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Inge Nickerson, Barry University
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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 *JACS* 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 *JACS*.

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

We intend to foster a supportive, mentoring effort on the part of the referees which will result in encouraging and supporting writers. We welcome different viewpoints because in differences we find learning; in differences we develop understanding; in differences we gain knowledge and in differences we develop the discipline into a more comprehensive, less esoteric, and dynamic metier.

The Editorial Policy, background and history of the organization, and calls for conferences are published on our web site. In addition, we keep the web site updated with the latest activities of the organization. Please visit our site and know that we welcome hearing from you at any time.

Inge Nickerson, Barry University
Charles Rarick, Barry University

NOTES

SUBPRIME MORTGAGES: A CASE PROVIDING THE PERSPECTIVES OF A HOME BUYER AND A CDO TRADER

Michael Tucker, Fairfield University

CASE DESCRIPTION

The case provides two levels of understanding the subprime mortgage crisis. The first level is from the perspective of home buyers worried about being closed out of an overheated housing market. The second level is from the perspective of investment firms trading exotic securities created by investment banks out of the subprime mortgages. The case could be used with undergraduate or graduate financial management students as well as in case courses. The calculations are straightforward and there are ethical issues. The case could be used in a business ethics course with the calculations provided the discussion ensuing would be on the home buyers' decisions, the mortgage lenders behavior, the investment bank's fiduciary responsibilities, and the moral hazards of any proposed legislation to remedy the crisis.

CASE SYNOPSIS

A couple buys a new home in 2006 in the Atlanta suburbs where prices have been rising. Lacking a down payment but with passable credit they purchase the home with a subprime mortgage that has the added complication of negative amortization on a six month interest only mortgage. When the mortgage resets at a rate pegged to the constant maturity T-Bill rate, the payments are much greater and they have difficulty making them. Their mortgage is one of many rolled up into Collateralized Debt Obligations (CDOs) created by investment banks. An investment company trading in CDOs has been making money using highly leveraged positions on what have been investment grade securities. When interest payments suddenly cease, the investment company is faced with a liquidity crisis. The case returns to the couple holding the subprime mortgage as they confront foreclosure with the added possibility of having to pay taxes on the difference between the sale price of their home and the amount they owe.

INSTRUCTORS' NOTES

Suggested Questions and Answers

There are two sets of questions provided. The first set is directed toward undergraduate finance students and leads them through the analysis in a step-by-step fashion. The second set of questions is more open ended and is better used for graduate students or more advanced undergraduates at the instructor's discretion. Instructors employing the second set of questions may refer to the discussion of the first set for guidance while allowing for more free ranging approaches that students may arrive at on their own.

Additional tables are provided below to be distributed at the discretion of the instructor. All information in the tables is available within the case with the exception of the revision in the tax law passed on December 20, 2007 eliminating the tax on forgiven mortgage debt. That information appears in the first set of questions and is ancillary to the case though it makes an interesting sidebar for discussion.

Useful Dates	
Mortgage closing date	1/15/2006
First payment	2/15/2006
Reset mortgage date	8/15/2006
Bank contacted about renegotiation offer after 2 payments made at reset rate and 6 missed payments.	4/15/2007

Useful Figures	
Home Price	300,000
Points to be paid as a percentage of sale price	2&
Legal fees	1,000
Other fees	1,000
Commission to be paid as a percentage of sale price	3.00%
Interest only rate for 6 months beginning with first payment on 2/1/06	2.00%
Negative amortization based on differential of ARM at closing and interest only payment	
ARM at time of closing	5.17%
Reset mortgage rate above constant maturity T-Bill rate	3.50%
Constant maturity T-Bill rate to be used for mortgage reset 8/15/06	5.27%
Term of 8/15/06 ARM reset	29.5 years
Bank ARM rate offer above T-bill rate on 4/15/07	2.50%

Useful Figures	
T-bill rate on 4/15/07	4.97%
New term of 4/15/07 mortgage	30 years
Wilkes' marginal tax rate	25.00%

Question Set 1

1. **What is the monthly payment for the initial six months on the 30 year 2% interest only mortgage? Be sure to add in all additional costs rolled into the mortgage as described in the case.**

The mortgage for 317,000 consists of the items as shown below:

Home Price	300,000
Points at 2%	6,000
Legal Fees	1,000
Other Fees	1,000
Commission at 3%	<u>9,000</u>
Total Mortgage	317,000

For interest only at 2% the monthly payment is $(0.02/12)*317000 = 528.33$

2. **What would the monthly payment be for the mortgage at the ARM rate of 5.17% that prevailed at the closing of the loan?**

1734.81

3. **According to the terms of the mortgage the difference between the introductory rate and the current ARM rate (5.17%) is added to the principal increasing the principal on the mortgage (negative amortization). What is the new principal when the loan resets in six months?**

$(1734.81 - 528.33)*6 + 317,000 = 324,238.87$

4. Under the reset terms, the ARM benchmark is the constant maturity Treasury bill rate which is 5.27% at the time of reset. Considering that the term has been reduced by six months (29 ½ years remaining), what is the new mortgage payment?

2564.40

5. How does the new mortgage payment added to monthly expenses, noted by Mary Wilkes in Table 1, compare with pre-tax monthly income? Is this sustainable?

	Monthly Cost
Autos (Gas & Maintenance)	350
Utilities	350
Car Payment	300
Food & Dining	800
Cable	175
Clothing	200
Credit Card Debt	500
Monthly Federal Tax	510
Monthly Property Tax & Insurance	400
Social Security Tax	<u>477</u>
	4,062

Adding the mortgage payments brings the total to \$6,626.40 which is \$376.40 above the \$6,250 monthly pre-tax income (\$75,000/12)

6. What rate of return did Whitewater Investments and Kent receive on the \$100 million invested in the \$1 billion CDO he describes?

Buy	1,000,000,000.00	
Investment	100,000,000.00	
Borrow	900,000,000.00	
Interest Rec'd	75,000,000.00	at 7.5%
Interest Paid	45,000,000.00	at 5% of 900,000
	30,000,000.00	gain
Return		30% on 100 million investment

7. **Given the 15:1 leverage on the \$1.3 billion in CDOs, how short is WI of making the interest payment to the insurance company this month? Would you recommend taking any action at this point?**

CDO rate	7.8%	
Rate of WI loan	6.0%	
Leverage ratio	15:1	
CDO	1,300,000,000	
Equity	81,250,000	1/16 of the total CDO investment
Borrow	1,218,750,000	15 times equity
Interest Rec'd	5,492,500	65% of CDOs paying interest: $0.65 * .078 * 1,300,000,000 / 12$
Interest Due	<u>6,093,750</u>	on loan to WI; $0.06 * 1,218,750,000 / 12$
Loss	601,250	cash shortage

8. **If Kent sells the performing CDOs for 89 cents on the dollar and the non performing CDOs for 60 cents, how much are the losses to principal on the deal for WI exclusive of the interest payment not collected? Should WI do this if it means bankruptcy?**

Performing Loans	845,000,000
Sold for \$0.89 on the Dollar	752,050,000
Loss	92,950,000
Remaining Bad Cdos	455,000,000.00
Sold for \$0.60 on the Dollar	273,000,000
Loss	182,000,000
Total Loss	274,950,000
Net Cash Inflow	1,025,050,000
Total Losses (Includes Cash Shortage from Prior Question)	275,551,250.00

Liquidating the portfolio at this point could reduce the severity of the bankruptcy since all indications are that the market for CDOs will worsen. If WI could go into the market and short CDOs, there could be an outside chance of recouping some of the huge losses, but it is unlikely that there would be much profit margin on shorting CDOs at this time. It is also

very unlikely WI could sell the nonperforming CDOs for 60 cents on the dollar making this situation even worse than it appears.

9. Does the proximity of foreclosed and/or vacant houses reduce the value of occupied homes?

Vacant and/or foreclosed homes do reduce home values in the immediate vicinity and perhaps further away since the stock of housing overall rises which depresses prices. Abandoned homes may deteriorate, be invaded by drug dealers and other undesirables which raises costs to municipalities. Municipalities, Buffalo for one, have pursued absentee owners of foreclosed houses in court demanding they maintain the houses.

10. Assume the Wilkes elect to make one payment at the new ARM rate of 2.5% above the CMT (4.97% in early April 2007). They will be making that payment on a new principal consisting of the principal as of their last payment plus all missed payments (six months). The loan is also rewritten so that it is reset to 30 years. What is their new payment? Note: they made two payments at the first reset rate that reduced principal with the last of those two payment made on September 15, 2006.

	Outstanding principal	Total payment	Interest paid	Principal paid	
			3170		
	324,238.87				
7	324,044.11	2,564.40	2369.6457	194.75	Payment made Aug-06
8	323,847.94	2,564.40	2368.2224	196.18	Payment made Sep-06
9	323,650.33	2,564.40	2366.7887	197.61	missed pmt
10	323,451.27	2,564.40	2365.3445	199.06	missed pmt
11	323,250.76	2,564.40	2363.8897	200.51	missed pmt
12	323,048.78	2,564.40	2362.4243	201.98	missed pmt
13	322,845.33	2,564.40	2360.9482	203.45	missed pmt
14	339,234.34	2,564.40	2359.4613	204.94	missed pmt
15	339,085.60	2,260.47	2111.7337	148.73	New payment Apr-07

New payment of newly constituted mortgage is \$2,365.01, a lower payment reflecting the lower interest rate of 7.47%. The principal on which that payment is calculated is \$339,234.34, which is obtained by adding the sum of the six missed payments to the outstanding principal at the time of the last and second payment made to the reset ARM: $(323847.94 + 6 * 2564.40)$.

11. Assume foreclosure proceeds and the Wilkes are removed from their home. The house is sold on December 1, 2007. At that time all payments they have missed are added to the loan and their gain is calculated as debt forgiven based on the sale foreclosure sale price of \$195,000. What will their tax bill be if they are in the 25% tax bracket? How much in taxes do they save if the house is sold instead on January 1, 2008? In December 2007, President Bush signed a tax bill that eliminated the capital gains tax on the differential between foreclosed home sales and outstanding loans. Consider the impact of the new tax bill effecting mortgage debt if the Wilkes' home is not sold until January 1, 2008.

House sold at	195,000.00	foreclosure price
loan 12/1/07	356,039.11	
debt forgiven	161,039.11	
tax due	40,259.78	

If sold on Jan 1, 2008	
loan 1/1/08	358,299.58
tax avoided	40,824.90

12. What do you think of the ethics of the Wilkes' decision to make one payment on the new loan and then default, living in the house as long as they legally can? Did Gallagher behave ethically?

Their behavior is unethical. They could have or should have known the terms of the mortgage. The debt is their responsibility. They took a risk by accepting the interest only mortgage. There may be some responsibility for their not understanding the mortgage that could be attributed to Gallagher, but they did have the documentation and the ability to ask someone what it all meant.

Gallagher provided the information that the mortgage lender required. He did not act in the best interest of the customer and in so doing acted unethically. A FICO credit check is insufficient to determine if an applicant can afford a mortgage. Certified income documents and tax returns are more useful tools for determining if a buyer can afford to make loan payments. Income qualifications were the norm until the housing market overheated. Gallagher failed his borrower clients but he did meet the lender's requirements. The lender was eager to loan, securitize the loan and sell it thinking all responsibility would be removed at that point. The lender was also at fault in not requiring more complete financial information. The ability to turn around and sell securitized loans prompted lower

credit standards. The resulting CDO meltdown is directly tied to overestimating the credit reliability of underlying mortgages. This could be seen as a regulatory problem that may be rectified after the fact by legislation. Those in favor of the market working itself out would counter that this is what is occurring. Market workouts injure borrowers, investors, and confidence.

13. Does it create a moral hazard to bail out some borrowers with offers of reduced payments?

By bailing out some borrowers, lenders effectively reward those who do not pay. The argument that the mortgage documents are too complicated is not valid unless deliberate fraud is committed by the lender in presenting the terms of the loan. In the case of Bill and Mary the terms were clear, but they were both focused on the buying the house, not on their financial obligations. Henry Gallagher qualified them for the loan with a simple credit check that did not verify their income was capable of supporting the payments on the mortgage. Since he did not ask for income documentation and was not required to do so by the lender, he would not have even been aware of what percentage of their income would have to go toward the loan, taxes and insurance.

Alternative Question Set

1. Consider yourself a financial counselor to the Wilkes prior to their taking out the first mortgage. What would your recommendations be? Then consider what your advice would be if you were retained as an advisor at the other crucial decision points assuming they already had taken out the loan. If you were privy to the pending mortgage debt forgiveness bill in 2007, would that have changed your advice about what to do about the new offer from the lender in April 2007?
2. Comment on the ethics of the people the Wilkes dealt with from the realtor to the mortgage broker. Were the Wilkes always ethical?
3. As an outside consultant to Whitewater what would you have recommended for investment strategies at the time of the initial investments in CDOs? Was this too profitable a situation to miss out on? Are there exit strategies that might pertain when market bubbles form?

Responses to alternative questions:

- 1. Consider yourself a financial counselor to the Wilkes prior to their taking out the first mortgage. What would your recommendations be? Then consider what your advice would be if you were retained as an advisor at the other crucial decision points assuming they already had taken out the loan. If you were privy to the pending mortgage debt forgiveness bill in 2007, would that have changed your advice about what to do about the new offer from the lender in April 2007?**

The calculations made in the first set of questions (1 to 5) or something similar would be useful a financial consultant to refer to. Wilkes ability to carry a mortgage payment at the full ARM rate available in January 2006 could be shown to be infeasible. They would need to set their sights on less expensive housing. The negative amortization built into the teaser rate that is so appealing needs a clearer explanation by an advisor as they are shown. The greater ballooned principal and higher rate make for an impossible payment situation.

One option is to default at the first reset point, August 2006. The mortgage is underwater at this point. Alternatively they could try to sell but in the case that appears to be a poor option. Selling at a loss would provide an exit. As an advisor you can see that the calculations worked out in question 10 show that there is little savings to be had on the reduced ARM interest mortgage offered by the lender in April 2007 after they've missed six payments.

Do the Wilkes have leverage with the bank to cut a better deal? While that is possible it would depend on local conditions. Those conditions appear dire in the immediate new housing development. If the lender is also involved with other houses in the development they may be more willing to help keep the Wilkes in their home with a sweeter offer though with their current income level and other obligations it's a stretch to imagine what could be worked out.

The possibility of a major tax liability from any consequent sale of the foreclosed house below the value of the mortgage is very real. Assuming you know of the pending bill to eliminate this tax, would it be ethical to advise the Wilkes to accept the new ARM offered in April 2007, make a payment or two, and then stop in the hopes that they can hold out long enough until the bill passes? Their incremental costs for any payments made would not be the entire house payment but would instead be the difference between the payments and a comparable rental. Offsetting that would be the probability of avoiding a large tax burden that they would not be able to pay as shown in the calculations in question 1.

2. Comment on the ethics of the people the Wilkes dealt with from the realtor to the mortgage broker. Were the Wilkes always ethical?

Responses to questions 11 and 12 cover the ethics of all parties involved in the mortgage. There are other players that are not mentioned in the case that could be added to the discussion. Bond rating agencies are paid by bond issuers setting up an upward ratings bias. They also have to rely on the explanation of the nature of the underlying instrument provided by the issuer. Since CDOs were complex instruments based on probabilities and correlations, which in turn were based on assumptions there was ample room for both confusion and obfuscation. Were regulators remiss for not having foreseen the problems that could ensue with securitization? Regulations in place at the time were insufficient to deal with complex securitization. The CDOs were also expanding home ownership. This would be a good opportunity to juxtapose the free market philosophy of Friedman with more constrained and regulated viewpoints.

3. As an outside consultant to Whitewater what would you have recommended for investment strategies at the time of the initial investments in CDOs? Was this too profitable a situation to miss out on? Are there exit strategies that might pertain when market bubbles form?

Did Whitewater fail in its fiduciary responsibility by not more closely examining the structure of the CDOs? Did Whitewater engage in excessive leverage? Whitewater probably did not have the ability to dig more deeply into individual CDOs but could have pursued a closer understanding of the pitfalls of these relatively new instruments. An advisor might have stressed the high risk subprime borrowers backing the CDOs. Subprime mortgage borrowers do not have much of a track record which adds uncertainty. Uncertainty is risky, which partially explains the premium returns that were available.

CDO value and risk diminution was built on the assumption of ever rising house prices. Housing demand at the time was being supported by bringing in the bottom of the market, subprime borrowers, with questionable loan practices (FICO, instead of checking income qualifications).

This could have been seen as the market peak and a warning to exit. Having just seen the tech bubble burst only a few years earlier, sophisticated investors such as Whitewater should have been more cautious. Housing affordability was signaling pricing problems. The Wilkes' ability to obtain a loan is indicative of how a couple that could not afford a mortgage was able to obtain one.

An investment strategy that skirts intrinsic value is dangerous. The housing bubble was not that different from investors overpaying for IPOs on the basis of the ability to sell

the shares to the next buyer at a higher price. Housing prices had been rising nonstop for some years. It was the rising prices that supported the mortgages, the subprime borrowers and the “investment grade” CDOs. Lenders were willing to support Whitewater’s CDO leverage initially under what looked like a low-risk situation.

The abrupt reversal as is typical with inflated markets when demand falters could have been predicted. An advisor might have suggested participating initially but watching housing demand and affordability closely. This amounts to market timing and is a difficult strategy to pull off in all situations. A prudent approach would have limited investment with more modest leverage and more clarity on what market changes would move the value of CDOs. Calculations of Whitewater’s positions shown in questions 7-9 pertain to determining the profit they would miss if they did not participate as well as how seriously they were damaged by leverage in the final analysis.

SUBS BY DESIGN: THE CASE OF A FAMILY BUSINESS IN TRANSITION

Barbara K. Fuller, Winthrop University

CASE DESCRIPTION

This case focuses on the growth of a family-owned franchise from its inception in 1987 to 12 stores in 2008. The patriarch is now 70 years old and the succession planning for the business is just beginning. The background of the family and history of the company create a portrait of the current situation and provide the environment for making future decisions. The case first concentrates on the issue of growth by providing students with an opportunity to develop a profit and loss statement for a new store offered to the franchisee. All of the key figures available to the entrepreneur are provided allowing students to put themselves into the role of the decision-maker. Secondly the patriarch of the family, Ryan, is thinking about retirement. The case develops Ryan's personality as well as the characteristics and behaviors of his two children over the 20 years of the business. As the founder, Ryan must now decide what is best for the business as well as the family as he becomes less active and the business moves to the next generation. The case provides students with a unique perspective by extensively quoting Ryan and Greg Smith, the founder and his son, thus giving them insight into the thoughts of the individuals involved in the decision making. All of the events in the case are based on a true entrepreneurial experience, but the names have been disguised to provide privacy to the owner. The profit and loss statement uses actual figures and depicts the situation as it existed at the time the offer was made. The case has a difficulty level appropriate for junior to senior level undergraduate students. It is suitable for use near the end of an introductory course in entrepreneurship which is where small business growth is usually covered in entrepreneurial textbooks or in a separate entrepreneurship course that has more of an emphasis on growing the business and succession planning. Although not developed for a finance class, it could be use by emphasizing the purchase decision associated with the Rock Crest location. Depending on the emphasis at least some basic accounting background would be helpful. The case is designed to be taught in two class hours and is expected to required four hours of outside preparation by students. However, there is a lot of latitude provided to the instructor as to what direction to take the case.

CASE SYNOPSES

Ryan Smith, laid off from his position as plant manager for a textiles firm, begins a new career as the franchise owner of a group of sandwich shops doing business as Smith Enterprises.

The case covers Ryan's startup of Subs by Design with the help of his family and the trials and tribulations of growing a family business. Startup financing came from some unique sources including from a fellow franchisee in a nearby territory. Early family support came from his daughter Bree who gave Ryan the confidence he needed to open the first two franchises. Bree and her husband, Brad, helped Ryan grow the business during its early days. Greg, Bree's younger brother, was not interested in the business, until an injury kept him from pursuing his first love, professional baseball. After the injury his father urged him to join the company. The case looks at the interaction among Ryan, Greg, and Brad as they continue to grow Smith Enterprises. The triangular relationship eventually results in Brad leaving to pursue a career in real estate.

After Brad and Bree's departure, the company continued to grow. Smith Enterprises is now looking forward to operating 12 stores which include two stores currently under construction. However, recently Ryan was presented with an interesting offer from the franchisor for a prospective store in a potential hot growth area. Ryan must make a decision on the offer within the next three weeks. If he doesn't accept the offer, the franchisor will offer the location to someone else. The case ends with Ryan who is now 70 looking at his retirement and planning for the succession of the business. He has to decide how to divide his estate and what to do with the business as it moves to a second generation of ownership.

INSTRUCTORS' NOTES

The specific teaching objectives

1. To explore the issues associated with family businesses that significantly alter the way businesses are organized and function in the marketplace. See references by Ang (1991) and McMahon & Davies (1994) for more information on how large and small firms operate differently because of special issues.
2. To identify the different stages of organizational growth and explain the nature of the transition to different stages as they relate to the Subs by Design.
3. To develop a profit and loss statement for the purpose of evaluating the feasibility of opening a franchise in a new location.
4. To evaluate various financial and legal strategies for passing a business on to the next generation.

Recommendations for Teaching Approaches

Teaching the case revolves around the growth of a family-based franchise business. Decisions about how large and how fast to grow a business are dependent on the capabilities and skill of the owner. Paramount to the overall success of the firm is the matching of company's

capabilities with the opportunities presented over time. Subs by Design owner, Ryan Smith, in the past was concerned with only his capabilities, but now must consider the fact that he will soon be retiring and the next generations will be taking over the business. The opportunity presented by Subs by Design for a new store in Rock Crest Village is a focal point of the case. A typical question to open with is, "If you were Ryan Smith, what would your recommendation be in terms of growth for Smith Enterprises, should Ryan accept the proposal by Subs by Design for a new location in Rock Crest Village or turn down the offer allowing another franchisee to accept the offer?" Proponents of accepting the franchisor's proposal will cite the profit potential especially at the \$10,000 net sales level, the ability to keep competition at bay, and accommodating the franchisor's request to open an additional store in the territory. Those opposed will refer to the lack of profits at \$7,000 net sales, the high level of competitions and lack of organizational structure. This will allow you to take the discussion to an analysis of the Weekly Profit and Loss Statement in appendix A of the case and in questions 1 and 2 in the instructor's note.

The case discussion can end by looking into the future of the business with students proposing and supporting different options for Ryan to retire from the business. Ryan has options to sell the business, to do an initial public offering, to bring in outside management, to offer an employee buyout, or to utilize a number of family succession planning options. The discussion should eventually get around to the fact that he has a son and daughter who have worked in the business and are interested in continued ownership in Smith Enterprises. However, there are issues associated with the division of stock in the company and management succession. Suggested questions to start the discussion include: How much ownership do Ryan's children expect in the business? When does Ryan plan to retire, and how much value does he need from the business to maintain him and Vicki during their retirement years? How involved should Ryan be in the business from now until his death? What financial and legal strategies should Ryan use for passing on his business to his children?

SUGGESTED ASSIGNMENT QUESTIONS

NOTE: An entrepreneur is a jack of all trades. Much like the entrepreneur, this case covers many decision areas that a business owner may face as the firm grows and is turned over to the next generation. The case had been constructed to give instructors multiple options. Students can be given the entire case to develop or the instructor can develop specific course or topic objectives and use only specific applications. The questions have been organized by content area to help instructors see the variety of directions available for class discussion.

Feasibility Analysis for a New Store Location: A Financial Focus

1. **Develop a weekly profit and loss statement for the Rock Crest Village location based on the normal projection of \$10,000 per week in sales? Based on your financial analysis would you recommend that Ryan open a Sub by Design store in Rock Crest Village or allow another franchisee to open a store in that location? Justify your answer.**

Appendix 1				
Rock Crest Village Weekly Proforma Profit & Loss Statement Comparison of Sales Volume at \$10,000 and \$7,000				
	\$	%	\$	Comments
Net Sales	\$10,000			\$7,000.00
-Cost of Goods	\$3,100.00	31.00%	\$2,170.00	\$7,000*31%
= Gross Margin	\$6,900.00	69.00%	\$4,830.000	Net Sales – CoGS
Expenses	Fixed expenses do not change based on volume of business			
-Gas	\$5.00 ¹	0.05%	\$5.00	fixed expense
-Electric	\$175.00 ¹	1.75%	\$175.00	fixed expense
-Telephone	\$15.00 ¹	0.15%	\$15.00	fixed expense
-Garbage	\$25.00 ¹	0.25%	\$25.00	fixed expense
-Insurance Coverage	\$40.00 ¹	0.40%	\$40.00	fixed expense
-Labor-Taxes	\$2,200.00 ¹	22.00%	\$2,200.00	fixed expense
-Repair/Maintenance	\$80.00 ¹	0.80%	\$80.00	fixed expense
-Miscellaneous	\$80.00 ¹	0.80%	\$80.00	fixed expense
-Rent and other contractual costs associated with lease	\$902.00 ²	9.02%	\$902.00	fixed expense
-Royalty	\$800.00	8.00%	\$560.00	\$7,000*8%
-Advertising	\$450.00	4.50%	\$315.00	\$7,000*4.5%
=Total Operating Expenses	\$4772.00	47.72%	\$4397.00	Gross Margin-Expenses
-Loans/Administration	\$500.00	5%	\$500.00	
Net Profit/Loss	\$1628.00	16.28%	-\$67.00	GM-Total Exp.-Loan
Notes: Based on recommendations in the case from Ryan's past experience.				
¹ Cost of goods sold and expenses are each taken as a percentage of net sales				
² Rent includes other contractual costs as outlined at the bottom of the lease agreement: Initial Minimum Guaranteed Rental (\$3700/month) + Initial Common Area Maintenance Charge (\$125/month) + Initial Insurance Escrow Payment (\$18.75/month) + Initial Tax Escrow Payment (\$62.50/month) = Monthly Payment Total (\$3906.25/month). \$3906.25 (rent and other contractual costs associated with the lease/month)* 12 months = \$46,875.00/year. \$46,875.00/year divided by 52 weeks = \$901.44/week rounded to \$902.00				

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2. **If, because of the stiff competition in Rock Crest Village, the franchisee was only able to produce \$7,000 in sales, how would this affect the profitability of this location? How would this affect your analysis and recommendation for opening a Subs by Design store at the Rock Crest Village location?**

Based on his analysis of the weekly profit and loss statement outlined above, Ryan decided the costs were too high at the Rock Crest Village location. His gut told him that sales would be closer to \$7,000 than \$10,000. He tried to negotiate with the landlord for better terms, but could not strike a deal that he felt was reasonable. The profit and loss statement at \$7,000 in net sales was not profitable. According to Ryan, the most important part of the profit and loss statement is the bottom line. Net profits need to be in the 10 to 20% range. To reach these numbers the rent cost should be around 6 to 7 % of net sales. Other issues that concerned Ryan were the stiff competition and the ability of the current organizational structure to handle additional stores.

The store was offered to another franchisee with the territory just north of Ryan's geographic area. The franchisee did open a store in the Rock Crest Village location. The store has now been open for over a year with sales of around \$7,000 per week. Rock Crest Village has grown and become a very successful development. However, the competition for customers is quite aggressive and few retailers are making their perceived profit margins.

Business Management Issues

3. **How has the leadership style of Subs-By-Design changes over the 20 years it has been in business? Relate the change in leadership style to the business growth cycle and be sure to discuss the differing management styles of father and son.**

The type of leadership seen in an organization most often matches a firm's stage of growth. Research indicates that the most directive and autocratic styles are seen with firms that are in Stages 1 or Stage 2 of their development whereas a more nondirective leadership style such as consultative or participative are used in Stage 3. During the first two stages the business requires more nurturing environment and therefore a more directive style of leadership, such as the benevolent-autocratic style described in the case by Ryan. Ryan was responsible for all of the major decisions in the organization both strategic and operational. As the firm grows into a Stage 3 organization is becoming more professionalized and Greg's leadership style shows a more interactive and participative leadership style. He is beginning to give up some control, has delegated some tasks and is convinced that more middle management is need if the organization is to grow beyond its current size. There is

additional information in the following question along with some references for additional reading if needed on the relationship of business growth cycles to leadership style.

