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JOURNAL OF THE INTERNATIONAL ACADEMY FOR CASE STUDIES

INSTRUCTORS' NOTES

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LETTER FROM THE EDITORS

Welcome to the *Journal of the International Academy for Case Studies.* The editorial content of this journal is under the control of the Allied Academies, Inc., a non profit association of scholars whose purpose is to encourage and support the advancement and exchange of knowledge, understanding and teaching throughout the world. The purpose of the *JIACS* is to encourage the development and use of cases and the case method of teaching throughout higher education. Its editorial mission is to publish cases in a wide variety of disciplines which are of educational, pedagogic, and practical value to educators.

The cases contained in this volume have been double blind refereed, and each was required to have a complete teaching note before consideration. The acceptance rate for manuscripts in this issue, 25%, conforms to our editorial policies. The Instructor's Note are published in this volume and the corresponding cases are published in a separate issue of the *JIACS.*

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

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

Inge Nickerson, Barry University
Charles Rarick, Purdue University, Calumet

NOTES

WHEN CHANCE TURNS TO DISASTER: PARTS A, B, AND C[1]

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

CASE DESCRIPTION

This is a field-based disguised case which describes how an instructor's replacement for the last four weeks for three courses encountered plagiarism with two group case term papers and how he and the administration dealt with the situation. In Part A, Professor Reynolds is asked to replace Professor Chance for the last four weeks of the semester after Professor Chance missed two weeks of three Business Strategy courses. He develops a new course outline which he presents to the class only to find that certain students object to the new outline given the fact that it does not factor in previously graded work. In Part B Professor Reynolds stays with the current outline and assigned student groups cases from their text to present to the class and then required a group case term paper. In examining two of the papers, he noticed that they had been verbatim copied from the instructor's manual. Professor Reynolds consulted with the Dean and they then informed the Provost that these students would be withdrawn from this course and allowed to retake the course without penalty. Students freely admitted that they had copied from the instructor's manual, which was earlier given to them by Professor Chance. In Part C Professor Chance is confronted by the Provost about the situation and ends up storming out of the Provost's office refusing to resign.

The case is designed to be taught in one class period (may vary from sixty minutes to one hundred minutes, depending upon the course structure and the instructional approach employed [see instructor's note] and is expected to require between six to ten 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 two-part case describes how Professor Reynolds dealt with substituting for Professor Chance, a professor who seemed to have not been working out well with his classes. In Part A the students were complaining to Dr. Reynolds that much of their work was not being graded, and, if the work was graded, it was being graded too harshly-- at a graduate student level. Professor Reynolds unilaterally decided that the best approach in the remaining four weeks of class would be to cover the course basics, and grade students not based upon past work (although those who received grades of B or better would receive extra credit) but upon four criteria: Mini-case Analysis (25%), Group Case Presentation (25%) and Group Case Report (50%). This decision did not go over well with some of the members of each class who had submitted work to Dr. Chance and now would not be considered as part of their grade unless they received a B or better (this would be used as extra credit).

Part B begins with Reynolds explaining to his students that it would be difficult for him to use Dr. Chance's grading of their work given Dr. Chance's seemingly inconsistent grading of their work. Reynolds then discussed with the Provost his new course outline and how he would handle prior course work and the Provost approved of Reynolds's resolution. After sitting through student presentations and reading student group papers, Professor Reynolds realized that two groups' of the groups' papers were verbatim copies of the instructor's manual. The Dean and Professor Reynolds interviewed the students individually who were involved in the plagiarism. Students clearly admitted to the plagiarism, however, the students indicated that Professor Chance gave them his instructor's manual for assistance. Reynolds and the Dean wondered if the students could be held accountable for their actions even though a faculty member was an unknowing "accomplice?"

In Part C the Dean and Professor Reynolds decided that the students who plagiarized would be withdrawn from the course without penalty since plagiarism was inexcusable, regardless of Chance's actions. The Provost then met with Dr. Chance who confirmed that he had leant the students his instructor's manual. The Provost asked for Chance's resignation and the case ends with Chance refusing to resign and storming out of the Provost's office.

INSTRUCTORS' NOTES

PART A

Dr. Reynolds walked into a bad situation. Taking over for another professor in the last four weeks of a semester in three courses, regardless of the rationale, makes it very hard on the students as well as on the faculty member in trying to find a fair and equitable way to evaluate students based upon the old instructor's criteria and any new criteria proposed by the new faculty member. Did Professor Reynolds handle this situation in an equitable manner by changing the course outline and by disregarding all of the unmarked work of students, while giving only those students who did receive grades and grades of "B" or better, extra credit? Although a very fair question, this was not the only issue that Professor Reynolds had to address.

PART B

Professor Reynolds' noticed that two groups' term papers had been plagiarized from the textbook instructor's manual. However, Professor Reynolds should have been prepared for such a situation since it is well known that students plagiarize work and that plagiarism has plagued academia for an extended period of time. "A study by The Center for Academic Integrity found that almost 80% of college students admit to cheating at least once. According to a survey by the Psychological Record, 36% of undergraduates have admitted to plagiarizing written material. A poll conducted by U.S. News and World Reports found that 90% of students believe that cheaters are either never caught or have never been appropriately disciplined." (http://www. mustangps.org/~kingch/Cheating.htm, June 21, 2006) "A study conducted by Ronald M. Aaron and Robert T. Georgia: Administrator Perceptions of Student Academic Dishonesty in Collegiate Institutions found that 257 chief student affairs officers across the country believe that colleges and universities have not addressed the cheating problem adequately. … A national survey published in Education Week found that 54% of students admitted to plagiarizing from the internet; 74% of students admitted that at least once during the past school year they had engaged in "serious" cheating; and 47% of students believe their teachers sometimes choose to ignore students who are cheating." (http://www.plagiarism.org/plagiarism_stats.html, June 21, 2006.)

Circumstances notwithstanding, "plagiarism has never been easier than it is today. Before the Internet, cheating was labor-intensive and obvious. Potential plagiarists had to find appropriate works from a limited pool of resources, usually a nearby library, and copy them by hand. Since these resources were almost always professionally written, the risk of detection was very high." (http://www.plagiarism.org/learning_center/plagiarism_the_internet.html, June 21, 2006.)

Although not mentioned in the case, the Internet now makes it quite easy to find thousands of relevant sources in seconds, and, in the space of a short time, plagiarists can find, copy, and paste together a term paper, article, or even a book. Because the material online is produced by writers of varying levels of quality and professionalism, it is often difficult or impossible for educators and editors to identify plagiarism.

Even when an instructor or editor does suspect plagiarism, the sheer size of the internet seems to work in the plagiarist's favor. Search engines can be useful for tracking down suspect passages, but even they have their limitations, given the number, variety, and password-protected nature of many websites. Even where search engines do prove useful, manually searching the internet for matches of hundreds of papers or articles can be a formidable task.

