flora steadfastly refused to discuss the mater with Wahl's representatives. Wahl to Wahl, Today, LLC eventually brought suit against Flora alleging, trademark infringement, dilution, false designation, unfair competition, cybersquatting, various state law claims, and libel.

Case A Questions – Trademark Infringement - Trademark Dilution - Cybersquatting - Commercial Disparagement

1. Can Wahl assert prima facie claims for trademark infringement and dilution against Flora on the basis of the domain names she registered or her "gripesite"?
2. Has Flora violated the provisions of the Anticybersquatting Consumer Protection Act by registering the domain names?
3. Does Wahl have a tort claim for commercial disparagement against Flora?
4. For each of the claims discussed above, what defenses or counterarguments might be available to Flora?

Case B Questions - First Amendment Free Speech

5. If Flora claims that her site is merely a vehicle by which she is exercising her First Amendment free speech rights, how will a court rule?
6. Assume that Flora's free speech argument is successful. Would any of the following additions to her website lead a court to reach a different conclusion?
   a. A warning statement that the site is not the official site of Wahl with a link to Wahl's website.
   b. A link to a Wahl competitor or other commercial website.
   c. A link to commercial websites from which Flora receives a fee each time the link is clicked on by a user.
   d. A link to www.complaints.com a website where consumers can post complaints about goods or services they have received.
   e. A link to www.wahltowahltodaysucks.com or to the www.sucks.com website.
   f. A solicitation on Flora's website seeking donations for the "fight" against Wahl.
   g. An offer to sell an anti-Wahl t-shirt featuring an anti-Wahl slogan, or an offer to provide a "free" anti-Wahl t-shirt with a charge for shipping and handling.

THE EVOLUTION OF CROCS, INC.: WILL CROCS FACE EXTINCTION?

Scott Droege, Western Kentucky University
Lily C. Dong, University of Alaska-Fairbanks

CASE DESCRIPTION

The primary subject matter of this case concerns the four "Ps" of marketing—product, price, place, and promotion. Secondary issues examined include entrepreneurship and business strategy. The case has a difficulty level three, appropriate for junior level courses. The case is designed to be taught in one class hour and is expected to require one hour of outside preparation by students.

CASE SYNOPSIS

Crocs, Inc. was founded in 2002 by three avid boaters who began a small company to make shoes specifically designed for boating. The owners were surprised by their own success; Crocs rapidly moved from a boating shoe to a fashion statement. After taking the company public in 2006, Crocs has come under increasing shareholder pressure to diversify. The fear was that Crocs limited product line was a "one trick pony" and as soon as consumer fashion tastes changed, Crocs sales would quickly decline. Crocs has responded to this pressure by moving beyond shoes to increase the variety of its product line, but in doing so the firm has encountered entrenched competitors that have fought back against Crocs' market encroachment. Management is well aware that competition and shifting consumer tastes could make Crocs extinct. These threats will drive Crocs to further hone its product, place, pricing, and promotion decisions. Exactly how Crocs will manage this, however, remains to be seen.

BACKGROUND: THE BIRTH OF CROCS

The birth of Crocs began in May of 2002, when three friends from Boulder, Colorado went sailing in the Caribbean. This was a rather unremarkable event in itself. However, soon their names, Lyndon "Duke" Hanson, Scott Seamans, and George Boedecker, would become well-known in the footwear industry.

The thing that made this sailing trip stand out lay in the hands of one of the friends, or rather on his feet. Scott Seamans had purchased a pair of foam clogs in Canada. Impressed by their performance while boating, the three friends began visualizing the perfect boating shoe. They envisioned shoes that were comfortable, functional, and durable. This led them to the idea of Crocs.

Crocs are made from proprietary closed-cell resin material, which the company often refers to as croslite, that feels nearly weightless. In fact, a pair of the largest size of Crocs available weighs less than six ounces. The closed-cell resin softens with body heat and molds to the shape of the foot. Also, because the material is closed cell, it's anti-microbial so it virtually eliminates odor. To add to their functionality, the soles are non-marking and slip resistant and don’t hold mud or debris and the ventilated toe box is designed so that air, water, or sand can filter through the shoes. Crocs are extremely easy to maintain and can be sterilized, bleached, or washed in a washing machine. They are also ideal when it comes to comfort standards, with features like built-in arch support, orthopedic heel cups, circulation stimulation nubs on the insoles, and supportive orthopedic molded soles.

Although Crocs has been able to patent the basic design, problems remained. The weakness of the patent is such that competitors can easily copy the basic elements of Crocs’ products with only minor modification. Nevertheless, Crocs believed its niche market would value the “original” and would hesitate to switch to competitors. Early, on, this was a correct assumption until Crocs gained momentum. As the market niche was developed, however, Crocs had the market to itself. One reason is not so much related to the relative weakness of its patents, but to the idea that competitors viewed Crocs as ugly shoes that would not appeal to a broad customer base. This bought time for Crocs to establish a foothold.

Hanson, Seamans, and Boedecker decided to turn their ideas into reality and focus on developing and marketing their innovate footwear. They leased their first warehouse in Florida, chosen because of its location "specifically so we could work when we went on sailing trips there," Hanson says. "From the get-go, we mixed business with pleasure." While it may not have been the traditional business strategy, their mixture of business and pleasure worked and the reality of Crocs began to form.

Crocs began marketing its shoes at a November 2002 boat show. Crocs were originally intended to be sold to boaters, because of their slip proof, non-marking sole and the fact that they are waterproof and odor resistant. However, this market soon expanded to include gardeners, healthcare workers, waiters, and other professionals who had to be on their feet all day. This market began to encompass markets Crocs had never considered. Over the course of a year what had started out as simply an idea on a sailing trip evolved into one of the greatest footwear phenomena of the decade.

As the popularity of Crocs rapidly increased, its founders began to realize just how much potential the company had. "I ran day-to-day operations," Hanson said. "During the day, I would answer the phones and handle the required paperwork to set up the business entity wherever we were doing business. After dinner, I'd come back and enter orders until I fell asleep in my chair." Soon Hanson realized that even working sixteen hour days the three friends could not keep up with the demand by themselves.

This led Crocs to make the company's first office hire, Tegan Sarbaugh. The number of employees would continue to grow exponentially in the years to come. In an effort to help the company reach its greatest potential, the three founders made one of their best hiring decisions and brought in Ronald Snyder as CEO and President of Crocs, Inc. Snyder was a former Flextronics executive and an old college friend of Crocs' founders. He was asked to do some consulting for the new company and soon realized the promise Crocs held.

Snyder decided on a revolutionary business distribution model for Crocs. The established methods of distribution forced retailers to order shoes months in advance and buy in bulk. Instead, Crocs allowed retailers to order only several weeks in advance and to order as few as twenty-four pairs of shoes. This strategy encouraged consistent pricing by preventing the problem of overstocking and having to sell Crocs on clearance. More importantly this strategy catered directly to customer needs by allowing Crocs to deliver currently popular styles and colors quickly to customers.

In 2004, Snyder made one of the most beneficial business decisions in the history of Crocs. Snyder decided to buy Finproject NA, a Canadian manufacturer who made Crocs and owned the formula for their proprietary material, the closed-cell resin known as croslite. Upon their purchase Crocs, Inc. gained control over manufacturing and timing. Snyder describes this as a "eureka" moment. "We had everything required to take the company to the next level," he says. "Proprietary processes, proprietary material, intellectual property, and distribution."

THE IPO AND GROWTH OF CROCS

Four years after it was founded, Crocs, Inc. became a publicly traded company. There were several reasons why the company owners chose to go public. Firstly, they wanted to untie their assets by exchanging their equity for cash. Also, the public market was more liquid than the private market. One important factor to keep in mind is that Crocs did not go public simply because the company needed cash, a common action for struggling companies. Crocs' decision to become a publicly traded company did not reflect decline, but rather tremendous growth.

The company filed for an initial public offering on August 15, 2005. On February 8, 2006 Crocs announced its public offering. Crocs, Inc. common stock was listed on the NASDAQ stock market the CROX ticker symbol. The initial offering price was to be $13.00 to $15.00 but was revised to a range of $19.00 to $20.00. The first day opening price was $30.00. Since then, CROX has roughly tripled on a split-adjusted basis.

During the six month span from January 1, 2006 to June 30, 2006 Crocs, Inc.'s revenues increased from $36.7 million to $130.5 million, an increase of over 350%. The first quarter alone had revenues of $44.8 million, an increase of more than fourfold over the revenues of the first quarter of 2005, which were $11.0 million. Also during the time between January 1, 2006 and June 30, 2006 the Crocs net income went from $6,441,000 to $15,666,000.

THE FOOTWEAR INDUSTRY: WHEN CROCS ATTACK

Crocs, Inc. has made immense progress within the footwear industry. In its fourth year of business, Crocs already has financial numbers that hold their own amidst companies that have been competing in the footwear industry for decades. Crocs, Inc. is classified as being in the Footwear Industry of the Consumer Cyclical Sector. The following statistics compare Crocs to the Footwear Industry as of December 12, 2006.

Table 1: Valuation Ratios

Description	Company	Industry	Sector	S&P500
P/E Ratio Trailing 12-Months (TTM)	35.74	21.49	19.36	20.64
P/E High - Last 5 Yrs.	NM	27.69	31.37	37.82
P/E Low - Last 5 Yrs.	NM	14.10	13.99	14.72
Beta (Stock Price Volatility)	NM	0.76	1.09	1.00
Price to Sales (TTM)	6.11	2.00	1.41	2.93
Price to Book Most Recent Quarter (MRQ)	9.45	4.00	3.59	3.92
Price to Tangible Book (MRQ)	9.97	4.48	6.42	7.20
Price to Cash Flow (TTM)	31.33	17.80	12.77	14.56
Price to Free Cash Flow (TTM)	NM	24.76	30.22	32.40
% of Shares Owned by Institutions	85.48	68.19	55.20	68.39

Table 2: Growth Rates

Description	CROX	Industry	Sector	S&P 500
Sales (MRQ) vs Qtr. 1 Yr. Ago	190.76	20.87	8.29	15.97
Sales (TTM) vs TTM 1 Yr. Ago	242.50	12.20	9.32	16.71
Sales - 5 Yr. Growth Rate	NM	9.45	7.96	9.90
EPS (MRQ) vs Qtr. 1 Yr. Ago	143.59	6.98	5.49	23.85
EPS (TTM) vs TTM 1 Yr. Ago	245.63	7.48	21.81	23.52
EPS – 5 Yr. Growth Rate	NM	18.79	12.95	15.71
Capital Spending - 5 Yr. Growth Rate	NM	0.91	3.38	5.73

Table 3: Profitability Ratios				
Description	CROX	Industry	Sector	S&P 500
Gross Margin (TTM)	55.67	43.75	30.64	45.17
Gross Margin - 5 Yr. Avg.	NM	41.82	30.80	44.89
EBITD Margin (TTM)	28.38	15.19	12.19	23.06
EBITD - 5 Yr. Avg.	NM	13.70	11.34	20.85
Operating Margin (TTM)	26.19	13.53	8.49	20.26
Operating Margin - 5 Yr. Avg.	NM	11.19	8.14	19.00
Pre-Tax Margin (TTM)	26.39	13.60	8.46	18.95
Pre-Tax Margin - 5 Yr. Avg.	NM	11.14	7.64	17.17
Net Profit Margin (TTM)	17.36	8.86	5.58	13.67
Net Profit Margin - 5 Yr. Avg.	NM	7.40	4.92	11.67
Effective Tax Rate (TTM)	34.23	34.70	31.70	30.49
Effective Tax Rate - 5 Yr. Avg.	NM	34.70	36.86	31.84

Table 4: Financial Strength				
Description	CROX	Industry	Sector	S&P 500
Quick Ratio (MRQ)	2.62	1.94	1.34	1.22
Current Ratio (MRQ)	3.45	3.13	2.12	1.73
LT Debt to Equity (MRQ)	0.01	0.06	1.43	0.58
Total Debt to Equity (MRQ)	0.01	0.11	1.55	0.73
Interest Coverage (TTM)	91.98	18.32	7.22	14.77

As the charts above show, Crocs is ahead of the industry in many areas. Its growth rate is over 900% higher than that of the industry. This shows the potential that Crocs has within the footwear industry but also illustrates the risk investors are taking on a concept that may or may not be simply a fad. The hard question Crocs owners must face is whether Crocs is going to fade away like bell bottom jeans or have staying power like Nike athletic shoe lines. The next section considers how the marketing mix addresses some of these challenges.

EVOLUTION OF CROCS' MARKETING MIX

Products and Target Market

Crocs currently targets multiple market segments ranging from boaters to gardeners to simply individuals wanting a comfortable pair of sandals. However, the firm's initial target market was boaters. Crocs' initial foray into the market was an effort to provide a comfortable pair of non-slip boating shoes to a niche market. This target market soon expanded to others who would pay a premium price for comfort. Nurses, retail store clerks, and others who spent most of the day on their feet quickly recognized the value proposition Crocs offered: while expensive, these individuals were willing to pay a premium to avoid the discomfort of traditional shoes. Today, Crocs targets an even wider swath of the market. Crocs' product category advertisements state that Crocs are for "women, men, kid, sports, and everyone." To further broaden their market, Crocs advertises that among these segments, customer will find its products to be comfortable "on the beach, around the house, in the rain, in cold weather, off the road, for walks in town," and even something that will "look good in the office." Crocs has kept its original characteristics of light-weight, non-slip, brightly colored product lines while created additional styles to accommodate the needs of different consumers. Crocs also offers apparel products such as t-shirts, shorts and even women's leggings.

Pricing and Distribution

Crocs footwear charges an average retail price of $30 per pair. To maintain its image as a premium mix of quality and comfort, Crocs does not utilize incentives to retailers that offer sales promotions. An advantage of this is that Crocs avoids margin squeezes often associated with retail price incentives. A disadvantage is that Crocs discourages retailers from using price concessions to help clear out inventory build-ups.

Crocs chose to bypass the traditional distribution models of incumbents such as Nike and instead adopt a distribution model with similarities to just-in-time inventory management. Rather than having retailers order large quantities months in advance that might result in clearance sales, Crocs has allowed retailers to order as few as 24 pairs of shoes. Shorter waiting periods and smaller order quantities allow retailers to accommodate changing consumer tastes and deliver the most current styles available.

In addition to conventional retail distribution channels, online distribution is another major tool Crocs utilizes. Up to this point, Crocs has managed to avoid the channel conflicts that often arise when suppliers bypass retailers by offering products directly via the internet. However, as competition heats up, retailers could potentially opt for lower-priced alternatives to Crocs in response to Crocs online distribution.

Promotion

Most marketers will agree that brand name itself is the most direct economic tool for promotion. A successful brand name should be simple, meaningful, easy to pronounce and easy to remember (Keller 1998). The brand, "Crocs," was derived based on the water-repellent nature of the materials used, the toughness of the products to withstand the elements while still fitting like a skin rather than a traditional shoe.

The major promotion tools Crocs has been using are online promotions and magazine print ads. Online promotion is achieved by displaying customer testimonials about how customers enjoy wearing Crocs footwear. For example, Lena ANG wrote, "We've just returned from a winter holiday in Perth. Though it was cold, we were pleasantly surprised that our Crocs could still keep our feet warm even without socks. Our Crocs took us to the farms, deserts and even the sand dunes. I must say that they came in handy when we did our sand-boarding activities at the sand dunes. We didn't have to carry all the sand back to our hotel in our shoes. " The customer's story explains the usage benefits of Crocs shoes and reduces doubt that Crocs might be good only for boating and gardening. Crocs website also provides a list of "shows and events" the company attends at different cities and towns across the US during the year so that it can capture exposure and publicity with minimal expense. Crocs also uses press releases and public relations to create good will among consumers through designing events such as "breast cancer awareness month" when they donate five dollars to the Breast Cancer Research Foundation for every pair of a certain style purchased through the company website. Crocs' print ads are often found in magazines such as Curve.

CURRENT CHALLENGES: THE EXTINCTION OF CROCS?

The Crocs brand has become a general term to describe brightly-colored, lightweight shoes similar to Kleenex as a generic term for facial tissue. However, the market has become filled with more and more 'imposter' Crocs. These shoes are being sold in a wide range of stores, from small retail stores to massive chains including the formidable retailer, Wal-Mart. These imitations are often more easily accessible than Crocs as well as less expensive. While a basic pair of Crocs sells for around $30, imitation Crocs can be found for as little as $5.

Another challenge Crocs is facing now is competition from strong footwear brands such as Sketchers. Sketchers has launched its new "Cali Gear" product line with more styles and weight similar to Crocs. With the advantage of Sketchers' established distribution channels, the Cali Gear brand has easily taken the in-store display spots in all the major retailers such as Sears and FredMeyers. It is a head-on competition with Crocs. Cali Gear captured more distribution channels while Crocs seems to be holding the specialty product retailers. Even though Crocs has made great efforts and achieved success in expanding its product lines to attract a wider range of customers, its distribution channel remains relatively limited, especially in comparison to competitors such as Sketchers.

Combating Challenges

One factor giving Crocs, Inc. an advantage over imitators is its customer loyalty. Crocs fans are the company's best method of advertisement. The hoards of satisfied customers claim that no other shoes can replace their Crocs. In fact, some of these customers claim that they were convinced to buy Crocs by other Croc wearers. The shoes attract attention and when this attention is expressed the owners communicate their passion and loyalty for the brand. 'Imitation' Crocs don't have this wide-scale loyalty and word of mouth advertising. However, are Crocs fans enough to keep the company afloat in world full of predators?

Crocs, Inc. has already taken steps to defend its status. As of April 3, 2006, the company had received four patents issued by the U.S. Patent and Trademark Office. These patents cover a range of utility aspects of most of Crocs footwear, as well as design elements of their more popular styles, including the Beach, Cayman, Nile, and Highland models. Additional patents have been filed regarding some of Crocs other shoe styles. Also, the company has either filed for or received a number of other patents covering its styles in other areas of the world, including European Union, Asia, South America, Australia, and Canada.

In addition to patents, Crocs, Inc. has also filed complaints with the U.S. International Trade Commission and the U.S. Federal District Court against eleven companies that manufacture, import, or distribute products that Crocs, Inc. believes infringe upon company patents. In a recent ITC compliant, Crocs requested an order that prohibits all future imports of these infringing goods as well as prohibiting further sale of infringing goods that are already present in the United States. As of June 2006, Crocs had already settled in three lawsuits involving infringements on its patents. Inter-Pacific Trading Corporation, Inc., Shaka Holdings, Inc., and Acme EX-IM, Inc. were all found guilty of infringing on patents held by Crocs, Inc. These companies were forced to abandon or modify their current shoe designs to avoid infringement in the future. Ron Snyder, the CEO and president of Crocs, stated:

> *"We are very pleased to have the unique qualities of our footwear recognized by the issuance of these patents. We take great pride in the design and construction of our products and receipt of these patents demonstrates the level of innovation we have applied to our footwear. We also take very seriously our responsibility to protect this intellectual property. Although consumers have clearly demonstrated their desire for the genuine Crocs brand, it is incumbent upon us to fully protect our intellectual property and we will do so in every appropriate instance where we believe our intellectual property is being infringed."*

Crocs, Inc. already has plans to increase its sales and beat out their competitors. The company has expanded to include a wide range of products in addition to shoes. Customers can now purchase Crocs apparel, umbrellas, knee pads, beach towels, and sunglasses. One of Crocs' current projects is to open its own retail store in New York City. The 1,600 square foot store will be located in the upscale SoHo district. Crocs has also begun producing specially branded Crocs for companies such as Google, Tyco, and Flextronics, as well as for sports teams like the L.A. Lakers. At least seventy colleges have preordered more than half a million pairs of Crocs made in their respective school colors.

One of Crocs' major endeavors is targeted toward maintaining its youth market. The company has recently made a deal with Walt Disney to produce Disney Crocs. The first of this line, featuring Mickey Mouse shaped holes, have already been released. More designs in the Disney line are planned including Mickey Mouse and Friends, Winnie the Pooh and Friends, Disney Princesses, Disney Fairies, as well as Pirates of the Caribbean and Disney Pixar's Toy Story and Cars. Others will be released in accordance with the release of new Disney movies. Snyder predicts that this strategy will "help offset the copycat factor."

Crocs management hopes to increase its market overall by giving customers an ever wider range of choices. In the spring of 2007, Crocs added nine new models to its collection. These models include a high heel, a new flip flop style, and versions similar to the more traditional Crocs, except in two-tones and patterns. In addition, a modified color palette is available including new colors like celery, lavender, cotton candy, and sea foam.

One recent financial endeavor came when Crocs, Inc. acquired the membership interest of Jibbitz, LLC. Jibbitz specializes in the customization of Crocs, including accessories such as bracelets for Crocs and charms that fit in the holes of Crocs. The purchase price of Jibbitz was $10 million, but, based on Jibbitz's future earnings targets, it has estimated potential revenues of an additional $10 million. Ron Snyder commented "We are very excited about this acquisition as we believe Jibbitz represents a tremendous strategic fit for our company. We look forward to leveraging each organization's strengths in order to fully capitalize on the many new and exciting growth opportunities in our future."

Crocs customer loyalty and multiple attempts to expand and satisfy its target market shows Crocs potential. However, despite Crocs' efforts to protect its products patents and lawsuits, competitors remain a very real threat. The questions that must now be asked are: how can Crocs stay ahead of competitors? Will Crocs be able to maintain its status at the top of the food chain or is it an endangered species that fades into extinction?

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ANALYSIS OF STRATEGIC ISSUES AT BEWARI.COM: A B2B CASE STUDY IN THE MIDDLE EAST

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CASE DESCRIPTION

The main subject of this case is B2B e-commerce in the Middle East. Secondary issues examined are: strategic factors facing the company examined in the case study; the B2B business model; privacy and security issues of e-commerce; and new business strategies for B2B.

This case has a difficulty level of four and is best utilized in a senior level Strategic Management / E-Marketing course. Depending upon the depth of analysis, the case can be taught in three to six hours and requires a preparation time of three to six hours.

CASE SYNOPSIS

The introduction of Internet use and the resulting growth in e-commerce has changed the service industry in the 21st century. These factors have led to changes in online transactions and have introduced new, Internet-only services companies, forcing traditional service institutions to quickly develop and implement an e-commerce strategy.

The current case analyzes strategic issues surrounding e-business at Bewari, a B2B company established in June 2000 that allows companies in the Arabian Gulf region to buy and sell goods and services online. Bewari is a hypothetical company. At the request of the real company's management, its name is kept confidential since Bewari did not want to disclose its operations to its competitors. This case study is chosen since the Arabian Gulf region is unique in terms of culture, tradition, business practices, human and organizational values compared to those in developed economies. Most of the economies in the region are oil-rich. Business development practices in one economy in a particular sector are rapidly imitated by businesses in the neighboring economies in the region. The economies in the region form a major trade bloc of major importance to neighboring European and Asian economies.

Bewari has chosen to create and maintain the highest standard B2B customer service and trading facilities in the Middle East. The case shows that Bewari:

- *is an ideal partner for helping companies reach new markets in real time*
- *is agile enough to respond to fast changing market opportunities*
- *provides innovative online B2B services, enabling B2B firms to extend their reach and enhance their competitive standing, and integrates supply chain.*

Nevertheless, growing pains have ensued. From its inception, Bewari has given access to the resources and culture thought necessary to allow it to succeed. While Bewari was given the right resources and freedom to succeed, it was asked to do so within an organization incapable of producing the desired product. Bewari faces pressure from its stakeholders to improve performance and maximize synergies from recent alliances. In addition, decisions and options regarding Bewari must be taken into consideration as part of Bewari's overall strategy.

CASE ISSUES AND SUBJECTS

Competitive Strategies	Resources Allocated to Bewari
Vision Statement	Marketing Niche
Target Market/Customer-based	Hyper-competition
Corporate Culture	Synergy
Cannibalizing Existing Customers	Privacy Issues
Internet Security	

BACKGROUND

Bewari's management is facing a set of challenging issues detailed in Part 4 of this case. It is therefore important for business students to evaluate the issues facing Bewari's Management and to focus on: (a) the key strategic factors for success, and (b) the strategies to be implemented and how the company responds to the challenges in the fast-growing B2B market in the Arabian Gulf. In the process, students are also expected to analyze the political, economical, societal, technological and legal factors impacting Bewari. Students are encouraged to use the following tools for their strategic analysis:

a. A SWOT analysis based on Porter's five-force model
b. Recommend short-, medium- and long-term strategies for Bewari to implement

Students should go through Appendix -1 as suggested background reading for the case analysis. From the case analysis they are expected to find specific answers to the following questions:

i. What are the strengths and weaknesses of Bewari?
ii. What are the opportunities and threats facing Bewari?
iii. What are the strategic factors facing Bewari?
iv. How does each of Porter's five forces impact on Bewari?
v. What are the security and privacy issues relevant to online e-commerce?
vi. What are the supply chain management issues involved in B2B e-commerce?

The case is organized into six parts. Part 1 highlights the background; Part 2 discusses the conceptual framework of e-commerce. Part 3 discusses Bewari's business, its customers and products. Part 4 sets the stage for strategic analysis of the case. Part 5 identifies the student tasks, and Part 6 concludes the case.

SETTING THE STAGE: E-BUSINESS CONCEPTUAL FRAMEWORK

The adoption of e-business requires a framework guiding sustainable business development. Timmers (1999) draws on theoretical constructs relevant to the transformation introduced to value creation by the adoption of e-business practices and proposes an analytical framework and method for constructing e-business models. According to Timmers, a business model refers to the architecture of products, services and information flow including a description of the various business actors involved and their roles. Such a model provides understanding how the business mission and objective of any of the companies that are actors within the model are realized. Timmers proposes that the major elements of the analytical framework are based on: coordination, cooperation-competition, customer value and core competency issues. The major implication that a business model could have is positioned at a strategic level, thus the reasons for the development of a business model are relative to the strategy of the firm (Hammel and Heene, 1994).

Depending on the type of trading partners, there are many categories of e-business including, Business to Business (B2B), Business to Consumer (B2C), Consumer to Business (C2B), Consumer to Consumer (C2C), Government to Business (G2B), Government to Citizen (G2C), Business to Government (B2G), and Intra-business (Organizational Unit to Organizational Unit). Without the use of face-to-face operations, all e-business transactions are performed electronically by using computer and communication networks. The three principal categories of e-business applications are:

1. Electronic markets or e-market places: buying and selling goods and services;
2. Inter-organizational systems: facilitating inter- and intra-organization flow of goods, services, information communication and collaboration.
3. Customer service: providing customer service and help, handling complaints, tracking orders, etc (Senn, 1996).

BEWARI'S BUSINESS MODEL

Bewari is a B2B company helping businesses in the Arabian Gulf region to reach new markets in real time agile enough to respond to fast-changing market opportunities. Through Bewari's portals, buyers can find, compare and procure products and services from the familiarity and convenience of their desktop Internet browser. Suppliers can list their products and services and sell them through online catalogues or auctions.

Bewari's target market includes business and government organizations that actively trade in goods and services within the region. It also facilitates the purchase of goods/services enabling sellers to trade at most competitive prices through auction-induced marketing. It also provides secure and affordable space to market to over 3500 trading partners, who have negotiated more than 35,000 online tenders (e4all, 2006).

Vision and Mission

The vision of Bewari is to be the leading business-to-business (B2B) online marketplace in the Middle East, and play a pioneering role in transforming regional economies into an internet-based trading environment, creating outstanding value for customers and increased ROI.

The mission of Bewari is to maximize the business potential of its customers in the Middle East by providing them with innovative online B2B services, enabling them to extend their reach and enhance their competitive standing and supply chain integration.

The CEO brings to Bewari the expertise gained in the high-tech community of Silicon Valley. During his 20+ years of service, the CEO has led a strategic sourcing program worth more than one billion dollars; brought more than one hundred million dollars in savings to the holding company, one of the world's largest consumer packaged goods (CPG) firms; launched an e-marketplace whose current membership consists of global industry leaders with a combined revenue of over nine hundred billion dollars; and developed a go-to-market strategy which captured a market worth 1.3 billion dollars.

Structure

Bewari implemented an alliance structure which is currently loose. The structure currently has a heavy marketing focus as the key on branding the service.

Customers

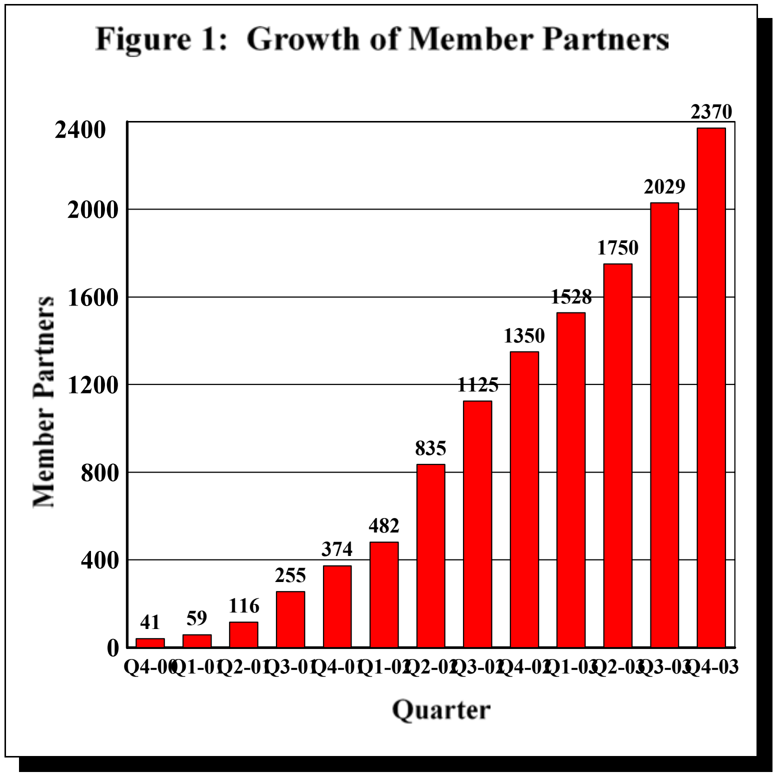
Bewari has a base of 60,000+ trading partners who have negotiated 50,000+ online auctions valued at over 2.5 billion dollars. In addition, buyers have transacted 85,000+ electronic purchase orders. The major customers fall into following segments:

- ♦ Government and semi-government organizations like ministries, public services departments and municipalities.
- ♦ Large businesses like global companies, manufacturers, producers, agents, and financial institutions.
- ♦ Trading companies like business groups, and commodity traders operating on a local or regional level.
- ♦ Small companies like businesses with smaller trade requirements.

Being a government-initiated profit-driven online B2B initiative, Bewari aims to reduce procurement costs of its members. Over 60% of the online auctions are conducted by the private sector while 40% are done by the government. The government is the largest buyer in the region and 60% of the procurement business arises from the government sector. Bewari offers convenience services like purchase and sales access under one brand to create "stickiness" and increase switching costs for the consumer.

Business Model

Bewari uses a franchise model in each member country. One of the major advantages of this approach is to ensure that the B2B operation is through a 100% locally-owned company. Bewari provides partner technology, training, ongoing support and much more - essentially all of its accumulated intellectual property and experience necessary to establish and operate the business.