Growth Challenges

- 4. What are the growth challenges Smith Enterprises faces as it moves from its current 10 store franchise base to what could be as many as 20 franchises in the next few years? Put together a time line that outlines your recommendations for growth and what that means to the management structure at Smith Enterprises.**

A good source for looking at growth within companies is Eric Flamholtz and Yvonne Randle's book, *Growing Pains: Transitioning from and Entrepreneurship to a Professionally Managed Company*. Class discussion should focus on management systems needed for each stage of growth. First have students identify where Smith Enterprises fits into the stages of growth and then evaluate how effective the business has been at each stage and how it is poised to move into the next stage. Flamholtz and Randle (2007) identify four stages of growth from inception to maturity: Stage 1 - New Venture, Stage 2 – Expansion, Stage 3 – Professionalism, and Stage 4 – Consolidation. Smith Enterprises is in the second stage of growth. Many of the issues of Stage 1 and startup were identified and resolved by the franchisor. The market niche and core products and services were already established. However, Smith Enterprises established its own operational systems. In the beginning, these systems were rather informal and totally run by Ryan. The company culture was established through Ryan's daily interactions with family and employees. He wanted things done quickly and liked to see things done his way. For Ryan the business was a source of personal pleasure which he expressed as "I love to get up in the morning and go to work." Ryan brought much to the business in terms of his past management experience and his keen eye for accounting and financial systems. Although he had worked for corporations all of his life, in the back of his mind he had always thought about owning his own business. He overcame his fear when faced with a career obstacle at the age of 50. The rights Ryan purchased from the franchisor made the transition into business ownership much easier than a normal startup. However, as Ryan moves into Stage 2 of the growth process, he will increasingly need to rely on his own capabilities and experiences, as well as Greg's leadership strengths. The business has grown slowly, but deliberately.

As Smith Enterprises moves into Stage 2 the management systems are still relatively informal. Store level management is in place and consists of people inside and outside of the family, but no regional or middle management structure had been developed to allow the company to grow much beyond its current level. Greg does mention that a couple of store managers may be at the Stage where they are ready to take on more responsibility at the

regional level. However, no operational systems have been established at the corporate level to accommodate this growth.

Issues that may complicate the picture are the role Bree and Brad may play in the business upon the death of Ryan. Also decisions made by Ryan and Greg as to how large they want the business to become in the future may greatly influence which systems should be put into place. Ryan indicated that Greg can handle 10 stores as easily as he handled four, but what about 20 stores. Ryan contends that now that they have the format in place they can manage 100 stores just as easily as 10. But is this really true? Do they really have the structure in place to move to Stage 3? What management systems would need to be developed to move to the next Stage? How would Greg's rather laid back management style fit with the growth of the more formalized systems and controls required as the business grows? When there is change in one dimension or element of a business, it affects the alignment of other elements of the organization. As a company grows, the management structure demands that new task be accomplished and often with new and different people. The entrepreneur is pressured to manage in a different way, usually outside his comfort zone. In fact, many entrepreneurs choose to operate lifestyle businesses that provide just enough salary and size without adding the risk and complexity required by larger companies. Flexibility and control are often traded off for size and maximization of wealth. Which direction will Smith Enterprise take? Growth decisions will depend on Greg's ability to transition to a more structured hierarchical managerial style and his comfort level. Greg talks about his 40 birthday in 6 years, and tends to see this as a major juncture in his life. Where will Smith Enterprises be in 6 years?

Ryan's Retirement and Succession Management

- 5. How would you assess the triangular relationship between Greg, Bree and Brad that eventually results in Brad leaving to pursue a career in real estate? What is the significance of Ryan's gift to Bree and Brad when they leave the business? Was he too generous or not generous enough? Should this gift affect Ryan's will in any way? If so, how? Discuss the reasoning behind your answer.**

First hires in a family-owned business usually include members of the extended family which we see in this case. Early on Ryan relies heavily on the support of his family, especially Bree. She provides him with encouragement and works diligently during startup and for the first ten years of the business. In addition she brings her husband into the business to work with her father. Since he comes in from outside the family, this would be a good place to talk about how outsiders fit into the family structure. How are they treated

and what types of issues arise when outsiders are included in the operations of a family business.

Most of the literature indicates that much of the culture of the family crosses over into the operation of the business, and therefore, the behavior of individuals across these two boundaries is often very similar. If fathers are strict with their children at home they will continue that strict behavior in the work environment. If that strictness is felt by the children it is multiplied by those outside the family such as son-in-laws.

The gift to Bree and Brad was to thank Bree and Brad for the more than ten years they had worked for the company. At the time they received the two stores, Smith Enterprise had opened 10 stores, and these two stores were worth \$1.2 million. Ryan gave them the stores so Brad would have time to get his real estate business started. Ryan admitted that he had allowed Brad and Greg to compete for the presidency of Smith Enterprises. Ryan's comments on the competition he encouraged between Brad and Greg.

Ryan: "On the one hand it was hard, I let Brad and Greg compete, but on the other side when Brad decided to leave I gave him and Bree the two stores so they would have income while establishing their new venture. Bree and Brad helped me build the business when the Subs by Design franchise was new and unknown. In the past two years, Brad has become very successful in the real estate business and is moving on with his new career."

Ryan is aware that although his tactics allowed the strongest leader to take over Smith Enterprises, it also created some tension among family members. Bree and Greg get along as most sisters and brothers, but there are still tense moments when discussing certain subjects. Greg feels like the person in the middle and although he has proved himself as a talented leader with a good business sense, he would prefer to have a better relationship with his sister and Brad. At this point in time Ryan's "Will" is still in process however; most likely the assets of Smith Enterprise will go to Greg with the rest of the family assets going to Bree. Other family assets are well over a million dollars.

This is a good place to talk with students about the fair versus equal distribution of assets. Pushing family members back together in a business after the tension caused in earlier times does not seem appropriate. However, giving the business to Greg does create some inequity in the distribution of family assets. Students can debate various options available to Ryan as to the division of his estate. Most students will favor equal distribution of assets. They need to list the pro and cons of such a decision as it relates to the future of the business.

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- 6. How should Ryan plan for his retirement? What are the options available to Ryan in harvesting or managing the succession of his business? Which option would be the best based on the information you have from the case? Justify your answer. Should Ryan get a business valuation? Why or why not? What other professional help does he need in planning his retirement from the business?**

Ryan can choose among many options available to founders who are ready to retire. He has options to sell the business, to do an initial public offering, to bring in outside management, to offer an employee buyout, or to utilize a number of family succession planning options. Since his children have been involved in the operation of the business his best option would be to develop a family succession plan. However, with family issues that have evolved through the growth process, Ryan has some serious decision to make to assure that his children are treated fairly and the business is given the best chance of survival.

Succession planning is quite complicated. Many legal and tax issues are associated the process. First Ryan will need to look at what type of help or expertise he will need in developing his succession plan. This may include several professional advisors. The IRS for tax purposes will want a valuation for the business. An estate-planning lawyer will be needed to help with deciding which method is best for Ryan to use for the stock transfer and how management succession will occur in the business. He can make recommendations and create the formal documents. Together with his financial advisor and accountant Ryan can make decision that will most closely match his values and comfort level. There are many succession options available and each have financial, tax, and control issues associated with them. First the IRS allows individuals to pass \$1 million in tax free gifts, plus \$12,000 a year. A second option, a family limited partnership allows owners to transfer up to 99 percent of a business while retaining control. Other options self-canceling installment notes and private annuities allows the younger generation to pay the older one a series of payments plus interest for a set period of time or until the owner's death in the case of the self-canceling note or for the seller's lifetime in the case of the private annuity. With a grantor-retained annuity trust ownership is transferred to an irrevocable trust which the owner can access for a specified period of time after which the equity is transferred to the heirs. An intentionally defective grantor trust allows one to sell the business to a trust in your family's name in return for a long-term installment note. Ryan has started the gifting process and is looking at a family limited partnership.

EPILOGUE

Rock Crest Village Site:

Ryans gut feeling was right. The new location in Rock Crest produced less than \$7000 in sales volume after it opened. The current owner is currently looking for a buyer. Ryan may be interested if he is able to negotiate a lower cost structure with the landlord.

Succession Issues:

Ryan is in the process of working with his CPA, estate attorney, and business appraiser to develop his will. At the time of this writing, most of the decisions about the division of his estate have been decided. The business in its entirety will be passes on to Greg who has gradually been taking over the leadership role in the company. Most of the rest of his property, which is a sizable estate, will go to Bree.

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KING OF THE HILL: COMPETING FOR FOREIGN DIRECT INVESTMENT IN 'DIXIE'

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CASE DESCRIPTION

The primary subject matter of this case concerns foreign direct investment (FDI) in the southern U.S., specifically automobile FDI in Alabama. Secondary issues concern the aggressive competition, using incentives and state-specific features, of southern states in recruiting foreign investment and the employment opportunities that FDI brings. This case has a difficulty level of three. It is suitable for a junior level course and can be taught in a 90 minute class with two hours of preparation by students outside of class. The case could also be used in a senior-level international management class to illustrate the reach of globalization into our corner of the world. This case can be used as a template for professors in other states in illustrating the proximity of FDI in their state and the consequences of that FDI. We propose that there is international activity in the form of FDI here or abroad as well as exporting and importing in virtually all states. A professor can use this case as is or as a template to reflect international activity in his/her local geographical area. Students should relate to the importance of international business as they see its relevance to their lives.

CASE SYNOPSIS

This case is designed to illustrate the concepts of foreign direction investment, job creation, state incentives as a factor in FDI, and the unique features that a foreign investor wants from a state. The case can be used in its entirety or in part as appropriate. For example, one could investigate recruiting methods used by U.S. states in the pursuit of FDI and the results of that pursuit. Or one could investigate the facets of employment, such as a non-union environment, educational development, and tax policies, that are particularly attractive to foreign investors. Or one could compare the incentive packages offered by various southern states and determine the return on their investment.

Countries are faced with numerous challenges as they compete for the same Foreign Direct Investment (FDI) dollars. FDI is increasing as the world evolves into a global marketplace for industry. The U.S. government continually adjusts its policies and tax procedures in order to be a viable player in the world market. The southern U.S. has become more aggressive in recruiting

foreign investment by providing incentives to attract industries and communicating the unique advantages they offer to foreign companies interested in a U.S. presence. Many southern states, including Alabama, have been successful in improving their economies and providing new employment opportunities by offering the incentives required to attract FDI and industries to the area.

This case can be used as a template for professors in other states. We have included a reference page to assist others in modeling a case based on what is done here. The figures for FDI initially are reported for the U.S. The Bureau of Economic Analysis (www.bea.gov) offers information for each geographical area. Each state has a web site as well as a Development Office. Much of our information came from the ones for Alabama.

INSTRUCTORS' NOTES

Recommendations for Teaching Approaches

This case helps students appreciate the global reach of business today. In all states, there is foreign direct investment and state development offices to assist in attracting FDI. Allow the students to read the case and then assign the questions. They can use the Internet to find all the answers which are provided below. We also provided an extensive reference section to assist the teacher (and the students if you want to provide it to them). Students are adept at finding information on the Internet and enjoy the success that this case brings.

Discussion Questions

We suggest to first look at Alabama and its participation in trade. The students should answer the following questions:

1. What percent of FDI to the US is in the southern states?

The southeastern states of Alabama, Florida, Georgia, Kentucky, North Carolina, and Virginia occupied 20.3% of the nations FDI in 2003. Alabama made up 7.1% of FDI in 2003. Its increase rate in FDI - gross book value, 75%, was higher than that of the southeast and the U.S., respectively 40% and 65%.

Table 1: Foreign Direct Investment by Year in U.S.

Year	FDI Projects	Capital Investments in U.S. Dollars
2005	370	\$10.99 billion*
2004	580	\$14.26 billion
2003	589	\$11.61 billion

*Data through July 2005

Table 2: Source Country of Multinationals Investing in U.S.

Source Country	Projects
Japan	328*
Germany	258
United Kingdom	241
Canada	180
France	95

*Data through July 2005

Table 3: Top Multinational Companies Investing in United States

Company	Projects
Toyota	16
DHL	15
Honda	12
DaimlerChrysler	9
Infineon Technology	7

Data Through July 2005
www.LOCOMonitor.com

2. What caused this increase in FDI to the southern area?

Some reasons for the increase in FDI were: multi-modal transportation and distribution infrastructures, a capable workforce at competitive salaries, excellent training system, the lowest electricity costs, a low cost of living, a public-private partnership, and the lowest state income and property taxes and incentive programs. For example, Alabama provided tremendous incentives and tax breaks for inducing the automotive investments.

Alabama gave incentives package to Mercedes-Benz (1993) of \$253 million including: training workers, clearing and improving site, upgrading utilities, and buying 2,500 expensive vehicles. They paid Mercedes Benz \$150,000 per job created. Compare this to the presumed frontrunner at that time, North Carolina, which offered \$100 million.

3. What tax incentives does Alabama offer companies in FDI?

Alabama has statutory tax incentives that are favorable for all companies such as income tax breaks. Corporations pay Alabama income tax based on their net taxable income derived only from business conducted within the state and a fifteen year carry forward of net operating losses. Property taxes are significantly lower than most states with the limit of state mileage rates on both real and personal property at 6.5 mills (www.ado.state.al.us). Business property is taxed on 20% of its fair market value with an exemption of all tangible personal property being warehoused in the state for shipment to a destination outside the state. Alabama has favorable sales and use taxes for raw materials used by manufacturers. A business privilege tax is capped at \$15,000 except for financial institutions and insurance companies (www.ado.state.al.us).

For qualifying companies in Alabama, an impressive incentive to locate businesses within the state is the annual income tax capital credit of five percent of the total capital costs of a qualifying project for twenty years. In contrast, other cities and counties may offer abatements for non-educational state, county, and city property taxes for a period of only ten years. For manufacturing use, abatements are approved for non-educational county and city sales and use taxes on construction materials and equipment (www.ado.state.al.us).

4. What part does unionization sentiment in a state have on FDI decisions?

Human resources (HR) are an important contributor to most firms' decisions regarding FDI. HR includes such areas as wage levels, unionization, labor politics, and skills of the workforce. U.S. and European multinational companies' decisions regarding investment abroad are strongly influenced by comparative location advantages prejudiced by the differences in union penetration, collective bargaining contexts and government workplace regulations. German-owned DaimlerChrysler Corporation, in its Alabama operations, has been aggressive in its efforts to rid itself of union representation by Bridgestone/Firestone who is Japanese owned. DaimlerChrysler wishes to operate as a union-free enterprise. Foreign multinational companies strive to minimize the likelihood of their company being unionized by location decisions regarding where to invest within the U.S. Foreign-owned manufacturers are more negatively influenced by union penetration rates than U.S. manufacturers in making location investment decisions.

5. Why do countries engage in foreign direct investment (FDI) in Alabama and other southern states? What unique things does Alabama offer? See www.ado.state.al.us

The Southern U.S. has been very aggressive in recruiting international companies. Economic development is one of the first job priorities of southern politicians. Tennessee, Alabama, Georgia, Kentucky, South Carolina and Texas have been eager to grow their manufacturing bases and have welcomed foreign automakers with numerous incentives, many industrial sites, a skilled work force and a non-union environment. Alabama possesses many natural resources that make it attractive to foreign multinational corporations, among these are attractive climate, accessible ports and rivers, excellent infrastructure including a good transportation system, and reserves of natural gas, coal, and marble.

For business relocation purposes, Alabama attracts businesses with benefits by having a pro-business culture and lower resource costs than many other states. Often, it is the work ethic of local citizens that is cited as the key to Alabama's success in attracting global companies and the subsequent growth of these companies (Chemical Market Reporter, 2004). In addition to the booming automotive industry in Alabama, the state is a significant base for the U.S. chemical industry. This industry including the plastics sector accounted for 25,300 Alabama workers in 2003. The chemical industry has prospered in Alabama due to several factors: the low cost of conducting business locally, a bipartisan pro-business environment within the government, a readily available skilled workforce, and low utility costs (Chemical Market Reporter, 2004).

Foreign investors have invested an enormous amount of FDI in the automobile manufacturing business in the southern United States. The following companies have manufacturing plants located in the south: Nissan operates plants in Mississippi and Tennessee, Toyota has operations in Kentucky and Texas, and Hyundai, Honda, and Mercedes have manufacturing plants within Alabama.

6. What is the impact of Alabama Investment Development Training (AIDT)?

Alabama Industrial Development Training (AIDT) is among the most highly rated workforce-training program in the U.S. (Expansion Management, 2003). They provide state-of-the-art industrial training and support services for new and expanding industries. AIDT has several training centers located statewide. For example, the AIDT center in Lincoln, Alabama, continually assists the Honda Manufacturing plant located nearby with employee training and support as they expand their processes. They provide mobile training units, an experienced staff paid by AIDT and on-site production facilities at no cost to the business client. AIDT often works in partnership with the local community colleges in their training center areas to coordinate customized training for their clients.

7. What is the Alabama Technology Network and what is its influence on FDI?

Alabama currently has twelve Alabama Technology Network (ATN) Training Centers located throughout the state that works with business and industry to increase the competitiveness of Alabama companies through a network of service providers. This network merged under the umbrella of the Alabama Department of Postsecondary Education in 2005, in order to fully partner with the Alabama College system to enhance workforce-training capabilities. During Training for Business and Industry Network (TBIN) meetings within the state, I observed Alabama Postsecondary Chancellor Roy Johnson reveal his plans to increase the number of ATN center locations in the state within the next two years as part of his workforce development plan in order to meet the increased technology training needs of the future Alabama workforce.

ATN's administer the Manufacturing Extension Partnership (MEP), which provides a network of increased services to manufacturers. ATN's assist businesses that have lost jobs or are forced to revamp their processes due to foreign competition. They offer applications for the Federal Incumbent Worker Grants that enable manufacturers to retrain their employees with a fifty percent match of grant funds for training costs.

8. What was the incentive package Alabama gave Honda?

Alabama gave Honda \$158.3 million, including: buying the land and preparing the site for construction, training the plant's employees, and \$55.6 million in tax breaks. Additional incentives in 2002 for \$450 million expansion included: \$45.1 million from the state for employee training, and road, sewer and water improvements; \$33.1 million from the state and local area for various tax breaks, which will be allocated over a 20-year period; and \$11.5 million from the city of Talladega and Talladega County for site preparation, and sewer and water improvements.

9. What was the incentive package Alabama gave Hyundai?

The incentive package given by the state of Alabama to Hyundai (2002) included: \$252.8 million, including; \$76.7 million in tax breaks, \$61.8 million in training grants and \$34 million in land purchase assistance, road and bridge development, and water and sewer improvements.

10. What are the aggregate benefits of FDI to Alabama?

The benefits of FDI (aggregate automotive industry in Alabama) include: Job creation 44,834 (2005), as compared to 31,197 (2003); 124,190 direct and indirect jobs. Alabama wages are: Motor vehicle manufacturing: \$1,274/weekly (~\$64,000/annually). All manufacturing industries are: \$725/weekly (~\$36,000/annually). All industries are: \$620/weekly (~\$31,000/annually). Also there was Employment growth (due in part to other expanding industries such as the aerospace sector) 3.5% unemployment rate (2005); as compared to 5.3% (2004). Additionally, there was State sales taxes (paid by auto industry workers in 2003) of \$101 million (state); \$46 million (sales). Finally, over 160 Hyundai, Honda, and Mercedes suppliers have located within the state

11. What makes Alabama and its infrastructure attractive to foreign investors?

Alabama has a lot to offer foreign investors. The following shows the depth of commitment to attract FDI:

- ◆ World-wide connectivity through the statewide multi-modal transportation/distribution infrastructure with an easily accessible interstate and four-lane highway network connects every major city and most other communities throughout the state, motor freight terminals, rail systems, port and barge transportation, and international air service.
- ◆ A capable workforce is available at competitive wages.
- ◆ Alabama Industrial Development Training recruits, assesses and trains qualified potential employees at no cost to the industry and based on company criteria.
- ◆ A variety of advanced engineering, technology, research, and development facilities and programs are located at various universities and colleges throughout the State.
- ◆ Ranked nationally among the lowest electricity costs for industrial users (Morgan Quitno's State Rankings 2003) and a net exporter of electricity, Alabama's three major electric utilities provide dependable, low-cost power.
- ◆ Water resources are approximately 20 times greater than present usage. One-twelfth of all the ocean-flowing water in the U.S. travels through Alabama.
- ◆ Alabama's forestland covers more acres than the size of Connecticut, Delaware, Maryland, Massachusetts, New Hampshire and Rhode Island combined.
- ◆ A low cost of living complements an enviable quality of life in areas such as recreation, entertainment and cultural diversity.
- ◆ The Alabama Technology Network (ATN), a public/private partnership of the University of Alabama System, Auburn University, the Economic Development Partnership of Alabama and selected two-year technical colleges, provides worker

training and technology transfer to industry in Alabama. ATN works to enhance the competitiveness of companies, strengthen the industrial base and improve the effectiveness of the work force through a coordinated network of education, training and technical assistance providers.

- ◆ Official U.S. Customs Ports-of-Entry are located at Birmingham, Mobile, and Huntsville International Airports.
- ◆ NASA's Marshall Space Flight Center is a regional transfer hub for government/industry teams who travel to industrial sites. In Alabama, an estimated 1,170 jobs were created or saved over an 18-month period through its programs and 41 new products were created.
- ◆ Auburn University's Industrial Extension Service helps small and medium-sized manufacturers solve technical and business problems, provides work force training and disseminates advanced technology.
- ◆ University of Alabama Birmingham's (UAB) office for the Advancement of Developing Industries is the state's advanced technology business incubator and is nationally recognized as a technology transfer organization.
- ◆ The state income and property taxes are among the lowest found anywhere in the United States. In addition, Alabama offers statutory incentive programs such as a corporate income tax credit for qualifying companies. This includes the cost of land, buildings, machinery and equipment. The program provides an annual corporate income tax credit of five percent of the total capital cost of the project for 20 years. Assuming a total cost of \$20 million in building and equipment, the abatement provides up to \$1 million in credit against Alabama corporate income taxes each year for a term of 20 years.
- ◆ Alabama provides industrial site preparation grants to assist new and expanding manufacturers.
- ◆ The Alabama Enterprise Zone program provides a package of business development incentives, which offers businesses some of the most favorable arrangements in the country.
- ◆ One-half (1/2) of the U.S. population lives within a 500-mile radius and over two-thirds (2/3) lives within 750 miles.

BELGROVE FARMS INC.

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CASE DESCRIPTION

The primary subject matter of this case focuses on the calculation and use of comparative advantage in the allocation of resources within the firm. Secondary issues involve the use of accounting techniques and statistics to complete the business decision analysis of a profit opportunity. The case also presents strategic thinking and ethical issues related to business conduct in a family firm and the effects on consumers.

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

This case is designed for use in an upper-division, inter-disciplinary business course. The purpose of the course is to enable students to utilize the knowledge they have gained in their lower-division core business courses that include one economics course in microeconomics and two accounting courses (one course in financial accounting and one course in managerial accounting) and one statistics course.

Specifically, the case incorporates the understanding of comparative advantage, opportunity cost and how prices affect the allocation of resources, how cost data should be used in decision making, and the calculation of expected value.

CASE SYNOPSIS

Students are faced with a factual setting that presents practical business and ethical issues. The client, Belgrove Farms, is considering changing production from standard yellow corn to genetically modified corn. The farm has four sub-divisions that vary in production of the new product. Cost data is provided by an existing proposal. Future pricing of the genetically modified corn is uncertain. Using the concept of comparative advantage, the student must choose the appropriate allocation of production among the four sub-divisions, and calculate the anticipated change in profits. Students must also consider the nature of a family firm and any strategic or ethical issues associated with the proposed change in production.

INSTRUCTORS' NOTES

Recommendations for Teaching Approaches

This case is designed for use in an upper-division, inter-disciplinary business course. The purpose of the course is to enable students to utilize knowledge they have gained in the lower-division business core. In addition, the course aims to improve students' communication and teamwork skills. Student teams prepare the answers to questions presented in the case with coaching from faculty. The faculty coaching is intended to provide answers to team questions. All teams submit a formal written business report containing an analysis of the issues presented in the case. One team of students formally presents their case solution to the class. A second team of students acts as a "discussion team" by asking the presenting team for further explanation or clarification of their recommendations. Following the discussion team's exchange with the presenters, the entire class is welcome to participate in an active question and answer session.

Although the case is designed to be used in an upper-division, inter-disciplinary business course, the case can be easily modified for use as an in-class or take-home assignment in an introductory microeconomics course.

DISCUSSION QUESTIONS AND ANSWERS

General note: the firm is considering changing production to a new product, genetically modified (GM) yellow corn. The letter from Kevin Thorp (Exhibit 1) suggests a total switch in production from all AA yellow corn to all GM yellow corn. The production summary data (Exhibit 2) reveals differing relative capabilities of producing either AA yellow corn or GM yellow corn among the farm's four sub-divisions. One objective of the case is to help students understand that analyzing the sub-divisions as separate resources, and determining the profit-maximizing output from each sub-division can increase the farm's total profitability. Another objective of the case is to help students understand that the contribution margin (CM) for AA yellow corn per sub-division is the appropriate measure of the opportunity cost of producing GM yellow corn.

- Q. 1. Belgrove Farms has four sub-divisions (four different farms it has previously acquired). Since the farms have different relative productive abilities (AA yellow corn vs. GM yellow corn), and production can be shifted by farm, consideration must be given to the best combination of outputs to maximize the economic profit.**
- a. Calculate the output of each farm for AA yellow corn or GM yellow corn. From this data, calculate the economic cost of AA yellow corn in terms of GM yellow**

corn (ratio) and the economic cost of GM yellow corn in terms of AA yellow corn (ratio)

[i.e., 1 AA = ? GM; or 1GM = ? AA.]

Using the data from Exhibit 2, Table 1 shows the relative outputs of AA yellow corn or GM yellow corn for each farm. To calculate the physical opportunity cost for each farm, simplify the AA yellow corn to GM yellow corn ratios. For example, the Brookhurst Farm can produce either 20,000 bushels of AA yellow corn or 22,000 bushels of GM yellow corn. (Equation: 20,000 AA = 22,000 GM.) Dividing both sides of the equation by 20,000 results in 1 AA = 1.1 GM. Thus, the physical opportunity cost of each bushel of AA yellow corn is 1.1 bushels of GM yellow corn. Dividing both sides of the equation by 22,000 results in 1 GM = 0.91 AA. In this instance, the physical opportunity cost of each bushel of GM yellow corn is 0.91 bushels of AA yellow corn. The physical opportunity costs for each bushel of AA yellow corn and GM yellow corn for the remaining farms are determined in exactly the same manner.

Farm	Acres	AA ¹ (1,000s)	GM ¹ (1,000s)	1AA = GM	1GM = AA
Brookhurst Farm	200	20	22	1.10	0.91
Fordum Estates	500	50	50.5	1.01	0.99
Gatos Peligo	300	60	90	1.50	0.67
Sally's Place	800	160	320	2.00	0.50
Total	1,800	290	482.5	---	---

¹ The relative outputs of AA yellow corn or GM yellow corn for each farm are stated in Exhibit 2.

- b. Our marketing division has put together a projection of expected selling prices (see Exhibit 5). Apparently there are some consumer issues about the new corn. These issues may affect the expected selling price of GM yellow corn. Evaluation of some alternative prices for GM yellow corn may be in order.**

The expected selling prices are stated in the price forecast portion of Exhibit 5.

AA yellow corn (domestic): \$5.00/bushel

GM yellow corn (domestic): either Scenario #1, \$5.50/bushel or Scenario #2, \$4.70/bushel.

- c. **Combine the relative output ratios from Q.1.a. with the selling prices from Q.1.b. to determine an optimal output table at each selling price of GM yellow corn. (Remember opportunity cost and comparative advantage analysis from economics, and contribution margin from accounting?)**

The relevant comparison to make in deciding which crop to produce on each farm is to compare the contribution margin of a product with the opportunity cost. The contribution margin (CM) is the sale price of the product minus the expected production cost/bushel.

CM = Sale price per bushel – Expected production cost per bushel. The expected production cost (EPC) per bushel is stated in the cost analysis portion of Exhibit 1. The contribution margin describes how much each unit of output contributes to profit.

The opportunity cost of any choice is the forgone value of the next best alternative. If the production capacity of AA yellow corn on each farm were equivalent to the production capacity of GM yellow corn, the decision of which corn to produce is easy to make. If a farm can produce the same amount of corn, AA yellow corn or GM yellow corn, then the corn that produces the highest contribution margin will be the corn that will be produced on the farm. However, in light of Exhibit 2, it is evident that the production capabilities of AA yellow corn vs. GM yellow corn are not equivalent. The difference in production capabilities was the focus of the ratios that were determined in Question 1.a. Thus, in this case, the opportunity cost of growing AA yellow corn is the contribution margin of GM yellow corn times the number of bushels of GM yellow corn given-up for each bushel of AA yellow corn.

