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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
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CASES

PFF BANK & TRUST: "CUSTOMERS FIRST" BRAND OF BANKING

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Stanley C. Abraham, California State Polytechnic University, Pomona

CASE DESCRIPTION

The primary subject matter of this case concerns PFF Bank and Trust, a fast growing regional bank located in Southern California. Secondary issues examined include the structure of the banking industry, competition in the banking industry and the challenges facing the financial services sector. The case has difficulty levels of four, five and six. The case is designed to be taught in three class hours and is expected to require four hours of outside preparation by students.

CASE SYNOPSIS

The case presents PFF, a $4 billion full-service community bank headquartered in Pomona, California. The case begins with a discussion of the structure of the banking industry. It continues with a discussion of major industry trends such as consolidation, record earnings, declining mortgage volume, technological advances and the corporate scandals that have rocked the financial services industry in recent years. The case then presents PFF, beginning with its founding in Pomona in 1892 as The Mutual Building and Loan, continuing with its explosive growth mirroring the population expansion in the Inland Empire of Southern California, and ending with its current challenges. The case discusses the organizational and management structure of PFF, its corporate culture, and key elements of its growth strategy, sprinkled with excerpts from an interview with its CEO, Mr. Larry Rinehart. The case then turns to the competitive landscape in PFF's home turf, the Inland Empire, and discusses major regional and national competitors. The case concludes with the future challenges that PFF faces.

The case provides many tables and figures to support its content, especially detailed multi-year financial statements for PFF Bancorp. In addition, it includes an appendix that provides information on how to analyze a bank. Since accounting systems of financial institutions are different from those of other companies, we believe this would serve instructors and students well. The greatest strength of the case is that it focuses on a firm that has been very successful competing in a regional space against other regional and much larger national competitors in an industry with which students are seldom familiar. The challenge facing the student analyst is coming up with a defensible set of recommended strategies for a firm that has been very successful in doing what it does to continue to be successful in its competitive space.

INTRODUCTION

Mr. Larry Rinehart (Rinehart, 2005), President and CEO of PFF Bancorp, the public holding company that operated PFF Bank & Trust (PFF), was contemplating the bank's future. In his 13 years as President and CEO, PFF had transitioned from a mutually owned savings-and-loan (S&L) institution to a publicly traded full-service bank listed on the NYSE, an accomplishment of which Larry was particularly proud since PFF was the only local financial institution listed on the NYSE and was one of only a handful of firms in the Inland Empire (a geographical region east of Los Angeles comprising San Bernardino and Riverside Counties) to have been represented on the NYSE's famous podium. PFF, a $4 billion full-service community bank headquartered in Pomona, California, had achieved a 15% annual growth in return on stockholders' equity (ROE) since going public in 1996. The banking industry had changed tremendously during the 27 years Larry had spent with PFF. Deregulation created new competitors and new regulations passed by Congress to combat the corporate malfeasance of the past few years and address terrorism created additional challenges for firms that operated in the industry. How should PFF weather the shifting competitive and regulatory landscapes of the banking industry? How should PFF continue to sustain such growth in ROE and achieve its financial objectives of 10% annual growth in EPS?

STRUCTURE OF BANKING INSTITUTIONS

Banking institutions included commercial banks and thrifts, distinguished primarily by their ownership and management of assets and liabilities (Encarta, n.d.b). As of Q1 2005, the FDIC insured 7,598 commercial banks with total assets of over $8.59 trillion, total deposits of over $5.70 trillion, and 1.8 billion employees; 1,332 thrifts with $1.69 trillion in total assets, over $1 trillion in total deposits, $1.2 trillion in net loans and leases, and 277,920 employees (FDIC, 2004).
Commercial banks can be owned by stockholders or by holding companies. A holding company primarily holds stock in another company (see Table 1 for the largest US Bank Holding Companies). In 2000, 76% of banks were owned by bank holding companies, as compared with 62% in 1984 (Encarta, n.d.b). Holding companies enabled banks to engage in financial activities otherwise prohibited by law by allowing them to set up subsidiaries under the holding company. These subsidiaries engaged in activities such as financial-investment services, underwriting securities, and other investment-banking activities (Encarta, n.d.b).

Table 1: Largest US Bank Holding Companies Ranked by Total Assets

Rank	Company	Total Assets ($M)		
		3/31/2003	3/31/2004	% Change
1	Citigroup, Inc.	1,137,373	1,317,591	15.8
2	Bank of America Corp	680,197	816,012	20

Table 1: Largest US Bank Holding Companies Ranked by Total Assets				
Rank	Company	Total Assets ($M)		
		3/31/2003	3/31/2004	% Change
3	J.P. Morgan Chase & Co	755,156	801,078	6.1
4	Wachovia Corp.	348,064	410,991	18.1
5	Wells Fargo & Co.	369,607	397,354	7.5
6	U.S. Bancorp	182,231	192,093	5.4
7	SunTrust Banks, Inc.	120,062	125,245	4.3
8	National City Corp.	117,494	111,355	-5.2
9	BB&T Corp.	79,648	94,282	18.4
10	Fifth Third Bancorp	84,325	93,732	11.2
11	State Street Corp.	79,109	92,896	17.4
12	Bank of New York Co. Inc	79,548	92,652	16.5
13	KeyCorp	86,490	84,448	-2.4
14	PNC Financial Services Group Inc.	68,619	74,115	8
15	Comerca Inc.	55,805	54,468	-2.4
16	SouthTrust Corp.	51,349	52,673	2.6
17	Regions Financial Corp.	48,465	48,777	0.6
18	AmSouth Bancorporation	42,099	47,415	12.6
19	UnionBanCal Corp.	40,387	46,102	14.2
20	Charter One Financial Inc.	43,249	41,279	-4.6

Source: Standard & Poor's (2004, August 19). *Standard & Poor's Industry Surveys: Banking, Vol 172, No. 34, Section 1*. New York: McGraw-Hill Companies.

Commercial banks derived their earnings primarily from two earning assets: loans and securities. Loans included commercial, consumer, and real estate loans. Commercial and residential real-estate loans were long-term, secured by real property and generated predictable cash flow, thus making them the least risky type of loan. Commercial and industrial (C&I) loans, made to businesses, could be secured or unsecured and could vary in maturity – short-, medium-, or long-term. These loans had flexible interest rates, low processing costs, and were typically the lowest yielding of a bank's loans. Consumer loans included credit-card lending and other installment loans. They tended to be medium-length in maturity, had predictable cash flow in interest and principal payments, but carried a higher risk of default and tended to have higher processing costs than business loans. In addition to loans, banks invested in securities to earn interest income. Since banks needed to maintain liquidity to meet deposit withdrawal and sudden increases in loan demand, they held about 95% of their portfolio in fixed-income securities such as municipal bonds and U.S. government and Treasury bonds. Commercial banks also invested in trading-account securities, which were interest-bearing securities held primarily to realize capital gains. These tended to have higher risks as they were strongly affected by interest-rate trends (Standard & Poor's, 2004a). As of Q1 2005, commercial banks had net loans and leases of $4.91 trillion and trading-account assets of $488 billion (FDIC, 2004).

Thrifts' earning assets were typically composed of residential-mortgage loans although they could offer consumer loans (see Table 2 for the Leading Thrift Institutions and Table 3 for a typical Savings Association Insurance Fund (SAIF)-insured thrift's loan portfolio). The single-family-home mortgage was either fixed-rate, the 15- to 30-year mortgage, or adjustable rate mortgages (ARMs). ARMs had been an essential instrument in reducing thrifts' vulnerability to interest rate changes. The interest rates on ARMs varied monthly, quarterly or annually based on the movement of a cost-of-funds index or on the one-year Treasury bill rate. When interest rates were low, consumers preferred fixed-rate mortgages so they could lock in a low rate. The low fixed-mortgage rates of 2001 through 2003 created record refinancing activities and made fixed-rate mortgages the choice of new homebuyers. Rising mortgage rates and predictions of higher rates in 2005 and 2006 have created a resurgence in ARM lending. In Q2 2004, 50% of the industry's originations were ARMs, up from the high teens between July 2000 and July 2003. Many thrifts also offered hybrid ARMs, with initial fixed term of three to ten years. As with commercial banks, the primary liabilities of thrifts included time and demand deposits (Standard & Poor's, 2004b).

Table 2: Leading Thrift Institutions Ranked by Total Assets

Rank	Company	Assets ($M)	
		12/31/2002	12/31/2003
1	Washington Mutual	268,298	275,178
2	Golden West Financial	68,406	82,550
3	Sovereign Bancorp	39,524	43,505
4	New York Community Bancorp	11,313	23,441
5	GreenPoint Financial	21,814	22,985
6	Astoria Financial	21,698	22,458
7	IndyMac Bancorp	9,574	13,240
8	Commercial Federal	13,081	12,189
9	Downey Financial	11,978	11,646
10	Flagstar Bancorp	8,204	10,570

Source: Standard & Poor's (2004, December 2). *Standard & Poor's Industry Surveys: Savings and Loans, Vol 172, Number 49, Section 2*. New York: McGraw-Hill Companies.

Table 3: Typical SAIF-Insured Thrift's Loan Portfolio	
Category	% Loans (as of 12/31/2003)
1-4 family mortgages	61.9
Mortgage-backed securities	10.5
Construction	8.1
Apartment	6.2
Consumer	5.4
Commercial	4.5
Commercial real estate	2.5
Land	0.9
Total	100
Source: Standard & Poor's (2004, December 2). *Standard & Poor's Industry Surveys: Savings and Loans, Vol 172, Number 49, Section 2*. New York: McGraw-Hill Companies.	

Deposits, debt, and shareholders' equity were the principal liabilities of commercial banks and thrifts. There were many types of deposits: consumer-demand and time deposits, corporate-demand and time deposits, foreign deposits and borrowings, and negotiable certificates of deposit or jumbo CDs. Demand deposits could be withdrawn by the depositor at any time and in any amount. Examples included checking accounts, money orders, travelers' checks, etc. Checking accounts were also transaction accounts because they could be used to make payments to a third party.

Time deposits were those in which a depositor kept his or her money in the bank until a specified date, or incurred penalties. Certificates of Deposit (CDs), money-market, and negotiable-order-of-withdrawal (NOW) accounts were examples of time deposits. They typically required a minimum deposit amount and often paid higher interest rates than regular savings accounts. The traditional savings account was also a time-deposit account which paid interest to the depositor but had no specific maturity date (Standard & Poor's, 2004a). Thanks to consumers who sought investments with higher rates of return, such as mutual funds, the very low deposit growth of the late 1990s was being reversed. The stock market crash of 2000 and 2001 produced a "flight to safety," with more investment dollars flowing into banks. The FDIC's Q1 2005 report showed deposit growth of 9.5% for all institutions insured by the FDIC (FDIC, 2005a). Debt for banks included federal funds, other short-term borrowings like commercial paper, and long-term debt (FDIC, 2004). The Gramm-Leach Bliley Act of 1999 deregulated the financial services industry and blurred the lines between banks and other financial services providers such as insurance and investment companies. Many thrifts pursued a commercial/consumer-banking model in response to competition in their core business. Many in the thrift industry believed that thrifts should be folded into the banking industry. Many thrifts experienced a decline in their deposits-to-loans ratio and ongoing pressure on margins from Fannie Mae (Federal National Mortgage Association or FNMA) and Freddie Mac (Federal Home Loan Mortgage Corporation or FHLMC). Fannie Mae and Freddie Mac were government-sponsored enterprises (GSEs) that engaged in purchasing, guaranteeing, and securitizing mortgages for sale to investors or for holding in their portfolios. The GSEs had access to less expensive financing (due to investors' perception of implicit government backing in the event of an insolvency) and lower operating costs, which gave them a competitive advantage over thrifts and enabled them to gain a larger share of mortgage-debt holdings. However, the growth of GSEs has had a beneficial effect on thrifts by allowing them to function as mortgage bankers, that is, sell their fixed-rate-mortgage production to the secondary markets (Standard & Poor's, 2004b).

INDUSTRY TRENDS

Commercial banks and thrifts enjoyed record earnings due to expanding economic conditions. Real GDP growth over the period 2001-04 was 2.8%. Real GDP growth in Q1 2005 was 3.8% over Q1 2004 (Bureau of Economic Analysis, n.d.). The consensus was for continued economic improvement. According to the FDIC, over 62% (nearly two in three) of commercial banks reported earnings in 2004 higher than a year earlier, and 47% of savings institutions had higher 2004 earnings than a year earlier. Both commercial banks and savings institutions insured by the FDIC reported record earnings in Q1 2005. Net income was $34.3 billion, a 7.7% increase over the record of $32.4 billion set in 2004. The FDIC attributed this primarily to lower expenses for bad loans and the absence of significant merger-related costs. The industry experienced a decline in net operating revenues (the sum of net interest income and total non-interest income) primarily due to rising short-term interest rates. A flattening yield curve means declining NIM (net interest margin, which is net interest income divided by average earning assets) and lower net interest income. NIM dropped to a 15-year low of 3.54% from 3.63% in Q4 2004. Net interest income of $435 million declined 0.3% from Q4 2004 (FDIC, 2004).

Although the industry continued to enjoy strong mortgage demand, mortgage volume slipped from its recent record levels. Mortgage originations were expected to decline 36% in 2004 and 28% in 2005. The greatest drop was expected in the refinancing area, where total originations were expected to drop 43% in 2004 and 24% in 2005. Deposit growth outstripped loan growth for the second quarter in a row. Total deposits increased by $124.5 billion in Q1 2005, a 38% decline from the $200.5 billion increase in the previous quarter. Loans increased by $81.8 billion in Q1 2005, 40.5% lower than the $137.7 billion increase in the previous quarter. According to FDIC Chairman Powell, "The growth in deposits is an especially good sign for the banking industry. It shows that Americans appreciate the safety, the simplicity, and the convenience of FDIC-insured deposits, because there are many other options available to them" (FDIC, 2004).

The competitive drive to expand market share, increase the number of products and services offered, enhance geographic coverage, and improve efficiency led to significant consolidations in the industry over the past 20 years. The peak of consolidation activities in the mid-1990s saw 600 banks absorbed by mergers and acquisitions annually. The pace of merger activities declined from 2000 to 2002 due to declining stock prices. The number of bank mergers had reduced to fewer than 300 by 2003. However, S&P foresaw greater merger activity with small to mid-size regional banks (assets of less than $20 billion), especially those located in high-growth areas like the Southeast, Texas, and parts of the West Coast, as likely targets of larger domestic or foreign banks. The need to compete more efficiently in a deregulated environment will continue to drive consolidation over the long term, which has increased concentration in certain segments of the industry. For example, 60% of the credit-card market was controlled by the five largest providers, 60% of the corporate-lending segment was controlled by the five largest banks, and 40% of the mortgage market was controlled by the largest ten firms in that segment. Consolidation also allowed banks to gain economies of scale and to earn healthy shareholder returns from larger portfolios. Consumers as well as the banks themselves benefited from these scale advantages (Standard & Poor's, 2004a).

The financial-services sector was battered by multiple scandals. In 2003, Freddie Mac came under investigation by the Securities and Exchange Commission (SEC) and the Justice Department on accounting irregularities. In 2004, Fannie Mae was cited with violating generally accepted accounting principles (GAAP) by the Office of Federal Housing Enterprise Oversight (OFHEO) and also came under investigation by the SEC and the Justice Department. Congress passed the Federal Enterprise Regulatory Reform Act in 2004 to transfer overseership from OFHEO to an independent regulator, the Office of Federal Enterprise Supervision in the Treasury Department, with additional powers to regulate the government-sponsored enterprises (GSEs) Freddie Mac and Fannie Mae. In 2003, Eliot Spitzer, New York State's attorney general, announced that certain mutual funds had engaged in improper trading practices – "market timing" and "late trading." Several financial institutions, including banks, were named in the mutual-fund scandal. This poses a potential risk for the industry in the form of financial penalties and damage to their reputation (Standard & Poor's, 2004a). Already highly regulated, these scandals posed the threat of additional regulations. Newer regulations, such as the Bankruptcy Abuse Prevention and Consumer Protection Act passed by Congress in March 2005, were favorable to the industry; however, others, such as Sarbanes-Oxley Act of 2002 (SOX) and the USA Patriot Act of 2001, have created additional costs for financial institutions.

Advances in technology enabled the industry to increase efficiency through lowering operating costs. Technology improvement enabled the replacement of labor-intensive functions and a reduction in labor-related expenses (Standard & Poor's, 2004a). The Internet enabled banks to provide several of their traditional services online, such as mortgage-lending and deposit-gathering. Online mortgage originations comprised 45% of total originations in 2003 and 43% in 2002. Online banking was fast becoming the industry norm. Many banks invested substantial resources to provide the convenience of online banking. The Internet also created new competitors such as E*Trade Bank, Ditech, and ING Bank, which operated primarily online. Despite the growth in online banking, banks continued to make investments in their brick-and-mortar infrastructure as a way to reach consumers (Standard & Poor's, 2004a). One of the downsides of technology has been the loss of customer information to computer hackers and identity theft. Several banks have had sensitive customer information stolen by computer hackers. As a result, banks have had to devote substantial resources to security infrastructure.

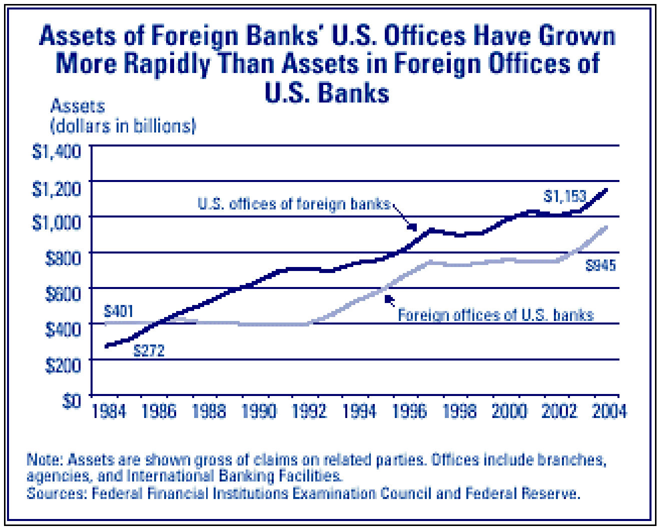
Globalization was another important industry trend. With a maturing and saturated US market in most product/service segments, many banks pursued globalization to increase revenue growth and market power. Banks had many reasons to go global, a key one being to service the banking needs of their domestic clients. Many banks "followed the customer" to foreign countries where they operated. Not only were U.S. banks growing their international operations, foreign banks were also expanding their presence in the U.S. (see Figure 1). As of 2004, U.S. banks had $945 billion in foreign assets, an increase of 136% from the 1984 figure, and foreign banks had $1.15 trillion in U.S. assets, an increase of 324% over the 1984 figure. U.S. banks focused their activities in Asia and Europe, with Asian banks having a 23% share of U.S. banks' foreign assets as of December 31, 2004, and European banks having 54% (see Table 4). While commercial and industrial lending dominated the overseas operations of both U.S. and foreign banks, non-banking subsidiaries were the fastest source of foreign assets for U.S. bank-holding companies (FDIC, 2005c).

Table 4: Location of Foreign Branches of U.S. Banks (dollars in billions)

	31-Dec-94		31-Dec-04	
Location	Assets	Asset Share	Assets	Asset Share
Asia	$76	23%	$104	23%
Canada	0	0%	11	2%
Europe	161	48%	245	54%
Latin America	13	4%	13	3%
Caribbean	63	19%	41	9%
Other	21	6%	41	9%
Total	$333	100%	$456	100%

Source: Federal Deposit Insurance Corporation. (Summer 2005). FDIC Outlook: The globalization of the U.S. banking industry. Retrieved on August 16, 2005, from http://www.fdic.gov/analytical/regional/ro20052q/na/2005summer_03.html

Figure 1: Comparing Assets of Foreign Banks' U.S. Offices with Foreign Offices of U.S. Banks



Source: Federal Deposit Insurance Corporation. (Summer 2005). *FDIC Outlook: The globalization of the U.S. banking industry.* Retrieved on August 16, 2005, http://www.fdic.gov/analytical/regional/ro20052q/na/2005summer_03.html

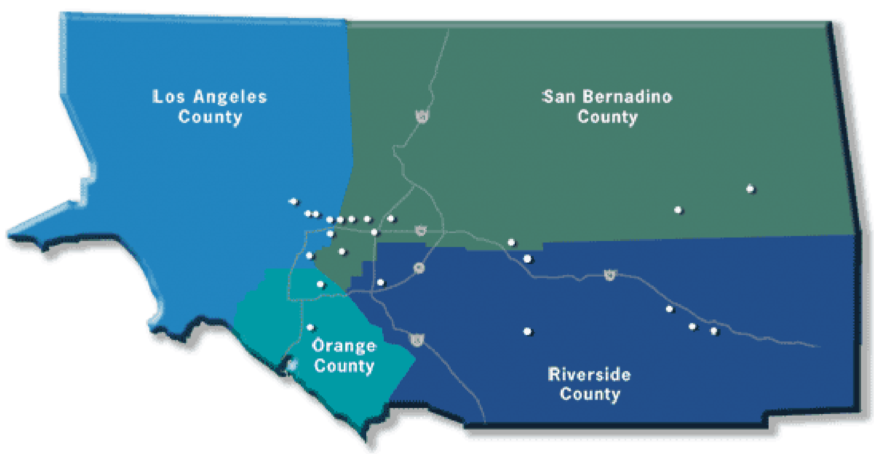
Many globalization activities involved the very large banks with very large corporate customers. However, small firms accounted for a third of U.S. exports in 2001 and continually faced challenges to finance their international operations. California had the largest number of small-manufacturing-enterprise (SME) exporters at 55,000 firms, followed by Florida, New York, Texas, and Illinois. SMEs typically needed financing to produce the goods they exported, e.g., working-capital loans, or to finance the sale of exports, e.g., letters of credit. Only about two percent of banks engaged in any significant amount of trade financing in 1988, and the FDIC believed that the numbers have not changed much since then. Growth in worldwide trade may provide smaller banks an opportunity to garner additional loan business and increased fee income by servicing the needs of SMEs (FDIC, 2005b).

HISTORY OF PFF

PFF was founded on Christmas Eve of 1892 by a group of community leaders in Pomona as The Mutual Building and Loan. The company opened its first branch in Pomona, California, a city located in the Inland Empire about 30 miles east of downtown Los Angeles. The bank's corporate office was located in Pomona. The Mutual Building and Loan Company focused on making loans to local individuals, two of whom were Walter and Cordella Knott, who founded the now famous Knott's Berry Farm theme park in Southern California. During the difficult times the nation faced in the Great Depression of the 1930s, the Federal Home Loan Bank Board was created to establish a federal system of bank charters. In 1938, The Mutual Building and Loan became known as Pomona First Federal (PFF) (PFF Bank & Trust, 2005a).

PFF, still focused on home loans, grew apace with the housing demand in Southern California. In response to housing needs created by returning WWII veterans and new families moving into the Pomona Valley, PFF developed a construction-loan program. Pomona Valley continued to grow in the mid-50s. PFF expanded by opening new branches in Upland, Chino, and San Dimas, all neighboring communities. Eleven additional branches were opened in the seventies and eighties. By 2005, PFF had grown to 30 full-service-banking branch offices in eastern Los Angeles County, northern Orange County, and Riverside and San Bernardino Counties (see Figure 2). It planed to add two new branches in fiscal 2006, one in the city of Riverside and the other in Mira Loma, with additional branch openings planned in the future (PFF Bank & Trust, 2005b).

Figure 2: PFF Branch Locations



Source: PFF Corporate Website, accessed July 20, 2005
http://www.pffbank.com/locations/index.htm

During the 1990s, PFF consolidated all lending functions into its Loan Center in Rancho Cucamonga and initiated the laptop-loan-origination system in order to shorten the loan-approval process. The laptop initiative enabled customers to apply for loans in their homes with a loan counselor who accepted and transmitted the application to the Loan Center for faster processing.

More recently, the firm established a TeleBanking Center where customers can obtain personalized service in both English and Spanish 24/7. The firm also had a "24/7 Internet Banking" and online banking for business, iLink, and a Spanish-language website in addition to its English-language website. The company's goal was to "raise the bar" on service and convenience by making banking easier than ever. PFF also offered the FastTrack Loan, a business line of credit aimed as allowing small business owners the ability to meet operating expenses, take advantage of trade discounts or finance new inventory. The streamlined loan process allowed applicants to receive a decision in 48 hours and to activate the account by simply writing a check against their PFF business account.

PFF went public in 1996, adopted the name PFF Bank & Trust, and created the parent company PFF Bancorp, Inc. PFF Bancorp was a unitary savings-and-loan holding company and federally chartered, thus making it a federal savings bank, subject to regulation by the Office of Thrift Supervision (the "OTS") and the Federal Deposit Insurance Corporation (the "FDIC").

Since the initial IPO, PFF's stock price went from $10 to $28 after two different stock splits. Excluding the stock splits, Larry estimated the stock's value in the high $60 range. The bank realized compounded annual earnings growth in the vicinity of 15% for the last ten years. Larry believed that PFF was slated to maintain the 15% compounded annual growth in 2005 (Rinehart, 2005).

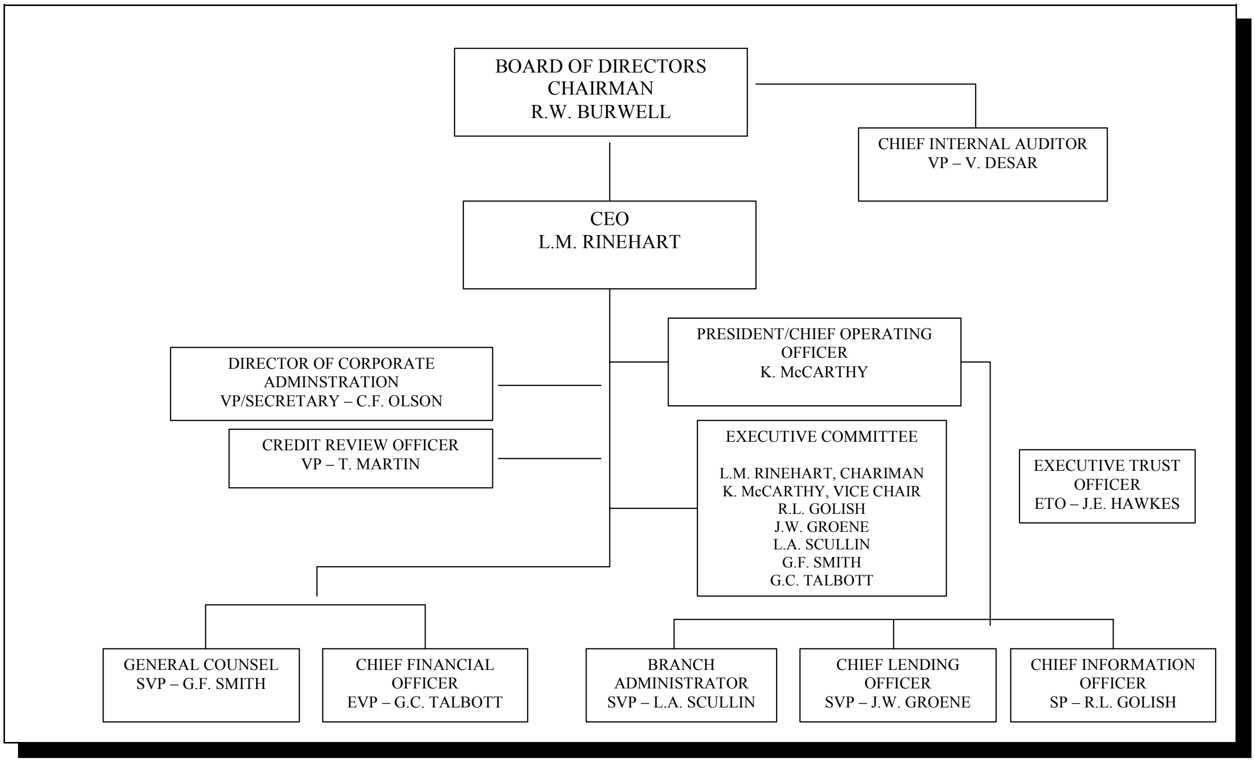
PFF MANAGEMENT AND ORGANIZATIONAL STRUCTURE

PFF's seven-person executive committee was responsible for formulating policies and procedures for the firm and for developing and monitoring the strategic plan (see Figure 3 for the current organizational chart). This structure allowed the bank to be entrepreneurial by permitting quicker decision-making. The development of Diversified Builder Services and Glencrest Investment Advisors are examples of the PFF management team's ability to recognize opportunity and to move quickly to execute them.

At $4 billion in assets and 30 branches, PFF was very small relative to its larger competitors. This enabled it to be agile and to very quickly recognize and take advantage of opportunities in its environment. According to Larry, "we are able to make decisions very quickly, whereas they [larger competitors such as WAMU and Wells Fargo] typically cannot. If one of my team finds a plot of land and says: 'Larry, this would be great to build a branch on. I've done the demographics, the homework and it is not just a fly by night recommendation, we really need to get this thing now.' We'll do it; we'll turn that decision the same day. I think they're incapable of moving quite that quickly. Our agility gives us the ability to act upon these things quickly, to recognize these opportunities and act on them."

Larry had what he described as a "hands on, but not hands in" leadership approach. "That means I want to know everything of significance and importance in the different departments of the bank, but I don't interfere unless it's absolutely essential and I don't get involved in the details and inner workings. I've got competent people working for me. I cannot do a better job than them. Just tell me what is going on so I'm always informed. This helps me plan my next move better."

Figure 3: PFF Organizational Chart



PFF CULTURE

PFF's culture focused on customer service. The company had established multiple award programs aimed at maintaining and sustaining its service culture. The Quest for Excellence Employee Program rewarded employees for ideas that resulted in improved customer service and reduced costs. Employees were given the Service Champion Award, the highest service honor an employee could receive, for going beyond the call of duty in satisfying customer needs. PFF also gave a Got Service Award, where employees recommended colleagues who had gone beyond the call of duty to provide them assistance in resolving a customer problem. The recommendation went to a committee which conferred the award and also to the supervisor and colleagues of the recommended employee. PFF communicated awards for excellent service via its newsletter, which also contained letters of commendation from customers to employees. The firm strongly believed that for employees to participate to their maximum effectiveness, they had to be owners of the bank.

PFF management established an Employee Stock Ownership Program (ESOP) when the bank went public. The ESOP had added substantially to several employees' incomes due to the appreciation of the stock value and had enabled the bank to retain high-quality employees. PFF was a hometown bank and many executives were known personally to the employees and participated in company events. Management's open-door policy was communicated personally to all employees during new-hire orientations by Larry who gave employees his direct extension. Managers were encouraged to talk and listen to employees, and employees were encouraged to take any issue to any level of management.