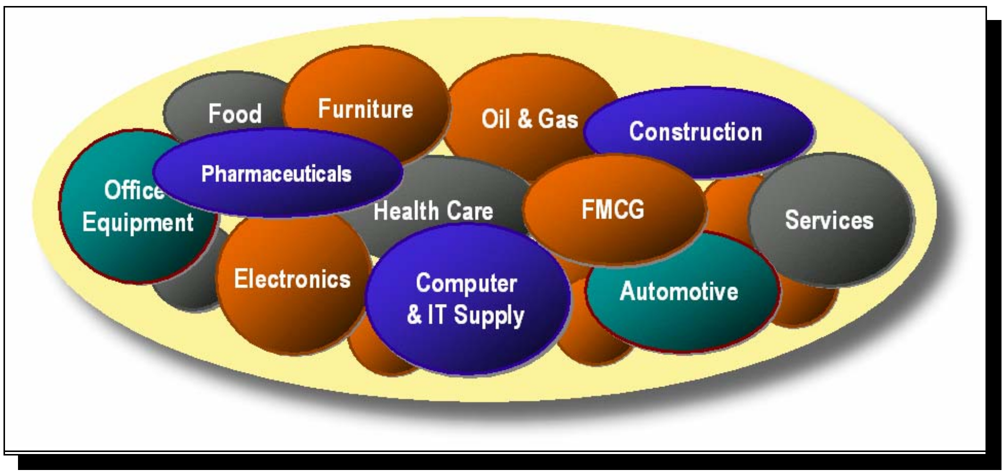
The number of member partners has increased substantially over the last three years (Figure.1). Partnering with Bewari is unquestionably the lowest-risk option for the establishment of an electronic marketplace anywhere in the Arabian Gulf region. Bewari is operating in a market space which is expected to grow exponentially over the next few years as the trend of electronic procurement in the region follows the rest of the world.

Bewari has to its credit numerous awards and accolades such as the: Quality Appreciation Program Award 2005; IT Weekly - Arab Technology Award 2005; Super brands Award in 2003, 2004 and 2005; American Business Council Business Award 2004; World Summit on the Information Society in 2003; MEED Award for the Best IT Project in 2002; Publishing Group ITP: Best B2B Marketplace; Best B2B World Economic Forum in Davos (Switzerland) and Oracle Application World in Paris; "Best Content Provider in e-Business" at the Gulf Brand of the Decade Award.

Products and Services

The range of commodities transacted online through Bewari include oil and gas, building and construction, healthcare, automotive, agriculture, information technology, engineering, electronics, office equipment, stationery and the FMCG industry (Figure.2).

Figure 2: Bewari's Products and Services



Auctions and tendering (Reverse Auctions):

Bewari supports both seller and buyer online auctions, to fully maximize the value of B2B transactions conducted through the marketplace. Customers can create new auctions, to meet specific purchasing requirements in a transparent and efficient manner; auto-extend Auctions, so that auctions extend if new bids are received in the closing minutes, driving competitive behavior among suppliers; place bids online so that suppliers can bid in real time at online auctions and monitor bidding action so that users can see what's happening in the marketplace around the clock.

Catalog management, hosting and search facilities:

Bewari enables manufactures and suppliers to post their products and services on the market place, providing them with access to new markets without the associated start-up costs, enabling them to acquire new customers without the need for a physical presence. Cutting - edge taxonomy and categorization features enable suppliers to review, approve and audit their catalog data, load pricing for the entire marketplace or adjust price bands for specific customers.

Spot buying:

Buyers can source products using the powerful search facilities of Bewari's marketplace or via company's trading partner directory, enabling them to leverage cost-scales and efficiencies, buy goods at the best-fit price and find goods and services not available to them in their local market.

Project collaboration:

Bewari's project collaboration platform enables members from the construction industry and other collaboration sectors to centralize electronic documents align business processes and create a detailed audit of project activities. The tool delivers projects with reduced administrative costs, faster completion time, improved accountability and fewer errors.

Online procurement training:

In order to maximize their online procurement efforts, Bewari offers comprehensive training opportunities on how to create and award auctions, make spot purchases, develop catalog content, and utilize the notification features of the portal. Customers can access the company's online E-learning training materials, at any time

Procurement consulting:

Bewari's procurement expertise has led to world-class standards of procurement consulting ranging from analysis of current processing structures to the development of strategic plans.

Member services and support:

Bewari provides attractive membership services, which include buyer memberships, supplier memberships, integration memberships, strategic e-sourcing, and catalog management.

Link Service:

Recently, Bewari has come up with the idea of building a national directory which includes information about all the companies in the region. This directory enables the company to promote or ask for trade leads. All the companies can communicate with each other through E-mail or MSN Messenger. Also, they can upload images of their products and build a virtual showroom. Each company can also have its own website. In this case, the local Economic Department collects nominal fees from the registered companies and integrates their database with all the information collected from the companies in the back-office system. The agreement between Bewari and the Economic Department enables the government to extend this service to the public. They can utilize the kiosks located everywhere for Link Service.

Dubai Tea Trading Center (DTTC):

In January, 2006, Bewari partnered with the Metal and Commodity Trading Center (MCTC) in creating tea trade portals. MCTC is engaged in creating storage and blending facilities for teas from various countries in the region to boost regional buying and selling. The tea portal allows tea-related organizations to showcase their products and services, create trade leaders to buy and sell, and identify new partners in different countries.

Bewarimylink.com:

On June 6, 2006, Bewari launched Bewarimylink.com a service for all businesses and companies registered with the Department of Economic Development. Its mission is to expand the scope of commerce in the region. This service offers a compelling e-commerce proposition for organizations from every industry regardless of size.

Competitors

The following firms are Bewari's major competitors:

- Ariba.com: It is an international company (with the head office in the US) which manages E-auctions. It undertakes mainly consulting activities, and is not very focused on e-services.
- Quadreu.com: It focuses on oil and gas activities. It manages only auctions.

Apart from these, there are many small competitors who have recently entered e-business and will present a formidable competition to Bewari in the coming years.

Security and integrity

Bewari is powered by Oracle, which provides technology and scalability to provide a safe and reliable environment for conducting business over the Internet. As part of the marketing plan, Bewari has adopted project collaboration software that reduces the initial project cost and the cost of ownership by centralizing electronic documents, and aligns business processes throughout the supply chain. Bewari handles procurement activities through its reliable and secure platform. It is considered one of the most important tools for achieving accountability, credibility, and transparency. Bewari is also considering starting a traditional B2C E-commerce website, however, it feels that people should be ready for such a service, and now is not the right time.

Impact of Bewari on customers

Bewari's services have tangibly impacted customer businesses as detailed below:

a. Reduced Costs
  - o Regional Water and Electricity Authority saved over 48% in stationery costs.
  - o Civil Defense: Saved over 1 Million in local currency on fire-fighting equipment.
  - o Airlines: Saved over 2.5 Million in local currency on in flight menus and 2 Million in local currency on mineral water.
  - o Local municipality: Saved over 120,000 in local currency on desktop computers.
  - o Police: Saved over 14% on uniforms, shoes, helmets and other equipment.
  - o Eritrean government: Saved over 32% on 2500 PCs, monitors and peripherals
  - o Local government: Saved over 14% on average across all agencies

b. Reduced Procurement Cycle Times
  - o Government workshop: From 3 weeks to 10 days for automotive spare parts
  - o Ports Customs and Free Zone Corporation: From 3 weeks to 10 days for cabling and tires
  - o Airlines: From 3 weeks to 24 hours for corporate printing.
  - o Regional electricity and water supply authority: From 20 days to 5 days for electrical items
  - o Local municipality: From 2 weeks to 7 days for chemicals and insecticides
  - o Construction company: From 6 months to 4 weeks for specialized light fittings
  - o Local health and medical services: From 5 days to 2 minutes to prepare summary of quotations

c. Extended Market Reach
  - o Small IT products suppliers who had never supplied to government: These suppliers were awarded over USD $2M in Government contracts within 60 days of participating in company's auctions.
  - o A large private group company in the manufacturing industry: Expanded supplier base from one to six suppliers for specialized pallets, overcoming non-competitive pricing and poor responsiveness.

- o A large IT company specializing in large corporate contracts: Extended market reach into small-medium opportunities by deploying low-cost resources to bid on company's auctions.
- o A leading transport company with ad hoc printing requirements: Reduced costs by 50% by awarding business to a non-traditional printing company with which there had been no prior relationship.
- o The World Food Program had been unable to source 1.5M polypropylene bags: Accessed 7 quality suppliers and awarded the business in 18 hours, meeting a critical deadline for the provision of humanitarian aid.

ISSUES FACING BEWARI'S MANAGEMENT

Bewari still competes with standalone startups to recruit and retain the best people, and it has a difficult time, despite working to establish a startup friendly in Dubai. In B2B industry, low to medium barriers to entry exist, and the alliance/partnership strategy is imitable by other traditional e-commerce providers. Bewari's management is facing the following strategic issues and challenges

Systems (Processes)

Bewari as an organization must keep its operations and systems in order to maintain the startup environment. It develops technologies and relationships on its own. A system is not currently in place to share information and learning across Bewari's online expertise. Advantages exist via association with the company's network and through the connection to regional E-Government and Economic Department portals.

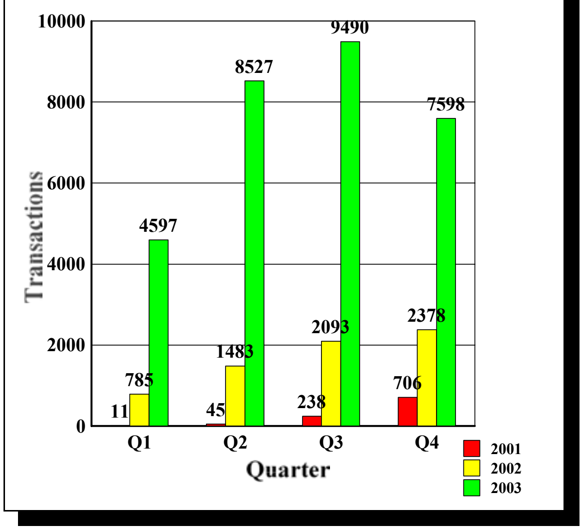
Performance

Multiple B2B services are currently being offered to help gain customer acceptance. An initially promising advertising campaign is helping to develop Bewari's name as synonymous with B2B e-commerce. Service charges vary according to the type of membership in Bewari. For suppliers it ranges from $1,000 to $2,400 a year. For buyers, the charges vary from $1,000 to $10,000 a month. The number of quarterly transactions shows trends of consistent growth over the last three years (Figure.3). By the end of 2003, the trade volume of Bewari was $520 Million. It exceeded 2.5 billion dollars by the end of 2005. In the first quarter of 2006, the volume of trade stood at $200 million. Is this growth sustainable?

Resistance to Change

Buyers (end users) have been using their traditional or electronic procurement system for some time. They are happy with the results. Buyers are asking why they should change, and what value is added to their businesses by implementing changes.

Figure 3: Growth of Transactions at Bewari



Trust (Security and Privacy)

Buyers and suppliers need to ensure that their transactions have a high level of security and privacy. In addition, they need to be aware of security features available in the application. The challenge is: how can trust be created in the minds of B2B buyers and suppliers?

Laws and regulation

Buyers and suppliers need to be sure that their electronic transactions are accepted legally by the court. The challenge is how to reassure buyers and suppliers of this.

Infrastructure

Buyers and suppliers need to have an internet connection in order to start using any web-enabled e-commerce application. The challenge is how to increase internet penetration on the part of buyers and suppliers.

Stakeholders

Bewari is facing pressure from its stakeholders to improve performance and take advantage of synergies from recent alliances.

STUDENT TASKS

Students are expected to use the findings from the Porter's five forces model and SWOT analysis, to guide the management of Bewari, specifically in regards to the following:

(a) How can Bewari continue to sustain its performance in the hyper-competitive B2B environment?
(b) Is there cannibalization in Bewari and its associates?
(c) What strategy should Bewari take in the emerging B2B scenario?
(d) How can change be implemented among buyers and sellers of Bewari?
(e) How can trust be developed among the associates?
(f) How can transactions be legally bound with certainty?
(g) What is the future of Bewari in the era of e-commerce?

CONCLUSION

There is a scarcity of e-commerce case studies in the Arabian-Gulf region. The present case is of importance to business students in the region since it stimulates discussion concerning strategic issues and challenges facing Bewari. The case study also contributes to understanding the local environment and the challenges of e-commerce for practitioners and academicians as well as business students. The case is equally useful for E-marketing students in that it facilitates understanding of the role of intermediaries in an online B2B and G2B scenario. Further, it can also be used as a tool to understand new successful online businesses in the Middle East.

ENDNOTE

[1] For the purpose of maintaining anonymity the name of the real company has been changed to Bewari.com, and referred in the discussion as Bewari for simplicity

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Appendix

Background Reading Material on Bewari

E-business has received much attention from all types of businesses recently. Rapid developments in e-commerce and e-technology have accelerated intra-business and inter-business online transaction during recent years. Recent research articles [Sodhi 2001; Skjott-Larsen et al. 2003; Lu and Antony 2003; White and Daniel 2004] have attributed e-marketplace adoption to the rapid development of the internet-enabled supply chain. Faloon (2000) and Grieger (2003) noted that e-marketplaces emerge in different industries, supporting different forms of exchange of goods and services, involving different types of actors, and reducing the transaction and operating costs inherent in supply chains. Further, in his study, Zhu (2004) explores firms' incentives to join a B2B exchange that provides an online platform for information transmission, by using a theoretical model involving asymmetric information in the form of a game. He concludes that individual rationality of participation in the online exchange reflects the tradeoff between information transparency and data confidentiality with implications for the microstructure design (e.g., data access rules) of B2B electronic marketplaces.

As information technologies (IT) develop, novel approaches to business process redesign emerged. The rapid expansion of e-commerce values in the past few years have convinced many people that a new economy has emerged. Organizations today frequently integrate Internet technology to redesign processes in ways that strengthen their competitive advantage. However this competitive advantage needs a sustainable focus since success breeds imitation and invites more entries.

Eric (2005) explores the various B2B e-business models using in-depth interviews and case studies conducted with Australian Agribusiness firms. They identified 10 B2B e-business models with rationales for these selections based on organizational size, the industry sector, and the current state of e-business model application.

Information systems strategies for competitive advantage

Studying the evolution of business organizations has received much attention in organization theory and MIS research (Phan, Vogel and Nunamaker, 1995). Because organizations are not internally self-sufficient, they require resources from the environment, and thus become interdependent with those elements of the environment with which they transact. Organizational theorists (Pfeffer and Salancik, 1978) argue that organizations develop internal and external strategies which seek to minimize the uncertainty arising from dependence on the environment for resources.

As technology advances and the e-business market develops, market niches open and close frequently, creating rapid changes in the market. The prevalence of technical innovations may be regular, sporadic, or rare; these patterns of change have different implications for business organizations. When innovations occur often, a niche may open up and the organization competes to take advantage of cost savings and market penetration that often result in better profits and greater market share.

From the information systems (IS) perspective, the value chain model (Porter, 1985) highlights interdependence activities in businesses where competitive strategies can be best applied and where IS are more likely to have strategic impact. As IT developed, novel approaches to business process redesign emerged. Most organizations today use Internet technology to redesign their processes in ways that provide new, more competitive advantages. Through the infrastructure of existing B2B exchanges in the e-market place many organizations will eventually be able to integrate activities of their value chain encompassing suppliers, customers, and distribution channels within an industry or across industries.

However, Porter (2001) has argued that the key question is not whether to deploy e-business now to take advantage of Internet technology, but how to deploy it. Gaining competitive advantage requires building on the proven effective strategic principles. Business enterprises can gain competitive advantage by operational effectiveness, doing the same as competitors do but doing it better, and by strategic positioning, doing things differently from competitors in a way that delivers a unique type of value to customers. Key principles of strategic positioning are: goals that target long-term ROI, distinctive value chains, trade-offs for uniqueness in the market, strategies that fit together, and continuity of corporate direction. Porter also argued that Internet technology should be used as a "complement to" rather than a "cannibal of" traditional ways of competing. Without understanding how to deploy Internet technology, entering e-business can bring disastrous consequences.

To succeed, companies also need to search and implement innovative strategies that capitalize on both the power of the Internet and changes in both traditional and electronic markets. Companies that run e-businesses should have tight supply chain relationships with customers, suppliers and distributors (Scarborough and Spatarella, 1998). Similarly, established companies that view e-commerce as a stand-alone appendage to their business would be less likely to succeed in their efforts.

In the process of forming a corporate strategy to respond to the challenges of environmental change, normative thinking requires that a firm should analyze its industry forces and value chain activities in order to identify opportunities for IT innovation (Wheelen and Hunger 2006). The choice of an appropriate strategy could then lead to superior performance. In the case of e-commerce, firms implementing such initiatives should carefully analyze external forces, internal resources and their core competencies. The outcome of this process should be reflected through a tight integration between corporate strategy and e-commerce (Chang, Jackson and Grover, 2003).

Timothy and Samuel (2004) studied a sample of B2B e-marketplace survivors to identify the attributes linked to financial performance. Their B2B framework depended on strategic management literature of industrial organization economics, the resource-based view and competitive heterogeneity. They test the conceptual model through regression analysis of revenue and profitability drivers captured in a survey of 272 surviving e-marketplaces. Their results provide insights into successful strategies for the B2B e-marketplace and significant variables related to ownership, funding levels, speed, and continuity and to some extent the scope of service offered.

Despite the benefits provided by e-commerce, however, adopting e-commerce does not ensure a competitive advantage, because the technologies are open and available to competitors (Lord, 2000). The ability to mobilize IT resources in conjunction with other resources is critical to superior performance of the firms (Bharadwaj, 2000). Therefore, firms that see e-commerce integrated with their strategic orientation would be more likely to leverage complementary assets and enhance both efficiency and effectiveness.

PHILIP MORRIS USA V. WILLIAMS: PUNITIVE DAMAGES, DUE PROCESS, AND THE U.S. SUPREME COURT

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CASE DESCRIPTION

The primary subject matter of this case is the impact of recent United States Supreme Court decisions regarding the application of the Due Process Clause in determining punitive damages awards. Specifically, this case looks at the most recent decision in Philip Morris USA v. Williams (2007) of three significant Supreme Court decisions regarding punitive damages awards.

The case looks at the two previous Court decisions regarding the criteria used in determining punitive damages awards and the effect of those decisions on the final decision in this trilogy. Given new appointments to the U. S. Supreme Court, the case provides an opportunity to examine the impact of those changes on this recent decision.

All three decisions raise questions about the commitment of firms to ethical and socially responsible behavior given the restrictions to the size of punishments that may be levied against them when their behavior is found to fall below the recognized standards of "acceptable."

This case would be appropriate for use in business law/legal environment of business, business marketing, or business ethics with a difficulty level of two or three depending on the course.

CASE SYNOPSIS

In Philip Morris USA v. Williams (2007), the United States Supreme Court decided that the Due Process Clause prohibits a state from using punitive damages awards to punish a defendant for injuries it inflicts upon non-parties, i.e. strangers to the litigation because such awards amount to a taking of property without due process, there being no fair notice of the severity of the penalty the state may impose (Philip Morris USA v. Williams, 2007). This decision is the third in the United

States Supreme Court's recent forays into the constitutionality of punitive damages awards, but the first punitive damages case decided by the Court since the retirement of Justice O'Connor and the death of Chief Justice Rehnquist, and the addition of Justice Alito and Chief Justice Roberts to the Court (Murray, 2007).

The purpose of this paper is to examine how Philip Morris USA v. Williams fits into the trilogy of punitive damages decisions issued by the United States Supreme Court, to assess the impact of the Chief Justice Roberts and Justice Alito's joining the majority decision, and to determine the reach of the Due Process Clause in restricting punitive damages awards (Hamdini, 2006).

Careful discussion of the case should enable the students to better understand (1) the use of punitive damages in legal decisions; (2) the concept of Due Process; (3) the possible implications of these decisions of corporate behavior; (4) the significance of the composition and creation of majorities on the United Supreme Court.

WILLIAMS V. PHILIP MORRIS INC. (2002)

Jesse Williams began smoking cigarettes manufactured by Philip Morris while serving in the army in Korea in the early 1950s. The Army provided the cigarettes, and soldiers encouraged Williams to smoke to keep the mosquitoes away. Williams continued to smoke the cigarettes until the mid-1950s, when he switched to the Marlboro brand, also manufactured by Philip Morris and positioned as the first male-oriented filter cigarette. Williams smoked Marlboros or Marlboro Lights for the rest of his life, his cigarette consumption ultimately increasing to three packs a day (Williams v. Philip Morris Inc., 2002).

While his family encouraged him to stop smoking and told him cigarettes were hazardous to his health, Williams insisted that the cigarette companies would not sell cigarettes as dangerous as his family claimed, that he heard on television smoking cigarettes does not cause cancer and was not harmful to the smoker's health, and that the tobacco companies never said smoking was harmful or something was wrong with tobacco (Williams v. Philip Morris Inc., 2002).

Williams was unsuccessful in his several attempts to stop smoking, regardless of the approach he took: quitting "cold turkey," cutting down on the number of cigarettes smoked, or using nicotine patches or gum. His addiction to cigarettes was so strong that, upon running out of cigarettes, he would travel to the store to buy cigarettes regardless of weather hazards and would leave his wife in the nonsmoking section of restaurants to smoke a cigarette in the smoking section. According to an expert witness, Williams "was highly addicted to cigarettes" and his addiction was both "physiological" and "psychological" (Williams v. Philip Morris Inc., 2002).

While Williams was generally in good health throughout his life, chest X-rays and other diagnostic tests undertaken in September and October 1996 demonstrated that he had an inoperable carcinoma in his right lung, the primary cause of which was cigarette smoking. Upon learning of the diagnosis, he "expressed a feeling of betrayal" and claimed the cigarette companies "were lying all the time." Chemical and radiation treatments were unsuccessful, and Williams died in March 1997 (Williams v. Philip Morris Inc., 2002).

Mayola Williams, the widow of Jesse Williams and the personal representative of his estate, brought an action against Philip Morris to recover compensatory and punitive damages for his death (Williams v. Philip Morris Inc., 2002, at 828). Ms. Williams pursued personal claims of negligence and fraud, and the jury returned a verdict in favor of plaintiff on those claims, awarding economic damages in the amount of $21,485.80 and non-economic damages of $800,000 on each claim. Ms. Williams also pursued claims of negligence and fraud on behalf of her deceased husband. The jury determined that Jesse Williams' own negligence was 50 percent of the cause of his harm and declined to award punitive damages on his negligence claim. The jury awarded Jesse Williams punitive damages in the amount of $79 million on the fraud claim. The trial court determined that the punitive damages award was excessive under the United States Constitution and reduced it to $32 million. The trial court also reduced the award of non-economic damages to $500,000 in accordance with an Oregon statute which caps the amount that may be recovered as non-economic damages in a wrongful death action at $500,000 (Williams v. Philip Morris Inc., 2002, at 828).

Decision of Court of Appeals of Oregon

Philip Morris appealed to the Court of Appeals of Oregon. Philip Morris contended (1) it was entitled to a directed verdict on the fraud claim, because there was no evidence that Philip Morris directed a specific misrepresentation to Williams or that Williams reasonably relied on any such representation, (2) that the jury instruction on punitive damages was erroneous, because it failed to inform the jury that a punitive damages award should bear a reasonable relationship to the harm caused to Williams and should not be used to punish Philip Morris for harms to others who were not before the court, and (3) that the punitive damages award was excessive (Williams v. Philip Morris Inc., 2002, at 830).

The Oregon Court of Appeals rejected Philip Morris' fraud argument, and determined that, unlike most fraud cases, plaintiff's theory was that

> [D]efendant, in concert with other tobacco companies, engaged in a decades-long public-relations effort to create the impression in the public that there was a legitimate controversy about the health effects of smoking, even though defendant knew that such an impression was false. According to plaintiff's evidence, defendant sought to create enough doubt about the connection between smoking and disease that potential and actual smokers would have something to which they could point to justify beginning or continuing to smoke (Williams v. Philip Morris Inc., 2002, at 837).

The Court then found that there was abundant evidence in the record supporting Plaintiff's theory of fraud. Studies undertaken in the early 1950s showed that cigarette tar could cause cancer in mice and that there were statistical correlations between smoking and lung cancer. Total cigarette sales fell in 1953 for the first time in the twentieth century, apparently in response to the publicity over the studies. Philip Morris, in concert with other tobacco companies, initiated an intensive campaign to undercut concerns about the consequences of smoking and to convince the public that the effect of cigarettes on smokers' health was unclear and that additional research was required to establish a definitive answer. This message was communicated in Oregon and throughout the United States for the next several decades, despite the fact Philip Morris knew that there was no legitimate controversy about the health effects of smoking, and that smoking caused serious health risks, including lung cancer. Further, because Philip Morris made these misrepresentations to the public at large, it is responsible to any person reasonably relying on the communicated information, whether or not Philip Morris intended to defraud a specific or particular person. Hence plaintiff did not have to demonstrate Philip Morris specifically directed its misrepresentations toward Williams; rather, all that plaintiff had to establish was that Williams was "within a class of people whom defendant intended to be the recipients of and to rely on the message that it conveyed," a matter confirmed by the jury's "yes" answer to the following question:

> Did defendant make false representation concerning the causal link between smoking and cancer upon which Jesse Williams relied, and if so, were such false representations and reliance a cause of damage to plaintiff, as to cigarettes sold to Jesse Williams on or after September 1, 1998 (Williams v. Philip Morris Inc., 2002, 832-4).

Further, there was abundant evidence Philip Morris communicated its message of denial about the connection between smoking and health harms "over many years and in many ways." Philip Morris, together with a number of tobacco companies, employed a major public relations firm to counter the impact of the early studies linking cigarette smoking to cancer. In its ensuing campaign, the tobacco companies, tobacco growers and tobacco marketers signed, published, and advertised in 448 newspapers a statement entitled "A Frank Statement to Cigarette Smokers," in which they stated their belief cigarettes were not harmful to health, and announced the establishment of the Tobacco Industry Research Committee to undertake research into tobacco use and health. Thereafter, throughout the 1950s and 1960s, the tobacco industry adopted a "common front," uniformly communicating the same message of denial about the linkage between smoking and health harms through the Tobacco Industry Research Committee (Williams v. Philip Morris Inc., 2002).

With the issuance of the 1964 Surgeon General's report emphasizing the connection between cigarette smoking and lung cancer, Philip Morris and the tobacco industry took a new tack: emphasizing the need for additional research, suggesting the linkage between health harms and cigarette smoking was unclear, and creating sufficient doubt in the minds of smokers to discourage them from stopping smoking. Philip Morris and the tobacco industry continued this campaign of doubt throughout the 1960s, 1970s, and 1980s, consistently suggesting other factors played a role in smokers' deaths and emphasizing the lack of proof that smoking causes cancer. Further, the evidence established that Philip Morris and the tobacco industry intentionally avoided conducting research in the United States that might resolve the very questions they claimed needed further research. Instead, they "conducted all sensitive research in a [European] laboratory . . . taking care to avoid preserving records of the results in this country." (Williams v. Philip Morris Inc., 2002, at 838) The director of research at Philip Morris said his role was to attack and discredit reports linking smoking and cancer and to sustain the controversy over whether smoking caused cancer. Philip Morris and the tobacco industry promoted their message through press releases, news articles, statements of opinion leaders, and appearances of industry spokespersons on commercial and public television, all uniformly emphasizing that the evidence linking health harms to tobacco was merely a statistical relationship, that there was no proof a tobacco ingredient caused disease, and that there could be other causes unrelated to tobacco use for the cited health harms. Indeed, when the tobacco industry finally conceded in the early 1990s "that tobacco could be a risk factor associated with a number of diseases," industry representatives continued to insist that "there was a long chain of intervening events involved before a disease arose from cigarette smoking" and that they "did not believe cigarette smoking was addictive" (Williams v. Philip Morris Inc., 2002, at 838).

There was also evidence that Williams received the message sent by Philip Morris and that the message discouraged him from overcoming his addition to cigarettes. He watched television and read the *Oregonian* and other newspapers and magazines, all of which were the media carrying the message, and his own statements demonstrated that he received and relied on the message (Williams v. Philip Morris Inc., 2002, at 835).

Because its review of the evidence presented supported the jury's finding "that Williams purchased cigarettes after September 1, 1988, in reliance on defendant's previous and continuing representations and that those cigarettes were a substantial factor in causing his lung cancer," the Oregon Court of Appeals concluded that "the trial court did not err in denying [Philip Morris'] motion for a directed verdict on the fraud claim" (Williams v. Philip Morris Inc., 2002, at 835).

In examining Philip Morris' arguments on the award of punitive damages, the Court initially described the nature of its review of punitive damages as codified by the Oregon legislature:

> If an award of punitive damages is made by a jury, the court shall review the award to determine whether the award is within the range of damages that a rational juror would be entitled to award based on the record as a whole, viewing the statutory and common-law factors that allow an award of punitive damages for the specific type of claim at issue in the preceding (Williams v. Philip Morris Inc., 2002, at 836).

The Court also emphasized that the decision of the Supreme Court of Oregon in *Parrott v. Carr Chevrolet, Inc.* (2001), confirmed that the "rational juror" standard is consistent with the Due Process standard outlined in *BMW of North America, Inc. v. Gore* (1996), and that the *Gore* guideposts and the Oregon statutory standard utilize five criteria in determining the range of punitive damages that a rational juror is entitled to award:

> (1) the statutory and common-law factors that allow an award of punitive damages for the specific kind of claim at issue * * *; (2) the state interests that a punitive damages award is designed to serve * * *; (3) the degree of reprehensibility of the defendant's conduct * * *; (4) the disparity between the punitive damages award and the actual or potential harm inflicted * * *; and (5) the civil and criminal sanctions provided for comparable misconduct (Williams v. Philip Morris Inc., at 836).

As noted above, Philip Morris claimed that the jury instruction on punitive damages was erroneous, because it failed to inform the jury that a punitive damages award should bear a reasonable relationship to the harm caused to Williams and should not be used to punish Philip Morris for harms to others who were not before the court. The Court of Appeals of Oregon noted, however, that, while the first part of the requested instruction (bearing a reasonable relationship to the harm caused) was correct, the second part (not inflicting punishment for others who were not before the court) was not correct. The second part was incorrect, because the Oregon Supreme Court "made it clear that the potential injury to past, present, and future consumers as a result of a routine business practice is an appropriate consideration in determining the amount of punitive damages," and because Oregon's statutory standard on punitive damages "allows the jury to consider other punishments" (Williams v. Philip Morris Inc., 48 P.3d at 837). Because part of the requested instruction was incorrect, the trial court was entitled to reject it in its entirety.

In considering Philip Morris' argument that the punitive damages award was excessive, the Court emphasized that there was sufficient evidence in the record to support the jury's award of punitive damages in the amount of $79 million. In addition to showing Philip Morris deliberately made misrepresentations to Williams, the evidence established: (1) Philip Morris knew smoking cigarettes caused lung cancer and other health harms; (2) Philip Morris knew that nicotine was addictive and caused smokers to continue to smoke; (3) Philip Morris "conducted research in such a way as to avoid studying the health effects of smoking, all the while asserting publicly that there was need for further research on that very issue; (4) Philip Morris' "actions caused harm to many others in Oregon besides Williams"; and (5) the sale of cigarettes is hugely profitable (Williams v. Philip Morris Inc., at 839).

The Court then addressed factors relevant to the *Gore* criteria for reviewing punitive damages awards and determined: (1) the jury could find that there was a strong likelihood that Philip Morris' misrepresentations would cause serious harm, because its public relations campaign was deliberately designed to give smokers a crutch to continue their addiction to cigarettes and put them at risk of serious injury; (2) the jury could find that, by 1958 and certainly by 1972, Philip Morris knew its actions would likely cause harms; (3) the jury could find that Philip Morris' misconduct was highly profitable, generating "billions of dollars of profit over many years"; (4) the jury could find Philip Morris' "misconduct lasted over four decades" and Philip Morris concealed its misconduct "as long as it could" until the "judicially-required releases of documents occurred in the 1990s"; (5) the jury could find Philip Morris never "showed any regret or changed its conduct upon the discovery of its actions", and (6) the jury could find Philip Morris "is a wealthy corporation" and "a small award of punitive damages would have no effect on it"; and (7) the jury could find that no other punishment was inflicted on Philip Morris for its misconduct (Williams v. Philip Morris Inc., 48 P.3d at 837, citing ORS 30.925(2).