CM = sale price – EPC.

AA yellow corn CM = \$2.30 = (\$5.00 - \$2.70)

Scenario #1: GM yellow corn $CM_1 = \$2.25 = (\$5.50 - \$3.25)$

Scenario #2: GM yellow corn $CM_2 = \$1.45 = (\$4.70 - \$3.25)$

Determine output by comparing the dollar contribution margin with the dollar opportunity cost of production. This can be done for either column in Table 1: (1AA = ? GM or 1GM = ? AA).

For example, Brookhurst Farm under scenario # 1:

Consider planting AA yellow corn. For Brookhurst Farm, the opportunity cost of each bushel of AA yellow corn is \$2.48 (1.1 GM yellow corn x \$2.25). Planting AA yellow corn would not contribute the most to profit since the gain is \$2.30/bushel and the opportunity cost is \$2.48/bushel

Consider planting GM yellow corn. The GM yellow corn contribution margin is \$2.25/bushel; the opportunity cost is \$2.09/bushel (0.91 AA yellow corn x \$2.30). Profit will be maximized by planting GM yellow corn on the Brookhurst Farm since the gain of \$2.25 is greater than the opportunity cost of \$2.09.

For further illustration, consider Gatos Peligo under scenario #1:

Consider planting AA yellow corn. For Gatos Peligo, the opportunity cost of each bushel of AA yellow corn is \$3.38 (1.5 GM yellow corn x \$2.25). Planting AA yellow corn would not contribute the most to profit since the gain is \$2.30/bushel and the opportunity cost is \$3.38/bushel.

Consider planting GM yellow corn. The GM yellow corn contribution margin is \$2.25/bushel; the opportunity cost is \$1.53/bushel (0.67 AA yellow corn x \$2.30). Profit will be maximized by planting GM yellow corn on the Gatos Peligo farm since the gain of \$2.25 is greater than the opportunity cost of \$1.53.

Following similar reasoning for the remaining farms will produce results as seen in Tables 2 and 3 below.

Farm	Acres	AA (1,000s)	GM (1,000s)	1AA = GM x \$2.25	1GM = AA x \$2.30
Brookhurst Farm	200	20	<u>22</u>	\$ 2.48	\$ 2.09
Fordum Estates	500	<u>50</u>	50.5	\$ 2.27	\$ 2.28
Gatos Peligos	300	60	<u>90</u>	\$ 3.38	\$ 1.53
Sally's Place	800	160	<u>320</u>	\$ 4.50	\$ 1.15
Total	1,800	50	432	-----	-----

The underlined numbers in Tables 2 and 3 indicate which product should be produced on each farm.

Farm	Acres	AA (1,000s)	GM (1,000s)	1AA = GM x \$1.45	1GM = AA x \$2.30
Brookhurst Farm	200	<u>20</u>	22	\$ 1.60	\$ 2.09
Fordum Estates	500	<u>50</u>	50.5	\$ 1.46	\$ 2.28
Gatos Peligos	300	<u>60</u>	90	\$ 2.18	\$ 1.53
Sally's Place	800	160	<u>320</u>	\$ 2.90	\$ 1.15
Total	1,800	130	320	-----	-----

Notice at the lower price for GM yellow corn, only Sally's Place should produce GM yellow corn.

Accounting Analysis of the Two Scenarios:

Students may alternatively calculate the total contribution margin from each farm and allocate production by picking the highest total CM per farm.

Scenario #1 analyzes how to use the farms if GM yellow corn sells for \$5.50 per bushel. Scenario #2 analyzes how to use the farms if GM yellow corn sells for \$4.70 per bushel.

Scenario #1: Compares total CM of AA yellow corn to CM of GM yellow corn at a selling price of \$5.50 per bushel for GM yellow corn.

Table 4a. Contribution Margins per bushel under Scenario #1

Selling price per bushel AA yellow corn	\$5.00
Variable cost per bushel AA yellow corn	2.70
Contribution Margin per bushel AA yellow corn	\$2.30
Selling price per bushel GM yellow corn	5.50
Variable cost per bushel GM yellow corn	3.25
Contribution Margin per bushel GM yellow corn	\$2.25

Table 4b. Total Contribution Margins per farm under Scenario #1

Farm	Acres	AA yellow corn prod. @\$2.30/bsh	GM yellow corn prod. @\$2.25/bsh	Total CM AA yellow corn	Total CM GM yellow corn	Highest CM
Brookhurst Farm	200	20,000	22,000	\$46,000 ¹	<u>\$49,500</u> ²	\$49,500
Fordum Estates	500	50,000	50,500	<u>115,000</u>	113,625	115,000
Gatos Peligo	300	60,000	90,000	138,000	<u>202,500</u>	202,500
Sally's Place	800	160,000	320,000	368,000	<u>720,000</u>	720,000
Belgrove Total	1,800	290,000	482,500	\$667,000	\$1,085,625	\$1,087,000

¹ This amount is derived by multiplying the quantity of AA yellow corn produced on Brookhurst Farm (20,000 bushels) by \$2.30 (the contribution margin per bushel of AA yellow corn).

² This amount is derived by multiplying the quantity of GM yellow corn produced on Brookhurst Farm (22,000 bushels) by \$2.25 (the contribution margin per bushel of GM yellow corn).

Table 4c. Income Data under Scenario #1

	AA	GM	Highest CM
Sales and changes in value of crop inventories	\$1,450,000 ¹	\$2,653,750 ²	\$2,626,000 ³
Cost of Production	\$783,000 ⁴	\$1,568,125 ⁵	\$1,539,000 ⁶
Selling, General, and Administrative Expenses ⁷	\$313,200	\$313,200	\$313,200
Technological Expenses ⁷	\$93,960	\$93,960	\$93,960
Other ⁷	\$11,745	\$11,745	\$11,745
Income from continuing operations before taxes	\$248,095	\$666,720	\$668,095

¹ Based upon production of 290,000 bushels of AA yellow corn at a sales price of \$5.00/bushel.

² Based upon production of 482,500 bushels of GM yellow corn at a sales price of \$5.50/bushel.

³ Based upon dollar opportunity costs in Table 2, with Fordham Estates producing 50,000 bushels of AA yellow corn at a sales price of \$5.00/bushel (\$250,000) and the remaining farms producing 432,000 bushels of GM yellow corn at a sales price of \$5.50/bushel (\$2,376,000).

⁴ Based upon production of 290,000 bushels of AA yellow corn at a variable cost of \$2.70/bushel.

⁵ Based upon production of 482,500 bushels of GM yellow corn at a variable cost of \$3.25/bushel.

⁶ Based upon Fordham Estates producing 50,000 bushels of AA yellow corn at a variable cost of \$2.70/bushel (\$135,000) and the remaining farms producing 432,000 bushels of GM yellow corn at a variable cost of \$3.25/bushel (\$1,404,000).

⁷ Based upon first prior year expenses listed in Exhibit 3.

The accounting analysis confirms that if GM yellow corn sells for \$5.50 per bushel, AA yellow corn would only be grown on the Fordum Estates farm; the remaining farms would grow GM yellow corn.

Scenario #2: Compares total CM of AA yellow corn to CM of GM yellow corn at a selling price of \$4.70 per bushel for GM yellow corn.

Table 5a. Contribution Margins per bushel under Scenario #2

Selling price per bushel AA corn	\$5.00
Variable cost per bushel AA corn	2.70
Contribution margin per bushel AA corn	\$2.30
Selling price per bushel GM corn	4.70
Variable cost per bushel GM corn	3.25
Contribution margin per bushel GM corn	\$1.45

Table 5b. Total Contribution Margins per farm under Scenario #2

Farm	Acres	AA yellow corn prod. @\$2.30/bsh	GM yellow corn prod. @\$1.45/bsh	Total CM AA yellow corn	Total CM GM yellow corn	Highest CM
Brookhurst Farm	200	20,000	22,000	<u>\$46,000¹</u>	\$31,900 ²	\$46,000
Fordum Estates	500	50,000	50,500	<u>115,000</u>	73,225	115,000
Gatos Peligo	300	60,000	90,000	<u>138,000</u>	130,500	138,000
Sally's Place	800	160,000	320,000	368,000	<u>464,000</u>	464,000
Belgrove Total	1,800	290,000	482,500	\$667,000	\$699,625	\$763,000

¹ This amount is derived by multiplying the quantity of AA yellow corn produced on Brookhurst Farm (20,000 bushels) by \$2.30 (the contribution margin per bushel of AA yellow corn).

² This amount is derived by multiplying the quantity of GM yellow corn produced on Brookhurst Farm (22,000 bushels) by \$1.45 (the contribution margin per bushel of GM yellow corn).

Table 5c. Income Data under Scenario #2

	AA	GM	Highest CM
Sales and changes in value of crop inventories	\$1,450,000 ¹	\$2,267,750 ²	\$2,154,000 ³
Cost of Production	\$783,000 ⁴	\$1,568,125 ⁵	\$1,391,000 ⁶
Selling, General, and Administrative Expenses ⁷	\$313,200	\$313,200	\$313,200
Technological Expenses ⁷	\$93,960	\$93,960	\$93,960
Other ⁷	\$11,745	\$11,745	\$11,745
Income from continuing operations before taxes	\$248,095	\$280,720	\$344,095

¹ Based upon production of 290,000 bushels of AA yellow corn at a sales price of \$5.00/bushel.

² Based upon production of 482,500 bushels of GM yellow corn at a sales price of \$4.70/bushel.

³ Based upon dollar opportunity costs in Table 3, with Sally's Place producing 320,000 bushels of GM yellow corn at a sales price of \$4.70/bushel (\$1,504,000) and the remaining farms producing 130,000 bushels of AA yellow corn at a sales price of \$5.00/bushel (\$650,000).

⁴ Based upon production of 290,000 bushels of AA yellow corn at a variable cost of \$2.70/bushel.

⁵ Based upon production of 482,500 bushels of GM yellow corn at a variable cost of \$3.25/bushel.

⁶ Based upon Sally's Place producing 320,000 bushels of GM yellow corn at a variable cost of \$3.25/bushel (\$1,040,000) and the remaining farms producing 130,000 bushels of AA yellow corn at a variable cost of \$2.70/bushel (\$351,000).

⁷ Based upon first prior year expenses listed in Exhibit 3.

This accounting analysis confirms that if GM yellow corn sells for \$4.70 per bushel, then only Sally's Place should produce GM yellow corn.

Q. 2. Using the client's production cost data (Exhibit 1), demonstrate the change in profits expected from the above production recommendation for the alternative potential selling prices of GM yellow corn.

1. Sales: Multiply the total output of each product by the price.

A. AA: $(290,000 \times \$5.00) = \$1,450,000$.

B. GM Scenario #1: $(22,000 + 90,000 + 320,000) \times \$5.50 + 50,000 \times \$5.00 = \$2,626,000$.

- C. GM Scenario #2: $(20,000 + 50,000 + 60,000) \times \$5.00 + 320,000 \times \$4.70 = \$2,154,000$
2. Cost of production: Multiply the total output of each product by the per bushel cost.
- A. AA: $(290,000 \times \$2.70) = \$783,000$.
- B. GM Scenario #1: $(22,000 + 90,000 + 320,000) \times \$3.25 + 50,000 \times \$2.70 = \$1,539,000$.
- C. GM Scenario #2: $(20,000 + 50,000 + 60,000) \times \$2.70 + 320,000 \times \$3.25 = \$1,391,000$

	AA Yellow	GM Scenario #1	GM Scenario #2
Sales and changes in value of crop inventories	\$1,450,000	\$2,626,000	\$2,154,000
Cost of production	\$783,000	\$1,539,000	\$1,391,000
Selling, General, and Administrative Expenses	313,200	313,200	313,200
Technological Expenses	93,960	93,960	93,960
Other	11,745	11,745	11,745
Income from continuing operations before taxes	\$248,095	\$668,095	\$344,095

Based upon the income from continuing operations before taxes as stated in Table 6, the production mix under scenario #1 will result in increasing profits by \$420,000 ($\$668,095 - \$248,095$). The production mix under scenario #2 will result in increasing profits by \$96,000 ($\$344,095 - \$248,095$).

Q. 3. Assuming the probabilities of alternative prices for GM yellow corn are as stated in Exhibit 5, calculate the expected change in profits from adopting our recommendation. (This is important since it can be used to justify our consulting fees.)

20xx expected profits: If there are alternative future scenarios, the expected profit is calculated as the sum of the probability of a scenario multiplied by the expected profits in that scenario.

In this case, the probabilities are 60% likely scenario #1 (GM yellow corn price = \$5.50) and 40% likely scenario #2 (GM yellow corn price = \$4.70). The expected profit is therefore: $(0.60 \times \$668,095) + (0.40 \times 344,095) = \$538,495$.

The percentage increase in expected profit is $[(\$538,495 - \$248,095) / \$248,095] = 117\%$

Q. 4. Okay, that's the economic analysis, but consider the nature of a family business and any strategic and ethical issues that might be important, and check with me. We want to make the right recommendation for the client.

This is an open-ended question. The instructor may invite the students to consider the nature of a family business, and the long run strategic and ethical implications of adopting the proposed new production of GM yellow corn.

Family business: A family business is subject to a number of unique potential problems. Family relationships may not translate easily into successful working relationships. Employment of family members may alter a successful management hierarchy. In this case, Kevin Thorp is a young business school graduate who is recommending a complete change of product. Robert Belgrove (his uncle) is the CEO with a more conservative viewpoint. Students may discuss the general problem in family businesses associated with the intergenerational differences in business philosophy and risk taking.

Strategic thinking: There are a number of ways to approach the issues of strategy that arise in the case. One approach is the Liedtka model. This model consists of five elements of strategic thinking – a system perspective; intent-focused; intelligent opportunism; thinking in time; and hypothesis-driven. The primary focus of strategic thinking is concerned with a creative and divergent thought process. Strategic thinking looks to the future. In this case, the students could analyze the five elements of strategic thinking in an attempt to develop strategies to deal with economic liabilities that may arise in the future.

Ethical considerations: Students may also evaluate the ethical issues related to the process of genetic modification. There are numerous approaches that are used to determine if one's actions are ethical. The most common of these approaches is the Stakeholder/Utilitarian Theory (maximize the net benefits to society as a whole, *i.e.*, the greatest good to the greatest number). Other theories include the Rights Theory (respecting and protecting individual rights); Justice Theory (fair distribution of benefits and burdens); Categorical Imperative Theory (looking at the results if everyone acted in the same manner); and the Front Page Test (reaction if the decision is reported on the front page of the local newspaper). To answer this question, instructors must provide students with a framework wherein they can analyze Belgrove's decision from an ethical standpoint. Obviously the instructor will prefer that the ethical discussion include the approaches discussed in his or her course.

Changing to genetically modified products may also involve some additional risks for the firm. Students might mention:

1. Product liability risk: If the new product causes problems for the buyers, then the firm may face product liability lawsuits.
2. Brand name damage: Consumers may be unsure which product they are receiving if the firm produces any GM yellow corn. If there is concern about GM products or if real problems arise, the firm's brand name may be associated with the GM problems, leading to less demand for the firm's products.
3. Changing government regulations: Public concern may lead to changes in government regulations of the production and sale of the GM products. This may affect future costs or revenues.
4. Other costs may in fact change as two products, AA yellow corn and GM yellow corn, are produced. Two products create more complexity which may drive up administrative costs.

THE MISSING INVENTORY AT ZENITH INTERNATIONAL TRUCKS, INC.

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

CASE DESCRIPTION

This case was primarily developed for undergraduates taking a course in business ethics, although the case does include issues in accounting (inventory control) and the legal environment of business (corporate theft). The case specifically deals with how a firm handles the discovery of possible corporate theft and students should therefore have been exposed to material on white-collar crime. The case also deals with possible conspiracy to commit a crime (the RICO act) since one might wonder why and how the inventory control system did not indicate missing inventory prior to this time period. The case has a difficulty level appropriate for sophomore level or above. The case is designed to be taught in one class period (may vary from fifty to eighty minutes depending upon instructional approach employed, see instructor's note) and is expected to require between two to four hours of outside preparation by students (again, depending upon instructor's choice of class preparation method).

CASE SYNOPSIS

Derived from observation and field interviews, this case centers on Bob Harris, the new Assistant Controller of Zenith's parent company, United Truck Corporation, and Dave Manning, the Service Manager of the Yonkers facility. Bob Harris had been brought into Zenith by United Truck Corporation¹ because the old operation, Magnum International Trucks, was losing money and United wanted the renamed firm (Zenith) attractive enough for a sale to another International dealership. Dave Manning first came to Bob Harris' attention when Dave was paid a bonus incentive for the month yet the Yonkers Service Department only contributed \$ 2,484.42 to the firm's profit margin. Bob spoke with Dave and explained that Dave's bonus would in the future be based upon the facility's profits rather than gross sales. This would avoid the impact of heavy sales at the end of the month and returns the following week. Dave remained silent on this topic. The second time Dave Manning was confronted by Bob Harris was when there was a short fall in inventory at the Yonkers facility based upon a misplaced transmission. Bob confronted Dave in-person with this discrepancy

and therein Dave resigned. Students are left wondering what actions should or would Bob Harris take in light of this missing inventory and Dave's obvious attempts to avoid be held accountable for said items.

INSTRUCTORS' NOTES

In an article in *Entrepreneur*, the author noted that nothing has changed in the post Enron era. "Lying and dishonesty simply have become a much more accepted part of business – and of American life. ... Greed still rules the day." (Kurlantzick, 2003, p. 71) Yet the lack of legal, no less moral, behavior extends not only to an individual's own materialism and avarice but has become so rampant as to have created "an engrained tolerance of [others'] lying and bad behavior." (Ibid) We have come to not only expect illegal and immoral business behavior, but to in fact accept it.

Learning Objectives

The overall purpose of this case is to have students examine two critical and interrelated issues; the uncovering of a potential white collar crime and the role of investigative accounting. This case in particular has practical value to students since many of them may find that they as general employees, supervisors, or managerial accountants may encounter similar situations. Students are asked to probe beyond personalities and the immediacy of the moment and examine the underlying nuances of the posed problem.

Specific learning objectives are as follows:

- ◆ for students to understand the legal and moral obligations of uncovering possible white-collar crimes.
- ◆ for students to recommend actions that the Assistant Controller should take in light of Dave Manning's resignation relative to Dave Manning.
- ◆ for students to make recommendations about the firm's inventory control system.

Teaching Strategies

Preparing the Student Prior to Case Analysis

There are several approaches, none of which are mutually exclusive, that an instructor may employ in terms of utilizing this case. It is strongly recommended that regardless of the specific methodology employed, that students prior to reading this case be exposed to some material on inventory control systems and corporate theft. (See Reference section.) This will provide students

with the proper perspective and allow them to acknowledge some of the legal, ethical, and managerial issues embedded in the case.

This conceptual framework may be delivered prior to assigning the case by using at least one (1) of the follow methods:

- ◆ a short lecture and/or discussion session on the above noted topics.
- ◆ a reading assignment prior to reading the case that covers several of the topics mentioned.
- ◆ a short student presentation on each topic.
- ◆ a guest lecturer on one of the topics.

Traditional Case Method

In the traditional case method, the student assumes the role of a manager or consultant and therein takes a generalist approach to analyzing and solving the problems of an organization. This approach requires students to utilize all of their prior learning in other subject areas as well as the field of management. This case, in particular, will also require students to draw upon their knowledge of leadership, structure, culture and systems thinking. It is strongly suggested that students prepare for the case prior to class discussion, using the following recommendations: allow adequate time in preparing the case, read the case at least twice, focus on the key strategic issues, adopt the appropriate time frame, and/or draw on all your knowledge of business. (Pearce and Robinson, 2000)

The instructor's role in case analysis is one of a facilitator. The instructor helps to keep the class focused on the key issues; creates a classroom environment that encourages classroom discussion and creativity, bridges "theory to practice" by referring back to key concepts learned in this or prior courses, and challenges students' analyses in order to stimulate further learning and discussion. There are several variations of the aforementioned approach including written assignments, oral presentations, team assignments, structured case competitions, and supplemental fieldwork. Regardless of the variation employed, it is recommended that the students' work be evaluated and graded as partial fulfillment of the course's requirements.

Research/Web Assignment

This is certainly not the first situation ever reported dealing with potential employee theft and therefore students should be able to search the web to find similar circumstances and cases dealing with employee theft, in particular stealing inventory from the firm. Have students research this topic in general and in particular theft in the automotive industry. The following web sites and articles may be of particular assistance:

“Dealing with Employee Theft” http://www.findarticles.com/p/articles/mi_m1038/is_n3_v32/ai_7739141.

“Theft <http://en.wikipedia.org/wiki/Theft>.”

Paul H. Carr (1988). Extra eyes mind the store while owner's away. *San Antonio Business Journal*.(Oct 31) 2(41); Sec. 1. 1.

SUGGESTED QUESTIONS AND ANSWERS

The following questions may be employed by the instructor either as guidelines for the instructor for case analysis and/or as questions to be distributed to the class in conjunction with the case. This methodology provides the instructor some latitude in terms of how much direction he or she wishes to provide the student and therein allows the instructor to modify the difficulty of the case to fit his or her class’s needs. The questions are divided by topics.

1. Describe the legal aspects of theft, and conspiracy to commit a crime (the RICO act).

The purpose of this question is to provide students appropriate background to the case by allowing students the opportunity to determine the legal definitions of theft and conspiracy.

Theft and RICO are categorized as white collar crimes and “both state and federal legislation enumerate the activities that constitute white-collar criminal offenses. The Commerce Clause of the U.S. Constitution gives the federal government the authority to regulate white-collar crime, and a number of federal agencies (see sidebar), including the FBI, the Internal Revenue Service, the Secret Service, U.S. Customs, the Environmental Protection Agency, and the Securities and Exchange Commission, participate in the enforcement of federal white-collar crime legislation. In addition, most states employ their own agencies to enforce white-collar crime laws at the state level.” (Anonymous (n.d.). White ‘c’ collar crime ...)

Theft. Generally, a person commits the crime of theft of property if he or she:

- ◆ Knowingly obtains or exerts unauthorized control over the property of another, with intent to deprive the owner of his or her property;
- ◆ Knowingly obtains by deception control over the property of another, with intent to deprive the owner of his or her property; or
- ◆ Knowingly obtains or exerts control over property in the custody of a law enforcement agency which was explicitly represented to the person by an agent of the law enforcement agency as being stolen.

Without proof of intent to deprive, no criminal act has occurred. There must be an element of dishonesty which may be revealed from the words or actions of the perpetrator. In California, the Supreme Court has held that proof that a defendant intended to take property only temporarily, but for so extended a period of time as to deprive the owner of a major portion of its value or enjoyment, satisfies the intent element of a theft prosecution in California.

A person commits the crime of theft of services if:

- ◆ He intentionally obtains services known by him to be available only for compensation by deception, threat, false token or other means to avoid payment for the services; or
- ◆ Having control over the disposition of services of others to which he is not entitled, he knowingly diverts those services to his own benefit or to the benefit of another not entitled to such services.

Theft is often classified into degrees of misdemeanors or felonies carrying varied penalties according to the value of the item stolen. State laws vary, so local laws should be consulted for the specific requirements in your area.

Relevant legal forms include:

- ◆ Jury Instruction - 3.2 Civil Theft Jury Instruction - Theft Of Government Money Or Property Jury Instruction - Theft Or Embezzlement By Bank Employee Jury Instruction - Theft From Interstate Shipment Jury Instruction - Theft Of Mail Matter Jury Instruction - Theft Or Receipt Of Stolen Mail Matter Jury Instruction - Theft Of Mail Matter By Postal Service Employee AOC-CR-142; Warrant for Arrest - Felonious Financial Transaction Card Theft/Financial Transaction Card Fraud (Felony/Misdemeanor) - Revised 8-97 AOC-CR-152; Indictment - Financial Transaction Card Theft/Financial Transaction Card Fraud Certificate of Identity Theft: Judicial Finding of Factual Innocence Casualties, Disasters, and Thefts Sample Letter - Hotel Room Theft.” (Anonymous (n.d.). Theft law and legal definition.)
- ◆ Theft is also known as *larceny*. “Illegal taking and carrying away of personal property belonging to another with the purpose of depriving the owner of its possession.
- ◆ The wrongful and fraudulent taking and carrying away by one person of the mere personal goods of another from any place, with a felonious intent to convert them to the taker's use and make them his property without the consent of the owner.
- ◆ To constitute larceny several ingredients are necessary. The intent of the party must be felonious; he must intend to appropriate the property of another to his own use. If the accused have taken the goods under a claim of right, however unfounded, he has not committed a larceny.
- ◆ There must be a taking from the possession, actual or implied, of the owner; hence if a man should find goods and appropriate them to his own use, he is not a thief on this account.

- ◆ There must be a taking against the will of the owner and this may be in some cases where he appears to consent; e.g., if a man suspects another of an intent to steal his property, and in order to try him, leaves it in his way and he takes it, he is guilty of larceny. The taking must be in the county where the criminal is to be tried. But when the taking has been in the county or state and the thief is caught with the stolen property in another county than that where the theft was committed, he may be tried in the county where arrested with the goods, as by construction of law, there is a fresh taking in every county in which the thief carries the stolen property.
- ◆ ... Larceny is divided in some states into grand and petit larceny depending upon the value of the property stolen.” (Anonymous (n.d.). Larceny. *The 'Lectric Library's Lexicon On*)
- ◆ Conspiracy to commit a crime (the RICO act). “The RICO Act was passed by the United States Congress to enable persons financially injured by a pattern of criminal activity to seek redress through the state or federal courts. The RICO Act applies to a wide variety of crimes. Originally, the breadth of the RICO Act was intended to give law enforcement, and private persons, broad power to fight organized crime, whether “organized crime” was traditional mobsters, members of a drug ring, or gangsters. The RICO Act has over time, however, resulted in unforeseen applications.
- ◆ For example, corporations have been sued under the RICO Act for allegedly distributing false advertisements; lawyers, bankers, accountants, and other professionals, have been sued under the RICO Act for allegedly assisting clients in organizing, or assisting in the organization of, schemes to defraud; spouses have been sued for allegedly concealing the value of marital assets in divorce proceedings; and, civil protest groups have been sued for intimidating and extorting the customers of the industries that the protest aimed to disrupt. Although Congress may not have intended these more unusual applications of the RICO Act, they can be legitimate uses of the RICO Act.

If you have been injured by a violation of the RICO Act, you may sue the person who allegedly violated the Act and, if successful, recover a monetary award equivalent to three times the value of the property you lost or that was stolen from you, plus the legal costs and fees you incurred to bring the lawsuit.” <http://www.lectlaw.com/def/a142.htm>, September 29, 2003.)

2. How might theft (larceny) and conspiracy to commit a crime apply to this case situation?

This question deals with the application of the legal definitions found in question 1 with the case situation. Students are asked to examine the facts of the case and see if there is clear cut evidence of larceny and a conspiracy to commit a crime.

Students may note that there seems to be enough evidence to warrant a further investigation for possible larceny by Dave Manning or others working in the Yonkers facility since auto parts that were signed for by Dave Manning were not in inventory. The key to this question is that the explanation for the missing inventory may be due to several mitigating factors not explored in the case including a poor inventory control system (the parts are somewhere in the shop but we do not know where), a poor job control system (we used this part already but have not deleted it from our inventory), and theft by others besides Dave Manning. Dave's resignation, however, is quite suspicious and students might believe that "if there is smoke, there is fire." Again, nothing in the case would point to Dave Manning's theft of goods.

Conspiracy may be far more difficult to prove although students should certainly wonder how the Yonkers operation continued to lose money and why goods were unaccounted for by the accounting department at the Yonkers facility. For example, students might feel that June in accounting was covering for Dave but felt the need to report a large discrepancy to Bob Harris since the smaller ones could easily be covered up as accounting errors which Bob did not seem overly eager to investigate. Or, students might hypothesize that Dave and/or others in the facility working together (or even with outsiders) in order to steal parts. Again, other factors may serve as alternative explanations including that Dave was acting alone based upon his reaction to the change in the bonus system.

3. What are the legal and moral obligations for uncovering white-collar crimes such as larceny?

This question asks student to perform two separate analyses: one, to determine the firm's legal responsibilities relative to uncovering white collar crimes; two, to determine the firm's moral responsibilities as well.