PFF built its brand on customer service and invested significant resources on training employees for superior customer service. The logo of the company was "customers first." Employees were encouraged to greet customers by name. The bank estimated that about 50% of new customers came from existing-customer referrals and believed this showed that the "customers first" pledge was working. According to Larry:

> You have to have that customer-first attitude, because if you don't, there is no reason for that customer not to walk across the street to Bank of America or Washington Mutual. They have more branches, more ATMs, and also some longer lines and some things that go along with it, but why wouldn't they? So you better put that customer first no matter how bad of a day you're having. I want you to have that smile on your face when you greet that customer—it's critical to our success. You as the frontline teller, or the frontline new-accounts person, are PFF to those people. It's not Larry Rinehart or our board of directors. They know Jane or John Doe on that teller line as PFF and whatever they take back from their experience with you is going to go back to their friends, their relatives… And if Jane or John was rude to that customer today, they're going to go back to their friends and say what a bunch of SoBs at PFF. But if Jane or John is smiling, even when they're having a real tough day and they're saying, 'Glad to have your business, Mr. Smith, is there anything else I can help you with?' they're going to take that back too, and that's the way PFF has to survive against the large banks.

The company had contracted with an independent firm since 1998 to conduct branding-advocacy studies aimed at attracting new customers and retaining current customers. The study measured five variables: trust (confidence that the bank can handle a full spectrum of services), esteem, satisfaction (do customers like the bank), loyalty (will customers stay with the bank), and advocacy (will customers recommend the bank to friends, relatives, co-workers, etc.). The latest "brand advocacy" score placed PFF in the top spot in both business- and customer-banking segments relative to its competitors (see Table 5 for the customer-banking results). PFF's "customers first" brand placed the company second in aggregate total deposits for the communities in which it operated. The bank had a 14.3% aggregate share in its served market.

Table 5: Brand-Awareness Tracking in Customer-Banking	
Trust	Top Spot among regional banks in Inland Empire
Esteem	Top Spot among regional banks in Inland Empire
Satisfaction	Top Spot among all banks in Enland Empire
Loyalty	Top Spot among all banks in Inland Empire
Advocacy	top Spot among all banks in Inland Empire
Sourse: PFF Bancorp, 2005	

PFF'S GROWTH STRATEGY

PFF had pursued a strategy of organic expansion or "de novo" branching, that is, it expanded branch operations by building branches from scratch. The company bucked the trend of expansion via acquisition in the banking industry. With the exception of a small acquisition to enter the Sacramento market, it expanded primarily through de novo branching. This strategy enabled the company to build new branches in places where people were moving to, not places where people are moving from (Rinehart, 2005). The Southern California region had experienced a 12.81% population growth rate since the 1990 census. The Inland Empire experienced the highest growth rate both in Southern California and statewide (Southern California Association of Governments, n.d.). In 2004, the area accounted for more than 35% of the new jobs in Southern California, 48% of all housing starts, and 75% of new industrial construction in the state of California (PFF Bank & Trust, 2005b). The four-county area where PFF located branches experienced an average population growth rate of 20% between 1990 and 2000, with Riverside County experiencing the highest rate at 32%, San Bernardino 20%, Orange County 18.1%, and Los Angeles 7.4% (Southern California Association of Governments, n.d.). With homes getting more expensive in Orange and Los Angeles counties, more and more people were moving into San Bernardino and Riverside counties, areas where PFF had concentrated its branch-expansion activities.

To transition from an S&L to a full-service community bank, PFF had to deal with the challenge of developing new products and services. Similar to its "de novo" branching strategy, the firm developed new products and services internally to further meet the changing needs of its customers. Glencrest Investments Advisors, Inc. was a registered investment advisor. Glencrest provided wealth-management and -advisory services to high-net-worth individuals and businesses through its three California offices located in Claremont, Irvine, and Palm Desert. The subsidiary was developed internally, as Larry explained:

> What we did was find a wonderful individual, Tom Stefancie, who had a tremendous track record as far as trading fixed-income securities and equities with a very large firm back east. He was going into semi retirement. We were so impressed with Tom that we talked him into coming to work for us full time. Really, the business is built around the individual…. So, I'm very proud of the formation of Glencrest, and it is growing very rapidly. It has about $350M in assets under management right now.

Diversified Builders Services, Inc. (DBS) was created to meet the needs of developers in PFF's market. It provided financing and consulting services to homebuilders and land developers. It operated out of one office in Claremont, California. In true entrepreneurial fashion, DBS grew out of one individual with a great idea. Again, as Larry explained:

> The manager of our major loan department, Kevin Brooks, did all the tract-construction lending and all the very large loans for the bank. After about 15 years, he burned out. He took a break, and came back with a great idea. He had many connections with the builders, and wanted to get involved in specialty areas of financing for them, for example, if they needed a bridge loan to acquire a piece of property very quickly, or to have entitlements processed for a tract map, or assistance in appraising different properties. All these myriad opportunities we had with the builders resulted in the formation of DBS. We told Kevin to run with it, gave him a great salary, a great incentive program, and bonus potential. The company is now two years old. The first year, it produced $2M in after-tax income to the bank, and this year it has produced in the vicinity of $3M after tax for the bank. I think that the real significance, what really astounds you when you hear those numbers, is that it's a three-person operation. Kevin Brooks, an assistant, and an administrative assistant. It's entrepreneurial, but it's something that we just said, 'This guy can do it, he's been here 15 years, so let's see what happens.'

PFF had targeted the "Generation Y" market with on-line banking, no-hassle account opening and faster transaction services. Sixty million individuals born between 1979 and 1994 made up this market. One in four lived in a single-parent household, three in four had working mothers and they started tapping away at computers in nursery school (Neuborne & Kerwin, 1999). They spent most of their time on-line, they responded to ads differently, and preferred to encounter ads in different places. PFF specifically targeted this group with a new advertising campaign that had a less serious business tone and more comical ads than was typical in the banking industry.

PFF also targeted Hispanics, who represented the largest ethnic group in Southern California at 40.6% (Southern California Association of Governments, n.d.). Approximately 35-45% of the Inland Empire's population was Hispanic. This was a $2M to $2.5M emerging market (Rinehart, 2005). PFF allowed undocumented aliens to use the *matricula consular* cards (an official Mexican-government document that contains the name, date, place of birth, current photograph, the holder's signature, a U.S. address, and a current address) to open accounts and cash checks. The U.S. Treasury Department gave explicit approval to U.S. banking institutions to accept the *matricula consular* card for identifying and verifying the identity of customers seeking to open financial accounts (Treasury Department, 2002). According to Larry:

> When Ron Gutierrez, our emerging-market director, came to me and said that most Hispanic people did not have checking accounts and were utilizing these paycheck stores, paying up to 20% just to cash their check. Then to add to that misery, they were walking around with all this cash in their pockets. We decided to honor the card, regardless of political feelings... It's interesting that that comes back to enhancing the bank's shareholder value. We're doing something that is the correct and right thing to do socially. As a consequence, we get new Hispanic business, which enhances shareholder value through increasing stock price and having more customers.

A core element of PFF's strategy in this emerging market was to gain the trust of this target market. Another core element of the strategy was to educate. Employees of the firm volunteered in Pomona's K-12 schools because of its high concentration of minorities. They educated the children regarding banking and sound personal-finance practices including how to balance a checkbook, how to save, and how to apply for a loan. To better compete for this segment, PFF developed a Spanish-language website, and marketed through Spanish-language publications and radio stations.

PFF focused on what the company called the Four Cs: commercial loans and leases, construction and land, commercial real estate, and consumer loans.

> The four Cs are what we emphasize in our lending program because they have higher yields. It's just that simple. Construction loans generate an awful lot more as far as return goes than a single-family home loan. They're riskier loans so you have to allow for bigger general valuation allowances, but they pay out much quicker. You deal with people that you know, you respect, you trust. We base our loans primarily on the projects rather than the individuals' financial condition. These are customers that we've known for 10 or 15 years and they've weathered all the storms in homebuilding. The rising interest rates, I don't like to see. But the impact on the bank, it's minimized. Our net interest margin continues to expand even with rising interest rates, albeit very slowly. That's something very rare for a bank in the United States. As far as the residential loans we have, virtually all of those loans are

adjustable-type mortgages. The fixed rates are sold off to Fannie Mae. We don't want the fixed-rate exposure. We retain the servicing too, so we never lose that customer relationship.

The company derived the preponderance of its revenues from interest on loans and leases, and additional revenues from fee income and interest and dividends on securities. Its primary sources of funds included deposits, principal and interest payments on loans, leases and securities, and Federal Home Loan Bank (FHLB) advances and other borrowings. PFF concentrated its deposit-gathering activities in the communities where its branches were located. PFF originated loans on a wholesale basis throughout Southern California, and it had expanded its lending activities to markets outside Southern California on a limited basis. The bank focused primarily on local promotional activities, extended hours on weekdays, Saturday banking, Internet banking, and its website (located at www.pffbank.com) (PFF Bancorp, Inc., 2005).

PFF's goal was steady growth. The firm did not intend to succumb to the "merger mania" currently gripping the banking industry. PFF focused on the following key financial objectives in order of importance:

A minimum threshold of 10% increase in EPS over the prior year's earnings
A minimum threshold of 15% annual ROE
Below 50% efficiency ratio (how much it costs to generate a dollar) was considered good in the industry; PFF was at 48%.

PFF's strategy appeared to be working (see Exhibits 1 and 2 for financial statements). In the fiscal year that ended March 31, 2005, net income after taxes was $45.8 million, an 11.98% growth rate over 2004; total assets were $3.9 billion, a 5.4% growth rate over 2004; total loans were $3.4 billion; and total deposits were $2.7 billion (PFF Bancorp, Inc., 2005).

Exhibit 1: PFF Bancorp, Inc. and Subsidiaries Consolidated Balance Sheets

	As of March 31,				
	2005	2004	2003	2002	2001
	(Dollars in thousands, except per share data)				
Assets					
Cash and equivalents	$44,844	60,151	50,323	105,965	51,526
Investment securities held-to-maturity (estimated fair value of $6,647 and $5,979 at March 31, 2005 and 2004)	6,736	5,742	5,753	703	702
Investment securities available-for-sale, at fair value	61,938	62,957	94,094	93,820	59,137

Exhibit 1: PFF Bancorp, Inc. and Subsidiaries Consolidated Balance Sheets					
	As of March 31,				
	2005	2004	2003	2002	2001
	(Dollars in thousands, except per share data)				
Mortgage-backed securities available-for-sale, at fair value	250,954	292,888	215,266	196,580	302,964
Collateralized mortgage obligations available-for-sale, at fair value	—	—	15,200	62,778	82,315
Trading securities, at fair value	—	—	—	2,334	2,375
Loans held-for-sale	1,466	2,119	3,327	106	583
Loans and leases receivable, net	#######	3,149,318	2,688,950	2,494,667	2,285,307
Federal Home Loan Bank (FHLB) stock, at cost	41,839	42,500	26,610	35,133	46,121
Accrued interest receivable	16,413	14,752	14,162	15,653	18,466
Assets acquired through foreclosure, net	—	683	75	507	351
Property and equipment, net	30,385	27,430	23,325	21,575	22,946
Prepaid expenses and other assets	24,942	19,154	16,939	13,111	13,638
Total assets	#######	3,677,694	3,154,024	3,042,932	2,886,431
Liabilities and Stockholders' Equity					
Liabilities:					
Deposits	#######	2,455,046	2,326,108	2,168,964	2,021,261
FHLB advances and other borrowings	769,423	851,600	485,385	558,000	575,000
Junior subordinated debentures	30,928	—	—	—	
Deferred income tax liability	3,534	14,068	7,521	6,849	7,849
Accrued expenses and other liabilities	34,313	40,609	61,878	25,042	24,323
Total liabilities	#######	3,361,323	2,880,892	2,758,855	2,628,433
Commitments and contingencies	—	—	—		
Stockholders' equity:					
Common stock, $.01 par value.	248	168	208	203	200
Additional paid-in capital	164,536	144,585	131,770	135,540	131,919
Retained earnings, substantially restricted	178,288	173,188	150,282	161,123	137,703

Exhibit 1: PFF Bancorp, Inc. and Subsidiaries Consolidated Balance Sheets					
	As of March 31,				
	2005	2004	2003	2002	2001
	(Dollars in thousands, except per share data)				
Unearned stock-based compensation	-352	-2,121	-3,996	-5,750	-8,953
Treasury stock (126,200 and 419,550 shares at March 31, 2005 and 2004, respectively)	-1	-3	-92	-73	-68
Accumulated other comprehensive income (losses)	-5,793	554	-5,040	-6,966	-2,803
Total stockholders' equity	336,926	316,371	273,132	284,077	257,998
Total liabilities and stockholders' equity	#######	3,677,694	3,154,024	3,042,932	2,886,431
Source: PFF Bancorp					

Exhibit 2: PFF Bancorp, Inc. and Subsidiaries Consolidated Statements of Earnings					
	Year Ended March 31, (Dollars in thousands, except per-share data)				
	2005	2004	2003	2002	2001
Interest income:					
Loans and leases receivable	#######	167,309	169,954	188,131	199,511
Mortgage-backed securities	9,944	9,219	8,203	15,610	22,274
Collateralized mortgage obligations	—	(327	92	3,214	6,393
Investment securities and deposits	4,600	4,123	7,127	8,776	11,771
Total interest income	209,934	180,324	185,376	215,731	239,949
Interest on deposits	39,934	36,770	52,791	76,015	94,989
Interest on borrowings	18,326	12,559	19,456	28,609	48,482
Total interest expense	58,260	49,329	72,247	104,624	143,471
Net interest income	151,674	130,995	113,129	111,107	96,478
Provision for loan and lease losses	2,654	2,725	4,840	5,000	5,004
Net interest income after provision for loan and lease losses	149,020	128,270	108,289	106,107	91,474

Exhibit 2: PFF Bancorp, Inc. and Subsidiaries Consolidated Statements of Earnings					
	Year Ended March 31, (Dollars in thousands, except per-share data)				
	2005	2004	2003	2002	2001
Non-interest income:					
Deposit and related fees	10,514	10,027	8,815	9,427	8,969
Loan and servicing fees	6,471	6,595	5,262	4,972	3,854
Trust, investment and insurance fees	4,419	3,806	3,888	2,086	1,846
Gain on sale of loans, net	321	809	559	359	390
Gain on sale of securities, net	4,771	1,795	1,343	25	-16
Loss on trading securities, net	—	—	-575	-107	-1,490
Other non-interest income	979	2,006	606	281	766
Total non-interest income	27,475	25,038	19,898	17,043	14,319
Non-interest expense:					
General and administrative:					
Compensation and benefits	51,733	47,179	37,323	34,319	30,332
Occupancy and equipment	14,654	12,706	12,158	11,905	11,792
Marketing and professional services	9,985	8,027	7,787	6,969	6,310
Other general and administrative	14,120	11,990	10,198	8,934	8,632
Total general and administrative	90,492	79,902	67,466	62,127	57,066
Foreclosed asset operations, net	75	339	-190	-102	-324
Total non-interest expense	90,567	80,241	67,276	62,025	56,742
Earnings before income taxes	85,928	73,067	60,911	61,125	49,051
Income taxes	40,155	32,118	25,489	25,761	20,791
Net earnings	$45,773	40,949	35,422	35,364	28,260
Basic earnings per share	$1.86	1.7	1.4	2.03	2.32
Weighted average shares outstanding for basic earnings per share	#######	24,090,768	25,302,080	########	12,182,855
Diluted earnings per share	$1.81	1.63	1.35	1.96	2.24
Weighted average shares outstanding for diluted earnings per share	#######	25,063,509	26,300,936	########	12,640,281
Source: PFF Bancorp					

I COMPETITION IN THE BANKING INDUSTRY

When asked to identify the competition, Larry Rinehart had the following to say:

> "Most certainly the regional banks. In addition, probably to an equal extent, it's the locally based community banks—Foothill Independent, Vineyard Bank… there's a plethora of these little community banks out there. Foothill and Citizens Business Bank come to the forefront. I would say the top five are Bank of America, Washington Mutual, Citizens Business Bank, Foothill Independent, and Vineyard. I'll tell you a concern that I've got. Take Bank of America, right across the street. It used to delight me somewhat to walk into their lobby and see that it was jam packed with people; it would take you sometimes 30 minutes to get through that line. The interior was unkempt; they didn't seem to take any pride in their work ("they" being the tellers and new accounts people). It delighted me because I knew you weren't going to get any of this at PFF. You're not going to get long lines, and you're going to get nice buildings and nice interiors. Within the last year, I've noticed major changes; they've got that personal greeter out there now. The lines are more expeditious, the interior is better. You can see that Bank of America is recognizing this as a shortcoming. They won't be able to sustain that. It's not the attitude and culture of the bank. They are recognizing it and it's intriguing me."

Regional Competitors

Foothill Independent Bank

Foothill Independent Bank was owned by Foothill Independent Bancorp, a publicly owned one-bank holding company listed on NASDAQ. The bank was headquartered in Glendora, California and, as of December 31, 2004 had total assets of $787 million and 163 full-time and 86 part-time employees (Foothill Independent Bancorp, 2005a). Foothill was founded in 1973 and in 1982 became the sole subsidiary of the newly formed Foothill Independent Bancorp (Foothill Independent Bancorp, n.d.). It offered a full range of commercial banking services and operated 12 banking offices located in Los Angeles, San Bernardino, and Riverside counties. Foothill offered drive-up and walk-up facilities, 24-hour ATMs at its banking offices, online banking, and a computerized telephone service (Foothill Independent Bancorp, 2005a).

Foothill reported record profits in the first half of 2005, aided by a growing loan portfolio and substantial improvement in its net interest margin. For the first six months of 2005, net income grew 22% to $5.38 million compared to $4.41 million in the first half of last year. According to George Langley, President and CEO of Foothill, "Our balance-sheet management has contributed to three consecutive quarters of net-interest-margin expansion. We have continued to build our low-cost deposit base, keeping our cost of funds relatively stable. However, as interest rates have increased, so have the yields on the adjustable rate loans in our portfolio. We may see further margin expansion as long as interest rates continue to rise at a reasonable pace" (Foothill Independent Bancorp, 2005b).

Citizens Business Bank

Citizens Business Bank, headquartered in Ontario, California, was a wholly-owned subsidiary of CVB Financial Corporation. CVB was incorporated in 1981 and D. Linn Wiley has served as President and CEO since October 1991 (Citizens Business Bank, n.d.). As of December 31, 2004, CVB had $4.51 billion in total consolidated assets, $2.12 billion in net loans, and $2.88 billion in deposits (Citizens Business Bank, 2005a). Citizens was chartered as a state bank on August 9, 1974 as Chino Valley Bank and, on March 29, 1996, became Citizens Business Bank. In early 2005, Citizens obtained two additional business-financial centers through its acquisition of Granite State Bank of Monrovia, California. Citizens was not a member of the Federal Reserve System (Citizens Business Bank, 2005a). Citizens reported net income of $17.7 million in Q1 2005, a growth of 75.7% compared with the same period in 2004. Assets grew at over 20%, deposits at 11.8%, and gross loans and leases at over 20% for Q1 2005 as compared with Q1 2004 (Citizens Business Bank, 2005b).

Vineyard Bank

Vineyard National Bank was founded in 1981 and changed its name to Vineyard Bank in August 2001. It prided itself on being one of California's strongest community banks. As of December 31, 2004, the bank had total consolidated assets of $1.3 billion, total consolidated net loans of $1.0 billion, total consolidated deposits of $965.5 million, and total consolidated stockholders' equity of $85.2 million (Vineyard Bank, 2005). Vineyard operated nine full-service banking centers in Los Angeles, Riverside, and San Bernardino counties, two SBA loan-production offices in San Diego and Anaheim, California and an income-property loan-production office in Irvine, California. Norman Morales had been the company's president and CEO since October 2000. For the six months ended June 30, 2005, Vineyard reported record net earnings of $9.2 million, a 47% increase over the comparable period in 2004 (Vineyard Bank, 2005).

National Competitors

Bank of America

Bank of America Corporation, the holding company for Bank of America (BofA), was formed from NationsBank's acquisition of BankAmerica Corporation in 1998 (Encarta, n.d.a). Bank of America introduced a credit card known as the BankAmericard, which was later renamed Visa when it sold its bank-card system in 1970. BofA saw tremendous expansion in the 1990s by opening bank branches in supermarkets and providing Internet banking. In addition to developing new products and services, the company continued to expand through mergers and acquisitions. In 1992, it merged with California's Security Pacific Corporation, in 1994 it acquired Continental Bank Corporation of Chicago, and in 1997 it purchased the San Francisco investment-banking group Robertson Stephens. NationsBank acquired BofA's parent company, BankAmerica Corporation, for about $60 billion in 1998 (Encarta, n.d.a). BofA acquired FleetBoston Financial Corporation in 2003 and MBNA Corporation, a leading issuer of credit cards, in 2005. During Q2 2005, BofA announced it would pay $3 billion to buy 9% of the stock of China Construction Bank, with options for increasing its stake in the future (Bank of America, 2005).

Bank of America, headquartered in Charlotte, North Carolina, was the second largest bank in the United States with 2004 assets in excess of $1 trillion and revenues of over $48 billion (see Table 1) (Standard & Poor's, 2004a). Net income totaled $14.1 billion in 2004, a 31% increase over 2003. BofA had 5,889 banking centers in 29 states and the District of Columbia, operated 16,798 ATMs, and had international offices in 35 countries supporting clients in150 countries (Bank of America, n.d.).

Washington Mutual

Washington Mutual, Inc., headquartered in Seattle, Washington, was the holding company for Washington Mutual (WaMu). Washington Mutual began in Seattle in 1889 as the Washington National Building Loan and Investment Association. It went public in 1983 and also acquired Murphey Favre, Inc., a full-service securities-brokerage firm. Kerry K. Killinger, executive vice president at Murphey Favre when it was acquired, became the CEO in April 1990 and was elected Chairman of the Board of Directors in January 1991 (Washington Mutual, Inc., n.d.).

Washington Mutual was the largest thrift holding company in the United States with total assets in 2004 of $307 billion, net income of $2.9 billion, and market capitalization of over $21 billion (see Table 2) (Washington Mutual, Inc., 2005). It had over 50,000 employees and served over 11.7 million households. It operated 1,939 retail-banking stores, 478 lending stores and centers, 3,350 ATMs and telephone-call centers, and enabled online banking. WaMu became truly bicoastal after its acquisitions of Bank United Corp. of Houston in 2001 and New York-based Dime Bancorp in 2002 (Standard & Poor's, 2004b).

PFF'S FUTURE CHALLENGES

Mr. Larry Rinehart retired from being President of PFF in the fall of 2005. He retains the position of CEO and Mr. Kevin McCarthy was made President in addition to his position of COO. Larry, Kevin and their team of executives were mulling over what to do next. Was the industry changing in ways that would make growth more difficult? Was the competition getting too intense? What key strategic issues did the bank face? In order to meet the firm's primary financial objective of 10% increase in EPS year over year, they would need to find new opportunities and avenues of growth. They needed to decide whether PFF should grow only in the Inland Empire in line with its current strategy or expand to other parts of California. The bank could replicate the success it has had in Southern California in Northern California. The Sacramento area in Northern California was experiencing similar growth patterns as in the south. Its population grew by 17.5% between the 1990 and 2000 Census (Southern California Association of Governments, n.d.). It is the third hottest building area in the U.S. PFF could expand its branch system in Northern California by closely sticking to the strategy that had worked so well for it in Southern California. They need to decide whether or not PFF should diverge from its de novo growth strategy and follow a different growth model by pursuing mergers and acquisitions. The bank could acquire small local banks as part of an expansion strategy or to reach particular target customers; or it could seek to be an acquisition target to the "right" national or international bank. PFF's location in one of the few population growth areas in the nation provided it attractive acquisition targets as well as made it an attractive acquisition target for large national and foreign banks seeking to expand their reach. Which of these (or other) options make the best sense for PFF over the next three years?

Mr. McCarthy was preparing to address the board and, besides reviewing PFF's current situation and strategy, was going to outline PFF's major strategic alternatives and recommend which one PFF should pursue. How would you help him?

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APPENDIX A
ANALYZING A BANK

Accounting systems of financial institutions differ from those of other companies. While some measures of financial condition are calculated in a similar manner as those of other corporations, such as ROA and ROE, there are measures that are unique to financial institutions. Such measures are most useful when trends are examined and when comparisons are made with similar financial institutions. Table A1 displays key measures of a bank's profitability.

Table A1: Measures of a Bank's Profitability

Measure	what iT shows	how to calculate
Yield on earning assets (YEA)	The quality of a bank's interest earning assets such as loans, short-term investments, lease financings, and taxable and nontaxable investment securities	Interest income on earning assets divided by average value of these assets
Cost of funding assets (COF)	How much a bank pays to obtain earning assets such as deposits and other borrowed funds used to generate income	Total interest expense on the funds a bank uses to support earning assets divided by total average level of funds employed
Net interest margin (NIM)	How successful a bank has been in managing its assets and liabilities	Yield on earning assets minus the cost of funding earning assets
Provision for loan losses	The provision's size as a percentage of total loans reflects the risk inherent in a bank's loan portfolio	Income statement item
Noninterest income	Income from noninterest sources such as charges on deposit accounts, insurance commissions, charges for trust services, and other fees.	Income statement item
Efficiency ratio	The costs associated with maintaining operations, including personnel, occupancy, retail branches, etc.	Noninterest expenses divided by net operating revenues

Source: Adapted from Standard & Poor's (2005, July 7). *Standard & Poor's Industry Surveys: Banking, Vol 173, No. 27, Section 2*. New York: McGraw-Hill Companies.

In addition to profitability measures, other measures of a bank's financial condition are shown in Table A2.

Table A2: Measures of a Bank's Financial Condition

Measure	what iT shows	how to calculate
Reserve for loan losses	An amount put aside by a bank to protect itself from possible defaults. It reflects the quality of the loan portfolio	Balance sheet item
Nonperforming loans	Loans that no longer produce interest income and for which repayment has been scheduled. The level of nonperforming loans indicates the quality of a bank's loan portfolio.	The ratio of nonperforming loans to total loans
Net charge-offs	Uncollectible loans and leases less collections from previously charge-off loans and leases	Calculated as a percentage of loans outstanding during a particular period
Debt leverage	Indicates the extent of a bank's financial leverage and relative risk profile	Long-term debt divided by the sum of total equity and total debt
Liquidity	A bank's ability to raise funds for lending and other purposes	The proportion of loans outstanding to total assets

Source: Adapted from Standard & Poor's (2005, July 7). *Standard & Poor's Industry Surveys: Banking, Vol 173, No. 27, Section 2*. New York: McGraw-Hill Companies.

ACCOUNTING FOR GLOBAL ENTITIES AND THE EFFECT OF THE CONVERGENCE OF U.S. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES TO INTERNATIONAL FINANCIAL REPORTING STANDARDS

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CASE DESCRIPTION

The primary subject matter of this case concerns strategic decisions that global entities, their executives, and accountants face in light of the almost certain convergence of U.S. Generally Accepted Accounting Principles (GAAP) to International Financial Reporting Standards (IFRS). Secondary, the effect of convergence to IFRS on the financial statements of U.S. based global entities, on financial statement users, and the accounting profession is explored. This case has a difficulty level of three to four and can be taught in about 45 minutes. Approximately two hours of outside preparation is necessary to fully address the issues and concepts. This case can be utilized in Intermediate Accounting as part of the coverage of pending changes in U.S. financial accounting and reporting, in an International Accounting course, or in a graduate accounting course focusing more extensively on underlying conceptual issues and the research components of this case. The case has analytical, critical thinking, conceptual, and research components. Utilizing this case can enhance students' oral and written communication skills.

CASE SYNOPSIS

In December 2007, the Securities and Exchange Commission (SEC) issued a rule entitled, "Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation to U.S. GAAP" (SEC, 2007). This new rule eliminates the typically costly reconciliation of financial statements prepared using International Financial Reporting Standards (IFRS) to U.S. GAAP that previously was required of non-U.S. companies reporting to the SEC. This rule is likely to significantly affect foreign entities, U.S. multinational entities, financial statement users, and the accounting profession.

The SEC's decision is part of a broader movement in the U.S. toward the acceptance of IFRS and is supported by the Financial Accounting Standards Board (FASB). The SEC also is *considering allowing U.S. companies to choose between U.S. GAAP and IFRS when reporting to the SEC and may require that all U.S. public companies utilize IFRS by the year 2016 (SEC, 2008).*

While no final decisions have been reached, it is virtually certain that the U.S. will be moving away from the traditional U.S. GAAP and toward a convergence with IFRS, which already are required or permitted in more than 100 nations. U.S. and global entities, the accounting profession, accounting majors, and financial statement users must prepare for this change. Educators play a key role in this process.

The primary focus of this case concerns the U.S. convergence to IFRS and explores the effects of IFRS on global entities' financial statements, financial statement users, and the strategic decisions accounting professionals and entities may face.

This case can be taught at the same time that expected changes in U.S. financial reporting are discussed in Intermediate Accounting or in a more advanced accounting course focusing primarily on underlying concepts and the case's research components. The case has critical thinking, analytical, conceptual, communication, and research components.

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

INTRODUCTION

For several decades, global organizations, such as the European Union, the International Organization of Securities Commissions (IOSCO), and the International Accounting Standards Committee (IASC), headquartered in London, England, supported international efforts to harmonize financial accounting standards and reporting. For example, the IASCO consistently recommended the "adoption of a set of high-quality accounting standards for cross-border listing" (Doupnik & Perera, 2007, 78). Consistent with the IASCO's goal, during the 1990s the IASC focused on developing a set of international standards that would be accepted for cross-border listing (Doupnik & Perera, 2007) and issued 41 International Accounting Standards (IASs).

In 2001, the IASC reorganized and the International Accounting Standards Board (IASB) was created. Harmonization efforts shifted toward globalization. In 2002, the Financial Accounting Standards Board (FASB) and the IASB signed what is commonly referred to as the Norwalk Agreement. In this agreement the two major standard setting organizations concurred to work together to develop a high-quality single set of accounting standards that would be utilized internationally for "domestic and cross border financial reporting." (FASB, 2002).

To achieve their high priority goal, the FASB and IASB agreed to eliminate existing differences between U.S. GAAP and International Accounting Standards, and to coordinate their efforts on future standard setting projects (FASB, 2002). The FASB and the IASB work closely together toward that goal. For example, each new standard issued by FASB during the past six years refers to the IASB standards and the compatibility of the U.S. standards with the IASB standards.

Currently, the standards issued by the IASB and its predecessor, the IASC, consist of 41 IASs and eight IFRS. These standards now are collectively referred to as IFRSs.