The Court decided that these seven determinations fulfill the *Gore* criteria for reviewing punitive damages awards that the Oregon Supreme Court adopted in *Parrott*. First, Oregon certainly has an interest in protecting the health and safety of its citizens, and Philip Morris acted contrary to that interest by engaging a fraudulent public relations campaign designed to encourage continued use of products it knew were harmful to their health. Second, Philip Morris' activities could certainly be deemed reprehensible. Philip Morris earned massive profits over four decades by conducting a "fraudulent scheme to induce people to use or continue to use a product that could cause serious illness or death to a significant percentage of those who used it as intended." Philip Morris' conduct adversely affected the lives and health of its customers and the economic interests of consumers and non-consumers over an extended period of time. Third, the Court rejected Philip Morris' argument that the disparity between the punitive damages and the actual damages awarded was too great, because the Oregon Supreme Court in *Parrott* refused to permit the use a "simple mathematical formula" in reviewing punitive damages awards, and because the record showed Philip Morris' actions were "egregious," were conducted over a long period of time, and injured a significant number of people besides Williams. Further, the Court decided, given Philip Morris' wealth and record of significant profits, a punitive damages award restricted by an artificial ratio to actual damages would not constitute "a serious punishment" that will deter further wrongdoing. Having upheld the jury's punitive damages award, the Court reversed the decision of the trial court and remanded the case to the trial court to enter judgment on the jury's verdict (Williams v. Philip Morris Inc., 2004, at 841-3).

Very clearly, in reaching its decision, the Oregon Court of Appeals struggled to integrate the *Gore* factors to evaluate punitive damages awards into the Oregon Supreme Court's precedent in *Parrott* requiring punitive damages awards to be upheld under the rational juror standard as mandated by statute in Oregon (Williams v. Philip Morris Inc., 193 Ore. App., 2004). For that reason, the Oregon Court of Appeals carefully built its case that Philip Morris conspired with the tobacco industry to create doubt about the dangers of smoking and thereby give those addicted to cigarettes an excuse to continue smoking. The Court convincingly traced the tobacco industry's advertising, public relations and promotional activities over four decades, and examined its chicanery in conducting research on the dangers of smoking and hiding its links to cancer. The Court focused closely on the reprehensibility of Phillip Morris' conduct: misrepresenting the dangers caused by smoking and the additive nature of nicotine, deliberately creating doubt about the risks caused by smoking, causing serious health harms among smokers and increasing the risk of such harms among non-smokers, and engaging in a prolonged fraudulent scheme designed to induce smokers to continue to smoke. Given the broad array of reprehensible conduct on the part of Philip Morris, it is not surprising that the Oregon Court of Appeals upheld the punitive damages award under the reasonable juror test.

After the Oregon Supreme Court declined to review the matter (denied without opinion), the United States Supreme Court granted Philip Morris' writ for certiorari, and remanded the matter to the Court of Appeals of Oregon for further consideration in light of *State Farm Mutual Automobile Insurance Co. v. Campbell* (538 U.S. 408, 2003).

Hence, to understand the subsequent treatment of Williams, it is necessary to review both *Gore* and *Campbell*.

BMW OF NORTH AMERICA, INC. V. GORE (1996)

In *BMW of North America, Inc. v. Gore* (1996), Dr. Ira Gore, Jr., bought a black BMW sports sedan from an authorized BMW dealer in Birmingham, Alabama, for $40,750.88. Dr. Gore drove the car for nine months without discerning any defects in its appearance. When Dr. Gore took the car to a detailer to make the car look snazzier, the proprietor of the store discovered that the car had been repainted. Because he had not been told by the dealer or BMW that the car was repainted, Dr. Gore felt he was cheated and initiated suit against BMW of North America, the American distributor of BMWs, claiming BMW's nondisclosure was a suppression of a material fact and seeking both compensatory and punitive damages (BMW of North America, Inc. v. Gore, 1996).

Dr. Gore's BMW was damaged while in transit from the BMW plant in Germany, and BMW's preparation center repainted the top, hood, trunk and quarter panels of the car. BMW failed to inform Dr. Gore that his car was repainted because the cost of repairing the damage did not exceed the threshold for disclosure under its nationwide policy. BMW would tell the purchaser that repairs were made to the vehicle if the cost of the repairs exceeded 3% of its suggested retail value, and then sell the car as used. If the cost of repair did not exceed the 3% threshold, BMW would not disclose to the buyer that repairs had been made. Because the cost of repairing Dr. Gore's car ($601.37) amounted to only 1.5% of its suggested retail value, BMW did not disclose the repair to the Birmingham dealer (BMW of North America, Inc. v. Gore, 1996).

At trial, Dr. Gore introduced the testimony of a former BMW dealer who claimed that a repainted a BMW car lost approximately ten percent of its value compared to a BMW which was not damaged and repainted. Because he paid $40,450.55 for his BMW, Dr. Gore claimed damages in the amount of $4,000. Maintaining that BMW sold approximately 1,000 cars that had been damaged and repaired without informing the buyers, Dr. Gore argued that he was entitled to a punitive damages award in the amount of $4 million to punish BMW for selling cars for more than they were worth. Determining that BMW's "nondisclosure policy constituted 'gross, oppressive or malicious' fraud," the jury returned a verdict in favor of Dr. Gore, awarding $4,000 in compensatory damages and $4 million in punitive damages (BMW of North America, Inc. v. Gore, 1996).

The trial judge determined that the punitive damages award was not excessive, and denied BMW's post-trial motion. On appeal, the Alabama Supreme Court rejected BMW's argument that the punitive damages award exceeded the constitutionally permissible amount, but determined that the jury incorrectly computed the punitive damages award and reduced it to $2 million (BMW of North America, Inc. v. Gore, 1996).

The United States Supreme Court granted certiorari, and decided that the $2 million punitive damages award was grossly excessive. Noting that "elementary notions of fairness enshrined in our constitutional jurisprudence dictate that a person receive fair notice not only of the conduct that will subject him to punishment, but also of the severity of the penalty that a State may impose," the Court identified and used three " guideposts" in determining that the punitive damages award was excessive: "the degree of reprehensibility of the nondisclosure; the disparity between the harm or potential harm suffered by Dr. Gore and his punitive damages award; and the difference between this remedy and the civil penalties authorized or imposed in comparable cases" (BMW of North America, Inc. v. Gore, 1996, at 574-5).

Noting that the degree of reprehensibility of the defendant's conduct is "[p]erhaps the most important indicium" of the reasonableness of a punitive damages award, the Court decided that "none of the aggravating factors associated with particularly reprehensible conduct" existed in BMW's conduct. The damages suffered by Dr. Gore were purely economic, and had no effect on the car's performance or safety; BMW did not make deliberate false statements, engage in affirmative misconduct, or act out of an improper motive. While the jury found that BMW suppressed a material fact which Alabama law required it to disclose, the omission of a material fact because of a good-faith belief there was no duty to disclose is far less blameworthy than a deliberate false statement. Because only a "high degree of culpability" can justify a substantial punitive damages award, and because none of the "circumstances ordinarily associated with egregiously improper conduct" existed, the Court concluded "that BMW's conduct was not sufficiently reprehensible to warrant imposition of a $2 million exemplary damages award" (BMW of North America, Inc. v. Gore, 1996, at 580).

Observing that the "principle that exemplary damages must bear a 'reasonable relationship' to compensatory damages had a long pedigree," the Court noted that the "second and perhaps most commonly cited indicium of an unreasonable or excessive punitive damages award is its ratio to the actual harm inflicted on the plaintiff" (BMW of North America, Inc. v. Gore, 1996, at 580). While the Court acknowledged it had considered the ratio between compensatory and punitive damages awarded in determining whether the punitive damages were excessive, the Court eschewed "the notion that the constitutional line is marked by a simple mathematical formula, even one that compares actual and potential damages to the punitive award" (BMW of North America, Inc. v. Gore, 517 U.S., at 582) and reiterated its insistence that the Court could not "draw a mathematical bright line between the constitutionally acceptable and the constitutionally unacceptable that would fit every case" (BMW of North America, Inc. v. Gore, 517 U.S., at 583). Nonetheless, the Court observed, "[w]hen the ratio is a breathtaking 500 to 1," the Court must raise its "suspicious judicial eyebrow" (BMW of North America, Inc. v. Gore, 517 U.S., at 583).

The Court identified the third indicium for assessing whether a punitive damages award is excessive: comparing the punitive damages awarded by the jury to the civil or criminal penalties that could be imposed for comparable misconduct. Observing that Alabama's Deceptive Trade Practices Act sets the maximum civil penalty for violations at $2,000, the Court concluded that the punitive damages award imposed on BMW cannot be justified as a deterrent to future misconduct, because a far smaller deterrent is considered sufficient under the statute. Further, the Court stated that the fact that "BMW is a large corporation rather than an impecunious individual does not diminish its entitlement to fair notice of the demands that several States impose on the conduct of its business" (BMW of North America, Inc. v. Gore, at 584-5; citing, Ala. Code § 8-19-11(b), 1993).

Based on its analysis of the three factors, the Court decided "that the grossly excessive award imposed in this case transcends the constitutional limit," and remanded the case to the Alabama Supreme Court to determine whether the appropriate remedy requires a new trial or an independent determination by the Alabama Supreme Court (BMW of North America, Inc. v. Gore, 517 U.S., at 585-6).

STATE FARM MUTUAL AUTOMOBILE INS. CO. V. CAMPBELL (2002)

In *State Farm Mutual Automobile Ins. Co. v. Campbell* (2002), the United States Supreme Court decided that a jury award of punitive damages in the amount of $145 million against an automobile insurance company was excessive and violated the Due Process Clause when compared to a compensatory damages award in the amount of $1 million. In *Campbell*, Curtis Campbell, driving with his wife, Inez, on a two-lane highway in Cache County, Utah, attempted to pass six vans traveling ahead of them. An oncoming car driven by Todd Ospital, attempting to avoid Campbell's vehicle, swerved onto the shoulder of the road, lost control, and crashed into a vehicle driven by Robert Slusher. Ospital died in the collision; Slusher sustained permanent disability; and the Campbells escaped unharmed (State Farm Mutual Automobile Ins. Co. v. Campbell, 2002).

In ensuing litigation, Campbell insisted he was not at fault, despite consensus among the investigators and witnesses that Campbell's unsafe passing attempt caused the collision. Nonetheless, and contrary to the advice of its own investigator, Campbell's insurer, State Farm, contested liability and rejected settlement offers by Slusher and Ospital's estate for the policy limit of $50,000 ($25,000 for each claimant). While State Farm assured the Campbells that their assets were safe and that they were not liable to the litigants, the jury returned a verdict $185,849 higher than the policy limit (State Farm Mutual Automobile Ins. Co. v. Campbell, 2002).

State Farm refuse to cover the excess liability, instructed the Campbells to prepare to sell their assets to cover the judgment, and declined to post a supersedeas bond permitting Campbell to appeal the judgment against him, forcing Campbell to hire his own lawyer to pursue the appeal. While Campbell's appeal was pending, Campbell, Slusher and Ospital reached the following agreement: Slusher and Ospital agreed not to seek satisfaction of their claims against the Campbells; the Campbells agreed to pursue a bad faith action against State Farm, to be represented in that action by counsel for Slusher and Ospital, and to permit Slusher and Ospital to participate in all major decisions in, and to have veto power over any settlement of, the bad faith claim; and the Campbells agreed to give Slusher and Ospital ninety percent of any verdict against State Farm.

In 1989, the Utah Supreme Court denied the Campbells appeal, and State Farm paid the entire judgment, including the excess above the policy limit. Thereafter the Campbells filed their bad faith action against State Farm, and the trial court, granting State Farm's request, bifurcated the trial into two phases, each with a different jury: (1) determining whether State Farm's decision not to settle was unreasonable, and (2) determining the liability of State Farm for its actions (State Farm Mutual Automobile Ins. Co. v. Campbell, 2002).

State Farm moved *in limine* to exclude any evidence of its alleged conduct outside of Utah, but the trial court denied its motion. The jury in the first phase found that State Farm's decision not to pay the policy limit was unreasonable. Before the second phase began, the United States Supreme Court decided *Gore*, and State Farm renewed its motion to exclude any evidence of its misconduct outside of Utah. The trial court denied State Farm's renewed motion, concluding that the evidence was admissible to determine whether State Farm's conduct was intentional and sufficiently egregious to warrant the imposition of punitive damages. During the trial, the court admitted evidence that, for over twenty years, State Farm engaged in a national strategy of capping payouts on claims to meet fiscal goals in numerous states. State Farm called this strategy "Performance, Planning and Review" or the "PP&R Policy" (State Farm Mutual Automobile Ins. Co. v. Campbell, 2002). Most of the evidence describing the PP&R Policy practices was unrelated to third-party automobile insurance claims, the type of insurance claim underlying Campbells' complaint against State Farm. The court also admitted extensive expert testimony describing State Farm's fraudulent practices in its nation-wide operations. The jury awarded the Campbells $2.6 million in compensatory damages and $145 million in punitive damages. The trial judge reduced those awards to $1 million and $25 million respectively (State Farm Mutual Automobile Ins. Co. v. Campbell, 2002).

On appeal, the Supreme Court of Utah reinstated the $145 million punitive damages award. In doing so, the Court utilized the three *Gore* guideposts. The Court determined that the extensive PP&R Policy evidence demonstrated that State Farm's conduct was reprehensible. The Court also ruled that the punitive damages award was appropriate when compared to State Farm's "massive wealth" and in light of evidence demonstrating that, because the PP&R policy was employed clandestinely, State Farm's adherence to the payout capping policy would be discovered and punished in only every 50,000 cases. The Court also decided that the punitive damages award was comparable to various penalties State Farm could have faced: $10,000 fines for each act of fraud, suspension of its license to conduct business in Utah, disgorgements of profits, and imprisonment (State Farm Mutual Automobile Ins. Co. v. Campbell, 2002).

The United States Supreme Court reversed the Supreme Court of Utah, ruling that "it was error to reinstate the jury's $145 million punitive damages award." In reaching its decision, the United States Supreme Court carefully reviewed the three *Gore* guideposts in evaluating the punitive damages award. In examining the first and most important guidepost, the court noted that "punitive damages should only be awarded if the defendant's culpability, after having paid compensatory damages, is so reprehensible as to warrant the imposition of further sanctions to achieve punishment or deterrence" State Farm Mutual Automobile Ins. Co. v. Campbell, 2002, at 419). The Court readily agreed that State Farm's handling of the claims against the Campbells was shoddy. State Farm employees tampered with company records to make Campbell look less blameworthy, and "disregarded the overwhelming likelihood of liability and the near-certain probability that . . . a judgment in excess of the policy limits would be awarded," and State Farm's trial counsel initially assured the Campbells that their assets were safe, and thereafter told them to get ready to sell their assets to pay the judgment (State Farm Mutual Automobile Ins. Co. v. Campbell, 2002, at 421). While the Court agreed State Farm's conduct was reprehensible and warranted an award of punitive damages, it felt a "more modest punishment" would satisfy Utah's legitimate interests (State Farm Mutual Automobile Ins. Co. v. Campbell, 2002, at 419-20).

The Court deplored the Campbell's strategy of using their case "as a platform to expose, and punish, the perceived deficiencies of State Farm's operations throughout the country" and framing their claim as a chance to "rebuke State Farm for its nationwide activities" (State Farm Mutual Automobile Ins. Co. v. Campbell, 2002, at 420). The Court noted that a "State cannot punish a defendant for conduct that may have been lawful where it occurred" and "does not have a legitimate concern in imposing punitive damages to punish a defendant for unlawful acts committed outside of the State's jurisdiction" (State Farm Mutual Automobile Ins. Co. v. Campbell, 2002, at 421). Further, the Campbells conceded that much of State Farm's conduct was lawful where it occurred, but claimed it was admissible to establish State Farm's motive against them. The Court rejected this argument, because, while evidence of lawful out-of-state conduct is admissible to show deliberate and culpable conduct in a state where the conduct is tortuous, that conduct "must have nexus to the specific harm suffered by the plaintiff" and "the jury must have been instructed . . . that it may not use evidence of out-of-state conduct to punish a defendant for action that was lawful in the jurisdiction where it occurred" (State Farm Mutual Automobile Ins. Co. v. Campbell, 2002, at 422).

Furthermore, the Court insisted, the Utah courts wrongfully "awarded punitive damages to punish and deter conduct that bore no relation to the Campbells' harm," because "a defendant should be punished for the conduct that harmed the plaintiff" rather than for his unsavory business practices that had nothing to do with the plaintiff's injuries. Such a punishment is violative of the Due Process clause, because it "creates the possibility of multiple punitive damages awards for the same conduct," nonparties not being bound by the judgment obtained by another plaintiff. Hence the Utah courts erred by "permitting evidence pertaining to claims that had nothing to do with third-party lawsuit [to be] introduced at length," and by permitting State Farm to be punished for misconduct occurring over a twenty-year period that had nothing to do with the Campbells' injuries (State Farm Mutual Automobile Ins. Co. v. Campbell, 2002, at 424). Rather, "the conduct that harmed [the Campbells] is the only conduct relevant to the reprehensibility analysis" (State Farm Mutual Automobile Ins. Co. v. Campbell, 2002, at 424).

In examining the second *Gore* guidepost - the disparity between the actual or potential harm suffered by the plaintiff and the punitive damages award - the Court reemphasized its reluctance to impose a bright-line ratio which a punitive damages award cannot exceed," but also observed "that, in practice, few awards exceeding a single-digit ratio between punitive and compensatory damages, to a significant degree, will satisfy due process." For that reason, the Court stated, "[s]ingle-digit multipliers are more likely to comport with due process, while still achieving the State's goals of deterrence and retribution, than awards with ratios in the range of 500 to 1 . . . or, in this case, of 145 to 1" (State Farm Mutual Automobile Ins. Co. v. Campbell, 538 U.S. at 425). The Court, however, did not want create "rigid benchmarks that a punitive damages award may not surpass," acknowledging that "particularly egregious" conduct which results "in only a small amount of economic damages" might surpass the single digit ratio range, while a substantial award of compensatory damages might warrant "a lesser ratio, perhaps only equal to compensatory damages, can reach the outermost limit of the due process guarantee" (State Farm Mutual Automobile Ins. Co. v. Campbell, 538 U.S. at 425; Pacific Mutual Life Ins. Co. v. Haslip, 1991; BMW of North America, Inc. v. Gore, 1996).

With respect to the ratio between the punitive and compensatory damages awarded to the Campbell, the Court observed: the Campbells were awarded substantial compensatory damages in the amount of $1 million; the Campbells' damages were economic in nature, rather than physical injuries; the Campbells' economic injuries were minor and were limited to an eighteen-month period during which State Farm refused to pay the verdict amount in excess of the policy limit; and the Campbells' compensatory damages covered the distress and humiliation they suffered, and the punitive damages award was duplicative to that award. Further, the justifications advanced by the Utah Supreme Court to sustain the punitive damages award - potential injuries suffered by policy holders residing in Utah and the wealth of State Farm - were insufficient. There was little evidence of harm to Utah's residents, and State Farm's healthy balance sheet has little or nothing to do with the harm suffered by the Campbells (State Farm Mutual Automobile Ins. Co. v. Campbell, 538 U.S.

at 427). Hence there was no justification for the Utah Supreme Court to sustain the disparate ratio between the Campbells' compensatory damages award and the punitive damages award.

With respect to the third guidepost - the difference between this remedy and the civil penalties authorized or imposed in comparable cases - the Court observed that the "most relevant civil sanction under Utah state law for the wrong done to the Campbells appears to be a $10,000 fine for an act of fraud, an amount dwarfed by the $145 million punitive damages award" (State Farm Mutual Automobile Ins. Co. v. Campbell, 538 U.S. at 428). Further, the Utah Supreme Court's attempted linkage of the punitive damages award to the possible loss of State Farm's business license, the possible disgorgement of profits, and the possible imprisonment of State Farm employees, was not only speculative but linked out-of-state conduct that had nothing to do with the Campbells injuries.

Because the application of the three *Gore* guideposts to the facts established by the Campbells, particularly in light of the substantial compensatory damages award, should have resulted in an award of punitive damages at or near the amount of compensatory damages awarded, the Court concluded punitive damages in the amount of $145 million "was neither reasonable nor proportionate to the wrong committed, and it was an irrational and arbitrary deprivation of the property of the defendant" (State Farm Mutual Automobile Ins. Co. v. Campbell, 538 U.S. at 429). On balance *State Farm* clarified several issues in the due process review of punitive damages awards. First, *State Farm* more clearly states the elements forming the basis for concluding the defendant's conduct was reprehensible: (1) the harm caused was physical in nature, rather than economic; (2) defendant's conduct showed indifference or reckless disregard of the health and safety of others; (3) the injured party was financially vulnerable; (4) defendant's wrongful conduct involved repeated actions, rather than an isolated act; and (5) the injury inflicted was the result of intentional malice, trickery or deceit, rather than an accident. Second, *State Farm* addressed the territoriality of the defendant's conduct in the examination of reprehensibility of conduct. States cannot impose punitive damages for conduct that was lawful where it occurred or for unlawful acts committed outside of the state's jurisdiction. Likewise, punitive damages awards are restricted to the conduct that actually harmed the plaintiff, and States cannot impose punitive damages for defendant's conduct that lacks a nexus to the injuries suffered by the Plaintiff, because it creates the risk of multiple damages awards for the same conduct. In other words, punitive damages are restricted to the conduct that actually caused the plaintiff's injuries rather than for sleazy or unsavory conduct that is not causally linked to the plaintiff's injuries. Third, *State Farm* clarified the use of the ratio of punitive and compensatory damages in assessing whether due process requirements have been met (Thomas, 2006). Single digit ratios (perhaps not greater than 4 to 1) are likely to pass muster, particularly when the basis of the compensatory and punitive damages awards is duplicative; larger ratios will probably not, unless particularly odious conduct caused minor economic injuries, the injury was hard to detect, or the non-economic injury was difficult to determine.

In the final analysis, *State Farm* sent several strong signals on future evaluations of punitive damages: (1) state courts cannot award punitive damages for out-of-state conduct that is lawful where it occurred; (2) state courts cannot award punitive damages for unlawful acts committed outside of the state's jurisdiction, unless that conduct is specifically related to the harm suffered by the plaintiff; (3) punitive damages cannot be awarded to punish conduct that injured individuals who are not before the court, but are restricted to punishment for the harm suffered by the plaintiff; (4) except for those cases in which particularly egregious conduct causes minor economic damages, the ratio of punitive damages to compensatory damages should normally not exceed a single digit; (5) punitive damages should not be awarded for potential harm to other state residents unless the potential harm is the same harm suffered by the plaintiff; (6) the wealth of the defendant should not influence the punitive damages award unless it has direct bearing on the harm suffered by the plaintiff; and (7) punitive damages can be assessed by examining analogous civil penalties that can be awarded for similar conduct, but not criminal penalties. As will be seen below, however, some of these signals were not clearly understood by the Oregon Court of Appeals and the Oregon Supreme Court.

WILLIAMS ON REMAND TO COURT OF APPEALS OF OREGON

On remand, the Court of Appeals of Oregon applied the three *Gore* guidelines as refined by *State Farm*. With respect to the first guideline, the Court emphasized that the defendant's conduct was reprehensible, particularly in light of (1) the sheer magnitude of defendant's misconduct, i.e., the length of time during which it intentionally mislead the public, the number of consumers injured or killed, and the nature of the physical injuries inflicted; (2) the defendant's knowledge that its conduct would harm others; (3) defendant's pecuniary motive; (4) defendant's engagement in repeated misconduct; and (5) defendant's intentional disregard and concealment of the results of its own research (Williams v. Philip Morris Inc., 193 Ore. App. 527, 2004, 557-563).

> With respect to the second guideline, the Court decided that the punitive damages awarded did not exceed the single-digit ratio carrying the presumption of constitutional invalidity, given the potential damages inflicted on residents of Oregon through defendant's fraudulent promotional scheme (Williams v. Philip Morris Inc., 193 Ore. App. 527, 2004, at 559).

With respect to the third guidepost, the Court justified the consideration of Philip Morris' wealth in making the punitive damages award on two grounds: (1) a large punitive damages award was necessary to punish Philip Morris, because a small award would be considered merely a nuisance or a cost of doing business, and (2) a large punitive damages award enacted a disgorgement of profits earned over decades of misconduct (Williams v. Philip Morris Inc., 193 Ore. App. 527, 2004, at 563).

Based on the above noted analysis of the three *Gore* guideposts, the Court concluded the $79.5 million punitive damages award did not violate the Due Process Clause. In reaching its decision, the Oregon Court of Appeals once again struggled to balance the *Gore* criteria for evaluating punitive damage awards with the Oregon Supreme Court's application of the *Gore* criteria in *Parrott*. Critically, the Oregon Supreme Court in *Parrott* permitted the examination of both the actual harms caused and harms that were likely to result in determining the reprehensibility of the defendant's conduct. Hence the Oregon Court of Appeals was able to conclude that the ratio between the actual and potential harms caused by Philip Morris' conduct and the punitive damage award was a single digit ratio, particularly because the same conduct that injured Jesse Williams actually injured and potentially harmed many other Oregon residents (Williams v. Philip Morris Inc., 193 Ore. App. 527, 2004, 546-547).

WILLIAMS ON APPEAL TO THE SUPREME COURT OF OREGON

The Supreme Court of Oregon granted Philip Morris' petition for review, and in its opinion resolved two issues raised by Philip Morris: (1) whether the court should have instructed the jury that "an award of punitive damages must bear a reasonable relationship to the harm caused to the plaintiff and that punitive damages cannot be imposed for alleged harm to non-parties, and (2) whether the punitive damages awarded were "unconstitutionally excessive in violation of the Due Process Clause (Williams v. Philip Morris, Inc., 340 Ore., 2006).

In addressing the first issue, the Court rejected Philip Morris' argument that *Campbell* overruled state rules permitting the court to consider harms to individuals not before the court, and noted that under Oregon law "the jury could consider whether Williams and his misfortune were merely exemplars of the harm that Philip Morris was prepared to inflict on the smoking public at large" in assessing a punitive damages award (Williams v. Philip Morris, Inc., 340 Ore. at 51). Philip Morris contended that the following language in *Campbell* prohibits states from awarding punitive damages for damages caused by nonparties to the lawsuit:

> Due process does not permit courts, in the calculation of punitive damages, to adjudicate the merits of other parties' hypothetical claims against a defendant under the guise of the reprehensibility analysis . . . Punishment on these bases creates the possibility of multiple punitive damages awards for the same conduct; for in the usual case nonparties are not bound by the judgment some other plaintiff obtains" (Williams v. Philip Morris, Inc., 340 Ore. at 52).

The Court rejected that argument, however, because "Philip Morris takes the . . . quoted material . . . out of context. The quote referred only to dissimilar acts and dissimilar claims; the Court intended to prohibit a punitive damages award from becoming a referendum on a corporate defendant's general behavior as a citizen" (Williams v. Philip Morris, Inc., 340 Ore. at 52). In the Oregon Supreme Court's view, the quoted language permits courts to admit evidence "of *similar* conduct against other parties" (Williams v. Philip Morris, Inc., 340 Ore. at 53, emphasis in original). Hence, Philip Morris' proposed jury instruction misstated Oregon law, because it would have prevented the jury from punishing Philip Morris for inflicting the same harms Williams suffered on other Oregonians through the same conduct that caused Williams' injuries and in the same way. In other words, in assessing the reprehensibility of Philip Morris' conduct, the jury may "consider evidence of similar harm to other Oregonians caused (or threatened) by the same conduct" (Williams v. Philip Morris, Inc., 340 Ore. at 55).

In addressing the second issue - whether the punitive damages awarded were excessive in violation of the Due Process Clause - the Court examined the three *Gore* guideposts. With respect to the first guidepost, the Court decided "there can be no dispute that Philip Morris's conduct was extraordinarily reprehensible" (Williams v. Philip Morris, Inc., 340 Ore. at 55). Philip Morris knew smoking caused serious and fatal disease, but continued to mislead the public for nearly half a century about the health risks associated with smoking. Philip Morris' scheme caused smokers to become addicted to cigarettes and to suffer serious illness and death. Philip Morris harmed a broad swath of Oregonians beyond those who became ill, namely all those smokers who kept buying cigarettes because of Philip Morris' deceit and who "*risked* serious illness or death for as long as they remained deceived (Williams v. Philip Morris, Inc., 340 Ore. at 56, Emphasis in original). Philip Morris inflicted physical injury on its addicted customers, was utterly indifferent to the injuries inflicted on Oregonians through its deceit, and engaged in "a carefully calculated program spanning decades" and employing trickery and deceit. Hence, the Court concluded the first *Gore* guidepost "favors a very significant punitive damages award" (Williams v. Philip Morris, Inc., 340 Ore. at 56).

In considering the second *Gore* guidepost - the ratio between the compensatory and punitive damages awards - the Court recognized that it could consider the harm actually suffered by the plaintiff and the potential harm suffered by the plaintiff, but could not consider the estimated harm inflicted on others. When the harms suffered by others were removed from consideration in calculating the ratio, the *Gore* guidepost was not met, because "[a]ll arguable versions of the ratios substantially exceed the single-digit ratio . . . that the Court has said ordinarily will apply in the usual case "(Williams v. Philip Morris, Inc., 340 Ore. at 60-62).

In considering the third *Gore* guidepost - comparable civil or criminal penalties - the Court concluded that the Oregon Court of Appeals misunderstood the guidepost, and incorrectly determined that no comparable sanctions existed. With respect to civil penalties, the Oregon Supreme Court noted that the parties failed to cite or bring comparable civil penalties to the Court's attention and that it did not find any in its own investigation. With respect to criminal penalties, the Court determined that Philip Morris's conduct "would have constituted second-degree manslaughter," which carries a penalty of up to ten years in prison and imposes a $50,000 fine on corporations that commit crimes in that same class. Recognizing that Philip Morris engaged in its conduct over many years and that its conduct caused many deaths, the Court concluded that the punitive damages award met the third guidepost (Williams v. Philip Morris, Inc., 340 Ore., at 57-60).

The Supreme Court of Oregon, therefore, was confronted by a situation in which the punitive damages award was supported by two *Gore* guideposts (reprehensibility of conduct and comparability of criminal sanctions) but was not supported by the third (ratio of punitive and compensatory damages). Recognizing that the "*Gore* guideposts were not bright-line tests" but merely guideposts and that reprehensibility of conduct was the most important of the three guideposts, the Court concluded (1) that, because Philip Morris' conduct was "extraordinarily reprehensible, by any measure of which [the Court] was aware," the $79 million punitive damages award "comported with due process," and (2) that the decision of the Oregon Court of Appeals should be affirmed (Williams v. Philip Morris, Inc., 340 Ore. at 62-63).

Very clearly, the starting point of the Oregon Supreme Court's analysis - determining that the language in *Gore* prohibiting an award of punitive damages for injuries inflicted on individuals not before the court was restricted to instances of dissimilar conduct and dissimilar claims - caused the Court to interpret the *Gore* criteria in the manner it did. More particularly, because the same type of conduct that injured Jesse Williams also actually injured or potentially harmed countless residents of Oregon, the Court could conclude that Philip Morris' conduct was reprehensible as measured by actual harms and potential injury caused to the residents of Oregon. Similarly, because Oregon's punitive damages statute not only expressly permits punitive damages to be awarded for injuries inflicted by the same conduct on other residents of Oregon but also restricts subsequent punitive damages awards for the same conduct, the Oregon Supreme Court concluded that the requested jury instruction was properly denied on the grounds it misstated Oregon law. Quite simply, the Oregon statute eliminates ensuing awards of punitive damages for the same conduct, thereby eliminating in its entirely Philip Morris' contention that awards should not be made for parties not before the court. Finally, because there was no precedent guiding the Oregon Supreme Court in situations in which the three *Gore* factors pointed in different directions, the Court's determination that the more substantial factors supported the punitive damages award is certainly reasonable. Unfortunately, however, as will be seen below, these issues were not addressed by the United States Supreme Court.