From a legal perspective, students may indicate that once a crime is suspected of being committed, that is a crime has been reported by an employee to an appropriate officer or manager of the firm, that an investigation is warranted to determine if in fact a crime had in fact been committed. Lack of proper due diligence might be construed as aiding and abetting a potential felon and therein becoming an accessory after-the-fact.

An accessory to a crime after the fact. An accessory is one "who is not the chief actor in the perpetration of the offence, nor present at its performance, but is some way concerned therein, either before or after the fact committed. ... An accessory after the fact, is one who knowing a felony to have been committed, receives, relieves, comforts, or assists the felon."

(<http://www.lectlaw.com/def/a142.htm>, September 29, 2003.) “Accessories after the fact are in general punishable with imprisonment (with or without hard labor) for a period not exceeding two years, but in the case of murder punishable by penal servitude for life, or not less than three years, or by imprisonment (with or without hard labor) to the extent of two years.” (<http://www.1911ency.org/A/AC/ACCESSORY.htm>, September 29, 2003.)

Three points need to be met under this law:

- ◆ Must have knowledge that a felony has been committed.
- ◆ Must aid or assist the felon in some way.
- ◆ The purpose of the aid must be to help the felon escape from the authorities. (http://www.lawnerds.com/testyourself/criminal_rules.html#Accessory, September 29, 2003.)

Using agency theory, students would indicate that managers, as representatives of the stockholders and/or owners, have both a moral and contractual obligation to investigate any alleged white collar crimes committed in the firm. They might also extend this argument to society in general, arguing that it is a citizen’s moral obligation to report a crime and to assist law enforcement officials to enforce the law. (Anonymous (n.d.). “Agency theory framework”.)

4. If you were Bob Harris, what short term actions would you take in light of Dave Manning’s resignation and the missing inventory?

This question focuses students on the key decision point of the case – what should you do when you question someone about missing inventory and he tenders his resignation? By being placed in Bob Harrison’s position, students are therein requested to develop a solution strategy, one that will deal with the short term problem of accounting for the missing inventory.

The students should recognize in this question several mitigating factors that may muddy their analyses:

- ◆ Dave Manning has not been accused of stealing any inventory and there is currently no evidence directly linking the missing inventory to Dave Manning.
- ◆ The missing transmission had not been located.
- ◆ It has been noted that historically there has always been some inventory missing, but never an item of this magnitude or cost.
- ◆ Dave Manning’s reasons for resigning were never enumerated (including the change in the bonus system).

Students may therefore recommend several short-term actions to be taken, some simultaneously. These actions may include:

- ◆ Investigating the missing transmission beyond merely tracking the paper trail. This would include interviewing all of the parties who had direct contact with the transmission besides Dave Manning (i.e. the person Dave would normally hand the transmission over to, mechanics who may have used the transmission) and checking the work orders to see if there were any repair jobs that would have used a similar transmission. A determination should therefore be made as to the possible whereabouts of the transmission, including whether or not it could have been stolen.
- ◆ Having an exit interview and debriefing session with Dave Manning. The purpose of this interview would be to provide Dave Manning the opportunity to explain why he suddenly decided to leave and to specifically have him address the issue of the missing transmission. He should also be informed at this meeting that an investigation is being conducted to locate the missing transmission and that his assistance would be greatly appreciated. Many students may perceive this action as superfluous since they might assume that Dave is “guilty until proven innocent.”

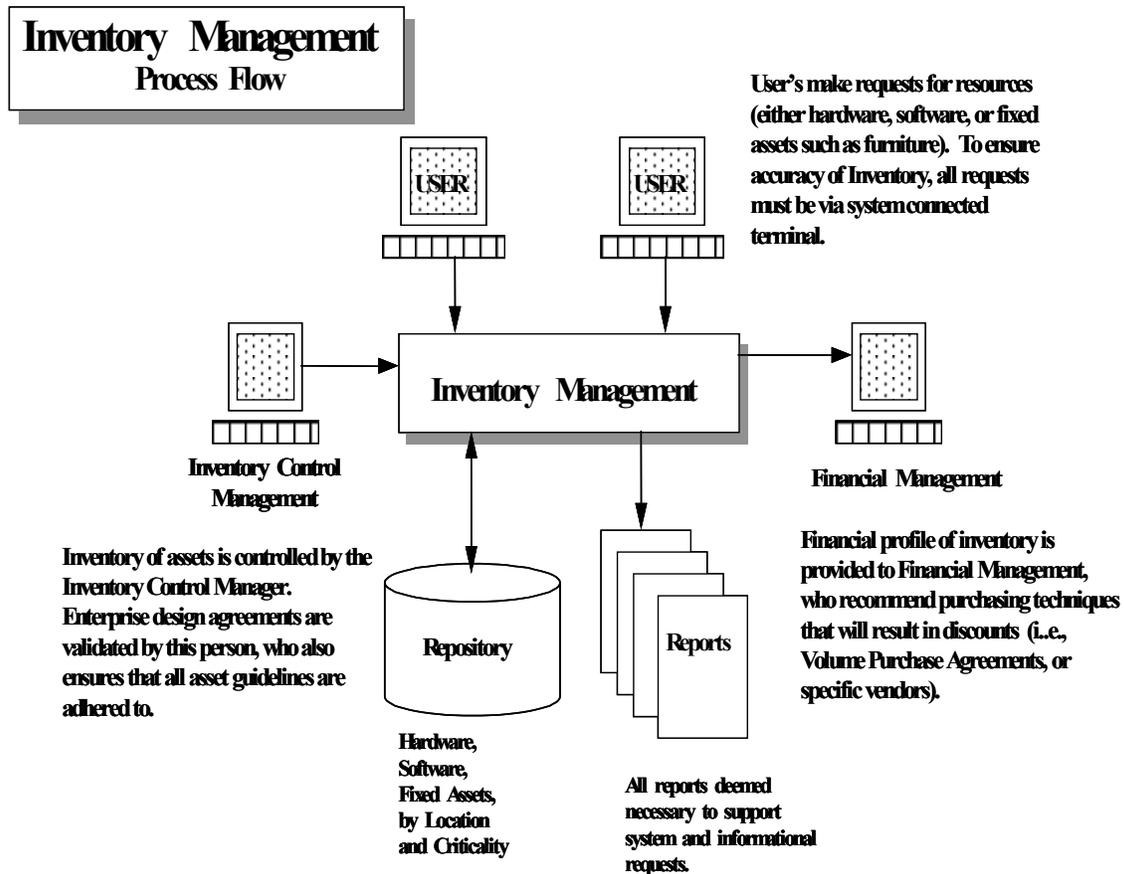
If the results of this investigation indicate that the missing transmission was stolen by Dave Manning this may lead to a further investigation of the entire missing inventory. The firm may also contact Dave Manning indicating the findings of their investigation with a request that he return the item in question or pay the firm the equivalent value of the item. The firm may also opt to report the findings of their investigation to a local and/or federal prosecuting attorney (file a complaint) in order to start a criminal investigation into the matter.

5. What longer term recommendations would you have for Bob Harris relative to missing inventory?

This question asks students to address the underlying problem of this case, the firm having a poorly designed and/or implemented inventory control system (tied into their accounting system) which therein made it easier for employees to possibly pilfer inventory.

Students should respond to this question by first defining inventory control or inventory management. Inventory Management is an enterprise-wide discipline concerned with the identification and tracking of raw materials and information from acquisition through usage (including waste). The information system might work as follows:

Overview of an Integrated Inventory Management System (Bronack, 2001)



Many students would also suggest using inventory control software. “Inventory control software is the central hub for any inventory-centric business. This type of software keeps track of all information about the items your company builds, buys or sells. Inventory control software also makes the management of pricing and maintaining stock levels much easier and more organized.

6. Why Do You Need Inventory Control Software?

No matter what size your company is, you need to accurately track inventory and sales to maximize your profitability. Maintaining profitable and competitive stock levels used to be an art, but with inventory control software it becomes an exact science.

Effective inventory management allows you to have the strong selling products on hand when customers demand them. It also helps identify slow moving products so you can reduce the cost associated with being “stuck” with products no one wants.

Inventory and the costs associated with storing inventory are major expenses. With careful control the quantity of inventory can be reduced saving funds. This allows for a reduction in warehousing costs associated with housing products.

Inventory control software will help you take charge of your stock levels and prevent inventory costs from consuming too much of your budget. Reductions in inventory levels—whether raw material, work-in-process, finished goods or supplies—can have a remarkable effect on your bottom line.

Inventory control software can:

- ◆ Link product item numbers with descriptions, prices, costs, and other important data
 - ◆ Track historical inventory purchase costs
 - ◆ Control reductions in inventory investment and in associated warehousing costs
 - ◆ Track vendor pricing and historical delivery time for purchased goods
 - ◆ Trace customer backorders and vendor purchases yet to be delivered
 - ◆ Convert different units of measure purchased verse sold
 - ◆ Associate internal item numbers with vendor product numbers
 - ◆ Provide detailed descriptions of inventory items
 - ◆ Record prices and complete break down of related production costs
 - ◆ Manage stock effectively and efficiently
 - ◆ Help eliminate loss from theft and inaccurate record keeping
 - ◆ Analyze trends in the movement of product to adjust your purchasing and sales
- Industry-specific inventory control software may:
- ◆ Track sales of items that don't reduce inventory (such as rentals and service)
 - ◆ Track dimensional inventory such as lumber or scaleable inventory that is sold by weight
 - ◆ Utilize multiple units of measure for items that may be purchased in bulk quantities but sold in various ways such as by the box, crate or individually.
 - ◆ Track purchases and sales of serialized inventory

Specialized Inventory Needs

Many industries have unique inventory needs. Not all inventory control software provides these features therefore careful consideration must be given to assure that the

software meets the needs of your firm. A few examples of specialized requirements from inventory control software are below.

Serial Number Control. Firms may assign a serial number to various inventory items. That serial number provides a mechanism to allow for proper tracking of warranty work on the specific product. Serialized products typically are identified to the product owner thus simplifying contact with owners when product recalls are needed. If your organization uses serial numbers, be sure to ask about the inventory control software's ability to track them before purchasing.

Lot Control. Those in the food and pharmaceutical industry assign lot numbers to segments of their product runs. These lot numbers are then associated with customer invoices. Lot control helps these industries determine where products are located in order to act quickly in the case of a health related hazard with the products. If you work for a pharmaceutical company (or similar firm) you'll want to question your inventory control software representative to be sure lot control is a feature that comes standard or can be added.

Kits or Assemblies. A kit or assembly function acts a quasi bill of material. This inventory feature is used when a firm aggregates various individual products into a "kit" which is then sold. Typically the components in a kit can be sold individually or as part of the saleable kit. Does your business sell kits or assemblies in addition to individual parts? Make sure your inventory control software is capable of handling this specialized need.

With inventory control software you can:

- ◆ Minimize inventory investment, through smaller shelf quantities
 - ◆ Implement just-in-time ordering to ensure items are rarely out of stock or overstocked
 - ◆ Reduce warehousing cost as a result of reducing inventory stock levels
 - ◆ Reduce administration time through automatic reordering based on movement
 - ◆ Improve profits by assuring strong selling items are in stock
 - ◆ Improve profits by identifying slow moving items and reducing on-hand quantities of those
 - ◆ Spend less time counting and tracking with real-time data – items sold are instantly subtracted from inventory upon completion of a transaction
 - ◆ Reduce purchasing costs with up-to-date supplier lead times and vendor price comparisons
 - ◆ Increase sales by providing alternate products that sales people can recommend if the initial item requested is not in stock
 - ◆ Increase sales by providing flexible customer pricing based on the customer, order size, frequency of orders, etc.
- Inventory control software often integrates with:
- ◆ Order Entry

-
- ◆ General Ledger
 - ◆ Purchase Order
 - ◆ POS
 - ◆ E-commerce
 - ◆ MRP
 - ◆ Bill of Materials
 - ◆ Work Order” (Anonymous (n.d.). “A guide to inventory control software.” *CPA Online*.)

In terms of the firm in the case, inventory can be tagged with a UPC code and scanned into an inventory accounting information database. The individual item is scanned each time it moves: from the receiving area to the storage warehouse, from warehouse receiving to its storage location, from its storage location to the mechanic’s work bay, and from the work bay into the vehicle. From an accounting perspective, the inventory would be entered onto the books once it is received and stored, and deleted from the inventory once it is placed in the vehicle and billed to the customer.

EPILOGUE

Bob called Dave at his home and told him he accepted his resignation. Over the next three months, the Company’s operations continued with very little internal problems. Bob spent less time at the facility due to other dealerships’ needs. He flew in every other week. During that time, there were talks of a potential buyer taking over the dealership, and as a result more attention was focused on closing the deal rather than the operations of the dealership. One final step was a physical inventory count for both locations to measure shrinkage. The physical inventory count at the Yonkers facility showed a loss of approximately sixty thousand dollars, which was considered very high and suspicious. The Maspeth facility had a loss of approximately ten thousand, which was considered normal.

Due to the inventory shrinkage amount in the Yonkers facility, United Truck Corporation sent their head of security to inspect the Yonkers facility for any questionable inconsistencies. This was a standard policy for United. The head of security ran various tests on the facility from fingerprints on the computers and desks as well as hair samples in the bathroom. The samples tested positive for cocaine and marijuana. The hair samples provided a positive identification to Dave Manning. Although Dave Manning was not brought up on criminal charges for stealing the inventory, he was arrested for drug possession, unrelated to Zenith, a few months after the initial incident occurred between Bob and him. Zenith International Trucks remained in existence until January 2004. At that time the dealership was bought by USA International, Inc. The Yonkers facility was closed and the employees from that location either moved to the Maspeth Office or resigned.

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ENDNOTE

¹ The names of the characters and the firm have been disguised.

SOUTHWEST AIRLINES: THE NEXT FIGHT BEGINS

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CASE DESCRIPTION

This case was developed through the use of secondary research material. The case has a difficulty level of five and is appropriate to be analyzed and discussed by advanced undergraduate and graduate students in a strategic management class.

The case allows the instructor the flexibility of concentrating on one strategic issue, or as a means of examining the entire strategic management process. The major focus within the strategic analysis as well as excellent stand alone modules is in the area of legal/political influence, economic, leadership succession, or the ability to survive in an unattractive industry. The instructor should allow approximately one class period for each element addressed. Using a cooperative learning method, student groups should require about two hours of outside research on each element researched. The case also provides an impetus to explore a very successful company during the current extreme economic downturn.

CASE SYNOPSIS

This case is a library, popular press and internet case which examines Southwest Airlines—a frequently examined company, yet one facing new challenges in the current economy. The review of annual reports, trade journals, government documents and proposed and enacted regulations must be accomplished carefully. While most students have a general understanding of the airline industry, few have the current knowledge to compare this industry against more traditional operations. A review of these resources should lead students in determining the future of the company and the current CEO, Gary Kelly.

INSTRUCTORS' NOTES

The information available in both the written case as well as outside research material provides a thorough platform for students to conduct a complete strategic analysis of Southwest Airlines as well as discussion of various select elements of that model. Provided in this note are the highlights of each element of the strategic management model.

General Environment

There are numerous issues that can be explored within the general environment. This level of the external environment will provide opportunities and threats that must be faced by all firms. In light of the fact that the issues arising from this level of the external environment are out of the control of individual firms, it is critical to position a firm to grasp emerging opportunities as well as avoid potential threats.

From a historical perspective, the legal/political environment was at the forefront. There had been tremendous influence of government agencies and their influence on competition within the industry. While considerable pressure was removed with the Airline Deregulation Act of 1978, the industry remains heavily regulated in other areas such as FAA, EPA, FCC as well as state and local agencies. The most recent impact of regulation is found with increased security measures as a result of 9/11.

T—Highly regulated industry

The price of fuel is an issue that can be broached in several areas of the general environment. This commodity being a limited resource and being controlled by numerous parts of the world less friendly to the U.S. has created concerns for any energy dependent industry.

An additional concern faced by all carriers is the impact of climate. The firms most often impacted are those that depend on flights in the northern tier of the country. While this once was a major opportunity for Southwest when its route structure was primarily limited to the southwest, its national expansion has exposed the company to delays in some of the major airports it currently serves.

T—Limited natural resource of fuel

T—Political instability in oil rich nation providers

T—Severe winter weather

At the forefront of any discussion of the general environment must be the economy. The economic downturn has resulted in several areas of concern for airlines—slow down in general business activities (thus less business and leisure travel), reduction in disposable personal income (less leisure travel), more difficult credit availability, and lack of confidence in the market.

T—industry is negatively impacted by downturns in the economy

The social force within the general environment also offers fertile ground for discussion. Students should tie in the economic hard times with a more cost conscious consumer, as well as measuring the impact that airport delays due to enhanced security have had on a time poor society.

T—Cost conscious consumer

T—Time poor society

While few discontinuous changes have occurred for technology within the airline industry, there have been some major incremental advances that have been geared toward increased efficiency—new fuselage designs such as sweepback wings, advanced aviation systems, and information systems modifications. Southwest Airlines has advanced many in the hopes of increased cost savings.

O—Aviation and IT systems technological advancements

INDUSTRY ENVIRONMENT

An industry is defined as the group of competitors that produce similar products or services that satisfy the same basic consumer need. In this analysis of the airline industry, the framework made famous by Michael Porter—the five force analysis is used to determine opportunities and threats impacting firms within the industry. According to Michael Porter, the attractiveness of an industry can be gauged by examining the influence of five specific forces: the threat of new entrants into that industry; the power of suppliers; the power of buyers; the threat of substitute products; and usually the fiercest—the rivalry of existing firms.

Each one of these forces addresses a basic issue. The threat of entry seeks to determine how difficult it is for other firms to enter the market. The power of suppliers and buyers is used to determine who holds an upper hand in the relationship between buyers and sellers. The threat of substitute products is used to determine if some other product/service outside of the industry offers a product/service that could be used by the consumer to meet the basic need of a product/service and in so doing set the price ceiling a firm can charge. Finally, the rivalry of the existing firms is a means of determining how competitive the industry. The combined pressure from these five forces determines the attractiveness, thus profit potential, of the industry.

Threat of New Entrants:

To determine how difficult it is to enter a particular industry, several areas can be examined. The threat of new entrants within an industry is dependent on capital requirements, access to distribution channels, government regulations, economies of scale, and the retaliation of existing

firms within the industry. A careful analysis of these issues clearly points to the fact that it will be very difficult for any firm to enter at the scope level maintained by the major airlines. Some opportunities exist (which explains the numerous national and regional participants) to compete at a lesser level.

Support for the position made by Michael Porter that government policy has the potential for being the highest barrier to entry can be found in this industry. Prior to the passage of the Airline Deregulation Act of 1978 (between the years 1938-1978) no new major carrier entered the market. After deregulation, the industry has experienced hundreds of entries even with the other existing barriers.

O—High barriers to entry

Power of Buyers:

The power of buyers within an industry is reliant on several factors including the relative amount of switching costs, the differentiation of products offered by the industry, amount of information available to buyers, and the volume of buyer purchases.

Buyers exert moderate to high control over firms within the airline industry. Minimum switching costs (short of the frequent flyer programs offered by most carriers), and access to considerable online information regarding flights, prices, and service performance makes buyers much more savvy. In addition, the business class customer when seen as a single buyer group can influence the airlines through their buying power.

T—Strong buyer power

Power of Suppliers:

The power of suppliers within an industry is comprised primarily of the number of suppliers, the differentiation of their products, the availability of substitutes, and the amount of switching costs required moving between suppliers. There are three primary supply groups found within this industry—airframes, fuel, and specialized labor (pilots). Each of these has the potential of exerting considerable pressure within the industry.

As discussed within the case, fuel is the highest of the costs associated with running an airline. It has consistently been the most difficult to manage due to the limited ability to influence pricing by individual firms. Many firms have elected to engage in hedging activities to offset the uncertainty of prices.

Availability of supply sources for airframes is also limited. Boeing and Airbus are the two main choices. Even though Airbus has made some strides in the U.S. market in recent years, Boeing still remains the leader.

Because of the specialized skills required by pilots, some consider them another important supply group. Due to the expansion of national and regional carriers, availability of this supply has increased with more pilots getting the opportunity to accumulate necessary flight hours, and salary growth has increased at a much slower rate.

T—Powerful Suppliers

Threat of Substitute Products:

The threat of substitute products for an industry is mostly dependent on whether there are products/services external to an industry which meet the basic need of a consumer and set the price ceiling for a product. Except for some firms, there has been limited pressure from substitute products in the past. Southwest Airlines is one that had greater pressure during its earlier years when average flight lengths were just over 400 miles. The substitute product they competed against was driving and their pricing strategy clearly took this into account. Now with average flights being over 800 miles there is considerably less pressure.

The only main change in the last five years has been the additional time involved in flying—earlier arrival requirements as long delays due to security measures. On short flights (and SWA still has many) the “price” of time needs to be taken into consideration.

Rivalry of Existing Firms:

The rivalry of existing firms is impacted primarily by the growth of the industry, the number of firms in the industry, the exit costs to leave the industry, and the storage costs for firms within the industry. Most will agree that this is usually the force creating the greatest concern in that it measures the competitiveness of the industry.

Because of the equally balanced firms in the industry coupled with slow growth since 2001 and the high fixed costs the airline industry has been characterized as an extremely competitive industry. This imperfect oligopoly has been dominated (in terms of market share) by only a handful of firms in pre deregulation, post deregulation and even now. Currently there are seven firms holding over 80 percent of the market share.

Another event should be addressed when examining the competitors under this force—mergers and acquisitions. The most recent combination of the two previous independent giants Northwest and Delta should have all firms in the industry nervous. This merger has created the largest airline in the world with considerable route coverage without redundancy of operations.

T—Highly competitive industry

Review of the five forces above provides a clear understanding of why the performance of the industry has been dismal over the last 3 decades—the industry is unattractive. The greatest defensible position that exists for the company is the extremely high barriers to entry for any firm wishing to compete at the scope level that Southwest Airline or the other major airlines compete at.

ORGANIZATIONAL DIRECTION

Company Vision:

“The mission of Southwest Airlines is dedication to the highest quality of customer service delivered with a sense of warmth, friendliness, individual pride, and Company Spirit.”

It is very clear that the purpose of the company centers on satisfaction of the customer and the delivery system in providing a high level of service—the employee. The core values that drive this purpose—customer satisfaction, employees, efficiency, and an enjoyable work environment are strong and supported by the day-to-day operations of the firm.

While specific published goals and objectives are difficult to find for the company, there are many outcomes that can be inferred by the actions of the company. Some of these outcomes include: expanding its geographical coverage within the U.S. into other profitable markets; have low turnover; maintain high customer satisfaction ratings; maintain efficient operations (the lowest costs in the industry); and achieve high returns for its shareholders. Support that Southwest has consistently met these goals is easy to find in published material regarding the company.

STRATEGY FORMULATION

Corporate Level Strategy:

Southwest Airlines has consistently pursued a corporate level strategy of internal growth—more city pairs, more equipment, more employees and some additional product lines (i.e. vacation packages, freight, general travel arrangements). Planned expansion through external growth using joint ventures with WestJet to serve Canada and Volaris to serve Mexico should be finalized in early 2009.

To date, the corporate level strategy followed by Southwest has been successful. Recent concerns have emerged regarding whether the company can continue to grow while maintaining the unique corporate culture with over 35,000 employees nation wide.

Business Unit Level Strategy:

The business unit level strategy being pursued by Southwest Airlines is open for considerable interpretation and will generate considerable debate within the classroom. On the surface, the strategy most pontiffs will apply to SWA is low-cost and in some circles low-cost niche. Those espousing low-cost industry wide generally come to this conclusion based upon the ruthless efficiency that the company is best known for. Those suggesting low-cost niche point to the original regional coverage beginning. Still others will argue for a combination strategy industry wide. Support for this last position is provided below.

One of the first areas to be examined when determining a firm's business unit level approach is the product/service being offered. Lo-cost firms generally offer a generic, standardized, no-frills product. For the leisure traveler SWA's offerings are just that. However, to the business traveler what is considered high quality to many is the option of having many flight choices that are frequent and leave and arrive on time—a recognized characteristic for the company. Gary Kelly confirmed this approach by suggesting “We offer a no-frills product at a great price with high customer service”.

Operationally, SWA maintains the lowest costs in the industry but accomplish this without sacrificing quality to the business travelers. The company has historically had one of the youngest fleets in the industry. The youth of the fleet has resulted in more efficient aircraft in terms of operational costs and allows for fewer delays as a result of less mechanical issues. In addition, due to the fact that the company uses only one type of aircraft (Boeing 737) maintenance quality and costs can be maintained at lower levels. Further, the Boeing 737 requires a cockpit crew of two rather than three as used for some aircraft again lowering operational expense without deteriorating the differential value.

Human Resource Management is another area where a combination strategy can be supported. As mentioned in the case the company is mostly unionized and pays one of the highest salary levels in the industry all pointing to differentiation. Where the company saves in terms of labor costs are in the area of lower retraining due to low turnover and the willingness of employees to put in additional hours for the company. Many will say they do this due to their loyalty to the company as well as their involvement in profit sharing. As mentioned above, savings are also garnered with less training required in the pilot and maintenance areas since it is limited to one type of aircraft.

The same approach can be applied to several other areas within the value chain for Southwest. A few of these include: lower airport fees due to operating in many smaller airports; being very selective and effective with its advertising expenditures; investing significantly in technology that has resulted in costs savings; a lean and efficient organizational structure. None of these areas create a negative view of the product offering.

STRATEGY IMPLEMENTATION

Several areas are often examined to determine if there exist any constraints that might prevent a company from effectively implementing their strategies. Often this focus is on process issues such as leadership, power, corporate social responsibility, or organizational culture. Southwest Airlines provides considerable latitude in addressing these issues.

Leadership:

Herb Kelleher has been the face of Southwest since its beginning. His zany leadership style—"management by fooling around" has been the focus of numerous studies in the management literature for years. He was well recognized as a hard drinking, heavy smoking maverick. Considerable concern initially emerged when he announced in early 2000 that he was stepping down as CEO and president. The company's selection of Coleen Barrett allowed Southwest to maintain its advantage through leadership. The most recent change was with Barrett's retirement and the assumption of total power by Gary Kelly. While, there may still be some concerns, it appears that Kelly will follow the same approach to leadership as his two predecessors.

Corporate Social Responsibility:

Corporate involvement in the communities around them has generated much discussion in terms of sustainability for organizations. Southwest's ability to satisfy all levels of Corporate Social Responsibility (CSR) has allowed the company to earn considerable respect in the business community. The model of CSR developed by Archie Carroll can be used as a framework to discuss this issue. Carroll maintains that companies need to meet economic expectations, adhere to all applicable laws, conduct business in an ethical manner, and to give to its communities. If these areas are completely satisfied it is suggested that the bottom line will also improve. SWA is well recognized in having done just that: 36 years of profits; no legal disparities; no ethical lapses; and considerable philanthropic activities.

Organizational Culture:

Many strategic management gurus will suggest that the only possible sustainable competitive advantage a firm can amass is that of a strong (positive) organizational culture. This is primarily due to the fact that a sustainable competitive advantage can only be created by having something that is not easily copied. Southwest has long been credited with having such a culture. Considerable attention, therefore, should be given to this possibility. In doing so, culture should be defined, the purpose examined, and the components of this process explored.

Culture has been defined as the customary way of doing things, accepted by all members of the organization, and a necessity for new members to accept before becoming a part of the organization. All of these elements are characterized within SWA. First, the ways of thinking and doing things within the company are clear. Second, employees have readily accepted and embraced these actions. Finally, if employees can not demonstrate they would be a good fit with this approach, they are not hired or will not last long as members.

Deal and Kennedy in their book *Corporate Culture* suggest there are four main purposes of a strong organizational culture—provide a sense of identity, increase employee commitment, serve as a frame of reference of expected behavior, and to ensure organizational stability. Each of these purposes has been achieved within Southwest.

In addition to describing the purposes of a strong culture, Deal and Kennedy also suggested there were four main ingredients for this phenomenon: strong core values; organizational heroes; rituals; and, ceremonies. Again, all of these ingredients exist and can be supported for Southwest. In addition, it may be the inability of others to copy these ingredients that supports the idea of other firms not being able to imitate the company's culture.

SWOT

While it is relatively easy for students to identify strengths, opportunities and possible threats relating to Southwest, they may have some difficulty in identifying weaknesses in a firm that has been profitable for 36 consecutive years. The chart below may be used to highlight some of those possibilities. Students should also be prompted to consider possible areas of concern for the company.