As a result of the joint efforts by FASB and the IASB, IFRS and U.S. GAAP are compatible in many areas. However, some significant differences still exist. For example, the LIFO (Last-in-first-out) inventory cost flow assumption is widely used in the U.S., but is specifically prohibited under IFRS. Other differences also exist and have to be reconciled if a global set of standards is to emerge.

The Sarbanes-Oxley Act of 2002 (SOX), an Act of Congress that was issued to improve financial reporting and protect investors, requires that the SEC conduct a study regarding the adoption of a principles-based set of accounting standards (U.S. Congress, 2002, HR 3763, 108, 2d). IFRSs generally are considered principles-based standards, while U.S. GAAP is considered more rule-based. SOX specifies that the U.S. standard setters should consider "the extent to which international convergence on high quality accounting standards is necessary..." (U.S. Congress, 2002, 108, 1Av).

U.S. GAAP has influenced accounting standards in many countries. A decade ago, some still expected that U.S. GAAP will eventually become globally accepted, but this no longer is likely (Herz, 2008). Instead, during the past few years, a distinctive global shift toward use of IFRS emerged. In fact, in January 2003, the European Parliament declared that starting in 2005, all companies listed on European stock exchanges are required to file financial statements consistent with IFRS (Deloitte, 2003). This rule was implemented in 2005 by the approximately 7,000 European public companies listed on European stock exchanges.

Many nations have adopted IFRS for financial reporting purposes. Today, more than 100 nations either require or permit the use of IFRS for financial reporting (KPMG, 2008). It is very likely that IFRS will soon become globally accepted. Robert Herz, Chairman of FASB, supports convergence to IFRS. In a recent interview with the *Journal of Accountancy*, Mr. Herz estimated that within the next five years, convergence to some form of IFRS will occur (Herz, 2008). In addition, the SEC, which requires that U.S. as well as non-US companies that raise capital on U.S. financial markets must file their financial statements with the SEC, also supports convergence to IFRS.

During 2007, the SEC issued a proposal to allow non-U.S. companies to choose between U.S. GAAP and IFRS when reporting to the SEC. In December, the SEC issued a final rule allowing this choice and effectively eliminating the often costly reconciliation to U.S. GAAP (SEC, 2007). This rule has affected foreign issuers quite significantly. According to a SEC representative, approximately 100 non-U.S. SEC registrants that routinely prepare IFRS-based statements in their home country now file IFRS-based financial statements with the SEC as well. Only one company that prepares IFRS-based financial statements still chooses to reconcile to U.S. GAAP (Erhardt, 2008).

The SEC currently also is considering allowing U.S. public companies to choose between IFRS and US. GAAP when filing their financial statements with the SEC. However, choice between two sets of financial reporting standards is not the ultimate goal (SEC, 2007). A single set of high quality globally accepted financial accounting standards tends to better serve the financial users and likely lead to the greatest comparability between companies.

In fact, on November 14, 2008, the SEC issued a proposal entitled, “Roadmap for the Potential Use of Financial Statements Prepared in Accordance With International Financial Reporting Standards by U.S. Issuers,” which would require that U.S. public companies start utilizing IFRS for fiscal periods ending after December 15, 2014, 2015, or 2016, depending on the filing status of the entity (SEC, 2008). In addition, the SEC may permit early adoption of IFRS by certain very large corporations for fiscal periods ending after December 15, 2009 (SEC, 2008).

Professional organizations, such as the American Institute of Certified Public Accountants (AICPA) also support convergence efforts. For example, on May 15, 2008, the AICPA launched a website “AICPA.IFRS.com” to help inform and educate accounting professionals about the expected change (AICPA, 2008).

Standard setters, accounting educators, public accounting firms, global entities, and many U.S. entities are preparing for the expected convergence to IFRS. Public accounting firms and especially the “Big 4" are spending tremendous resources to prepare their professionals for the coming change.

Current accounting students - the future accounting professionals - must become knowledgeable about IFRS and the effect on companies’ financial statements, consider strategic decisions entities may face on the path toward convergence, and must prepare for the pending convergence. This case addresses many of the issues that arise during this process.

Elisa Hartwald is the Chief Financial Officer (CFO) of Wichtel Corporation, a multinational company, whose parent company is headquartered in the U.S. The company is a consolidated entity currently consisting of the parent and seven majority owned vertically integrated entities. All of its subsidiaries are located in Western Europe. The U.S. parent company purchases and imports parts from its subsidiaries as well as from unaffiliated entities. The European subsidiaries are listed on European stock exchanges and prepare financial statements consistent with IFRS.

During the past, Wichtel has raised capital selling stocks and bonds only in the U.S. Because of the cost of compliance with SEC regulations, the company’s European subsidiaries also have raised capital exclusively in their home countries. Wichtel Corporation’s board of directors recently voted on a new expansion project that would allow it to gain global market share. The company currently is exploring the possibility of raising additional capital either in the U.S. or on European markets.

Elisa, who is a Certified Public Accountant, has closely followed developments toward global harmonization of financial accounting and reporting. She is very familiar with the differences between U.S. GAAP and IFRS and the difficulties and challenges of consolidating entities utilizing different GAAP. She also is aware of the trend toward convergence of U.S. GAAP to IFRSs. Elisa already has prepared a brief summary focusing on current differences between U.S. GAAP and IFRS that are pertinent to Wichtel Corporation. This summary is shown in table 1.

Table 1: Differences between U.S. GAAP and IFRS

Accounting Issue	U.S. GAAP	IFRS
Inventory: Cost Flow Assumptions	LIFO, FIFO and weighted average methods are permitted.	FIFO and weighted average methods are permitted; LIFO is expressly prohibited.
Inventory: Valuation - Lower-of-cost-or-market Rule	Market is defined as replacement cost constrained by net realizable value (ceiling) and net realizable value minus normal profit (floor) Inventory value write-downs cannot be reversed.	Market is defined as net realizable value (selling price less selling cost). In addition, inventory write-downs can be reversed.
Property, Plant and Equipment	Land is carried at cost. Plant and equipment are carried at cost less accumulated depreciation. Revaluation to market value is not permitted.	Allows choice between market value and cost less accumulated depreciation.
Intangible Assets	Depreciable assets with a finite life are amortized and carried at cost less accumulated amortization. Revaluation to market value is not permitted.	Allows choice between market value and cost less accumulated amortization.
Research and Development Costs	All research and development costs must be expenses as incurred.	Research costs must be expensed as incurred, but development costs can be capitalized as intangible assets if they meet certain criteria.
Discontinued Operations	A component of a business that can be separately held for sale is classified as discontinued operations.	Only major product lines or divisions are classified as discontinued operations.
Extraordinary Items	Items that are both unusual and infrequent are shown as extraordinary items, apart from income from continuing operations.	The category “extraordinary items” is not permitted under IFRS. Gains or losses arising from such transactions are shown as part of other income or losses.
Convertible Bonds	Convertible bonds are solely classified as liabilities.	Convertible bonds are classified as liabilities and equity (i.e., value is assigned to the conversion feature and classified as equity).
Terminology	Undistributed cumulative income is referred to as “Retained Earnings.”	Undistributed cumulative income is referred to as “Reserves.”

Elisa is in charge of preparing consolidated financial statements for the parent company and its European subsidiaries. Under U.S. GAAP and also IFRS, companies must consolidate entities that they control. In completing this process, Elisa must translate and reconcile the IFRS-based statements of Wichtel's European subsidiaries into U.S. GAAP. Then she combines the financial statements applying U.S. rules of consolidation. This is a complicated process.

Wichtel Corporation's most recent consolidated income statement and balance sheet are presented below:

Table 2: Wichtel Corporation and Subsidiaries Consolidated Income Statement for the year ended December 31, 2007
(Numbers are in Millions)

Sales Revenue	$ 21,700
Less: Cost of Goods Sold	10,200
Gross Margin	$11,500
Less: Operating Expenses	
Depreciation and amortization expense	1,585
Research and development expense	380
Rent expense	220
Wages and salaries expense	1,200
Bad debt expense	300
Pension cost	200
Utilities	100
Other accrued expenses	289
Operating expenses	$ 4,274
Operating Income	$ 7,226
Other income, losses and expenses	
Interest revenue	220
Interest expense	250
Loss contingency	200
Income from continuing operations (before taxes, non-control)	$ 6,996
Income tax expense	2,597
Non-controlling interest income	139

Table 2: Wichtel Corporation and Subsidiaries Consolidated Income Statement for the year ended December 31, 2007 (Numbers are in Millions)	
Income from continuing operations	$ 4,260
Loss from discontinued operations (net of tax)	400
Extraordinary loss (net of tax)	607
Net Income	$ 3,253
Basic earnings per common share	$5.94
Diluted earnings per share	$5.11

Table 3: Wichtel Corporation and Subsidiaries Consolidated Balance Sheet December 31, 2007 (Numbers are in Millions)	
Assets	
Current Assets	
Cash and Equivalents	$1,220
Investments	2,150
Interest receivables	105
Accounts receivable, net	3,000
Inventories (LIFO inventory method)	5,000
Prepaid insurance	120
Total Current Assets	$ 11,595
Non-current Assets	
Investments DEH joint venture	1,635
Property, Plants, Equipment (net of accum. depr. Of 10,000)	13,609
Intangible Assets	
Goodwill	2,675
Patents	1,775
Other Assets	
Deferred tax benefit	1,500
Total Non-Current Assets	$ 21,194
Total Assets	$ 32,789

Table 3: Wichtel Corporation and Subsidiaries Consolidated Balance Sheet December 31, 2007 (Numbers are in Millions)	
Liabilities and Stockholders' Equity	
Current Liabilities	
Accounts Payables	2,220
Interest Payable	329
Accrued wages payable	150
Deferred tax liabilities	200
Total Current Liabilities	2,899
Non-current Liabilities	
Notes payable	483
Bonds payable (5%, convertible)	5,000
Total Non-current Liabilities	5,483
Total Liabilities	$ 8,382
Stockholders' Equity	
Common stock	16,830
Retained earnings	5,940
Accumulated other comprehensive income - avail. f. sale securities	105
Non-controlling interest	1,532
Total Stockholders' Equity	$ 24,407
Total Liabilities and Stockholders' Equity	$ 32,789

The Chief Executive Officer (CEO), James Miellers, asks Elisa to consider their company's position regarding the SEC proposal to permit U.S. companies to utilize IFRS. James also asks Elisa to consider the company's strategic plans to raise additional capital in light of the expected changes in financial reporting rules and to consider their implementation strategies if the SEC requires (or permits) use of IFRS for all public companies. She decides to consider the issues and the likely effect of IFRS on the company's financial statements, discuss them with the CEO, and also to draft a comment letter to the SEC.

ASSIGNMENTS

Answer the questions that were assigned by your instructor. Provide concise answers.

Company-Specific and General Questions:

1. Consider Wichtel Corporation's most current financial statements presented in this case (see Tables 2 and 3). What would be the likely effect of adopting IFRS on Wichtel Corporation's financial statements? How would use of IFRS affect the company's key financial ratios?
2. How could use of IFRS affect Wichtel Corporation's cost of capital? How could this affect Wichtel Corporation's strategies regarding future sources of capital?
3. What are the advantages for Wichtel to continue preparing financial statements utilizing U.S. GAAP?
4. What would be the advantages of preparing financial statements utilizing IFRS?
5. What would be the likely effect on financial statement users if the SEC allows U.S. companies to choose between U.S. GAAP and IFRS for preparing their financial statements? What do you recommend that Wichtel Corporation should choose in that situation?
6. What would be the likely effect on financial statement users if the SEC requires that all U.S. public companies utilize IFRS for preparing their financial statements?
7. Draft a concise letter addressed to the SEC to express your opinion regarding the issue of whether U.S. companies should be (a) permitted or (b) required to prepare financial statements consistent with IFRS. Support your position and focus on advantages and disadvantages. Also indicate whether you would support early adoption of IFRS, if permitted, and whether you agree with the SEC's proposal to phase-in adoption over several years. Address the letter to Florence E. Harmon, Securities and Exchange Commission, 100 F Street, NE, Washington, D.C. 20549-1090.
8. Indicate any additional issues that the company may want to consider.
9. The SEC is considering requiring that all public companies use IFRS by the year 2016. How will this affect the accounting profession?

Researchable Questions:

1. Research and briefly describe the perceptions of the corporate or the financial community regarding allowing U.S. companies to choose between U.S. GAAP and IFRS.
2. What are some of the most important critical issues that must be addressed prior to convergence of U.S. GAAP to IFRS?
3. Research current developments regarding convergence to IFRS.
4. Convergence to IFRS has not yet occurred. Research and briefly describe major joint projects between the FASB and IASB.
5. Research the convergence issue from the perspective of non-public entities.

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A CAREER DILEMMA FOR PAT CARPENTER

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Albert Chiaradonna, Villanova University
Stephen A. Stumpf, Villanova University

CASE DESCRIPTION

The primary subject matter of this case is that of a high potential young manager, Pat Carpenter, employed by a successful large organization who is highly conflicted on the course of action to take when given a new assignment. Discussion questions range from the specific situation Pat faces to issues of corporate social responsibility. The case generates useful discussion on issues of values and value conflict, conflicting loyalties, identification of core beliefs and how they are lived, problem solving, corporate guiding principles, outsourcing, off-shoring, and government policy. Secondary issues address through role playing are how the same situation can be experienced differently, leading to different assessments as to the most appropriate courses of action. Case difficulty is 2-3 (sophomore to junior, depending on issues raised). The case is designed to be taught in a management or ethics course requiring from 30-50 minutes of class time and either no outside preparation, or about 10 minutes of pre-class preparation.

CASE SYNOPSIS

Pat Carpenter grew up in the small, somewhat poor town of Racton, WV, enjoying the sense of community it provided while working in Carpenter's General Store – Uncle Bob's store. Motivation and hard work, along with Uncle Bob's mentoring and coaching, contributed to Pat's success at college, and then at work for a major retailer – Shop-Mart. Pat's career progression for 7-years has been 'star-like' – from management trainee, to assistant store manager, store manager, and now Real Estate Manager, Mid-Atlantic Region. This job involves locating new Shop-Mart store sites within targeted locations, then beginning community relations so that the opening would go smoothly.

After three successful openings, Pat is asked to locate a site for the next Shop-Mart in Racton, WV. Pat knows that local stores often go out of business when Shop-Mart arrives, and this means Carpenter's will be at risk. In considering the situation Pat begins to experience significant stress, leading to depression and nightmares. To whom should Pat speak – spouse, boss, Uncle Bob? What will Pat say – or do – to move forward?

A CAREER DILEMMA FOR PAT CARPENTER

Pat Carpenter is 28 years old and from the small town of Racton, West Virginia -- population of about 16,000 when you include the surrounding area. Most of the families living there have lower to middle incomes, with about twenty percent of the population living below the poverty level. Although few people choose to move to Racton, Pat liked growing up in this close-knit community where people knew and cared about each other.

Even as a youngster it was clear that Pat was smart and ambitious. Pat took great pride in the fact that the townspeople told him, "Someday you're going to make us proud!" Pat always had a job growing up at Carpenter's General Store - Uncle Bob's store. Pat loved being at the store and not just because Uncle Bob paid him pretty well. Pat liked helping customers, most of who were known by name. Setting up displays and changing the merchandise for different seasons and holidays was always exciting. Over the years Uncle Bob, who had one child that didn't seem to take much interest in the business, taught Pat the ins and outs retailing. He taught Pat everything, including ordering merchandise, putting on a sale, customer relations, and keeping the books. Pat loved it all.

The best part about working at the store was Uncle Bob himself. Uncle Bob loved the store as much as Pat did. Uncle Bob said his mission in life was to make sure his neighbors got everything they needed at a fair price. He carried a wide variety of goods, based on the needs of the community. If you needed a snow shovel or piece of jewelry for your wife or girlfriend, it was no problem – Carpenter's had it all. What most impressed Pat about Uncle Bob was how he knew his customers and cared for them. If somebody was having "hard times," Uncle Bob somehow knew it. When they came into the store, Uncle Bob would make them feel comfortable, and say something like, "you know Jason, let's put everything on credit today – it's been a while since you used your credit privileges and I don't want to lose you as a customer!" This kind of generosity made it easy to understand why Uncle Bob was loved and respected throughout the community.

When it came time for Pat to go to college, there was no doubt about what to major in - Marketing and Merchandising. Pat did well in college and was very goal oriented – continuing to work summers at Carpenter's General Store. As a junior, though, Pat knew that some corporate experience was necessary. The career advisor recommended Pat for an internship at Shop-Mart, and Pat was thrilled. That summer, Pat was amazed by the breadth and comprehensiveness of the intern experience. Pat enjoyed the life story of the founder of Shop-Mart, and the values the founder held. Shop-Mart was the best company in the world. The fact that Shop-Mart had consistently been identified as one of America's Most Respected Companies in a popular business magazine confirmed this belief.

The people that Pat worked for at Shop-Mart during the internship noticed Pat's work ethic, knowledge, and enthusiasm for the business. Before the summer ended, Pat had been offered a job as a Management Trainee by Shop-Mart, to start upon graduation. Pat was thrilled. This was a dream job – holding the opportunity to move up the ranks in a great company.

Pat did indeed move up the ranks quickly, from management trainee, to assistant store manager, to store manager, to supervising manager of three stores, to the present position -- Real Estate Manager, Mid-Atlantic Region. This job involved locating new sites within targeted locations for new Shop-Mart stores, then beginning community relations so that the opening would go smoothly.

As work on site number three was finishing up, Pat's world was shook by an email giving the next location in which to identify a site – Racton, West Virginia! It was not that Pat didn't believe in Shop-Mart's expansion. What was printed in the popular press, especially the business press, only reinforced Pat's belief in Shop-Mart. After all, an executive viewed as one of the wisest business people in the world was quoted as saying that "Shop-Mart had been a major force in improving the quality of life for the average American, offering great prices on goods they needed and wanted."

At the same time, Pat knew that opening a new Shop-Mart could be disruptive to a town. Local establishments always lost some customers after a Shop-Mart opened as more goods at better prices, available in a one-stop-shopping experience was just too big a draw. Pat saw the advantages Shop-Mart provided to the community, particularly customers, within just a few months. Yet, the local stores in small towns often went out of business within a year. In Racton, one of those local stores was Carpenter's, now run by Uncle Bob's son, although Uncle Bob still came in every day to "straighten out the merchandise."

As Pat thought about this assignment, depression set in, and nightmares followed. Pat was frozen in time and space. Pat's spouse noticed the behavior change early on – sullenness, quiet during meals, no talk about work, no energy, and going to bed early – only to wake up in the middle of the night in a huff. Pat's nightmares involved Uncle Bob screaming something – although Pat could not make out what Uncle Bob was saying. This especially troubled Pat, since Uncle Bob never raised his voice.

Pat didn't know what to do – who might be helpful? Pat's spouse? Maybe talking it through could lead to some positive course of action. Pat's boss? Would Shop-Mart understand? Could Pat really disclose the conflict without fear? Uncle Bob? Should Pat disclose the situation and ask for advice? How will this make Uncle Bob feel?

ACKNOWLEDGMENTS

We wish to thank the Center for Responsible Leadership and Governance for their support, and Profs. Nicholas Rongione and Jonathan Doh for their comments on this case.

IMPLEMENTING IMAGING TECHNOLOGY IN GRADUATE ADMISSIONS AT GEORGIA SOUTHERN UNIVERSITY

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CASE DESCRIPTION

This case concerns the implementation of a document imaging and workflow routing system in a university graduate admissions context – a setting familiar to both students and faculty. Secondary issues include the identification of bottlenecks and inefficiencies in paper-intensive manual processes, an appreciation for the organizational and management challenges associated with the introduction of new processes and systems, and recognition of strategic/competitive advantages afforded by the adoption of information technologies. The case has a difficulty level of 3-4 and would be appropriate for junior-to-senior level students. The case is designed to be taught in two class hours and is expected to require 2-4 hours of outside preparation by students. It might also be helpful to invite representatives from your campus graduate (or undergraduate) admissions office to join in the discussion of this case.

CASE SYNOPSIS

This case describes the implementation of a document imaging and workflow routing system in the Office of Graduate Admissions at Georgia Southern University. The new system, which replaces a paper-laden, labor-intensive manual process, is intended to address a number of organizational issues. Specifically, the new system is intended to streamline the graduate admissions process by: (1) reducing the amount of paperwork across multiple departments; (2) improving the ability of these departments to locate, retrieve and share vital information; and (3) reducing the time required to process applications for admission to the graduate programs, thus improving the quality of service to prospective graduate students. The process problems that existed prior to implementation of the document imaging system as well as the strategies and approaches used to deploy the new system are detailed in this case. The case also describes the technological

infrastructure required to support the document imaging system, the challenges faced in implementing document imaging and workflow routing, and the benefits derived from implementation.

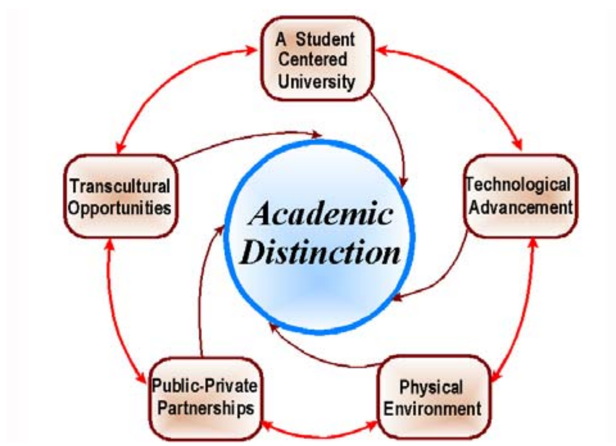
OVERVIEW OF GEORGIA SOUTHERN UNIVERSITY

Georgia Southern University (GSU) is a comprehensive center of higher education located in Statesboro, Georgia. Designated as a Carnegie Doctoral/Research University, GSU offers 120 degree programs at the baccalaureate, masters, and doctoral levels through eight colleges: Business Administration, Education, Health and Human Sciences, Science and Technology, Liberal Arts and Social Sciences, Information Technology, Public Health, and Graduate Studies.

The Georgia Southern student body is comprised of more than 16,500 students who represent 86 nations and almost every U.S. state. In 2006-2007 the University employed 1781 full-time workers (including 690 faculty members) and awarded 2,885 degrees.

The University is led by a President with the aid of Vice-Presidents for Academic Affairs, Business and Finance, Student Affairs and Enrollment Management, and University Advancement. The University's Strategic Plan, adopted in 2000 and revised in 2004, is built upon six strategic themes: academic distinction, student centeredness, technological advancement, trans-cultural opportunities, public-private partnerships, and physical environment.

Figure 1: Strategic Themes



From Georgia Southern University Strategic Plan (2004, p. 13).

Information technology plays a key role in the University's strategic plan, particularly with respect to the strategic theme of Technological Advancement. As stated in the plan:

> *"To enhance Academic Distinction, the University must use the best and most appropriate technological tools available to support teaching and learning opportunities and effective administrative practices." (Georgia Southern University Strategic Plan, p. 17)*

The imaging application discussed in this paper is a key example of how a technological tool has been implemented to support effective administrative practices. The Student Affairs and Enrollment Management (SAEM) Technical Support staff took the lead in the implementation of the imaging project. At the time of imaging implementation the SAEM Technical Support staff consisted of two full-time employees who reported to the Vice President of Academic Affairs.

CASE BACKGROUND

In 1998, the University recognized the need to improve efficiency in areas that were heavily inundated with paper-based processes. Information Technology (IT) Services thus undertook a project to implement document imaging and workflow routing in departments where there was a need to streamline business processes, reduce paperwork, reduce storage space, improve security, and improve information sharing. Those areas believed to benefit the most from the use of imaging technologies were those administering health services, financial aid, and admissions. The focus of this case is on the implementation of imaging technology to improve the graduate admission application process.

Prior to the deployment of the imaging system, graduate admission applications were processed manually by the College of Graduate Studies (COGS). There were several problems with the paper-based process. First, the process relied upon the use of pre-printed folders and a complex labeling system that together resulted in an estimated annual supply cost of $30-$40K - not including the cost of labor associated with maintaining these files. Second, these folders required an ever-increasing amount of storage space - space which was not readily available. Third, existing storage rooms were not secured. Due to security and space limitations, documents could easily be lost or misplaced. Fourth, similar issues were associated with archiving these folders when they were no longer needed.

More importantly, the paper-based admissions process was beginning to put the University's graduate programs at a competitive disadvantage. The President's office determined that the efficiency of the application process is one of the major factors in a candidate's ultimate selection of a graduate school and program. Specifically, the convenience, ease and timeliness of the admission process play an important role in attracting students. With the paper-based system the length of time required to process a graduate admission application and reach an admission decision averaged six to eight weeks. Reducing the time to make a decision about graduate admissions was a critical factor in deciding to implement imaging technology.

At about this same time, responsibility for graduate admissions was reassigned from the College of Graduate Studies to the Office of Admissions in an effort to provide more consistency in the admissions process for prospective graduate and undergraduate students. Within the Office of Admissions, a subunit henceforth referred to as the Office of Graduate Admissions (OGA) now handles all applications for admission to all of Georgia Southern's graduate programs.

Graduate Admissions and the Imaging Application

When prospective students apply for admission to a graduate program at Georgia Southern they fill out an application. In addition, they are required to submit the following items: application fee, official transcripts, admission test scores, and letters of recommendation. International students are also required to submit a completed Sevis Data Form (financial statement form) and an original bank statement not more than six months old. Some departments require additional documentation for admission.

Prior to implementation of the imaging system, prospective graduate students filled out a paper application and mailed it to the College of Graduate Studies. In addition, they arranged for all of the additional items necessary for their application to be mailed. As student materials arrived, the College of Graduate Studies created a file folder and label for each applicant. Items received for an applicant (transcripts, immunization records, financial records, letters of recommendation, etc.) were stored in the file folder. A graduate student file could contain anywhere from 15 to 100 pages of material depending on the status of the student (new student, transfer student, returning student, etc.). Once the file was complete, photocopies were made and delivered to the appropriate program director for a decision about admission. At Georgia Southern, program directors are faculty members who, in addition to their teaching duties, also assume responsibility for the management and delivery of one or more graduate degree programs. The program director reviewed the photocopied materials, recorded a decision and notes regarding the decision (stipulations or reason for denial) on a recommendation form, and returned the form to the College of Graduate Studies via campus mail. Once the recommendation form was received by that office the decision was manually posted to the University's student information system (Banner). The elapsed time from completion of the paper-based file to the posting of an admission decision in Banner was typically six to eight weeks.

Banner is a product of SunGard Higher Education, a division of SunGard. SunGard provides software for financial services, higher education and the public sector. (http://www.sungard.com/sungard/) "Banner is the world's most widely used collegiate administrative suite of student, financial aid, finance, human resources, and advancement systems." (http://www.sungardhe.com/Products/Product.aspx?id=832) It is used by over 900 institutions worldwide and runs on Oracle's relational database management system (Oracle RDBMS).

The imaging system used to automate the graduate application process is called Banner Xtender (Banner: Banner Xtender Solutions, 2005). The decision to use Banner Xtender was made by members of SAEM Technical Support and IT Services, and was based on the capability of Banner Xtender to naturally integrate with Banner. The system runs in a client/server environment and has a web-based interface as well. According to the Banner Xtender web site some of the benefits of choosing their system include the ability to "link documents to information in Banner, … create custom document collections without customization services or programming, capture data from paper and faxes into Banner with sophisticated record matching, distribute documents in client/server and Web-based environments, automatically capture and index any letters, billing statements, reports or other output, use virtualized storage and automatic archival and back-up of managed content, drill-down into documents to support Workflow and Banner processes." (Banner: Banner Xtender Solutions, 2005) The Office of Graduate Admissions uses Banner Xtender to scan, store, index and retrieve the paper-based documents provided by the applicant and for workflow tracking as the application materials are reviewed and processed by the program directors.

Currently, a prospective student applies to graduate school at Georgia Southern University through an online application. For those programs that require letters of recommendation, statements of purpose and resumes, forms have been built into the online admission application providing a one-stop opportunity for the applicant. External support documents, such as official college transcripts and test scores, are still handled via regular mail.

After the implementation of the imaging system, the staff in the Office of Graduate Admissions scans and indexes each document as it is received. Documents are indexed according to a student's Eagle ID, the unique Georgia Southern University identification number for each student, and document type. The document type eliminates the user having to sift through pages in a single file to find the document of interest. For example, an applicant's image file might include several types of documents, such as transcripts, immunization records, financial records, and letters of recommendation. When indexing by both Eagle ID and document type, a graduate program director can go directly to that student's transcripts by selecting the student and then the document type from a drop-down list.

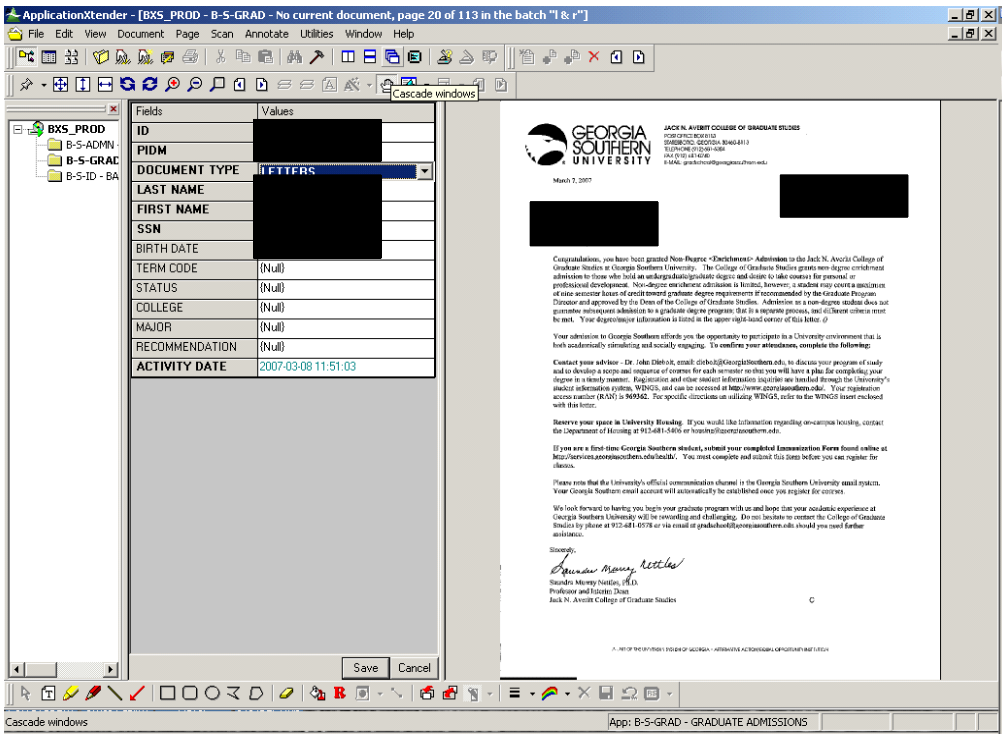
When the first document is received the applicant is assigned an Eagle ID. As additional documents arrive, they are placed in the student's virtual file. Figure 2 shows a new document being indexed and added to that file. Documents are also indexed according to the term, college, and major for which the applicant is applying, and the status of the application. Initially the status is left as "null" to signify that the application is not complete. When the file is complete, the Office of Graduate Admissions changes the status field to "complete" and generates an electronic recommendation form which becomes part of the virtual file. At this point, the application is ready for review by the appropriate program director.