"Additionally, the seemingly 'public' nature of online content blurs the distinction between publicly and privately owned information. Electronic resources which are, by nature, easily reproducible, are not perceived as 'intellectual property' in the same way that their material counterparts are. Just as peer-to-peer file-sharing programs have made it easy to trade copyrighted music files that most people would never think to steal in physical form, the internet makes plagiarism easy for students and writers who might have thought twice about copying from a book or published article.

Perhaps the greatest resources for would-be plagiarists in the educational world are the hundreds of online paper mills that exist solely for the purpose of providing students with quick-fix homework and term-paper solutions. Many of these services contain hundreds of thousands of papers on a wide variety of topics, and some even offer customized papers for an additional fee. The fact that many of these sites have become profitable ventures (complete with paid advertising!) only attests to the unfortunate truth that plagiarism has become a booming industry." (http://www.plagiarism.org/plagiarism.html, June 21, 2006.)

Given this backdrop of a plagiaristic society and the seemingly dire circumstances that the students seemed to have faced, is there anything that Professor Reynolds could have done with his course requirements or when he first met with his classes in order to minimize the potential for plagiarism?

PART C

The situation went from bad to worse, and shifted from focusing on Professor Reynolds' students to how the Dean and the Provost where going to handle Professor Chance's facilitating the plagiarism, albeit accidentally, by lending the instructor's manual to his students. Since a faculty member knowingly gave his students the instructor's manual, the Dean and Professor Reynolds should gave tread lightly in terms of the penalties associated with the plagiarism; but did they?

Chance's action would seem to have broken both an academic taboo and common sense (since instructor's manuals include answer keys that can easily be copied and decimated to other students over the web). However, Professor Chance had never taught in a traditional classroom setting before; he only taught in one-on-one and Internet settings. One is then left asking the question, given Professor Chance's lack of traditional academic classroom, why was he hired in the first place? Secondly, given his inexperience in this setting, why was the professor given the capstone course to teach and what support and supervision was provided to Professor Chance? Did the administration inadvertently set this situation up to fail?

The Provost's confrontation with Professor Chance also raises some interesting questions - whatever happened to the students' charges of sexual harassment and favoritism? Why weren't these charges even mentioned to Professor Chance? Also, Professor Chance refused to resign from his position when asked by the Provost and would, therefore, still be employed by the institution. Were Chance's actions so heinous (and was he so incompetent) that his continued employment would in fact jeopardize the quality of education received by his students?

RESEARCH METHODOLOGY AND DATA COLLECTION

This case is anthropological and autobiographical in nature since one of the authors experienced this situation firsthand. The others had experienced similar situations when faculty members in their departments took mid-semester medical leaves of absence (although their students did not plagiarize their work). Hence this research is subjective and phenomenological in nature since it is based upon the experiences of one of the parties described in the case. (An excellent discussion of phenomenological research is provided by Stan Lester at http://www. devmts.demon.co. uk/resmethy.htm, October 27, 2004.)

The writing style of the case, therefore, reflects a more colloquial style then one might find in a typical case and tries to capture the points of view of several of the case characters. The information for this case was collected by the co-authors through personal reflection, observations, e-mails, and discussions with the key characters in the case. The paraphrases presented in this case are from actual conversations between the case characters. The case was disguised, with some of the facts of the case altered, in order to further mask the case and protect all of the involved parties.

Intended Instructional Audience & Placement in Course Instruction

This case was primarily developed for graduates who were taking a course in higher education and administration since it deals with a real-life situation which post-secondary administrators and faculty may have to face. The content of the case also includes issues in human resource management (the hiring of professor Chance; charges of favoritism and sexual harassment; and lack of supervision, mentoring, and development), classroom management (the handling of old student assignments; the redesigning of the course), and ethics (the equity of not counting prior student work; student plagiarism; and the handling of Professor Chance). The case specifically deals with how the Dean, the Provost, and Professor Reynolds handled the problems that emerged from Professor's Chance's mismanagement of his three capstone courses. Parts A & B of this case may also be used for new faculty training purposes (either in a Ph.D. program or through new faculty development programs) since it directly addresses how both a faculty member and the college administration dealt with a rather unique form of plagiarism.

In terms of a course in Higher Education Administration, the case should be presented in conjunction with readings that address the topics of: evaluating faculty performance; recruiting, hiring, and mentoring and training faculty; dealing with difficult faculty members; avoiding legal problems; dealing with sexual harassment; and strategies for faculty development. (Leaming, 1998; Lees, 2006) Given the fact that these topics cover numerous text chapters, this case is somewhat comprehensive in nature and should be employed towards the end of the semester, perhaps as a sectional review, final case exam, or a comprehensive take-home case analysis.

Secondarily, the case may also be employed in any undergraduate class that deals with the issue of applied ethics (i.e. Business Ethics; Business, Government, and Society). There are several behaviors embedded in the case that could be questioned from a moral perspective. Those issues include:

1. Dr. Chance's giving students access to the instructor's manual.
2. The administration's immediate replacement of Dr. Chance for the entire semester before they even confronted him with the student complaints and harassment allegations.
3. Dr. Reynolds' discounting and/or dismissing of students' prior course work.
4. The students' use of the instructor's manual without proper citations.
5. The administration's request for Dr. Chance's resignation after it was found that he had given students access to the instructor's manual.

For a Business Ethics or Business, Government, and Society class, this case could be utilized with material that addresses the issues of proprietary technology and protection, and knowledge management. (Ghillyer, 2008; Lawrence and Weber, 2008). These topics are normally covered within one to two chapters on ethics and technology and therefore this case could serve as either an introductory case to these chapters or an end of chapter case.

For either groups' of students who do not have any background or assigned readings on plagiarism and education administration, handouts are available at the end of this teaching note that may be distributed to the class (See Appendix A - Handout on Plagiarism; Appendix B Handout on Education Administration).

Learning Objectives

The overall purpose of this case is to have students examine five critical, though indirectly related, topics: (1) the past issue of how the administration and Professor Reynolds dealt with replacing Professor Chance, (2) in Part A, how Dr. Reynolds dealt with students' complaints that prior work would not be counted towards their course grade, (3) the immediate issue in Part B as to how Professor Reynolds and the administration dealt with student plagiarism, (4) the immediate issue in Part C as to how the administration will deal with Professor Chance, and (4) the longer term issue of how to ensure that another professor does not find him or herself in the same situation as Professor Chance. This case, in particular, has practical value for graduate education students, since many of them may find that as educational administrators or faculty, they will have to deal with similar situations. Students are asked to probe beyond personalities and the immediacy of the moment and examine the underlying nuances of the posed problems.