Possible concerns:

- Has growth eroded ability to be as cost efficient
- Has growth created issues that damage culture
- Will new leadership live up to predecessors
- Are new northern routes good for the company
- Will competition drive prices too low

STRENGTHS	WEAKNESSES
<ul style="list-style-type: none"> • Strong culture • Efficient operations • Strong customer/employee focus • Low turnover • Young, efficient fleet • Low debt • Strong financial position • Strong leadership • Strong web site • Well respected company • Distinctive marketing 	<ul style="list-style-type: none"> • Pending/potential expiration of fuel hedging contracts • Increasing costs • Expiring labor contracts
OPPORTUNITIES	THREATS
<ul style="list-style-type: none"> • Falling interest rates • New technologies increasing efficient • Limited substitute products • High entry barriers • Bargaining power with Boeing • Declining fuel prices • Receptive business traveler • Underserved markets 	<ul style="list-style-type: none"> • Uncertainty in fuel prices • Increased airport security • Weather • Strong power of buyers • Substitute products in short-haul markets • Intense competition • New Northwest/Delta merger (increased competition) • Labor union demands

STRATEGIC CONTROL

The final element of the strategic management model is strategic control. This case provides an excellent platform for examining the use of financial analysis of a firm with very specific measurement concerns. In addition, this analysis should be challenging to students in examining a company that has been profitable for 36 consecutive years but may suddenly find itself in a situation where the 38th year may be its hardest to achieve that milestone.

Changes in operating expenses for airlines are driven by changes in capacity, or changes in ASM (Available Seat Miles). As ASM increases, expenses are expected to increase proportionately. If efficiencies are maintained, expenses should remain the same on a per unit (per seat) basis. Airlines monitor these per unit cost by calculating CASM (cost per available seat mile). This is computed by dividing total operating expenses by total available set miles. The last two years has witnessed a significant increase is the cost per unit for SWA. In 2006, this amount was \$8.80. It rose to \$9.10 and \$10.24 for 2007 and 2008 respectively. The major increase has been attributed mainly to the increase in fuel costs and a less successful hedging operation for the airline.

The following tables (Tables 1-6) provide additional comparative data that students should gather related to the competitive position of Southwest. Students should come to the conclusion that

although the company still remains profitable, the performance gap is shrinking and that 2009 may be much more discerning for the company.

TABLE 1: Comparative Net Income: 2002-2007

Company	2007	2006	2005	2004	2003	2002
Southwest	645	499	548	313	442	241
American	504	231	(861)	(761)	(1,228)	(2,523)
Continental	459	369	(68)	(409)	38	(451)
Delta	1,612	(6,203)	(3,818)	(5,198)	(773)	(1,272)
US Air	427	303	(335)	(89)	57.4	(179.7)

*Note: Not all airlines had reported their 2008 results at the time of the case

TABLE 2: Available Seat Miles (in millions)

	AMR	CONT	Delta	NWA	SWA	United	USAIR	Total Industry
2007	169.9	103.1	127.7	86.1	99.6	141.8	75.8	883.0
2006	173.9	97.7	125.5	85.6	92.7	142.8	77.0	866.0
2005	175.9	89.6	133.9	91.7	85.2	139.8	83.6	859.6

TABLE 3: Revenue Passenger-Miles Flown

	AMR	CONT	Delta	NWA	SWA	United	USAIR	Total Industry
2007	138.4	84.3	103.5	72.9	72.3	117.4	61.3	711.5
2006	139.4	79.2	98.9	72.6	67.7	117.2	60.7	690.7
2005	138.2	71.3	103.7	75.8	60.2	113.9	63.2	674.7

TABLE 4: Passenger Load Factor

	AMR	CONT	Delta	NWA	SWA	United	USAIR	Total Industry
2007	81.5	81.7	81.0	84.7	72.6	82.8	80.8	80.6
2006	80.1	81.1	78.8	84.8	73.1	82.1	78.8	79.8
2005	78.6	79.5	77.5	82.6	70.7	81.5	77.0	78.5

TABLE 5: Select Ratios

	ROR		ROA		ROE		Current		Debt/Capital	
	2007	2006	2007	2006	2007	2006	2007	2006	2007	2006
Southwest	6.5	5.5	4.3	3.6	9.6	7.6	.9	.9	17.8	15.5
American	2.2	1.0	1.7	.8	49.1	n/a	.9	.8	79.2	105.3
Continental	3.2	2.8	3.9	3.4	48.4	128.8	1.0	1.0	69.6	90.5
Delta	8.5	nm	6.2	nm	n/a	n/a	.8	.9	42.1	(97.5)
USAIR	3.6	2.6	3.2	3.6	35.5	43.6	1.3	1.2	67.8	75.0

TABLE 6: Compound Annual Growth Rate

Company	10yr	5yr	1yr
Southwest	10.0	12.4	8.5
American	2.1	5.8	1.5
Continental	7.0	11.1	8.4
Delta	3.4	7.3	9.3
US Air	20.1	41.7	1.2

KALTIM PLYWOOD: PRODUCTION IMPROVEMENT IN DEVELOPING COUNTRIES

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CASE DESCRIPTION

This is a field researched case about a failing plywood plant in East Kalimantan, Indonesia during the plywood manufacturing boom in that region. The research team had full access to the plant manager. The purpose of this case is to introduce students to the considerations in decision making in operational process improvement in accordance with capacity constraints and market conditions. This case is intended for use in an upper-level undergraduate Operations Management course early in the term and can be used as a scenario for discussion of capacity management. Students are expected to spend 2 to 3 hours of outside preparation reviewing concepts of capacity analysis, reading the case materials and brainstorming process improvement options. The instructor should advise students to pay attention to the particular relevance and importance of the bottleneck step in process capacity. The case can be taught in one 75- minute class period.

CASE SYNOPSIS

The events in this case took place when many logging firms in Indonesia were venturing into plywood production business with little experience. Ching-Mia Hung, a Taiwanese veteran of the plywood production business, was asked to turn around a failing plywood plant in East Kalimantan, Indonesia. Ching-Mia accepted the challenge and studied the plant patiently for a month before taking any action. Among his observations of the plywood production operation, Ching-Mia noticed several anomalies in inventory and capacity management with respect to external market conditions. This case presents students with a complex plywood production process with realistic and hard-to-come-by details, including the composition design of different plywood products, their respective production steps, common production challenges, and market demand information. Students are challenged to analyze the scenario and identify operational process improvement opportunities. Embedded in the case information are clues on improving operation without requiring additional equipment investment or new hiring. The instructor should encourage students to formulate action plans that utilize current resources more efficiently to cater to existing market conditions.

INSTRUCTORS' NOTES

Recommendations for Teaching Approaches

The case should be introduced after the students have read the relevant chapters on capacity management (Chapter 6, Capacity Management, *Foundations of Operations Management*, by Ritzman and Krajewski, 2002; Chapter 9, Capacity Planning and Facility Location, *Operations Management*, by Reid and Sanders, 2004). This case may also be used for an end-of-chapter discussion in capacity management.

Decision challenges include the identification of process bottlenecks and the allocation of production resources to different products for different markets. Specifically, order mix can affect the overall production capacity. From the perspective of profitability, one must consider unit price as well as production capacity in determining order mix.

In this case, students will:

- ◆ learn about the plywood production industry and the complexity of operational execution when considering the requirements and prices of different markets.
- ◆ experience the difficulty of recognizing operational problems and are challenged to formulate a potential solution to resolve such problems.
- ◆ identify the bottleneck in the operation.
- ◆ propose an improvement initiative to address the short- and long-term problems of the production process.

A discussion and explanatory lecture will include the following:

The capacity of an operation is dependent on the type of product produced when different products require different workloads from process steps. The 8,000 cubic meters per month mentioned in the case was a theoretical number based on the ideal capacity of equipments without consideration of operational characteristics, such as product mix or input quality (see below: Quality of logs to Unit I).

Long Term Process Change: Flexible Process to Match Supply with Demand

After removing bark, a log with no worm holes could be used to produce face and back veneers for the British panels. If there were some worm holes, the log could be used to produce face and back veneers for American panels. The American plywood market was willing to accept panels with some worm holes as long as the holes were filled with wood putty.

Thus, the production process could sometimes produce panels for the American market to handle the variability in log quality. In general, the production of thin panels was increased (while production of thick panels was reduced). All these changes could help increase the capacity of continuous dryer dramatically. This would result in increased process capacity.

In addition, the unit price of American thin panels was much higher than the Hong Kong thin panels.

Role of Yamato Forestry

The Yamato technicians were only focused on the production of Unit II factory because its products were exported to Japan for Yamato Forestry. Essentially, their operation was independent of Unit I's operation. Furthermore, Unit II's operation was on track during the period covered in this case. Thus, we ignored Unit II's operation in this analysis.

Quality of logs to Unit I

There seemed to be room for improvement regarding the quality of logs to Unit I. Ideally, if all surface veneers peeled were wormhole-free, then all surface veneers could be used to produce British thick panels. Thus, the actual yield (or capacity) of Unit I would be higher.

We did not address this issue in this analysis for two reasons. From the plant manager's perspective, Ching-Mia did not have full control over the quality of incoming logs. The quality of logs was influenced by the quality of trees harvested and the likelihood of logs' being damaged by worms when the logs were stored as inventory. Both of these factors were controlled by the logging operation rather than the plywood production operation. Picking only logs with good quality would mean an excess of unutilized logs, which would be bad for Kaltim at the firm level. Thus, Ching-Mia's objective was to utilize fully all logs regardless of their quality.

These elements should be drawn from the students in discussion and made visual in a multi-board format (so the decision-making elements can be seen concurrently).

An additional means of engaging students in solving the case is to divide the class into work teams to brainstorm Ching-Mia's potential solutions. Each team presents its own solution to the instructor and the remainder of the class (who represent the Kaltim management).

After all the brief presentations, the class determines which solution to implement. The instructor may need to use the lecture outlined above at this point, if discussion does not clarify the relevant issues sufficiently.

CASE QUESTIONS, ANALYSIS AND ANSWERS

1. **Even though the plant capacity should have been 8,000 cubic meters, Unit I was capacity constrained. What could be done to increase its capacity and profitability?**

Identifying the Bottleneck at Unit I

Unit I produced panels for the British market. These were 5-ply thick panels requiring thicker veneers, particularly the thick long core veneer. At the same time, many of these panels were WBP which required lower moisture content. Both these factors increased the drying time of veneers. Thus, the continuous dryers were the bottleneck of the operation. The production capacity of the entire operation was lowered because the continuous dryers were unable to cope with the demand.

Ching-Mia also noted that most of the steps had utilization rates of 60 percent to 80 percent, while the continuous dryers seem to be operating at 95 percent utilization rate (1,900 cubic meters/20,000 cubic meters). This confirmed that the continuous drying step was the bottleneck of the operation.

Process Improvement Options

As long as Unit I continued to produce the thick WBP and MR panels for the British market, the continuous dryers would continue to be the bottleneck. Several options existed to improve Unit I's capacity.

One could add additional continuous dryers to elevate the capacity of the bottleneck, thus improving Unit I's capacity. This should solve the capacity constraint. However, adding equipment would increase capital requirements. Thus it is not clear that this would improve overall profitability.

Alternatively, one could replace the production of the British panels with other panels that required less time from continuous dryers and with equal or more value. Thinner panels that used no long core veneers (as in the case of 3-ply panels) and/or thinner veneers required less workload from the continuous dryers. Thus, the lower decks of the continuous dryers could be better utilized. This would increase the capacity of the continuous dryers and thus improve the overall capacity of Unit I without additional equipment. Furthermore, as long as the alternative panels could generate equal or more revenue than the British panels, profitability of Unit I would clearly improve with higher capacity.

An A-level answer should identify the continuous drying as the bottleneck and suggest changing the production of the operation to improve capacity and profitability. Some students may suggest additional equipment as a means to improve capacity. While this is technically correct, buying additional equipment induces more cost, thus may not improve

profitability. Furthermore, the existing equipment (lathe, roller dryers, etc.) was not utilized efficiently. Changing the product mix turn out to be a better answer, when one takes into consideration the price difference between thin and thick panels (Exhibit D).

A B-level answer should correctly identify the bottleneck but without any meaningful process improvement suggestion. A C-level answer would fail in both identifying the bottleneck and suggesting process improvement approach.

Some students may suggest increasing steam pressure or drying temperature to speed up the drying process, thereby increasing the capacity of continuous dryers. This is actually possible. However, the potential gain in capacity is usually marginal and there is a risk of damaging the veneers (e.g., resulting in split veneers).

- 2. What could be done with the 500 cubic meters of surface veneers? Hendra believed that they should be made into thick panels for the Hong Kong market, but in the meantime, they had been sitting in the factory for a month. Unit I was still busy trying to meet existing orders from the British market. However, there was no order from the Hong Kong market. How else could these inventories be handled?**

Converting Idel Work-in-Process Inventory to Revenue

There were 500 cubic meters of dried veneer inventory (enough to cover a football field with about 5 inches thick of veneers). These 0.9 mm and 1.2 mm face and back veneers were a result of defective production processes (i.e., logs with wormholes were peeled into surface veneers).

These veneers would not meet the British market standard. In order to salvage them, they were appropriated for use for the Hong Kong thick panels once the short core and long core veneers became available. However, since the capacity of the bottleneck process (the continuous dryers) was allocated fully to produce the veneers for the British thick panels, it is unlikely that these work-in-process inventory could be converted to finished plywood soon.

In fact, according to Ching-Mia's observation, the inventory was growing. This is not surprising since this inventory was a consequence of error in production. It is expected that such errors would occur from time to time. In the long term, we should redesign the process to reduce the likelihood of such error. In the short term, we should figure out how to convert these veneers into finished panels.

We will make this decision in a two step process. First, we will rule out using these stored veneers for the 5-ply thick panels for any market.

Within the market of thin panels, we have prices for the American and the Middle East markets.

These inventoried veneers are currently used to make 3.0mm plywood panels. The 1.2 mm veneers are cut in half and used as short core veneers. The 0.9 mm veneers are used as face and back veneers. Thus, 3-ply thin panels (3.0 mm) can be made without requiring additional core veneers. These are sold to the Middle East market which is less stringent about surface veneers with wormholes.

The unit price of Hong Kong thick panels was \$170/cubic meter (see Appendix B of the case for prices). The unit price of Middle East thin panels was \$230/cubic meter. The production cost of the Middle East thin panels was \$20/cubic meter more than the Hong Kong thick panels because more glue and surface veneers were used.

$$230-170-20 = \$40/\text{cubic meters}$$

This change generated \$40/cubic meters x 500 cubic meters = \$20,000 profit (revenue from inventory that was consuming cost previously).

EPILOGUE

The average monthly production from January to June was about 7,000 cubic meters. After Ching-Mia took over, the average monthly production from July to December rose to 9,342 cubic meters. This was a 33.4 percent increase in production quantity. Most importantly, this was achieved with no addition in equipment capacity or labor. In the subsequent year, Kaltim resolve its partnership with Yamato and have Ching-Mia managed the operations at both Unit I and Unit II.

READINGS

Optional reading for students and/or instructors using this case

Cachon, G., and Terwiesch, C., (2006). *Matching supply with demand: an introduction to operations management*. Boston, McGraw-Hill.

Chapter 3: Understanding the supply process: Evaluating process capacity

Anupindi, R., Chopra, S., Deshmukh, S., Van Mieghem, J. and Zemel, E. (2006) *Managing Business Process Flows*, 2nd ed. New Jersey, Prentice Hall

Chapter 4: Flow Rate and Capacity Analysis

These two chapters provide many examples of process and capacity analyses. Cachon and Terwiesch also discuss the relationship between product-mix and process capacity.

Goldratt, E.M., and Cox, J. (2004) *The Goal*, 3rd ed. Barrington, Massachusetts: North River Press.

This is a classic reading on process improvement presented in a novel format. The story illustrates how a plant manager revitalizes his plant by following advice from a former college professor who teaches, for example, that reduction in the efficiency of some plant operations may make the entire operation more productive.

Skinner, W., “Manufacturing – missing link in corporate strategy”, *Harvard Business Review*, May-June 1969. p. 136-45.

A timeless piece that identifies that the importance or link, OM must have to corporate strategy. It introduces the notion that OM should not be a peripheral business function, but rather a key component to strategy. The article delves into the notion of “tradeoffs” with regard to OM and strategy

THE EVALUATION OF A FLOATING-RATE SALE-LEASEBACK

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CASE DESCRIPTION

The primary subject matter of this case concerns the evaluation of a sale-and-leaseback arrangement. Secondary issues examined include differences in tax ramifications and financial reporting implications of the leasing arrangement, and simple scenario analysis. The case is intended for an introductory finance course delivered to juniors and seniors in a business program. Students should have prior familiarity with the structure of the balance sheet and the income statement, and discounted cash flow analysis, including the concept of net present value. The case will require approximately two hours of preparation outside of class, after which it can comfortably be discussed in a one-hour class. It is recommended that the instructor provide a ten-minute overview of the case in a prior class period.

CASE SYNOPSIS

Rockhill, Inc. is an electric utility operating in mid-western United States. The process of deregulation in electricity generation has transformed the utility's competitive landscape, prompting it to divest much of its generating assets, shift its focus to electricity transmission and distribution, and revise several of its financial policies. Among other things, the company has adopted the policy to lease, rather than purchase, any additions to its fleet of vehicles. While the vehicles it currently owns represent slightly over 40% of its entire fleet (with the remainder being leased), over time, its "lease-only" policy will eliminate owned vehicles altogether, since vehicles must eventually be replaced. In the meantime, though, it wishes to evaluate the economic advisability of speeding up the process of eliminating ownership by converting the owned vehicles into leased vehicles through a "sale and lease-back" arrangement with another party.

One of Rockhill's financial analysts has just been assigned the task of determining whether such a lease will add value to the firm. She must project the cash flow implications of the switch from ownership to leasing, and then estimate the present value of those incremental cash flows. Based upon her analysis, she needs to make a recommendation to management at the upcoming meeting. The estimation of incremental cash flows will require a careful consideration of the tax treatment of the leasing arrangement as well as a forecast of the floating interest rate that the utility will have to pay on its lease.

INSTRUCTORS' NOTES

Background, Objectives and Approach

The idea for this case derives partly from field research, but all names and numbers have been changed to protect the identity of the people and businesses involved. In addition, a few details of the leasing arrangement have been modified to make the case more manageable, without detracting from the integrity or purpose of the analysis. For instance, the original lease was cancelable by the lessee at the end of the first twelve months, with a certain residual guarantee. If the lease were to continue, it would be renewable *monthly* thereafter for up to twelve more months. While the lease as presented to the student is also cancelable with a residual guarantee at the end of the first year, it is renewed for another twelve months if that right to cancel is not exercised.

The case seeks to encourage students to think about a firm's motivation for consummating a sale-and-leaseback transaction, and to recognize that a firm's decisions can have two sets of implications, one for taxes and another for financial reporting; the analyst must consider both. In this context, students encounter the idea of "off-balance-sheet" activities. The case also leads students to think through the incremental cash flow effects of the lease, and to apply their knowledge of basic valuation techniques. If the instructor is so inclined, he or she could use the case as an opportunity to discuss the process of deregulation in the electric utility industry, but this subject is not discussed at any length in the case. The students will be called upon to perform basic scenario analysis, for which the "Scenarios" feature under "Tools" in Microsoft Excel's will be very useful. The required steps for the scenario analysis are discussed in detail below.

The students will need to attempt all the Net Present Value calculations prior to a complete discussion of the case in class, and the instructor may therefore wish to provide a brief introduction to the case in the previous class period. The precise extent of guidance needed will depend on the skill level of the particular class, but it is expected that in most cases a quick overview of the context of the case, and brief explanation of how the sample amortization schedule in Exhibit 1 of the case is constructed will suffice. The instructor may choose to provide this overview by utilizing the information in the following section.

The last section of this note provides a set of questions with suggested answers that the instructor could assign to students as homework in advance of any class discussion of the case. The order of the questions suggests one possible flow of that discussion.

BACKGROUND INFORMATION FOR THE STUDENTS

For the sake of an overview of the case, the information in the *Request for Lease Analysis* section of the case can be summarized. This should give the students a basic grasp of what a sale-and-leaseback arrangement is. As noted in that section, for various reasons (which the students will

discover) Rockhill seeks to convert its owned vehicles into leased vehicles. It could consummate this conversion by determining the current market value of the owned vehicles, and establishing an amortization period and mutually agreeable value with a potential lessor. The lessor would then reimburse the utility for the agreed-upon market value of the vehicles, and the latter would lease the same vehicles from the lessor.

The specifics of the lease can be found in the section *The Analyst Gathers Information* within the body of the case. The instructor could summarize this information, and simultaneously provide some spreadsheet guidance to the students, by explaining the construction of the amortization schedule in Exhibit 1 of the case. In order to facilitate this task for the instructor, Exhibit A reproduces the formulae employed in the construction of that amortization schedule. Also, Exhibit B provides the full amortization schedule, with the FASB present value numbers shown (rather than hidden, as they are in Exhibit 1 of the case).

QUESTIONS AND ANSWERS

1. What might be the motivation for Rockhill Utility to lease rather than to buy the vehicles it needs?

Most utilities operate a large fleet of vehicles, which includes a variety of trucks, vans, cranes, backhoes, and tractors. Rockhill operates a total of approximately 450 such vehicles, whose prices range from \$3,000 to as much as \$200,000. If the utility were to purchase these vehicles outright, it would be faced with a large outlay of cash. Therefore, one motivation for leasing the vehicles, rather than buying them, is the conservation of cash. Another reason for leasing is related to the reporting of income. Based on rules of the Federal Energy Regulatory Commission (FERC), the depreciation on vehicles is based on their original cost, and continues at the same level as long as the utility owns those vehicles. Thus, these assets are often depreciated, for financial reporting purposes, well beyond their original costs. While this practice has no (positive) effect on cash flow, it does reduce reported income. Finally, by leasing the vehicles, the utility can potentially keep its debt and coverage ratios at more desirable levels, since it might avoid booking the large amount of debt it may have to incur to finance the vehicles in an outright purchase. This last point is true of “operating leases”, wherein the lessor allows the use of the asset for only a portion of its useful economic life, and retains the risks of ownership. The asset remains on the lessor’s books; and the lessee simply records rental payments as they occur. Operating and capital (or finance) leases are discussed further in questions 4, 5 and 6.

2. Describe a sale-and-leaseback arrangement.

In a sale-and-leaseback transaction, a firm sells an asset and immediately leases it from the buyer; that is, the former owner becomes a lessee, and the new owner becomes the lessor. By selling the asset, the lessee experiences an inflow of cash, but retains the use of the asset by making lease payments on a periodic basis.

3. What appears to be Rockhill's motivation for a sale-and-leaseback of its vehicles?

As the case mentions, Rockhill's management has already adopted a policy of leasing all *additions* to its fleet of vehicles. Now, it has requested an assessment of the feasibility of converting currently owned vehicles to leased vehicles via a sale-and-leaseback arrangement. In order to appreciate the motivation for this request, one should consider the recent developments at Rockhill. The process of deregulation in the industry affects the generation rather than the distribution of electricity. Rockhill has decided to divest its interests in electricity generation and to focus on the still-regulated transmission and distribution end of the business. Its sale of generating assets to Altisar has provided Rockhill with approximately \$1.65 billion in cash. Yet, this amounts to only 55% of the \$3 billion the company has recently spent in acquiring Teslar, an electricity distributor. Rockhill has bridged the gap with a large bond offering, which has adversely affected its debt ratio. The company is keen to avoid the fate of many others in the industry, whose credit ratings have recently been lowered by rating agencies such as Moody's and S&P. A downgrade would only serve to increase the cost of borrowing, and place greater financial stress on the utility. To be sure, the proceeds from the sale-and-leaseback will be of a much smaller magnitude, but it is an important part of the company's overall effort to improve its cash position. As noted in question 1 above, reported profits would also be buoyed by the elimination of the constant level of depreciation currently required by the regulator on owned vehicles, regardless of their age and original cost.

4. What is the difference between an operating lease and a capital (or financing) lease?

There is a difference in the manner in which the term "operating lease" is used by leasing practitioners and accountants. Students could be asked to conduct some of their own research on this topic, because the body of the case focuses primarily on the distinction between operating and capital leases from the standpoint of the accountant. The texts by White, Sondhi and Fried (1998), and Ross, Westerfield and Jaffe (2002), which are included in the list of references, could be suggested to the students as potential sources of information.

Operating Vs Capital Leases—Leasing Practitioner’s View: To a practitioner, an operating lease has the following three characteristics (see, for example, Ross, Westfield and Jaffe (1998)):

- a. Under an operating lease, the lease term is short in relation to the economic life of the asset, and the lessee’s payments are not sufficient to cover the full cost of the asset. The lessor hopes to bridge the gap by renewing the lease or selling the leased asset at its residual value. On the other hand, assets would be fully amortized under a capital (or financial) lease.
- b. Under an operating lease, the *lessor* usually insures and maintains the asset. In a capital lease, on the other hand, the lessor is not responsible for any service or maintenance.
- c. Under an operating lease, the *lessee* holds a cancellation option, which gives it the right to cancel the lease prior to expiration. Usually, capital leases cannot be canceled, and the lessee is obligated to meet all scheduled payments at the risk of bankruptcy. However, the lessee usually has the right to renew the lease at expiration.

Operating Vs Capital Leases—Accountant’s View: The body of the case provides a detailed description of how accounting rules classify contracts as operating or capital leases. In particular, Exhibit 2 of the case lists the Financial Accounting Standards Board (FASB) Statement 13 criteria (FASB 13, “Accounting for Leases”); if a lease satisfies any one of the four criteria listed there, it would be classified as a capital lease. Those criteria will not be repeated here, but students can readily note the significant difference between the practitioner’s and the accountant’s definitions of an operating lease; the latter is rather more technical, or specific.

5. What effects do operating leases and capital leases have on the balance sheet of the lessee?

Since this question pertains to the financial statement effect of the leasing arrangement, the decision on the classification of the lease as an operating or a capital lease will be based on the criteria set out by FASB (see question 4 above). If the lease meets any of the four criteria defined by FASB 13, then the lease is a capital lease, and would have the following implications for the lessee’s balance sheet: the present value of the lease payments will be shown on the right hand side of the balance sheet, and an identical amount will appear on the left hand side of the balance sheet as an asset. If the lease does not meet any of the criteria for capital leases under FASB 13, then it is classified as an operating lease, and no reference to the lease is made either as assets or liabilities on the lessee’s balance sheet. Thus,

the lessee has an opportunity to engage in “off-balance-sheet” financing if its lease can be classified as an operating lease.

If the lease is deemed to be an operating lease, and therefore does not impact the balance sheet, reported liabilities do not increase, and the lessee’s balance sheet appears stronger than it would if the lease had been classified as a capital lease. It might be worth noting that prior to FASB 13, generally accepted accounting principles (GAAP) required the classification of certain leases as capital leases, but the FASB 13 criteria (issued in 1976) cause more leases to qualify as capital leases (and hence to appear on the balance sheet).

- 6. According to the case, the analyst feels that its classification as an operating lease will make the sale-and-leaseback more attractive to management. Explain why this might be so (consider the effects on leverage ratios).**

Once sold, the assets would have reappeared on the balance sheet at the inception of the lease if the latter were classified as a capital lease. This was noted in the previous question. However, as the case indicates, the proposed lease fails to meet each of the four criteria of FASB 13 (see Exhibit 2 in the case), and hence will be classified as an operating lease.

One effect of this classification will be to keep the *debt ratio* from rising. Were the lease a capital lease, two identical values would be added to liabilities and assets. This would clearly cause the debt-to-equity ratio to increase. Even the debt-to-asset ratio would increase, since it would start out being less than 1; the addition of an identical amount to the numerator and the denominator would increase the ratio by increasing the former by a greater *percentage* than the latter.

Rockhill has recently issued a significant amount of debt in order to purchase Teslar, an electricity distributor, and has experienced an increase in its leverage ratios as a result. Therefore, from the standpoint of reporting to the public, the sale-and-leaseback arrangement would be yet more appealing to management if it were to be classified as an operating lease, since it would have no further implications for the balance sheet. The company would also like to avoid a bond downgrade (which has been fairly widespread in the industry of late), and is therefore quite sensitive to any further increase in its financial leverage. Of course, the lease disclosure requirements ensure the availability of sufficient information for serious analysts, such as those at rating agencies, to make any necessary adjustments while assessing the financial strength of the entity.