WILLIAMS ON APPEAL TO UNITED STATES SUPREME COURT

The United States Supreme Court reversed the Supreme Court of Oregon, and ruled that the Due Process Clause prohibits an award of punitive damages based in part on the jury's "desire to *punish* the defendant for harming persons who are not before the court (*e.g.*, victims whom the parties do not represent)," because "such an award would amount to a taking of 'property' from the defendant without due process" (Philip Morris USA v. Williams, 2007). Awarding punitive damages "to punish a defendant for injury that it inflicts upon . . . those who are strangers to the litigation" violates due process protections for three reasons (Philip Morris USA v. Williams, 2007, at 1063). First, due process requires that an individual should not be punished without first having "the opportunity to present every available defense" (Philip Morris USA v. Williams, 2007). This principle was violated, because Philip Morris was punished for an injury to a non-party without the opportunity to defend against the charge, for example by establishing that the non-party victim "knew that smoking was dangerous or did not rely on defendant's statements to the contrary" (Philip Morris USA v. Williams, 2007). Second, in the absence of evidence showing the number of victims, the extent of their injuries, and the manner in which their injuries occurred, employing punitive damages as a punishment for inflicting injuries on non-party victims subjects the defendant to speculative awards. This violates due process, because it subjects the defendant to an award of punitive damages that is arbitrary and uncertain and without notice. Third, the Court emphasized, there simply is "no authority supporting the use of punitive damages awards for the purpose of punishing a defendant for harming others" (Philip Morris USA v. Williams, 2007).

The United States Supreme Court agreed that evidence of actual harm to nonparties or grave risk to the public was relevant to show reprehensibility of the defendant's conduct, provided the jury is informed that the purpose of admitting that evidence was to establish reprehensibility and not to punish for harm caused to strangers. Due process, the court noted, requires "that juries are not asking the wrong question, *i.e*., seeking, not simply to determine reprehensibility, but also to punish for harm caused strangers" (Philip Morris USA v. Williams, 2007,at 1064).

Finally, the United States Supreme Court concluded that the following jury instruction requested by the defendant should have been given: "'you *may* consider the extent of harm suffered by others *in determining what [the] reasonable relationship is'* between Philip Morris' punishable misconduct and harm caused to Jesse Williams, *'[but] you are not to punish the defendant for the impact of its alleged misconduct on other persons, who may bring lawsuits of their own* in which other juries can resolve their claims . . . ." This instruction is required, the Court explained, whenever there is a risk that the jury, in considering the reprehensibility of the defendant's conduct, may seek to punish the defendant (Philip Morris USA v. Williams, 2007).

Having concluded that the Oregon Supreme Court "applied the wrong constitutional standard when considering Philip Morris' appeal," the United State Supreme Court remanded the case to the Oregon Supreme Court to apply the *Williams* standard: a jury may not punish for the harm caused to those who are not before the court, *i.e*., non-party victims (Philip Morris USA v. Williams, 2007, at 1065).

Counting the Votes in *Gore*, *Campbell* and *Williams*

The United States Supreme Court's decisions in *Gore*, *Campbell* and *Williams* were all majority decisions. In *Gore*, Justice Stevens, joined by Justices O'Connor, Kennedy, Souter and Breyer, authored the opinion. In *Campbell*, Justice Kennedy, joined by Justices Stevens, O'Connor, Souter, Breyer and Rehnquist, authored the opinion. In *Williams*, Justice Breyer, joined by Justices Alito, Kennedy, and Souter and by Chief Justice Roberts, authored the opinion. Those votes can be summarized as follows:

Decision	**Justices joining majority decision**					
Gore	*Stevens*	O'Connor	Kennedy	Souter	Breyer	
Campbell	Stevens	O'Connor	*Kennedy*	Souter	Breyer	Rehnquist
Williams		Alito	Kennedy	Souter	*Breyer*	Roberts
(Italics denote author of opinion.)						

In all three punitive damages decisions, at least a majority of the members of the United States Supreme Court agree that a grossly excessive punitive damages award violates the Due Process Clause, because it deprives the defendant of fair notice of the severity of the penalty a state may impose to punish the defendant's misconduct. In *Gore*, the Court described the three indices to be employed in evaluating the punitive damages award: the degree of reprehensibility of defendant's conduct, the ratio between punitive and compensatory damages, and comparable penalties that can be imposed on similar misconduct. In *Campbell*, the Court refined the three indices. Evidence seeking to establish the reprehensibility of the defendant's conduct was restricted to conduct that was related to the injuries the plaintiff suffered and that was unlawful in the state where it occurred or over which the state had jurisdiction, and the ratio between punitive damages and compensatory damages should normally not exceed a single digit. In *Williams*, the Court ruled that punitive damages cannot be awarded for harming persons who are not before the court.

Five members of the United States Supreme Court joined the majority opinion in both *Gore* and *Campbell*: Stevens, J., O'Connor, J., Kennedy, J., Souter, J., and Breyer, J. Following *Campbell*, Justice O'Connor retired and Chief Justice Rehnquist died. Justices Kennedy, Souter and Breyer remained in the majority in *Williams*; Chief Justice Roberts joined the majority in place of Chief Justice Rehnquist, and Justice Alito joined the majority in place of Justice O'Connor. Justice Stevens, who joined the majority in both *Gore* and *Campbell*, dissented in *Williams*. In Justice Stevens' view, the Oregon Supreme Court properly applied *Gore* and *Campbell* to Philip Morris' egregious conduct, and there is no reason to prohibit a state from imposing a significant punishment where the defendant's conduct harmed individuals not before the court (Philip Morris USA v. Williams, 2007, at 1065). Hence it appears (1) that the *Gore* criteria for evaluating punitive damages awards remain intact, (2) that the *Campbell* refinements of those criteria - requiring a nexus between the harm inflicted on others and the harm suffered by the plaintiff and the consideration of the territoriality of the conduct - will continue, and (3) that the *Williams* restriction on considering injuries to others for the sole purpose of evaluating reprehensibility of conduct and the *Williams* limitation of punitive damages awards to injuries suffered by the parties before the court will persist in the future. As was the case in all three decisions, substantially diminished punitive damages awards will be the rule in the future, yet another blow to plaintiffs' attorneys, for two main reasons: (1) in the event a large compensatory damages award is made, the ratio to be applied is small (perhaps one to one), and (2) in the event of minimal economic damages coupled with particularly egregious conduct - the only exception to single digit ratios expressly allowed - a higher ratio will be applied to a much smaller number (Orey, 2007). Hence, lower but more predictable punitive damages awards will be the rule in the future.

This can be illustrated by reviewing the punitive damages awards in *Gore*, *Campbell* and *Williams*. In *Gore* the punitive damages award would be substantially less, because (1) BMW's conduct did not rise to the level of reprehensibility, (2) modest economic damages (perhaps $4,000) in the absence of reprehensible conduct would be factored by single digit ratio (say 9 to 1), and (3) the civil penalty for deceptive practices is modest ($2,000). Hence the jury award of punitive damages in the amount $4 million in *Gore* would likely be reduced to under $40,000. Similarly, the punitive damages awarded in *Campbell* would shrink sharply. In *Campbell*, the defendant's conduct was shabby but not reprehensible; the Campbells suffered only modest economic damages (say $10,000), and the corresponding civil penalty was only $10,000. Because the defendant's conduct was not reprehensible, the ratio cannot exceed a single digit, and assuming a ratio of 9 to 1 is employed, the punitive damage award would not exceed $90,000. Hence the jury award of punitive damages in the amount of $145 million in Campbell would be reduced significantly to perhaps $90,000. In *Williams*, the conduct of Philip Morris was deemed clearly to be reprehensible, but the compensatory damages award was capped at $500,000, and there was no comparable civil penalty. Under these circumstances, because the compensatory damages awarded may or may not be deemed substantial, a single digit may be employed (say 9 to 1) if the damages are deemed substantial and a ratio of 1 to 1 would be employed if the damages are deemed substantial. Either way, the punitive damages award would not exceed $4,500,000. Hence the jury award of punitive damages in the amount of $79,000,000 would shrink to no more that $4,500,000.

Impact of the *Gore*, *Campbell*, and *Williams* Trilogy on Future Punitive Damages Claims

In his majority opinion in *Williams*, Breyer spoke of the need of developing "proper standards that will *cabin* the jury's discretionary authority" in awarding punitive damages (Orey, 2007). There can be little doubt that the addition of *Williams* completes the cabin's construction.

By spelling out the three "guideposts" used to determine whether a punitive damages award is excessive, *Gore* provides the basic frame and external shell of the structure. Excessiveness of punitive damages awards is determined by examining in order of importance: (1) the reprehensibility of the defendant's conduct; (2) the disparity between the harm or potential harm suffered by the plaintiff and the punitive damages award; and (3) the comparability of the punitive damages award and the civil penalties authorized in analogous cases. The first guidepost considers the nature of the damages suffered by the plaintiff. If the harm suffered was physical rather than economic, if the defendant's conduct shows indifference or reckless disregard to the health and safety of others, if the injured party was financially vulnerable, if the defendant's conduct was repeated over time, and if the defendant employed trickery, deceit or intentional malice, the defendant's conduct can be considered reprehensible. The second guidepost compares the ratio between the punitive and compensatory damages awards. If the ratio strikes the court as too high, the court is alerted to be suspicious in evaluating the punitive damages award. The third guidepost compares the punitive damages award to civil penalties that can be imposed for comparable misconduct in order to gauge the whether the former imposes excessive deterrent to the misconduct in question, without reference to the wealth of defendant.

Campbell fits out the interior walls of the cabin by refining the three guideposts. In considering the reprehensibility of the defendant's conduct, the focus must be on the specific conduct that injured the plaintiff; conduct not related to the plaintiff's injuries should not be considered, regardless of whether or not it is disreputable. Similarly, conduct that is lawful where it occurs or unlawful acts outside the state's jurisdiction cannot justify the imposition of punitive damages. Hence only unlawful conduct which has a nexus to the specific injury suffered by the plaintiff can be considered in evaluating reprehensibility, and consideration of that unlawful conduct is restricted to the issue of reprehensibility and cannot support punishment of the defendant. Otherwise the defendant can be subject to multiple punitive damages awards for the same conduct. In considering the second guidepost - the disparity between compensatory and punitive damages - ratios in excess of single digits are highly suspect, particularly where it is apparent that the compensatory damages award covers injuries (e.g. distress and humiliation) that are duplicative of punitive damages awards. In considering the third guidepost - the examination of comparable civil penalties - the focus should be on appropriate civil penalties designed to deter the type of conduct performed by defendant, rather than on penalties that might be imposed for conduct that has nothing to do with the plaintiff's injuries. In other words, punitive damages are restricted to the conduct that actually caused the plaintiff's injuries rather than for sleazy or unsavory conduct that is not causally linked to the plaintiff's injuries.

Williams supplies the cabin's roof. Punitive damages cannot be awarded to punish the defendant for injuring individuals who are not before the court or are strangers to the litigation, because the defendant is deprived of the opportunity to pursue a defense to the claimed injury, because, absent evidence of the extent and nature of such injuries, the defendant is subjected to a speculative and arbitrary judgment, and because there is no precedent supporting the use of punitive damages award to punish a defendant for hurting others. To prohibit such results in the future, juries will be instructed that they can consider injury to others only for the purpose of ascertaining reprehensibility of conduct and cannot use that evidence to punish the defendant.

CONCLUSION

The United States Supreme Court in *Williams* has ruled that the Due Process Clause prohibits an award of punitive damages that punishes the defendant for harming individuals who are not before the Court, because (1) the defendant is deprived of the opportunity to present a defense to the non-party's charge, (2) in the absence of clear evidence demonstrating the non-parties injuries and causation, the punitive damages award is based on speculation alone, and (3) there is no precedent supporting such an award. Further, while the infliction of harm on non-parties is relevant to demonstrate reprehensibility of conduct, the jury must be instructed that such evidence cannot be used to support punishment for harm caused to those non-parties. In reaching its decision, however, the Court failed to address the impact of Oregon's punitive damages statute. This statute prohibits subsequent punishments for injuries inflicted on non-parties as a result of the same conduct, i.e., there is only one punishment for the reprehensible conduct harming non-parties rather than multiple punishments for those injuries. Hence, the *Williams* decision entirely undercuts the imposition of punitive damages for harms to non-parties even if it is only once.

Equally important, the *Williams*' refinement of the *Gore* and *Campbell* factors will likely eliminate punitive damages awards that exceed a single digit ratio when compared to compensatory damages. Notably, the Court has restricted the relevance of the harms to non-parties to the first factor (reprehensibility of conduct) and prohibited the consideration of harms to non-parties in crafting the punitive damages award. Hence, in applying the second factor, the only damages that can be considered in computing the ratio are the actual harms suffered by the plaintiff compared to the punitive damages awarded. This necessarily will result in the virtual elimination of significant punitive damages awards, because the Court in *Campbell* indicated that a significant award of compensatory damages should result in a smaller ratio (perhaps one to one) of punitive damages compared to compensatory damages, and the narrow exception to a single digit ratio (particularly egregious conduct resulting in minimal economic damages) applies a higher ratio to a much smaller number.

Finally, given the voting pattern in *Williams*, it appears that the *Gore* criteria for evaluating punitive damages awards remain intact, that the *Campbell* refinements of those criteria will continue, and that the *Williams* restriction on considering injuries to others for the sole purpose of evaluating reprehensibility of conduct and the *Williams* limitation of punitive damages awards to injuries suffered by the parties before the court will persist in the future. In short, the plaintiff's bar should anticipate substantially diminished punitive damages awards in the future.

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HDTV DIVISION OF GLOBAL ELECTRONICS, INC.

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CASE DESCRIPTION

The primary objective of this case is to describe realistic capital budgeting issues within a large organization. The case illustrates ways that staff inside a corporate finance department (and in related departments) position themselves in the capital planning process. The case also stresses steps that a large firm can take to leverage its size to gain the maximum benefit of investment projects. Further,, the case demonstrates sensitivity analyses in the capital budgeting process, and the resulting internal rates of return.

We suggest the case be used to follow the related case "HDTV Systems", which shows the firm as a medium-sized enterprise and its capital budgeting issues before becoming a division of Global Electronics. This case should be used for students who have been exposed to capital budgeting in a prior course, either undergraduate or graduate. Class time should not exceed two hours, with approximately four hours of student preparation time.

CASE SYNOPSIS

This case involves a need for a decision regarding a large capital expenditure. Students will find that capital planning involves not only the use of accepted capital budgeting techniques, but also a considerable impact based on staff viewpoints that reflect their particular department's biases. Also explicitly presented are multiple levels of investment worth based on alternative, realistic assumptions. Students can verify IRR and payback calculations using Excel, and they will see that capital budgeting involves fragile forecasts and biases that managers bring to the analytical process.

INTRODUCTION

In the age of economic globalization, the survival and prosperity of most businesses depends on their ability to recognize new markets, identify higher quality yet cheaper sources of inputs, and establish well-coordinated networks between its internal units in order to take advantage of scale and strategic locations. Optimal capital budgeting procedures must take all these influences on revenues and operating expenses into consideration in meeting the expectations of shareholders. This perspective must permeate all layers of the organization and take root in its culture in order for the broad objectives of the enterprise to be achieved. A higher standard for capital allocation must be utilized demonstrating the opportunity available to better align resources with enterprise objectives and realize greater returns.

BACKGROUND

Global Electronics, Inc. is a multinational, multi-billion dollar enterprise. It operates several regional organizations across the globe, comprised of numerous operating divisions with the stated goals of creating customer loyalty, maximizing return on invested capital, and maintaining a competitive advantage. It faces challenges similar to many other large organizations as it attempts to ensure that its operating units have aligned goals, and that those goals reflect the realities and requirements for achieving success for the organization. The HDTV Division, which Global had recently acquired, manufactures strategically important products and is considered crucial to the corporation's future success. Its acquisition by Global Electronics added essential products to Global's full line of electronic products.

HDTV Division had demonstrated limited growth potential and lackluster profitability due to the saturated market it serves and fierce competition in the electronics industry. Although the division has managed to control operating costs through an aggressive productivity focus, the level of profitability has remained below that which is expected by the parent company. It was becoming increasingly evident that disparities exist between the incremental returns projected in capital proposals and the aggregated investment portfolio outcomes that are actually achieved. In addition, no significant strides have been made in market share.

In early 2007, at the urging of the headquarters' office, the division general manager, Mr. Bill Walsh, commissioned a review of the products the HDTV Division offered and the changes required to leverage the division's sales growth into improved pre-tax income and cash flow. It had become apparent that the division was falling behind in recognizing the changing tastes of a more sophisticated consumer. The general manager also recognized that sub-optimal production techniques were still in-place at a number of plants, which resulted in unfavorable product costs. It was extremely difficult to pass on those costs in terms of higher prices. The overall resulting division financial picture over the past five years was mediocre as seen below:

Year	2002	2003	2004	2005	2006
IRR	10%	13%	13%	12%	11%
Cost of Capital	9.25%	9.5%	10%	10.25%	10.50%

Global Electronics evaluated capital expenditures using the same measurements as HDTV Systems, namely the IRR and the payback period. However, there was little that Global could do to affect the cost of capital since its determination was largely based on monetary policy, the cost of financing sources available to the firm, and taking the firm's debt usage as given. Therefore, the challenge was in improving sales and operational efficiency to significantly improve the returns from invested capital.

The New HDTV Project

After conducting a market study, a proposal was made to introduce a new high-definition television using a new, leading edge display technology. This was an adaptation of the high definition project that HDTV Systems had considered but postponed. The product was named "UHDTV" to reflect the ultra high definition picture that the television delivers. In the first phase, the construction of a modern factory was recommended to build the new line of televisions. The general manager felt confident that consumers would rush to retail stores to replace their current television sets.

Ms. Violet Cunningham, the division capital planning manager, was keenly aware of the importance of the new product to the marketing staff. She was also aware of the importance of the project to the division which was already operating below capacity, yet the new product involved a capital proposal for a new plant. Therefore, she anticipated a close examination of the capital request.

Capital Expenditure Analysis

The existing capital request process started with divisional evaluation of projects. The finance department at headquarters then gathered the requests from the various divisions and verified the conformance of the analysis submitted with company capital expenditure policy. Next, the finance department assembled the final group of requests that met the approval criteria and final approval from executive management was sought.

Ms. Cunningham knew that in order to get a project approved, she must be able to convincingly present the qualitative and quantitative benefits of the project. To accomplish this, she used the Company's standard Capital Request form which is divided into sections labeled "Project Rationale" and "Expected Financial Benefits".

The plant manager, Mr. Gene Thomson, has worked with the General Manager (Mr. Walsh) for 11 years and in general, they view capital requests similarly. In particular, they agree on the following basic premises:

1. Capital requests are competitive across divisions. Divisions making the best case for their projects tend to get more projects funded.
2. In the past, executive management has looked favorably upon non-traditional factors like quality improvements, even when the project did not meet the overall payback and rate of return thresholds. Additionally, the corporate finance department has in the past applied varying financial thresholds, so requested projects sometimes face an ambiguous level of scrutiny.
3. The management and employees of the division prefer to manufacture as many of their product's components as possible to reduce reliance on external vendors and to provide employment security. Mr. Walsh feels his division was "burned" with two recent relationships that involved components made by other suppliers (one was another company division) that had quality shortfalls. In another instance, the division felt they could have manufactured a component at a lower price than was available from an outside vendor but could not secure the capital to do so. In the end, it was very difficult to balance total cost of quality impacts, current and future capital availability, and near-term pressures to reduce factory costs.
4. Marketing has historically made decisions for new model launches that frequently left minimal time to transform designs and manufacturing specifications into next-generation finished products. The demands of consumers and increasing competition have led to this compressed idea-to-production time cycle.

In April 2007, after consulting with Mr. Thomson and Mr. Walsh, Ms. Cunningham began preparing the capital request for the new television product and developed an initial range of IRR outcomes. Her first analysis resulted in a calculated IRR of 10%, while her second analysis resulted in an IRR of 13.5%. She also calculated a payback period of just over six years. The IRR and payback estimates were surprisingly similar to the estimates developed by HDTV Systems. The development of the IRR and payback is shown in the Exhibit below. The 13.5% IRR level clears the 12.5% cost of capital threshold for approval, but Ms. Cunningham is concerned that her initial calculation which produced an IRR of 10% might actually occur, because that IRR was based on assumptions about price and expenses that could actually result after the capital was spent.

EXHIBIT - Analysis of Capital Expenditure for Television Project by Global Electronics

IRR (Internal Rate of Return) Inputs and Calculations (in millions)	
Inputs:	
Project Capital, 100% at Year 0	$22
Revenues are Estimated over Eight Years	
Expenses as a % of Revenues	89%
One-time upfront start-up expenses as % of project costs	5%
Depreciation based on MACRS 7 Year Depreciable Life	
Working Capital based on Change in Revenues	20%
Tax Rate	37%
Salvage Value is included in Net Cash Flow on an after-tax basis	
Price Decline assumption	4%
Annual Net Cash Flow (NCF) Determination:	

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

OUTCOME I : INITIAL DIVISION ANALYSIS

	Change in	Change in	Change in	Subtotal	Subtotal	Change in	Change in	Salvage	Annual		SUPPLEMENTAL DATA - INITIAL DIVISION ANALYSIS				
Year	Revenue	Expenses	Deprec.		After Tax	Deprec	Work. Cap.	Value	NCF		Product	Expected	Cost per	Operating	Total Revenue
0									-22.0	Year	Price	Quantity	Unit[1]	Margin[2]	(Millions)
1	31.5	29.1	3.1	-0.7	-0.5	3.1	6.3		-3.7	1	900.00	35,000	579.87	0.36	31.5
2	67.5	60.1	5.5	1.9	1.2	5.5	7.2		-0.5	2	900.00	75,000	550.83	0.39	67.5
3	109.5	97.5	3.7	8.3	5.2	3.7	8.4		0.6	3	900.00	121,667	524.00	0.42	109.5
4	123.0	109.5	2.9	10.7	6.7	2.9	2.7		6.9	4	900.00	136,667	517.81	0.42	123.0
5	180.0	160.2	2.0	17.8	11.2	2.0	11.4		1.8	5	900.00	200,000	510.87	0.43	180.0
6	163.5	145.5	2.0	16.0	10.1	2.0	-3.3		15.4	6	900.00	181,667	511.50	0.43	163.5
7	120.0	106.8	2.0	11.2	7.1	2.0	-8.7		17.7	7	900.00	133,333	513.99	0.43	120.0
8	82.5	73.4	0.9	8.2	5.2	0.9	-7.5	3.0	15.4	8	900.00	91,667	510.68	0.43	82.5
INITIAL DIV. ANALYSIS IRR =			**13.5%**												

OUTCOME II : IRR with ANNUAL PRICE DROP in YEARS 4 through 8 and LOWER DEMAND

	Col 1	Col 2	Col 3	Col 4	Col 5	Col 6	Col 7	Col 8	Col 8		SUPPLEMENTAL DATA - OUTCOME III				
	Change in	Change in	Change in	Subtotal	Subtotal	Change in	Change in	Salvage	Annual			90%	of original demand		
Year	Revenue	Expenses	Deprec.		After Tax	Deprec	Work. Cap.	Value	NCF		Product	Expected	Cost per	Operating	Total Revenue
0									-22.0	Year	Price	Quantity	Unit[1]	Margin[2]	(Millions)
1	28.4	26.3	3.1	-1.1	-0.7	3.1	5.7		-3.3	1	900.00	31,500	588.23	0.35	28.4
2	60.8	54.1	5.5	1.2	0.7	5.5	6.5		-0.2	2	900.00	67,500	555.96	0.38	60.8
3	98.6	87.7	3.7	7.1	4.5	3.7	7.6		0.7	3	900.00	109,500	526.15	0.42	98.6
4	106.3	94.6	2.9	8.8	5.6	2.9	1.5		6.9	4	864.00	123,000	499.09	0.42	106.3
5	149.3	132.9	2.0	14.4	9.1	2.0	8.6		2.5	5	829.44	180,000	472.00	0.43	149.3
6	130.2	115.9	2.0	12.3	7.8	2.0	-3.8		13.6	6	796.26	163,500	454.09	0.43	130.2
7	91.7	81.6	2.0	8.1	5.1	2.0	-7.7		14.8	7	764.41	120,000	439.00	0.43	91.7

EXHIBIT - Analysis of Capital Expenditure for Television Project by Global Electronics															
8	60.5	53.9	0.9	5.8	3.6	0.9	-6.2	3.0	12.8	8	733.84	82,500	418.18	0.43	60.5
OUTCOME II : IRR			**11.9%**												
OUTCOME III : IRR from OUTCOME II plus 10% PURCHASE PRICE SAVINGS															
	Col 1	Col 2	Col 3	Col 4	Col 5	Col 6	Col 7	Col 8	Col 8		**SUPPLEMENTAL DATA - OUTCOME III**				
	Change in	Change in	Change in	Subtotal	Subtotal	Change in	Change in	Salvage	Annual			90%	of original demand		
Year	Revenue	Expenses	Deprec.		After Tax	Deprec	Work. Cap.	Value	NCF		Product	Expected	Cost per	Operating	Total Revenue
0									-19.8	Year	Price	Quantity	Unit[1]	Margin[2]	(Millions)
1	28.4	26.3	2.8	-0.8	-0.5	2.8	5.7		-3.4	1	900.00	31,500	582.07	0.35	28.4
2	60.8	54.1	5.0	1.7	1.1	5.0	6.5		-0.4	2	900.00	67,500	550.83	0.39	60.8
3	98.6	87.7	3.4	7.5	4.7	3.4	7.6		0.5	3	900.00	109,500	524.00	0.42	98.6
4	106.3	94.6	2.6	9.1	5.7	2.6	1.5		6.8	4	864.00	123,000	497.63	0.42	106.3
5	149.3	132.9	1.8	14.6	9.2	1.8	8.6		2.4	5	829.44	180,000	471.30	0.43	149.3
6	130.2	115.9	1.8	12.5	7.9	1.8	-3.8		13.5	6	796.26	163,500	453.33	0.43	130.2
7	91.7	81.6	1.8	8.3	5.2	1.8	-7.7		14.7	7	764.41	120,000	437.96	0.43	91.7
8	60.5	53.9	0.8	5.9	3.7	0.8	-6.2	3.0	12.8	8	733.84	82,500	417.51	0.43	60.5
OUTCOME III : IRR			**13.2%**								Notes: 1. Cost per unit is based on the change in expenses including depreciation, on an after tax basis. 2. Operating Margin is based on product price and cost per unit.				

As the division continued its analysis of the television capital request, Ms. Cunningham received a call from an analyst named Mr. Joe Vitera in the Company's corporate finance department:

J. Vitera: " Violet, we are nearly finished with our follow-up analysis of your prior television projects. I want to share our findings with you."

V. Cunningham: "Sure, how are we coming out on that project?"

J. Vitera: "Your expected IRR was 15%, but the actual return so far is only 11.5% by our estimation. We know that prices have held fairly steady and production volumes are OK, but our analysis shows that expenses eroded the expected return. My manager believes that either we have to cut costs or the project could be at risk."

V. Cunningham: "The labor agreement in late 2004 didn't help with increased wage and medical costs. We were advised by headquarters back in 2001 to assume more slowly escalating labor costs. Also, electrical components we buy from an outside supplier have been priced higher than originally projected. We were able to reduce other component costs, but not by enough to offset".

J. Vitera: "Yes, I agree with your explanations, but the return on the television project is still coming up too low. You may also need to factor in that Federated Electronics (a major competitor) is undercutting us on electronic product prices right now. Even though we've assumed fairly stable pricing, there are current indicators that this environment may be unfavorably changing. We may have to meet that threat while only realizing a modest price premium for our quality differential."

Based on this telephone call, Ms. Cunningham surmises that while both the division and corporate headquarters want this and other capital projects to show high returns, the capital request for the UHDTV project will continue to receive close examination. She returns to work on the capital request with this additional informational burden and she is increasingly aware of the concern at headquarters about pricing.

As the capital budgeting process continued for 2007, Ms. Cunningham tries to factor in all the various considerations that she can call upon in arriving at the final capital request for the new television line. Her estimates include a 4% annual price drop beginning in the fourth year of the project life, as well as a forecast of lower unit demand. These changes reduce the expected IRR to 11.9%, below the 12.5% cutoff (see Outcome II in the Exhibit). Since the 11.9% IRR is below the threshold, division management begins to believe the project is only viable with a "protect position" argument where the investment has the benefit of maintaining the company's presence in the market. Before the August 2007 capital request deadline, the division prepares to submit the project as an exception to the threshold. However, Mr. Walsh receives an email from the Procurement department indicating that another division of the company is putting in a capital request requiring equipment that can be purchased from the same vendor that the HDTV division plans to use for the new television production, and negotiations are underway to secure a discount from that vendor. This could benefit the UHDTV project.

Given the expected vendor discount, Ms. Cunningham is instructed by Mr. Walsh to assume a 10% reduction in the acquisition price of the production equipment. Based on the reworked capital request with the product price drop, the reduced demand forecast, and the reduction in the capital acquisition price from $22 million to $19.8 million, the expected IRR now stands at 13.2% (see Outcome III in the Exhibit).

Ms. Cunningham begins work on the "Project Rationale" section of the capital request form. She decides that she will develop this section by relating key company business objectives to the UHDTV project:

1. The product is expected to deliver innovation to the consumer through its leading edge display electronics not currently available on any current competitor models.

It is believed that the company will be the sole producer of the UHDTV technology for several years.

2. By offering a technologically advanced television at a small price premium over the competition, the division expects to increase market share. The estimated production volumes are modestly conservative.
3. While product quality is partially unknown at the outset and is better understood after the television is in use, tests of prototypes thus far are favorable even though the complexity of the product design has increased substantially. If high reliability occurs as planned, customers will become more likely to infer high quality attributes into other company products.
4. Because of the added costs for quality improvement and the cost of the sophisticated display, year-over-year targeted expense reductions are a weakness in the current plan.

The regional vice president, Ms. Lydia Parker, called her capital planning director, Mr. John Fremont, to discuss ways to identify winning projects that would enhance the overall performance of the HDTV Division and for that matter, all other divisions within the region. As a result of that discussion, the HDTV Division general manager, Mr. Bill Walsh, was asked to form a pilot committee of key people who would look at different aspects of capital budgeting. Using the new improvements identified, they were further requested to identify a new capital project that would make a significant impact on the bottom line of the division, utilizing the new capital budgeting processes to justify the proposal.

Meanwhile, when John Fremont saw the recommendation for the UHDTV television project arrive in his office mail, he requested that the division reconsider this capital proposal in light of the work the pilot committee was about to undertake. It might change their view toward the request.

The Pilot Committee

As Bill Walsh considered membership for the special assignment, he found that many of the same people who had been involved in the UHDTV project would also make strong candidates for the general capital study. He named the following people to the pilot committee:

- Gene Thomson, the plant manager for the existing television factory (and the slated plant manager for the new UHDTV facility)
- Violet Cunningham, the capital planning manager supporting the division
- Joan Wolford, the marketing manager for the television business
- David Maroney, the procurement manager for televisions, and

- Walter Blevins, a new but talented young design engineer just 11 months with the division

They were given six weeks to evaluate the current capital approaches, make recommendations for improvement, and identify and justify the next capital decision that the division should undertake to improve performance in a dramatic way. Following are additional elements of background information on the particular viewpoints taken by each team representative during the six week study and some direct excerpts from the report-outs where the team presented its conclusions and recommendations.

Marketing

Joan Wolford had led the extensive market research that resulted in many of the specifics of the UHDTV project. She remained a strong advocate for that project as it was proposed and was adamantly opposed to any delays to its launch schedule.

Joan recognized that the historical performance trends for the division were merely average, in her terms, but also believed the finance staff had assumed all the worst in the financial sensitivities for the UHDTV project. She felt the UHDTV was a hit and would be the investment that would begin to turn the division's performance around.

Marketing Conclusions / Recommendations

1. High definition televisions were strategically critical to the division. In Joan's view, however, this product category had been under-funded for several years and this was contributing significantly to lagging behind the competition and generating lackluster financial performance.
2. Through some new research, Joan discovered a complementary marketing opportunity that, if packaged with the UHDTV project, could turn a big hit into a mega-hit. Joan recommended that, for another $4.5 million in capital, the division could enter production of a television stand with built-in surge suppression and wiring. Given an additional $2 million in capital, the division could double available capacity for producing the stands. Joan believed they should enter the market strongly and secure commanding share quickly.

Design Engineering

Walter had not directly supported the UHDTV project, but in quickly reviewing the project's background, he determined there were in fact significant advances in electronics and picture quality.