To review graduate admission applications the program director runs a query in Banner Xtender to get a list of "complete" applications for that program. Figure 3 contains the blank query screen. The query is based on the following fields:

Document Type – select "recommendation" from the available options in the drop-down menu
Term – select the term for which the decision is being made from drop-down menu

Status – select "complete" from a drop-down menu
College – selected from the drop-down menu
Major – selected from the drop-down menu
Recommendation – select "null" as no recommendation has been made yet

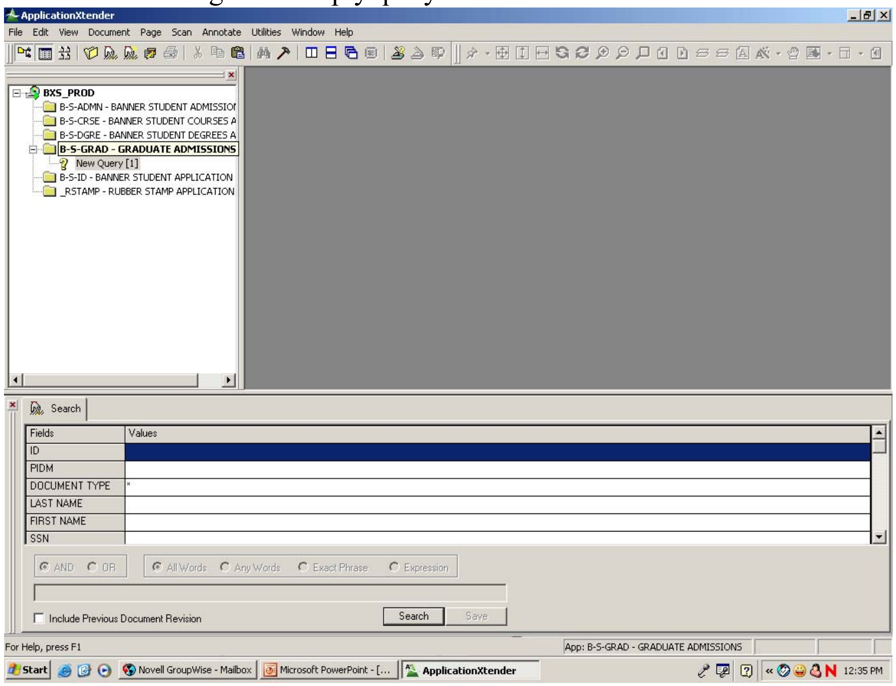
Figure 2: Document being indexed and added to student file



The program director saves the resulting list of applicants and then manually enters each applicant's Eagle ID to pull the corresponding application packet from Banner Xtender. In most cases, program directors print hard copies of the materials in the packet to use during the review process rather than relying solely on the virtual file. Some program directors are in the habit of changing the "status" field to "reviewing" to indicate that an application is under review.

Once the program director makes an admission decision, that decision needs to be posted to Banner Xtender. To post a decision and related stipulations or comments, the program director selects the recommendation form from the list of document types for that student and posts the decision directly to the form by using the "rubber-stamp" button. The rubber-stamp tool allows the program director to select the appropriate decision - Regular, Provisional, or Deny - and post it directly to the recommendation form along with the program director's Banner identification number, and the date and time the decision was posted. Figure 4 shows the recommendation form in Banner Xtender along with the rubber stamp tool.

Figure 3: Empty query form in Banner Xtender



The program director must also update the "status" and "recommendation" fields to reflect the decision. The value of the "status" field is changed to "decision." The value of the "recommendation" field is changed to match the decision that was placed on the recommendation form with the rubber-stamp tool. Figure 5 illustrates the fields that are updated by the program director. The recommendation form is then saved.

The Office of Graduate Admissions runs a daily query to identify applications for which admission decisions have been made (i.e., the value in the "status" field is "decision"). Figures 6 and 7 are screen shots of the query and the results that are generated. The Office of Graduate Admissions then manually posts the decision and any notations made by the program director from Banner Xtender to Banner and changes the value of the "status" field in Banner Xtender to "decision posted". At this point, the applicant may view the decision and any notes made by the program director via Banner Xtender's web interface. The turnaround time for an application with this system is two weeks. Table 1 summarizes the graduate admissions process before and after implementation of the imaging system.

Figure 4: Recommendation form in Banner Xtender

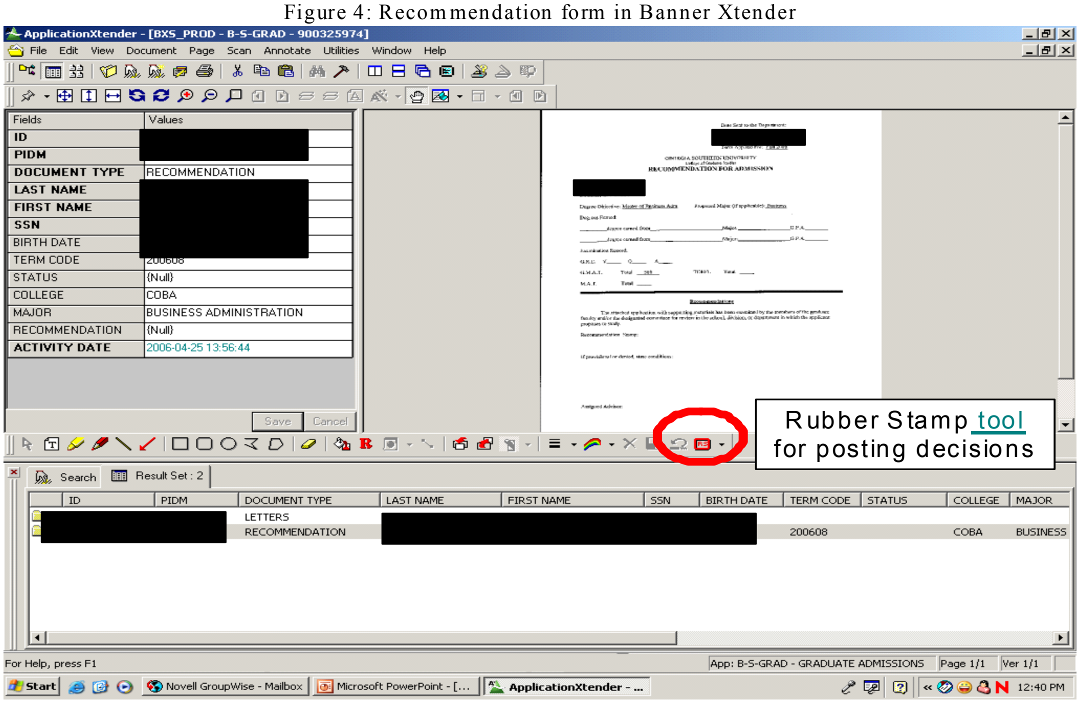


Figure 5: Fields to be updated in Banner Xtender once a decision has been made

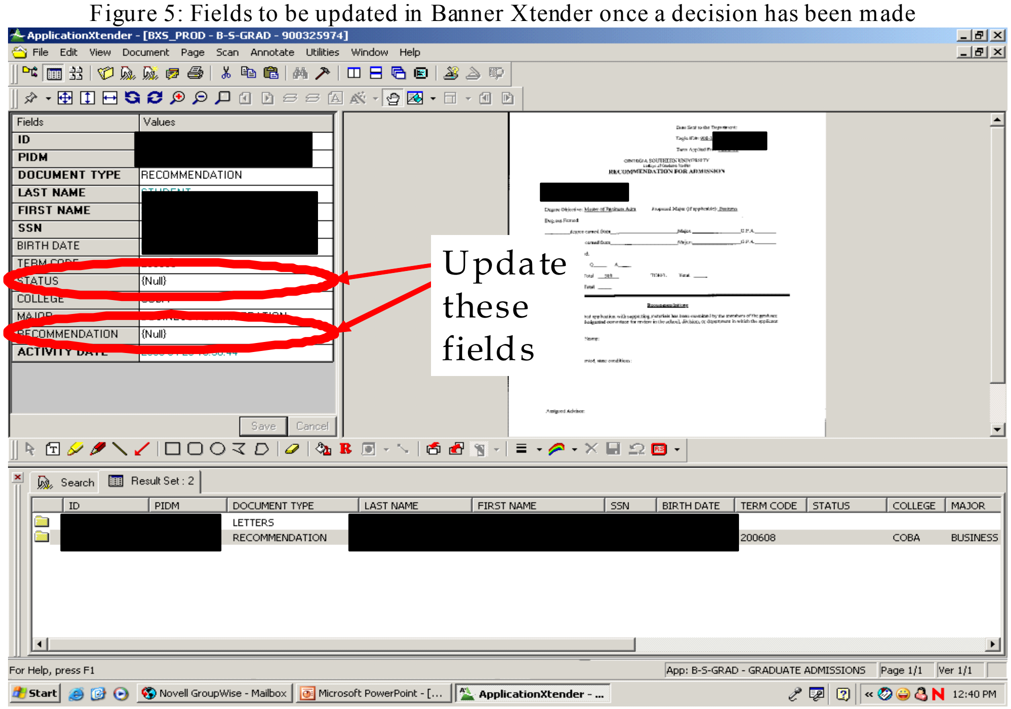


Figure 6: Query by Graduate Admissions for applications where a decision has been made

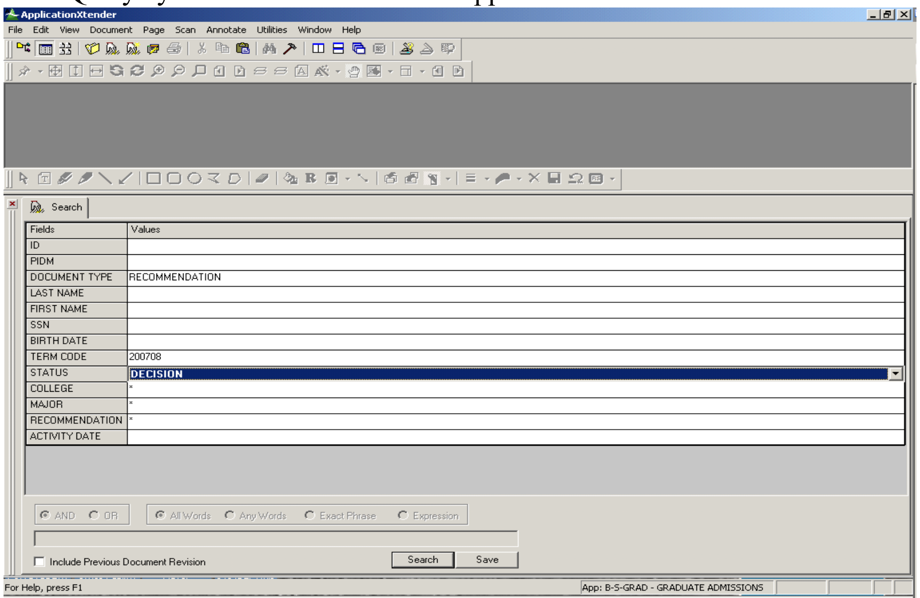


Figure 7: Results of query where decision has been made

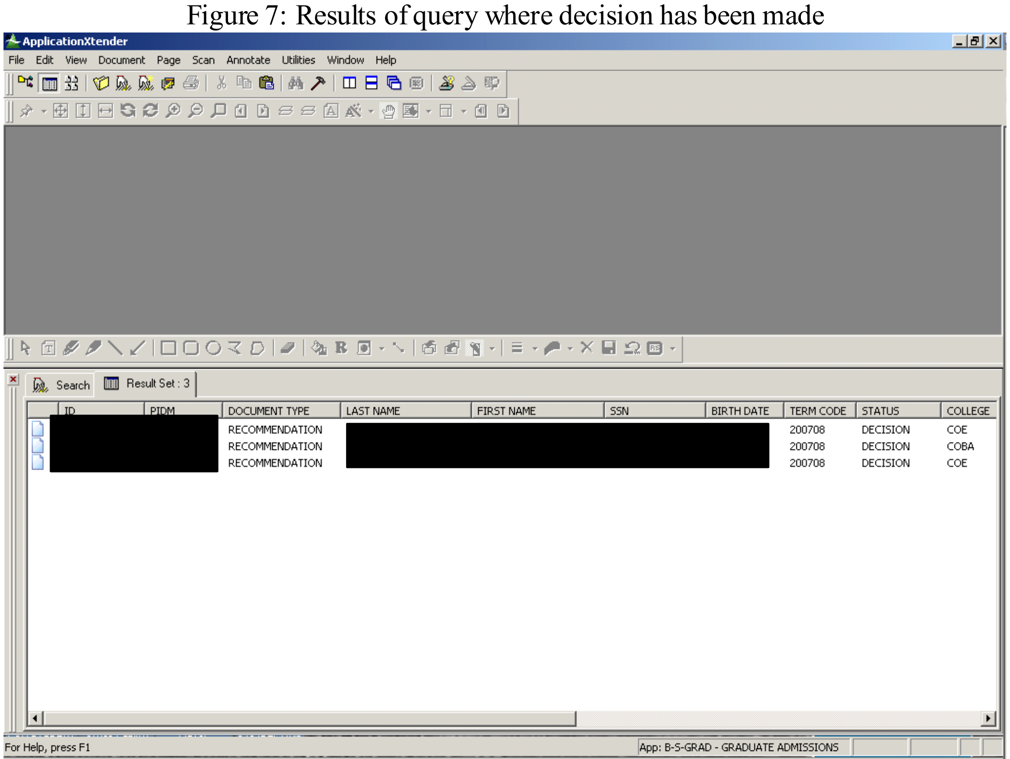


Table 1: Comparison of graduate admission process before and after the imaging system			
Who	Before	Who	After
Applicant	Complete paper application and related forms.	Applicant	Complete online application and related forms.
Applicant	Submit application and related forms via US Mail.	Applicant	Submit application and related forms electronically.
Applicant	Ensure that external supporting documents (official transcripts, test scores, etc) are forwarded via US Mail to Graduate Admissions Office.	Applicant	Ensure that external supporting documents (official transcripts, test scores, etc) are forwarded via US Mail to Graduate Admissions Office.
COGS*	Assign unique student identification number.		
	Create physical file folder & label.		
	Add documents to file as they arrive.	OGA*	Assign unique student identification number.
	Scan & index documents in Xtender as they arrive.		
	Confirm scans are readable.		
	Shred physical documents.		
COGS	When application is complete:		
	Make physical copy of file.		
	Print recommendation form.		
	Forward file & form to Program Director.	OGA	When application is complete use Xtender to:
			Generate electronic recommendation form.
			Set status to “Complete”.
Program Director	Review application and supporting documents.		
	Record comments/stipulations on the recommendation form.		
	Record decision on recommendation form.		
	Return physical file and recommendation form to COGS.	Program Director	Use Xtender to:

Table 1: Comparison of graduate admission process before and after the imaging system			
Who	Before	Who	After
COGS	Notify student of decision.		Run query to obtain list of complete applications.
			Pull applications for review.
			Update status to "Reviewing"
			Print portions of electronic file.
			Review application and supporting documents.
			Record comments/stipulations on electronic recommendation form.
			Use rubber stamp tool to record decision & update status to "Decision".
			Post admission decision and notes to Banner.
		OGA	Run Xtender query daily to identify "decisions".
			Post admission decision and notes to Banner.
			Set status to "decision posted".
		Applicant	View decision and notes online
Turnaround Time	6 – 8 weeks	Turnaround Time	2 weeks
*COGS = College of Graduate Studies, OGA = Office of Graduate Admissions			

Infrastructure of the Imaging Application

Scanning, storing and managing document images required an investment in new hardware and software. Although images were initially stored on existing servers, this capacity was quickly outgrown. The images were then migrated to a storage area network (EMC SAN CX400) purchased by another entity on campus. "A storage area network (SAN) is a high-speed network with the sole purpose of providing storage to other servers to which it is attached." (Shelly, Cashman and Vermaat, 2007, p. 742) The amount of storage needed on the Storage Area Network was based on the average file size for applicants to graduate programs. Each page is an image and the average image size is 70-80 KB. The expected storage requirement for each applicant was estimated by multiplying the average number of pages per applicant by the average image size. Total storage requirements were then determined by multiplying the result by the expected number of applicants. The imaging application currently requires about 250 Gigabytes (or 250 billion bytes) with another 250 Gigabytes allocated for expansion and growth.

The imaging application software is comprised of ApplicationXtender, WebXtender and ScanXtender (Banner: Banner Xtender Solutions, 2005)

> *ScanXtender: Used to scan large batches of documents. Georgia Southern has ten concurrent user licenses for this product.*
> *WebXtender: Web-based application used to view documents only. Georgia Southern has licenses for 125 concurrent users.*
> *ApplicationXtender: Installed on the client. Product used to index documents, update fields, etc. Georgia Southern has 125 concurrent user licenses.*

The standard PC configuration was sufficient for running the Application Xtender client. Due to upgrades in the Banner system and the need to view electronic images, larger monitors were needed for the processing staff. To accommodate this, monitors were upgraded from 15" to 17" or 19". Dual monitor systems were set up for staff members as needed.

Additionally, scanners were purchased to convert paper-based documents to images. The Office of Graduate Admissions currently uses Kodak i50 and i60 scanners. These scanners have the capability to scan double-sided documents in a single pass.

Implementation and Training

The imaging system was scheduled to "go live" for new applications received after October 2005. Prior to this date, a plan for converting from the paper-based system and a strategy for training end users had to be developed.

The conversion plan called for scanning and indexing all paper files for currently enrolled graduate students into the new system. This process took place from May through October of 2005 and involved scanning and indexing more than 2000 files. Once imaged, the paper files were archived.

All program directors and staff members working with the system had to be trained. Initially, a few key members of the Office of Graduate Admissions, IT Services and SAEM Technical Support learned to use the system through experimentation. They trained the remaining staff and program directors prior to the "go live" date. Hands-on training sessions were conducted by members of the Office of Graduate Admissions in a computer lab. Program directors and their staff were guided through their part of the admission process and provided with PowerPoint slides that included screenshots and instructions for some of the key activities they would be performing on the system. Training is on-going as faculty/staff assignments change and the technology evolves.

Impact of the New System

The imaging project was successful for several reasons. One key factor was support of the Student Affairs and Enrollment Management Technical Support staff and the Office of Graduate Admissions senior administrators. The imaging system provided a mechanism to grow graduate admissions and to use technology in support of efficient administrative practices, both part of the strategic plan for the University. Key administrators and members of the planning and development team had an attitude of 'this will not fail' and 'we will change everything that is now paper-based to an electronic version'. In addition, the employees closest to the application, those involved in planning, development and implementation, had positive attitudes, embraced change, and championed the system to the other users. There was also a sense of pride from administration that Georgia Southern was a pioneer in this area within the University System of Georgia. Finally, the planning committee chose a strong vendor with a good background in image processing.

Despite careful planning and multiple training sessions there were still several problems with the implementation. As is often the case with new technology, overcoming resistance to change was a challenge. According to staff that supported the development and implementation of the application, this resistance was particularly noticeable among program directors. Several program directors described the new system as placing additional work on them whereas the Office of Graduate Admissions perceived the new system as reducing workload.

Additional problems included dealing with the diversity of forms associated with the student population. This was particularly true with regard to forms needed for international students and, to a lesser extent, with transfer students. Transcripts are not always available in electronic format and are not standardized.

Several benefits experienced by the Office of Graduate Admissions include:

Improved "customer" service. Turnaround time for applications reduced from 6-8 weeks to 2 weeks.
Space savings. File rooms have been converted into offices.
Internal process efficiencies. Graduate admission applications were historically photocopied and delivered to graduate admission decision-making units around campus. This manual process strained resources and has been replaced by the capability to review, from anywhere on campus, an image of all graduate admission documents received from an applicant.
Redeployment of resources. As process flows have changed, so have responsibilities. For example, staff and student workers who previously maintained file folders have been reassigned to other projects. There is more of a need to analyze information

rather than just handle paper. Staff members in the Office of Graduate Admissions have embraced this, stating that it has enriched their jobs. Enables staff employees to serve in more meaningful, "information analyst" types of roles.
Automated backup. The Storage Area Networks are backed up on a regular basis.
Improved security. Although security risks cannot be fully mitigated, access to the electronic system is restricted. A secure Login is required and an audit trail is produced. Prior to implementation of the system, anyone could walk into the storage room and access student files.
Easier to share documents across units.
Saves time and money. Reduced storage costs and saved space. Reduced expenses for pre-printed file folders, complex labeling system, copying, paper, etc. (estimated at $30-$40K per year.)
Increased efficiency. Admissions did not fill two positions that were vacated despite an increase in the number of applications and number of graduate students. More importantly, there has been no loss of staff.

The Office of Graduate Admissions views the implementation of document imaging as a bridge step to full implementation of electronic forms. They are championing the idea of a paperless office, and favor getting the information online from the outset and keeping it there all the way through the process. The next frontier will be to define workflow processes and add automatic feeds and reminders, such as notification to a program director that a record needs to be reviewed, and notification back that the record has been reviewed, as opposed to the current process of manually entering queries periodically.

Some of the key challenges cited by SAEM Tech Support and Graduate Admissions include:

Refining the system while building it – which led to some frustration.
Scanning takes more time than originally envisioned. This is a primary driver for wanting to change processes to start with online entry.
Finding effective ways to deal with user resistance among program directors by automating workflow is vital to the continued success of the project.
There is still a need to refine the workflow routing process. Automatic feeds and reminder notices are needed.
Imaging is the "bridge" step to online forms. Online forms provide the additional benefit of forcing electronic archiving and records management. They also allow for search functionality on fields not used in the index.

The perception among program directors that the workload has shifted from staff in Admissions to program directors and their staff still remains. The response by the Office of Graduate Admissions is that these functions have to be completed, and it is easier to complete them this way, by pointing and clicking, than it is to handle paper. The bottom line according to the Office of Graduate Studies is, “We have to be able to handle bigger volumes if we are going to grow our applicant pools and our student body, and quicker turnaround is crucial to attracting students. We can’t grow the programs without these things . . . and we must grow the programs in order for them to remain viable.”

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RECEIVABLES MANAGEMENT: A CASE STUDY

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CASE DESCRIPTION

The primary subject matter of this case concerns receivables management. Secondary issues examined include the impact of a client's financial distress on a firm's cash flows; the use financial accounting data to challenge a firm's going concern principle and the formulation of new business strategies when the unexpected happens to a firm. The case is appropriate for first year graduate level. The case is designed to be taught in two class hours and is expected to require five hours of outside preparation by students.

CASE SYNOPSIS

Delta Inc. was formed in 1998 by Thomas Dake and George Roberts. The firm was organized and located in Baltimore, Maryland. It provided brokerage services for a wide range of financial transactions for businesses in the state of Maryland. Delta's strategy was to position itself as a discount broker because it perceived that borrowers' resistance to broker fees was much weaker when the lender paid the fees. Pink Tree Finance, a public company listed on the New York Stock Exchange, was Delta's major business partner. About 60 percent of Delta's receivables were due from Pink Tree. Although Delta regarded new client and lender relationships as opportunities for growth within the brokerage business, it also looked for opportunities in other businesses. As a result, the firm identified the West Baltimore Senior Housing Project as a good investment opportunity.

Delta planned to develop a property on West Baltimore Street into a senior housing facility and commercial spaces. The entire project was estimated to cost $10.5 million. Delta executed the purchase agreement for the existing West Baltimore Street property in September, 2001. In October, 2001, Delta applied to a bank in Baltimore for a commercial loan of $10.5 million to purchase and develop the property. The term sheet provided Delta with 90 days to close the loan transaction. It required a refundable fee of $100,000 on executing the term sheet. Delta planned to use the outstanding brokerage fees to be collected from Pink Tree to close its loan transaction. In the middle of January, 2002, Pink Tree filed for chapter 11 bankruptcy. Mr. Thomas Dake, CFO of Delta Group was now in a difficult situation of raising $100,000 to close the loan and to ensure that the West Baltimore Senior Housing Project would be realized.

INTRODUCTION

Although business failures are not new phenomena it is given very little coverage in the accounting curriculum. This case study introduces students to an important aspect of receivables management – the need to monitor your client's financial health and decreasing your reliance on few clients. The case investigates a discount brokerage firm owned and operated by two highly qualified individuals who were involved in expanding their business but failed to see the obvious signs of financial distress. "How much of our receivables, if any, can we collect from Pink Tree after they've filed for Chapter 11 bankruptcy[1]?" George Roberts, CEO of Delta Inc. asked the CFO, Thomas Dake. It was in the middle of January, 2002, and the partners of Delta Inc. were at an emergency meeting after they heard about Pink Tree's financial crisis. They were expecting to receive outstanding brokerage fees from Pink Tree that week. Delta was relying on these funds to close a loan transaction for a new business opportunity at West Baltimore Street.

As Mr. Thomas Dake left the emergency meeting, he reflected on the difficult situation his firm was experiencing. He had assured his partner he would come up with a solution but he knew it was not going to be easy given the little time they had. According to their attorney, Jeff Mathews, "If Delta does not come up with $100,000 to close the loan within two weeks, the transaction will be terminated and that would be the end of our new venture." The cash on hand was needed to meet all the other regular business expenses such as rent, salaries, etc.

Mr. Dake was in his office and reflected on why everything had suddenly gone wrong. He was very confident about Delta's finances until the unexpected happened. About 60 percent of Delta's accounts receivable was due from Pink Tree, so the firm's bankruptcy was a devastating problem for Delta. His thoughts were about finding a quick and effective solution as well as whether this situation could have been avoided. Mr. Dake thought back of some business courses he had taken in college in which a professor had discussed predicting bankruptcies using the Altman Z-score. Since then several newer probabilistic models have also been developed. Mr. Dake was an optimist and had never thought this academic topic would ever be of interest to him or his business. Now he wondered what the firm's future would be if the new business venture was not pursued. Would they lose the $30,000 in escrow? Would they recover anything from Pink Tree? Would the business survive without its biggest client in the future?

COMPANY BACKGROUND

Delta Inc. was formed in 1998 by Thomas Dake and George Roberts. The firm was organized and located in Baltimore, MD. It provided brokerage services for a wide range of financial transactions for businesses in the state of Maryland. Mr. Roberts was a principal and the CEO of Delta. Prior to founding Delta, Mr. Roberts had several years of financial management. His previous work experience included working as a licensed investment broker and managing logistics and supply chain integration. Mr. Roberts graduated with a Bachelor of Science in Urban & Regional

Planning. Mr. Dake was also a principal and co-founder of Delta. Previously, Mr. Dake was a financial analyst at a bank. He had a Bachelor of Business Administration degree.

Delta's expertise was in debt, equity, and accounts-receivable financing. Delta maintained relationships with equity sponsors, regional fiduciary institutions and non-traditional financing entities that provided financing to the firm's clients. The firm obtained its brokerage fees and commissions from lenders. A substantial portion of Delta's brokerage fees and commissions were from Pink Tree, a public company listed on the New York Stock Exchange. Between 2000 and 2001, Pink Tree's market value of equity increased by almost eight percent. The firm's assets increased by seven percent while revenues increased by ten percent during the same period.