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7. **According to FASB 13, Paragraph 7, a lease would qualify as a capital lease if the present value of the *minimum lease payments* at the start of the lease term is more than 90% of the fair value of the leased asset when the lease is entered into (see Exhibit 2). Verify that the analyst is correct in stating that the proposed lease fails to meet this criterion. Note that the minimum lease payments for Rockhill are the lease payments for the first twelve months *plus* the residual guarantee at the end of the first year. The present value should be calculated using the *lower* of the following two rates: the lessee's borrowing rate for secured debt, and the rate charged by the lessor on the lease.**

Exhibit A provides the spreadsheet formulas used to calculate the present value of the first twelve lease payments *plus* the residual guarantee, and the “percentage of fair value” figure. The 3.75% lease rate is employed as the discount rate because it is lower than the rate at which the lessee can borrow by issuing secured debt (which is 7% pre-tax; 4.34% after-tax). The calculated FASB Present Value is \$2,662,862, which is 88.76% of the fair value of the asset. Thus, the lease does not meet criterion four of FASB 13 for classification as a capital lease. Note that requiring the use of the *lower* of the two interest rates mentioned in the question increases the probability that a lease will be classified as a capital rather than as an operating lease (this point is made in White, *et al*, 1998).

8. **Describe how the sale-and-leaseback arrangement proposed by Rockhill will be treated for tax purposes.**

This aspect of the lease is dealt with in some detail within the case. There are four features of the proposed leasing arrangement that fail to meet the “true lease” rules, and which therefore cause the lessee to be regarded as the tax owner of the property. First, the lessee has the option to purchase the asset for a fixed price, equal to the unamortized lease balance, and thus has the right to any upside asset value. Second, the lessor's risk is less than 20% of the original cost of the asset, because of the residual guarantee provided by the lessee should the latter terminate the lease and the equipment be sold for less than the unamortized lease balance. Third, a part of the rent paid by the lessee actually represents amortization, which benefits the lessee since it can purchase the asset at lease expiration for the unamortized balance; effectively, the lease rental partly represents equity build-up for the lessee. Finally, a part of the rent paid by the lessee represents interest, which is calculated the way it would be on a loan.

These features of the lease suggest that it should be treated for tax purposes as a financing arrangement, with the lessee enjoying the benefits and a substantial proportion of risk of ownership. In fact, the analyst obtained documentation of IRS Field Service Advice on a similar lease, which deemed the lease to be a financing arrangement, or a “conditional

sale agreement”. This implies that Rockhill can use the interest on the lease to reduce its taxable income (it could do the same with depreciation, but the asset will not have any depreciable basis at the time the lease is expected to go into effect.)

- 9. Assume that if Rockhill decided to continue owning its vehicles, it would do so for two more years. This assumption is based on the assessment of the utility’s fleet department, which does not anticipate any salvage of the vehicles in the interim. Now calculate the value of the two-year sale-and-leaseback vis-à-vis continued ownership, and decide whether or not the utility should pursue the proposed leasing arrangement. Be sure to conduct a scenario analysis as part of lease the assessment. The analyst does not believe that the LIBOR will deviate by more than 60 basis points from the forecasted level. Conduct the scenario analysis by calculating the Net Present Value (NPV) of the “lease versus own” decision by successively considering LIBOR rates for 0the second year that are at most 60 basis points below and at most 60 basis points above the forecast LIBOR; you may change the rates in increments of 10 basis points.**

The assumption that the currently owned vehicles would not be salvaged within two years puts the choice of ownership on the same economic basis as the proposed lease. In essence, the choice between continuing ownership and selling with leaseback amounts to a “sell now or sell later” choice. Any proceeds from the sale of vehicles after two years would be common to both options, and therefore does not need to be included in the analysis. Exhibits C and D show the spreadsheet work involved in the valuation of the sale-and-leaseback.

As is discussed in the case, the appropriate rate for discounting the cash flows related to the lease is the after-tax cost of the lessee’s secured debt. Rockhill’s pre-tax cost of debt is 7%, and the utility’s marginal tax rate is 38%. Thus, students have sufficient information to ascertain the discount rate for the NPV calculation. Exhibit C shows all the information required for the analysis, as well as the cash flows and the NPV for the “lease versus own” decision. Note that the calculation uses two different LIBOR rates: one for the first twelve months of the lease, and another that the analyst has forecast for the beginning of the second year of the lease (at which rate the lease is expected to be renewed). The latter rate is in cell C5. Since the NPV is positive, being over \$60,000, the analyst will recommend that management approve the sale-and-leaseback arrangement.

Exhibit E shows the results of the scenario analysis. In order to generate this output using Microsoft Excel, the student could, having already calculated NPV using the forecasted LIBOR (results will be as in Exhibit C), click on “Tools” in the same worksheet, select “Scenarios”, and “Add” successive scenarios, beginning with the base, or forecasted, case of the second-year LIBOR of 2.6%. Additional scenarios can be called, for instance, “Down

10bp”, “Down 20bp”, and so on. For each scenario, the “Changing Cell” should be C5, which is the cell containing the forecasted second-year LIBOR. The values that the student will enter in place of the forecasted LIBOR will deviate by 10, 20, 30, 40, 50, and 60 basis points in either direction of the value in cell C5 (which starts out at 0.026, or 2.6%). Having thus defined all the scenarios, the student can then click on the “Summary” button within Scenario Manager, and either choose “Scenario Summary” or “Scenario Pivot Table”; that latter will fit on one printed page, the former will not. At this stage, the student will also need to choose cell G41 for the “Results Cell”, which will indicate to the program that the analyst (student) seeks alternative values of NPV based on these changed values of the LIBOR (cell C5).

The results of the scenario analysis indicates that the NPV of the lease stays significantly positive for the entire range of LIBOR values the analyst consider possible for the coming year. These NPV values range from above \$63,000 for the “best-case” scenario, in which the LIBOR is 60 basis points below the forecast, to above \$57,000 for the “worst-case” scenario, in which the LIBOR is 60 basis points above the forecast. The student may wish to verify that the NPV for the sale-and-leaseback remains positive, and is as high as \$51,080, even if the LIBOR rises by 200 basis points over the coming year. The analysis indicates that Meg Hawkins can make a strong case to management for accepting the sale-and-leaseback proposal.

REFERENCES

- Ross, S.A., R. Westerfield, and J. Jaffe (2002). *Corporate Finance*. New York: Irwin/McGraw-Hill.
- White, G., A.C. Sondhi, and D. Fried (1998). *The Analysis and Use of Financial Statements*. New York: John Wiley & Sons, Inc.

Exhibit A— Spreadsheet Formulae for the Amortization Schedule

Equipment Cost				3000000		
Payment Frequency				Monthly		
Amortization Period				24		
Expected Residual Value				0		
Spread over LIBOR				0.0125		
Indexed to LIBOR Rate				0.025		
Lease Rate				0.0375		
PV of 12 payments:						
NPV of Total Payments				=F40+F41		
As % of Fair Value				=D9/D1		

	End of	Unamortized	Amortization	Lease	Total	Lessee's Max.
	Period	Value	for the Month	Rate	Payment	Obligation
0		3000000	-	-	-	
1	=B14-C15	=B14-C15	=B\$14/24	=B14*\$D\$7/12	=C15+D15	
2	=B15-C16	=B15-C16	=B\$14/24	=B15*\$D\$7/12	=C16+D16	
3	=B16-C17	=B16-C17	=B\$14/24	=B16*\$D\$7/12	=C17+D17	
4	=B17-C18	=B17-C18	=B\$14/24	=B17*\$D\$7/12	=C18+D18	
5	=B18-C19	=B18-C19	=B\$14/24	=B18*\$D\$7/12	=C19+D19	
6	=B19-C20	=B19-C20	=B\$14/24	=B19*\$D\$7/12	=C20+D20	
7	=B20-C21	=B20-C21	=B\$14/24	=B20*\$D\$7/12	=C21+D21	
8	=B21-C22	=B21-C22	=B\$14/24	=B21*\$D\$7/12	=C22+D22	
9	=B22-C23	=B22-C23	=B\$14/24	=B22*\$D\$7/12	=C23+D23	
10	=B23-C24	=B23-C24	=B\$14/24	=B23*\$D\$7/12	=C24+D24	
11	=B24-C25	=B24-C25	=B\$14/24	=B24*\$D\$7/12	=C25+D25	
12	=B25-C26	=B25-C26	=B\$14/24	=B25*\$D\$7/12	=C26+D26	1150000
13	=B26-C27	=B26-C27	=B\$14/24	=B26*\$D\$7/12	=C27+D27	
14	=B27-C28	=B27-C28	=B\$14/24	=B27*\$D\$7/12	=C28+D28	
15	=B28-C29	=B28-C29	=B\$14/24	=B28*\$D\$7/12	=C29+D29	
16	=B29-C30	=B29-C30	=B\$14/24	=B29*\$D\$7/12	=C30+D30	
17	=B30-C31	=B30-C31	=B\$14/24	=B30*\$D\$7/12	=C31+D31	
18	=B31-C32	=B31-C32	=B\$14/24	=B31*\$D\$7/12	=C32+D32	
19	=B32-C33	=B32-C33	=B\$14/24	=B32*\$D\$7/12	=C33+D33	
20	=B33-C34	=B33-C34	=B\$14/24	=B33*\$D\$7/12	=C34+D34	
21	=B34-C35	=B34-C35	=B\$14/24	=B34*\$D\$7/12	=C35+D35	
22	=B35-C36	=B35-C36	=B\$14/24	=B35*\$D\$7/12	=C36+D36	
23	=B36-C37	=B36-C37	=B\$14/24	=B36*\$D\$7/12	=C37+D37	
24	=B37-C38	=B37-C38	=B\$14/24	=B37*\$D\$7/12	=C38+D38	

	PV Year 1 Payments	=NPV(0.0375/12,\$E\$15:\$E\$26)
	PV Residual Guarantee	=PV(0.0375/12,12,,\$F\$26*-1)

**Exhibit B—Sample Amortization Schedule for Rockhill, Inc.
Dalton Leasing and Finance Corporation**

Equipment Cost	\$3,000,000
Payment Frequency	Monthly
Amortization Period	24
Expected Residual Value	0
Spread over LIBOR	1.25%
Indexed to LIBOR Rate	2.50%
Lease Rate	3.75%
PV of 12 payments:	
NPV of Total Payments	\$2,662,862.24
As % of Fair Value	88.76%

End of Period	Unamortized Value	Amortization for the Month	Lease Rate	Total Payment	Lessee's Max. Obligation
0	\$3,000,000				
1	2,875,000	\$125,000	\$9,375.00	\$134,375.00	
2	2,750,000	125,000	8,984.38	133,984.38	
3	2,625,000	125,000	8,593.75	133,593.75	
4	2,500,000	125,000	8,203.13	133,203.13	
5	2,375,000	125,000	7,812.50	132,812.50	
6	2,250,000	125,000	7,421.88	132,421.88	
7	2,125,000	125,000	7,031.25	132,031.25	
8	2,000,000	125,000	6,640.63	131,640.63	
9	1,875,000	125,000	6,250.00	131,250.00	
10	1,750,000	125,000	5,859.38	130,859.38	
11	1,625,000	125,000	5,468.75	130,468.75	
12	1,500,000	125,000	5,078.13	130,078.13	\$1,150,000.00
13	1,375,000	125,000	4,687.50	129,687.50	
14	1,250,000	125,000	4,296.88	129,296.88	
15	1,125,000	125,000	3,906.25	128,906.25	
16	1,000,000	125,000	3,515.63	128,515.63	
17	875,000	125,000	3,125.00	128,125.00	
18	750,000	125,000	2,734.38	127,734.38	
19	625,000	125,000	2,343.75	127,343.75	
20	500,000	125,000	1,953.13	126,953.13	
21	375,000	125,000	1,562.50	126,562.50	
22	250,000	125,000	1,171.88	126,171.88	
23	125,000	125,000	781.25	125,781.25	
24	0	125,000	390.63	125,390.63	

PV Year 1 Payments	\$1,555,123.89
PV Residual Guarantee	\$1,107,738.35

Exhibit C: NPV Calculation, Assumes LIBOR Forecasted for Year 2 Obtains

Marginal Tax Rate		38.00%
Rockhill's Cost of Secured Debt		7.00%
After-Tax Discount Rate		4.34%
Expected LIBOR	Year 1	2.50%
	Year 2	2.60%
Sale Amount (Fair Market Value)		\$3,000,000
Spread over LIBOR		1.25%
Indexed to LIBOR Rate		2.50%
Lease Rate		3.75%
Term of Lease (months)		24

End of Period	Unamortized Value	Monthly Amortization	Monthly Interest	Before-Tax Outflow	After-Tax Outflow	Incremental Cash Flows
0	\$3,000,000-		-	-		\$3,000,000.00
1	2,875,000	\$125,000	\$9,375.00	\$134,375.00	\$130,812.50	130,812.50
2	2,750,000	125,000	8,984.38	133,984.38	130,570.31	130,570.31
3	2,625,000	125,000	8,593.75	133,593.75	130,328.13	130,328.13
4	2,500,000	125,000	8,203.13	133,203.13	130,085.94	130,085.94
5	2,375,000	125,000	7,812.50	132,812.50	129,843.75	129,843.75
6	2,250,000	125,000	7,421.88	132,421.88	129,601.56	129,601.56
7	2,125,000	125,000	7,031.25	132,031.25	129,359.38	129,359.38
8	2,000,000	125,000	6,640.63	131,640.63	129,117.19	129,117.19
9	1,875,000	125,000	6,250.00	131,250.00	128,875.00	128,875.00
10	1,750,000	125,000	5,859.38	130,859.38	128,632.81	128,632.81
11	1,625,000	125,000	5,468.75	130,468.75	128,390.63	128,390.63
12	1,500,000	125,000	5,078.13	130,078.13	128,148.44	128,148.44
13	1,375,000	125,000	4,812.50	129,812.50	127,983.75	127,983.75
14	1,250,000	125,000	4,411.46	129,411.46	127,735.10	127,735.10
15	1,125,000	125,000	4,010.42	129,010.42	127,486.46	127,486.46
16	1,000,000	125,000	3,609.38	128,609.38	127,237.81	127,237.81
17	875,000	125,000	3,208.33	128,208.33	126,989.17	126,989.17
18	750,000	125,000	2,807.29	127,807.29	126,740.52	126,740.52
19	625,000	125,000	2,406.25	127,406.25	126,491.88	126,491.88
20	500,000	125,000	2,005.21	127,005.21	126,243.23	126,243.23
21	375,000	125,000	1,604.17	126,604.17	125,994.58	125,994.58
22	250,000	125,000	1,203.13	126,203.13	125,745.94	125,745.94
23	125,000	125,000	802.08	125,802.08	125,497.29	125,497.29
24	0	125,000	401.04	125,401.04	125,248.65	125,248.65
				NPV		\$60,567.89

Exhibit D: Formulae Used to Generate Output in Exhibit C

	A	B	C	D	E	F	G
1	Marginal Tax Rate		0.38				
2	Rockhill's Cost of Secured Debt		0.07				
3	After-Tax Discount Rate		=C2*(1-C1)				
4	Expected LIBOR	Year 1	0.025				
5		Year 2	0.026				
6	Sale Amount (Fair Market Value)		3000000				
7	Spread over LIBOR		0.0125				
8	Indexed to LIBOR Rate		0.025				
9	Lease Rate		0.0375				
10	Term of Lease (months)		24				
11							
12							
13	End of	Unamortized	Monthly	Monthly	Before-Tax	After-Tax	Incremental
14	Period	Value	Amortization	Interest	Outflow	Outflow	Cash Flows
15	0	3000000	-	-	-	-	3000000
16	1	=B15-C16	=\$B\$15/24	=B15*((SC\$7+SC\$4)/12)	=C16+D16	=C16+D16*(1-SC\$1)	=F16
17	2	=B16-C17	=\$B\$15/24	=B16*((SC\$7+SC\$4)/12)	=C17+D17	=C17+D17*(1-SC\$1)	=F17
18	3	=B17-C18	=\$B\$15/24	=B17*((SC\$7+SC\$4)/12)	=C18+D18	=C18+D18*(1-SC\$1)	=F18
19	4	=B18-C19	=\$B\$15/24	=B18*((SC\$7+SC\$4)/12)	=C19+D19	=C19+D19*(1-SC\$1)	=F19
20	5	=B19-C20	=\$B\$15/24	=B19*((SC\$7+SC\$4)/12)	=C20+D20	=C20+D20*(1-SC\$1)	=F20
21	6	=B20-C21	=\$B\$15/24	=B20*((SC\$7+SC\$4)/12)	=C21+D21	=C21+D21*(1-SC\$1)	=F21
22	7	=B21-C22	=\$B\$15/24	=B21*((SC\$7+SC\$4)/12)	=C22+D22	=C22+D22*(1-SC\$1)	=F22
23	8	=B22-C23	=\$B\$15/24	=B22*((SC\$7+SC\$4)/12)	=C23+D23	=C23+D23*(1-SC\$1)	=F23
24	9	=B23-C24	=\$B\$15/24	=B23*((SC\$7+SC\$4)/12)	=C24+D24	=C24+D24*(1-SC\$1)	=F24
25	10	=B24-C25	=\$B\$15/24	=B24*((SC\$7+SC\$4)/12)	=C25+D25	=C25+D25*(1-SC\$1)	=F25
26	11	=B25-C26	=\$B\$15/24	=B25*((SC\$7+SC\$4)/12)	=C26+D26	=C26+D26*(1-SC\$1)	=F26
27	12	=B26-C27	=\$B\$15/24	=B26*((SC\$7+SC\$4)/12)	=C27+D27	=C27+D27*(1-SC\$1)	=F27
28	13	=B27-C28	=\$B\$15/24	=B27*((SC\$7+SC\$5)/12)	=C28+D28	=C28+D28*(1-SC\$1)	=F28
29	14	=B28-C29	=\$B\$15/24	=B28*((SC\$7+SC\$5)/12)	=C29+D29	=C29+D29*(1-SC\$1)	=F29
30	15	=B29-C30	=\$B\$15/24	=B29*((SC\$7+SC\$5)/12)	=C30+D30	=C30+D30*(1-SC\$1)	=F30
31	16	=B30-C31	=\$B\$15/24	=B30*((SC\$7+SC\$5)/12)	=C31+D31	=C31+D31*(1-SC\$1)	=F31
32	17	=B31-C32	=\$B\$15/24	=B31*((SC\$7+SC\$5)/12)	=C32+D32	=C32+D32*(1-SC\$1)	=F32
33	18	=B32-C33	=\$B\$15/24	=B32*((SC\$7+SC\$5)/12)	=C33+D33	=C33+D33*(1-SC\$1)	=F33
34	19	=B33-C34	=\$B\$15/24	=B33*((SC\$7+SC\$5)/12)	=C34+D34	=C34+D34*(1-SC\$1)	=F34
35	20	=B34-C35	=\$B\$15/24	=B34*((SC\$7+SC\$5)/12)	=C35+D35	=C35+D35*(1-SC\$1)	=F35
36	21	=B35-C36	=\$B\$15/24	=B35*((SC\$7+SC\$5)/12)	=C36+D36	=C36+D36*(1-SC\$1)	=F36
37	22	=B36-C37	=\$B\$15/24	=B36*((SC\$7+SC\$5)/12)	=C37+D37	=C37+D37*(1-SC\$1)	=F37
38	23	=B37-C38	=\$B\$15/24	=B37*((SC\$7+SC\$5)/12)	=C38+D38	=C38+D38*(1-SC\$1)	=F38
39	24	=B38-C39	=\$B\$15/24	=B38*((SC\$7+SC\$5)/12)	=C39+D39	=C39+D39*(1-SC\$1)	=F39
40							
41						NPV	=SG\$15-NPV(SC\$3/12,SG\$16:SG\$39)

Exhibit E: Scenario Analysis of Rockhill's Sale-and-Leaseback

Change in Year 2 LIBOR Relative to Forecast (basis points)	NPV
-60	\$63,414.05
-50	62,939.69
-40	62,465.33
-30	61,990.97
-20	61,516.61
-10	61,042.25
0	60,567.89
+10	60,093.53
+20	59,619.17
+30	59,144.81
+40	58,670.45
+50	58,196.09
+60	57,721.73

THE HAWTHORNE ORGANIZATION

Shelley Morrisette, Shippensburg University
Louise Hatfield, Shippensburg University

CASE DESCRIPTION

This case can be seen from many different angles -- pure strategy, small business management (including financing and cost accounting), family owned businesses, succession planning, international operations, leadership, entrepreneurship, or organizational change. The case traces the growth and progress of two entrepreneurial firms from creation to merger and beyond. This case would be most appropriate for undergraduate courses in entrepreneurship, small business management, and strategic management, as a written assignment -- and graduate courses as a class discussion. The case is designed to be discussed in one to one and one-half hours and should take students no more than three hours of outside preparation.

CASE SYNOPSIS

John Jones has been CEO of The Hawthorne Organization since 1990. During this time the firm has been on a roller coaster ride with plenty of ups and downs. The marketing research industry is savagely competitive and requires huge investments in technology, human resources, and sales and marketing. Unfortunately, The Hawthorne Organization has made a few bad bets along the way, for which it has paid a huge price. While The Hawthorne Organization is respected and considered one of the leaders in the industry, John has not been able to substantially differentiate its brand or products, or increase margins or profits. The numerous strategy and organizational changes have wrecked havoc on Hawthorne employees and operations. Now John Jones must decide what he should do next with his family-owned business.

INSTRUCTOR'S NOTES

Questions and Answers

1. Evaluate the company's financing strategy.

Warren Buffet once said -- "Leveraging a company is like driving your car with a sharp stick pointed at your heart through the steering wheel. As long as the road is smooth it works fine. But hit one bump in the road and you may be dead." Entrepreneurship

textbooks state it another way -- “it is better to own 50% of a billion dollar organization, than 100% of a million dollar organization. What this all points to is the way Bill and John Jones have decided to finance The Hawthorne Organization. They have used debt exclusively to build the company. When RLSC was launched in 1952 the only option open to Bill Jones was bootstrapping and he seems never to have realized that spreading the risk around might be the way to go, especially when you are playing with “the big boys”. The plans or strategies that John launched (and all Board members endorsed) may have been sound or even terrific, but were never given a chance to succeed because of the lack of capital. All of the plans and strategies were executed to differentiate Hawthorne products and revamp its value chain to better serve customers. The problem was that John could not foresee every contingency and when cash flows fell short of projections he was forced to abandon the plans. Thus, the strategies failed more due to poor implementation rather than terrible plans.

The big issue in this case is the lack of adequate capital to grow a firm in a mature industry. Because the industry is mature and growing at only 3%, for a firm to grow at 20% or more it must take market share from competitors. This is much more difficult than growing a firm in a high growth industry where a firm does not have to steal market share from competitors. Additionally, the industry requires huge investments in technology and human resources and therefore size and scope play a huge part in this equation (which means lots of infrastructure investment to stay competitive). Because of these factors it is almost impossible to greatly “grow” a company in a mature industry with internally generated funds (and debt) because margins are so narrow and operations do not throw-off huge cash flows. For a firm to be successful in a situation such as this it must have DEEP POCKETS and that usually means equity financing.

This case presents the real issues surrounding growth of a business in a mature industry. It is all about CASH FLOWS and how the growth will be financed. Earnings mean next to nothing and students need to understand this aspect of operating a business. For example, Hawthorne had positive earnings every year of operation, but was in a constant state of cash flow crisis. It could never catch-up and John kept trying to “grow” his way out of the problem. But “growth” takes cash and they never had enough to go around.

One possible solution to this problem would have been to acquire equity investors. In 1990 Bill Jones could have taken the company public. He would have secured the needed capital for expansion. Of course he would have lost some “control” of the company. He would have had to answer to the SEC, stockholders, and the public, but he would have placed his company in better shape to execute a growth strategy. Additionally, John Jones would never have been allowed to serve as CEO. Stockholders would have demanded a more qualified individual and in the end this is probably the reason Bill and John Jones never went public or acquired other equity funding -- they wanted to do what they wanted to do. Still you cannot have both (i.e., complete control and high growth) in a situation like this, and that is

the major problem facing this company. Bill and John Jones could have had control and slow growth or loss of control and high growth, but those are the only two options in this situation -- there is NO third rail.

2. Evaluate the succession planning at Hawthorne Research and The Hawthorne Organization.

The succession plans at Hawthorne Research and The Hawthorne Organization were very different. Jim Collins groomed John and to a lesser extent Karen and Linda to take over the company. There was a clear line of succession and the plan was executed over many years. Employees and other stakeholders were never in doubt about what was going to happen. Additionally, Bill Jones had developed a financial plan to make sure that the company would be passed on to his decedents without debts or large tax consequences. Attorneys, CPAs, and insurance agents had worked out a bullet proof strategy and it worked to perfection. One can argue with Bill Jones' choice of company heir, but not his planning and thought. Jim Collins on the other hand did not have a succession plan and it hurt his company greatly. In the end his firm had to be acquired to survive. It was only good fortune that a favorable deal and partner were found before Jim Collins died. Collins should have begun a succession analysis in the 1970s. Instead, he waited until operating results began to fall before addressing this issue. By this time the value of his company was dropping like the revenues and profits. The fact of the matter is -- Jim Collins was not a good businessman and was not actively engaged in firm operations. It is fine to have such a weakness, but it is unforgivable not to try to manage it. At the least Jim Collins should have hired a COO to manage the business-side of his company. Working through this person he could have structured a leveraged buyout of the company by key employees or sold the firm at a more opportune time. As it was he was in a weak bargaining position when he met Bill Jones in 1987. He was lucky that Bill Jones did not drive a much harder bargain.

Leadership and entrepreneurship are critical factors in small businesses. The Hawthorne Organization has plenty of entrepreneurial talent, but lacks real leaders at the executive level. John Jones is very entrepreneurial. He reminds us of someone who has 100 ideas a day, but only one is a great opportunity and he or his team is not capable of picking the one great opportunity from the long list of ideas. Thus, the firm in many ways is too entrepreneurial and cannot focus on one strategy for a period of time. That is where leadership must come in. Leaders are needed to be caretakers of the organization. In this situation they are either absent or not heeded. Either way, The Hawthorne Organization is like a train running off its tracks -- too many strategies, too many plans, too much commotion until the firm almost went under.

International operations are difficult to execute, but trying to execute them with little experience and a limited budget is folly. The Hawthorne Organization was in a cash crunch when they began their international expansion and this strategy almost put the company under even though sales and profits continued to increase. The problem was that the Board did not allow for possible set backs and problems with their plans. Costs for offices, associates, training, and such spiraled and cash flows lagged. But after nearly a decade this division is leading the turnaround at The Hawthorne Organization. Thus, it looks like the strategy was sound, but the timing and execution were off. It looks like John's idea to make Hawthorne the only international research company was sound, but was too far ahead of its time.

3. Describe the corporate culture change at The Hawthorne Organization.

The corporate culture changed dramatically as a result of the near bankruptcy in 1996. The first outcome of this event was the hiring of Steve Andrews. Steve was a numbers-guy and brought a system of cost control and accountability to the firm, which had never existed. The reporting characteristics of the new system spotlighted many of the problems occurring to The Hawthorne Organization -- poor margins, poor incentive programs, ineffective management of projects, terrible product pricing, and the inability of upper management to really understand its business. John and Steve did not get along. Steve illustrated that John did not understand the financial aspects of his company. Luckily for the company Trey Kramer was more diplomatic and was allowed to implement many of the policies suggested by Steve. These new policies changed the company dramatically. They forced all managers and employees to be more accountable and less freewheeling. Many could not take this change in corporate culture and left. Additionally, there were major layoffs due to economic conditions and these two events severely changed the character of the organization. Many feel that The Hawthorne Organization is no longer fun and is just like any other company. Thus, much of the Hawthorne spirit and DNA is gone. But at least now decisions are being made that make sense.

4. How would you rate the job John Jones had done leading The Hawthorne Organization?

John is his father's son. He seems to have two specific qualities of his father: he is entrepreneurial and he does not want to give up control of his company. Unfortunately, he pursued strategies that were incongruent with the realities of his situation. It is nearly impossible to pursue a growth strategy in a highly competitive industry without DEEP POCKETS. The Hawthorne Organization did not have the capital to launch such a strategy and so John was setting his firm up for failure.