Specific learning objectives are as follows:

1. For students to understand the numerous layers of the problems posed in this case and to do outside research on the topic of plagiarism and education administration.

2. For students to deal with the immediacy of the problem posed by Professor Reynolds replacing Professor Chance in the last four weeks of three capstone courses.
3. For students to determine whether Professor Reynolds and the administration handled this replacement appropriately as well as the reconstruction of the course and the discounting of prior student work.
4. For students to assess whether the administration and Professor Reynolds appropriately handled the plagiarism situation.
5. For students to judge whether the administration's treatment of Professor Chance (from hiring to request for his resignation) was proper.
6. For students to recommend policies and procedures that would ensure that this type of plagiarism would not reoccur and the faculty members would be properly hired, trained, mentored, and evaluated.

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, students, prior to reading this case, be exposed to some material on plagiarism, faculty human resource issues, dealing with difficult faculty, and classroom ethics. (Many colleges have excellent resources and websites describing plagiarism. For example, see Purdue's http://owl.english.purdue.edu/owl/resource/589/01/ on avoiding plagiarism.) This will provide students with the proper background and knowledge base and allow them to acknowledge some of the managerial and ethical issues embedded in the case. (Noonen and Blechman, 1999)

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.

Case Method

Although most of the students in a graduate education programs may have had some exposure to the case method, it behooves the instructor to provide students with a review of the case method of analysis. In the traditional case method, the student assumes the role of a manager (department chair, Dean, Provost, etc…) 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, although the focus should be on the current course content. 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 issues
- ♦ adopt the appropriate time frame. (Pearce and Robinson, Jr., 2005)

The instructor's role in case analysis is one of a facilitator. The instructor: (1) helps to keep the class focused on the key issues; (2) creates a classroom environment that encourages classroom discussion and creativity; (3) bridges "theory to practice" by referring back to key concepts learned in this or prior courses; and (4) 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 field work. (Nicastro and Jones, 1994).

Regardless of the variation employed, it is recommended that the students' work be evaluated and graded as partial fulfillment of the course's requirements. However, if this case is not employed as a comprehensive case, it is not recommended that this case (and its related assignments) have a large weight or impact on students' overall course standing.

Using Case Questions. Whether or not the instructor assigns questions for students to analyze with the case is usually a matter of educational philosophy and student readiness. Naumes and Naumes, for example, thought that if the questions were embedded in the case that "students will tend to focus only on the issues specifically raised by the questions …". (Naumes and Naumes, 1999). Lynn (1999), on the other hand, noted that the use of assignment questions provided students with more concrete guidance in case preparation and analysis; specifically directing them to consider the decision to be reached.

In deciding whether or not to assign questions, the instructor should first answer the following questions:

1. What is the level of course instruction?
2. What type of case is being taught? (Iceberg, incident, illustrative, head, dialogue, application, data, issue, or prediction - see Lundberg et. al., 2001 for full descriptions.)
3. What is the instructor's preliminary assessment of the students' ability to be self-directed learners?
4. What are the students' previous experiences with case instruction?
5. If the students have already been exposed to the case method, to what types of cases have they been exposed? Case incidents (1-2 page cases with questions)? Short cases (3-8 page cases with and/or without case questions? Comprehensive cases (greater than 8-15 pages) Harvard-style cases (greater than 15 pages)? (David, 2003)
6. What is the instructors preferred method for case instruction? (For example, "sage on the stage", "guide on the side", "student as teacher" (student-lead discussions), "observer and final commentator" (open class discussion with faculty summation, etc.).

Role-Playing (100 minutes)

Role-playing enacts a case and allows the students to explore the human, social, and political dynamics of a case situation. This case lends itself quite well to a two-part role playing exercise, since it involves a rather simple situation with only three to four characters and, therefore, most of the class can role play in this exercise.

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

1. Who are the key participants in the case? Why?
2. What is the "role" of each of these participants in the organization?
3. What is the dilemma that the characters are facing and/or how can they assist someone else in solving a problem?

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

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

The class should form groups of three to four students with three of the students enacting the key roles in the case (Professor Reynolds, the Dean, and the Provost) and the other acting as observers. The instructor should pass out a short reminder notice about participants staying within their roles.

Step 2: Enactment 1 - Deciding What to Do (20 minutes)

The student enacting the role of Professor Reynolds should be instructed to start the conversation, summarizing the situation in Parts A and B. The students enacting the roles of the Dean and the Provost should review the college's plagiarism policy (your own school policy should be employed, and readily available on the college's website or from the student or faculty handbook - if not see IM Table 1 Sample College Plagiarism Policy, below as a sample).

IM Table 1 - Sample College Plagiarism Policy

Brooklyn-LIU Campus Plagiarim Policies
Undergraduate Bulletin 2004-2006 (p.28-29) & Graduate Bulletin 2002-2004 (p. 11)
Discipline:

Cheating on examinations and plagiarism of any sort are unacceptable and, if proven, are cause for the most severe penalties up to and including suspension or dismissal from the University. The classroom instructor determines the rules of acceptable student conduct during examinations. Each instructor has the right to insist on procedures to ensure the integrity of those examinations- seating arrangements, no communication among students, the restriction of materials available to students during the examination, and so on.

If a student is discovered cheating in a classroom examination or written assignment, either by crib notes or by receiving information from or giving information to a fellow student or by any means not stipulated by the rules of the examination, the instructor has the

> right to confiscate all test materials from the person or persons involved and give the grade of zero for the examination to the person or persons knowingly involved. The instructor also has the right to fail the students for the course.
>
> Also, students who submit written or other work not their own or who submit work with sources inadequately acknowledged or with an inadequate system of documentation for a specific course assignment may be given the grade of zero for the work submitted and a failing grade for the course.
>
> Any breach of discipline may result in disciplinary action, including suspension or dismissal. The Faculty-Student Judicial Review Board, in accordance with its procedures, may hear all cases that may result in suspension or dismissal and will recommend an appropriate course of action to the Dean of Students. (http://www.brooklyn.liu.edu/library/services/refservices/AntiPlagiarism.htm)

Students in this role playing exercise should, therefore, decide what a fair punishment is for the students who have plagiarized the team case term papers given the following circumstantial evidence:

1. The former instructor handed them the textbook's instructor's manual.
2. Prior work had been discounted by the new instructor and only counted for extra credit if the grade was "B" or better.
3. The prior instructor was replaced with only four weeks remaining in a class based upon his perceived incompetence.
4. This was their last semester and the final course they needed in order to graduate.

The students' group decision should be written down on a piece of paper and handed to the instructor when they are completed.