Table 1
Pink Tree's Financial Statements - Balance Sheet
December 31, 2001 and 2000
(Amounts in millions)

	2001	2000
Assets		
Cash and cash equivalents	394.5	$665.50
Finance receivables	4,168.7	4,214.90
Investments	16,680.7	15,176.90
Goodwill	-	28.8
Other assets	984.1	751.9
Total assets	22,228.0	$20,838.00
Liabilities and Stockholder's Equity		
Liabilities		
Investor payables	8,918.2	$7,516.90
Other current liabilities	2,356.6	2,457.00
Long-term liabilities	9,003.7	8,774.90
Total liabilities	20,278.5	$18,748.80
Stockholder's Equity		
Preferred stock	750.0	$750.00
Common stock and additional paid-in capital	1,209.4	1,209.40
Accumulated other comprehensive loss	(108.6)	-139.1
Retained earnings	98.7	268.9
Total shareholder's equity	1,949.5	2,089.20
Total liabilities and shareholder's equity	22,228.0	$20,838.00

Table 2
Pink Tree's Financial Statements - Statement of Operations
December 31, 2001, 2000 and 1999
(Amounts in millions)

	2001	2000	1999
Revenues:			
Net investment income:	2,260.2	$1,945.00	$647.10
Finance receivables and other	51.5	106.6	185.1
Interest-only securities	-	-	550.6
Gain on sale:			
Securitization transactions	26.9	7.5	-
Whole-loan sales Servicing income	115.3	108.2	165.3
Fee revenue and other income	229.7	277.5	207.4
Total revenues	2,683.6	2,444.80	1,755.50
Expenses:			
Provision for losses	563.6	354.2	128.7
Interest expense	1,234.4	1,152.40	341.3
Other operating costs and expenses	642.4	770.8	697.2
Impairment charges	386.9	515.7	554.3
Special charges	21.5	394.3	-
Total expenses	2,848.8	3,187.40	1721.5
Income (loss) before income taxes	(165.2)	-742.6	34
Income tax benefit	(62.5)	-217.3	-13.9
Net income (loss)	(102.7)	($525.30)	$47.90

Table 3
Pink Tree's Financial Statements - Statement of Shareholder's Equity
December 31, 2001, 2000 and 1999
(Amounts in millions)

	A	B	C	D	E
Balance, January 1, 1999	2292.2	$ -	$1,338.30	($11.00)	$964.90
Comprehensive income (loss), net of tax:					
Net income	47.9	-	-		47.9
Change in minimum pension liability adjustment (net of taxes $2.6 m)	4.2	-	-	4.2	-

Table 3
Pink Tree's Financial Statements - Statement of Shareholder's Equity
December 31, 2001, 2000 and 1999
(Amounts in millions)

	A	B	C	D	E
Change in unrealized depreciation of actively managed fixed maturity investments and interest-only securities (net of taxes $7.6m)	(12.0)	-	-	-12	-
Total comprehensive income	40.1	-	-	-	-
Issuance of common stock	299.4	-	299.4	-	-
Tax benefit related to issuance of shares under stock option plans	3.3	-	3.3	-	-
Dividends on common stock	(200.0)	-	-	-	-200
Balance, December 31, 1999	2,435.0	-	1641	-18.8	812.8
Comprehensive loss, net of tax:					
Net loss	(525.3)	-		-	-525.3
Change in unrealized depreciation of actively managed fixed maturity investments and interest-only securities (net of taxes $70.6 m)	(120.3)	-	-	-120.3	-
Total comprehensive loss	(645.6)	-	-	-	-
Issuance of preferred stock	750.0	750	-	-	-
Repurchase of common stock	(126.0)	-	-126	-	-
Return of capital	(306.3)	-	-306.3	-	-
Dividends on preferred stock	(18.6)	-	-	-	-18.6
Other	0.7	-	0.7	-	-
Balance, December 31, 2000	2,089.2	750	1,209.40	-139.1	268.9
Comprehensive income (loss), net of tax:					
Net loss	(102.7)	-	-	-	-102.7
Change in minimum pension liability adjustment (net of taxes $2.6 m)	(3.9)	-	-	-3.9	-
Change in unrealized depreciation of actively managed fixed maturity investments and interest-only securities (net of taxes $21.7 m)	34.4	-	-	34.4	-
Total comprehensive loss	(72.2)	-	-	-	-
Dividends on preferred stock	(67.5)	-	-	-	-67.5
Balance, December 31, 2001	1,949.5	$750.00	$1,209.40	($108.60)	$98.70
A = Total					
B = Preferred Stock					
C = Common Stock					
D = Accumulated Other Comprehensive Income					
E = Retained Earnings					

Table 4Pink Tree's Financial Statements - Statement of Cash Flows December 31, 2001, 2000 and 1999 (Amounts in millions)			
	2001	2000	1999
Cash flows from operating activities			
Net investment income	$2,141.20	$1,994.60	$1,009.00
Points and origination fees	3.1	44.8	390
Fee revenue and other income	301.4	401.3	383.1
Interest expense	-1,212.30	-1,038.70	-293.5
Other operating costs	-692.8	-846.6	-676.6
Taxes	-23.9	-72.8	-188
Net cash provided by operating activities	516.7	482.6	624
Cash flows from investing activities			
Cash received from the sale of finance receivables, net of expenses	867.2	2,501.20	9,516.60
Principal payments received on finance receivables	8,611.30	8,490.10	7,487.20
Finance receivables originated	-12,320.30	-18,515.90	-24,650.50
Other	295.9	-262.3	-120
Net cash used by investing activities	-2,545.90	-7,786.90	-7,766.70
Cash flows from financing activities			
Cash contributed by parent resulting from asset transfer	-	-	18.2
Issuance of liabilities related to deposit products	1,872.40	2,168.80	1,128.80
Payments on liabilities related to deposit products	-1,961.10	-1,166.00	-288.3
Issuance of notes payable and commercial paper	11,755.60	20,452.10	22,220.30
Payments on notes payable and commercial paper	-9,666.90	-13,202.80	-15,321.30
Change in cash held in restricted accounts for settlement of collateralized borrowings	-241.8	-689.7	-76.8
Repurchase of shares of common stock	-	-126	-
Common stock dividends paid	-	-	-200
Net cash provided by financing activities	1,758.20	7,436.40	7,480.90
Net increase (decrease) in cash and cash equivalents	-271	132.1	338.2
Cash and cash equivalents, beginning of year	665.5	533.4	195.2
Cash and cash equivalents, end of year	$394.50	$665.50	$533.40

Table 5 **Pink Tree's Market Value of Equity** December 31, 2001 and 2000		
	2000	2001
Market Value of Equity	3965.23	4266.01

Pink Tree was the leading lender to Delta's clients. Pink Tree specialized in providing loans to risky consumers and the firm had a new lending program that required only a five percent down-payment to close transactions. In addition to it's relationships with lenders, Delta also had referral agreements with other brokerage firms to which they could refer financing deals that were not in their area of expertise for a fee.

Delta Inc. retained a pool of consultants (attorneys, accounting and investment banking professionals) to structure, manage and negotiate complicated financial transactions. According to Mr. Roberts, "Our investment team works closely with and is supported by extremely talented in-house credit advisors who can quickly and effectively offer a creative and timely solution in the form of debt, equity or account-receivable financing. Such financing can often be tiered and used to meet working capital needs, acquire debt, provide added liquidity in a turn around, satisfy off-balance sheet financing needs, or otherwise fund a special situation or event-driven financing. Delta works closely with its client to define the objectives of the transaction, identify the appropriate financing structure, and negotiate terms to influence the capital procurement process."

The first step is the application process; this enables Delta acquire information about prospective clients. The second step is due diligence. Clients have to provide their company and/or personal information including registration, financial statements, and tax returns. At this point, Delta develops a case analysis report and executes an engagement contract with the client. From the case analysis report, Delta determined the best financing option for prospective clients. When asked about the relevance of Delta's role as a broker, Mr. Dake responded, "We originate the loan. A borrower must complete a comprehensive application and disclosure process before a lender evaluates the loan request. We simplify this process for the borrower and lender, by conducting this research, counseling our clients on their loan package choices, and enabling them to select the right loan. We serve as an expert mentor and guide to our clients through the complex lending process. We also offer our clients more extensive choice of loan programs and access to more affordable loans."

As a loan broker Delta would typically have two revenue streams from each completed loan transaction. First, the lender such as Pink Tree would pay them a commission for finding them an acceptable borrower. The second revenue stream would be a fee from the borrower for finding them an institution that will loan them the money. Delta's strategy was to forego the second revenue stream completely in order to increase the number of applications processed and accepted thereby significantly increasing the first revenue stream. It is important to note that the first revenue stream is not increased by Delta to offset the loss of revenue from the second. It is not a marketing ploy;

Delta is truly a discount broker. Thus in a highly competitive industry, Delta created a niche for itself by providing superior client service free of cost to the borrower. This resulted in a substantial increase in operating performance. Delta's revenues and net income had increased by 267 percent and 217 percent respectively in just two years.

Table 6
Delta's Financial Statements - Statement of Financial Condition
For the Years Ended December 31, 2001, 2000, and 1999

	2001	2000	1999
Assets			
Cash and cash equivalents	$84,067	$65,857	$48,711
Accounts receivable	668,982	359,285	63,575
Total current assets	752,999	425,142	112,286
Long-term assets	674,181	674,181	674,181
Total assets	$1,427,180	$1,099,323	$786,467
Liabilities and Member's Equity:			
Accounts payable and accrued liabilities	514,227	380,986	195,224
Total current liabilities	514,227	380,986	195,224
Other liabilities	430,030	430,030	430,030
Total liabilities	944,257	811,016	625,254
Member's equity	482,923	288,307	161,213
Total liabilities and Member's equity	$1,427,180	$1,099,323	$786,467

Table 7
Delta's Financial Statements - Statement of Operations
For the Years Ended December 31, 2001, 2000, and 1999

	2001	2000	1999
Revenue:			
Brokerage fees	$631,054	$426,193	$156,082
Commissions	146,240	77,528	47,528
Other income	42,932	27,896	19,820
Total revenue	820,226	531,617	223,430
Expense:			
Compensation and benefits	439,253	250,643	95,225
Professional and other fees	41,511	36,338	22,450

Table 7 **Delta's Financial Statements - Statement of Operations** For the Years Ended December 31, 2001, 2000, and 1999			
	2001	2000	1999
Advertising and promotions	44,961	31,678	13,212
Office operations	51,229	44,013	16,218
Other expense	48,656	41,851	15,112
Total expense	625,610	404,523	162,217
Net Income	$194,616	$127,094	$61,213

Table 8 **Delta's Financial Statements - Statement of Changes in Member's Equity** For the Years Ended December 31, 2001, 2000, and 1999			
	Contributed Capital	Retained Earnings	Total
Balances at December 31, 1999	$100,000	$61,213	$161,213
Net income	-	127,094	127,094
Balances at December 31, 2000	$100,000	$188,307	$288,307
Net income	-	194,616	194,616
Balances at December 31, 2001	$100,000	$382,923	$482,923

Regarding Delta's customer relationship management, Mr. Dake says, "Delta always seeks to be more aware of how the strategic decisions and the changing operations of our clients may impact the services they require. Client knowledge is critical to a satisfactory relationship." The key to a superior customer relationship management for Delta was communication, accessibility, responsiveness and client, market and product knowledge. This made Delta the broker of choice for their clients.

Delta Inc. was an active member of the Maryland Chamber of Commerce. The firm participated in numerous networking events held by the Chamber each year. This gave the company opportunities to interact with other business leaders, government officials and potential clients and mentors. Delta was able to develop several relationships with clients and financial institutions through the Chamber's programs. Although the firm regarded new client and lender relationships as opportunities for growth, it also sought out opportunities outside its line of business. As a result of this strategy the firm identified the "West Baltimore Project" as a great investment opportunity.

Table 9 **Delta's Financial Statements - Statement of Cash Flows** For the Years Ended December 31, 2001, 2000, and 1999			
	2001	2000	1999
Cash flows from operating activities			
Net income	$194,616	$127,094	$61,213
Adjustments to reconcile net income to net cash provided			
by operating activities			
less: Increase in accounts receivable	-309,647	-295,710	-87,543
add: Decrease in accounts payable and accrued liabilities	133,241	185,762	30,041
Net cash provided by operating activities	18,210	17146	3,711
Cash flows from Investing Activities	-	-	-
Cash flows from Financing Activities	-	-	-
Net increase in cash and cash equivalents	18,210	17,416	3,711
Cash and cash equivalents at beginning of year	65,857	48,711	45,000
Cash and cash equivalents at end of year	$84,067	$ 65, 857	$48,711

NEW BUSINESS OPPORTUNITY

Delta Inc. planned to develop a property on West Baltimore Street into senior housing and commercial spaces that would generate rental income. The entire project was estimated at $10.5 million. Delta executed the purchase agreement for the existing West Baltimore Street property in September, 2001. The firm paid the purchase escrow of $30,000 from its cash on hand. In the fourth week of October, 2001, Delta applied to a bank in Baltimore for a commercial loan of $10.5 million to purchase and develop the property. The term sheet provided Delta with 90 days to close the loan transaction. It required a refundable deposit of $100,000 on executing the term sheet. The funds were refundable if the loan was not approved and accepted by both parties, for any reason, within a period of 90 days, after which, the funds would be non-refundable if the loan was approved.

Delta planned to use the collections from its accounts receivable (mostly from Pink Tree) to raise the $100,000 refundable deposit. In the middle of January, 2002, Pink Tree filed for Chapter 11 bankruptcy. The $87,000 cash on hand cannot be used as it is needed to cover operating expenses such as rent, salaries, utilities, etc. The management of Delta Inc. was now in a difficult situation of raising $100,000 in just a few days to close the loan for the West Baltimore Project to be realized.

DISCUSSION QUESTIONS

1. What is the critical issue facing Delta Inc.?

2. List some topics related to receivables management.
3. To what extent did Delta's business strategy impact the firm's accounts receivable and cash flow problems?
4. Calculate the Altman's Z-Score for Pink Tree and discuss whether Delta Inc. should have anticipated the risk of dealing with Pink Tree?
5. How should Delta report the Pink Tree debt in its financial statements?
6. What are the major constraints against the continued success of Delta as a discount broker?
7. What suggestions related to the liquidity and solvency of Delta's operations would you make?
8. What recommendations related to Delta's financing of the $100,000 would you make?

CASE LEARNING OBJECTIVES, IMPLEMENTATION GUIDANCE, AND OUTCOME ASSESSMENT

Case Learning Objectives

This case raises issues of accounts receivable management and the perils of having one major credit customer. Students are motivated to critically analyze the source of a firm's liquidity problems and develop preventive strategies. The students are introduced to the subject of bankruptcy and its implications for related parties. The case has the following specific learning objectives:

- ♦ To provide students with the opportunity to evaluate the impact of inadequate risk assessment of accounts receivables as well as insufficient financial flexibility.
- ♦ To expose students to the details of accounts receivable issues such as default risk and using accounts receivable as collateral for short-term borrowing.
- ♦ To provide students practice in assessing the liquidity and solvency of firms as it relates to bankruptcy prediction.

Implementation Guidance

This teaching case is designed to be used in the introductory financial accounting course in an MBA class. The case can be used in the section on ratio analysis or receivables management. The prerequisites for this case are, understanding the preparation, content, usefulness, and limitations of financial statement.

The recommended approach for teaching the case is to first assign the case to students individually or in groups before having a classroom discussion. The instructor may assign the discussion questions before or during the class discussion. As many students have diverse work experience, a less structured discussion is recommended. A preferred teaching strategy is to assign the case to the students in groups and have each group present their analysis in class. This will give the students an opportunity to discuss and identify the cause of Delta's predicament.

Each group should be asked to identify the critical issues facing Delta Inc., provide alternatives, recommend a solution and provide justification for the recommended solution. The presentation must include an analysis of whether Pink Tree's bankruptcy was predictable. After the group presentations, the instructor can lead a discussion on the role of financial accounting in formulating business strategies before summarizing the case.

Outcome Assessment

This case was tested successfully in a graduate class. One of the co-authors tested the case during the fall 2006 semester in a Financial Accounting course in the MBA program taken by students who do not have an undergraduate degree in business. The students were given a hardcopy of the case and it was discussed in class for thirty minutes. The students were also given information about the bankruptcy predictive model: Altman's Z-score and a copy of industry statistics

Table 10 :Altman's Z-Score
Z-Score Bankruptcy Model
Z = 1.2(T1) + 1.4(T2) + 3.3(T3) + 0.6(T4) + 0.99(T5)
T1 = Working Capital ÷ Total Assets
T2 = Retained Earnings ÷ Total Assets
T3 = Earnings Before Interest and Taxes ÷ Total Assets
T4 = Market Value of Equity ÷ Book Value of Total Liabilities
T5 = Sales ÷ Total Assets
Zones of Discrimination
Z > 2.99 = Safe Zone
1.80 < Z < 2.99 = Grey Zone
Z < 1.80 = Distress Zone

Table 11
Select Industry Financial Ratios
Source: Compustat

		Lending Institutions			Loan Brokers	
	1999	2000	2001	1999	2000	2001
Current Ratio	-	-	-	3.22	3.2	2.27
Current cash debt coverage ratio	-	-	-	0.23	0.08	0.15
Accounts receivable turnover	2.49	2.57	2.41	5.36	5.86	4.14
Debt to Asset	4.38	5.56	6.05	0.6	0.63	0.64
Cash debt coverage ratio	1.37	0.5	0.17	-	17.67	10.55

Seven groups were formed comprising of three students each. The students were instructed to analyze the case and answer the discussion questions at home. The following week one hour of class time was devoted to this case; each group was called upon to lead the discussion on one or two questions; the questions were not pre-assigned to any group in particular. The instructor gave the students two percent extra credit for submitting written responses and participating in the discussions. Each group's response was graded for completeness and accuracy, although it did not affect the extra credit points. Overall, the students' performance was above average and the students responded very well to the case study method of teaching; they said they gained a better understanding of the subject than the regular lecture style of teaching.

After the discussions were concluded, an anonymous survey of students' experiences with the case was conducted in class.

All 21 students participated in the survey. As shown on a five-point scale from strongly disagree (1) to strongly agree (5), for eight of the ten questions the means were four or five, indicating that students had strong positive perceptions about the case. As expected, 95 percent of the students believed the case to be a good example of real-world problems of accounts receivables management (Question 1). 85 percent found the case to be a good illustration of a real-world application of cash management (Question 2) and believed the case is a good demonstration of a real-world application of financial flexibility (Question 3). 76 percent believed the case provides good practice with ratio analysis (Question 4) and also found the case interesting (Question 5). 80 percent believed the case increased their understanding of accounts receivables management (Question 6). 66 percent believed the case increased their understanding of bankruptcy prediction using Altman's Z score (Question 7). 90 percent believed the case increased their understanding of accounts receivables management (Question 8). 95 percent found the case encouraged them to think critically about cash management (Question 9). 71 percent found the case to be a good illustration of bankruptcy prediction (Question 10). All the results are consistent with the case objective of enhancing the students' critical thinking skills.

Table 12
Feedback from Students
(n=21)

Questions	Mean	Median	Mode
1. The case is a good example of real-world problems of ineffective accounts receivables management	4.38	4	4
2. The case is a good demonstration of a real-world application of financial flexibility.	4.14	4	4
3. The case is a good illustration of a real-world application of cash management	4.14	4	4
4. This case provides good practice with ratio analysis	4.29	5	5
5. The case is interesting	4.19	4	5
6. This case has increased my understanding of accounts receivables management	4.05	4	4
7. This case has increased my understanding of bankruptcy prediction using Altman's Z score	3.95	4	5
8. The case has encouraged me to think critically about accounts receivables management	4.33	4	5
9. The case has encouraged me to think critically about cash management	4.38	4	4
10. This case is a good illustration of bankruptcy prediction	3.86	4	4

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HABITAT FOR HUMANITY: CAN MORTGAGE ASSET UTILIZATION BE IMPROVED?

Michael Tucker, Fairfield University

CASE DESCRIPTION

The primary focus of the case is mortgage valuation and building models from income statements that lead to cash flow projections under differing assumptions. This case is suitable for 2nd level undergraduate corporate finance courses (senior level), first or second level graduate corporate finance courses, or financial modeling courses. Levels of technical sophistication using Excel will enhance possible outcomes. The model and graphs used below to arrive at projections may be more sophisticated than some courses would require, particularly the use of the "spinner" in Excel to change values in the graphs. Preparation time: 5 hours.

CASE SYNOPSIS

The Board of Directors of Habitat for Humanity (HFH) of Bridgeport, Connecticut asked Fairfield University's MBA director to put together a team to study the possibility of securitizing some of its mortgages. The professor led MBA team research within the local organization and HFH organizations in other parts of the country. They discover that mortgages are routinely sold at varying discounts from face value. Using financial projections from HFH staff, the case requires the creation of a dynamic plan and forecast that shows how many additional houses could be built in the coming years under varying parameters such as sale price of the mortgages at different discount rates from face value, number of mortgages sold, and delinquency risk. Other issues raised in the case include precluding HFH mortgagees from selling their homes at a substantial profit and managing increases in property taxes.

INTRODUCTION

Mike Guarnieri and Hank Schilling, Board members of Habitat for Humanity of Coastal Fairfield County (HFHCFC) were interested in looking at how to better utilize the mortgage portfolio held by HFHCFC. In March of 2006 Mike obtained approval from Bob Knebel, CEO of HFHCFC, to approach his alma mater in order to propose a research project that would have MBA students explore possible ways to leverage the mortgage portfolio.

HFHCFC has been building homes in Bridgeport, Connecticut since the early 1990s. They currently hold 93 home mortgages in their portfolio. Some are pledged as collateral for loans. A few mortgages have been "sold" to third parties in their entirety or for part of their terms. Mike wondered if some of these mortgages might be "securitized" and sold with the proceeds used to ramp up construction beyond what could be accomplished with donations alone. When he spoke with Dana Wilkie, MBA coordinator at the university, about the possibility of putting together a team of MBA students to examine HFHCFC's mortgage portfolio, Dana was enthusiastic. "I'm sure I can put together a team of students. I also have a finance professor in mind who I think will be willing to work with them," she said.

BACKGROUND

Habitat for Humanity (HFH), founded in 1976 as a Christian based organization dedicated to providing affordable decent housing for the poor, built its 200,000th home in 2005. The homes are built with volunteer labor, some of it professional workers such as carpenters, electricians and plumbers. Prospective home buyers are required to invest "sweat equity," typically 500 hours of construction work on their home or others, to be eligible for a Habitat for Humanity mortgage. Funds are donated to finance the purchase of land, equipment and services that cannot be obtained through charitable donations. From humble beginnings in Georgia, HFH has become an international organization active in more than 3,000 communities throughout the world with over 1,600 affiliates. The personal involvement of former U.S. President Jimmy Carter and his wife Rosalyn beginning in 1984 resulted in national and international exposure of the organization.

HFH consists of many local chapters with their own independent organizations following the Habitat model of building homes with community volunteers and donations. Once completed, the houses are sold to qualified lower income buyers with financing consisting of zero interest mortgages. Buyers' equity investment is their construction work.

Bridgeport had been a bustling manufacturing city until the mid 20th century. Many of the old factories still stand, but they are now derelict and abandoned. With the departure of manufacturing first to the Southern U.S. and then out of the country, Bridgeport's tax base contracted. With diminished commercial real estate, the burden for tax payments fell on households. The tax rate on property as of May 2006 is 42.28 (4.228% tax levied on assessed value). Stamford, a more prosperous city with several corporate headquarters twenty miles down the Connecticut coast, has a mill rate of 30.68. Besides high residential taxes in Bridgeport, further discouraging new homebuyers is a crime rate above that of the surrounding area. Economically depressed Bridgeport does have a large population of working poor in need of decent housing. HFHCFC attempted to partially meet those needs. In the 1990s foreclosures and auction sales of property were common making the task of obtaining sites to build HFH homes somewhat easier and less expensive. For HFHCFC, convincing the working poor of the viability of the Habitat program was a big hurdle in the beginning. Unable to be as selective in granting mortgages led to one or two of the initial buyers running into financial difficulties. The only foreclosure for nonpayment came from among that pioneering group.

The days of having to go out and find prospective buyers are long past. Today HFHCFC has a waiting list of over 300 families. Many of the families are Hispanic making bilingual office staff necessary. Unlike the first few mortgages the staff at HFHCFC is now very familiar with applicants since they are on the waiting list and participating in construction earning their sweat equity for some time before they make a purchase.

INFORMATION GATHERING

The four MBAs (Joe, Steve, Conor and Stephanie) met at the HFHCFC offices in Bridgeport accompanied by their professor. The plan was for one or two of the students to subsequently come into the office several days to gather information from files and from HFHCFC people. There were many questions at the first meeting. Whenever Bob Knebel could not answer himself or could not find a full-time staff member to answer, he assured the students he would get the answer. Since several of those who contributed to HFHCFC operations did so on a volunteer basis, they did not work regularly in the office. This was the case for the treasurer which made obtaining financial information a slow process and as the students discovered, an iterative process.

With the recent real estate boom throughout the US pushing prices up, developers have taken a new interest in Bridgeport. The students were surprised to discover that the average property tax of Habitat homeowners is over $3300, well above the annual average mortgage cost of $2944. Concerned that ever escalating assessed property valuation could push some owners into serious financial difficulty, HFHCFC has negotiated a covenant to be included with the deed of sale that restricts the use of the home to low income housing for a period of 40 years. With this restriction the city was willing to maintain assessed valuation at approximately the well-under-market sale price paid by Habitat buyers. With HFHCFC homes selling for about $90,000 that would keep new home assessment well below market valuation. Even in marginal neighborhoods current assessment was well above $200,000 which would imply doubling of the current high property tax bills. HFHCFC was confident the same arrangement can be made with the city for assessment on already sold homes to roll back or prevent property taxes escalating.

A different matter of concern was the lack of any covenant in many of the existing older mortgages preventing owners from selling their homes at a substantial profit in the overheating housing market. Besides selling the homes there are other uses valuable assets can be put to that could create problems such as pledging them as collateral to obtain loans. In Chicago, Habitat for Humanity began to experience a rash of foreclosures on homes sold to the working poor. It turned out that an unscrupulous lender had approached Habitat homeowners with a proposition offering them the opportunity to "take money out of their homes" by refinancing at an appreciated value. Since all Habitat homes are sold well below market value and most then appreciate, substantial windfall gains were too much for some to resist. When faced with higher mortgages payments, now including interest, making payments became impossible. The unscrupulous lender was not as generous in working something out as Habitat would have been and foreclosure ensued. The Chicago chapter initiated a covenant with its mortgage holders that amounted to a "silent second mortgage." If the homeowner sold the house or attempted to refinance, an additional mortgage would activate. The amount of the silent mortgage was subject to change so that it amounted to the difference between the original mortgage and the fair market value of the home. This would effectively remove all upside gains from any transaction. HFHCFC had been incorporating silent mortgage covenants into all its mortgages for several years but there were still a substantial number of older mortgages that did not include it. HFHCFC had leverage with these mortgage holders to update the mortgage. They could combine the negotiated covenant regarding assessment and property taxes with the silent mortgage. To date, none of the older homeowners had sold or refinanced their homes but if mortgages were to be sold, the possibility of early repayment could effect valuation of any mortgages sold to third parties.

Bob recalled receiving a phone call from one of the mortgagees describing being solicited by a home equity lender. When Bob called the lender and pointed out that Habitat mortgages were zero interest and also had silent mortgage covenants, the lender expressed ignorance. "If I had known these were zero interest mortgages, I wouldn't have called."

In order to familiarize themselves with mortgage backed securities, the MBAs did some preliminary research into how these instruments worked. They discovered that securitization typically involved a government agency (GNMA or FNMA) which meant that there were many mortgages involved. Given the small size of the HFHCFC portfolio, it was unlikely the mortgages would be appropriate for the large scale government MBS programs. Another issue was the principal only aspect. While most mortgages involved repayment of principal with interest, the fact that Habitat mortgages were principal appeared to be a barrier to securitization. The students found that in fact mortgages were often repackaged so that buyers could purchase interest only cash streams and principal only cash streams each of which would react differently to changes in market conditions and changes in prepayment probabilities.

At the end of 2005, HFHCFC had granted 92 mortgages worth $6.1 million. Most mortgages were for single family homes though HFHCFC had built a limited number of multi-family units. Of those mortgages, 57 had been sold to either the Connecticut Housing Finance Authority (CHFA) or Fairfield County Bank Corporation (FCBC) or were backing lines of credit. That left $2.8 million uncommitted. CHFA had been more active in the past; they bought 26 mortgages since 1991. Reduced state funding and more demand would likely reduce CHFA's ability to buy mortgages to one or two per year for the foreseeable future. A major advantage in dealing with CHFA was that they paid full price for mortgages; HFHCFC got the entire outstanding amount of the mortgage to reinvest.

FCBC was not as generous as CHFA though they limited the discount from face value to 6.5% for the three mortgages they bought which amounted to a substantial difference from market value, i.e., the present value of the payment stream at current mortgage rates. Future participation by the bank was uncertain. In the case of all of mortgage sales, HFHCFC guarantees payment so that if the borrower is delinquent or in default, HFHCFC is responsible for making timely payments to the holder of the mortgage. Any future mortgage sales would be made under these terms.

HFHCFC also has borrowed against mortgages under Accelerated Asset Recovery (AAR) run by Habitat for Humanity International (HFHI) in Washington DC. Mortgages are used as collateral to back 7 year loans at an interest rate of 3.85%. A further stipulation of this program is that HFHCFC receives only 85% of the borrowed amount with the withheld 15% intended to cover delinquencies or foreclosure problems. Under this program, HFHCFC has borrowed a cumulative $1.7 million using 20 mortgages as collateral. The remaining source of funds aside from donations is the Bridgeport Neighborhood Fund (BNF). Working with Westport National Bank, BNF has provided a revolving line of credit collateralized with HFHCFC mortgages.

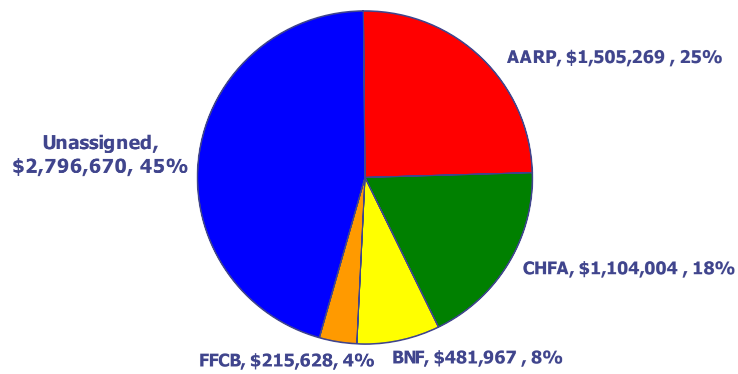
Steve pursued a line inquiry that involved contacting other Habitat chapters in the country to gather information on how they managed their mortgage portfolios. Bob Kelley of Greensboro, NC Habitat affiliate told Steve they had discussions with Fannie Mae about selling mortgages but FNMA wanted to employ a 6% discount rate to payments to arrive at a market value price. Bank of America was interested in long-term loans collateralized by mortgages but again the discount rate applied to payments would be 6%.

Collier County, Florida affiliate had gotten further with selling mortgages but not with any federal agency. Denise Daminanakes, Director of Finance described a vibrant program. “We have been active with about 22 different banks and finance companies but we are a big operation. We’re closing in on our 1,000th house and usually build at least 100 homes per year. The only mortgage sale we consider is for 100% of face value of the mortgage.” Collier County maintains collections and record keeping on all mortgages sold guaranteeing on time payment to the buyer of the mortgages even if a mortgage holder is delinquent or in default. With such a large portfolio of mortgages, record keeping is a major task. Collier County’s mortgage sales are mainly the responsibility of the Development Department, the same department that seeks donations. Buyers of principal only face value mortgages are effectively charitable donors.

Steve suggested there might be something in it for those who bought Collier County’s mortgages if they were banks. “The Community Reinvestment Act requires banks to serve the needs of their communities. CRA is pretty vague about how banks are to serve their communities but buying Habitat loans certainly looks like a viable means of doing it. On the downside, Office of Thrift Supervision is about to raise the size of the institution that must comply with CRA from the current $250 million assets to $1 billion.” Even the one billion dollar threshold would not be too much of a problem in the Bridgeport area since Bridgeport is located in Fairfield County, home to many well-heeled financial institutions that could be approached for assistance. Both Hank Schilling and Mike Guarnieri worked for GE Capital, a possible mortgage buyer. There were also other financial institutions on the HFHCFC Board.

Minnesota Habitat affiliates benefited from substantial assistance from the Minnesota Housing Finance Authority (MHFA), a more robust version of CHFA. MHFA maintains a fund, Habitat 21st Century Fund, that has grown to over $21 million. The fund is used to accelerate mortgage payments to Habitat affiliates as "loans" with the repayment being mortgage payments made. This effectively amounts to buying out the mortgages. Affiliates continue to service the mortgages and make up any shortfalls. Money collected by MHFA goes back into the fund.

Exhibit 1
HFHCFC Existing Mortgage Portfolio (12/31/05)



HFHCFC's securitization of mortgages will not be as financially sophisticated as the instruments the student team read about. It will simply amount to sale of a mortgage to a financial institution or CCFA. Ideally the sale price will be the full value of the mortgage but realistically it may be less. In any case, freeing up funds will allow for more construction.