It seemed to him that the HDTV Division had moved beyond some historical technical competencies in the design of this new product.

There were many parts and component designs that the UHDTV shared with other products, but there were also even more new parts, new dimensions and new materials. Out of curiosity, Walter contacted one of his counterparts in another region to check on the marketed designs and specifications there. He found many, very close similarities but few exact matches. During a committee meeting Walter had inquired about this observation but was quickly educated that unique consumer requirements on a region to region basis made it impossible to borrow much from elsewhere in the company.

Design Engineering Conclusions / Recommendations

1. Walter was not completely aligned with Joan's recommendations within the Marketing report. He did not dispute the research findings and agreed the design of the stand was "fairly straight-forward". However, he felt the stand did not draw upon any existing engineering organization talent, nor did it significantly leverage current equipment, products or designs.
2. Walter highlighted the risks of introducing new technologies, new materials, parts and components for what he termed, "essentially a hi-tech modification to our traditional product" – a comment that displeased Joan greatly.

Procurement

David Maroney had been with the HDTV division for a long time. He knew all the suppliers, and he knew the plant staff held strong opinions about approaches to strategic sourcing.

David had been instrumental in identifying the opportunities for leveraging the manufacturing equipment purchases that had been added late to the UHDTV financial justification. In the minds of some, it could save the project. David had combined purchases from two U.S. divisions, and approached a familiar U.S.-based supplier with volume-leveraged price negotiations.

There were dozens upon dozens of details that made up the UHDTV capital request. David had worked closely with the project manager on identifying supplier sources, which activities they would do in-house, and which parts would be bid to new suppliers. David and the project manager had tried to minimize the number of new relationships and long-distance supply-chain arrangements because they knew from experience how these situations jeopardize an on-time and successful product launch.

Procurement Conclusions / Recommendations

1. David didn't have a strong opinion on the television stand idea, but he did have a strong opinion about not wanting to be bothered with setting up suppliers (both equipment and materials) to support this new product.
2. David dismissed looking at suppliers of manufacturing equipment in China and elsewhere. He and the plant staff had heard the horror stories of mistakes in specifications, delays in deliveries, shortage of parts and seven day delays to get support in the plant when the equipment went down. David recommended using the familiar supply base names in the UHDTV proposal.

Plant Manager

Gene was excited about the UHDTV proposal. There was nothing better than taking over a new facility. Gene was an engineer by training and experience. He believed in his ability to successfully run a complex plant and this confidence extended into his opinions about outsourcing versus manufacturing in-house. Gene had never encountered a part that someone on the outside could make better than he could.

Plant Manager Conclusions /Recommendations

1. Gene liked the idea of the stand. It would be simple to make and would utilize floor space in the new plant, which would keep people busy.
2. Gene supported the capital recommendations as presented. He argued that many of the details – which showed a high degree of investment in support areas of production – proved that the plant could manufacture at a lower piece price than any of the outside supplier options. This would help his unit cost results.
3. Gene reluctantly disagreed with some of David's recommendations on supplier selection. Although he was very sympathetic to the risks to the operation by going to low-cost country sources, he could not dismiss some of the sizable capital savings projected. Gene considered saving capital on some of the supplier sources but re-investing the released funds back into the UHDTV/stand project in other ways, like flexible manufacturing equipment or spare tooling.
4. Gene sided with Walter's concern about the risks being introduced to the manufacturing environment through the complexity and changes to product designs. Gene's year-end performance evaluation was heavily influenced by product quality.

Capital Planning

Violet was most familiar with the calculations of financial risk and return inherent in the UHDTV proposal. Privately, she had mixed feelings. Even at 13.2% IRR, it was difficult to view this as a spectacular return project, poised to turn the business around. To her, the facts did not support Joan's view that the analysis was overly conservative. Violet had a growing concern that maybe the downside was underestimated but she had already signed-off on the analysis.

Violet found elements of the project exciting in terms of consumer relevant benefits. It all sounded innovative when explained in detail by either the marketing or engineering organization. Yet, why didn't that seem to translate into a better pricing assumption?

Violet thought the television stand idea was interesting, but while Joan promoted it as clear, breakthrough innovation and growth, Violet could not help but wonder if this was really true.

Capital Planning Conclusions / Recommendations

Violet ran the numbers on the television stand proposal and then folded the results into the previous UHDTV analysis. Her initial range of return estimates was 14-16.3%.

1. Violet was questioned during the team conference about the historical performance of the business and whether it warranted taking such a large investment gamble? Violet's reply sounded a lot like "this is the best we could come up with", and was unconvincing in terms of a total business turnaround. However, Violet did mention that if you doubled the television stand volume assumption and increased the share and pricing variables by enough, you could get the project to exciting return levels above 20%.
2. Violet was asked about opportunities to lower the amount of capital here or there and still maintain the overall financial attractiveness of the project. She commented that it was extremely difficult to accurately detach the capital and related benefit of particular product elements and the final pricing assumptions. In a sense, it was hard to really tell what was innovative, what was needed to support the innovation, and what was essentially traditional investing to add capacity, change a part, update a feature, or preserve existing market share.

OPERATIONAL IMPROVEMENT PROJECT MANAGEMENT: CATEGORIZATION AND SELECTION

Joo Y. Jung, University of Texas – Pan American

CASE DESCRIPTION

The field of project management is experiencing a burgeoning amount of growth in its applications. Companies apply innovative management methodologies such as project management in order to achieve rapid and continuous improvements in their operations. Selecting an appropriate set of operational improvement projects out of a potential pool of projects is a difficult task. How can companies select an optimum portfolio of projects?

The primary subject matter of this case study is concerned with objective evaluation of candidate projects that will address corporate business objectives based on a quantitative method. Projects can be objectively evaluated based on a quantitative method such as Six-sigma, which is defined as "a disciplined, data-driven approach and methodology for eliminating defects in any process, from manufacturing to transactional and from product to service" (www.isixsigma.com). The secondary subject matter for this case study is the project selection based on more a qualitative or abstract method utilizing the mapping process. The balancing act between quantitative methods and qualitative methods is highlighted in this case study.

This case study is appropriate for senior level undergraduate students and/or graduate level students while taking an operations management course. The case is designed to be used in conjunction with two to three hours of in-class preparation followed by approximately four hours of outside classroom analysis, discussion, and report write-up. In-class topics can include project selection models, project categorization criteria, and the project portfolio process.

CASE SYNOPSIS

This case describes a systematic way of categorizing, evaluating, and selecting projects using information from a leading automotive electronics component manufacturer. The projects discussed in this case study are based on real life projects. However, the company name, project names and financial numbers are modified in order to protect the company's identity.

This case study describes seven different project proposals that were presented to the company's management staff for evaluation and selection. Five projects are to be selected which *will be sponsored by the plant's top management. The projects come from multiple disciplines and department areas and are affecting the overall company performance. The company's performance is judged on their performance in reference to the following areas: scrap cost, first time quality, operational effectiveness, and assembly plant returns. The candidate projects are evaluated using both numeric and non-numeric project selection models to determine where the management team for this automotive electronics manufacturer should allocate and focus their efforts for the upcoming year. Several teams composed of personnel that have been trained in Six-sigma methodologies are available to begin addressing these issues immediately and will be supported by current trainees in these problem solving methodologies.*

BACKGROUND

The year is coming to a close and the time has come for the staff at the Automotive Electronics Group (AEG) – a San Antonio, Texas manufacturing operation - to review their goals for the coming year. The plant manager, Charles Garcia, is concerned that his plant will have difficulties meeting the goals set by the corporation's headquarters. Under the pressure due to recent reported losses, meeting this year's goals will be critical for the long-term planning of the company at this location. Mr. Garcia has called for a strategic planning meeting with his direct staff members in order to review the coming year's goals and determine key performance initiatives in order to meet their business objectives.

In preparation for the meeting, Charles Garcia has sent an email to his direct staff members requesting them to generate a list of project proposals that will significantly impact the company's bottom line. In addition, he is preparing a presentation where he will explain the corporation's business objectives. These objectives were prepared by the AEG's corporate executive council, and include the following:

- Financial Performance – Meet or exceed net operating income of $7.5M for the upcoming year.
- Customer Satisfaction – 15% reduction in the number of customer complaints as compared to the previous year's performance.
- Health and Safety – 10% reduction in number of recordable incidents as compared to the previous year's performance.
- Delivery Performance – 100% on-time delivery with less than 1% expedited shipments for the upcoming year.

Charles Garcia and his staff members at AEG realize a difficult task lies ahead of them. However, Charles Garcia has a plan to meet these goals by leveraging the Six-sigma applications and allocating proper resources to these activities.

THE COMPANY

Automotive Electronics Group (AEG)

AEG is a leading manufacturer of automotive electronics products supplying various products to the automotive industry. The Company was founded as the Automotive Components (AC) in 1990 and later was renamed Automotive Electronics Group (AEG) in 1998. Initial public offering for the AEG's common stock was initiated in 1999. Since then, the company has been listed on the New York Stock Exchange. Their main customers are the "Big Three" (GM, Ford, and Daimler Chrysler), while the Asian companies are steadily increasing their orders. While its corporate headquarters is located at the Michigan, AEG has a global footprint with operations in Europe, Asia, and North America regions. The Company boasts its world-wide presence of 150 manufacturing site locations with over 170,000 employees. AEG has a diverse product portfolio made up of crash sensing electronics, engine control units, mobile multimedia, and HVAC controllers. Sales of more than $25 billion were recorded in 2006. Financial problems have increased the necessity for the company to implement dramatic cost reduction initiative in order to show favorable results for the company's stockholders. In order to remain competitive with global competition, the company has implemented strict budgets that will challenge all manufacturing sites. AEG's performance in regards to the business objectives and metrics for the coming year will determine the immediate fate of the company.

San Antonio Operation

While AEG operates in over 150 manufacturing sites worldwide, close to 10% of the company's total revenue was generated by the San Antonio, Texas operation last year. Because of its high production volume and high operations cost, the San Antonio operation is receiving close attention by the corporate management. The San Antonio operation is primarily responsible for producing safety products. The San Antonio facility is composed of two plants joined by a common office area and loading dock. Plant-1 focuses on surface mount placement which integrates processes where individual components (i.e., resistors, capacitors, integrated circuits, etc.) are mounted on circuit boards. Plant-2 is primarily used to assemble the circuit boards into a case producing the final product. The final assembled units are also tested prior to being shipped to customers' vehicle assembly plants to ensure the quality of the products being supplied.

Quality Performance Metrics

Due to the urgency of the campaign, the San Antonio staff members were summoned to review and evaluate the project proposals. Projects must impact one or more key performance metrics which are used by all AEG manufacturing operations throughout the world to measure quality performance. Projects are to be evaluated on the following quality performance metrics:

Scrap: percentage of material cost that is wasted and can not be recuperated or sold. Scrap cost is an expense that directly impacts the site's operating income.

First-Time-Quality: percentage measure of good units coming out at a new process. First-Time-Quality is determined by the ratio of good units out of total units tested in the first run. This measure is provided as a percentage or converted into parts per million (PPM) by multiplying the percentage by one million.

Operational Effectiveness: amount of time a production piece of equipment is running producing parts during its scheduled run time. Alternatively, equipment down time measures amount of time equipment is stopped due to repair, maintenance, and testing. These measures impact delivery performance since excessive equipment downtime restricts the ability to produce products on time.

Assembly Returns: indirectly measures the customer satisfaction. Each Assembly Return counts as one customer complaint. This number must be minimized because it results in added expenses such as replacement cost, expediting cost and overtime charges. Furthermore, problem solving methodologies must be practiced to reach irreversible corrective actions to deter any further complaints.

PROPOSED PROJECTS

The San Antonio staff members have obtained the data from the relevant departments and will present seven projects for consideration. Expected free cash flows with initial investment cost and project durations are tabulated in Table 1. The numbers obtained are after-tax cost savings plus depreciation for capital investment. "Year 0" numbers are expected initial investment cost for equipment and working capital. "Case Defect" project requires three years of R&D cost before positive return begins.

Table 1: Expected free cash flows (in $ 1,000) from project

Project	Y0	Y1	Y2	Y3	Y4	Y5	Y6	Y7
1.Surface Mount Component	-1500	500	500	500	400			
2.Surface Mount Misfiring	-1000	400	300	300	200			
3.Final Test Failure	-300	200	200					
4.Surface Mount Terminal	-800	300	300	300	120			
5.Leak Test Failure	-500	110	110	110	110	110	110	110
6.Energy Saving	-150	40	40	40	40	40	40	40
7.Case Defect	-200	-200	-200	-200	100	200	400	600

Table 2 summarizes the proposed projects with the current key metric quality performance indicators.

Table 2: Project scores on key metric quality performance				
Project Proposals	$ / month	% Passing	Down time (Hr/wk)	# of Returns
1. Surface Mount Component	$ 30,000	97.5%	10	4
2. Surface Mount Misfiring	$ 15,000	98.0%	5	0
3. Final Test Failure	$ 0	96.0%	7	0
4. Surface Mount Terminal	$ 7,500	95.0%	5	1
5. Leak Test Failure	$ 5,000	90.0%	8	0
6. Energy Saving	-	-	-	-
7. Case Defect	$ 1,000	97.5%	1	3

PROJECT DESCRIPTION

1. ***Surface Mount Component*** - this project was proposed by Jerry Durham, the operations manager of occupant detection system components. This project deals with the highest scrap expense because safety products are not repairable. Any partial defect found during various steps of inspections requires the total assembly to be discarded. Several projects have already been worked in this area and lessons learned from other sites have also been reviewed and implemented. Some mangers feel that the performance of the placement equipment has reached its maximum capability. In order to fully address this project, a major process change is unavoidable. Furthermore, this issue was the top issue for customer complaints with four in last year.
2. ***Surface Mount Misfiring*** - misfiring in the Surface Mount area occurs when the revolver, assembly head, on the component placement machine attempts to retrieve a component from the feeder and attempts placing it on the circuit board, but is unsuccessful. This is a scrap issue that is affecting Plant-1's surface mount area. It is also affecting operational-effectiveness as the equipment must be adjusted in order to make sure that the revolver picks up the proper component. Downtime is unavoidable as these adjustments are made. The supplier for the component placement machines has made several software updates to the placement machines to reduce the number of misfires; however, the rate of failure has not been significantly improved. A design engineer believes the problem can be mitigated by redesigning several circuit boards which will be difficult and costly.
3. ***Final Test Failure*** - this project impacts first time quality and operational- effectiveness. All units failing at the final functional test station must be analyzed by a product engineer and

supported by a process engineer to determine the failure mode. In-house engineers are available to address this problem. Furthermore, Charles Garcia, the plant manager, is highly favoring this project proposal. He feels that this is a relatively easy project, but promises immediate improvements of the performance metrics. This project will require dedicated resources from several departments including: test engineering, product engineering, operations, and quality.

4. ***Surface Mount Terminal*** - the surface mount area also places connectors on several circuit boards. There are numerous potential causes for the surface mount placement equipment to place these connector terminals improperly on a circuit board. For example, the connectors could be arriving defective from the suppliers or the placement equipment coordinate settings are not being updated correctly for each production run. The team assigned to this project would need to investigate all the potential causes by involving the materials division and suppliers. Other AEG operations are experiencing a similar problem, but the root cause has not been found in last two years.
5. ***Leak Test Failure*** - after all circuit boards are assembled into a case, the unit is sealed and tested to ensure that the unit is enclosed properly. Air pressure is injected into the sealed unit and the test determines if there is a loss of pressure inside the unit. The leak test is completed on all units in order to ensure the units are sealed so that no contaminants can go into the unit. Any voids or leaks in the seal can cause damages from humidity on the electronic circuit board. This issue is affecting first time quality and scrap, but the bigger concern is the equipment down time which averages about ten hours per month. A minor process improvement and some product change might result from this project.
6. ***Energy Saving*** - the Facilities Manager, Frank Swartz is looking for funding for his project on energy savings. Mr. Swartz feels that his energy savings plan will reduce expenses on energy consumption by 20% annually. However, this project requires an upfront investment of $150,000. With rising energy costs, creative ways on how to reduce energy consumption in the plant will be required.
7. ***Case Defect*** – contaminant related defects are being found during final inspection at the San Antonio plant as well as at the customers' receiving inspection stations. Defects restrict the customers from assembling units on schedule. One customer is expecting a response from AEG about the contaminant defect issue by the early part of next month. Currently, the San Antonio plant is incurring daily cost of some $2,000 for sorting contaminant related activities. This industry-wide problem requires a significant amount of research effort in order to find the root cause and to implement corrective action. Outside research consultants are needed to conduct this study.

MANAGERIAL ISSUES AND CHALLENGES

In order to address the key issues, Charles Garcia wants to reassign a significant portion of his salary personnel from their current activities to various teams supporting the initiatives. Garcia acknowledges reassigning his people to projects may disrupt the main production activities, but the payoff will definitely be worthwhile. In addition, the individuals selected for these projects will require additional training in order to make improvements to existing systems.

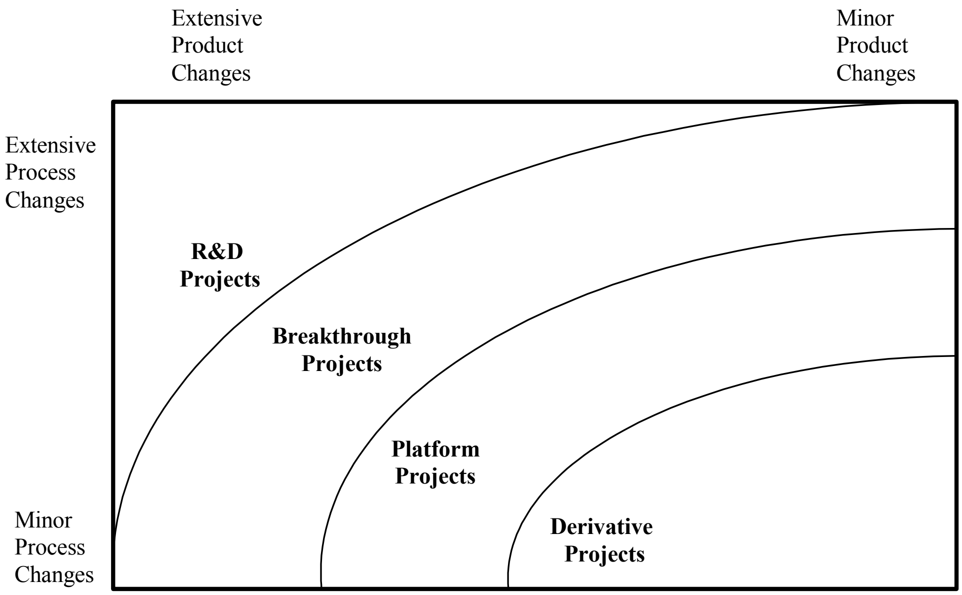
In preparation to the meeting, quality assurance manager, Sue Duncan suggests using a "screening" approach for selecting projects. The "screening" is a process where all potential projects are screened whether they clear different hurdles such as financial impact, strategic fit, and synergy with other projects. By reducing number of projects, the project teams can focus on the "critical few" projects that will better utilize the limited available resources. She also points out the need for implementing projects that can improve the current quality performance.

Ian Ridolfo, Six Sigma manager explains a project can follow the systematic approach of Six-Sigma DMAIC cycle and following questions should be addressed (Pzydek, 2000):

- DEFINE: What is the business case of the project? What is the project relation to what the customers want? What are the project scope and deliverables?
- MEASURE: What are the key metrics for the project? Are there adequate data for the process? What is the baseline? How do we measure the project progress and success?
- ANALYZE: What is the current status of project? Who will make the changes? What are the resources needed? What are the obstacles?
- IMPROVE: What activities are needed to improve the process? How will the improvements be made? What will be the status after improvement?
- CONTROL: Can we control the risk, quality, cost, schedule and scope? How do we monitor the progress? How can we maintain the improvements made?

Ridolfo introduces a project mapping procedure that is used by the industry in order to categorize the projects as a qualitative approach (Jung and Lim, 2007). He describes that a project can be positioned on the map depending on how much change it requires from existing system. For example, a project can be mapped based on the amount of change it needs from and existing product (what we make) and process (how we make). He offers four categories of "derivative," "platform," "breakthrough" and "R&D" based on amount of change needed. He explains, "Amount of effort, amount of risk, and possibly amount of financial return would increase as we move from derivative towards R&D categories."

Figure 1: Project categorization based on amount of product and process change



The challenge for the team will be identifying and selecting the optimum project portfolio so that they can achieve the most output with limited resources. Total amount of budget available to address selected projects is $3.5 million. The selected projects will be reviewed weekly and fully supported by the top management until the closure. Projects will be allocated with the most appropriate team members of relevant areas. Charles Garcia is excited and eager to hear what his staff members have to offer as he walks into the meeting room.

QUESTIONS

1. Based on free cash flow numbers provided (Table 1), calculate the Net Present Value (NPV) using 8% as the discount rate and Payback Period (years) for each project. Rank the projects based on NPV.

2. Scores for each quality criterion are provided with higher score for a project requiring more attention due to poorer quality related performance. The weight for each quality criterion is provided based on its importance. Using the key metric quality performance data provided, complete the table and rank the projects using the weighted scoring method.

SCORES	5	4	3	2	1
SCRAP ($ / month)	> $20K	$15K - $20K	$10K – $14K	$5K - $9K	< $5K
FIRST TIME QUALITY (% Good)	< 97.5%	97.5% - 97.9%	98.0% - 98.9%	99.0% - 99.4%	> 99.5%
OPERATIONAL EFFECTIVENESS (Down time / month)	> 10	8 – 10	5 – 7	3 – 4	< 3
ASSEMBLY RETURNS (Qty)	> = 5	4	3	2	< = 1

QUALITY CRITERIA AND WEIGHTS										
	0.50		0.15		0.10		0.25			
	SCRAP		FIRST TIME QUALITY		OPERATIONAL EFFECTIVENESS		ASSEMBLY RETURNS			
Project Proposal	Score	Weighted	Score	Weighted	Score	Weighted	Score	Weighted	TOTAL	RANK
1. Surface Mount Component										
2. Surface Mount Misfiring										
3. Final Test Failure										
4. Surface Mount Terminal										
5. Leak Test Failure										
6. Energy Saving										
7. Case Defect										

3. Based on project descriptions provided in the case, categorize (position) the seven projects using the project map suggested by the Six Sigma manger.

4. Based on your findings from questions 1, 2 and 3, which projects should Charles Garcia pursue during the upcoming years?

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BUSINESS ETHICS, BUS 3333: COMMUNITY ORGANIZING RURAL NEBRASKA CASE

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CASE DESCRIPTION

This case focuses on the business ethics topic of corporate governance in a nonprofit organization with issues involving conflicts of interest, organizational politics, and lack of internal controls. Secondary issues focus on accounting problems associated with accounting controls of the organization. The case has a difficulty level appropriate for an undergraduate junior level Business Ethics or Accounting course. It is designed to be taught in one to two class periods with the requirement of three to six hours of outside preparation by students.

CASE SYNOPSIS

Unlike Dragnet, the detective show, more than the names of the innocent have been altered in this case based on facts, people, and events from a real nonprofit organization. The facts and events came to light when the organization's respective state auditors issued findings from a compliance audit. While nonprofit organizations may receive funds for promoting social welfare as in this case, the ethical and business issues are common to ethical dilemmas, business structure and related business issues for all business organization forms.

RURAL NEBRASKA CASE

Background

Community Organizing Rural Nebraska (CORN) was established on October 25th, 1966. Upon its adoption of the set of bylaws and articles of association on January the 13th, 1967, it was designated as an association of the state of Nebraska under section 47 N.S., 1965 Supplement 1004 (L), of state law. On February 4, 1967, it was formally designated as the fourth Economic Development District in Washington, D.C.

The primary mission of CORN is to serve 23 of Nebraska's 93 counties' rural constituents' needs for services generally provided by city government in larger towns and cities. The association obtains, manages, or administers grants and funds for such services as fire or police protection, geriatric care, and waste management. General these grants and funds come from state or federal agencies and governments. The association charges a small percentage, four to six percent, of the funds administered to cover this non-profit entity's costs and to pay the salaries of the staff.

An executive director appointed by the Board of Directors leads CORN. A professional in enterprise, endeavor, or venture staffs each specialized subsidiary department of this non-profit corporation.

Community Assistance Rural Disposal, Inc. (CARD) is a nonprofit corporation formed September 12, 1993, for the purpose of managing the landfill purchased by CORN on November 1, 1992. The land fill was purchased from the city of Beatrice. The city cannot afford to offer such services outside the city limits yet the smaller municipalities of Crab Orchard, Adams, and Courtland need and use the services. CORN is one of the few organizations that can afford to provide these. The corporation has the same tax status as CORN. CARD also operates and maintains a trash hauling disposal service operating under the name of Country Disposal Services. CARD proves larger amounts of revenue as well as creates higher potential liabilities for the organization. EPA Standards require that CARD monitor and maintain the land fill for 30 years after its closure.

Personnel

Mark "Guy" Jefferson, executive director. Guy came to CORN as its first executive director. A native of Orlando, FL, Guy brings 20 years of business experience to the organization. Those who know him, describe him as a visionary and a brilliant man from a brilliant family. An entrepreneur by nature, Jefferson made and lost at least two fortunes before directing CORN. He uses his entrepreneurial skills to lead the organization as though he owns it. During his tenure at CORN, the organization expanded into waste disposal services, purchased land for housing and other development, expanded food service and other services to rural communities, and plans to build affordable housing for the poor in rural areas.

Adam Jackson, fire chief and assistant director. Adam's experience includes 12 year in fire protection and safety, first as a fireman in Beatrice and then as fire marshal in North Platte.

Jason Lincoln, director of nutritional programs. Trained as a dietitian, and possessing a degree from Bellevue University, Jason works with community food banks and senior citizen centers nutritional programs. Jason has been down on his luck in the past and has a soft spot for the poor. Because of his past experiences, he works closely with Jefferson on the affordable housing plans. Amy Kennedy, director of aging programs. Amy earned a master's degree in sociology with an emphasis in gerontology but she lacks work experience.

Lucas Wilson, accountant. Lucas earned a degree in computers with a minor in management from Doane College last year. However, Jefferson chose to promote Wilson to the position of accountant for CORN. In this role, Wilson prepares financial statements, accounts for the grants, and supervises two accounting clerks, one for revenue accounting and one for payables.

Corky Ford, director of Community Assistance Rural Disposal, Inc. Corky worked for the city of Plattsmouth Sanitation Department for two years prior to joining CARD. Ford supervises this related, but separate entity. Jefferson hired him.

Jenny Grant, receptionist/secretary. Miss Grant prepares letters and greets visitors to the organization, and has only worked for CORN for a short time.

Sarah Adams, public relations. Capable of deftly handling touchy situations, Jefferson hired her under questionable circumstances. Rumor has it that her former employer, Nebraska Senator John Roosevelt, mentioned to Jefferson that Ms. Adams wanted to move back to her hometown of Wymore, Nebraska, a nearby city. Ever the entrepreneur and sharp deal-maker, Mr. Jefferson realized that hiring Ms. Adams from Senator Roosevelt could to lead to favorable political treatment in the future. As rumor has it, Mr. Jefferson said that he needed a public relations director for CORN and hired her by telephone interview that same day. Mentally moving on to the next deal, Jefferson did not mention the hire to anyone else. When Adams arrived at CORN a month later, announcing that she was a new employee, rumors began to flow. In spite of her rocky start at CORN, Sarah Adams proves to be adept at handling the publicity surrounding the events of CORN.

Board of Directors

The Board of Directors for CORN consists of twenty-eight members. Twenty-three counties appoint their respective representatives. For these 23 appointments, the articles of association recommend qualifications for Directors:

> *Directors are appointed to serve a three year term, with initial terms of staggered lengths.*
>
> *Every Director on the board should be an expert in one of the CORN program services.*
>
> *Of the directors at least five members should possess substantial accounting or finance knowledge relative to the government programs.*

However, these appointments tend to be chosen from local government officials or politicians. Those chosen have proven an interest in the governance of their respective counties, but may lack, accounting or business acumen to direct this type of organization.

Executive Director, Jefferson appoints the other five members of the Board, who also serve as Members of the Executive Committee. The Executive Committee has all the powers of the full Board to change charter, to negotiate loans, to approve purchases, to fire or hire, and to approve bonuses. The current members of the Executive Committee are:

> Bob Weatherford, fire chief of Freemont, NE. A fireman with 27 years of firefighting experience, Bob held offices in several state and county fraternal firefighting organizations. The state fraternal firefighting agency recommended him to the CORN board.
>
> Dr. Harry Karney, Superintendent of North Platte Independent School District, retired. Dr. Karney started his career as a biology teacher at North Platte Junior College. By attending evening and summer classes, Dr. Karney completed a doctoral program in educational administration. Throughout his 40 years of work in North Platte, he earned the promotion to principal and then won the appointment to superintendent. James Whitecloud, a former student, recommended Dr. Karney to the CORN board.
>
> James Whitecloud, newly-elected assistant chief of the Otoe Tribe. Most Friday afternoons, James can be found on the golf course with Adam Jackson, and occasionally with Jefferson. Otoe tried to open several retail businesses, but none lasted more than 18 months. Jefferson recommended Whitecloud to the CORN board.
>
> Emily Cyril, head dietitian at Grand Island Memorial Hospital. Ms. Cyril, a new appointee to the CORN board, brings a history of service with community organizations and boards. She serves as a meal and budget consultant for the Nebraska Meals-on-Wheels program, on the board of Miracles and Meals, and completed a term as a state officer of the United States Dietary Association. The Nebraska Meals-on-Wheels program suggested Ms. Cyril as a replacement to C.W. Camden, the prior dietary expert on the CORN board.
>
> Hon. Eric Holdenville, representative of the 4th District. Rep. Holdenville continues his 12th year in term at the Nebraska legislature for 12 years. During legislative breaks, he operates a financial consulting service in Lexington, NE. His understanding of finance, of grants and government funding, and of legislative issues proves invaluable to the CORN board. However, during the most recent year, he

authored several potential bills and missed three of the last five regular CORN board meetings.

Bonuses, Incentives, and Other Pay Issues

Salaries and all other operating expenses must come from the 4-6% fees charge for administration of the grants and funds the association funnels to rural communities and organizations. As an association tied to a non-profit organization CORN bases fees on administrative services not total grants administered. Jefferson, not the Board of Directors, initiated bonus pay and incentive pay both of which he receives. The Executive Committee sets salary and raise amounts for the Executive Director. The full Board of Directors has always approved these actions. Salaries for all other directors and staff are set by the board in conjunction with the recommendation of the Executive Director.

Accounting/Auditing

Duncan and Associates, CPAs, completed the audit of the 1996 financial statements and records of CORN. The auditors issued an unqualified audit opinion on the financial statements. The following are select notes to the financial statements:

Note 10: Economic Dependency

CORN receives much of its revenue from federal and state grants. Because the grant amounts are appropriated each year at federal and/or state levels, changes in appropriation could have a significant adverse effect on CORN's operations. Management is not aware of any anticipated actions that will negatively impinge on the amount of funds the organization will receive in the next fiscal year.

Note 11: Purchase of Platte Services, Inc.

On June 8, 1996, Community Assistance Rural Disposal, Inc., completed a stock purchase agreement for Platte Services, Inc., a Nebraska corporation doing business as Platte Disposal Services and operating a business of trash hauling and landfill disposal, to supplement the existing operations at Beatrice, NE.

CARD paid $445,344 in a stock purchase agreement for Platte Services, Inc. and received all the outstanding stock of Platte Services, Inc., property, furniture and equipment totaling $400,000, a certificate of deposit in the amount of $40,000 and goodwill of $5,344.

CARD financial information includes the revenues and expenses of Platte Disposal Services from June 8, 1996 to September 30, 1996. The fixed assets are included in the fixed assets of CARD. The results of operations for Platte Services, Inc. cannot be separated from those of CARD because of management practices.

Even though the auditors issued an unqualified audit opinion they did note some problems. In a separate report on internal control structures required for audits in accordance with government auditing standards, the auditors shared several reportable conditions to the Audit and Committee of the Board of Directors.