Step 3: Debriefing 1 (20 minutes)

The instructor should post all of the suggested solutions on the board and allow for an open discussion of the results of the exercise, perhaps employing the following questions:

1. Did the majority of the class agree with the solution strategy proposed by Reynolds, the Dean, and the Provost in the case? If so, why?
2. What were the differing solutions? How much did they vary by?
3. If groups hard harsher punishments, what were they and what was their rationale?
4. If groups had more lenient punishments or none at all, what were they and what was their rationale?

Step 4: Enactment 2 - Confronting Professor Chance (20 minutes)

Two roles will need to be enacted, those of Professor Chance (the observer from Enactment 1) and the Provost. The student enacting the role of the Provost should be instructed to start the conversation by summarizing the situation, specifically how Professor Chance's lending the instructor's manual to his students accidentally allowed them to plagiarize their term papers. The student enacting that part should be instructed to display the Provost's displeasure at these actions but to not over-dramatize the situation. The instructions to the students playing Professor Chance would be to admit to the act but to assume that this was an honest mistake, one that will never happen again.

The role play should continue with the Provost pushing for Professor Chance's resignation and for Professor Chance offering both a rationale for his actions with the classes in general, and this situation in particular. The student enacting the Provost does have the opportunity to present the charges of favoritism and sexual harassment at this time, while the student playing the role of Professor Chance may point to his lack of supervision, support, mentoring, and supervisory direction.

Step 5: Debriefing 2 (20 minutes)

Once the role play is completed, the instructor might want to ask the following questions:

1. Was the situation resolved, or did Professor Chance, as in the case, storm out of the Provost's office?
2. If the situation was resolved, what was the resolution?
3. What were the similarities and differences in the resolutions reached? Rationale for each resolution?
4. What does the class as a whole think about what should be done with Professor Chance?

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

5. Did this exercise animate the case? Did students get a "feel" for the issues surrounding Professor Reynolds and Professor Chance's situation?
6. What were the strengths and weaknesses of the exercise? What changes would they make to the exercise given their experiences with it?

The debriefing session should produce closure for students by connecting the theory of family firm management and ethical behavior with case specifics and the results of the role-playing exercise.

SUGGESTED CASE QUESTIONS [2]

PART A

1. What problems were posed by Professor Reynolds replacing Professor Chance in the last four weeks of three capstone courses?
2. Did Professor Reynolds and the administration fairly (from the students' perspective) handle this replacement appropriately as well as the reconstruction of the course and the discounting of prior student work?

PART B

3. What could Professor Reynolds and the administration have done to try to prevent plagiarism from occurring?
4. Did the administration and Professor Reynolds handle the plagiarism situation appropriately?

PART C

5. Did Professor Chance's behavior warrant replacement? Were there any extenuating circumstances with Dr. Chance that were not investigated?
6. Was the administration's treatment of Professor Chance handled (from hiring to request for his resignation) properly? How would you have handled the request for Dr. Chance's resignation?

PART A

1. What problems were posed by Professor Reynolds replacing Professor Chance in the last four weeks of three capstone courses?

This question asks students to describe the impact of replacing Professor Chance by Professor Reynolds mid-semester. Students must interpret case facts and determine the problems that explain why certain problems may have emerged due to this replacement.

A poor answer to this question will be an answer which merely lists the students' opinions as to what were the problems in the case caused by replacing Professor Chance and not supported by any sources of information.

A fair answer will include an acknowledgement that the first problem is that any change in the normal flow and operation of a classroom will be disruptive for the students attending that class, especially in a capstone course where students are expecting to graduate. Change theory would posit that a change that has not been planned with class involvement and that has not prepared the recipient for change is bound to have if not disastrous, certainly unsettling affects. (Rowley and Sherman, 2001). This is evidenced by the fact that several students felt quite upset that the material that they had already worked on in for the class would not count towards their final grade, unless they received a grade of B or better. Since many students submitted work that had not been graded, this work would not count toward their final grade.

A good answer would indicate in more detail that a change, specifically in the course outline, is quite problematic in that the course outline, or syllabus, performs 17 functions: (1) describes course content; (2) places the course in the context of the program; (3) delineates entry-level skills; (4) explains course logistics; (5) cites reference materials; (6) details the sequence of course activities; (7) outlines course goals; (8) enhances student motivation; (9) suggests alternative learning modes; (10) provides students with a mechanism for self-monitoring; (11) identifies terminal performance objectives; (12) serves as an articulation tool; (13) publicizes and promotes the course; (14) provides a reference point for course modifications; (15) explains the grading system; (16) fulfills accreditation requirements; and (17) serves as an instructor/student contract [emphasis added]." (Lear, Jr., 1980)

In essence, a new course outline, especially one for only the next four weeks, with a new instructor would seem to imply that , although the content of this new course may be similar to the prior course (although it would seem that it may not),. This is quite apparent in that not only has the course content and course logic changed, course performance objectives and the grading system has changed as well.

A very good answer would also indicate that another problem that may emerge is that, by changing the course outline without mutual consent, the new instructor had broken a tacit contract that existed between the class and the previous instructor. A contract is defined as "a binding agreement between two or more parties for performing, or refraining from performing, some specified act(s) in exchange for lawful consideration" (http://www.investorwords.com/1079/contract.html) yet the new instructor abolished that agreement and acted as if that agreement was not binding upon him and the institution he represented. Lear has posited that "course syllabi … serve as student performance contracts" (Lear, Jr., 1980)
and therefore any change in that contract would need to be done by mutual consent. It was evident from the case that several students objected to the change in contract since it discounted the value of their previous work and did not take into consideration their prior ten weeks of effort.

An excellent answer would address not only the problem of change but the problem of equity as well. How could the professor unilaterally decide to change the grading requirements of the course without at least consulting the class beforehand? Secondly, how could he, in all fairness, discount any previous work submitted, approximately 2/3 of the course, therein only counting the work submitted for the last 4 weeks of the semester?

Equity is defined as "justice according to fairness, especially as distinguished from mechanical application of rules under common law." (http://www.people.vcu.edu/~bwooldri/pdf_docs/social_equity_pdf/sep_ education.pdf) Justice as fairness as described by John Rawls "consists of two principles: that all have the greatest degree of liberty compatible with like liberty for all, and that social and economic inequalities be attached to positions open to all under fair equality of opportunity and to the greatest benefit of the least well-off members of society." (http://en.wikipedia.org/wiki/Justice_as_Fairness) The question then, given this definition, is, "Are students in these classes given the greatest amount of liberty and has the inequality of the student-teacher relationship impacted the outcome of the decision?"