Many of John's ideas and plans were very sound. For example, his plan to "expand the footprint" was a solid idea to get closer to the customer. It worked well, but it drained cash. His plan to become a "billion dollar company in the next eight years" was just plain stupid. The Hawthorne Organization did not have the resources to internally grow that fast in a competitive industry. John's international idea was sound, but once again he did not have the resources to execute his plan. So we would give John a "C-" -- good ideas and plans, but terrible execution.

John is an entrepreneur and has many blind spots. For example, his interactions with Steve Andrews proved that he did not like criticism. He did not like the feedback and scrutiny he received and so he let Steve Andrews leave the firm. This indicates his lack of real leadership ability. Still John has great talent for new ideas and products. He is constantly looking for new opportunities and company growth. However, he must realize that not all of his ideas are feasible and be a little more selective. He must partner with others to screen and mold his ideas into better opportunities for The Hawthorne Organization. An important part of any opportunity screening process is financial analysis and feasibility assessment. John does not want to submit his ideas to intense analysis and criticism and this indicates his lack of leadership strengths. Entrepreneurship grade "B". Leadership grade "D". Next, John failed to understand the financial consequences of the company. Even with a growth strategy a company must have profit margins to have earnings and cash. Growth is not enough; margins are always needed to be successful. Financial management "D". Overall grade "D+". John has done a below average job leading The Hawthorne Organization. He has had many successes and many failures. However, today the company is operating and is ready for the next business expansion.

5. Should John Jones have done anything differently? Why?

John's biggest mistake was being too optimistic. He felt he could grow the company without equity financing. He pursued strategies that were impossible to execute given his lack of capital and, thus, placed his company at real risk of going under. He should have decided what he was capable of carrying out given his lack of capital. In other words, he could have grown The Hawthorne Organization at a slow-moderate rate, or he could have acquired equity funds and pursued a high growth strategy (and lost control), but he could not have done both. Another big mistake that John made was not realizing the importance of control and finance in a project business. Margins are needed in any business -- a focus on growth is myopic. Also, John did not understand what happened to the product mix of margins when the two companies merged. Margins for marketing research projects (i.e., one-offs) were smaller than margins from leadership and selection projects. Most of the growth from the new company was big marketing research projects and so margins shrank. The

problem was that The Hawthorne Organization did not have project cost data to illustrate this mistake. Consequently, the company continued to have cash flow problems.

6. What options does he have now?

John has many options today. He could sell the company, but the timing is not very good. Because the research industry has been in a recession for the past five years sales and profits have been depressed. Thus, he would be selling the company at a terrible time. It would be better to keep the company for three or four years and focus on growing the company's sales and profits and then think about selling. He could break the company into two parts (i.e., domestic and international) and sell-off one or both. This option would bring the highest price. He could NOT take the company public now. The Hawthorne Organization is not a "hot" firm. Its financial returns are not good. It has not grown in a decade. It does not have outstanding products or brand equity. Its leadership is not great. Thus, there is no way it could get an IPO underwritten. John should begin to re-build the company's core competencies -- great research products marketed through a stellar sales organization. We believe that he will need to hire several key executives for this option. For example, he could hire Tony Michaels as his COO. He also needs a first class CFO (someone like Steve Andrews, but with some tact). Also John needs to realize that he might not be the right person to lead The Hawthorne Organization at this time. It might be best for him to step aside and find a new CEO. This option will take many years and will be a difficult task, but he would then be able to leave the company to the next generation of Joneses. Naturally, he could sell the firm at a later date after some of the "buzz" is regained or he could bring in equity investors to help finance the re-building.

7. What should he do? Why?

If John wants to sell the company, we suggest that he divide the sale into two parts. The domestic company has almost all of the cash flows and should be valued at around \$120 million (see question 5 for details). Selling the international offices separately should gain about \$60 million (i.e., this is the book value to create and staff these offices). Thus, John should get around \$180 million for The Hawthorne Organization using this strategy. If he sold the entire company he would be forced to take much less, but it is also a riskier strategy to break-up the firm and sell the two parts. If John decides to keep the company and re-build its operations, we believe that he should hire a new CEO and CFO and Trey Kramer should be kept on as President. These three individuals should be given the authority to operate The Hawthorne Organization. A moderate growth strategy should be pursued with special focus on improving the products and research capabilities of the firm. Thus, John could decide on

either of these two strategies depending on how confident he feels in his abilities. If the turnaround is successful and profits increase to normal industry margins the company could easily be worth \$275 million in five years, -- we would vote for the turnaround.

8. How much is The Hawthorne Organization worth today?

In 2005 the firm made \$17 million. At a normal multiple of “7” the company is worth \$120 million or so. But this is a floor figure because the industry is just coming out of a mini depression where earnings have been historically low. In 1999 the company earned \$25 million. At the same multiple the company would be worth \$150 million. As suggested above, if the firm is split into two -- domestic operations and international operations -- more value could be unlocked. Thus, the domestic operations would fetch \$120 million and the international operations would claim around \$60 million. We feel that if John Jones keeps the company and is successful in a turnaround that both parts of the company will become much more valuable. Also, John could sell the international operation at any time and keep the domestic operation for as long as he wishes. But if he elects to sell the domestic operation he must sell the international operation as well (he can sell each to a different buyer). The reason is simple -- the international offices need a home office to coordinate operations (they are not set-up to work independently).

9. Was the company in better shape in 1990 or now? Why?

This is a tough question. In 1990 The Hawthorne Organization had a better leadership team, sales organization and research team, but it was in worse financial shape and did not have control over costs, prices, and margins -- so it was working in the dark. The result was, that even with great people, products, economic conditions, and culture the company floundered. Today the company does not have great products. The leadership team has been depleted, but we feel that John and Trey are both stronger and wiser than they were 16 years ago. Financially The Hawthorne Organization is much stronger today. Their debt is much more manageable today than it was in 1990. Their project cost accounting system is first rate. Margins and profits are rising. Salaries and wages are more reasonable today. Employees' performance is more closely linked to pay. Thus, we feel that The Hawthorne Organization is better off today, but does not have the same opportunities for success that the company had in 1990 because of economic conditions, competition, and the uncertainty of the industry. The research industry will be a tough place to make a buck in the next decade.

PARTNERING WITH AN NGO TO START A MICROLOAN PROGRAM IN A GHANAIAN VILLAGE: A GLOBAL ORGANIC TRIPLE-BOTTOM-LINE SOCIAL ENTERPRISE IN THE MAKING

Harriet Stephenson, Seattle University

Donna L. Mace, Seattle University

CASE DESCRIPTION

The primary subject matter concerns social entrepreneurship which incorporates the triple bottom line. Secondary issues include financing new ventures, human resource development and motivation, globalization of collegiate curriculum with experiential/service learning methods, globalizing microenterprise, and entrepreneurship in a nonprofit. This could be used in for-profit or nonprofit management or entrepreneurship courses, developmental economics, and finance. It has a difficulty level of four, appropriate for senior level and five, appropriate for the first year graduate level. The case is designed to be taught in 1-3 class hours with two hours of outside preparation that can be done online.

CASE SYNOPSIS

The director of a student consulting program in a university hears about a way to globalize the program by partnering with an NGO in Wilmot, New Hampshire, WomensTrust, to start a microloan program in a Ghanaian Village. A meeting is called with interested colleagues, alumni, and students. There is support for the concept but several other possible scenarios are proposed. A go with Ghana decision is made somewhat unilaterally and without a business plan. Entrepreneurial enthusiasm abounds as in a typical start-up. The team must now quickly do its homework--get the buy in of the relevant stakeholders especially the Dean of the Business School, and the University Administration. The Dean would be concerned about the level of positive impact on students and alumni and mitigating possible increased overload on faculty. The University is concerned about liability and safety issues. There is a desire to make sure this is a triple-bottom-line social enterprise, which achieves desired outcomes of helping empower women to have more secure lives for themselves and their families. The people, profit, and planet aspects must be addressed. Is there some way of getting to Ghana without burning tons of carbon dioxide during a 14,000 mile round-trip flight? The model calls for investing \$15,000 to begin a microloan program that charges interest to its peer lending group members and then becomes self-sustaining at 400 borrowers. How are they

going to raise the \$15,000 to start the process? It is an organic development model which starts with microloans and may grow into providing help with education, health, and meeting other needs if the women feel that is what they want. How will that be financed? What if the team doesn't get the buy in? The reservations cannot be canceled.

INSTRUCTORS' NOTES

The following material explains and provides details about suggested answers to each of the questions that the team raises in its strategy sessions. We have tried this case and found it to be useful. Where something has worked particularly well, it is noted. A mix of methodologies is covered if the instructor wants to use them: Interview business people and nonprofit directors, debate certain questions, develop pro and con list. The case can be used without homework but would be enhanced with a couple hours spent on www.womenstrust.org, www.microcreditsummit.org, and <http://www.sustainabletimes.ca/articles/miccredit.htm>. One of the discussion questions asks to do a prospectus for the project. This is useful in a for profit or nonprofit course.

This case has been successfully used in a senior capstone course in a school of business and economics.

Names of individuals, except those of WomensTrust, have been disguised as have the university and city in which this is occurring. Otherwise, this is actual case of people two days away from traveling to Ghana to vet a village.

The term social enterprise or social entrepreneurship has evolving definitions. Mark Pomerantz, editor, Social Enterprise Magazine-Online, has described it thus: innovative, mission driven, outcome/social change oriented, income generating, activities that display an element of risk, business acumen, and effective non-traditional leadership.

- 1. They need ideas on how to raise money. Ideally, they need a plan on how to raise the money...a plan that will not detract from current capital funds efforts and that will be consistent with the University's 501(c)(3) educational mission. How does this differ from financing a for-profit start up?**

This discussion is geared to getting the student to think “out of the box.” Most students will have some familiarity with how to finance a business or most will have an idea how nonprofits are funded. This can be an opportunity to think over the profit and nonprofit definitions. We are counting on nonprofit and for profit leaders to be able to communicate with their constituents. Nonprofits need businessperson expertise on their boards for business practices then can lead to efficiencies and donor requested effective use of resources. For profits need nonprofit leaders on their boards to become more of triple-bottom-line

sustainable organizations. Cause marketing is desired by for-profit consumers. For profits partnering with nonprofits is key strategically today as is nonprofits partnering with for profits.

One productive way of handling this question is to require interviewing one for-profit manager, president, CEO and one nonprofit executive director, manager. What were the major sources of funding for the first two years of start up of your organization? What seemed to work the best? If you had it to do again, what would you do differently? Do you have both for-profit and nonprofit people on your board? Is the mix you have now ideal? Why or why not?

For nonprofits: The answer might include infusion by the founder; fund raising; grants; auctions; donations; membership fees; advisory boards; boards of directors; securing sponsors; selling advertising; developing cause marketing partnerships; utilizing giving circles; forming action groups; credit card borrowing; partnership with major player in microcredit such as CRS, World Vision, Accion, and Plan USA (not currently into microcredit—why not?); getting financial support from Ghana itself.

For profits: Typically, especially for small business, start with founders own resources, after that include credit cards, mortgaging home, then the 3 F's of friends, families, and "fools"—the fools is to capture the concept of anyone investing or loaning money to a start up is a fool—it is hard to make a successful start up. Suppliers are possibly a source of funds if they will provide credit--bringing in a partner with money, or who has other 3 F's than founder does; bank borrowing.

Focusing on this particular case, one method of funding suggested by the WomensTrust model involves *giving circles*. A mini lecture is included here on giving circles.

Mini Lecture

The response to this “overall how can we financially cover it” question could focus on the following: a) WHO might be interested in participating and why? b) HOW might they be interested in participating? c) WHAT might they be interested in supporting? And d) WHEN, meaning over what timeframe, might this work?

a) **WHO might be interested and why?**

To best answer this portion of our question, let's take a look at the recent changes and trends in philanthropy. An organization call Giving Forum is a great source for analysis about recent changes in giving and for exploration into the “donor of the future.” First, we can learn by looking backwards that the face of philanthropy is changing in dramatic ways:

Surge of high-profile giving by the wealthy

Increased giving by women, racial and ethnic communities, youth, and other non-traditional donors

(<http://www.givingforum.org/givingcircles/>)(<http://www.givingforum.org/dof/>, 2005-06).

Looking forward, Giving Forum presents twelve key trends, four of which are particularly relevant to our question at hand:

1. Interest in giving internationally will increase among all types of donors.
2. Donors will be increasingly attracted to self-formed learning and giving communities or gatherings that foster connectivity and exploration, sponsor events, etc.
3. More and more donors will take care of all of their giving – flash and more sustained – with internet giving portals.
4. People need to see themselves (i.e., people of their kind) in the leadership of the institutions to whom they give their money, time or allegiance will increase.

An article in the March 8, 2007 *Chronicle of Philanthropy*, “Turnover Rate High Among Baby Boomer Volunteers,” by Suzanne Perry, found that on average 31% did not continue volunteering the second year. “Volunteers were most likely to return if they had made a greater commitment to an organization--among other factors.” Giving circles may well help in getting and keeping donors.

So for our purposes relative to adding such an opportunity to our course curriculum, we would be very much “in tune” with current and future philanthropy demand! If fact, our “circle here-to-circle there” relationship connectivity and exploration approach seems to take the philanthropy demand for building and exploring relationships to the max! And as for a university having a learning-and-helping stake in a developing country’s entrepreneurship and economic development resilience, who better than Brandon University to host: a) self-formed learning and giving communities, b) new technology methods, and student-lead infrastructures?

As for the types of participants interested in such a learning-and-helping venture through Brandon University, they could be vast. They could literally run the gamut from current students in this course or in other courses (nonprofit, technology, etc), to alumni, to staff, to friends of those affiliated with the university, to the community geographically or aligned with Jesuit principles and conceivably many of the stakeholders might be interested. (For suggested scope there, see listing of stakeholders in Question 6.

b) HOW might they be interested in organizing?

Giving Circles

By again consulting resources available thru the Giving Forum and their 2005 partnership with New Ventures in Philanthropy, we learn that Americans are finding ways to have greater control over their charitable giving and ultimately having a bigger impact. As such, new vehicles are emerging – especially for giving in lasting ways. The most startling insight however, is that “giving circles” are the latest trend in philanthropy and they are proliferating! Having been described as “a more meaningful version of a book club” by one member, they have wide appeal across gender, race and age.

(<http://www.givingforum.org/givingcircles/>,
<http://www.givingforum.org/newventures/givinglandscape.html>), (Personal Finance C. 2006. *Grass-roots Philanthropy*. King Country Journal.)

“Giving circles” (giving or donor circles) are when donors come together, formally or informally, to pool their resources as a powerful grassroots philanthropy force. And they are so popular because they represent a “win-win” all the way around! Collectively, they are:

- bringing new and more money into the philanthropy sector
- exposing members to new organizations and issue areas
- changing how donors (members) give -- are more involved and thoughtful, focused and strategic in their giving; generally give fewer, but larger gifts, and are re-directing and increasing their personal giving
- providing opportunities for members to participate in agenda-setting, deliberation and decision-making
- providing opportunities for members to connect with other donors and nonprofit professionals in new ways
- connecting members with individuals in need through increased awareness of and interaction with issues faced by these individuals
- providing networking opportunities to develop relationships and contacts that will last a lifetime based on significant meaningful activities that make a difference.

(<http://www.givingforum.org/givingcircles/research.html>).

Are they all the same? No, these circles appear to follow a typology of six levels, and range from a Level 1 *Stakeholder* “traditional fundraising identity group” up to a Level 6 *Proactive* “formal collaborative: donor advised fund” as follows:

Dependency	Intensity		Circle Name	Purpose	Member Commitments	Expectations
CIRCLE	HIGH	5	Proactive	<i>Lasting Legacy</i> Finding the leverage points - systems	\$25,000-100,000	* Identifying good strategy that makes systems change * Being a leader on the issue
		4	Collaborative	<i>Making a Difference</i> A difference in funded projects	\$10,000-25,000 3-5 year commitment Focused on making a strategic difference with their money	* Making impact * Connections to others with similar drive
	MED	3	Active	<i>Learning & Giving Together</i> About the issue and making connections	\$500-2500 2+ year commitment Emotional interest in issue together, learning is central activity of circle	* Learning and understanding the issue better * Connect to others * Social change proportionate to giving level--see results
	LOW	2	Trust	<i>Friend-Raising</i> Emerging – driven by the participants	Free-will; <=\$1000 Relationship identity still emerging Time & goals are circle-dependent	* Personal factors * Identification with like-minded others
ORG		1	Stakeholder	<i>Fundraising</i> A stake in the org.	\$1000-25000 Relationship is with org. More than a donor, but time is minimal	* Being an org. stakeholder
(5 Donor Circle Types: Launching & Leveraging Shared Giving. 2005. Women’s Funding Network.)						

To illustrate some examples, let’s take a look first right here in our own Spokane backyard. *Women’s Funding Alliance* hosts the “*Ripple Fund*” and is a small, intimate circle of 5 members who contribute a minimum of \$5,000, and learn first-hand about issues affecting women and girls in our community, participate in the grant making process, more

effectively and strategically expand their personal philanthropy, and extend WFA's grantmaking capacity to more women's and girls' organizations. (WFA encourages other women to start new circles.) Cited as a level #2; Trust circle (in study) because of its intimate nature and free-will time commitment.) *Social Venture Partners, Spokane (a branch of the 22 giving circles with thousands of members worldwide)* is described as "a giving circle on steroids" whose 270 members donate \$5500 per year for 2 years, and they are encouraged to work on a committee, to attend workshops about social issues and philanthropy, or to contribute time to nonprofit groups. Assumed a Level #3; Active circle. *Pangea: Giving for Global Change* is an association of individuals where members contribute \$1000 or \$2500 annually to a grant pool plus an additional 10% of their contribution to an administrative fund in order to increase engagement of U.S. donors in international philanthropy through grantmaking, education, and travel.

Another example of how circles can operate simply and creatively under a national umbrella is *Dining for Women*; whose tag line is "changing the world one dinner at a time". Dining for Women offers the opportunity for independent, local chapters where women "dine in" together once a month, bringing a dish to share and then pooling their "dining out" dollars (i.e. \$30 each) towards grass-roots programs in education, healthcare, vocational training, microcredit loans, and economic development to help improve the lives of women and children living in extreme poverty in some of the least developed countries in the world. In Greenville, S.C., women contributing \$25 per dinner each specifically planned out and funded "two years of nursing school for an East African woman".

And what is *World Class*? It's WomensTrust offering -- so in keeping of what we've learned above -- of a "big tent" secular, non-partisan institution in which to house donor circles of like-minded people. Originated by Skidmore College's Class of 1971 and their friends, World Class's mission is to engage, educate, and empower women to improve the conditions of their lives and that of their families. They started it because they shared a passionate concern for human rights and poverty issues; backward they rallied in common around their peers who died at Kent State and in Vietnam, and forward looking to the poor women and girls in Africa whose lives and promise are so much in jeopardy today. Hence, they come together and draw inspiration around their slogan: "redeeming their promise".

With these circle examples in hand, how might Brandon University raise the initial \$15,000 requirement? Here are some scenarios ...

1. *Offer a giving circle partnership with a unique village to each "class of" group within the School of Business.* What would our math look like? \$15,000 divided by 1000 total students this year = only \$15 per student needed. And, for organizational sake, suppose we looked to this group to shepherd this task? With 1000 total students divided by 30 of you, each of you would need to be responsible for contacting 66

students and collecting a total of \$500. Depending on your entrepreneurial skills and on the interest you receive, you would either end up with either: a) each “class of” member putting in their fair share, b) a subset putting in higher shares, c) finding a way of raising “your shepherding share thru a social enterprise effort, or d) negotiating with your shepherding team to social enterprise the whole lot.

2. Extend scenario #1 to partner with other schools on campus
3. Extend scenario #1 to “like alumni”
4. Offer scenario #1 for only alumni
5. Extend scenario #1 to selected high school students via a contest or other mechanism?

We’ve mentioned our alumni above. But, what about the effect this could have on their existing donation considerations with the University capital campaign, and specifically the \$3 million for the Entrepreneurship Center? With giving circles, we need not be talking about a lot of money per person; it’s more about pooling like-minded people together to do bigger impact things. And earlier we talked about the win-win nature of giving circles. So our hypothesis here to be validated would be that this association would only serve to make their tie with BU stronger and more intimate, and that they’d end up giving to more overall thru BU. This may also be a very effective way of reaching out and bringing in some alumni who are not now nor have been engaged with BU.

Another Alternative: Kiva.org

Another relevant way to organize – also very in-keeping with our philanthropy giving trend learning – is by utilizing KIVA.org! Kiva uses the power of the internet to facilitate one-to-one connections that were previously prohibitively expensive. Child sponsorship has always been a high overhead business, but Kiva creates a *similar interpersonal connection* only at *much lower costs* due to the instant, inexpensive nature of internet delivery. The individuals featured on their website are real people who need a loan and are simply waiting for socially-minded individuals to lend them money.

Today, Kiva.org is its own 501(c)(3) nonprofit public benefit corporation registered in the state of California, and donations to Kiva.org are tax-deductible. Kiva is a Swahili word meaning “agreement” or “unity”, and Kiva.org’s loans are personal agreements between lender and borrower -- there is no note or security involved. Kiva partners with many existing microfinance institutions. In doing so, Kiva gains access to outstanding entrepreneurs from impoverished communities worldwide. Their partners are experts in choosing qualified borrowers, and through Kiva.org, these partners upload their borrower profiles directly to the Kiva.org site so you can lend to them.

Kiva then lets you connect with and loan money to unique small businesses in the developing world. By choosing a business on Kiva.org, you can "sponsor a business" and help the world's working poor make great strides towards economic independence.

It's a beautiful thing to see Kiva Loans raised in a matter of hours, knowing that their Field Partners are also watching the website and informing borrowers when the loan is fully raised. And throughout the course of the loan (usually 6-12 months), you can receive email journal updates from the business you've sponsored. As loans are repaid, you get your loan money back. Kiva provides a data-rich, transparent lending platform for the poor, and they are constantly working to make the system more transparent to show how money flows throughout the entire cycle.

Kiva has created something quite extraordinary, uplifting, dignifying and empowering. They've made the world a little bit smaller and extended "helping hands" in a really revolutionary way. They've introduced folks to each other with pictures and profiles, and created a network of over 20,000 people around the globe as of 1/07.

So, given what we're trying to accomplish here, what all could be done with this dynamic and viral model?

- Partnering up Kiva.org with WomensTrust—OK'd in November 2006—possibly could be used by Brandon
- Accepting a combination of loans and donations – by personal preference and/or by type of “on-the-ground” service need
- Emailing friends, family, fellow students, or co-workers about Kiva and opportunities
- Hosting a banner on your profile, blog or website
- Adding a footer to your outbound email
- Joining a YahooGroup to learn how people are supporting Kiva in their cities, campuses, companies, and communities
- Support Kiva on MySpace, Friendster, Squidoo, and FatWallet
- Fulfilling a Kiva need
- Volunteering with Kiva
- Buying and Wearing Kiva Gear

c) WHAT might they be interested in supporting?

We've talked so far about supporting a village at a time. But lets also discuss what types of services could be funded as well.

The \$15,000 mentioned to date is the amount currently estimated for starting up *a microlending operation in a new village*. Because WomensTrust is a “bottom up” model, one which honors the importance of working at the grassroots level, each

donor circle would carry with it both the freedom and the responsibility of helping to develop market-driven programs based on relationships and dialogue with the women of the “village circle”. Additional needs here could be tied to loan process, equipment, business expansion, or staffing.

Other needs could be related to the women’s microenterprise venture (business consulting, etc) or could be much more general and life-skills based. In Pokuase, they provided education for girls; a vital need and one easily taken for granted among those of us attending a school like BU. Other such needs that could come up for a giving circle to address would be: literacy classes for women, monthly stipends for the elderly, special resource centers for women offering access to computers, research and training. The beauty of the circle here-to-circle there relationship, is that each village partnership opportunity can be customized to needs, desires, and resource availability.

And just as with the \$15,000 funding example above, each new opportunity can become an entrepreneurial challenge to tackle for an existing circle or a new one that wants to “own” the project. Just “be the circle,” use your natural talents, and be creative about figuring it out!

Different customized opportunities might lend themselves to individuals contributing toward. Might break up the opportunities into smaller financial commitments. For example, instead of asking for \$10,000 to fund a scholarship program, one might offer funding one girl through preliminary school or two or ten girls that might appeal to individual donors.

d) WHEN, meaning over what timeframe, might this work?

We have options to explore here. This entire premise could revolve from something as simple as one village that is supported by each group of students that takes XYZ class every fall quarter from class to class. Or, it could originate with each class (or other group) and stay with them indefinitely.

2. They need to be able to show how a program in Ghana could benefit the students and will enhance the learning experience campus-wide if possible both undergrads and graduate students.

This is an opportunity to get students or participants who use this case to sell themselves on why a global, interdisciplinary learning experience would be valuable. Adding potential benefit to University, community, faculty, and could enhance discovery learning. This is handled well with dividing the “class” into groups of 3-5 or in pairs:

1. Brainstorm how this Ghana program might benefit the students (graduate and undergraduate) or enhance the learning experience. (Give 5 minutes—then round robin report asking each group to add one that has not been covered.)
2. “Brainstorm potential benefits to students of going to a university that sponsored such a program. First group that get to 5, let me know.”
3. List the potential benefits
 - to the University
 - to the students
 - to Spokane/community

Some of the pros and cons might be

<i>Pros</i>	<i>Cons</i>
Faculty development	Money
Help people	Costs/time
Morally right	Resistance to American ways
Better school's image	Liability of students
Gain cultural awareness	Profitability to school
Following school's mission	Money could go to other university needs
Recruiting students	Strain on faculty resources
Good international experience for students	
Get grade to give back to community	
Broaden vision of well-rounded individual	
Gives back to global community	
Experience	
Promoting what is taught—triple bottom line	

The response to this question by a class of graduating seniors in capstone course in business included the following:

1. This type of program presents a mass amount of benefits to students. In a Jesuit education, we are supposed to use outside experience to make us a more well-rounded person. This is presenting an experience that could be life-changing and enable students to bring lessons learned from Ghana and incorporate it the US culture so we are able to learn about real life situations other than reading text.

2. We can not limit our vision just locally. By doing that, we are handicapping a student's experience. Ghana does not have the resources we do. As a Jesuit university, we have a responsibility to use our knowledgeable students/faculty to create a profitable environment around the world. It opens a student's ability to broaden himself or herself as a person to a whole new level.
3. Benefits: broadening horizons--respecting humanity, not so close-minded, ignorant; opening eyes to real-life issues that may not directly affect them, but something they can do to alleviate the problem (WWJD?); this experience can help students realize how blessed/privileged they are and they are capable of helping others their efforts are worth it.

There is pressure from the AACSB accrediting body of business schools to globalize the curriculum. Nonprofit leaders as well as for profit gain from studying other cultures and countries. Other accrediting bodies increasingly stress value to students of experiential learning, service learning, and value of using world as learning laboratory.

Indeed, globalization is here and a real part of our lives. Today's technology connects us in new and evolving ways; opening up our access to news, learning and opportunities. Students are going to expect and question our teaching relative to its global impacts. Coverage of microenterprise as an economic development model, here versus abroad in developing countries, just makes good sense. Additionally, such an offering could be used for generating business plans capable of competing in the social enterprise track of business plan competitions.

Globalizing a particular program also opens up the playing field for play from different degree levels, as well as other academia disciplines. It allows for meaningful cross-play and additional angles perspective within degree tracts, following on and adding onto each year, and/or across degree tracts. In either case, knowledge is shared among various levels of expertise. Education is worth more when it expands our horizons beyond the pure or standard academia. This would no doubt be a popular additive to our programs.

Lastly, as trends in philanthropy tell us that donors of all types are more and more interested in giving internationally, we know this topic is definitely in vogue.

3. **And, would it be possible to show how this could help with communicating with and getting alumni involved with the University? Alumni of all majors?**

The concern had been to not cannibalize the regular capital funds campaign. This discussion question lends itself well to understanding different needs of different stakeholders. As noted in Question 5's response looking at motivation for getting involved in project, even within a group there are differences thus there are probably alumni who are

not involved with the university now who this would appeal to. This will probably get some good PR, which will reach the alumni and help make them even prouder to be alumni.

When the undergraduate senior capstone course respondents looked at this, a couple typical responses were as follows:

Would undergrads/grads in a class be interested in following it as alumni?