The auditors list of problems included the following:

Year-end adjusting entries for accounts receivable and payable were not made.

Notes payable and the related assets were not included in liabilities and assets, but rather were incorrectly listed as miscellaneous expenses or lease expenses.

A multimillion dollar bond issue for which CORN is the fiscal agent was not included in the records.

CORN operated on a cash basis. Payroll records have been improperly maintained at net amounts. Such a practice misstates employer payroll taxes and withholding for employee retirement, insurance, and other withholding amounts.

The auditors point to a lack of general ledger to organize the accounting records. Their recommendation is to use this structured accounting process.

The Executive Committee has the ability to act on the Board's behalf. However, no minutes could be found to document actions taken by the Executive Committee. The auditors are concerned that the Board may not have sufficient financial information (see other notes) to adequately exercise its oversight authority. The full Board of Directors should consider changes to significantly limit the authority of the Executive Committee, but then this committee has the same powers as the full board.

Inter company receivables and payables between CORN and CARD were not recorded.

The separate records for CARD indicated that CARD funds were used to pay CORN bond obligations.

Note payments did not match supporting documents and most paid invoices were not defaced.

Credit cards for the organization had been issued in Jefferson's name. In examining the credit card receipts, $17,433.21 were questionable as expenses for CORN. These questionable items included travel and lodging expenses, meals, office supplies, clothing, gifts, books, antiques, and some unidentified. All directors have corporate credit cards and are supposed to submit receipts prior to CORN's payment of the bill.

Payments to taxing authorities were made late.

Four of five nutrition program reports were submitted late.

State Audit and Results

Shortly after the issuance of the audit report by Duncan and Associates, CPAs, and at the insistence of the Board of Directors, the state of Nebraska conducted a compliance audit. The state auditors found that Jefferson had received bonuses when his employment contract did not specify bonuses. However, the Executive Committee authorized a four percent bonus of all new funds he produced for CORN. While such payment might be acceptable, the concern and question was as to whether payment to Jefferson was for a percentage of administration or the cable grant. The state auditors found that he had received more than $200,000 in bonuses and above over his salary during a five- year period through this arrangement. He also received similar bonuses from CARD, although no minutes or contracts seemed to exist to validate these transactions.

The Nebraska State Auditors Office noted that $15,563 of the $72,657 Jefferson had charged to the CORN American Express card were for clothing, repairs to his personal vehicle, cosmetics, flowers, liquor, gourmet foods, airline travel for Mrs. Jefferson, a trip to Orland, antiques, collectibles, garden supplies, vacations, and more.

In reviewing the credit card expenses, the auditors noted problems with the supporting documents for Adam Jackson's expenses. When questioned, Mr. Jackson admitted that he had purchased a receipts book to submit alternate receipts for charges. It had become his habit to periodically take some of the local firemen out for a couple of rounds of beer and games of pool as a gesture of goodwill. He knew that this was not a legitimate expense and that that government agencies would not pay for alcohol or beer, so he wrote his own receipts and submitted them. Over time because no one seemed to question these receipts, he altered copies of the receipts and submitted those rather than buying a new receipt book. As part of the Executive Committee, he also began to charge a few personal items to the American Express Card. Nebraska State Auditors estimated that his misuse and abuse of the credit card totaled $7,483.15.

Kearney County District Attorney has filed charges against Guy Jefferson and Adam Jackson.

DISCUSSION QUESTIONS

1. What are the ethical issues involved in the case for individuals?

2. What are the ethical issues involved for the organization?

3. Who are the stakeholders?

Assignment

Using business and ethics theories, philosophies, and other materials as appropriate evaluate the complexities of this case and present your findings as a report.

RASCAL-MILDEW, INC.: A CASE OF THE INVENTORY HOT POTATO

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CASE DESCRIPTION

The primary subject matter of this case is Inventory Management in a high tech company with a very short product life cycle due to continual product improvements. Rascal-Mildew Inc. went from one of the best managed companies in the U.K. to a company that ultimately succumbed to competitive forces, lead by severe inventory problems. The case has a difficulty level of undergraduate seniors in Operations Management or Auditing and/or graduate level MBA Operations Management or MACC Cost Accounting and/or Auditing programs. The case is designed to be taught in one class (one hour and fifteen minutes), assuming cases are presented in groups of four students, with a fifteen minute presentation per group and fifteen minutes wrap up by the instructor. Student workload should be expected to be eight hours per group or roughly two hours per group participant at the undergraduate level. Workload should increase to ten to twelve group hours at the graduate level.

CASE SYNOPSIS

The case presents students with a combination of quantitative and qualitative aspects of Inventory Management. The products' high tech nature and unusual short life cycle should have made inventory management a serious priority in the company. The company lacked any detailed sales plan that could be driven down to specific product configurations for manufacturing to produce. This lead to the Manufacturing organization building what it thought would sell due to the Sale organization's reluctance to accept Inventory level and mix responsibility. Students should examine the role of the Sales organization in forecasting sales and inventory levels and tie this information to product life cycle.

At the same time, Manufacturing was combating increased automation to reduce direct labor costs leading to excess capacity. This was evidenced by the Labor Efficiency report. Manufacturing management's response was to increase efficiency by building more inventory, instead of laying off direct labor. In addition, during this time a Manufacturing Resource Planning (MRPII) implementation was underway throughout the organization. Students should be able to pick up the change in the WIP aging, indicating a much better priority planning process than pre-MRP times.

Further complications can be examined related to the audit-client relationship. This aspect could be explored at the graduate level so students can better understand the "political" nature of the audit relationship. The circumstances could also be examined in a post Sarbanes-Oxley environment where students understand how the audit-client relationship may be different. Lastly, the student is faced with the reality of considerable excess and obsolete inventory and how to financially cope with the effects of writing it off the books.

This case was prepared solely to provide material for class discussion. The author did not intend to illustrate either effective or ineffective handling of a managerial situation. The author has disguised all names and other identifying company information to protect confidentiality.

INTRODUCTION

In June of 1986, Cost Accounting Controller Nick Trevino reviewed the latest Rascal-Mildew monthly Manufacturing Performance Reports wondering who was really in charge of the company inventory levels. Nick sat in last month's Executive Staff meeting because his boss Fernando Lopez, V.P. of Finance was out of town. During that meeting, the topic of inventory levels came up and Ken Matty, V.P. of Sales said to Ray Bucci, V.P. of Manufacturing, "we sell em and you make em".

The high tech industry is typically characterized by rapidly changing technology and Rascal's modem, data encryption, and multiplex products were in the upper end of the product life cycle growth curve. Last year's audit report by Coopers and Lybrand indicated inventory levels were approaching a high level and the obsolescence risk and related financial exposure were rapidly growing. Nick was trying to decide an appropriate inventory level, the existing and potential obsolescence risks, and the potential obsolescence write-offs. If he only knew who was really in charge of Inventory, these and other questions could be asked to the appropriate people.

History of Rascal-Mildew, Inc.

Founded in 1955 by Monty A. Mildew and based in Sarasota, Florida, the company originally manufactured electronics products under the name Mildew Electronic Corporation. Monty soon established close ties with the U.S. government and began making electronics items for the National Aeronautics and Space Administration (NASA). With the construction of Cape Canaveral in Florida, the company won many of the early contracts for manufacturing electronic equipment used in America's early, unmanned space flights.

As competition for government contracts, particularly in the field of space exploration, grew more intense, in 1966 Mildew decided to enter the burgeoning commercial communications market. The company's first contract included the design and construction of a modem (computer-telephone interconnecting device) that was capable of transmitting data over an ordinary telephone line at

2,400 bits per second in a bandwidth of 3,000 cycles per second. At the time, building a modem that could send data at such speed was regarded as highly unlikely. Yet the Mildew engineers surpassed the design specifications stipulated in the contract, and constructed a modem that transmitted data at 2,400 bits per second at 800 cycles per second, a significantly narrower band of transmission. To put this achievement in perspective, commercial modems used in 1994 will soon meet an international standard to move data at a rate of 28,800 bits per second, or ten times faster.

Mildew's success in building this modem was revolutionary because it was considered next to impossible but also because other kinds of communications such as voice and teletype messages could now be sent over the same telephone line. Thus customers were able to communicate their data twice as fast over a telephone line which could also be used for other communications. The modems Mildew had designed and built, models 4400/24 and 4400/48 were initially sold to Western Union and soon became the standard modems in the industry. Mildew found itself in the enviable position of being the only company capable of manufacturing 2,400 bps (bits per second) modems that could operate on unconditioned switched telephone lines.

In 1969, Mildew began its relationship with Rascal Electronics Ltd., a British-based manufacturer of radio communications products. Brownie Raymond and Caldwell Custer founded Rascal as a two-man consulting firm in 1950. Seven years passed before Rascal marketed its first proprietary product: a high-frequency radio receiver. Custer died the following year, in 1958, but the company's momentum continued. Rascal went public in 1961. With revenues over $140 million in 1969, Rascal had already established an extensive network of manufacturing facilities in developing countries around the world. Rascal approached Mildew and convinced Monty to create Rascal-Mildew Ltd., a joint-venture company which would build and market Mildew's data communications products through Rascal's international network. The joint venture proved so successful that it accounted for a large percentage of Mildew's revenues and profits within a few years. The arrangement with Mildew also made a significant contribution to Rascal's revenues.

Less than a decade later, with Mildew's help Rascal had developed into one of fastest growing and most profitable European companies in the communications industry. Building upon its manufacturing and marketing network in developing countries, Rascal reported revenues of over $400 million. Rascal's revenues were increasing at a compounded rate of 33 percent per year for the last five years, while profits were increasing at a rate of 37 percent per year and its exports at the impressive rate of 40 percent per year during the same period.

Pleased with Mildew's contribution to Rascal's success, management at Rascal decided to acquire Mildew in 1977. At the same time, Digital Direct Company, a computer-terminal manufacturer located in Long Island, New York, and only half Mildew's size, also decided to purchase Mildew. After a prolonged war with Digital Direct, Rascal purchased Mildew for $60 million. The company was then renamed Rascal-Mildew.

By 1979, Rascal-Mildew reported $100 million in sales for its parent company and was regarded as one of the industry leaders in modem supplies and equipment. Yet in spite of the fact that Rascal-Mildew had recently introduced a highly innovative data-encryption device and a new product line of intelligent communications terminals, the parent company began to reduce its subsidiary's expenditures for research and development. Angry at what they perceived as British management's insensitivity to Rascal-Mildew's potential for growth, almost all of Rascal-Mildew's management team either was fired for communicating their grievance or soon resigned. Rascal subsequently tightened its control of its subsidiary by absorbing it into a new Data Communications Group headquartered in England. The engineer who had been in charge of developing Mildew's first modem back in 1966, Edward Blottner, was chosen as head of the new Rascal-Mildew and reported to management in England.

Rascal-Mildew began to experience declining profits during the early 1980s. In 1985. Rascal began to suffer from a shakeout in the information technology industry. A recession in the American data communications industry dealt a severe blow: Rascal-Mildew and Rascal-Viking, once accounting for 40% of total revenues, totaled only 27% at mid-year.

In 1984, Rascal established Rascal-Vader and entered the brand new cellular radio market in Britain. As Rascal's expansion in England and other countries continued, the company grew increasing dependent on its subsidiaries, especially American-based Rascal-Mildew, for additional revenues. Fortunately, Rascal-Mildew was having one of its most profitable years ever. A conglomerate of some 150 medium-sized, autonomous companies, Rascal was named "best-managed company" between 1976 and 1985 by Britain's prestigious *Management Today* magazine.

Cost Accounting

The Cost Accounting organization was part of the larger 140 employee Finance organization, responsible for all company accounting activity. Fernando Lopez headed the Finance organization since 1980 with three area Controllers reporting to him. Nick Trevino had been with the company since 1981 and has been part of the meteoric rise in sales. During this time, the Cost Accounting department staff declined from 14 people down to 8, mainly as result of an automated cost system. Cost Accounting was responsible for a number of financial functions. Inventory valuation, variance analysis, and the annual physical inventory which consumed an inordinate amount of time. Raw Materials activities included recognition of Purchase Price Variance, Incoming Inspection scrap analysis, Purchase Price standards development and reconciliation of sub-ledger detail to general ledger. Work in Process accounting included work order variance analysis, scrap, rework, and reconfiguration, development of manufacturing standards working with Industrial Engineering, and reconciliation of sub-ledger detail to general ledger. Finished Goods accounting responsibilities included maintaining and reconciling the serialized finished goods data base detail to the general ledger.

Each year, the auditors required Rascal-Mildew to do a complete wall-to-wall physical inventory to validate the value carried on the Balance Sheet. The planning process began four months in advance of the event and required the entire company's manufacturing operations to shut down for one week. Cost Accounting was in charge of the Physical Inventory (PI) from start to finish. These activities included complete reconciliation of tag detail, valuation of partially completed work in process and serial number specific finished goods. The PI began during the last week of January and Cost Accounting spent most of the remaining fiscal year (ending March 31) reconciling and making final adjustments to the year- end numbers.

Nick went back into his files and reviewed last year's audit "scorecard" and kept re-reading the statements related to the high level of inventory and potential for obsolescence. He then reviewed the current obsolescence reserve balances for each inventory classification while recalling the meeting two years ago with Fernando Lopez regarding an increase for those reserves. Given the recent decline in profitability, an increase in reserves meant even less profit for Rascal-Mildew's bottom line. The U.K parent, Rascal Electronics, Ltd. would not allow any further deterioration of profits, so funding additional reserves was not permitted. Instead, a more novel approach was used to convince the auditors Rascal-Mildew did not need additional obsolescence reserves. The idea was to sell these older products to emerging third world countries at current residual value. Since there was no existing market, it could easily be argued that the residual value was an appropriate cost basis for valuation. Therefore, it was anticipated the auditors would likely not require additional obsolescence reserves.

Rascal-Mildew was Coopers and Lybrands' (C&L) largest client in the Southeast, with its new office building located in Miami. Concurrently, C&L also had a very large systems consulting contract with Rascal-Mildew. Nick and Fernando had several meetings with Jim Jones, the current audit partner-in-charge to review the Inventory reserves. Jim replaced Mary Smith, the partner-in-charge of the last three audits and knew that last year's audit report was one reason Mary was removed as partner-in-charge of the audit. The problem did not occur in the last year, but had been an accumulation of the last three year's activity and Mary's strategy was to allow Rascal-Mildew to work their way out of the problem over time. Jim realized that Rascal-Mildew has not worked out the problem and in fact, it has gotten worse.

Rascal-Mildew sales and profitability began to decline in the early 1980's as a result of product commoditization. When modem use for data transfer became popular with clients such as American Express, Mastercard, and American Airlines, the response from these companies was to lease modems, not buy them due to the high purchase price and short technology life. As speeds increased from 2400bps to 14.4kbps in three years, companies were quickly turning in their existing modems and immediately upgrading to the latest high speeds and technical advancements. These older, "Off-Lease" modems still had residual value because they were not fully depreciated and that value was still being carried on the Balance Sheet as part of overall Inventory.

From 1981 to 1986, Nick had seen modem speeds go from 2400bps to 56kbps. He had seen the cost of modems dramatically drop as manufacturing efficiencies were gained with more automation. In 1984, a new technology called surface mounted devices, emerged as a way to miniaturize the product. Competitors scrambled to tool up for this new manufacturing method, promising to reduce size to one quarter of the previous size, greatly increase quality through reducing manufacturing defects, and greatly reducing direct labor needed to produce the modems under the old technology. In fact, Mike Rohrer, Director of Manufacturing Engineering had submitted a Capital Expenditure request for $10mm for a new Flexible Automated Board Line (FABL). The payback was roughly 2.4 years and reduced the manufacturing cost of a standard 14.4k modem from $1145 to $454. This new line would be dedicated to all new modem products with the anticipated savings previously noted. This project was approved without any significant discussion regarding anticipated technological obsolescence.

Manufacturing Management

Ray Bucci was Rascal-Mildew's V.P. of Manufacturing and six Directors reporting to him including Don Wayneston, Director of Materials, and Mike Rohrer, Director of Manufacturing Engineering. Don served as Materials Director until 1983 when he was replaced by David Haley. David was the Senior Management Consultant from Coopers and Lybrand heading up the Systems Implementation project and had no significant inventory management experience. David had all materials departments reporting to him, including Master Scheduling, Purchasing, and Warehousing. Master Scheduling, headed by Clark Weston, was responsible for evaluating inventory needs, opening manufacturing work orders, deciding on the quantities of any given work order, and eventually, evaluating Material Requirements Planning (MRP) output reports. Master Scheduling determined what was going to be made in production and also the production priority. Clark operated with essentially no input from the Sales organization as V.P. Ken Matty felt that was Manufacturing's responsibility.

Ray Bucci concerned himself with primarily getting product out the door and felt that was his organization's first and most important responsibility. On more than one occasion, Ray remarked that paperwork was something he felt was an accounting responsibility, not manufacturing. His perspective on inventory was that his organization had "custodial" responsibility for Raw, Work-In-Process, and Finished Goods inventory but not the inventory levels themselves.

Conclusion

As Nick entered his office late Thursday night, he wondered how he would deal with the results of his latest analytical tool - Excess and Obsolete (E&O) analysis. Roughly one half of the $130mm inventory value was classified as either excess of demand requirements beyond 12 months or obsolete with no foreseeable demand at all. Who would he advise of these results, as he thought to himself. Nick suspected Fernando knew this might be the outcome, and an entry to write down inventory by Fernando of $65mm would likely be his last. Ray Bucci had no interest in this number because his position was that of an "inventory custodian". Ken Matty could care less about the level of inventory and saw his job as to sell product, not manage it. It would be the end of Nick if he brought this analysis directly to the new partner-in-charge of the audit, as Nick was certain he would rightly insist on writing down the Inventory – an immediate $65mm bottom line negative impact. The night was getting on and Nick was getting tired and pondered how a company that was one of the best managed in the UK had come this point.

Table: I: Inventory Balances Comparative - FY84, FY85, and P1 though P11, FY86 ($000)

	FY84	FY85	P1	P2	P3	P4	P5	P6	P7	P8	P9	P10	P11
Raw Materials	21.0	28.0	33.0	33.6	33.4	32.0	33.3	34.6	36.0	33.3	30.0	29.0	28.0
WIP	25.8	24.2	22.8	20.6	21.0	23.2	23.8	25.3	26.1	27.5	27.0	25.4	24.7
Finished Goods	24.0	35.0	35.5	35.3	36.0	34.5	34.5	33.0	31.5	32.0	32.5	32.8	33.2
Off Lease	27.0	34.0	35.0	36.0	37.0	38.0	41.0	43.0	44.0	43.5	44.5	42.0	42.0
Ords Shipped Unbilled	2.20	2.80	2.50	2.50	2.30	2.20	2.38	2.60	3.40	3.30	2.50	2.45	2.90
Total Inventory	100.0	124.0	128.8	128.0	129.7	129.9	134.98	138.5	141.0	139.6	136.5	131.65	130.8

Table II: Inventory Reserve Balances, as of P11, FY86, ($000)

	FY86
Raw Materials	4.00
WIP	1.30
Finished Goods	3.20
Field Stock	1.40
Total Inventory Reserves	9.90

Table III: Aged Production Manufacturing WIP - Divisions 10, 11, 60, and 61
Comparative FY84, FY85, and P1 through P11, FY86 ($000)

	FY84	FY85	P1	P2	P3	P4	P5	P6	P7	P8	P9	P10	P11
3 Periods or less	11.5	9.00	5.50	3.80	5.90	8.60	7.80	8.20	7.30	7.00	6.20	5.00	3.90
4 periods old	0.60	1.10	1.60	1.80	0.60	0.00	0.00	0.50	0.70	0.20	0.10	0.00	0.10
5 periods old	0.00	0.80	0.90	1.20	1.00	1.00	0.80	0.00	0.50	0.50	0.30	0.20	0.00
6 periods or more	0.00	0.90	1.00	1.40	1.70	2.20	1.80	2.10	1.50	0.80	0.40	0.40	0.00
Total Shop floor WIP	12.10	11.80	9.00	8.20	9.20	11.80	10.40	10.80	10.00	8.50	7.00	5.60	4.00

Table IVAged Production Engineering WIP - Divisions 03 and 06As of P11, FY86 ($000)		
	Division 03 P11 aging	Division 06 P11 aging
3 Periods or less	276	0.0
4 periods old	207	0.0
5 periods old	14	103
6 periods or more	884	470
Total Engineering WIP	1381	573

Table V: Profile of In-Process Stores (WIP) - P6-P11, FY86 ($000)						
	P6	P7	P8	P9	P10	P11
PC Assembly	7568	9365	10491	11000	10162	10920
Chassis/Cables	1326	1156	1163	1268	1302	1352
Total IPS by Category	8894	10521	11654	12268	11464	12272
Mux Product	1123	1454	1595	1614	1550	1375
All Other Products	7771	9067	10059	10654	9914	10897
Total IPS by Product type	8894	10521	11654	12268	11464	12272

Table VI: Labor Efficiency Report - Actual vs. Standard D/L FY85 through P11, FY86		
	Period Labor Efficiency	Cumulative Labor Efficiency
FY85 – P1	81.0%	81.00%
P2	91.0%	86.00%
P3	80.0%	84.00%
P4	79.0%	82.75%
P5	86.0%	83.40%
P6	79.0%	82.67%
P7	77.0%	81.85%
P8	69.0%	80.25%
P9	87.0%	81.00%
P10	62.0%	79.10%
P11	59.0%	77.27%
P12	74.0%	77.58%

Table VI: Labor Efficiency Report - Actual vs. Standard D/L FY85 through P11, FY86		
	Period Labor Efficiency	Cumulative Labor Efficiency
P13	70.0%	77.00%
FY86 – P1	72.0%	76.64%
P2	67.0%	76.00%
P3	60.0%	75.00%
P4	55.0%	73.82%
P5	64.0%	72.88%
P6	75.0%	73.00%
P7	92.0%	73.95%
P8	89.0%	74.67%
P9	99.0%	75.77%
P10	96.0%	76.65%
P11	97.0%	77.50%

Table VII: Manufacturing Operations Non-Productive Direct Labor FY 86, in $			
Department	P9	P10	P11
Production	16357	2254	7849
Test	11996	3118	3335
Quality Control	2378	27	85
Total Non-Productive D/L	30731	5399	11269

Table VIII: Manufacturing Operations Actual Overtime Premium – FY86													
Departmen t	Period 1	Period 2	Period 3	Period 4	Period 5	Period 6	Period 7	Period 8	Period 9	Period 10	Period 11	Period 12	Period 13	Total
Production														
247	1,549	2,621	3,245	3,411	2,899	3,274	3,352	2,952	4,044	1,127	3,176			31,650
262	2,892	4,643	5,827	7,741	7,755	3,522	119	2,241	7,605	2,127	5,322			49,794
263	4,774	2,974	7,619	13,395	13,970	7,486	1,160	364	3,392	1,049	1,919			58,102
264	1,850	861	3,910	5,917	6,113	2,005	44	84	4,361	755	3,767			29,667
266	515	240	1,301	1,832	458	601	35	36	1,053	67	357			6,495
Sub-Total														
Prod. Dept.	11,580	11,339	21,902	32,296	31,195	16,888	4,710	5,677	20,455	5,125	14,541	0	0	175,708

Table VIII: Manufacturing Operations Actual Overtime Premium – FY86

Department	Period 1	Period 2	Period 3	Period 4	Period 5	Period 6	Period 7	Period 8	Period 9	Period 10	Period 11	Period 12	Period 13	Total
Test														
282	1,508	1,120	2,948	2,179	862	414	0	134	2,597	1,552	21			13,335
283	1,573	338	3,119	1,598	659	1,508	84	644	3,748	879	2,660			16,810
285	3,387	1,874	4,225	2,930	2,270	3,806	0	410	4,608	944	2,282			26,736
289	35	48	784	959	334	142	302	83	616	45	0			3,348
Sub-Total														
Test Dept.	6,503	3,380	11,076	7,666	4,125	5,870	386	1,271	11,569	3,420	4,963	0	0	60,229
Qual Cont														
302	26	51	(21)	0	0	23	47	0	0	0	0			126
303	1,343	577	1,336	1,695	741	301	70	574	2,708	206	1,305			10,856
305	876	670	729	1,162	658	104	11	307	1,005	325	479			6,326
317	0	0	0	15	157	7	52	7	7	0	0			245
Sub-Total														
Qual Cont	2,245	1,298	2,044	2,872	1,556	435	180	888	3,720	531	1,784	0	0	17,553
Tot. Mfg O/T	20,328	16,017	35,022	42,834	36,876	23,193	5,276	7,836	35,744	9,076	21,288	0	0	253,490

Table IX: Work-In-Process (WIP) - Breakdown by Major Category – FY86

Description	Period 1	Period 2	Period 3	Period 4	Period 5	Period 6	Period 7	Period 8	Period 9	Period 10	Period 11
Mfg Projects:											
Mfg											
Div 10, 11, 60, 61	9,035,114	8,194,364	9,171,646	11,806,458	10,368,394	10,777,829	10,023,380	8,459,813	7,059,953	5,662,712	4,071,722
Admin.											
Division 69, 19	9,418	1,259,844	738,372	154,172	625,186	623,636	1,033,665	1,434,763	295,585	643,480	404,445
Labor Inefficiencies	(412,000)	(950,000)	(950,000)	(950,000)	(950,000)	(950,000)	(2,208,000)	(977,769)	(135,769)	(164,769)	0
Total Manufacturing											
Controlled	8,632,532	8,504,208	8,960,018	11,010,630	10,043,580	10,451,465	8,849,045	8,916,807	7,219,769	6,141,423	4,476,167
Engineering Projects:											
Division 03	576,964	553,607	656,020	804,259	1,471,369	1,510,168	1,606,342	1,590,107	1,759,656	1,545,167	1,381,072
Division 06	791,108	772,143	859,525	874,671	863,145	762,951	760,488	633,825	610,448	589,539	573,191

Table IX: Work-In-Process (WIP) - Breakdown by Major Category – FY86											
Description	**Period 1**	**Period 2**	**Period 3**	**Period 4**	**Period 5**	**Period 6**	**Period 7**	**Period 8**	**Period 9**	**Period 10**	**Period 11**
Serialized Goods											
(Holding Acct.)	619,573	730,608	712,623	841,298	900,451	873,948	917,142	929,840	971,450	1,050,311	1,047,865
Total Engineering											
Controlled	1,987,645	2,056,358	2,228,168	2,520,228	3,234,965	3,147,067	3,283,972	3,153,772	3,341,554	3,185,017	3,002,128
Government Systems											
Projects:											
Division 90	94,079	136,396	168,415	204,509	239527	302,189	361,267	401,970	434,389	444,643	411,075
Total Gov't. Systems											
Controlled	94,079	136,396	168,415	204,509	239,527	302,189	361,267	401,970	434,389	444,643	411,075
Capitalized Variances	1,991,736	2,024,289	2,208,509	2,305,227	2,423,949	2,546,384	3,102,431	3,395,791	3,754,205	4,217,457	4,556,051
In-Process-Stores	10,103,451	7,852,778	7,450,603	7,148,894	7,903,734	8,894,062	10,520,273	11,654,005	12,268,514	11,463,976	12,272,387
Total Consolidated WIP	22,809,443	20,574,029	21,015,713	23,189,488	23,845,755	25,341,167	26,116,988	27,522,345	27,018,431	25,452,516	24,717,808

PURAC ENVIRO-FILTER COMPANY

Richard Sjolander, The University of West Florida
David Eppright, The University of West Florida

CASE DESCRIPTION

The primary subject matter of this case is the pricing of consumer goods in International Markets. Secondary issues include price discrimination by small firms in foreign markets; product differentiation in international markets; branding and price discrimination. This case has a difficulty level of 3-4 and is targeted at business students in a first course in international business or international marketing. The case can be used either as a functional case on pricing in the international environment, or as a study in exporting. One hour of class time should be sufficient to handle the case discussion and students should budget 2-3 hours of time for case preparation.

CASE SYNOPSIS

The PURAC Enviro-Filter Company is a small manufacturer of air filters located in southern Florida, USA. Diana Page, the firm's marketing manager is in the process of determining her target price for the upcoming year for their most profitable product, the F-18 filter. Just as she was finalizing her recommendation, one of her salespeople approached her with the possibility of entering into a contract for a distributor branded sale to Russia. This would be a new market for her company. The price offered by the Russian mass merchandiser is much lower than that charged for branded PURAC filters in the domestic market. This new market opportunity complicates Diana's decision process. She must decide at what price to offer her goods for sale at home, and consider the relative advantages of the new offer presented by the foreign market proposal. She must decide the probably effect of these additional sales on the firm's profitability and what conditions to negotiate with the Russian company if PURAC decides to accept their offer.

INTRODUCTION

The PURAC Enviro-Filter Company is a producer of specialty filters in the United States. The company was established by three partners, who took early retirement from the Ford Motor Company in the early 1980's. The PURAC company is located in south Florida, about 50 miles north of Miami. Sales had initially been limited to automotive filters, primarily air filtration filters for air conditioning systems for cars produced in the domestic market. As the company grew it expanded the product assortment to include other filter applications, especially in the area of climate control filters. The company has been profitable in all but three years and has seen some growth over the years. The owners conservatively portray the company as having been marginally successful in the specialty filters industry. The competitive situation in the industry is stable with each competitor stressing the various features of their products in their advertising campaigns.

Diana Page is in charge of marketing for PURAC. She has been with the company since graduating from business school in Miami four years ago and was recently promoted to marketing manager for the firm. She has worked in the marketing area since joining the firm and this is her first major assignment.

THE ANNUAL PRODUCT REVIEW

Each year the company engages in a major review of their products and Diana is now looking at the coming year, trying to determine the optimal price to be charged in the specialty filters market. She remembers that many times in her product pricing class during her final year of studies she encountered cases requiring her to determine the optimal price to be charged for products in distinct market segments. She hopes that the logic from those cases will carry over to her present situation. She has been working on the problem for several days and reviews her notes to help her visualize the situation. The PURAC Enviro-Filter company competes in an industry consisting of 4 domestic competitors. They have successfully held out foreign competition in the market by virtue of the fact that it is a relatively small market, and their customers prefer to deal with local companies. The total industry demand is supplied by these companies. Each company is aware of the pricing policies followed by each firm in their industry. Prices in the market tend to be quite stable, following a particularly nasty price war just before Diana joined the company. Rumor in the company is that the industry lost an estimated 20 per cent of gross revenue during the price war. Diana is aware of the figures for PURAC sales, and they are not pretty: revenues were down 18 percent in spite of a 10 percent increase in sales volume during the price war. Clearly, everyone at PURAC is very concerned about not doing anything that might lead to a repeat of that fiasco.

Based on the prior two years' sales and the expert opinions of her sales force, Diana developed the following demand schedule for the coming year for the F-18 filter, one of the company's best selling products. This particular product is expected to be very well received in the in the retail market. It has been totally redesigned from the older F-8 model, which was beginning to be eclipsed by advances in competitive filters and will be in all stores this coming year.

Diana realizes that the estimates used in the demand schedule are sensitive to the pricing strategies of her competitors, and has tried to consider these threats (of competitive reactions) to PURAC's pricing policies when making her estimates. She feels that the estimates are best guesses at what PURAC can expect to do at the various possible prices with the F-18 filter during the coming year. She comes up with the following estimates.

Table 1: PURAC Enviro-Filter Demand Schedule	
Price to Wholesalers In Dollars	Units of F-18 Demanded
$4	3,000,000
$5	2,000,000
$6	1,800,000
$7	1,600,000
$8	1,300,000
$9	900,000
$10	500,000

Next, she called Leo in the controllers' office to get the correct cost estimates for the coming year. Given her demand forecast and the company's cost estimates, she thinks she has the necessary information to form the basis for a forecasting spreadsheet. She sets it up in the following manner to illustrate her estimates of the break even points, as well as total revenues, costs and profits at various output levels for PURAC Specialty filters. She starts by filling in the numbers she knows, as shown below.