Students might perceive that the new instructor had taken advantage of the class and the inequitable power relationship by acting in an authoritarian manner by imposing his new course requirements. This not only creates a perception of inequity by the students but may also lead to possible student grievances (Robinson and Bridgewater, 1979) (if they receive a perceived unfavorable grade) and perhaps even legal redress. (Santora and Stoner, 2003)

2. Did Professor Reynolds and the administration fairly (from the students' perspective) handle this replacement appropriately as well as the reconstruction of the course and the discounting of prior student work?

This question asks students to evaluate the actions of the administration relative to the problems posed by replacing Professor Chance as well as alternative choices the administration could have made in light of being fair and just to the students in the class.

A poor answer to this question will be an answer which merely denotes the students' opinions as to whether or not replacing Professor Chance was done properly as well as how correct it was for the new instructor to reconstruct the course and discount prior student work.

A fair answer would note that research indicates that "the average valence variable from the expectancy theory model was found to be the best overall predictor of actual academic performance" (Geiger and Cooper, 1995) and that role expectations of teachers and adult students indicates that if teachers and students had similar expectations toward educational goals and objectives, then by mid-semester, the teachers would not have changed their initial work requirements; and few would have altered their teaching style. (Blumenthal, 1969) It is therefore safe to assume that students would have an expectation that course requirements would remain stable throughout the semester. A shift in course requirements, and the instructor, would therefore negatively impact their motivation and therein their learning and course performance.

Expectancy theory suggests that the amount of effort or motivation that an individual will exert ultimately depends on three perceptual relationships: expectancy, instrumentality, and valence. Expectancy is a person's subjective estimation of the likelihood of successfully performing a particular behavior, instrumentality is a person's subjective estimation of the likelihood that a particular behavior will result in certain outcomes, and valence is the positive or negative value that a person places on each of these outcomes. (Hancock, 1995)

By changing the course instructor, the course outline, and, the course requirements, the administration impacted students' expectations of classroom performance and therein students' performance in the course (research indicates that 28 percent of the variance [R2] in the students' cumulative grade point averages can be explained through expectancy theory). (Pringle, 1995). The administration, therefore, should have taken great pains in supporting students' performance expectations and therein a perception of fairness, as per Adams' equity theory. (Adams, 1965)

A good answer would go into some detail as to how the administration could have supported students' current set of performance expectations and their perception of fairness. For example, rather than having the secretary inform students via emails and phone calls over the weekend that a new professor would be in to cover the courses for the next four weeks until the end of the semester (and that he would be grading them), a meeting by the Dean with the class to discuss the change would have served as an excellent 'instrumental behavior' on the part of the administration to facilitate student performance. This discussion would address students' concerns about the current instructor, inform the students of the faculty member's leave of absence, and deal with expectations about the new instructor and the material he was going to cover, students' preferences in terms of how their prior work was going to be employed as part of their grade, and their preferences and expectations as to what assessment instruments were going to be employed for the last four weeks of class for grading purposes. This information would then be delivered to Professor Reynolds by the Dean so that he could construct a modified course outline and grading system that would have met most of the students' expectations about the course, prior work, and future course requirements.

A very good answer would have Professor Reynolds as the new instructor engage the class in the development of the new course outline in order to ensure that he and the students had similar expectations toward educational goals and objectives and therein a better perception of fairness. This could, as per the "good" answer above, be a follow-up to the Dean's discussion by presenting to the class a proposed updated syllabus that would address: how prior work would be dealt with (how would graded and ungraded material count towards their final grade), what material would be covered in class, and what additional assignments would be required including the weighting of those assessment instruments. Students should then be given an opportunity to actually develop their own syllabus for the class, with the understanding that not everyone will agree on the final result but that each and every student would have input into the final outline and grading system. The outcome may not be perceived as "fair" by everyone but at least the process would have allowed for student voice. (Hirschman, 1970)

An excellent answer might have Professor Reynolds take an even more interactive approach to developing the new course by, rather than presenting a proposed course outline, actually acting as a facilitator for the class in their development of their own outline for the course. He would assist the students by describing his learning objectives for the class, what their options were in terms of learning content (what specific knowledge of strategic management could they acquire), the learning process (what combination of instructional methodologies would be employed (i.e., lecture, discussions, films, case, experiential exercises, student-lead lecture/discussions, guest lecturers, simulations, etc.), and the assessment instruments (exams, papers, presentations, participation, etc.) and their weightings. He would then conduct an open class session where he would work with the class to develop their own learning objectives and to develop an outline that addressed those objectives.

PART B

3. What could Professor Reynolds and the administration have done to try to prevent plagiarism from occurring?

This question asks students to examine the question of plagiarism in general terms and to determine what could be done at the school and instructor level to minimize student plagiarism.

A poor answer to this question will be one that merely denotes the students' opinions as to what the administration and professor Reynolds have done to minimize student plagiarism and would not include any references or citations to outside sources.

A fair answer would start by defining plagiarism. "Plagiarism is a form of cheating, and within academia is seen as academic dishonesty. It is a matter of deceit: fooling a reader into believing that certain written material is original when it is not. Plagiarism is a serious and punishable academic offense, when the goal is to obtain some sort of personal academic credit or personal recognition. … [In this case] plagiarism is the passing off of another person's work as if it were one's own, by claiming credit for something that was actually done by someone else." (http://en.wikipedia.org/wiki/Plagiarism)

At the administrative level, they should: "(1) communicate policies on academic misconduct regularly to students and faculty; (2) encourage faculty to discuss dishonesty with students; (3) establish non-permissive test environments with watchful instructors, spaced seating and varying exam formats; (4) enforce policies in a consistent, fair and timely manner; and (5) maintain emphasis on mature behavior, self-responsibility and proper conduct." (Gerdeman, 2000)

At the instructor level, there is an acknowledgement that "the majority of the faculty does not regularly follow institutional policy and most handle incidents of cheating and plagiarism on their own. They believe that the responsibility for reducing academic dishonesty lies primarily with students and faculty." (Burke, 1997) That being said, "plagiarism is avoided by learning and using the agreed citation style; such as MLA style, Chicago style, or APA style. Students will also be expected to learn and adopt the style that has been adopted by the university they are attending." (http://en.wikipedia.org/wiki/Plagiarism) There is an expectation that faculty should therefore not only instruct their students on what constitutes plagiarism, and how to avoid it, but that faculty will be diligent in checking students' work, including adopting of electronic plagiarism checkers as a means of systematically policing student submissions. (Scanlon, 2003)

A good answer would go beyond the fair answer by acknowledging that there are two forms of plagiarism: purposive and accidental. "Intentional and obvious plagiarism, where an entire essay or research paper is copied from another source, is often blamed on stress or laziness. Accidental plagiarism is often the result of poor citation or referencing or of poor preparation, or a misunderstanding of plagiarism per se. Sometimes a student will arrive at university unprepared for the writing of academic essays and research papers, and will take a few semesters to familiarize themselves with what is required." (http://en.wikipedia.org/wiki/ Plagiarism)