Ryan obtained data to construct Table 1 from HFHCFC outlining planned fund raising and expenditure activity through 2010. Note that while Total Revenue far exceeds Total Annual Funding Needs, Total Cash Revenues approximates those needs. Revenues exceed cash flow because sales of the houses (mortgages) is booked as revenue at face value of the mortgages. The only way to convert mortgage revenue to cash flow aside from collecting it over the term of the mortgage is to either sell the mortgage or pledge it as collateral for loans. The team's faculty advisor was suspicious of the projected mortgage revenue figures for 2006-2010. They appeared to be too low. He suggested using the 2005 figure and adding new mortgages as if they were sold at the beginning of each year with each being 30 year duration and amounting to total construction costs divided by number of homes built in any given year. "I know that will be a slightly different number than the average cost per house minus administration costs but from conversations I've had it more closely tracks actual mortgages," said the advisor. "I also think we should assume sales of new mortgages do not exceed nine mortgages per year. That's well below the number of new home construction figures each projected year. We'll need to look at how many additional homes could be built with those sales each year and the resulting mortgage revenues will need to be rolled into each year's mortgage revenues and of course accumulated. And build in some assumption for late payments, etc.

HFHCFC may also be selling the mortgages at different discount levels from face value. It would be useful to look at a variety of scenarios and combinations, different discount rates, different delinquency rates in the single digit range, and different numbers of mortgages up to nine per year. The bottom line will be the number of additional houses that can be built each year and in total for the 2006-2010 period."

Table 1: Revenue & Cash Projections for HFHCFC 2005-2010

	2005	2006	2007	2008	2009	2010
Finances	Actual	Plan	Plan	Plan	Plan	Plan
Avg cost per house minus admin	87,518	91,000	95,500	97,500	100,000	104,000
Programs & services	194,135	243,918	628,489	659,913	692,909	727,554
Construction costs	1,533,781	1,485,000	1,620,000	2,024,000	2,090,000	2,328,000
Development costs	95,288	205,000	220,000	228,000	230,597	239,821
General administration	274,722	254,000	275,000	285,000	295,000	305,000
Total Annual Funding Needs	2,097,926	2,187,918	2,743,489	3,196,913	3,308,506	3,600,375
Cash contributions	1,672,968	2,000,000	2,300,000	2,660,000	2,800,000	3,100,000
Gifts in kind	72,504	150,000	150,000	150,000	150,000	150,000
Mortgage revenues	151,281	140,000	160,000	175,000	185,000	200,000
ReStore NET	18,606	35,000	45,000	55,000	65,000	75,000
Accelerated asset recovery	220,000					
Sale of mortgages to CHFA	75,000					
Other cash revenues	159,821	220,000	100,000	165,000	110,000	80,000
TOTAL CASH REVENUES	2,370,180	2,545,000	2,755,000	3,205,000	3,310,000	3,605,000
Sale of houses (net gain in assets)	1,146,219	1,344,600	1,620,000	2,024,000	2,090,000	2,328,000
Total Revenue (including sale of houses)	3,516,399	3,889,600	4,375,000	5,229,000	5,400,000	5,933,000
Houses completed and sold	13	15	17	22	22	24

MOUNT CEDAR TECHNOLOGIES, INC.: A CASE STUDY IN DESIGNING A HIGH PERFORMANCE ORGANIZATION

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CASE DESCRIPTION

In today's global economy, organizations are faced with many challenges including motivating and rewarding employees; communicating and making effective decisions; evaluating group and team behavior; assessing their organizational structure and determining its effectiveness, assessing its leadership and determining its effectiveness; and evaluating alternative methods to managing change in the newly designed organization. Successful managers must learn the importance of creating functional and effective structures, processes, and understanding and managing the human side of the organization as this will enable people to effectively work together to achieve agreed upon goals. Therefore this term-long group case study, designed to cover multiple aspects of Organizational Behavior and Theory and Organization Design, will give you an opportunity to design an effective organization.

The author developed the case for class discussion rather than to illustrate either effective or ineffective handling of the situation. The names including the organization have been disguised. The case, instructor's manual, and synopsis were anonymously peer reviewed and accepted by the Western Casewriters' Association for its annual meeting, March 27, 2008, Oakland, CA.

CASE SYNOPSIS

Mount Cedar Technologies, Inc. was founded in Los Angeles, California in 1995. It began as an importer and distributor of computer accessories, but by 2000 had evolved into an IT infrastructure integrator specializing in hardware and software products, storage and security solutions, and technical services to Enterprise, Small and Medium Businesses, and to Government, Educational, and Medical institutions. Its employees grew rapidly from 6 in 1995 to more than 170 employees in 2006.

The company lacked an organizational structure to improve its operations' effectiveness. Additionally, there were complaints from employees who did not feel equitably treated, resulting in the loss of talented employees. Department managers acknowledged that they were very busy reacting to problems and customer issues, allowing them little time to coordinate and listen to their employees.

Decision making was highly decentralized. This resulted in the loss of possible gains to be obtained from cooperation among other managers. The silo effect that resulted from this structure meant that departments were making decisions based on what was best for them.

While John Curtis (CEO) had been instrumental in growing the organization, his present leadership style had become increasingly problematic to many including upper management. He liked to surprise people by showing up un-invited to meetings and all employees and managers were expected to provide off the cuff answers to questions he would throw at them during these visits.

Managers were asked to focus mostly on financial measures. The culture was described by many people as a task oriented one that did not encourage risk taking or empowerment. Additionally, the organization was lagging in the areas of training and the advancement of women and minorities. Finally, upper management wanted to grow its business by adding new product offerings.

INTRODUCTION

Sam Farris was hired as the new Vice President of Mount Cedar Technologies, Inc. in December 1998 to work closely with the company's top executives to oversee daily operations, support sales and technical logistics, to be part of the top management team, and to determine, along with other executives, the future strategic direction of the company. During a coffee break, he shared the following advice with his senior management team (John Curtis, President and CEO; Bob Holt, Vice President of Finance and Human Resources; and Frank Mathew, Vice President of Sales): "Re-visit your organization and take it to the next level! You have great people, great customers, and great products. You need to build an effective, sustainable business, and be a regional leader in what you do."

ORGANIZATIONAL HISTORY AND BACKGROUND

Located in Los Angeles, California; Mount Cedar Technologies, Inc. (hereto referred to as "Cedar Tech") was founded in August 1995 by John Curtis and Frank Mathew who were classmates and friends. Both graduated in May 1990 with a bachelor's degree in Management Information Systems from a Seattle area university. Both John and Frank relocated to Southern California right after graduation, and worked for a major technology solutions provider in the city of Los Angeles before starting their own company. Cedar Tech was jointly owned by John with a 51% share and by Frank with a 49% share. More than 80% of Cedar Tech's business comes from customers within the state of California. Less than 20% of business comes from other states.

Cedar Tech was originally an importer and distributor of computer cables, audio/video cables, surge protectors, and a host of computer accessories. In the fall of 1998, Cedar Tech added new products to its offering when it became a provider of third party technology, including hardware, software, and services to corporate customers. Its new product offerings included computer and networking accessories, computers, peripherals, printers, displays, printer consumables, and software. Its services included installing hardware and peripherals into systems. It provided standard and custom hardware configuration for personal computers (PCs), notebooks, printers, and servers. Services included the installation of memory, hard drives, digital video editing, network cards, modems, video cards, and other peripherals. Software services included the installation and configuration of software in systems based on customers' requirements.

Cedar Tech evolved again in March of 2000 when it acquired Denta Solutions of Los Angeles, a small solutions provider, specializing in IT storage. This acquisition provided Cedar Tech with 11 certified storage engineers and 2 project managers. In the company general meeting after the buyout, Frank had the following to say to employees: "…there can be little doubt that the most significant contributions to playing in the IT solutions arena was the acquisition of Denta Solutions" Frank noted as he talked to the employees in the company general meeting after the buyout of Denta completed in late March of 2000.

Today, Cedar Tech's business profile reads "as an IT infrastructure integrator specializing in IT hardware and software products, IT storage and security solutions, and IT services to Enterprise; Small and Medium Businesses (SMB); and to Government (state and local), Educational (K-12 and higher education), and Medical institutions (GEM)".

CEDAR TECH KEY BUSINESS PRACTICES

Cedar Tech's main business activities revolve around the following key business components:

Enterprise Storage

The company designs, implements, and manages storage infrastructure to customers' requirements and objectives. All of Cedar Tech engineers are trained and certified by storage vendors including HP, IBM, Network Appliance, Qlogic, Sun, and VMware.

Security Services

Cedar Tech provides its customers with security services. Such services include applications security, vulnerabilities and attacks; security needs assessment services, secure content management, intrusion management, and remote access security. Its security engineers are certified by the industry's top-tier vendors including: Cisco systems, McAfee, SonicWall, Symantec, and Trend Micro.

Services and Help Desk

Cedar Tech provides a host of IT services to customers including customized service support plans (CSP), hardware and software installation, operating systems upgrade and downgrade, rack frame construction, Windows operating system server installation, network server setup, image load/transfer, phone service support, dispatch services, 7/24 call center, on-site desktop services for software and hardware, needs analysis, network cabling, and warranty repair depot for HP, Lenovo, Lexmark, and Toshiba. All of Cedar Tech's technicians are A + and vendor certified.

Business to Business "B2B" On-line IT Products Fulfillment

Through partnership with top IT industry distributors, including Ingram Micro, Tech Data, Synnex, Avnet, and Bell Microproducts, Cedar Tech is able to provide its corporate, government, educational, and medical customers with more than 100,000 products from top brands[1]. Cedar Tech provides on-line ordering, order tracking, and products sourcing for the industry's top vendor brands including but not limited to: Apple, Cisco, Computer Associates, HP, IBM, Intel, Kingston, Logitech, McAfee, Microsoft, Sun, and Symantec. It is important to note here that gross profit margin on products fulfillment varies from one product to another but is usually low.

Software Licensing

Cedar Tech added its software licensing group in mid June 2003 to help customers with their volume software licensing requirements. Its qualified and vendors' certified software advisors helped customers choose the best licensing program for their business, facilitated and worked out the details of the licensing agreement, and kept track of customers' software assets. One important service of the Software licensing group is to ensure that customers will never go out of compliance when contracts are near expiration or up for renewal. Software advisors hold industry-standard certifications and are required to stay current with program changes and enhancements through continuous top-tier vendor trainings. On this focus/key business practice, Frank commented that:

> *We experienced a great deal of success with our customers, and we have seen our customers demanding new technologies that were within our reach. This demand and our success with what we have done eventually inspired us to revisit our offerings and turn our business into what it is right now.*

At the beginning of 2001, John, Frank, Bob, and Sam set objectives, directions, and goals to help grow this very young organization. Adding more third party vendors and new customers were the core of their objectives. Additionally, the new directions were to divide organizational responsibility four ways: John was to focus on the overall organizational leadership and management, Bob on the financial and human resources core, Frank on the customers (sales), and Sam on the operations, logistics, and vendor relations. While one of Cedar Tech's first goals was to double the organization's sales and profits on an annual basis, its second goal was to attract, hire (through a phase-in strategy based on need), and retain good sales, technical, and other professional personnel. While they all believed that the organization was far from its full potential, they agreed to coordinate work on daily basis and meet on a weekly basis if nothing urgent required immediate attention.

THE STATE OF THE INDUSTRY

It is no secret in the IT marketplace that PCs alone do not bring enough margins to solution providers. However, offering them as a part of a complete solution is a very critical part of any providers' revenue. A growing number of IT customers demand that their solution providers offer hardware in addition to whatever solutions they provide. According to VARBusiness State of the Market report, other technologies have shown reliable growth over the years including storage hardware, security software, wireless networking and Voice over Internet Protocol "VOIP". Such technologies are poised to continue at their present growth rate (Schwartz, 2006). For example, 45% of solution providers surveyed by VARBusiness expected to expand or add wireless focus. Accordingly, wireless and security software were also on the rise as customers were forgoing wired connectivity in favor of wireless ones (Schwartz, 2006). Business software demand was on the rise too. Solutions providers eye Enterprise Resource Planning "ERP", Customer Relationship Management "CRM", and other business applications as new areas of business growth (Schwartz, 2006). Additionally, mobility business and custom software application are on the rise too and as they provide high profit margins (Lawinski, 2007).

According to Schwartz of CMP Channel (2006), Cisco systems Inc., were bullish about demand for its technology. Cisco focused on what it saw as demand for Voice over Internet Protocol (VOIP) and had the desire to add more intelligence into customers' networks. According to Cisco's officials, it was expected to grow 15-20% for the 2007 fiscal year (October 1-September 30). Cisco intended to call the network a platform for unified communications. As a result, it was expected that customers would increase their Cisco spending over the next 12 months (Schwartz, 2006).

According to VARBusiness magazine, 53% of fast growth solution providers' revenue came from reselling products versus 47% from services. On the contrary, 47% of the top third solution providers' revenues came from products versus 53% from services (Boyne, 2007).

In this industry, security was a sector that was in rapid transit. For some solution providers, it was the hottest revenue generator (Clancy, 2007). The average gross margin for network security was 18.4% in the 2007 compared to an average of 19.5% in 2006 (Clancy, 2007).

According to Walsh, the Western region (hereto referred to as "California, Oregon, Washington, Idaho, Wyoming, Hawaii, and Alaska"); although the slowest growing one out of the US seven regions, was the fourth highest revenue generating region (Walsh, 2007). Home to 92

VARBusiness 500 companies that brought $41.9 billion in revenue compared to the mid-Atlantic region, home of 103 solution providers with more than $126.2 billion in gross revenue (Walsh, 2007). It was important to note that the Southern region was the fastest growing one as listed in VARBusiness 500, with 104 solution providers that generated over $63.6 billion in revenue and an increase of 17% over 2005 (Walsh, 2007).

THE STATE OF THE COMPANY

The beginning of the new century was a pivotal one for Cedar Tech. After five years of continuous growth, Cedar Tech had become a major player in its field. The company no longer imported cables and computer accessories as of mid 2000. Instead, it purchased them for resale to its customers from Tech Data Corporation, Ingram Micro, or directly from Belkin or Black Box Network Services.

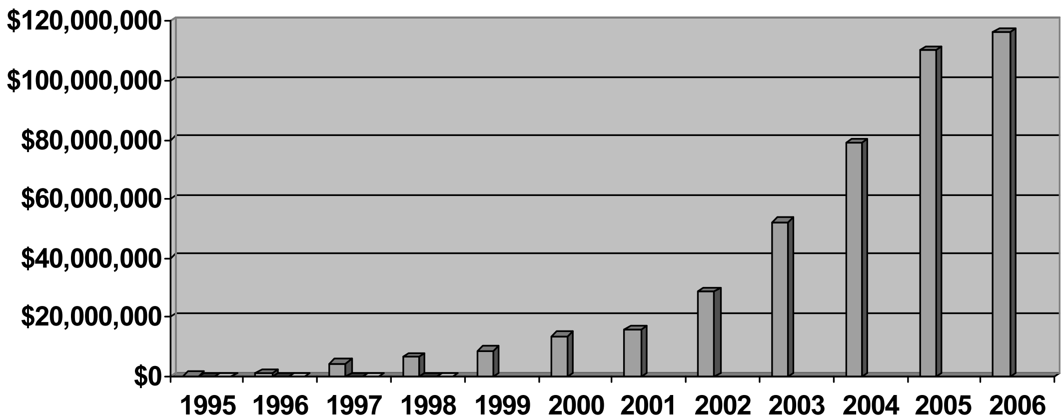
Top management was excited about its state and optimistic about Cedar Tech's future. Its annual sales revenue grew rapidly from a humble start of $80,000 in 1995 to over $116 million in 2006 as shown in Tables 1 & 2, and Figure 1.

Table 1: ANNUAL SALES REVENUE

Year	Annual Sales Revenue
1995	$ 80,000
1996	$ 1,250,000
1997	$ 4,425,000
1998	$ 6,750,000
1999	$ 8,650,000
2000	$ 13,740,000
2001	$ 15,800,000
2002	$ 28,650,000
2003	$ 52,450,000
2004	$ 78,870,000
2005	$ 110,260,000
2006	$ 116,330,000

Table 2: Cedar Tech SALES AND EARNINGS, 2002-2006					
	2002	2003	2004	2005	2006
Sales (in millions)	28.65	52.45	78.87	110.26	116.33
Net earnings (in millions)	2.936	5.822	8.644	13.06	14.541
Earnings percent of sales	10.25%	11.1%	10.96%	11.85%	12.5%

Figure 1: Annual Sales Growth



Over the past ten years, Cedar Tech has been able to add a few strategic customers. Additionally, Cedar Tech employees grew from 6 employees in 1995 to more than 170 employees as of December 2006. See also table 3. As a result, beginning in 2002, and for every subsequent year, Cedar Tech has been listed as a member of the elite 500 known in the technology industry as VAR 500 (Value Added Reseller[2]).

PART A: THE ORGANIZATION'S STRUCTURE

The growth of Cedar Tech has been so fast it operated informally with a loose and flexible arrangement of roles. Although this old structure, flexible roles, and informal relationships had worked well in the past, there were signs that problems were arising. Since 2001, the finance and human resources department reported to Bob, the sales department directly reported to Frank, and operations, services, and production reported to Sam as summarized in Table 3. At the end of the calendar year 2006, Cedar Tech had 167 employees and 4 top executives. See also Figure 2.

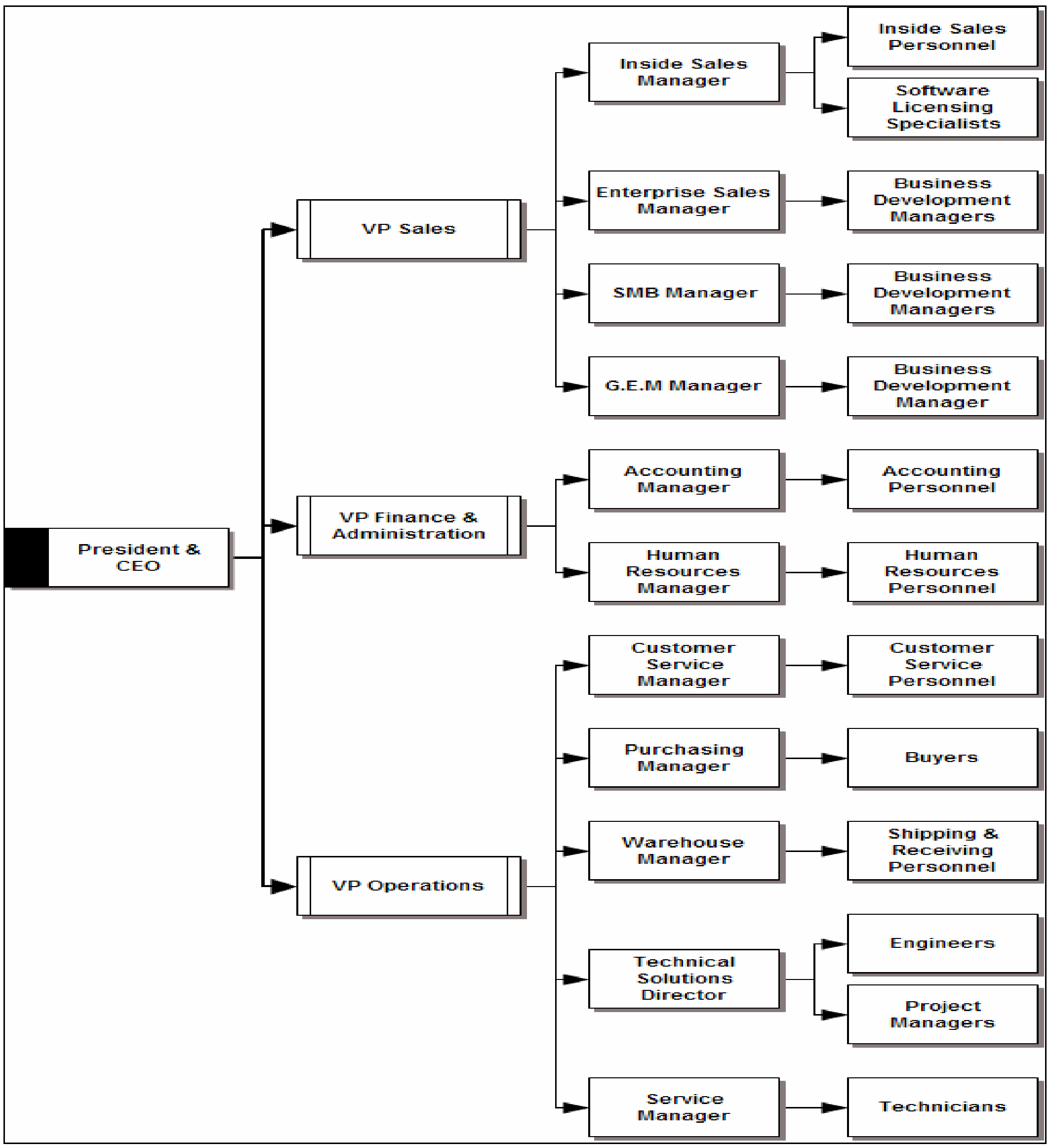
Table 3: Number of Employees by Areas of Management as of December 2006.			
Levels/Areas	Sales	Finance and Human Resources	Operations*
Upper Management			
President/CEO (1)			
VP (3)	1	1	1
Middle Managers			
Directors (1)	0	0	Technical 1
Managers (11)	4	2	5
First-line Mangers/Sup.	0	0	0
Employees (155)	Inside sales 26	Accounting 13	Shipping 26
	Bus. Development 23	H. Resource 4	Customer Service 9
	Software Advisors 6	Rec./Admin. Support 3	Project Managers 8
			Engineers 14
			Technicians 23
Total Organization (171)	60	23	87
* Vice President of Operations assumes the top management role for operations; IT services and support; and production			

PART B: PEOPLE AND MOTIVATION

For many years, there have been complaints from employees to top management that they did not feel equitably treated, and that has caused several talented individuals to leave. When Sam Farris met with department managers, they acknowledged that they were very busy reacting to problems and other customer issues. These managers were left with little time to strategize, organize, coordinate, or listen to their own employees. Additionally, socialization was unheard of at Cedar Tech. There were no company sponsored social events and no formal recognition for employee's achievements. In some cases, managers invited their top achievers out for lunch to say thank you for a good job. High rate of absenteeism and voluntary turnover was at an all time high and existed across all departments. In addition, promotion and/or salary increase was not systematic or standardized. It was solely based on the managers' recommendation and justification to the department's vice president.

John and his top management team believed that the only way the company could continue to grow and prosper was to create stability and increase the productivity of its people. Top management was determined to create an incentive plan and a formal recognition program to encourage creativity and productivity. Management goals, as presented to employees, were to have highly motivated, highly skilled, entrepreneurial, team players, high performing, and committed individuals at all levels.

Figure 2: Mount Cedar Technologies, Inc. Organizational Chart as of December 2006



PART C: DECISION MAKING AND COMMUNICATIONS

Managers in each of Cedar Technologies' areas were more or less free to make their own decisions on lots of things. The decision making was highly decentralized. Thus managers in operations operated quite independently from managers in sales and marketing, and differently from any other part of the organization. John Curtis believed that this highly decentralized decision making resulted in the loss of possible gains to be obtained from cooperation among other managers and created redundancy in various functions.

In addition, as business grew, departments and divisions grew too. As departments and divisions grew, communications and information sharing were becoming limited to individuals within departments or divisions. The silo effect that resulted from this structure meant that departments were making decisions based on what was best for their department and not the company as a whole. Top management wanted open communications at all levels. On numerous occasions, John Curtis would have a general meeting with all employees to update them on the progress, success, and directions of Cedar Tech. Given these meetings, he was surprised that only few were aware of company goals and strategy.

PART D: DOES LEADERSHIP MATTER?

John usually showed up to work at 10 am when he took his cup of coffee and checked his e-mails and phone messages. Afterwards he liked to make his rounds among all departments, no exception. He liked to surprise people by showing up un-invited to their meetings. Employees and managers from various departments were expected to be questioned by him and know that they needed to answer to him on work progress. On many occasions, when he came back from vacations or business trips, he liked to be updated by every manager on what went on in his/her department during his absence. Many managers believed that these updates and questioning were waste of time and demotivating. His business style had caused a few problems with employees, managers, directors, and even with his top management team. In defending his leadership style, his usual response to the top management was:

> *The company did well and we must have been doing the right thing in managing this company. As a President and CEO, I needed to be kept in the loop…all loops and all details. Granted, I'm an organized and disciplined executive who needed to know what went on and help fix problems. What I lack is having a systematic way to enable me to lead this company into the future.*

Everyone here believed that John had been instrumental in growing the organization during its start-up. However, his behavior and leadership style has become increasingly disruptive and problematic to many. He and his top management team believed that it was imperative to create a development plan for him and other top leaders.

John and his top team wanted to lead the company into a new structure that supports their new corporate strategy and vision and knew that they needed employees, supervisors, and managers to cooperate enthusiastically in order for the change to succeed. They believed that their employees should have more power than they had. Mr. Farris sighed: "our success is highly dependent on instituting a new approach to management through empowerment".

PART E: WHAT CULTURE DO THEY NEED?

All managers stated that top management appraised their performance solely on profitability and other financial measures. Therefore, these managers were left with no choice but to focus on financial measures in evaluating their subordinates. It was no secret to anyone that the culture at Cedar Tech was task oriented. Additionally, middle managers claimed that they spent lot of time reading and writing memos and creating tighter controls over operations and employees. During a few exit interviews, employees complained about the organization's culture. It was an inert one as described by few middle level and lower level managers. John Lyttle, one of the departing managers, in his October 2006 exit interview, stated that "this company is super conservative, upper management is cautious, does not encourage risk taking or the empowerment of people." Many departing employees would have liked to have worked in an organization with greener grass, flowers, birthday cakes, and parties. The remaining employees were becoming cynical of management. New employees were being hired to fit in with the current culture, not the culture that they liked to be in.

The top management team believed that they needed to encourage a flexible and a playful environment out of the belief that it motivates creativity. Additionally, they believed that their ultimate success was dependent on ensuring that the culture supported the organization's strategy. Traditionally, all new employees were immediately tied into a task with no formal training or mentor provided. Consequently, it was left up to them to learn the culture and expectations of Cedar Technologies. Should they not fit into the culture or perform well, their employment was terminated.

PART F: LEARNING, TRAINING, AND DIVERSITY

The organization's top management believed that the learning organization is a system-wide change program that advocates the reduction of layers and the involvement of everyone in the organization-management and non-management in continuous effort that will lead to positive change and growth in the individual, team, and organization (Brown & Harvey, 2006). Management wanted to grow and nurture its employees. To underline this belief system, a poster hanging in Cedar Tech's main conference room reads: "Welcome To Our LEARNING ORGANIZATION". However, the reality of the organization belied the message on the poster in that no learning really existed.

As far as training goes, the organization's growth had caused some difficulty in ensuring that new employees received adequate training before they started their actual work. Other than a minimal on-the-job training by a supervisor or co-workers, new employees were not provided adequate training, learning and knowledge transfer. That frustrated many employees especially new ones who were left on their own to learn the ropes by trial and error. For the unsuccessful ones, exiting was the way out. As a result, bad habits were being reinforced and the organization's productivity begun to suffer.

In a late December of 2006 dinner meeting of the organization's top executives, at the local Hilton hotel, John made an interesting statement when he said:

> *I am surprised that we operate in the midst of a diverse environment yet we do not represent that diversity inside our organization nor do our managers understand how to deal with a diverse workforce. As we all know, no women and minorities are represented in our top management. Additionally, they are small in number in our middle management.*

This statement initiated a debate over whether initiating diversity training, including promoting women and minorities and making the organization more family friendly, creating job sharing and flexible hours, would have helped improve morale and reduced employee turnover rate.

PART G: GROWTH: VOICE OVER INTERNET PROTOCOL "VOIP" AND VIDEO CONFERENCING

Cedar Tech management was determined to grow its business through adding new strategic customers and through increasing its incremental revenues from existing ones. Twenty percent of fiscal 2006 revenues came from new customers. Additionally, as the demand in the market place for VOIP got higher, Cedar Tech found itself hard pressed to add this practice and meet the demand of its existing customers. That meant adding a new Cisco VOIP practice and phase-in new Cisco certified engineers.

In addition to that, IP Security, unified communications, unified voice and video communications, and wireless would be a compliment to VOIP and therefore Cedar Tech's new strategic partners would be Cisco and Tandberg[3].

Taking into considerations the state that it is at right now, the big question facing Cedar Tech management is whether the company is ready to expand and whether it should get into new practices.

ACKNOWLEDGMENT

The author extends his deepest appreciation to external reviewers of this case who offered instructive criticism and advice. The case has benefited by incisive comments from Trudi Ferguson of the University of Southern California, Christine Jagannathan and Richard Simpson of the University of La Verne.

ENDNOTES

1 For a list of top 25 IT distributors, visit: Channel Web Network "06 State of distribution: Top 25 distributors". CMP Channel: A United Business Media Company. The top 25 list was retrieved on November 11, 2007 from http://www.crn.com/var/main/2006dist.jhtml

2 For a complete list of VAR 500, visit Channel Web Network "VAR 500". CMP Channel: A United Business Media Company. The VAR 500 list was retrieved November 11, 2007 from http://www.crn.com/var/apps/2007/var500/search_handler.jhtml?rank=1-50.

3 Tandberg is a global leader of video conferencing. "TANDBERG designs, develops, and manufactures videoconferencing systems, and offers sales, support, and value-added services in more than 50 countries worldwide". Retrieved on November 14 from: http://www.ivci.com/videoconferencing_tandberg.html.

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CAPE SHOE COMPANY

Eli Fishman, CEO, Cape Shoe Company
Jack L. Sterrett, Southeast Missouri State University
Bert J. Kellerman, Southeast Missouri State University
Peter J. Gordon, Southeast Missouri State University

CASE OVERVIEW

The primary subject matter of this case concerns entrepreneurial start-up and strategic management and marketing issues. The objective is to provide students the opportunity to apply their research skills and knowledge regarding highly competitive industry and buyers to develop strategic management and marketing strategies. It is suitable for a senior-level course as well as students in an MBA program and can be taught in a 75 minute class session with two hours of preparation by students outside of class.

CASE SYNOPSIS

The Cape Shoe Company case focuses on an entrepreneurial start-up in the highly competitive shoe industry. Upon the closing of a Florsheim shoe factory in a region of the Midwest that was once home to a large number of shoe and apparel manufacturers, with the majority of these having closed over the previous 30 years due to lower cost of overseas production, and concerned about the continuing loss of shoe manufacturing in the U.S., an entrepreneur from Chicago with minimal experience in the shoe industry, visited a Florsheim factory prior to its closing by Florsheim. After deciding that the facility represented too valuable a resource to be abandoned, the entrepreneur subsequently purchased the shoe plant and named his new venture the Cape Shoe Company. Based on his concern about losing American manufacturing jobs, and the belief that he could produce a competitively priced product, his plan was to produce ***100 percent Made in America*** *shoes.*

The interesting focus of this particular case and ensuing discussions is that the entrepreneur has made the decision to go forward with Cape Shoe Company and his ***100 percent Made in America*** *theme, although having yet to determine target market(s), competition, product differentiation, marketing channels, marketing strategies, etc. Regarding the rather unique nature of the Cape Shoe Company start-up, and current industry scenario, students virtually have a clean slate in which to begin discussions concerning recommendations on strategic management and marketing questions.*

INTRODUCTION

Manufacturing has been a primary source of America's wealth for almost 200 years. In the early 1800's America obtained virtually all of its manufactured goods from Europe. During the War of 1812 the British blockaded many European harbors preventing America from obtaining needed goods. As a consequence, America began to develop its own manufacturing capabilities in the Northeast. After the War, in order to help pay for the war effort and to protect nascent manufacturing concerns, the Federal government placed a large tariff on imported goods. Southern states, which were primarily agricultural at the time, opposed the tariffs threatening civil war. Despite these divergent interests, a compromise on tariffs was reached to benefit the North and the South. Incipient manufacturing businesses needed to be cultivated for the future of the country.