Table 2: Cost and Revenue Projections for the F-18 Filter							
Price in Dollars	Units (millions)	Variable Cost $/unit	Fixed Cost (millions)	Total Cost	Total Revenue	Break Even pt. (units)	Profit
4	3	2.20	5.3	_____	_____	_____	_____
5	2	2.20	_____	_____	_____	_____	_____
6	1.8	2.35	_____	_____	_____	_____	_____
7	1.6	2.50	_____	_____	_____	_____	_____
8	1.3	2.50	_____	_____	_____	_____	_____
9	0 .9	2.90	_____	_____	_____	_____	_____
10	0 .5	3.10	_____	_____	_____	_____	_____

THE FRANKFURT INTERNATIONAL TRADE SHOW

Shortly after finishing her forecast, and while still pondering the optimal pricing decision Diana got a call from Bert Salisbury, one of her salesmen. He attended a international trade fair in Frankfurt, Germany the previous week to show various PURAC Enviro-Filter products to a primarily Central European audience of distributors. PURAC became interested in exploring the possibility of international sales following some intense lobbying by the Florida Department of

Commerce at a recent chamber of commerce meeting in Stuart. They decided to participate in a trade delegation from the state attending the international trade fair in Germany. One of the people Bert met at the fair, Sergio Burke, had just sent him a fax from his office in Bucharest, informing him that one of Sergio's clients in St. Petersburg was very interested in introducing a line of specialty filters in their stores in Russia. The initial request for proposal was of an opportunity to bid on an order for 200,000 specialty filters to be sold as a dealer branded product by a major retail chain in Russia. This got Diana's attention!

Burt made a quick call to Sergio and then reported back to Diana. Sergio, it seems was unwilling to name his customer at this time. He would only say that the specialty filters would be purchased for shipment in lots of fifty thousand each at the beginning of each quarter to St. Petersburg, and that the competition for this sale was expected to be quite intense. However, on a positive note, he led Bert to believe that he can secure the order for PURAC at a price in US dollars of $3.25 per unit CIF. Several things were discussed during the call, including the importance of the terms the Russians were quoting in their offer. That the buyer was willing to quote the deal in dollars seemed very significant to Sergio. He said it indicates that they are serious bidders and sends a clear message that they are interested in obtaining the lowest possible price for the filters.

Diana agreed with this assessment. Their offer was certainly low! The price they were offering to pay was less than any thinkable price for the PURAC Enviro-Filters, even before factoring in the additional cost of dealing internationally.

Some additional research on the part of Bert and Diana revealed that the CIF term in international trade meant Cost, marine Insurance, and Freight prepaid to the point of entry into the receiving country. This would further reduce the value of the contract for PURAC. They checked with a freight forwarder in Miami and were given a ball park figure of $500. per thousand filters to cover the additional expense of export shipping and insurance. PURAC normally sells ex. Factory, or free on board buyer's conveyance terms for domestic sales.

Both Diana and Bert are aware that the offered price is far below the domestic price PURAC charges for the product. Diana states very bluntly that she has no interest in starting another price war in her market. She considers the matter settled and directs Bert to please try to do a better job of screening leads in the future so that company resources are not wasted chasing dead leads.

Bert is discouraged with his contact in Bucharest. How could he seriously think there was a possibility of doing business with his company. There seems to be quite a difference in culture between the eastern part of Europe and the US. Still, Bert is not willing to dismiss the matter out of hand. He would like to research the matter a bit more. The client seems to be a viable distributor in Russia and there may be more ways to analyze their bid. Sergio has assured them that his source will not go to any of PURAC's competitors for bids if they get a reasonable offer from PURAC.

Bert suggests to Diana that they review the situation a bit further. Upon his suggestion, Diana sets out the following points for them to consider:

CASE QUESTIONS

A. How would one characterize the nature of demand in the U. S. market? They discuss the market in terms of the four types of market demand structures (competitive, monopolistic competition, oligopoly, monopoly) and identify implications for PURAC Enviro-Filters in terms of the use of the various marketing mix variables in the market under each type of competitive situation. Please develop this analysis. Include in your discussion of each of the types of demand structures, as well as the various characteristics of the market for specialty filters that affect your decision as to the nature of the market (type of competitive environment).

B. Recreate the table she calls her forecasting spreadsheet, calculating the missing data points. This information should prove critical in answering the questions faced by PURAC Enviro-Filters in terms of its decisions in its markets.

C. Why might Diana be interested in knowing the break-even quantities at the various proposed prices? What does this information tell her?

D. What is the profit maximizing volume for PURAC Enviro-Filters to sell under its own brand name in the U. S.? At what price should they sell specialty filters, and what is the expected profit?

E. Should PURAC Enviro-Filters try for the Russian sale? Back up your answer with analysis (meaning that specific numbers and reasoning should be shown.

F. What would the bottom line effect be of the additional sales be on revenues, costs, and profits from the units sold by PURAC Enviro-Filters both under its own brand and the dealer brand in each country?

G. What sorts of guarantees, or conditions, would PURAC Enviro-Filters Company want from the retail chain purchasing the specialty filters for sale in Russia? Please be specific as to the sorts of contractual arrangements PURAC might want from the Russian company that would make the eventual contract more attractive to the American company and the reasoning behind your various suggestions.

H. What might lead the Russian buyer to offer to sign a contract for the filters in U.S. dollars instead of Russian rubles? Discuss how this affects the risks for each company.

KOHL'S DEPARTMENT STORE: FASTEST GROWING RETAILER IN 2007

Julie A. Zachman, University of Wisconsin-Parkside
Cathleen Folker, University of Wisconsin-Parkside

CASE DESCRIPTION

The primary subject matter of this case concerns an overview of the U.S. retail industry and specifically addressing an in-depth view of the Kohl's Department Store strategy. This case is primarily based on secondary source information and is ideal as a leadoff case for business undergraduate students (level 4) to demonstrate their ability to interpret basic strategic planning concepts. The case was written to provide an opportunity for students to 1) apply Porter's Five Force Framework to analyze the impact of the competitive forces on industry attractiveness, 2) prepare a thorough SWOT analysis to assist in developing potential strategic options, and 3) practice evaluating an organization's strategy. The decision focus of the case centers on what strategy can sustain a competitive advantage given the high level of consolidation within the retail industry. The case is designed to be taught in 2 class hours and is expected to require 6 hours of outside preparation by students.

CASE SYNOPSIS

The retail industry is in a state of flux, marked by a high-level of consolidation and new partnerships. The long-term trend of consolidation and intense competition for the mass market has been especially difficult for the traditional department stores as the popularity of the shopping mall declines while big-box discounters and specialty stores become more attractive alternatives. Amidst the recent restructuring arises the need to transform the competitive landscape; executing a well defined corporate strategy will be a key factor in determining which retailers will stay on top.

Making headlines with its aggressive five-year growth strategy, Kohl's Department Store continues to capture the attention of the public and investors alike. After years of retail consolidation, how does Kohl's manage aggressive department store expansion? Will the Classic American Family be able to "expect ***great*** *things" from Kohl's ten years from now or will the department store overextend itself and relapse into stagnant sales growth?*

RETAIL LANDSCAPE

The retail industry is currently being bombarded with merger and acquisition activity, ultimately restructuring the retail landscape once again. During the 1970s, downtown retail stores began losing consumers to the upcoming regional shopping mall structures typically located in the suburbs. Shopping malls appeal to consumers' social needs by becoming focal points in the community offering more than outlets for obtaining desirable goods by providing entertainment through movie theaters, restaurants, parks and fountains as integral components of the social outing. For some, shopping is a means of entertainment in itself to reduce boredom, keep up with the latest trends, and swap ideas with friends. The shopping experience is enhanced by the retailer who can appeal to the consumers' desires, not just their basic needs. Although enclosed malls have been successful at holding their ground for the past few decades, the frequency of mall excursions is on a downswing.

The mid-1980s brought about a surge of manufacturer's factory outlet stores and outlet centers serving price and value conscious consumers. Along came the 1990s when retail channels really blossomed into new opportunities. Located off the beaten path, outlet centers and big-box discounters were on the upswing. Revitalized downtowns, strip malls, and catalog sales continued as on-line shopping made its debut. Today's consumer has more shopping channels to choose from than the time to shop. Competition among retailers is gaining momentum, especially for multi-line retailers or department stores, as evidenced by an approximate 50% decline in revenue over a decade (Adjoined Consulting LLC, 2006). See Exhibit 1 for revenue share by retail format.

Exhibit 1A
1995 Revenue Share by Retail Format

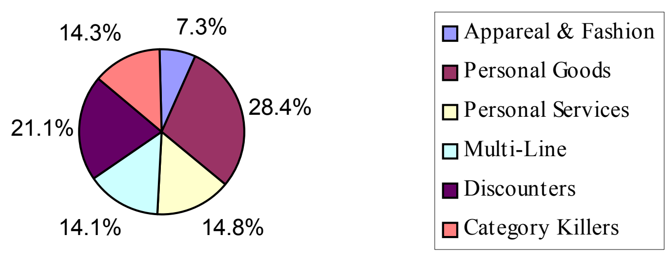
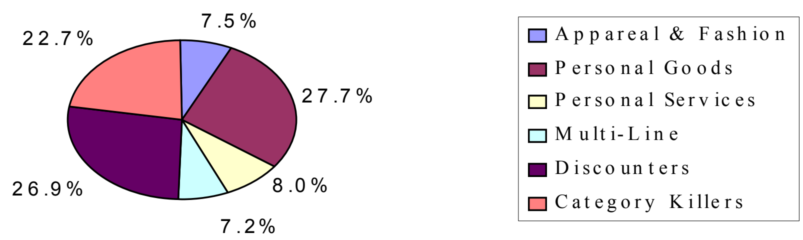


Exhibit 1B
2005 Revenue Share by Retail Format



Source: Adjoined Consulting LLC, 2006

Shopping Seasons

Retailers are particularly keen to two shopping seasons: back-to-school and Black Friday weekend. Back-to-school shopping season is an important indicator for retailers since it serves as a checkpoint for emerging trends and identifying popular products prior to the holiday season. Both apparel and electronics are closely monitored to ensure the right mix is available of the most desirable merchandise. Special promotions are common to kick-off the back-to-school shopping season earlier which extends the shopping season all together. The National Retail Federation determined for the 2006 season, spending rose 13.4% to $54.2 billion; back-to-school (K-12 grade) reached sales volume of $17.6 billion while back-to-college segment reached sales volume of $36.6 billion, led by freshmen requiring dorm furnishings. Both department stores and specialty stores experienced higher traffic volumes than their counterpart discount destinations (Facenda, 2006). Both retailers and consumers alike recognize Black Friday weekend as the beginning of the holiday shopping season. The National Retail Federation's 2006 Black Friday Weekend Survey found that more than 140 million consumers went shopping over Black Friday (Thanksgiving) weekend, spending on average $360.15, an 18.9 % hike above 2005 figures (Grannis & Krugman, 2006b). Retail stores opened earlier than ever to capture holiday spending as evidenced by The Prime Outlets in Pleasant Prairie, Wisconsin, which held its first "Midnight Madness" event in 2006 for bargain hunters willing to venture to the outlet mall at midnight for special promotions. The National Retail Federation's survey reports that one third of the early birds were at their first shopping destination by 6 am. Although discount stores continued to be the most popular, the volume of shoppers was much lower than in 2005 (49.6% from 60.7%) whereas traditional department stores (38.8%) and specialty stores (37.5%) held their ground. Tying for most popular items were categories of clothing/clothing accessories and books/CDs/DVDs/video games at 41.4% (Grannis & Krugman, 2006b).

Shopping On-line

Home technology continues to be on the forefront of transforming consumer lifestyles. The advantage of multi-channel retailing is perhaps most obvious with on-line shopping where customers can place orders and have their purchases delivered to nearby store locations or directly to their residence. Customer satisfaction levels rose in 2005 to outpace traditional stores according to a University of Michigan study (Guest, 2006). The former belief that on-line shopping would be hampered by consumers' need and desire to touch and feel merchandise as an integral part of the shopping experience, is no longer a primary concern. The advantages consumers recognize, including a wealth of product information, specific comparisons, consumer reviews and enhanced convenience, are proving to outweigh the physical aspects. According to the U.S. Commerce Department, on-line retail sales are rising almost fourfold faster than sales at traditional retailers; impact on holiday sales are at $22.9 billion compared to total retail sales of $960.3 billion from October-December 2005 (Guest, 2006). An increase in web site visits typically translates into higher sales (see Exhibit 2 for market share of site visits).

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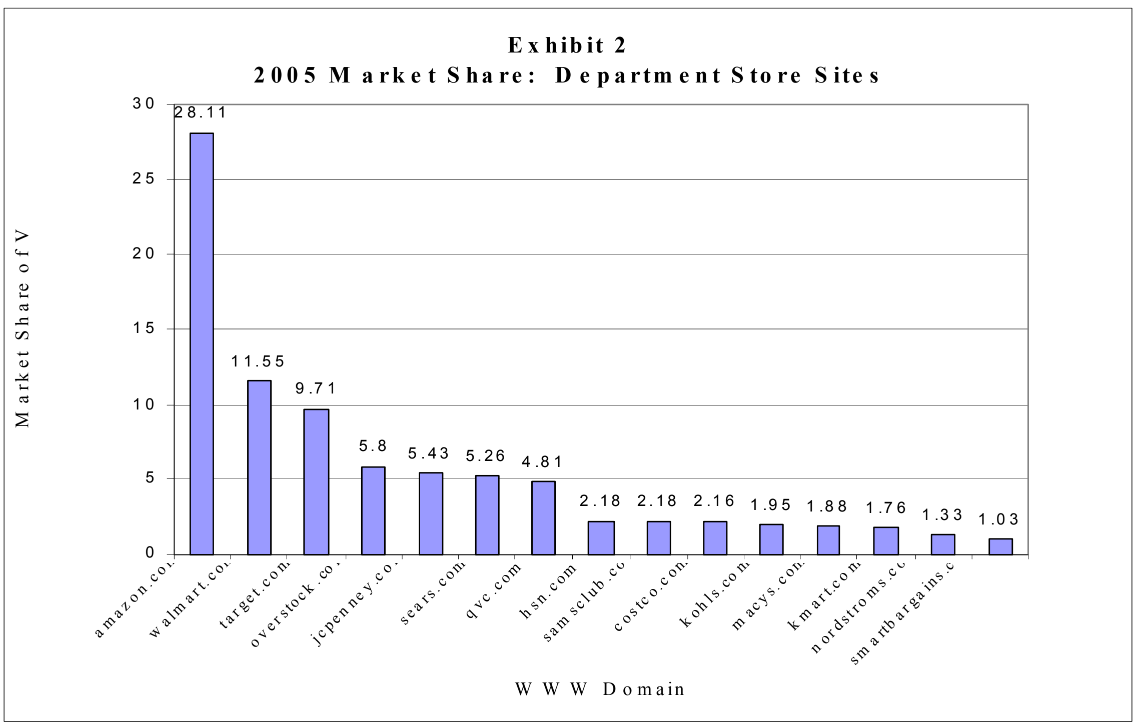


Source: Prescott, 2005

The National Retail Federation launched the www.cybermonday.com website in November, 2006, to aid consumer convenience over the holidays with one-stop shopping for the best on-line deals. The site includes nearly 400 on-line retailers that offer holiday promotions and special savings throughout the holiday season and on Cyber Monday, the Monday after Thanksgiving which is noted as the kick-off day for the on-line holiday shopping season. On-line retailers target the working class with lunch hour promotions and special savings proving to be one of the biggest shopping days of the holiday season. The popular "buy on-line, pick up in-store" feature draws additional sales from 27% of those who opt to pick up their selections in-store (Grannis & Davis, 2006).

Since products are available to anyone, anywhere with access to the Internet, on-line shopping is becoming more appealing to time-conscious consumers. With multi-channel retailers often encouraging consumers to shop on-line, competing retail formats will need to continue to find ways to integrate Internet shopping into the traditional shopping experience in order to tap into this growing market segment. Some retailers use free-standing computer kiosks within their stores, others offer discounts when placing orders on-line.

U.S. Retail Sector

The National Retail Federation represents an industry consisting of 1.6 million U.S. retail establishments realizing sales of $4.7 trillion in 2006 (Grannis & Krugman, 2006a). The retail industry uses "same-store sales" as a benchmark to gauge a merchant's retail health by comparing revenue generated from locations which have been open for at least one year. When major retailers like Wal-Mart report disappointing sales for first quarter 2007, concerns surface that the American economic growth is slowing down. Meanwhile, high-end department stores continue to post impressive gains beyond analyst expectations (Cornelius, 2007).

Some retail analysts believe the department store channel has been forced into a position between the low-end discounters and high-end retailers (Tsiantar, 2006b). Examples of department store classifications include:

Low-end retailers:	*Kmart, Target, Wal-Mart*
Mid-tier retailers:	*Federated, JC Penney, Kohl's, Sears*
High-end retailers:	*Nordstrom, Saks Fifth Avenue*

To survive, department stores need to return to becoming the choice, one-stop shopping destination where convenience, fashion, and customer service create loyalty among shoppers. Perhaps the greatest challenge facing department stores is generating merchandise that is new and distinctive, setting their store format apart from other shopping destinations to encourage sales growth. Creating customer value is a key retail strategy employed to establish differentiation among department stores.

Recent closings and consolidation efforts are contributing to department store market share loss as the elimination of shopping destinations continues. For example, 207 department store locations fell empty when Montgomery Ward closed in 2000. Likewise, with the Federated-May merger in 2005, some 93 malls have duplicate stores which are likely to transpire into vacant anchor locations (Chittum, 2005). Replacements for traditional department store anchors are anything but traditional. The emergence of movie theaters, book stores, restaurants and big-box stores including Target, Home Depot, and Best Buy as mall anchors is becoming commonplace. What is known today as the traditional department store and shopping mall will undoubtedly transform the industry landscape once again.

A second major contributing factor of the department store transformation is the lack of competitive differentiation among their merchandise. Market share for department stores has been declining for decades as consumers' preferences continue to shift towards non-mall retail and specialty stores which offer greater convenience and exclusive merchandise. While mergers and consolidations provide 1) the means to compete nationally, 2) benefits from pooled talent, and 3) greater supply chain and administrative efficiencies from their size and leverage ability, competition among remaining players will heighten.

Customer Service

Conscious consumers are demanding more from retailers and are making decisions on where to shop based on expectations of merchandise quality and customer service. While fashion continuously evolves at a faster pace coupled with a more knowledgeable discount-driven customer, successful retailers will need to rely on heavier use of customer insight to improve merchandise offerings and other relevant elements of the shopping experience. Direct customer feedback offers retailers a better understanding of customer lifestyles and stages which can be used to tailor merchandise offerings and services more closely to customer needs and desires. Let's face it, today's consumers have more choices than ever; if consumers don't find what they're looking for at an acceptable price, they'll shop elsewhere.

Since the definition of customer service varies among individuals, retailers must continuously evaluate their customers' experience to ensure satisfaction for repeat business and future market share growth. Whereas a well informed sales associate plays a key role, it is only one component of a successful retail equation. Consumers are seeking more than material goods that meet their needs; they want fair prices, convenience in parking and accessibility, along with a fulfilling adventure. Today's consumers want their shopping excursions to be efficient and easy; a positive customer service experience encompasses favorable hours of operation, atmosphere of store, and fair return policies.

Performance success is dependent on the retailer's ability to match value with consumers' perception of value. Retailers need solid marketing strategies, adequate advertising budgets, and effective promotions that meet the consumers' expectations in brand offerings. Larger retail chains can market on a national basis and remain flexible to respond regionally to fashion and taste preferences. Additionally, larger chains carry more leverage when negotiating terms with brand names due to their volume purchases. This buying power allows retailers to offer quality merchandise without necessarily raising prices, building a high-caliber reputation of quality products at reasonable prices. Other retailers are building value through private label branding. Retailer success however, is dependent on understanding the customer's evolving tastes and preferences and on the retailer's ability to execute on service to build loyalty among patrons.

Loyalty of the Private Card

Department and specialty stores are increasingly using credit cards as a loyalty marketing tool. New customers are enticed with additional savings, typically 10-15% on same day purchases, when they open a store credit card. Meanwhile, repeat customers often earn rewards of additional discounts when using the private label credit card for purchases during promotional events. Private label cardholders shop more at the store, buy more expensive items, and are more likely to be impulse buyers (Cornelius, 2007). Additionally, historical data can be obtained and analyzed by merchants as a means of attracting loyal customers to return through promotional mailers aimed specifically in response to customer spending habits. For example, if a customer frequently purchases jewelry on the store credit card, the department store would use this information to ensure the customer is included on the mailing list for accessory sale promotion advertisements. Rewarding loyal customers is essential for increasing same-store sales that lead to revenue and profit growth.

Value of the Gift Card

Effectiveness of gift cards is gaining momentum as a means of convenient shopping for the consumer and as a means of extending the holiday season for merchants. The use of gift cards for any number of special occasions and for corporate recognition and/or reward programs is increasing in popularity. Gift cards are growing in popularity as convenience to obtain cards continues to expand beyond where the card can be used to include on-line shopping, supermarkets, and convenience stores as a one-stop shopping trip for a multitude of specialty and department store selections. According to ValueLink, nearly two-thirds of consumers will purchase or receive gift cards since card giving is preferred (52%) over cash giving (38%) (Simpson, 2004). Furthermore, some retail merchants are now accepting gift cards as a viable means for on-line payment while others are expanding into personalizing gift cards with custom images.

Both open-ended denominations and reloadable and/or disposable gift cards are options the merchants may offer. Gift cards have lower transaction costs in comparison to credit and debit cards, may impose dormancy fees for inactivity, and increase impulse purchases, all of which benefit the retailer. Likewise, the ability to reload value onto a gift card increases patronage and loyalty of the card recipient. However, retailers are unable to record the value as sales until the card is redeemed and lost cards are of little value to consumers, especially when $27.8 billion was incurred in gift cards during the 2006 holiday season alone (Grannis & Krugman, 2006a).

INFLUENCES AT HOME AND ABROAD

Industry Outlook

Retail industry consolidation over the last several years has resulted in a reduction of department stores as mall anchors. Anchor stores benefited from valuable name recognition and typically served as the major attraction for mall shoppers. Although department stores led the retail industry in same-store sales figures, its growth may be artificially inflated by the overall trend in retail consolidation. As shopping destinations close, sales shift to the remaining department stores, therefore surviving stores receive a bigger piece of the shrinking pie. Further fluctuations in the retail sector will be largely dependent on the economy and the ability of surviving retailers to acquire land at suitable locations to meet their growth strategies.

The upcoming, lifestyle centers are increasingly popular and provide a modern day alternative to the enclosed shopping mall. New construction appears to be ramping-up since 2003. Features such as open-air settings, entertainment complexes, medical services, and garden parkways exist side-by-side to address a wide spectrum of lifestyle needs. Lifestyle centers attract top specialty retailers thus offering category exclusivity since they cater to the serious shopper looking for convenience through easy access and drive-up parking. They are easily accessible to meet demands of today's time conscious consumer.

Worldwide Regulation

Textiles and apparel have been hot topics to both industrialized and developing country economies because of their importance in trade relations. On January 1, 2005, the Agreement on Textiles and Clothing Act (ATC), supervised by the World Trade Organization, was signed into law by President Clinton. The intent was to improve access to the textile markets of developing countries by applying quantitative restrictions on specified textile and clothing products. The agreement imposed a ten-year, four-stage transition period for producers in developed countries to prepare for potential intensified competition from developing countries (Gelb, 2005).

Removal of quotas serves to further enhance globalization by removing obstacles in lower labor-cost nations to win competitive markets from their more advanced, developed neighbors. The expected result is a significant shift in volume of textile and apparel exports by developing nations. Likewise, the U.S. economy is expected to benefit since industrial users and end consumers of these products will encounter lower prices from increased competition as the quota phase-out accelerates.

Impact of the Economy

U.S. economy is becoming increasingly sensitive to the effects of the growing trade and budget deficits as the U.S. currency becomes more vulnerable to rising inflation and interest rates. A weaker dollar impacts consumer spending habits. Additionally, the job market, which is a significant indicator in consumer confidence, dropped to its lowest level during the year by August, 2006, directly impacting disposable income (Rosalind Wells Wells & Associates, 2006b). Consumers will undoubtedly continue to search for value deals giving the advantage to discounter and warehouse clubs over department stores and mall-based retailers.

Although third quarter of 2006 posted accelerated growth of 6.8%, economic growth is expected to decline to 4.6% in 2007 (Greider & Peterson & Medina & Bell & Hux & Czekaj, 2007). Consumers face increased financial pressures from higher energy costs and rising interest rates, indicating a slower economy. Discretionary spending will decline as the masses divert their personal income to cover basic necessities like home heating and the rising costs of health care and transportation. Retailers aimed at serving the affluent will fare more favorable than those catering to middle or lower income households since their target market is less sensitive to these financial pressures.

The impact on the retail industry is holiday procrastination of those seeking last minute deep discounts coupled with a high level of gift card redemption during sale promotions after the holiday rush. Discount retailers are the most heavily impacted by rising energy costs, lower employment, and modest income growth.

Lower mortgage interest rates over the past several years have enabled homeowners to refinance their homes and then tap into their home equity lines of credit for furniture, appliance, and home furnishing purchases. When mortgage rates climb and the value of homes escalates, affordability for potential new homeowners is in jeopardy, thus many consumers will pull-back on discretionary spending to achieve their personal goal of home ownership. Economists of the Federal Reserve reported that a "combination of cash-outs, capital gains from home sales and home equity lines of credit added about $700 billion to economic activity" in 2005, between 2% and 8% of total consumer spending (Rosalind Wells Wells & Associates, 2006a). However, the housing market is softening, leading experts to uncertainty in regards to how the housing market will impact the general economy and consumer spending.

KOHL'S DEPARTMENT STORE: "EXPECT GREAT THINGS"

The Kohl's story began as a supermarket chain known as Kohl's Food Stores with its first southeastern Wisconsin store built in 1946 on Burleigh Street in Milwaukee. Founder Max Kohl expanded from what had become Milwaukee's largest supermarket chain into the retail sector with the first Kohl's Department Store located in Brookfield, Wisconsin in 1962. By 1972, the British-American Tobacco Company's U.S. retail division, BATUS Inc., purchased a controlling interest in Kohl's. Two of Max Kohl's children, Allen and Herb Kohl, continued to manage the company until 1979 which consisted of 50 grocery stores, six department stores, three drug stores and three liquor stores (Wikimedia Foundation, Inc., 2007b). The Kohl family then became interested in real estate development as evidenced by the family's involvement as some of the original owners of Northridge and Southridge malls in Milwaukee, Wisconsin (Daykin, 2002).

Thereafter, Herb Kohl became the franchise owner of the Milwaukee Bucks NBA team in 1985 and continues to serve as the richest United States Senator since his election in 1988. Herb Kohl has donated $25 million to the University of Wisconsin-Madison, where he earned his undergraduate degree, for the construction of a new arena known as the Kohl Center. In 1990, he founded the Herb Kohl Educational Foundation Achievement Award Program which provides grants worth $100,000 annually to graduating seniors, teachers, and schools throughout the state of Wisconsin. As a Democrat leader, Kohl led the 2005 victory effort to amend the Protection of Lawful Commerce Arms Act to require handguns to be sold with child safety locks (Wikimedia Foundation, Inc., 2007a).

Meanwhile, the Kohl's Food Stores were sold to A&P in 1983 and have since closed in 2003 whereas the Kohl's Department Stores were acquired by a group of investors in 1986 who added 27 stores in Illinois, Minnesota, and Michigan within two years (Wikimedia Foundation, Inc., 2007b). The corporation became publicly traded in 1992, and today is recognized as the fastest growing retailer in the nation. With its rapid growth strategy, Kohl's has expanded from its Midwest roots to operating 834 store locations across 46 states as of April, 2007 (Kohl's Department Store, 2007b). Over 114,000 associates work towards enhancing the in-store shopping experience by adhering to the retailer's core concepts of brands, value and convenience (Kohl's Department Store, 2007c).

Kohl's continues to operate family-oriented department stores which feature competitively priced exclusive and national brand apparel, shoes, accessories, and home product/houseware merchandise (see Exhibit 3 for product mix). The retailer has expanded into the development and manufacture of its own private labels; both exclusive and private labels provide department extension opportunities. The "Only at Kohl's" statement has become a key, central marketing strategy to distinguish the retailer from others and to enhance same-store sales growth. The department store chain primarily competes with mid-tier retailers in softline merchandise and to some extent, discounters in hardline merchandise.

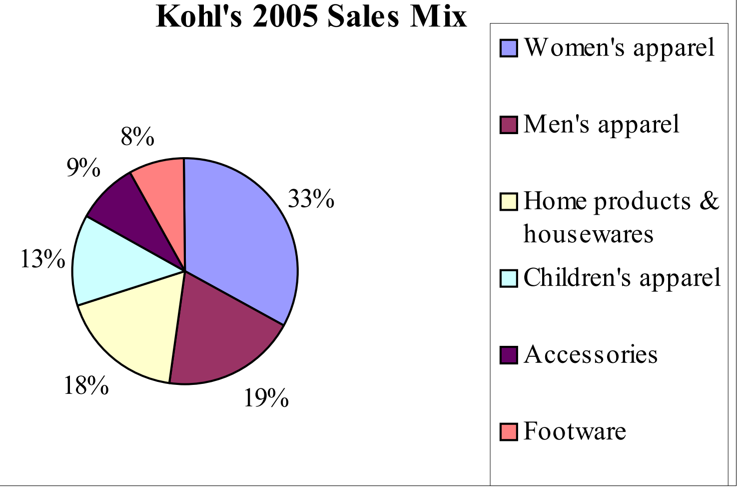


Exhibit 3
Kohl's 2005 Sales Mix

Source: Cowen, 2007

The retailer strives to provide a relaxed shopping experience for its core shopper, the middle-income family. Stores are strategically located near the core demographic, in suburban neighborhoods, and are typically stand-alone structures in strip malls where ample parking is available. The busy "soccer mom" enjoys the convenience of a close-to-home location, the ease of accessibility (hours and parking), central checkouts, a flexible return policy, and courteous associates that Kohl's offers.

The Kohl's mantra, "Expect Great Things," is backed by the retailer's mission:

> *"To be the leading family-focused, value-oriented specialty department store offering quality exclusive and national brand merchandise to the customer in an environment that is convenient, friendly and exciting."*

(Kohl's Department Store, 2006c)

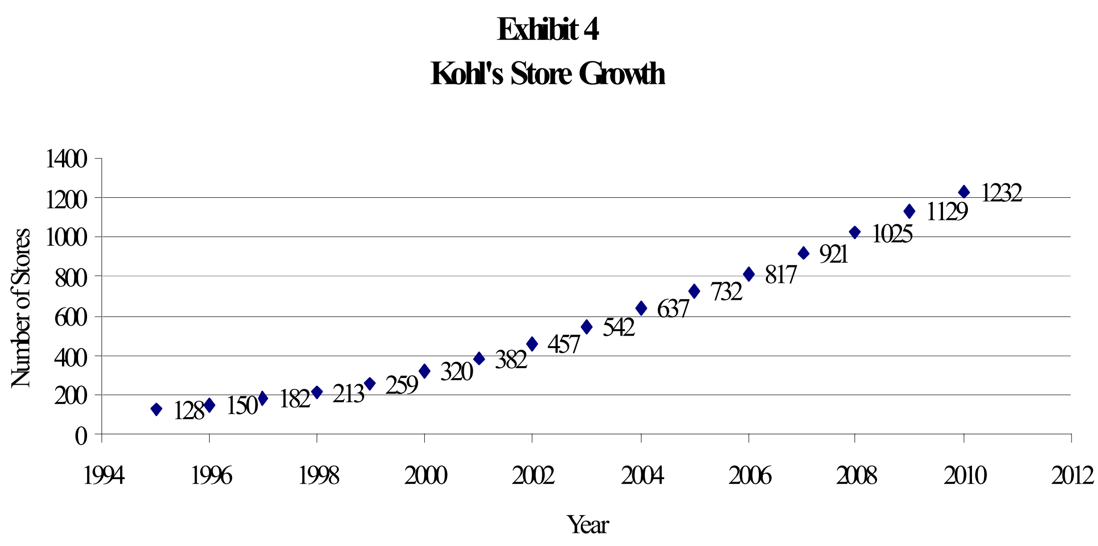
Kenosha's Store Manager, Tim Cornelius, simplifies the Kohl's approach: "It's all about how are we going to please *her*. How do we impress *her*?" "Her" would be the "25 to 45 year old woman who wants to look fashionable and have her family be fashionable" which generates approximately 85-90% of Kohl's sales revenue (Cornelius, 2007). The Classic American Family, women aged 35 to 44 with children, represents a 6.1% share of the retail market and will continue to be the primary target segment and the "bread and butter" for the retailer. A young mom, aged 25 to 34, is Kohl's secondary target segment which represents a 3.9% share (Marks & SanFilippo, 2005).