This division of the types of plagiarism should therefore lead to differing interventions from the administration and the faculty. In order to avoid accidental plagiarism, the administration should have a standard policy, usually published in the student handbook and the college catalog, for defining what constitutes plagiarism, and an educational mechanism (be it a required course, a required learning component of a course, etc.) for insuring that students not only are taught what constitutes plagiarism but can demonstrate that they are capable of avoiding it. (http://www.unc.edu/depts/wcweb/handouts/plagiarism.html) At the faculty level, accidental plagiarism can best be dealt with by faculty seeing "themselves less as plagiarism police and begin to converse with their students about the evolving process of idea-making." (Kraus, J., 2002). "Educators have attended and continue to attend to plagiarism in positive ways that help students better recognize, understand, and avoid it: we educate students on how to properly work with sources…". (Willen, 2004)

Intentional or purposive cheating requires a different approach. At the administrative level, the key to dealing with cheating would seem to be the development of an enforcement system that applies the college's standards of academic integrity both fairly and consistently; i.e., "at St. Thomas University School of Law [the faculty and students] are divided over the way plagiarism charges against five students were handled. Only two of the students were found guilty and were sentenced to complete a five-page paper on plagiarism, two had the charges against them dropped before a hearing was held, and one was acquitted by a student panel. The punishments were seen by one associate professor of law as proof that the law school does not take cheating seriously." (Mangan,

1997) This perception of inequitable and loose treatment of offenders sends two inharmonious messages to students: (1) that the university really does not stand behind its policies when actually confronted with having to apply them; and (2) even when applied, the university cannot be consistent in its application. This lack of consistent and discriminatory enforcement of policy would tend, therein, to support a cheating mentality in that students would perceive a weak system of enforcement - if threats are not backed by enforcement then a system of law cannot exist. (Hart, 1994)

Purposive cheating can be dealt with at the faculty level via expectancy theory by "ensuring that students (a) understand the rules of ethical writing, (b) expect the writing assignment to be manageable, (c) expect ethical writing to lead to personally important benefits, (d) expect plagiarizing to be difficult, and (e) expect plagiarizing to lead to personally important costs." (Malouff and Sims, 1996) Again, faculty must apply the college's plagiarism guidelines, policies, and procedures in order to ensure consistent and fair application of those guidelines.

A very good response would further recognize that academic dishonesty is a multifaceted phenomenon which goes beyond instructor and administrative influences and "appears related to: (1) individual characteristics such as student academic achievement, age, social activities, major, and gender; (2) peer group influences; (3) instructor influences; and (4) institutional policies." (Gerdeman, 2000) That being the case, interventions must be aimed at dealing with social influences and well as individual student influences. In that regard, "the current generations of students do not view plagiarism as theft." (Wood, 2004) Therefore the administration and the faculty have to understand that, in order to deal with purposive plagiarism; they must address the issue of academic integrity [and integrity in general] and what that means in the age of digital information.

"Academic integrity contains fundamental values and principles that reinforce educational mission and academic processes. Academic integrity focuses on standing up for academic honesty, trust, fairness, respect, and responsibility." (Drinan, 1999) The solution, therefore, is to try to develop a culture where academic integrity and honesty are highly valued, nurtured, and rewarded. From the institution's perspective, "faculty needs to teach them about standards of academic integrity; help them to understand academic culture; and explain the ramifications, both intellectual and ethical, of cheating. [To facilitate this process], some schools have developed pledges and honor codes to help cultivate an ethos of integrity on campus." (Willen, 2004)

"Faculty can build bridges to student understanding of academic values by modeling academic integrity as an institutional norm." (Wood, 2004) This requires that faculty "should move beyond a tendency to see student plagiarism as fully informed attempts to defraud the academic process" (Kraus, 2002) and "that they have a primary role in values education." (Burke, 1997)

An excellent answer would acknowledge that the best way to address plagiarism at the faculty level would be for faculty to "address the problem by designing projects which make plagiarizing difficult." (Willen, 2004) More specifically, "faculty in many disciplines have even given up on assigning research papers that require students to identify, locate, evaluate, and use research materials on their own. Instead, they simply have their students write papers based on assigned, pre-selected readings." (Grassian, 2004) Although this may minimize the potential for purposive plagiarism from other sources (assuming that these pre-selected readings are new, not employed by an earlier class, and have not been analyzed by someone else and posted to the internet), students may still be plagiarize from each other and may still accidentally plagiarize by failing to cite any outside sources used to support their analysis of the readings.

4. Did the administration and Professor Reynolds appropriately handle the plagiarism situation?

The purpose of this question is to have students address the issue of how the plagiarism was handled by the administration, especially in light of the fact that Professor Chance's accidentally assisting students in this endeavor. Students are asked to determine whether or not there were better alternatives which the administration could have availed them of.

A poor answer to this question will be an answer which merely denotes the students' opinions as to whether or not Professor Reynolds and the administration properly dealt with the issue of student plagiarism and would not include any references or citations to outside sources.

A fair answer to the question would indicate that Professor Reynolds did take this problem to the Dean, rather than act on his own, and, therefore, acted appropriately by not dealing with this problem by himself. However, there was no indication in the case that the Dean acted in consultation with any college guidelines that would have both defined what plagiarism was and, more specifically, detailed the procedures for handling an accusation of plagiarism.

A good answer would include some research as to what the typical procedures for handling an accusation of plagiarism would entail. See below excerpt as an example:

Procedure for Handling a Possible Case of Plagiarism or Misuse of Sources

When you think you may have a case of plagiarism, it is essential that you document (by email and other means) the process from beginning to end. Remember that everything you write (especially email) could become a legal document, so document as if a bevy of lawyers were looking over your shoulder.

We want you to consult and follow these procedures, but as the teacher of record in these courses it will be you who decides in almost all cases what actions (disciplinary or otherwise) should be taken.

There are three parts to handling a potential plagiarism case:

1. Arranging a meeting with the student, copying documents, and arranging for a director to be present at your meeting with the student,
2. Meeting with the student and assessing the nature and severity of the case,
3. If you decide the student has plagiarized, imposing an academic consequence and contacting the Dean of Students Office.

Arranging a meeting with the student, copying documents, and informing a director when you think you may have a case of plagiarism (not just misuse of sources), take care of these preliminaries (in no particular order).