1. I definitely think that undergrads/grads would be interested in following this project as alumni because the poorest of the poor is a huge issue right now, as well as poverty, hunger, and AIDS. By implementing a program, such as this, I would want to know the steps/actions later. This would be something that I would take pride in the fact that my university not only stood for social justice principles, but also put them into practice. Additionally, by following such an undertaking, I could perhaps involve my employer and encourage them to donate to this worthy cause. I do see this project as innovative student involvement, which will help our university continue to prepare leaders and attract new students.
2. I think students who used this as undergrads or grads would definitely be interested in following and supporting it as alumni. I think most students would understand that this is a process that would take a couple years and wouldn't happen over night. Many students would like to see if these loans/class, etc. actually helped jump-start these people's lives and if they were able to pay back the loans and such. No one likes to put time and effort into something without seeing the results, which in this case wouldn't be seen until later down the road.

Harkening back to our philanthropic giving trends, we know that donors are interested in: giving internationally, being a part of self-formed learning and giving communities that foster connectivity and exploration, using internet giving portals, and seeing themselves (i.e., people of their kind) in the leadership of the institutions to whom they give their money, time or allegiance.

Therefore, it stands to reason that some Brandon University alumni could be quite attracted to the dynamic, learning, and community-oriented aspects of our donor circle concept. Depending on each alumnus's personal degree and interests, they would have the ability to influence a particular circle's emphasis (or angle) as well as test approach. And the dynamic learning aspect of it all seems particularly appropriate for an *ongoing connection* and *with a university*; their university!

Additionally, other alumni could be drawn to the speed and individuality of the Kiva.org aspect of an offering. Would be great to see how much customization would be possible to give it a Brandon U flavor and way to see what all our giving individually could amount to as a group!

BU is positioned to offer powerfully attractive “what and how” alumni opportunities for a global giving connection. Ample evidence exists to indicate that giving and involvement enhance the positive feelings about one's self and about the organization that makes such an opportunity available. And by broadening the reach (cross-sell) of our relationships with them, as well as making the giving more intimate and on-going in nature (upsell), this program addition could only serve to benefit the overall time, talent, and treasure donations of our alumni.

4. B.B. needs to be able to show why globalizing microenterprise/microfinance should be a module in the senior capstone course where the Triple Bottom Line and Sustainability are rallying themes. Is that adequately covered in their proposed prospectus? How can a project that starts off with a 14,000 mile CO₂ polluting flight be rationalized as environmentally friendly?

The prospectus shows how the triple bottom line and sustainability would be addressed—those are almost core values. These might look like below using the prospectus designed by D.M. in the case.

- To help empower women to help them help themselves secure the kind of life and livelihood they want for themselves and their families
- In support of Brandon University's mission -- a huge supporter of service learning and the education of whole person, as great champions of justice especially for the poor
- In collaboration within the SBI Institute – piloting a national model for globalization
- In support of promoting a Triple-Bottom-Line and Sustainability approach to economic development making sure don't do more damage than good; buying carbon offsets units offset carbon emissions from air travel—(see Flight of 14,000 Miles below)
- In collaboration across schools--School of Business's “Entrepreneurship Center” with the College of Arts and Sciences' Center for Nonprofit and Social Enterprise Management
- In synergistic learning support of other efforts currently going on in Nicaragua, and in collaborative support with Catholic Relief Services and local Ghana
- For increased engagement among alumni
- In collaboration and/or exchange with other universities
- In collaboration with the Ghanaian Association of Greater Spokane
- In support of Microenterprise and Environment Guiding Principles* as developed by the participants at the Microenterprise and Environment Conference, Valley Forge, Pennsylvania, July 2004

***Microenterprise and Environment Guiding Principles**

- The environment is a sacred trust. The earth and all its life are interconnected and sacred.
- Addressing the human spirit is essential. Environmental and human integrity are inextricably linked. Improving inner human quality results in improving the environment.
- All microenterprises impact the environment. Do no harm. Eliminate or mitigate negative impacts. Seek positive impacts.
- Protecting the environment is an opportunity. Environmental protection makes good economic sense.
- Creating financially cost-effective solutions is vital.
- Each person is responsible. Responsibility means personal ownership and action.
- Agencies should work with local, national and international governmental agencies to promote sound environmental practices and policies. Agencies should help people understand why the environment is important to their lives. Donors and agencies should model good environmental behavior.
- Benefits and costs are both short and long term. True costs include environmental costs. Agencies should identify, account for and mitigate environmental costs. Environmental benefits created should be recognized. Costs of creating environmental benefits should not be borne solely by MFIs or clients.
- Creating partnerships is crucial. Partnership with stakeholders is the key to appropriate environmental protection in development.
- Participation in project planning and decisions is for everyone. Participation must be inclusive, equal and fair.

In the capstone course, students are asked to work with owner or nonprofit executive director to clarify guiding principles and values driving the organization so the recommendations will have the right context. The Starbucks Mission Statement format is recommended to follow. It lays out the triple-bottom-line issues acknowledging importance of people, planet, and profit.

Starbucks Mission Statement

Establish Starbucks as the premier purveyor of the finest coffee in the world while maintaining our uncompromising principles while we grow.

The following six guiding principles will help us measure the appropriateness of our decisions:

- Provide a great work environment and treat each other with respect and dignity.
- Embrace diversity as an essential component in the way we do business.
- Apply the highest standards of excellence to the purchasing, roasting and fresh delivery of our coffee.
- Develop enthusiastically satisfied customers all of the time.
- Contribute positively to our communities and our environment.
- Recognize that profitability is essential to our future success.

Flight of 14,000 miles be rationalized as environmentally friendly?

This is a good question to assign ahead of time asking the students to be prepared to support the contention and refute the contention. Googling terms such as carbon-dioxide emission offsets; offsets finance green activism; TerraPass; climate change and offsets; Carbon Fund; Carbon Neutral, Clean Air Pass--will get them started.

Could divide class in half to develop 10-point arguments pro and con. One spokesperson per half could make the case. Give 15 minutes to prepare.

Travel companies such as British Airways and Travelocity and Expedia sell offsets to finance green activism. They pass the money onto enterprises, for profit and not, such as Native Energy, Carbon Fund or TerraPass, that invest in wind farms, solar energy, energy efficiency technology or other green projects.

This is highly controversial subject about effectiveness of the programs, some of the accountability of the enterprises taking the money. Some argue that offsetting isn't as good as stopping the source of pollution. Supporters say offsets raise awareness of global warning while helping finance green projects. Carbon Fund an offset provider in Silver Spring, MD, contributed 93% of nearly \$800,000 raised in 2006 to 27 green projects.

The practice of paying to offset carbon dioxide has been growing rapidly--for houses, for energy uses of houses. Popular rock acts Coldplay, Barenaked Ladies and Bon Jovi pay for carbon offsets to mitigate effects of their international tours.

There are many issues in emerging carbon offset industry (a) what are effective projects? (b) there is a lack of industry standards which makes outside verification for accountability unreliable; (c) the role of profits; (d) how is pricing determined with organizations charging between \$5 and \$30 to offset one ton of carbon; (d) methods for paying...

In this case, the team from Brandon has purchased 100,000 miles of carbon offsets to pay for their four round trips of approximately 14,000 miles each and those of the

WomensTrust team that will be meeting them in Ghana at 10,000 miles for the Executive Director. They acknowledge this isn't a good answer but better than none. Their intent will be to utilize technology to the degree possible to be able to have hands on with the village from a distance. That will be one of the challenges they see. They don't want to just send money into the universe but neither do they want to pollute the universe. They will be taking with them a refurbished laptop from PC Recycle who is donating the laptop for the cause. The team is conscious of the Triple Bottom Line/ Sustainability commitment it has. However, this is a relatively new area of application especially for those involved in global microenterprise.

5. They need to have a clear understanding of who are the relevant stakeholders and their value propositions/needs in this endeavor, which may end up being a very big investment of time and money.

This question is good discussion question which can be to identify stakeholders. Could ask students to identify which will be most impacted, how and why? Could also role-play several of the constituents assigning different roles to two or three person teams. What might each want or need from this project? Have discuss and present. Useful to make the point that change usually has many more impacts and ramifications than we expect. This exercise may help to make that point.

A list of stakeholders might include:

The women in the village that will participate in the initial microloan program	Students in Economic Development course
The other people in village	Students in African students club and the club adviser
The village that is selected—	Administration
Teachers in village	J.Q. runs international internship program
WomensTrust, Inc.	Legal counsel--liability 501(c)(3) compliance
Susan Kraeger, Executive Director of WomensTrust	Catholic Relief Services Ghana
Alumni	Ashesi University-Accra
Donors in circles	Other students and instructor of Exec Master of Nonprofit Leadership program
Dana Daken, Founder WomensTrust	Ghana association in Spokane
Core Team: B.B., D.M., C.B., and C.W.	The Environment--CO2 from plane trip--planet
Faculty School of Business	TerraPass--carbon dioxide off sets.
Faculty across campus	The World Class team
Students in senior capstone course	AACSB

Not all will be equally affected or instrumental in the success of this project. However, to the degree that any category is important to your success, it is critical to understand why they would be involved—what they want or need to get out of it. For example, we asked three of the members of the Core group and each may have different motivations for being involved.

D.M., the student who has an MBA and is now working on executive masters of nonprofit leadership, has expressed:

Three years ago, I journeyed to Africa (Zambia and Kenya) with World Vision and witnessed “first hand” a taste of the plight dealt those living in extreme poverty. But in particular, I learned about my female sisters in poverty abroad; about those things I take so for granted -- about the likely life of abuse they face today ...

- Abuse being born – not desired or cherished because of their sex
- Abuse growing up -- no/less basic education; rather doing the hard work
- Abuse of early womanhood – forced to marry (or be owned) at a very young age, and maybe experiencing a mutilating “right of passage” in preparation
- Abuse of being married – hard labor, abuse and HIV/AIDS of husband’s adultery
- Abuse of being widow or divorced – losing all property rights

However, I also learned of hope. In addition to seeing the pure joy of hope in the eyes and smiles of those who had learned of God’s love, I also learned of a second and very tangible form of hope – the hope of self-sufficiency and choice making delivered through the simplicity of microloans. I was astounded to learn how little could deliver so much! And, to further learn that these women were such good return providers of the money and of its bounty – for them, for their families, and for their villages – I got really charged up. What a winning proposition; what an easy sell! As a marketer, I knew I had to move forward. I returned home pledging to do something more about this, and began work with other World Vision women studying concepts like grassroots, movements, and donor circles. I’ve since pledged to learn more about formal nonprofit leadership and social justice through the executive masters program at Brandon University. Now, as I embark upon this project as my program Capstone project effort, I take my next contributive step towards learning and contributing in a unique and advancing way. I am so happy to have met B.B. and to have joined heart and mind with this formational group.

Value Proposition

I find the WomensTrust model stimulating because it uses the dynamic grassroots power of “unique partnered circles” – *ONE here of donors (or investors) partnered with ONE over there (microenterprisers)* – sharing, learning, and growing together to alleviate the suffering of poverty and abuse. My desire centers on the following key learning:

1. The key drivers inherent in the success of these partnered circle collaboratives. For example, does success increase:
 - If the group here is also all women?
 - If the group here all rallies around a particular affinity or expertise?
 - Based on some particulars of the discovery focus groups – timing, attendees from both sides, discussion questions?
 - Other?
2. How and when we should measure success?
3. The value publishing plays on in the collaborative learning process?

C.B. has expressed:

For the past two and a half years, I have been working in the field of economic and community development. The need for small business support in the State of Washington is enormous and the work is overwhelming. It’s often difficult to see a direct correlation between the services that we provide and the likelihood that a business owner will go on to greater success and a better life.

My interests are global; the master’s degree I completed two years ago at Brandon University is in international business. Most of my career has been spent in service to nonprofit organizations, either as an employee or a volunteer. I look for opportunities to provide major impact, whether serving on a founding committee or making connections that result in significant funding. The Ghana Village project allows me to utilize my microcredit experience in the developing world. The community I developed while at BU is prime for a meaningful social enterprise experience. To be able to put the two together for global impact is a volunteer opportunity I simply cannot pass up.

B.B. has expressed:

I was ready for something new definitely not retirement. Attended Global Microcredit Summit in Halifax during November. Muhammad Yunus of Grameen Bank had received Nobel Peace Prize for his microcredit efforts. Heady. Thousands of people are involved in

global microcredit and empowering the poorest of the poor. Met lots of people. Waiting to get van to airport outside hotel, two other women were in similar guise. We decided to share a taxi to airport. Dana Dakin is founder of WomensTrust and Susan Kraeger is Executive Director. Heard about this adopt a village model—you too can do what we are doing—anyplace you want to. See how easy it is. It was “love at first sight.” Seemed like perfect way to globalize microcredit/microenterprise units in classes...expand SBI reach globally. We have maybe four international SBI’s. This model could be replicated in other universities—adopt a village, work it in to classes, training moments. The model WomensTrust had was consistent with my understanding of the way things should be done—microcredit is the beginning of a process not an end in itself. The community will decide what more needs to be done so they have buy in and will carry it out. Serendipitous, tipping point, synergistic things started happening. It is very appealing to make this my next concentrated area of research and publication. There is a great core group of people to work on the project...inspiring, committed, enthused, supportive, and open. What a deal to feel we can make a difference while furthering our own goals and needs. Would really like to be part of the group that helps get model replicated in those villages to those women and children who are under the radar and who are and will be left out because they aren’t scaleable—too small to make it worth big players’ energies if you are going after reaching 175 million people by 2010 you can’t dilly dally with a village of a few hundred or thousand. We can help bridge the global gap between have and have-nots one village at a time ... scaleable when you look at entire collegiate system--that could be humanness of giving--with each circle, each spawning several giving circles.

6. **They need to be able to show that they would not be adding yet another energy draining responsibility on some faculty. This idea being implemented could positively impact various stakeholders including the faculty.**

When the question was asked of students in the senior capstone course, one of the responses was:

This is another potentially time consuming and resource draining activity for faculty. Would the university be poorly utilizing its faculty? What is the return or value there? The university would not be poorly utilizing its faculty. The most powerful and impactful professors are there with real world experience that he/she can incorporate and integrate with the course content or use to support concepts. Moreover, faculty who worked on this project and lived this experience would have great lessons to teach, stories to tell, and bases for assignments.

A debate or some variation could be staged for the second part of the question. Debates usually liven up things and are a good inclusion.

This question could lead to further exploration of subject of burn out in your career, burnout in your job, burnout in your life, what can you do? That makes it more interesting to the group doing the analysis. The question could also read what is the role of innovation and creativity in organizations? What are the pros and cons of change in organizations?

As for the specific issue relating to more positive benefits for the faculty than balancing negatives, much has been written about faculty stress and dissatisfaction in academia. One dated but still relevant treatment of the issue was published in 1987 in Jossey-Bass Inc.'s *New Directions for Teaching and Learning Series*, Kenneth E. Eble, Editor-in-Chief,--"Coping with Faculty Stress" Peter Seldin, Editor.

"There is evidence in the research literature that the decade of the 80's has been, and is, producing a generation of professors trying to cope with surprisingly high levels of job stress."

That statement could have just as well have read "the years 2000-2007". A study of 2,000 faculty members at 17 colleges found that 62 percent acknowledged severe or moderate job stress. Another study reported similar findings in a survey of 1,900 professors in public and private universities with 60% of the total daily stress in their lives coming from their work as faculty members. The reasons for that given are:

1. Stringent unrealizable (by many academics) requirements for promotion and tenure
2. Professors are more aware of the wide discrepancy between their hopes and expectations and the actual reward offered by their profession
3. Fewer job change opportunities are available--especially as the academy ages--with many faculty seeing themselves as imprisoned in their jobs with little chance to ascend the academic ladder--stuck at current rank...
4. Many full-time faculty see part-time faculty who are growing in numbers as potential job threat.
5. Increased perceived threats to do away with tenure.

When research on stress among college and university professors was analyzed, the specific sources of stress were grouped into the following categories:

- Inadequate participation in Institutional Planning and Governance
- Too many tasks, too little time.
- Low pay and poor working conditions.

- Inadequate faculty recognition and reward
- Unrealized career expectations and goals
- Unsatisfactory Interactions with students, colleagues and the department chair.

"What does seem clear to us is that a college or university represents a rich collection of talent. When properly mobilized, this knowledge and assortment of skills can be shared across departmental lines and disciplines. This is when an institution becomes more than a place of work. This is when it becomes a community. This is when people not only give but also receive. This refueling of mind and spirit is what renewal is all about."

This WomensTrust model is perfect renewal undertaking ... all benefit. Indeed, when we talked with B.B. the faculty member initial mover of this project, it became evident that over the years--she was now on her fortieth year with the university--she had taken on significant (to her) new projects about every 7-10 years. She had ownership in the projects and was passionately involved in them. It was clear at her current 67 that the university would recognize the value of the project for her faculty development as well as the development and growth of the 3 other core members plus several other faculty who would respond by adding a module in their course, joining on an immersion program to Ghana which several faculty and students had already requested, etc.

In looking back through the reasons given for involvement by the four, this opportunity that they have made for themselves is highly motivating--they believe passionately in what they are doing--plus they are enjoying the trip and each other...it makes maybe some other potentially rougher edges in a potentially stressful environment get a life--get perspective. Innovation and creativity must be encouraged and supported especially when those innovations so directly support the mission of the organization. In entrepreneurship, start-ups are well known for their notorious highs for the founder and the original team and members. The same happens with nonprofits getting into revenue generating activities--"for profit" ventures. These are often developmental opportunities for the organization which may need a shot in the arm. New products or services within an organization keep the motivation running. Development and growth are powerful win-win motivators. Clearly as noted by the student's comment, this project has the potential for impacting positively many stakeholders. It is committed to a triple bottom line direction which should deliver a lot of win-wins for the people, planet, and profit/economic returns/efficient use of economic resources.

Post Script to Instructors' Notes

By December 31, 2007, B.B. and the MBA alumni have an application in for The Village Net to become a 501(c)(3). They are currently operating under WomensTrust's financial status until the 501(c)(3) is approved. The Village Net program (www.TheVillageNet.org) in Ofankor, Ghana has 60 borrowers, and there are 25 borrowers in Mwaani, Kenya and 35 in Suswa. The alumnus, C.B., is now full-time executive director. She had been one day a week for two months.

B.B. has guaranteed the executive director (C.B.) salary and health benefits for a year at which time it is planned that grants and donations will come on line. The authors are working on Case B, which will capture issues of starting a business in another country. Nairobi is an unknown quantity as the election results get played out. The villages are two hours from Nairobi. In the meantime, if you would be interested or you want social entrepreneurship projects in Ghana or Kenya for your students, please contact the authors and they will put you in touch with B.B. or C.B.

The Adopt a Village model is working well for Brandon, and they are eager to help other colleges and universities pursue such a model.

THE DAILY EXAMINER: STRATEGIC INITIATIVE 2013

**Patricia Lapoint, McMurry University
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CASE DESCRIPTION

The primary subject matter of this case concerns strategic decision making, outsourcing, and organizational politics. The case can be used to explore the intricacies of strategic planning in a strategic management course. Students are asked to analyze data in order to determine whether to adopt a new strategic plan for the company. Making such a determination requires the students to complete a cost/benefits analysis, an analysis which includes both financial as well as human elements. The case has a difficulty level of four. 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 8 hours of outside preparation to be fully prepared to complete the case.

CASE SYNOPSIS

CEO William Rogers is well aware that the internet poses a significant threat to traditional print newspapers like The Daily Examiner, a regional, employee-owned newspaper. Therefore, Rogers hired Skip Van Wart as CFO because of his reputation as a strategic change agent for staid industries. Although Van Wart has limited experience in the newspaper industry, he has initiated turnaround strategies in other companies. During his 10 months with the company, Van Wart conducted a study of all areas of operations as well as readership patterns. The study concluded that The Daily Examiner faced a strategic dilemma, determining that two major changes were strategically necessary: 1) the newspaper must develop an online newspaper segment; and 2) the current printing operation should be outsourced. The conclusions of the study are based on the increasing age demographic of the Daily Examiner readership, the growing online market, as well as the opportunity to reduce what could become excessive operational costs, i.e. capital outlays in replacing the printing presses. Immediate implementation of the plan is complicated by two major elements: (1) there are three years remaining on the lease of one of the printing presses and (2) outsourcing the printing operation would affect about 30% of the employees. Having worked in the printing area, Rogers has strong interpersonal ties with many of the employees there. In addition the printing employees, collectively, own 42% of the company's stock and include the single largest shareholder, Buck Johnson, who had served as Rogers' mentor. Rogers therefore, faces a tough

decision: reject the initiative and stay true to the paper's historic roots and support the long serving employees, or adopt the initiative and make radical changes in order to meet perceived future needs?

INSTRUCTORS' NOTES

This case provides an opportunity for students to analyze decision-making related to the strategic planning process. In order to conduct such an analysis, students will have to complete a cost/benefits analysis of the options facing the company. The analysis requires both a review of the financial aspects as well as the human elements involved as a result of what ever decision is reached. These instructor notes include information that will be useful to the discussion leader in guiding students through the process of analyzing an outsourcing decision and examining the potential human impact of such a decision.

The preferred teaching strategy for this case includes student assignments and class discussion. After assigning the case for reading ask the students to prepare written responses to the questions listed below in the "discussion questions" section. Since the case involves both conducting analytical financial analysis and considering the human implications of any decision, the difficulty level of the case and the amount of out of class time needed to complete it can vary by how many of the questions the instructor wishes to cover. The instructor may choose to use "strategic planning teams" to develop their analysis. Each team could present its analysis in class and be critiqued by the other teams.

To provide an introduction to the complexities of outsourcing, the instructor may want to use a video to frame the issues. Two excellent videos are available. Mike Taibbi (2008, July 8) of NBC Nightly News presents a two and a half minute segment, *Paper Cuts*, which provides a very timely framing of the impact of the internet on daily newspapers <http://www.msnbc.msn.com/id/21134540/vp/25590403#25590403>. This brief clip, which students can view as part of their out of class preparation, is highly recommended as it crystallizes the key issues involved in the case. A more historical look at newspapers as a business is provided by the 28 minute video *The Newspaper Industry* (Stone, 1998). This Films for the Humanities production examines all aspects of newspapers as a business, including the pressure to constantly adapt and operations decision-making.

Note that the decision point in this case is very apparent, Rogers must decide whether to adopt the strategic initiative. The complexity of the case can be increased by also dealing with "turf battles" by having Johnson attempt to "rally the troops" in getting the printing department employees to openly oppose the outsourcing and voting their stock in opposition to the management team.

This case will allow the instructor to meet the following objectives: To explore:

- ◆ the considerations of implementing a strategic plan.
- ◆ the cost/benefits of outsourcing.

- ◆ the human issues involved in making an outsourcing decision.
- ◆ the political implications of getting an outsourcing decision accepted in an employee-owned company where a substantial number of the employees are affected by the decision.

CASE OVERVIEW

This case revolves around the decision of whether to implement a new strategic initiative. A strategic plan has been developed which makes two major recommendations: the implementation of one seems relatively obvious (expanding the newspaper's online presence), while the other is much more precarious (outsourcing the printing department). While the two recommendations are independent, in reality they are linked with each other as funding to do the former is related to the latter recommendation.

The strength of the case lies in combining analytical, writing and persuasion skills. Students must demonstrate an understanding of both the financial and human issues involved in making a decision to outsource an entire department. Students must also develop a strategy for convincing the employee-owners of the need to implement such a plan. The instructor has the flexibility of deciding how in depth the students should go in dealing with the unique problems created by the fact that this is an employee-owned company.

DISCUSSION QUESTIONS

1. Financially speaking, which is the better option, outsourcing or keeping printing operation in house?

Students might be tempted to simply compare the unit cost of in-house printing operations of \$.85/unit to the outsourcing unit costs of \$.80/unit and \$.88/unit for the 10-12 million units and 8-10 million units respectively, and conclude that the most cost effective decision is to outsource the printing operation. There are two issues, however that should be considered--1) the likelihood that the 10-12 million units can be realized; and 2) the warehouse and shipping costs (9% or \$.0765/unit) of the unit cost will still occur with the outsourcing option. Also, for several years, the lease agreement unit costs (\$.0425/unit) will need to be included as a real charge. With simple calculations that factor into the analysis the warehouse and shipping costs, students would likely choose retaining the printing operation. On the other hand, students might argue for a Just-in-Time approach and suggest that reducing the inventory levels could reduce the warehouse and shipping costs, thus making the outsourcing option more attractive.

2. In what ways does the cost differential for unit printing costs for the two levels of outsourcing affect the decision?

The larger the unit volume, the smaller the fixed cost portion of the unit cost is. So the fixed cost allocation of 4% will be less, thus reducing the unit cost for in-house printing. The two unit costs for the two volume ranges for outsourcing reflect the fixed cost component. That is why the higher volume range of 10-12 million units for outsourcing is \$.80/unit and at the lower volume range (8-10 million units) is \$.88/unit. It is very important that the newspaper have a high probability of achieving a sales volume in the range of 10-12 million units in order to get the lower unit price of \$.80. Otherwise, it would be more expensive to outsource at the 8-10 million unit level.

3. Financially speaking, should the paper break the lease?

Table 3 provides the data that students will need to complete the calculations. The lease agreement represents 5% or \$.0425/unit. At the current volume level, it would cost the company approximately \$425,000/yr. for the remainder of the lease contract. To break the lease agreement, attorney fees and court costs are approximately \$63,000. Assuming a loss of 15% of the readership due to the negative public relations, a potential cost of \$234,000/yr. could occur [1,040,000 units x \$.15 profit/unit]. If there are no other hidden costs, this would make the 'break the lease' option more financially attractive.

4. The newspaper prides itself as an employee-friendly company and a community partner. If the decision is to outsource the printing operation, how does the company downsize in a caring and compassionate way without alienating the entire employee group and creating a negative public image of the newspaper within the community, its readership, and its advertisers?

While responses will vary, answers should indicate that these are important issues and any outsourcing plan must address them. Answers should consider the "human" side of downsizing... what happens to the affected employees, can they transfer to other positions? Is re-training possible and if so at what expense? Will this affect the papers ability to attract other employees? Responses should also recognize the negative side of "a good business decision." There well might be public battles, if not court cases, over the breaking the lease and/or the downsizing decision. Responses should recognize that not all decisions can be easily quantified.

5. How does the fact that is an employee owned company affect the outsourcing decision?

If the decision is to outsource, how can Rogers convince the employee-owners in the printing department of the need to adopt the strategic initiative? (Responses should reflect awareness that an employee owned company is “different” than a publicly held business. Employees see each other not as stockholders, but as friends. The “best business decision” is not always the one that will gain support. Also the employees have more influence and leverage over the decisions in an employee-owned company. Rogers should use the data provided in Tables 1, 2 and 3 to build his argument. Urge them to take a proactive approach to build a strong newspaper for the future by establishing a strong online presence. He should also develop a plan to deal with these workers, i.e. re-training, early retirement, etc.

6. (Optional issue). Given the ownership percentage of the Printing operation, what is the likelihood of them engaging in some activity which would undermine an outsourcing decision?

Answers should reflect that Rogers should be prepared for a wide range of potential responses from the printing employees, everything from enthusiastic acceptance and agreement to a proxy fight in order to prevent outsourcing.

7. As “the new guy” does Van Wart create unnecessary antagonism with the employees by conducting such a massive study with such far reaching conclusions so soon on the job?

The responses will vary, from yes, very antagonistic, to not at all. Expect the response to be based on the student’s willingness to change. Some students will be eager to get things “hopping,” while others will favor a more conservative, “take your time approach.” Responses should indicate an awareness of the consequences of either extreme, as well as the potential consequences of adopting the other extreme [i.e. acting quickly vs. acting slowly].

8. While the movement to an online presence seems inevitable, is there a way to establish an online presence for the paper without shutting down the printing department? Can the decision to “go on-line” be delayed?

Responses should indicate that the dynamic changes in the newspaper industry require action. No matter what the decision on the printing operations, establishing an online presence is critical to the survival of the paper. Therefore, students should address the issue if the printing department is retained, how does *The Daily Examiner* provide the resources? One option would be to argue that the online could increase the demand function, which could

increase the probability of the 10-12 million units sold, therefore, moving the newspaper closer to the decision to outsource. In this way, the online process is a means to bolster sales no matter if they print in house or outsource the function.

9. Considering your overall analysis to the questions above, what is the overall best business decision for *The Daily Examiner*?

Responses will vary, but they should provide a synthesis of the issues they have addressed above. This answer should be consistent with the prior analysis.

10. Are there other options *The Daily Examiner* should consider?

While answers will vary and maybe inventive, one option that should be included is the possible consolidation of the printing operations with other newspapers or businesses.

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