Although the retailer has been loyal in serving the needs of its core demographic, Kohl's is pursuing new opportunities, such as targeting non-family oriented women with additional discretionary income. One segment, dubbed the "independent taste segment," consists of women aged 45 to 54 and represents a 4.5% market share. The second segment, referred to as the "self-focused explorer," consists of single women aged 25 to 34 and represents an additional 3.1% market share opportunity (Nolan, 2006). In parallel with its refined strategy of attracting new customer segments for continued growth opportunities, Kohl's is executing a rapid store growth strategy to expand its presence nationally.

Rapid Expansion Strategy

Kohl's continues to demonstrate its ability to achieve its five-year growth strategy which includes opening approximately 100 new stores per year with an end goal of operating over 1,200 stores by the close of 2010 (see Exhibit 4 for store growth). Although the retailer has always strived for a 20% store growth goal, the recent "grand openings" have caught investors' attention. In October, 2006, Kohl's celebrated its largest nationwide grand opening event. As stated by Larry Montgomery, chief executive officer, "…sixty-five new stores is the largest one-day opening in our history…We are well-positioned to continue to execute our five-year strategic growth plan. We have a strong, growing base of stores across the country, and there are many more markets where we can expand" (Kohl's Department Store, 2006b). At the time of the 2005 strategic growth announcement, Kohl's estimated that it would almost double its number of stores and would generate 2.5 times the net income realized in 2004 by 2010 (Nolan, 2006).

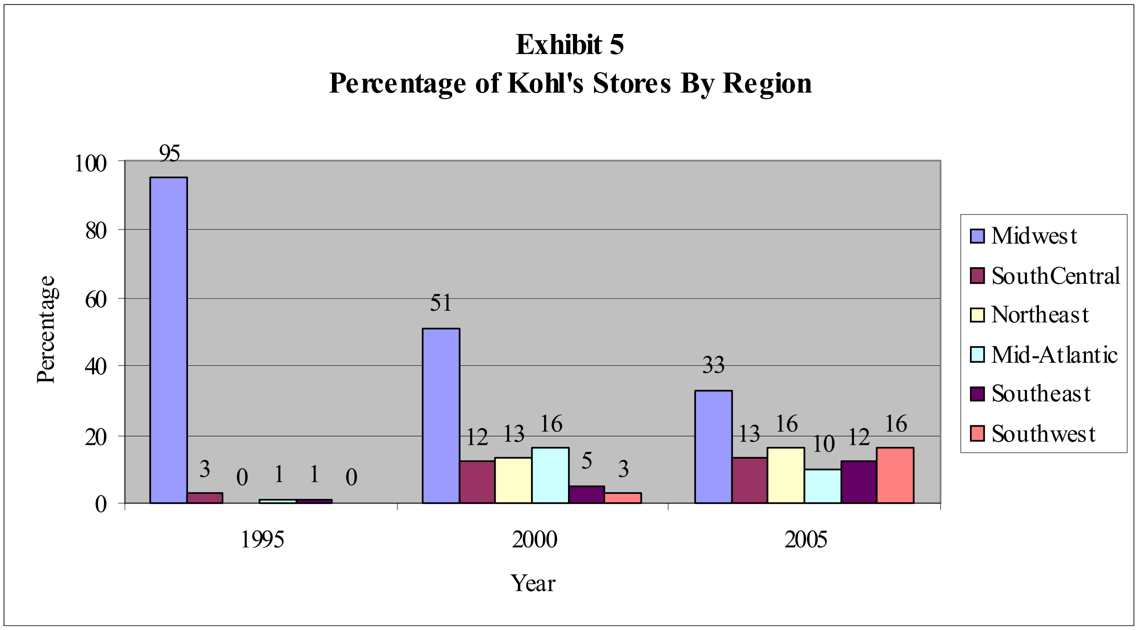
Typically consisting of free-standing stores in strip malls and more recently in lifestyle centers, Kohl's will continue to apply its three-prong prototype approach to new store locations. As seen in Table 1, the vast majority of new stores are located in suburbs where Kohl's is able to reach its core demographic with the most ease. Additionally, this strategy allows the retailer to serve a variety of markets of all sizes, lock-out competitors with isolated locations, and save funds typically spent on premium real estate property. A single floor of apparel and home furnishing items are similarly organized around a race track floor plan contained within a box-like structure. Not only does the floor plan provide economies of scale, it provides customers and merchants consistency since they already know the floor space they have to work with (Cornelius, 2007).



Note: Estimated growth based on retailer's growth strategy.
Source: Various Kohl's Annual Reports

Table 1: Kohl's Store Prototypes			
Store Prototype	Store Openings	Square Foot Selling Space	Expected First Year Sales (in millions)
Small	6%	68,000	$10-$12
Suburban	93%	88,000	$14-$16
Urban	1%	133,000	$20-$25
Source: Marks & SanFilippo, 2005			

In the past decade, Kohl's has done more than just multiply its locations; it has grown from a regional to national department store. Originally a Midwest-based retailer, Kohl's has expanded into new markets in every region of the United States (see Exhibit 5 for shift in stores per region). The on-going success and improvements in same-store sales performance is aided by nine distribution centers, each serving approximately 100 store locations, and a tenth center to fulfill the e-commerce sales requirements (Cornelius, 2007).



Source: Kohl's Department Store, 2006

Although Kohl's is recognized as the nation's fastest growing department store while rivals are losing market share and are being absorbed in industry-wide consolidation, the question remains: Is bigger really better? Will Kohl's be able to conquer and sustain market share by rapid expansion?

Private Brand Strategy

Traditionally Kohl's has been known as a department store that offers the basics at decent prices. "Basics used to account for 70% of Kohl's merchandise mix, and fashion only accounted for 30%. The company is closer to as 50/50 split currently, based on our channel checks" (Nolan, 2006). This strategy of launching exclusive and private label apparel selections has become a focal point for Kohl's as a means for attracting new customers (see Exhibit 6 for Kohl's brand portfolio). Sales of exclusive brands have increased by 30% over the past year to represent 34.5% of overall sales revenue (Financial Wire, 2007).

Under its remerchandising efforts, Kohl's has been ramping-up exclusive and private label merchandise while simultaneously downplaying national brands. The approach has been beneficial as evidenced by the Nine & Co line outperforming expectations, extension of clothing lines such as Candies and apt. 9 into home collections, and the positioning of Kohl's to complete the launch of its "beauty" department fuelled by Estee Lauder, which offers cosmetics, skincare, fragrance, and bath & body products. Additionally, the skateboarding icon, Tony Hawk, has teamed-up with Kohl's to offer a line of clothing and shoes that appeal to athletic young men and children.

Exhibit 6: Kohl's Brand Portfolio	
Portfolio	Brands
Exclusive	American Beauty, Candies, daisy fuentes, FLIRT!, Oh Baby! by Motherhood, Stamp 10, Tony Hawk
Private	Apt. 9, Croft & Barrow, Sonoma, So…, Tek Gear, Urban Pipeline
National	Adidas, Arrow, axcess, Axist, Bail, Calphalon, Carter's Champion, Chaps, Cuisinart, Dockers, Jockey, KitchenAid, Laura Ashley Lifestyles, Lee, l.e.i., Levi's, Mud, Nike, Nine & Company, OSHKOSH, Reebok, Russell Athletic, Sag Harbor, Speedo, Unionbay, Villager, Warner's, Yankee Candle, ZeroXposur
Source: Kohl's Department Store, 2006	

As exclusive and private brand offerings strengthen the product mix, they will continue to be a cornerstone of the Kohl's strategy. Kohl's has been busy polishing its image and thus enticing high-profile designers into agreements that will enhance Kohl's future image as the sole destination of particular lines. For example, high-end designer Vera Wang will provide design inspiration while Kohl's handles the production side of the new apparel line, Simply Vera Vera Wang, expected to debut this fall. This multiyear agreement is expected to generate an additional $500 million by the third year (Hoover's-Kohl's, 2007). Home furnishing lines, primarily bedding and bath categories, with a strong Hispanic design and Mediterranean influence will be developed under the Casa Cristina name. The well respected host and producer of "The Cristina Show," Cristina Saralegui, is a key connection to the Hispanic population as a result of the show's success and rank as the number one U.S. produced program on Spanish-language television (Kohl's Department Store, 2006a). In 2007, shoppers will also be able to purchase Food Network-branded home merchandise and the ELLE-branded line of apparel designed by the publishing company of ELLE magazine. Numerous brand extensions are expected as well. Upcoming in May, Kohl's will introduce its first national brand to be carried in every department with the roll-out of the Chaps Home Collection designed by Polo Ralph Lauren (Kohl's Department Store, 2007c). The goal is simple, to make "Only at Kohl's" synonymous with trendsetting shoppers' preference.

To best show-off Kohl's merchandise, the retailer is working towards more consumer-friendly floor displays that will distinguish lifestyle categories, various price points, and style variations more clearly. Using the matrix in Table 2, Kohl's is able to evaluate product offerings and refresh its merchandise mix in each of the targeted lifestyle segments. Additionally, the matrix serves as a tool to modify floor layouts consistently to reflect the good-better-best merchandise strategy Kohl's has adopted (Felgner, 2006); when new merchandise arrives, exclusive, private, and national brands will be categorized into classic, updated, and contemporary segments. Creative visual merchandising, or the display of store merchandise, assists customers with fashion tips and innovative ideas on how to mix-and-match apparel selections of interest.

Table 2: Lifestyle-Merchandise Matrix

	Classic	Updated	Contemporary
Good			
Better			
Best			

Classic: Traditional customer with an understated style (Chaps, Croft & Barrow)
Updated: Traditional at heart but more relaxed (axcess, Axist, Sonoma)
Contemporary: Fashion-forward, trend-right customer (apt. 9, daisy fuentes, Tony Hawk)

Kohl's is also tweaking prices to fit its new good-better-best strategy to take price points a little higher. According to Kohl's president Kevin Mansell, "People will pay for what they want," this is why Kohl's will continue to "up" the prices of new merchandise rollouts in the "better-best" segments (Marks, 2006). This will be particularly important as the retailer continues to research and implement brand extensions into other departments. Ideally, successful retailers need to build brands that connect with the wants of their loyal customers while attracting new customers to increase same-store sales.

Catering to Customers

"Expect Great Things" has a twofold meaning in regards to the quality customers have become accustomed to from Kohl's: merchandise selection and customer service. As explained by Kenosha's Store Manager Tim Cornelius, the internal catch phrase "3E" refers to the quality standard employees are committed to which stands for "every store, every customer, every time, we try to exceed customer expectations" (Cornelius, 2007). This hasn't always been the mantra however. During the late 1990s, Kohl's lost sight of what the customer was looking for in the shopping experience. Intensive research was undertaken in 2003 to better understand where the retailer was missing the mark; the outcome was in large part due to the lack of innovative merchandise (Cornelius, 2007). In addition, Kohl's acknowledges that today's consumer spends less time shopping; therefore, offering convenience is vital. This realization is in-line with the results of the Kanbay Research Institute's findings which classify the current Kohl's shopper profile as either a "speedster" or a "thrifty" (see Exhibit 7 for shopper profiles). Since the Kohl's research, the retailer routinely engages in ongoing feedback to aid in establishing a competitive advantage, maintain loyalty, and ensure customer growth. "We're getting there" says Cornelius, "Ideal customer service involves 1) can we bring the customer in, 2) finding the merchandise, 3) see how to coordinate, and 4) no checkout lines. Then we have done our job" (Cornelius, 2007).

Exhibit 7: Kanbay Retail Shopper Profiles			
	Description	Core Requirements	Retailer
Elites	Interested in high quality service, “money is no object” attitude, and brand loyalty	Distinct brand	Coach
		Personalized service	Gucci
		Reputation for quality	Neiman Marcus
Speedsters	Concern with time spent shopping, accessibility of stores, and ease of checkout	Ease of shopping	Amazon.com
		“In and out” fast	CVS
		Unique selection	Kohl’s
Allures	Primarily about the fun factor and the social element of the shopping experience	Social event	Carter’s
		Outgoing, friendly staff	The Gap
		Hip store image	Target
		Trusted brand names	Dkohl’s
		Helpful staff	Dollar Tree
		Loyalty rewards	Wal-Mart
Thrifties	Interested in basics and require a wide range of merchandise	Trusted Brand Names	Dollar Tree
		Helpful Staff	Kohl’s
		Loyalty Rewards	Walmart
Source: Adjoined Consulting LLC, 2006			

In response to keeping in-step with the rising expectations of its customers, Kohl’s realizes the desire for a more relaxed shopping experience and is taking action to redesign and upgrade its stores. The redesigned store, referred to as the “innovation” store, features a contemporary exterior look of earth tones, marble accents and large display windows. The significant changes however revolve around making the customer’s shopping experience more enjoyable. Interior upgrades include widened aisles, additional promotional and directional signage, higher ceilings, and improved lighting (Troy, 2006). Customer service and restrooms are also being upgraded. Perhaps the most exciting design element addresses the fitting room area which features more rooms and larger spaces for "tweens", pre-teens aged 8 to 12 years, to accompany one another while making their final purchase decisions. Not to fret, lounge areas are provided for any exhausted parents. Although it is uncertain the percentage of new store openings that will incorporate the “innovation” store design, the prototype features and design elements are expected to circle-back in part to existing stores (Cornelius, 2007).

To enhance its ongoing effort to meet the needs of its customers, Kohl’s offers on-line shopping as a means to accommodate the more time-pressured consumer. Although the site primarily features the more basic or traditional lines of merchandise, the retailer expects to expand the site's selections in the future to include more exclusive-labeled selections (Cornelius, 2007). According to the retailer's website, www.kohls.com, e-commerce researchers are employed to evaluate and execute new technologies to present merchandise, create new shopping aids to assist visitors, and update the company information pages routinely to better serve the public. To date, one can search the site for a particular product by entering an item number or by a keyword search, sign-up to receive e-mail notifications of sale events, and check the status of current orders, including shipment progress. Upcoming newlyweds can register at Kohl's Bridal Aisle Gift Registry which is also available on-line. Furthermore, visitors may register personal information to be held "on record" for future, expedited checkouts and can use gift cards, return credits, or major credit cards as payment options (Kohl's Corporation Inc., 2007).

In addition to the convenience its website offers, Kohl's reaches a national audience to maintain customer loyalty through extensive marketing and promotional events. Major events, such as same-day grand opening of multiple stores, are celebrated by rewarding loyal customers and attracting new with additional savings on Kohl's Credit Card purchases. Kohl's encourages the use of its private-labeled credit card as a primary marketing tool. The ability to track and analyze historic spending habits enables the retailer to focus promotional material towards audiences that are prone to favorably respond to an event, thus increasing sales and profits by effectively targeting the appropriate audience (Cornelius, 2007).

"Kohl's Cares for Kids" Program

Catering to the customers is just one aspect of the Kohl's story. Kohl's prides itself on caring for local communities, especially their children, which further enhances its appeal to the Classic American Family segment. The Kohl's Cares for Kids Program "is a promise of hope for a brighter, healthier future for children in our communities" (Kohl's Department Store, 2007c). Encompassing more than corporate financial contributions, the Program entails rewarding scholarships to minors for their volunteer efforts, selling special merchandise as fundraisers for schools, hospitals, and non-profit youth groups, and encouraging employees to engage in philanthropic activities. Under the Program, Associates band together in an "A-Team" and choose a youth-focused, non-profit organization they want to support. Kohl's Associates donate their time and expertise while the corporation donates $500 to each A-Team's chosen event or non-profit organization. Throughout the Program in 2006, Kohl's provided almost $33 million to aid U.S. communities; partnered with 143 hospitals to offer support to children in need; and volunteered over 57 thousand hours (Kohl's Department Store, 2007c).

KOHL'S SOFTLINE RIVALS

According to the U.S. Department of Labor, department stores are described as those retail providers who employ 50 or more employees and carry a general line of men and women's apparel, home furnishings, and housewares. The merchandise is arranged in separate departments, each financially responsible, but integrated under a common management (U.S. Department of Labor, 2007). Even though department stores sell a wide range of products, the merchandise and in-store service are noticeably better quality than found at big box discounters who compete on price and geographic dominance.

Kohl's direct competitors are mid-level department stores, primarily JC Penney and Federated for softline merchandise, and to a much lesser extent the big-box discounters like Target for hardline merchandise (Cornelius, 2007). Kohl's is able to carry top national brands that are not typically available through discount retailers and offers them at lower prices than most rival department stores by controlling their costs (see Exhibit 8 and Exhibit 9 for financial data). Volume discounts from economies of scale are generated by offering similar merchandise at every store. Typically Kohl's carries the same merchandise at each location but may vary selections slightly based on regional demand. For example, stores located in the Midwest would carry a larger selection of outwear for the winter season whereas the southern region stores would carry more in lighter-weight apparel (Cornelius, 2007). Additionally, each store layout is similar, providing wide race track aisles for ease in navigating to departments and to central checkouts which provide faster service than other department stores. The free-standing locations also contribute to the bottom-line by avoiding high premiums associated with rental space in shopping malls and added dues for security and maintenance. The isolation of Kohl's aids the retailer in locking-out the competition since shoppers do not have a "back-up" store readily available for comparison shopping.

JC Penney

At the start of 2006, JC Penney operated 1,019 department stores, of which only 236 were owned, throughout the U.S. and Puerto Rico (CNNMoney, 2007). Aside from apparel and home furnishing merchandise, the retailer offers salon, optical, portrait photography and custom decorating services through its store and catalog businesses. Through an owned subsidiary, JC Penney Realty, the organization has invested funds in 14 partnerships that own shopping mall properties (Various companies, 2007). JC Penney has made a conscious effort to pull-out of unprofitable markets; it sold its Eckerd drugstore chain, closed doors on six Mexico department stores, and relocated eleven stores domestically.

Exhibit 8
Kohl's Financial Summary

	2006	2005	2004	2003	2002
Operating Data (in millions)					
Net Sales	$15,554	$13,402	$11,701	$10,282	$9,120
Gross Margin	5,654	4,763	4,114	3,395	3,139
SG&A Expenses	3,401	2,964	2,584	2,158	1,884
Reopening Expenses	50	44	49	47	41
Depreciation and Amortization	388	339	288	239	193
Operating Income	1,815	1,416	1,193	951	1,021
Net Interest Expense	41	70	63	73	56
Net Income Before Taxes	1,774	1,346	1,130	878	965
Net Income	1,109	842	703	546	601
Other Data					
Earnings Per Share	$3.31	$2.43	$2.04	$1.59	$1.75
Net sales per selling square foot	$256	$252	$255	$268	$284
Number of stores open at year end	817	732	637	542	457
Total square feet of selling space (in thousands)	62,357	56,625	49,201	41,447	34,507

Source: Kohl's Department Store, 2007

Exhibit 9
Financial Ratio Comparison

	Industry	Kohl's	JC Penney	Federated	Target
P/E	18.07	23.04	16.71	24.45	18.74
Gross Margin %	28.30	36.37	39.32	39.94	32.58
Operating Margin %	6.56	11.68	9	6.81	7.56
Net Profit Margin %	4.01	7.13	5.7	3.66	4.68
Quick Ratio	0.34	0.42	0.93	0.33	0.76
Current Ratio	1.18	1.77	1.9	1.17	1.32
LT Debt/Equity	0.49	0.19	0.7	0.64	0.55
ROI	11.91	15.26	12.01	4.05	10.79
ROA	8.01	10.33	9.02	3.15	7.71
ROE	19.38	19.18	27.34	7.67	18.68

Source: Various companies, 2007

JC Penney has been striving to alter its hum-drum image since the late 1990s by offering more fashionable merchandise to entice middle-income families. The "Every Day Matters" slogan reminds the target segment, women aged 35 to 54 years (Frazier, 2005), to view JC Penney as a revitalized shopping destination where better fashion designs await them. The expansion of its private and exclusive merchandise includes partnerships with brands a.n.a., Arizona, Bisou Bisou, E. 5th, Liz Claiborne, Nicole by Nicole Miller, and Sephora USA. JC Penney uses a gap analysis approach to guide its branding strategy. This involves reviewing the customer's life and style preferences, identifying disconnects in current product offerings, and then building a private brand to fill the gap. For the past several years, the department store has increased sales of private labels by 3% annually; today, private labels represent more than 40% of the store's revenue. Additionally, Penneys plans to open 150 new, free-standing locations and remodel another 200 existing stores by 2009 (Hoover's-JC Penney, 2007).

Federated

After the 2005 acquisition of rival May Stores (Marshall Field's), Federated operated 850 plus store locations, generating $27 billion annually, which created the nation's largest department store chain (Hoover's-Federated, 2007). Federated offers apparel, cosmetic, accessory and home furnishing merchandise under the Macy's and Bloomingdale's names. About 80 duplicate store locations which were acquired with the purchase of May will be off-loaded as the retailer streamlines its operations (Chittum, 2005). Additionally, Federated sold-off the David's Bridal stores and is currently closing a deal to sell the After Hours Formalwear stores in 2007. The influx of cashflow will aid in the catalog and e-commerce businesses which the department store chain intends to invest $130 million over the next few years (Hoover's-Federated, 2007).

Federated is making a shift in its product lines to focus on attracting a younger clientele. In 2003, the department store's CEO, Terry Lundgren, devised a four-point plan to increase Federated same-store sales that includes: 1) strengthening private brands, 2) simplifying pricing, 3) marketing on a national level, and 4) improving the physical aspects of the in-store experience (Hoover's-Federated, 2007). The retailer already has plans to expand its home furnishing selections to encompass a new line designed by Martha Stewart to debut in fall of 2007. Lundgren explains that his intent is to "offer high fashion without high prices but in a more chic and comfortable setting than typically found at a discounter" for the middle-income consumer. Plans to remodel will include widened aisles, improved signage, additional staff for assistance, and upgraded fitting rooms with plasma-screen televisions (Tsiantar, 2006a).

LOOKING FORWARD

As the retail sector continues to take-on a new form through rapid consolidation and new partnerships, department store competitors will continue to face new challenges. Aside from the challenges presented by a growing interest in discount and specialty stores as preferred shopping destinations, retailers pursuing rapid growth strategies will need to consider the likelihood of acquiring favorable locations for expansion efforts, attracting and retaining professional staff, and fine-tuning their merchandise mix and customer service levels to exceed customers' expectations. Amidst these opportunities is the essential need to maintain favorable relations with their core target market. What can retailers do to make their brands the premiere choice and identify with customers? How will department store retailers align their business efforts to ensure success?

JC Penney presented its 2007-2011 long-range plans to boost store growth and expand its customer base. The department store has developed multi-tiered approach which includes: 1) building an emotional connection with customers, 2) offering inspiring merchandise and services, 3) becoming the destination for a retail career, and 4) establishing itself as a growth leader in retail. JC Penney anticipates it will open 250 new stores and renovate 300 store locations within the next five years (JC Penney, 2007a).

The department store has already shown progress towards offering inspiring merchandise and expanding its customer base. Recently launched in 2007 are the Ambrielle lingerie brand and the re-introduction of cosmetics by Sephora. For the 2007 back-to-school season, JC Penney will debut an exclusive denim and sportswear line designed by Chip and Pepper Foster, identical twins who have sparked rapid popularity among teens and young men through a celebrity cult following (JC Penney, 2007b). Univision Television Network has partnered with a host of merchants, including Penneys as the exclusive retailer, for sponsorship in a new reality show aimed at the Hispanic market segment. The show, Neuestra Belleza Latina (Our Latin Beauty), will air the first reality-beauty program to test the talent and character of a dozen Hispanic finalists (Latino Talk, 2007). The weekly production will provide JC Penney high brand exposure of its merchandise and the opportunity to connect with viewers.

Federated is currently pursuing a change in its parent company name to Macy's Inc. to align its corporate name with its largest brand in hope of enhancing the Macy's brand-driven reputation. However, over 59,000 die-hard Marshall Field's fans are lashing out at the corporate giant to preserve the landmark location on State Street, Chicago as Marshall Field's by signing an on-line petition to retain the store's name. This particular location attracted more than nine million visitors each year as one of Chicago's most popular tourist destinations (Wikimedia Foundation, Inc., 2007c) known for its 150 years of history, as the second largest department store in the U.S., and founder of the bridal registry and first in-store restaurant – The Walnut Room. Demonstrators protested outside of the flagship store by cutting-up Macy's credit cards and advertising their website, fieldsfanschicago.org, which provides alternate shopping destinations. Since Federated's takeover and rebranding efforts as Macy's, same-store sales at former Marshall Field's locations have declined by an estimated 30-40% (Topix, 2007).

On the brighter side, Federated continues to forge ahead with its commitment of $2.3 billion in capital spending. One area of significant focus is the organization's desire to expand its direct-to-consumer business to more than $1 billion in 2008 sales figures, a 60% increase from 2006. Plans are in motion to build a 600,000 square-foot distribution center and to improve the macys.com website, order management system, and warehouse management system (Federated Department Stores, Inc., 2007).

Kohl's is on-track with its aggressive store expansion and renewed merchandising mix. It plans to capture additional market share through expanding its exclusive brands while upgrading stores and opening new locations with its prototype features. Recent headlines announce the corporation's commitment to "green power," signifying its dedication to "making a difference" by reducing greenhouse gases directly linked to global warming. In an April 2007 press release, Kohl's announced it would convert more that 75% of its California locations to solar power by the end of 2008. According to Jigar Shah, CEO of SunEdison which is North America's largest solar energy service provider, the Kohl's solar program is "the single largest purchase of solar energy in U.S. history" (Kohl's Department Store, 2007a).

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SOUTHEAST SPORTING GOODS: APPLICATION OF INFORMATION SYSTEM PURCHASING PRINCIPLES

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CASE DESCRIPTION

The primary subject matter of this case concerns information systems. Secondary issues to be examined include identification of technology issues for a small business and the design of a new system. The case, when used for a RFI and RFP exercise, has a difficulty level of five. The case is designed to be taught in three class hours and is expected to take approximately fifteen hours of outside student preparation.

CASE SYNOPSIS

The company president, to whom Eric reports, gives him his first assignment, "You've got a budget of $230,000 to upgrade our old computer system. We want a fast, flexible network. And we want to move some of our marketing effort to the Internet. We'd also like to move toward having our salespeople use laptops or PDAs to enter orders directly from customers. Make a list of what we need in the way of hardware and software. Include everything –"

Students are presented with a business scenario in which they need to have a new information system installed for a small company where a recent graduate has just started working. Students are asked to review the scenario, create an organizational overview to be used as part of a Request for Information (RFI), create a functionality list for a new information system, create an internal memo to justify the expenditure on the new system, and outline what the possible responses to a Request for Proposals (RFP) might be. Included in the instructor's note are guidelines for the use of RFIs and RFPs, complete directions for an assignment, and a completed response. Graduates in the Information Systems area or with MBAs are expected to have an immediate impact on their new company. Many times the graduate is in a newly created position with little guidance from a mentor or more experienced worker. This is especially true for small and medium sized corporations, the very ones that are creating the most new jobs. This case and instructor's note fills a specific void in the field of applying information systems education. Although aimed at small *business situations, the knowledge gained through this exercise is equally or more important to graduates who take jobs in government and non-profit agencies or supplying those offices.*

SOUTHEAST SPORTING GOODS

The First Assignment

Eric Green, a recent graduate of Small State University, has just been hired as the first full-time IT manager for a small sporting goods manufacturing company. During the interview process, Eric met with the company president, Sue Boss, and all three of the vice-presidents. Because of Eric's interest in sports and knowledge of business and information systems, he was hired over other similarly qualified individuals. Eric agreed to take the job because he liked the family atmosphere of the place and how decision-making was very participative.

The company president, to whom Eric directly reports, gives him his first assignment. Boss says, "We are committed to a new, upgraded information system and have budgeted $230,000 to spend on it. We want a fast, flexible network. And we want to move some of our marketing effort to the Internet. We'd also like to move toward having our salespeople use laptops or PDAs to enter orders directly from customers. Make a list of what we need in the way of hardware and software. Include everything – computers, cables, network cards, etc. Also, tell me how we are going to go about converting from our old system to our new system. Oh yeah, get this system proposal started within one week. We've got to get going on this before the old system dies on us."

"One more thing," Boss continued, "you better make sure the system is easy to use, because you have to train everyone on how to use it. The VP's have all been asked to meet you in the conference room at 8 am tomorrow, but judging from your interview, you are the expert and they won't have much to contribute except the type and timing of information they need."

Company Information

Southeast is a small, but very profitable slow growth company. They make braces, primarily for knees and elbows, to prevent further injury and allow the athlete to continue to enjoy their sport. An outside sales force of eight salespeople cover the southeastern United States selling to over 1,000 small retailers, both sporting goods stores and medical supply outlets. Most of their new products come from a local professor in Sports Medicine at Small State University, Dr. Harold Boss. The partnership is friendly and mutually beneficial and all patents are jointly held.

The home office staff includes the company president and three vice-presidents (marketing, finance and operations). The president is responsible for all hiring and Human Resource decisions. Ms. Boss reports to a Board of Owners. The Board represents a group of silent partners who invested in the company 20 years ago. The vice-president for marketing is responsible for managing the sales force and implementing the marketing efforts which includes catalog preparation and distribution and frequent direct mail campaigns. The vice-president for finance is responsible for maintaining the general ledger, managing accounts payable, accounts receivable, purchasing and inventory. There are four office professionals assigned to the finance function. One each to the general ledger, accounts payable, purchasing and inventory, and accounts receivable, but there is considerable task sharing and helping across tasks. The company's current accounting systems use a job based system with perpetual inventory systems. All accounting work, including payroll are completed in-house, except for year-end returns. The vice-president for operations is responsible for receipt and storage of shipments, the manufacturing process, along with filling and shipping customer orders. There are ten workers assigned to the operations function along with one supervisor and a clerical assistant.

The office, plant and shipping areas are housed within the same building but in separate areas. The office is at the front of the building, with the plant in the middle and the shipping area at the rear of the building. The building is approximately 7500 square feet, measuring approximately 100 feet deep by 75 feet wide.

The current information system is almost twenty years old. Some pieces of hardware, such as the old mainframe system, date to the start of the company in 1987 and few pieces share the same manufacturer. There are frequent hardware breakdowns, network connections are slow, or non-existent, and the software is a patchwork of modified off-the-shelf accounting and personal productivity packages. Some needed applications were generated using a database management program from a company that is no longer in business. Updates and patches have been handled by a consulting contract with a computer tech employed at Small State University; unfortunately he just got a new job at Big State University and will be leaving.

The work is getting done, but the company's managers are starting to get nervous about the continued performance of the system.

What now?

As Eric sat in his new, undecorated office planning for the VP meeting, his thoughts were racing. The sales staff may resist, many of them were nearly computer illiterate. He had overheard Bill, a senior salesman say that the TV said the other night that "the web would replace salesmen in ten years." There were no guidelines anywhere on purchasing. No RFI or RFP forms. Larry, in operations, said that most purchasing was done with a few phone calls to trusted suppliers or old friends. How did this place make sure they got the best deal? What happens when one of the "old hands" retires? Some of the Vice-presidents <u>are</u> approaching retirement age.

If Eric gets this right, he is a hero to this company. If he comes in under budget, Ms. Boss jokingly said, "I may adopt you." It <u>is</u> a family-type firm. If Eric blows the assignment, will he be homeless?

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