Nearly two hundred years later the issue of free trade and tariffs has again become a salient polemic. Unlike the early 1800's, the antagonists are not regionally delineated. Like the early 1800's, the adversaries are defined by differences with respect to the nature of their work – manufacturing-based businesses versus information-based industries. As manufacturing diminishes in both volume and perceived significance, the majority of workers who are employed in service-oriented firms are more concerned with purchasing goods at the lowest possible costs, regardless of their production origin. In most developing countries labor is brutally exploited enabling manufactured goods to be produced at costs substantially below U.S. made goods.

A *Business Week* magazine feature article titled, "A Life of Fines and Beating – Wal-Mart's Self-Policing in a Chinese Sweatshop Was a Disaster. What Kind of Monitoring System Works?" describes the inhumane conditions in which Chinese workers are forced to produce leather goods for Wal-Mart, Kathie Lee Gifford, New Balance Shoes, and Timberland Shoes. Migrant workers from the countryside desperate for work take jobs in factories like the Chun Si Handbag Factory. Chun Si made handbags sold by Wal-Mart and Payless ShoeSource. A factory job offers living quarters and a temporary-residence permit that migrants need to stay out of jail. Workers were paid \$22 a month and charged \$15 a month for food and lodging in a crowded dorm. Additionally, the factory issued expired temporary-resident permits. This means workers are subject to arrest if they ventured out of the immediate neighborhood. The workers were captives of the factory. Abuse of this nature can only occur with the tacit approval of the local authorities.

Chun Si Factory's 900 workers were locked in the walled factory compound for all but 60 minutes a day for meals. Guards regularly punched and hit workers for talking back to managers or even walking too fast. Workers were fined \$1 for infractions like taking too long in the bathroom. Wal-Mart, Payless, and others denied these conditions existed. But investigations by *Business Week* confirmed product sold in their stores was made in this factory under these circumstances. The article further described the elaborate schemes developed by owners to circumvent independent oversight.

By purchasing low-priced imports, many well paid American manufacturing jobs are lost. In 1965, 31 percent of the U.S. labor force was engaged in manufacturing. Early 21st Century, only

15 percent of U.S. laborers worked in manufacturing. This was the same as the number of people working in government. In 1965, CEO salaries were 44 times average worker pay. CEO salaries now exceed 212 times the average worker pay. The growing income disparity between the top one percent of U.S. households and the bottom 90 percent of U.S. households had been monitored by the Federal Reserve. The Fed had revealed that in the 1990s wealth controlled by the top one percent of households increased from 30.1 percent to 34 percent. The share held by the bottom 90 percent of households decreased from 33 percent to 31.3 percent. The top one percent then controlled more wealth than the bottom 90 percent by a margin of 34 percent to 31.3 percent.

Prosperity at the top of the economic pyramid has obscured declining incomes on the lower portions of the pyramid. There are abundant employment opportunities for elite information workers. Sufficient opportunities to earn a "Living Wage" must also exist for non-elite workers. These job prospects are found in the manufacturing sector. Manufacturing jobs usually pay better wages than growing service related positions because there is a greater value-added component – manufacturing creates more wealth.

It has been estimated that more than 20 percent of working Americans or more than 25 million people are **under**employed. Even while working eight hours a day, forty hours a week, they do not earn enough to keep a family of four above the poverty line. This is almost double the number of **under**employed in the early 1970's. Real wages have fallen about 20 percent since then.

In the industrial Midwest, as well as in the Northeast and West, American shoe and apparel makers are closing factories at an alarming rate. Virtually all of this production has moved to low wage, Third World countries in Asia – China, in particular. As a result, our annual trade deficit with China is expected to approach one hundred billion dollars. This deficit amount is added to the two to three hundred billion-dollar annual trade deficit the U.S. has with Germany and Japan.

CAPE SHOE COMPANY

Abbey Manufacturing, a plastic molding manufacturer, had produced a line of plastic molded display material for the shoe trade. The success Abbey realized in the intensely competitive plastic molding industry was based primarily on selling high quality product at low prices. Profitability was achieved by carefully controlling overhead costs, including administrative, sales and capital expenditures. People involved with production also handled many product development and front office responsibilities.

Eli Fishman, the CEO of Abbey Manufacturing, believes strongly in the importance of manufacturing in the U.S. economy. And, since Abbey sold model display products mainly to the shoe trade, it had provided him the opportunity to become knowledgeable about the industry. In 1999, Florsheim, a well-known nationally branded shoe manufacturer announced the closing of its Cape Girardeau, Missouri plant, ending a long history of producing high quality men's shoes in America.

Mr. Fishman, concerned about the continuing loss of shoe manufacturing in the U.S., decided to visit Cape Girardeau to inspect the plant. After inspecting the plant, prior to its closing by Florsheim, he decided that the facility represented too valuable a resource to be abandoned. The physical plant and employee skill levels were virtually irreplaceable in the U.S. Cape Girardeau, a town of approximately 40,000 inhabitants, is located in Southeast Missouri along the Mississippi River. This region of Missouri was home to a large number of shoe and apparel manufacturers, but most of these have closed over the last 30 years due to the lower cost of overseas production.

Mr. Fishman was subsequently able to purchase the Cape shoe plant and its equipment for a relatively low price. The Cape shoe plant was a 92,000 square food facility on 12.6 acres formerly owned and operated by Florsheim Group. At full capacity, the plant will employ more than 300 skilled workers. Production employees had an average of almost 20 years of shoe making experience. Supervisory personnel average over thirty years of shoe making experience. The plant was equipped with more than eight hundred separate shoe making machines and three assembly lines. The building, fully air-conditioned, was designed for all safety and health related considerations. Mr. Fishman decided to name his firm Cape Shoe Company.

Mr. Fishman's plans included paying all Cape Shoe Company employees an hourly rate which was *higher* than the locally determined "Living Wage" which was \$8.84/hour, and also paying full medical benefits. Living Wage is defined as a wage sufficient to maintain a family of three above the eligibility level for food stamps. The Living Wage contrasts sharply with the federally mandated Minimum Wage of \$5.15/hr. with no benefits. Minimum wages are more closely associated with unskilled service jobs, such as those in the retail and food trade.

While Cape Shoe Company would have higher labor costs than most producers overseas, it will have an excellent production facility, modern equipment, and a highly skilled workforce. Because the plant purchase price was low, it would help to keep overhead low. Mr. Fishman also believed that he could reduce selling costs, and that, along with low overhead costs, would allow him to price competitively. He believed that the market for American-made goods was substantial, as long as items were priced competitively with foreign-made goods. Based on his concern about losing American manufacturing jobs, and the belief that he could produce a competitively priced product, his plan was to produce **100 percent Made in America** shoes. While there are some competitors who still tout their products as American made, many use components that are made outside of the U.S. and some assemble their products outside the U.S.

Mr. Fishman's plan to produce a **100 percent Made in America** shoe was born, not having yet decided, however, on target market(s), what kinds, styles, and brands of shoes he should produce, how to differentiate his product from competitors, what channels he should use to sell his products, how he should promote his products, what should be his pricing strategy, and so on.

INDUSTRY NOTE

Throughout the industry, shoes are traditionally distributed through a variety of channels. These include direct sales using the Internet, catalogs and shoe-trucks; selling through large retail chains and department stores; and selling through smaller independently owned retailers.

Going direct to individual consumers generally requires a substantial investment in direct mail material and advertising. Retail chains and department stores are often self-serve. They prefer branded products since there are generally no salespeople to recommend a particular line. To establish a brand over a relatively shorter period of time, it is necessary to invest heavily in advertising. The final option is to sell to independent retailers.

Independent retailers are generally small, local stores offering their customers full-service fitting. Operating in many cities and small towns across the U.S., these shoe store owners tend to be sensitive to the quality a manufacturer offers. Just as important, they many times are able to steer consumers to particular footwear. The independent retailers tend to also relate to the manufacturers position on the loss of U.S. manufacturing jobs. Further, the independents appreciate the service smaller manufacturers' offer with respect to filling small orders.

A traditional shoe marketing channel flows from the factory, through a commissioned sales representative, to a retailer to the final consumer. The factory margin tends to be about 60 percent; the commissioned representative receives approximately 7 percent, and the retailer margin is another 66 percent. A pair of shoes with a $40.00 direct labor and material cost would retail for approximately $114.00. Attempting to maintain initial factory margin and bypassing the sales representative would result in a retail cost approximately 15 percent less than branded shoes, which use an extensive sales representative network and require higher factory margins.

TASK AT HAND

Based on the facts presented herein, and your research skills and knowledge regarding the shoe industry and shoe buyers, your task is to help Mr. Fishman develop strategic management and marketing decisions. Specifically, you are asked to develop recommendations on five strategic points:

1. Identify specific industry target markets and provide appropriate recommendations and reasoning for Cape Shoe Company.
2. Identify industry competition and provide appropriate recommendations and reasoning for Cape Shoe Company.
3. Identify various ways in which industry products are differentiated and provide appropriate product line and differentiation recommendations and reasoning for Cape Shoe Company.
4. Identify various marketing channels for the industry and provide appropriate recommendations and reasoning for Cape Shoe Company.

5 Identify specific marketing strategies and provide appropriate recommendations an and reasoning for Cape Shoe Company.

WORKPLACE VIOLENCE HITS HOME: ARE YOU READY?

Carrol Haggard, Fort Hays State University
Patricia LaPoint, McMurry University

CASE DESCRIPTION

The primary subject matter of this case concerns human resource management, workplace violence, and organizational politics. The case can be used to explore the intricacies of developing a HR workplace violence policy and getting that policy adopted by upper administration. Students are asked to develop a written workplace violence prevention policy. Developing such a policy requires them to research the elements which should be included in such a policy, to develop a plan of action to implement the workplace violence policy, to identify the critical issues of risk/liability to the company's officials, management's responsibility and legal liability for maintaining a safe work environment, and how to get senior management to "buy off" on the plan. The case has a difficulty level of three. The case can be presented and discussed in two to four class periods depending on the number of issues considered. Students can be expected to spend about 10 hours of outside preparation to be fully prepared to complete the case.

CASE SYNOPSIS

Digital Logistics Systems (DLS), as is true of many companies, never considered the possibility of workplace violence. However, a near fist fight in the Advertising/ Promotions department brought the issue firmly to the attention of Tom Ross, the department manager. By chance, the incident was overheard by Sarah Davis, the HR manager. Ross and Davis meet over the issue, where it is agreed that Ross will handle the disciplinary action for the employees while Davis will develop a workplace violence prevention plan. Davis recognizes that not only will she need to develop the plan, and develop a program to implement it, perhaps her biggest task will be in convincing upper management of the necessity of adopting the plan.

WORKPLACE VIOLENCE HITS HOME: ARE YOU READY?

"That was unbelievable" Tom Ross muttered to himself as he collapsed into his office chair. Ross is the Advertising/Promotions Department manager of a regional branch of Digital Logistics Systems (DLS), an information technology company. It is 5:45 p.m. and Tom had just returned to his office following a volatile department meeting that had left him both physically and emotionally exhausted.

As he reflected on what had just transpired, Tom thought that emotions at the meeting had reached a boiling point, as tempers steadily increased between two ten year employees. Peter was arguing a position that Edgar responded to with "that is ridiculous." Peter, whose temper and accompanying bad mood had been steadily increasing for the last two weeks as he brooded over his not getting a promotion that he thought that he deserved, especially since he was the one who had orchestrated Harold's leaving to open up the position. So, when the argumentative statement was made, Peter could no longer control his bottled up emotions and launched into a tirade of accusations, recounting his 30 years of experience, demanding that Edgar apologize for calling him ridiculous. Edgar was unwilling to do so, declaring that he had said "that is ridiculous" not "you are ridiculous." As tempers continued to flair, before any of the other 12 individuals in the room could fully appreciate what was happening, Peter and Edgar were standing face to face yelling at each other. Peter started shoving Edgar, saying with his military training, he could snap Edgar in half. Edgar responded that this was not a bar, and that Peter should behave in a professional manner. It appeared to Tom that Peter wanted to move beyond the shoves into actual blows, but was restraining himself. Since it was not clear how long Peter would continue with self restrain, Tom knew it was time to act, so got between the two employees. Most of the others had left the room as Ann had declared, "I guess that the meeting is over." Tom was able to get the two separated and to go back to their respective offices, as with so few there, Ann was correct the meeting was over.

Tom, as well as the other observers, was stunned by the events which had just occurred. He knew that Pleasantville, a town of 25,000 was always perceived as a safe city, a place where some still didn't lock the doors to their houses. The thought of work place violence was never considered as a possibility of something which might occur here. As Tom reflected, he remembered that he would shake his head at news reports of workers who had gone "postal" in the actions by workers. In fact, he remembered that he had had that same reaction only this morning as he was reading in the newspaper the report of the financially strapped Atlanta auto dealer who fatally shot two of his workers because they had asked for a raise (AP, 8-1-07). However, he also remembered feeling that such acts would occur someplace else. He NEVER imagined that such actions could take place in Pleasantville.

Given the new reality of the possibility of workplace violence at Digital Logistics Systems, Tom turned to his computer to get some information. He was astonished when a Google search for the term "workplace violence" returned 2,670,000 entries. Clicking on one of the early links, he was taken to a 2004 *USA Today* article (Armour, 2004, July, 19) which reported "In an average week in U.S. workplaces, one employee is killed and at least 25 are seriously injured in violent assaults by current or former co-workers." This first line of the article astounded Tom. While he remembered hearing reports of shootings at various worksites, where a fired employee was seeking revenge, or a depressed ex-lover would hunt down his former lover, he had no idea that such incidents were so common. Yet another click took him to a website which contained a bibliography on the prevention of workplace violence which listed well over 100 articles on the topic (Evans & Zarda, 2008). Tom was stunned at the amount of information about the topic and at the list of resources dedicated to the prevention of workplace violence.

After looking at a number of other websites, Tom turned from his computer in order to sit and contemplate. After a few moments of quiet reflection, it became clear to Tom that the quaint little town of Pleasantville was no longer the idyllic place that he had convinced himself that it was. The reality was that if a near fist fight could occur here, then certainly there was the potential for even graver events occurring. Tom knew that he needed to act but was uncertain as to what to do. Just then he noticed that his voice mail light was blinking. The message was from Sarah Davis, head of the HR department, who wanted to see Tom the first thing in the morning to discuss the incident. It seems that Sarah had been leaving the building when she just happened to walk by the open door of the conference room as the commotion was taking place. The message left Tom with mixed feelings. On one hand he knew that he could rely on Sarah's sound professional judgment to provide him with guidance while at the same time he was feeling some apprehension about a possible perception that he was not able to handle his department.

What Tom didn't realize was that Sarah was just as apprehensive about the meeting. Sarah knew that some action had to be taken regarding the employee's behavior. But she also realized that she had to walk a thin line between preempting Tom's authority over his department while at the same time fulfilling her duties as the HR manager.

The meeting the next morning began by Sarah describing to Tom the situation as she saw it. She told Tom that as the conference room was on her way from her office to the parking lot, she had just happened to hear the dispute that was taking place. She assured Tom that she was not "spying" on him, it was just a chance happening that she had heard what was going on. That being said, Sarah said that there were two issues on the table: 1) what to do about the employee's and their inappropriate workplace behavior, and 2, on a broader level, the need to develop a workplace behavior / violence prevention policy. Tom was nervously shaking his head in agreement as Sarah made these two points. Sarah continued, in her view, the issue of the specific behavior of the employees was Tom's responsibility, while developing and securing the approval of a policy was her responsibility. Tom, feeling relieved that the department was still seen as his responsibility, was still unclear as to what should be done about the employees, but voiced his agreement with Sarah. He also expressed his appreciation for her professional attitude. Sarah, in responding, sensing Tom's uncertainty about what action to take regarding the employees, suggested that while she felt that Tom should deal with the issue, that at a minimum, there should be a formal disciplinary letter added to both employee's files stating that such behavior was not acceptable and that any future occurrences of such behavior would result in more serious disciplinary action. Tom agreed and again thanked Sarah for her suggestion. Sarah said that she might need to call on Tom in her efforts to get the policy adopted.

Sarah knew that her principle tasks would be in determining:

1. *How to develop a work place violence prevention plan? What would such a plan look like and could it actually prevent violence from occurring?*
2. *How do I convince upper administration to adopt a workplace violence prevention policy?*
3. *How do I develop a plan of action for implementation of a workplace violence prevention policy?*

Sarah knew that her superiors held the same naïve view that she, until a few hours ago shared, workplace violence is something which occurs elsewhere, not in Pleasantville and CERTAINLY not at DLS. Sarah knew that it would take considerable persuasion to convince her bosses that a plan needed to be developed. In considering the prospects of building her argument, Sarah went to the Bureau of Labor Statistics website for information. There she found information about the types of workplaces which experienced workplace violence and the effects of such violence on issues which could affect the company's bottom line.

Table 1: Percent of establishments experiencing an incident of workplace violence by type of incident and selected industry, 2005

Industry	Total establishments	Type of Incident			
		Criminal	Customer or Client	Co-worker	Domestic Violence
Service Providing	5,933,800	2.4	2.3	2.1	0.9
Retail Trade	1,000,900	5.3	2.6	2.3	2.0
Transportation & Warehousing	200,010	1.5	1.0	3.6	0.8
Utilities	15,880	2.1	4.1	8.4	1.0
Information	132,400	2.6	3.1	5.3	2.9
Finance & Insurance	444,980	1.1	2.2	2.1	1.3
Real estate	339,660	1.3	1.4	0.4	0.4
Leisure & hospitality	666,410	5.9	4.4	4.1	1.2
Accommodation & food services	554,320	6.9	4.8	4.6	1.3

Source: Bureau of Labor Statistics, 2005

Table 2: Percent of establishments of employees who have been affected by workplace violence by type of effect for selected industries, 2005

Industry	Total establishments with an incident of workplace violence	Type of Effect					
		Absenteeism	Health insurance premiums	Turnover	Fear levels	Productivity	Morale
Service Providing	305,020	7.8	3.3	5.7	22.2	8.2	19.8
Transportation &Warehousing	8,800	13.6	Na	12.2	31.8	2.8	15.7
Utilities	1,870	9.6	Na	Na	60.4	17.1	16.6
Information	8,230	1.2	Na	.4	5.1	28.1	30.0
Finance & Insurance	19,260	1.2	Na	.2	20.9	1.5	4.8
Real estate	8,460	6.0	Na	8.5	7.1	6.4	7.6
Leisure & hospitality	54,840	1.7	Na	4.8	15.0	8.3	24.1
Accommodation & food services	50,530	1.8	Na	5.0	15.0	8.9	25.1

Source: Bureau of Labor Statistics, 2005

Sarah also felt that she could bolster her argument by looking into the company's legal responsibility with respect to workplace violence. She would need to determine whether any legal liability falls upon the company officials i.e., senior management.

Sarah knew that she faced a significant amount of work to not only craft a workplace violence prevention policy, but also to convince senior management of its importance to the company. As she reflected on the week's events, she could not help but feel somewhat sad that things would never be the same in the company or in the small town of Pleasantville.

LAYING IT ON THE TABLE: LINESTAT CORPORATION

Keith Jenkins, Sam Houston State University
Robert Stretcher, Sam Houston State University

CASE DESCRIPTION

The primary issue in this case involves the managerial response to an unusual exchange between two managers of Linestat Corporation. The case is appropriate for undergraduate management, human resources management, and business law courses. The case is designed to to introduce students to the concepts of sexual harassment and be taught/discussed in a 45-minute time frame, and should require about an hour of outside preparation by students.

CASE SYNOPSIS

Marinda Vasquez, a senior branch officer for Linestat Corporation, and her boss, Ron Farrington, are faced with an unusual situation. Another of the branch's night managers, Derek Randle, a night technical services operator, has been observed in an inappropriate act after-hours in the company's boardroom. Statutes and precedents are presented relating to the incident, and the reader is tasked with determining a solution to the situation, deciding on appropriate managerial actions.

LAYING IT ON THE TABLE

Ron Farrington, CEO of Linestat Corporation, sat at his desk, trying to finish the task that had to be done before he could justify going home. His concentration was interrupted by the ringing telephone. Ron wondered for a moment why someone would be calling at midnight, but he decided to answer anyway.

"Ron Farrington" Ron said.

"Hi, Mr. Farrington, this is Marinda Vasquez." Marinda was Vice President of Operations for the Newark branch, essentially the highest level manager at the branch. "I figured you would still be in the office. I have....an issue here. Can we talk?"

Ron was perplexed. "Sure, Marinda. What's up?"

"Well...I came back in to the office to get my briefcase, which I had left in the conference room earlier today. I just needed some information to finish something I was working on. When I walked into the conference room, I saw Derek, *the night technical services operator for the evening*, lying on the table."

"What, sleeping?" Ron asked.

"No, naked," Marinda replied. There was a lengthy pause.

"OK, you have my attention," Ron said. "And why was Mr. Randle in the conference room at midnight, naked on the conference table? Are you OK?"

"Oh, I'm a little shaken. It was kind of scary. He jumped up very quickly, and I didn't know what he was going to do." Marinda was petite in stature, and Derek was a big, powerfully built man. "I snatched my briefcase and left quickly. He was apologizing as I left, but he didn't try to follow me. He said he was expecting his girlfriend."

"Is he still there?" Ron asked.

"I don't know. I just came to my office," Marinda replied.

"Lock your office door, Marinda. I'll hold." Marinda locked her office and returned to the phone.

"Oh- I see him and someone else walking in the parking lot now," Marinda said. "What do you suggest I do?"

"Well, I would just tell you what we've done in the past, but as you might guess, this is a first for us. First, be very careful getting home. I'll be in about 7:00 tomorrow morning - later this morning, rather. I'll call our HR people and see what they say, and then I'll call you. If Derek comes in, try not to have any contact until after we talk. I'm sorry this happened to you," Ron said.

"It's not like you could have foreseen it, Mr. Farrington," Marinda replied. "I'll be fine, and I'll wait for your call."

"OK, Marinda, good night" Ron replied.

HUMAN RESOURCE STATUTES

The primary statute that regulates the employment relationship is the Civil Rights Act of 1964. This statute was passed in response to perceived racial discrimination that was prevalent at the time. The debate that occurred expanded the original intent to include other groups that also felt the effects of discrimination. The statute addressed discrimination in several activities including, voting rights, education, public accommodations, and employment. The section relating to employment is referred to as Title VII. The prohibition against discrimination has led the courts to allow employers to be held liable for actions based on sexual discrimination and sexual harassment.

The Statute prohibits discrimination in employment stating as follows:

It shall be an unlawful employment practice for an employer—

(1) to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or

privileges of employment, because of such individual's race, color, religion, sex, or national origin; or

(2) to limit, segregate, or classify his employees or applicants for employment in any way which would deprive or tend to deprive any individual of employment opportunities or otherwise adversely affect his status as an employee, because of such individual's race, color, religion, sex, or national origin. (USCA 20000e-2) .

The statute prevents discrimination based on persons being in a protected class. Persons not in a protected class are not given this protection. The individual is allowed to be compensated for loss suffered by discrimination and to be reinstated to positions lost due to the discrimination. The statute has been interpreted and explained by the court as employees have asserted the violation of their rights by employers in these protected classes.

CASE PRECEDENTS

The Courts have interpreted the sexual discrimination provision of the Civil Rights Act as allowing two types of causes of action, quid quo pro and hostile environment. Quid quo pro harassment occurs where a person who can influence an employee's job requires conduct of a sexual nature in exchange for either benefits to the employee or to prevent punitive action against the employee. "The gravamen of a *quid pro quo* sexual harassment claim is that tangible job benefits are conditioned on an employee's submission to conduct of a sexual nature and that adverse job consequences result from the employee's refusal to submit to the conduct." (Hicks V Gates Rubber Co. 833F.2d 1406.) The quid quo pro claim is basically a person being threatened with loss of job, pay, promotion, for failure to engage in a sexual act with a supervisor or other employee who could cause the threaten loss. The other type of sexual harassment, the hostile environment, has greater difficulty in being defined. The Court has defined five elements that must be met for a claim of sexual harassment to be successful. "Five elements which comprise claim of sexual discrimination based on existence of hostile work environment are that plaintiff belongs to protected category; plaintiff was subject to unwelcome sexual harassment; harassment complained of was based upon sex; harassment complained of affected term, condition or privilege of employment; and respondeat superior, that is, defendants knew or should have known of harassment and failed to take prompt, effective remedial action." (Robinson v. Jacksonville Shipyards, Inc. 760 F.Supp. 1486) One of the major questions arising in the hostile environment claim is whether the actions rise to the level of creating a hostile environment. One sexual comment may not be enough to give rise to a claim that an employee has been subjected to a hostile environment, but could one act? The question of what type and level of conduct or comments has been the focus of many cases with varying results. The Supreme Court eventually addressed the issue in Harris v Forklift Sys. "But we can say that whether an environment is "hostile" or "abusive" can be determined only by looking at all the circumstances. These may include the frequency of the discriminatory conduct; its severity; whether it is physically threatening or humiliating, or a mere offensive utterance; and whether it unreasonably interferes with an employee's work performance." (510 U.S. 17).

The fact that Derek was found naked waiting for his girl friend creates an awkward situation. The first thought that jumps into Ron's consciousness is related to sex in the work place. Sexual harassment and sexual discrimination have been major issues that companies have had to deal with since the enactment of the Civil Rights Act. Ron knew he must respond the next day before there would be time to consult with attorneys. What action should be taken with reference to Derek? What would you want to know about him and his work activities? Does Derek's act constitute a hostile environment?

What recommendation should Ron give to Marinda? Could Ron's response or lack of response constitute sexual harassment of Marinda? What steps should the company take to provide for the company's interest?

REFERENCES

Chamberlin v. 101 Realty, Inc. 915 F.2d 777,C.A.1 (N.H.),1990.

Robinson v. Jacksonville Shipyards, Inc. 760 F.Supp. 1486.

TERESA HARRIS, PETITIONER v. FORKLIFT SYSTEMS, INC. 510 U.S. 17 1993.

CHANGING THE HR FUNCTION AT BELLA'S: A CASE STUDY

Bobby Medlin, USC Upstate

CASE DESCRIPTION

The primary subject matter of this case concerns analyzing and evaluating a decision a small business must make concerning the management/administration of its human resource function. The case depicts a general manager's concern that individual performance as well as organizational performance/effectiveness of a small business is beginning to suffer due to the human resource management demands that have become part of her position's role in the firm. This case has a difficulty level of four. It is designed to be taught in one class hour and is expected to take approximately three hours of student preparation time.

CASE SYNOPSIS

Students are provided with a management scenario describing a general manager's request to the owner of a small business to change the HR management function within the firm. This change would involve either A. hiring a full time HR professional who would become part of the management team, B. outsourcing the entire HR function to another organization, or C. outsourcing selected portions of the HR function while keeping select areas inside the organization. Students are asked to review the scenario, evaluate each alternative, and make a recommendation to the owner of the firm. Within the evaluation of alternatives, students are also instructed to develop a job description and a job specification to support the recruiting/selection process that will occur if option A. is chosen; to offer a step by step process that should be followed if option B. is chosen; to identify and support areas that should/shouldn't be outsourced if option C. is chosen. In addition, students are asked to evaluate any additional alternatives that would address the issue. Finally, students must make and support recommendations to the management of this organization. HR outsourcing statistics to supplement the class discussion is provided as an Appendix.

THE HR CHANGE CASE

Lynne's day had started at 7:00 this morning with a meeting with the disgruntled store manager of location number two—and things hadn't slowed down since. Her "to-do" list was already full, but she had barely had time to glance at it. She was too busy with her "other stuff" (as she liked to call it)—things that kept her from being able to focus on what she really should be doing in her role at Bella's.

"Tough day, huh," said Illa. Lynne and Illa, the two key players in the management of Bella's, were meeting for drinks after work, like they had done every other Thursday (her ex-husband's night with her kids) for the past twelve years, to discuss business and life. These get-togethers used to start around 5:30. Lynne glanced at her watch as she handed the wine list back to the waitress. It was 9:25. "It'll get better," said Illa.

"Illa, it's 9:30—and believe me, this is a regular thing now. It's costing me a fortune in babysitting, my kids never see me anymore, and it's just wearing me out. And you know as well as I do that it's not going to get better; it's going to keep getting worse. We've gone over and over this," said Lynne. "We decided that we've got to do something. Let's don't start rehashing or questioning our decision again now."

"You're right. But you know I have reservations about whichever way we decide to go" said Illa.

"I know, and I have concerns, too," Lynne replied. "But you know things can't stay as they are now. I keep telling you this, and I know you don't want to hear it, but I can't keep this up. I've got two full time jobs—three if you count my kids. I'm the general manager AND the HR director—and not just the director—I handle ALL the HR issues. There aren't enough hours in the day. Not to mention the fact that I'm simply not running the place the way I always have, the way it should be run, because I'm constantly having to play human resource manager. We have five stores now—we probably should have changed things when we opened number 4. It's not like it used to be. You've been gone so much this last year that I don't think you really see how difficult this has become."

Two years ago, Illa had made a conscious decision to focus more on her personal life. She had turned 55 and decided it was time to do some of the things that she'd wanted to do but had never been able to find the time. She'd never been very involved in the day-to-day operations of the firm, but during the past two years, she essentially ignored the everyday operations in exchange for enjoying life for awhile. Her projects included building a new home, taking two cruises, and spending months at the beach in Florida. She trusted Lynne implicitly to run Bella's, so Illa had no concerns about this basic lifestyle change—after all, she kept reminding herself, it's not forever. But she had to admit that she probably didn't recognize or truly feel the impact of the changes in Bella's that had been occurring gradually since she'd been "away".

"OK," said Illa. "You're right. So, one more time—what are our options?"

"You know the options; we've discussed them all many times," said Lynne. "But one more time, here they are:

A. We hire an HR manager that will handle all our HR, from A to Z.
B. We turn our HR over to someone else--outsource all our HR to a human resource firm; there are several in the city.
C. We keep some of our HR activities in-house and outsource the other things—whatever we decide."