- o Make a copy of the relevant documents.
  In addition to copying the document in question, you may also want to copy such documents as other examples of the students' writing, the assignment, and (if you have it) the document you believe the student plagiarized from.
- o Inform one of the FE Directors or the English Department Chair about the problem by email.
  Explain the case in moderate detail, including why you're questioning the work. In addition, we encourage you also to meet with one of us in person.
- o Arrange for another person (director, mentor, or other colleague) to be present.
  For legal reasons and for your own protection, a director or mentor must be present during your meeting with the student. The director in most cases will be a Rhetoric and Writing director, but you can also arrange to have another faculty member present. It is preferable that this director/faculty member not be your gender; i.e., if you're a female, choose a male, etc.
- o Arrange a meeting with the student.
  Tell the student you need to speak with him/her about the assignment in question and arrange a meeting outside of class.
  Meeting with the student and assessing the nature and severity of the case
  This is the tricky part. This is where you try to discern exactly what the problem is: Has the student deliberately and dishonestly appropriated someone else's ideas or words (plagiarism)? Did s/he make an innocent (not dishonest) mistake because she didn't know how to use sources? Or is the problem somewhere in between?
  Try to maintain a coaching relationship; avoid becoming a plagiarism cop. Give the student the benefit of the doubt. To whatever extent possible, assume ignorance, not dishonesty. If it's a case of a markedly different style, assume first that the student has made a quantum leap (which does happen occasionally, thank goodness).

Here are some general guidelines.

1. Before the meeting, arrange for another person (director, mentor, or other colleague) to be present. This is for your protection. As with all student conferences, keep your door open.
2. Give the student an opportunity to explain her or his actions.
   In almost every case, you should not begin by accusing the student or showing him/her your evidence. Ask questions that will help you determine whether this is a case of plagiarism (academic dishonesty) or merely a case of misusing sources or a getting too much help.
   For instance, you might ask the student
   - o how s/he went about composing this paper;
   - o specifically what help s/he received with this paper;
   - o what sources s/he used.

3. Explain why you're questioning the work.

   You can show the student evidence if you have it, or explain what concerns you - (e.g., a markedly different style or level of discourse; a document similar to hers that a student from another section wrote or that you found on the Internet).

   Remember that students sometimes make a leap in writing ability so marked that it only appears to be a different writer. When this happens, you can close the case and congratulate the student on his/her progress.

4. End the meeting with your assessment and (when appropriate) explain how s/he can avoid such problems in the future.

   When appropriate, use this as a teachable moment to explain, for instance, documentation practices or what constitutes too much help. Explain precisely what you want him/her to do: revise the paper (e.g., if sources are inadequately cited); re-write the paper (e.g., if the student received too much help).

   If you think harsher sanctions (e.g., zero for paper, failure of course, etc.) might be appropriate, do not at this time tell the student what further actions (if any) you will pursue. In cases where you believe the student has plagiarized, meet with a Rhetoric and Writing director.

   (If you decide the student has plagiarized) Imposing an academic consequence and contacting the Dean of Students Office

   If you determine the student has been academically dishonest, do the following:

   1. Meet with one of the directors to discuss the case.
   2. Take one or more of the following disciplinary actions.

      We can advise you about which course of action is most appropriate, but you will almost always be in control of this decision.

      o Require a re-write (usually an entire re-write where the student starts from scratch)

.

      o Fail the assignment.
      o Fail the student for the course.
   3. Write the student a memo explaining your actions.
   4. Contact the Dean of Students Office via an email memo.

      In all cases of academic dishonesty, the teacher of record (must inform the Dean of Students Office about the case. You have two options here: (1) just having the Dean of Students Office keep a record of the incident or (2) pursue a possible Student Code of Conduct violation.

      In either case, write an email memo to the Dean of Students Office. Your email should do the following:

      o Request that the Office examine the students' record to determine whether there are previous cases involving the student, and inform you about their findings.
      o Provide a detailed account of the events concerning the case.

- o Summarize the academic actions you have taken against the student for the academic dishonesty.

  This memo becomes a legal document, so it is vital that you stick to the facts and use a professional tone. If you're new to this, please get help from one of the directors. Should the case be serious or should the student have a history of academic dishonesty, we encourage you to have the Dean of Students Office pursue a Student Code of Conduct charges against the student. As always, you will make this decision. (http://www.unm.edu/~english/Resources/pdf/Plagiarism.pdf)

A very good answer would indicate that, although the Dean and Professor Reynolds did not seem to have consulted with the College's policies and procedures manual, Professor Reynolds did obtain evidence as to the nature of the plagiarism. The Dean and Professor Reynolds did in fact interview each of the students involved with the plagiarism incident, and the students readily admitted that they had used the instructor's manual. The case also indicated that the Dean informed the Provost of the incident and the Provost concurred with the imposed penalty of withdrawing all of the students involved with the plagiarism incident from the class (there was no preferential treatment). This would, from a procedural perspective, be an appropriate way in which to handle the plagiarism incident.

An excellent answer would indicate that, although the students' freely admitting copying material from the instructor's manual, Professor Chance had not been consulted about the incident until after the decision was made to withdraw the students from the class. That is, Professor Chance did not have an opportunity to substantiate the students' claims that he gave the instructor's manual to them and that the students had purposely copied the manual and used the material. Without consulting Professor Chance about the incident, the administration and Professor Reynolds could have made a grievous error - why would you take the word of students who had admittedly plagiarized the instructor's manual? What, however, would have occurred if this was not, in fact, actually what had occurred? Would the same punishment for plagiarism had been imposed if it had come to light that these students had stolen or illegally downloaded a copy of the instructor's manual? (Haworth, 1997)

This answer might also address the issue of the punishment itself (given the mitigating circumstances of prior student work not counting, replacing the instructor, and imposing new course requirements during the last four weeks of the semester); that is, does the crime of plagiarism warrant course withdrawal? Doesn't the administration have to take some responsibility for not only hiring Dr. Chance (and, therefore, setting up what students might have perceived as an untenable situation in the first place) but also hiring a replacement during the last four weeks of the course who, with the approval of the administration, imposed new course requirements? Didn't the administration and Dr. Reynolds perhaps accidentally establish a situation where students' expectations were such that they felt that perhaps the only way they could pass the course was through cheating? Worse, did the administration and Professor Reynolds take any conscious steps to minimize accidental and purposive plagiarism?

In this answer, students may posit that a penalty of such a nature of being withdrawn from the capstone course, and, therefore, having to repeat the course in order to graduate from the College, was perhaps overly drastic. A less punitive requirement, such as students having to individually redo the assignment using differing cases from those in their textbook, would have more clearly made the point that it was the students' actions that were reprehensible but also that the Professor Chance, an employee of the university, was indirectly culpable for their actions in that he gave them access to the instructor's manual. If the temptation would not have been presented to them, perhaps they would have completed the assignment without plagiarizing.

PART C

5. Did Professor Chance's behavior warrant replacement? Were there any extenuating circumstances with Dr. Chance that were not investigated?