THE COMPANY

Bella's is a full service day spa and hair salon featuring a wide variety of spa treatments including full body massages, body scrubs and wraps, European facials, specialty manicures and pedicures, skin treatments, waxing, and complete variety of cuts, conditioning treatments and chemical services for the hair. Exclusive lines of hair and body products are also available. Bella's also features a retail department which specializes in unique custom jewelry. Bella's flagship store and headquarters are in a city with a population of approximately 250,000 people in the southern United States. It also has spas/salons in four other smaller cities (all with populations over 50,000) in the same state. Last year, Bella averaged approximately 45 employees per store; annual sales last year were approximately $10,000,000. The management of Bella's considers the firm to be a one-of-a-kind establishment serving a wide segment of the population. The success and growth of Bella's has far exceeded all of Illa's original expectations.

COMPANY HISTORY

The company was founded twelve years ago by Illa Fitzgerald, a former beautician/massage therapist who had worked in the salon industry since finishing cosmetology school at age 21. She used an SBA loan, investment dollars from five family members, and her personal life savings to fulfill her dream—owning her own spa/salon. Her vision was to create a unique company that offered a complete array of products and services aimed at creating and maintaining healthy minds, bodies, and spirits. Bella's is now a decade old, and Illa takes great pride in knowing that her company has come very close to completely fulfilling her vision.

Illa fully recognized from the very beginning that her business/managerial experience was very limited. She was also fully aware that managing the day to day operations of her business had very limited appeal to her anyway. Therefore, her first critical decision was made three months before the salon opened—the decision to hire Lynne Gibson as general manager of Bella's.

Lynne Gibson has served as the general manager of Bella's since its inception. Prior to taking this position, Lynne had worked at a major women's clothing retailer, initially as a management trainee and finally as a regional manager. Before Bella's, Lynne and Illa, while not close friends, were certainly acquaintances who had gotten to know each other professionally. Illa had shared her dream with Lynne and had often told her "you know when I do this thing, I want you to come run it for me." Lynne never really gave it much thought, but when Illa made a formal offer, Lynne decided it would be a good move, professionally and personally. She had been very successful in retailing--but the long hours plus the weekend demands had begun to take a toll on her personal life. A single mother of two, Lynne decided that this change would be a new challenge, and it would also enable her to be more successful in balancing family and career. From day one, Lynne basically was involved in or actually made all the managerial decisions at Bella's. Though

Illa was certainly the lead player in strategic decisions, Lynne was the ultimate decision maker for anything operational—including all human resource issues.

Bella's began with six employees: Illa, Lynne, three hair stylists, and one massage therapist. All were friends or acquaintances of the owner. Very little recruiting took place in the initial hires beyond Illa convincing each to come be a part of her new business. A salary was offered with a promise of "as we grow and become more and more successful, I'll make sure you're rewarded for your contribution." During the first few years of operation, traditional HR issues rarely arose. Bella's offered no benefits, no training was provided since employees were trained professionals, no recruiting or selection processes were developed or implemented (it consisted of Illa's ability to persuade personal contacts to change jobs and come work at Bella's). Legal issues relating to HR were rarely a concern because of the small number of employees. And Illa felt that employee handbooks or policy manuals were simply not needed. No formal performance appraisals were done—it was simply a matter of Illa and Lynne deciding how much raise to give each employee every August (end of the fiscal year). When human resource issues did arise, Lynne simply took care of those responsibilities. The time and the expertise required was limited and certainly not beyond anything that Lynne could manage. But as Lynne has said so often, "that was then, this is now."

CURRENT SITUATION

Lynne Gibson is the general manager of Bella's Incorporated; she is also the store manager of its flagship location. Within her store, a Retail Manager and a Service Manger report directly to Lynne. Additionally, the Store Managers at each of the other four Bella locations report directly to Lynne. Within each store, individual store managers are the only employees serving in a supervisory position with each being responsible for all daily operational issues of his/her salon. All other responsibilities/decisions for individual locations are taken care of by Lynne. This includes all purchasing, marketing, financial, and human resource decisions. Individual store managers do have the opportunity to offer informal input into hiring decisions for his/her store. The salon managers' salaries average approximately $30,000 annually. Three have college degrees, and they average four years experience. Each began as a part-time sales clerk/receptionist either at Bella's or at another salon. Bella's offered a benefits package that was fairly standard for an organization of its size. This included health insurance (of which the employees shared in the cost of the premiums with Illa's and Lynne's being paid totally by the firm) and retirement (in which Bella's made modest contributions).

As Bella's has grown, human resource issues have gradually taken more and more of Lynne's time and energy—not to mention becoming more and more critical to the success of the firm. Lynne is directly responsible for all the recruiting/selection, training, compensation, benefits, and performance appraisals (along with informal store manager input). She is also directly involved in all issues involving formal discipline and terminations. In addition, all compliance issues (such as the annual EEO report) are handled by Lynne. Though Lynne's background prior to Bella's did not include any human resource activities or responsibilities, she has become relatively knowledgeable and proficient in performing the HR requirements for Bella's.

Lynne and Illa both view and treat HR as an "added onto" responsibility for Lynne rather than an essential function of her job as general manager; however, Lynne has certainly come to recognize and appreciate human resources as being extremely critical in the current and future effectiveness of the company—and therein lies the problem. HR has become an essential function *for the company*--and Lynne knows that due to time and expertise constraints, she simply cannot give HR the level of focus and attention it requires.

Due to Bella's growth, Lynne knew that a number of HR things that she'd just never gotten around to were becoming more and more critical. For example, there were no written job descriptions or job specifications for any position; there were no established guidelines or procedures for recruiting and hiring; there was no formal orientation or training program for new hires; all performance appraisals were done informally without established forms and procedures; no employee handbook existed; there were no formal policies concerning absenteeism or discipline. These were just some of the professional management techniques that Lynne felt were imperative for continued company success. In fact, though she hadn't had time to put together any quantitative data to support these opinions, Lynne was very confident that some results were beginning to confirm her concerns. She was sure that it was taking longer and costing more to fill positions; that turnover was up across the company and that retention rates for new hires was down; that job satisfaction for managers and new hires had decreased; that absenteeism and employee complaints were up. And she felt certain that overall performance company-wide was not as strong as it had been in years past. Fortunately, sales and profits were up this quarter compared to the same quarter last year—but it was the smallest increase in the past five years, less than 1%. Would the numbers be in the red next year? Lynne didn't like her answer to that question.

It was time to for a change.

INSTRUCTIONS TO STUDENTS

Address each of the following:

1. Thoroughly evaluate each alternative provided. Develop a job description/job specification for the new position as part of the evaluation of option A. For option B., include a discussion of how generally accepted advantages and disadvantages of outsourcing might apply to this firm. For option C., be certain to identify areas of HR that you feel should/should not be outsourced. Also, for each alternative, address any implementation concerns as well as specifics regarding how each might impact the performance outcomes that Lynne feels are declining.

2. Are there additional options that Lynne and Illa should consider? Are they more attractive than the ones under consideration?

3. What are your recommendation(s) to Lynne and Illa?

REFERENCES

Bohlander, G. and S. Snell. (2007) *Managing Human Resources,* U.S.A.: Thomson Publishing.

Miller, S. (June, 2005) *HR Outsourcing: All the Way? SHRM's HR Outsourcing Forum.*

APPENDIX A

The following provides some statistics concerning Human Resource outsourcing:

- ♦ Fifteen percent of all outsourcing in the U.S. is in the area of human resources; 85 percent of U.S. employers outsource at least one HR function (Bohlander and Snell, 2007).
- ♦ The market for human resource outsourcing is approximately $25 billion; annual growth in the human resources outsourcing market is forecasted at 6 percent (Miller, 2005).

AN INSURANCE CLAIM: A DISPUTE OVER ACCOUNTING RULES

John P. Osborn, California State University, Fresno

CASE DESCRIPTION

A grower, an individual, claiming damage to his grape crop, files an insurance claim. The claim is more than a million dollars and asserts that inclement weather forced a late harvest of the crop resulting in a loss. The grower sales the late harvested grapes to a corporation owned 100% by the grower based on an agreement that the corporation will pay the grower the amount of the sales proceeds of the concentrate after all expenses are paid. The corporation converts the grapes into concentrate and then sells the concentrate to an unrelated party. The corporation prepares and provides a worksheet to show that the amount available to be paid to the grower (the net income from the transaction) is clearly less than the insured amount. The worksheet is presented in an income statement like format and is purported to be in conformity with Generally Accepted Accounting Principles (GAAP) by a Certified Public Accountant (CPA) hired by the grower. The insurer disagrees that the worksheet appropriately reports the net income from this transaction and further disagrees with some of the assertions relied on to prepare the worksheet. The dispute goes to arbitration. The arbitration board has the difficult task of determining whether the worksheet appropriately reports the net income from the transaction and, further, whether the worksheet is in conformity with GAAP and whether it includes expenses that are reliable.

CASE SYNOPSIS

This dispute provides a practical example of an attempt to use accounting to justify an insurance claim, as well as an examination of the relevance and reliability of the accounting presented to justify the claim. This case has been used in a forensic accounting course and could also be used in intermediate accounting courses to provide a practical discussion of GAAP rules and auditing courses to provide a practical discussion of GAAP rules and auditing techniques used to analyze financial statement assertions. The case provides examples of cost allocations, related party transactions, adequate documentation and other accounting issues.

FACTS AND DISCUSSION QUESTIONS

The weather in California does not always cooperate with agricultural production. Because of the inclement weather in 2004, the harvest of some of the grape crop was delayed by up to ten weeks. The sugar content in the grape increases the longer the grape is on the vine, but the lengthier time period reduces the number and types of buyers who are looking for specific characteristics in the grape. For example, because of the longer than normal stay on the vine, the table grape market was not available and the vintner market, if not entirely unavailable, was reduced. The inclement weather also eliminated the possibility of the turning the grapes into raisins.

The grower harvested the grapes and delivered them to a plant where the grapes were reduced to juice, and then to concentrate. The conversion to concentrate was completed in late 2004, and the sale of the concentrate took place in early 2005. The grower owns the plant converting the grapes to concentrate, and the sale of the concentrate was to an unrelated party.

The grower filed a claim with the insurance company, stating that the delayed sale of the crop resulted in a sales price that is less than the insured price per ton. The insurance company countered by stating that the sales price exceeds the insured price per ton. The dispute went to binding arbitration.

The grower contended that the crop was harvested and sold to a corporation in 2004. The sale was on a contingent basis. The agreement between the grower and the corporation stipulated that the corporation would reduce the grapes to concentrate and then sell the concentrate. The amount that would be paid to the grower would be the corporation's sales price less all appropriate expenses. The corporation even produced a worksheet, Exhibit 1, which applies the stipulations of the resolution, proving that the remainder amount after reduction of the sales price by expenses did, on a per ton basis, fall short of the insured per ton amount. There was not a contract to that effect, but there was a corporate resolution that briefly spelled out the nature of the agreement. The resolution was signed by the president of the corporation and dated in fall, 2004. The grower believed this to be a legal and binding contract because the grower, who owned 100 percent of the corporation, and the president of the corporation were the same person. The grower asserted that his signature was proof that both sides accepted the terms.

The insurance company disputed some of the grower's contentions. There was evidence that the sale of the grape crop to the grower's 100 percent controlled corporation was an outright sale for a fixed price per pound, and the price per pound exceeded the insured price.

The insurance company also disputed some of the financial information reported in Exhibit 1. The sale of the concentrate by the corporation was to an unrelated party so the amount of revenue was not disputed. However, some of the expenses on Exhibit 1 produced by the grower's accountants were questioned because of their subjectivity. Some of the expenses, including the reduction of the grapes to juice, then concentrate involved related party transactions between the grower, a concentrating plant owned by the grower and the corporation. The reduction and concentrating fees were paid by the grower to a 100 percent owned concentrating plant and then the fees were allocated to the corporation. Some of the other expenses reported in Exhibit 1 were not actually paid by the corporation. The grower paid some of the expenses, with a portion of the amount paid allocated to the corporation. Because of the possibility that the related party transactions were not arm's-length there was concern that the amounts for some of the expenses were not objectively determined. The insurance company believed the expenses on the worksheet were subjectively determined to the point of being irrelevant for the purpose used by the grower.

The documentation available to determine the appropriateness of the claim is:

- The worksheet, revenues less expenses, (see Exhibit 1). This worksheet was the primary document used by the grower to prove the amount of the loss. The document was presented in the deposition of the accountant for the grower. The grower's accountant prepared the document for the arbitration. The CPA for the grower, when deposed, asserted that the worksheet was prepared in accordance with GAAP, except for exclusion of appropriate disclosures. The accountant who prepared the worksheet worked for the grower but the CPA asserted independence.
- The reviewed financial statements of the grower. The CPA asserting Exhibit 1 to be in accordance with GAAP also prepared reviewed personal financial statements for the grower. The footnotes included in the reviewed financial statements for 2004 report the sale of the grapes to the related party corporation for $3,746,260. The footnotes further state that the grapes will be processed into concentrate and sold by the corporation.
- Partial accounting records for the periods 2004 and 2005. Included are the cash transactions between the related parties. During 2005, $3,130,000 was paid from the related corporation that acquired the grapes to the grower and explained to be for rent, interest, miscellaneous expenses, crushing, and hauling related to the 2004 grape crop. The timing of the amounts paid coincided with cash received by the corporation. In other words, the corporation paid cash to the grower as it received the cash, after payment of any expenses. During the period in question all cash received by the corporation, after expenses were paid, was paid to the grower. The corporation's working capital was never considered. There was an attempt by the grower to explain the cash payments as payments for the expenses listed above. However, the corporation could not produce the appropriate tax forms (1099s) for the payments made to the grower that would have been required by law.
- Other various records and documentation useful in determining how amounts in the worksheet are determined.

DISCUSSION QUESTIONS

1. Based on the facts as explained in the previous section if you were hired as a forensic accountant by the insurance company would you be concerned that the revenues and expenses reported in Exhibit I are not reliable? If not, why?

2. Was Exhibit 1 prepared in conformity with GAAP? Why did the grower's CPA contend that is was in conformity with GAAP?

3. Were the expenses in Exhibit 1 objectively determined? Your instructor will provide you with the forensic accountant's analysis of some of the expenses on Exhibit 1 (see Analysis of Expenses by the Forensic Accountant in Instructor Notes). Based on the analysis of the forensic accountant has your opinion changed regarding the objectivity of the expenses analyzed?

4. Was the grower's control over the operations an issue with the usefulness of Exhibit 1?

5. Is the method used by the grower appropriate to determine the net income from the grapes? If not, are there other methods that could be used to determine the net income from the transaction? Your instructor will provide you with other methods the forensic accountant provided to the arbitration board for the purpose of determining the net income of the transaction (see Alternative Methods to Compute Sales Price in Instructor Notes). Which method do you think the arbitration board chose to apply to determine whether the grower's claim was justified?

REFERENCES

American Institute of Certified Public Accountants (AICPA). 1999. Special Reports. *Statement on Auditing Standards No. 62*. New York, NY: AICPA.

American Institute of Certified Public Accountants (AICPA). 2000. Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises. *Accounting Principles Board Statement No. 4*. New York, NY: AICPA.

EXHIBIT 1 WORKSHEET REVENUES LESS EXPENSES ($ IN THOUSANDS)	
Concentrate only	$4,545
Other income	114
Total Revenue	4,659
Less Expense:	
Concentrating fees	270
Supplies, manufacturing and packaging	241
Wages	207
Utilities	173
Operating supplies	37
Licenses and fees	5
Depreciation	10
Miscellaneous	4
Leases:	
From outside lenders	93
From related parties165	
Selling expenses and commissions	73
General administrative:	
Wages	30
Office expense	23
Insurance	16
Property taxes	32
Professional fees	31
Management fees	216
Profit, 20% gross sales	933
Total costs	2,559
Remainder	$2,100

TICO MANUFACTURING

Todd D. Mick, Metropolitan Community College
Lou Fowler, Missouri Western State University

CASE DESCRIPTION

The primary subject matter of this case concerns Lee Tipton, who founded Tico in rural Missouri and quickly became a leader in pallet re-manufacturing, then dealt with a crisis in faith and family succession. The case has a difficulty level of three, appropriate for junior level. The case is designed to be taught in one 90 minute class and is expected to require 2 hours of outside preparation by students.

CASE SYNOPSIS

The primary subject matter of this case concerns Lee Tipton, who faced bankruptcy after a union strike, then found an entrepreneurial idea as a gift from God. Creating and successfully operating a small business is a challenge for virtually all entrepreneurs. In particular, the challenges facing rural entrepreneurs can often seem insurmountable. The entrepreneurial subject matter of this case concerns the successful growth of a backyard hobby to a thriving corporation. Willingness to adapt to changing market conditions and customer expectations were key criteria for this entrepreneur who went from bankruptcy to a multimillion dollar organization within one decade. The case emphasizes the organizational growth from a sole proprietorship, to a subchapter S corporation, to a spin-off of subsidiary corporations. Also seen in this case is the pivotal point technology has made for small rural entrepreneurs to compete on a global level.

The Teaching Note reviews the pivotal points in the case; entrepreneurship and spirituality, creativity, business evolution and the usefulness of segmented financial statements, which are included. This case is designed for an undergraduate entrepreneurship, accounting or management class and is based on Lee's own words and interviews.

INTRODUCTION

The rain was coming down in what the old timers still called a gully washer. Lee stood in the rain, drenched, his face upturned, eyes closed, letting the dark, wet Missouri night enfold him. His mind thought that all he needed to do was outstretch his arms and he could play out the pivotal scene from *Shawshank Redemption*; even funnier how your mind wanders when your soul is broken Lee thought quickly. He was a Teamster without a trucking firm in small town Missouri; his benefits exhausted, no job prospects, his wife taking care of two children and delinquent notices had started arriving. Lee believed he was a good man, had provided for his family, his community and his church, so how could God leave him at a time like this? Despair washed over even stronger than the rain as his eyes fell on the trash heap behind his work shed and suddenly, he knew the answer.

CHILLICOTHE AND CHURCHILL TRUCKING

Chillicothe, Missouri and Churchill Truck Lines were synonymous. Both owed their success to the other. Chillicothe gained a strong, growing employer with jobs that covered the salary scale. Churchill gained strong community and political support with a willing and able workforce. Over the years, Wal-Mart came to town along with upscale jewelers and clothing stores. Every so often someone mentioned that a town of 10,000 might want to think of a broader economic base, but this was northern Missouri and the heart of America; employers and employees were loyal to one another and those thoughts quickly vanished. Unfortunately, in 1994, so did Churchill Truck Lines. Virtually overnight, which is a case study in itself, Churchill Truck Lines ceased to exist and laid off drivers, secretaries, dispatches and executives. The only ones left were the lawyers and no one was talking to them. One of those truck drivers with over 20 years with Churchill was Lee Tipton.

UNIONVILLE AND LEE

Lee had lived in Unionville, northeast of Chillicothe, his entire life. Naturally, he knew everyone since you could hit a baseball clear across the entire town, but small is good when he thought back to growing up and now raising his children. Small is safe and small is secure. Farming was the lifestyle of choice, in fact, if you didn't farm; you made your living off those that did. The Tipton family was no different, until Lee became the family rebel and took a union job in Chillicothe driving for Churchill. Of course, rebel was a loose term since the family knew that at some point, children would have to work outside Unionville or leave. Corporate farms were reaching into even rural Missouri creating larger and larger farm operations. At the turn of the 20th century, a farm over one hundred acres was a sure sign of wealth; at the turn of the 21st, wealth generating farms were counted in the thousands of acres. Increasingly, families had to concentrate their farmland in one branch of the family and expect the other family members to find non-farm jobs. Education was one path, moving to Kansas City or St. Louis was another, but in north central Missouri, there was a third option, Churchill.

Driving a truck is not a major career move for most people, but the steady income, benefits, regular hours and schedule, took Lee by surprise and he kept driving for 20 years. One common aspect of many of Churchill's deliveries were wooden pallets used to ship and unload freight via forklift. These pallets were made out of pine for the most part, poor wood not able to be used elsewhere, but useful in making pallets. Unfortunately, being of poor wood quality, the pallets did break or simply wear out and landfills were increasingly refusing to take them. For landfills, the pallets were difficult to crush, did not break down quickly biologically, and were space consuming as a result. The result was landfills refusing to haul away broken pallets or charging a surcharge to do so. For most rural firms, it was simply easier to throw the pallets out back and even in Kansas City and St. Louis, urban firms would stack them up and let employees or locals use the wood for whatever they liked, as long as they took the pallets away. Lee even had a few broken pallets behind his work shed that he used for various reasons.

Then in year 18 of driving with Churchill, a trucking client, seeing Lee load up a few broken pallets into his empty truck before heading back to Unionville, asked what he was going to do with those. Lee responded that they were good scrap wood for whatever came along. The client, however, mentioned that he would buy the pallets back if Lee would fix them. Lee was taken aback; the price the client offered was roughly half what a new pallet cost, so he saw the advantage for the client, Lee basically had no costs, so he thought, why not.

PALLETS, PLLETS AND MORE PALLETS

Refurbishing pallets was a fun hobby; Lee could use the truck to haul them back and forth, for the most part, and make some money on the side, which was always welcome with a mortgage and two children. Slowly, other firms would hear about Lee's business by word of mouth and his side business actually started to become an actual business. However, Lee didn't take it too seriously; if he could work on pallets, he did, if not, he didn't. The money wasn't that great to become a major part of his life.

Then came the Teamster strike against Churchill, mismanagement by Churchill of virtually every aspect of the strike, and then Churchill's sudden bankruptcy filing and complete shutdown. What Lee saw outside behind his shed that fateful rainy night was a pile of broken pallets. What he believes God showed him that night was his future. And so in 1995, Lee got to working on refitting and reworking pallets so they could be used and he then set out to sell these same pallets to former Churchill customers that he knew. He called his fledgling firm Tico, organized it as a proprietorship, and started work in his backyard shed in the evenings and spent the morning and early afternoon contacting clients. Quickly the business grew beyond just his shed and beyond just Lee's ability to do all the work. Within a year he had a worker to help refurbish the pallets, leased a small shop in Unionville and devoted himself to selling.

The second year the state of Missouri also played a pivotal role in developing Tico. Given the savings on landfill waste by recycling pallets, the Missouri Department of Natural Resources issued grants totaling over $150,000 to Tico for acquiring equipment and building expansion. Lee was able to hire three additional employees and leased a bigger building. A year later this happened again until year five when he simply built a new building and continued to hire more employees. By year five he was not only recycling used pallets, but building new ones as well, and had broadened his manufacturing base to include cardboard recycling and producing mulch. By 2002, Tico had grown to close to $2,000,000 in gross revenues and housed some $3,000,000 in total assets.

Tico had also been good for Lee personally. His house was paid for, he owned a lot at a private recreational lake, a pontoon boat and had carefully managed a portfolio of investments. It began to worry him that, since Tico was operating as a proprietorship, legally, his personal assets were considered no different than his business assets. If for some reason the company were to fail, his personal assets could be taken to pay any company debt that had amassed. Lee decided to incorporate. In corporate law, the business is considered a separate legal entity from the owner and if Tico, Inc. were to fail, only business assets would be at risk. Because Lee wanted to keep Tico small and family owned, he incorporated as a Subchapter S Corporation. This type of business organization has several desirable features for small business owners, the most important of which is that it avoids the double taxation that can occur in a regular C Corporation. Sub S allows tax characteristics to flow through onto the individual's 1040 and provides a much simpler tax return; furthermore, Sub S has only one class of stock and can be entirely family owned. Thus, with Lee as the majority stockholder, he maintained control of Tico.

Throughout this time, Lee continued to feel God's calling in operating his business. His primary business plan was, and still is, to seek out God's guidance and follow it. His priorities are to provide a living for his family, provide good jobs for his employees, and make a positive impact on his community. Lee's son, Allen, is production supervisor at Tico and his son-in-law, Tony, is employed as a truck driver. Lee pays and treats his workers well, he believes, and this is born out by Tico's low turnover rate. In addition, Lee is treasurer and a deacon for his local church and serves as a board member for the local hospice organization. Naturally, Lee would like to turn a healthy profit, but he feels that to focus only on the bottom line is not what God has in mind for him. Furthermore, Lee states that "the business owns me, I don't own it." Lee feels strongly that Tico is a tool that he is to use to accomplish God's plan for him.

TICO TODAY

Today, Tico occupies three different buildings in Unionville's Industrial Park; one manufacturing building, a warehouse and a heat treatment facility to cleanse pallets without using chemicals thereby destroying insects and bacteria. These heat-treated pallets can then be used for food transport, since chemically treated pallets cannot because of the potential for leaching chemicals into food. Tico was the first heat-treating pallet facility in Missouri. Currently, there is an increasing market for heat-treated pallets and only one other heat treatment facility in Missouri, a clear competitive advantage. In addition Lee thinks that it is probably one of their more profitable product lines. Lee received a $50,000 grant (Missouri Department of Natural Resources) and invested an additional $20,000 to get the heat treatment facility up and running, grossing revenues of $1,200 daily with costs of $30 per day to operate. And in regards to heating, the Tico facility is heated in the winter by unusable scrap wood generated throughout the year. Scrap wood that is still usable is ground up and sold to landscapers as mulch. Very little is allowed to go to waste.

Tico currently employs over 50 full-time and over 10 part-time employees, operating five days a week. On a weekly basis, Tico ships out over 5000 pallets, while repairing roughly 500 per day and dismantling 1000. While allowing for custom pallets, 85% of Tico's pallets are standard size.

For hardware, Tico has 14 semi-trucks and 33 trailers, with 14 drivers. Initially, the trucks hauled pallets away from Unionville to whatever firm needed pallets; however, the trucks would come back to Unionville basically empty, except for additional recyclable pallets. As fuel prices climbed, so did the need to efficiently maximum it's use. Lee acquired his brokerage license to haul freight. Now rather than his trucks returning back empty, he finds hauls he contracts to haul freight to north central Missouri and south central Iowa and make money on the return trips (roughly a 300 mile radius from Unionville). Tico would find these haul loads by using various web portals and business websites to locate firms needing immediate or even long-term shipping needs. In addition, the high number of trailers allows for drop-and-hook, where the trailer is just left at the client's place of business, and when full of broken pallets, is picked up and an empty trailer dropped off. This method is what started the cardboard recycling part of Tico; customers were looking for somewhere to throw their boxes and asked Lee if they could put them in with the pallets. Seeing another business avenue, Lee agreed and now ships several trailer loads a week.

LEE'S DILEMMA

Lee's son, Allen, 37, and Lee's son-in-law, Tony, 35 and married to Lee's daughter Cathy, both work at Tico. Lee wants to sell Tico and retire from active business management; however, neither Allen nor Tony can afford, on their own, to buy Tico. If Lees wants to retire and sell, he will have to go outside the family to capture the full value of Tico. Unfortunately, potential buyers have all insisted that Lee stay with the business in some capacity. Faced with this dilemma, Lee approached both Allen and Tony again with the option to buy. However, they cannot either individually or combined obtain the financial backing for a buyout. Combining their finances they might be able to buy Tico on a payment plan of over 15 years, but that is a risky proposition, since Tony is not sure he wants to commit to staying in Unionville and with Tico for such a long period of time. Lee is 58 years old and feels he is not in a position to start over if things do not work out so he wants the full value of Tico upfront. As with most people facing retirement, Lee wants to minimize risks and be free to travel. His desire is to be able to walk away from Tico; he does not want the firm dependent on him, yet he does want Tico to go on after he leaves and provide jobs for people in Unionville.

Another concern for Lee is that there is a lot of liability associated with owning and operating a truck line. Lee worries that even one fatality accident with one of those big rigs could result in a law suit that might be beyond his insurance limits. Another major concern for anyone working in the pallet industry is the constant threat of fire in the manufacturing plant. Lee would like to find a way to protect his manufacturing business if something were to happen with his freight line and a way to protect his freight line if something were to happen to the manufacturing plant.

Income statements from Tico's last three years are shown below:

Tico Inc. **Income Statements**					
	2004		2005		2006
Sales					
Certified Heat Treated Pallets	43,500		239,840		310,310
Corrugated Packing Boxes	11,830		3,540		8,970
Mulch	15,880		22,000		28,620
Pallets	2,722,820		2,858,070		2,836,500
Packing Paper	71,620		87,160		66,830
Freight Hauling Revenue	825,340		1,406,670		1,850,100
Total Sales	**3,690,990**		**4,617,280**		**5,101,330**
Cost of Goods Sold					
Lumber to Make Pallets	440,700		526,000		570,000
Material to Make Boxes	5,080		3,500		5,030
Recovered Pallets Purchased*	387,900		540,000		615,300
Raw Paper Material	57,080		55,340		48,160
Total COS	**-890,760**		**-1,124,840**		**-1,238,490**
Gross Profit	**2,800,230**		**3,492,440**		**3,862,840**
Expense					
Propane for heat treatment	1,530		7,750		10,400
Freight Hauling Truck Expenses	4,090		13,040		17,410
Lease Payments for Trucks for Hauling Freight	33,880		51,320		136,250
Advertising	4,800		2,010		2,590
Janitorial	6,350		6,000		5,520
Donations	1,500		3,920		4,950
Saw Blades for Cutting Pallets	10,755		23,454		5,220
Nails Used in Pallet Construction	110,167		65,891		45,438

Tico Inc.
Income Statements

	2004		2005		2006
Shop Supplies and Tools Used in Making Pallets	42,500		26,250		35,370
Fuel for Freight Hauls	384,750		656,400		918,600
Depreciation on Building & Equipment	16,160		14,241		14,664
Insurance on Truck and Trailors	48,078		49,572		62,556
Interest Expense	31,380		45,350		70,320
License and Permits for Trucks	21,950		19,500		20,500
Office Supplies	7,670		10,150		9,050
Payroll**	980,000		1,125,500		1,117,000
Payroll Taxes**	81,190		113,150		101,000
Insurance for Employees**	70,420		55,870		29,480
Work Compensation Insurance**	65,250		97,480		89,340
Professional Fee/Dues and Subscriptions	5,070		5,000		5,300
Equipment Repairs & Maintenance	19,130		15,180		15,953
Trailer Repairs & Maintenance	14,870		17,500		18,860
Truck Repairs & Maintenance	93,400		114,500		66,300
Taxes	108,900		115,000		121,200
Utilities***	29,800		34,500		41,750
Total Expenses	**2,193,590**		**2,688,528**		**2,965,021**
Net Income	**606,640**		**803,912**		**897,819**

* recovered pallets are refurbished and resold as regular pallets
** Payroll is allocated as follows: Pallet Production 60%, Freight Hauling 20%, Administration and Office 15%, Heat Treatment 2% , Mulch 1%, Boxes 1%, and Paper 1%.
*** Utilities are allocated as follows: Office 10%, Heat Treatment 30%, and Pallet Production 60%.