The purpose of this question is to have students examine Chance's instructional behavior as reported by students and to determine if that behavior was so abominable as to warrant replacement for the last four weeks of the semester.

A poor answer to this question will be an answer which merely lists the students' complaints against Professor Chance and that is solely based upon the student's opinion and not supported by any sources of information.

A fair answer to this question would first define what actions would warrant mid-semester replacement. This requires recognition by the student that faculty replacement and suspension is governed by faculty personnel policies that normally are found in the faculty handbook and/or in the faculty member's collective bargaining agreement. (Bianco and Chalofsky, 1999) The student would, therefore, have to access his or her college's faculty handbook or collective bargaining agreement. An alternative would be to access information from the internet. An internet search would be quite fruitful and uncover text similar to the following:

> Section VII. Policies Regarding Cessation of University Employment
>
> a) Suspension and Discharge
>
> 1. The permissible grounds for the discharge or suspension of either a faculty member with permanent tenure or a faculty member without permanent tenure before a fixed term expires are incompetence, neglect of duty, and misconduct [emphasis added] of such a nature as to indicate that the individual is unfit to continue as a member of the faculty.
> 2. The policy for due process before discharge or the imposition of serious sanctions, i.e., diminishment in rank, is identical to the procedure described in Section 603 of the Code. (http://www.acs.appstate.edu/orgs/facsen/appendixa.html)

The student in this question has to determine if Professor Chance was guilty of incompetence, neglect of duty, and misconduct. According to the case, Professor Chance had been out for the last two weeks, claiming that he was not feeling well. In that time about fifty of his seventy students came over and complained. Their complaints were that: (1) he was absent most of the time; (2) he didn't cover a lot of material; (3) they didn't use the book, which cost them around $180; (4) he only graded about 50% of the midterms and out of that only 20% got grades; (5) on another assignment, he only gave about 10% of the class feedback and grades; and (6) some students said he was grading them using graduate standards, but they are only undergraduates. There were also charges of sexual harassment of a female student and racial discrimination by two black students levied against Dr. Chance. Based on this data, the student would then make a determination whether or not Dr. Chance was incompetent, neglectful of duty, and unfit to continue as a faculty member.

A good answer would include greater specificity from the faculty handbook or union contract relative to the functions and responsibilities of a faculty member and, then, application of that job description to the case situation in order to determine if Professor Chance was guilty of incompetence, neglect of duty, and misconduct. For example, Texas A&M denotes the following responsibilities for a faculty member:

2.2 Faculty Responsibilities

A. Teaching Faculty

Texas A&M International University is committed to excellence in instruction, a concern for students, and the integrity of the institution. As such, all teaching faculty are expected to:

1. Make known to students in writing the goals and requirements of each course, the nature of the course content and the methods of evaluation to be employed.
2. Meet classes as scheduled.
3. Instruct so as to meet course objectives.
4. Maintain competence in teaching fields.
5. Be professional in conduct, in the classroom, and show respect for students.
6. Be available to students for consultation on course work during regular published office hours.
7. Serve as academic advisor in accordance with College policy on advisement.
8. Engage in service activities according to requirements for performance by rank as stated in Section 2.4 of this Handbook, and applicable College and Departmental policies.
9. Engage in scholarly activity according to requirements for performance by rank as stated in Section 2.4 of this Handbook, and applicable College and Departmental policies. (http://www.tamiu.edu/facsenat/faculty.htm)

After perusing this list, students might denote that Dr. Chance seemed negligent in at least items 2 (meet class as scheduled) and 5 (showing respect to students) and, therefore, substantiate grounds for dismissal.

A very good answer will include the realization that most faculty handbooks and union contracts have a section dealing with due process, describing how a matter of this magnitude and seriousness should be handled. Without going through due process, the removal of Dr. Chance could be deemed as premature (at best) and heavy handed (at most), since Dr. Chance had at no time been given an opportunity to present his side of the story (the purpose of having defined procedures for dealing with such situations). (Rossow and Tate, 2003) Students might also cite the procedures associated with bring such charges, see below.

SECTION 603. DUE PROCESS BEFORE DISCHARGE OR THE IMPOSITION OF SERIOUS SANCTIONS

(1) A faculty member, who is the beneficiary of institutional guarantees of tenure, shall enjoy protection against unjust and arbitrary application of disciplinary penalties. During the period of such guarantees the faculty member may be discharged or suspended from employment or diminished in rank only for reasons of incompetence, neglect of duty or misconduct of such a nature as to indicate that the individual is unfit to continue as a member of the faculty. These penalties may be imposed only in accordance with the procedures prescribed in this section. For purposes of these regulations, a faculty member serving a stated term shall be regarded as having tenure until the end of that term. These procedures shall not apply to nonreappointment (Section 604) or termination of employment (Section 605).

(2) The Chancellor or his delegate shall send the faculty member by registered mail, return receipt requested, a written statement of intention to discharge him. The statement shall include notice of the faculty member's right, upon request, to both written specification of the reasons for the intended discharge and a hearing by an elected standing faculty committee on hearings.

(3) If, within ten days after he receives the notice referred to in paragraph (2) above, the faculty member makes no written request for either a specification of reasons or a hearing, he may be discharged without recourse to any institutional grievance or appellate procedure.

(4) If, within ten days after he receives the notice referred to in paragraph (2) above, the faculty member makes written request, by registered mail, return receipt requested, for a specification of reasons, the Chancellor or his delegate shall supply such specification in writing by registered mail, return receipt requested, within ten days after receiving the request. If the faculty member makes no written request for a hearing within ten days after he receives the specification, the faculty member may be discharged without recourse to any institutional grievance or appellate procedure.

(5) If the faculty member makes a timely written request for a hearing, the Chancellor or his delegate shall insure that the hearing is accorded before an elected standing committee of the institution's faculty. The hearing shall be on the written specification of reasons for the intended discharge. The hearing committee shall accord the faculty member twenty days from the time it receives his written request for a hearing to prepare his defense. The hearing committee may, upon the faculty member's written request and for good cause, extend this time by written notice to the faculty member.

(6) The hearing shall be closed to the public unless the faculty member and the hearing committee agree that it may be open. The faculty member shall have the right to counsel, to present the testimony of witnesses and other evidence, to confront and cross-examine adverse witnesses and to examine all documents and other adverse demonstrative evidence. A written transcript of all proceedings shall be kept; upon request, a copy thereof shall be furnished to the faculty member at the institution's expense.

(7) The Chancellor, or his delegate or counsel, may participate in the hearing to present evidence, cross-examine witnesses and make argument.

(8) In reaching decisions on which its written recommendations to the Chancellor shall be based, the committee shall consider only the evidence presented at the hearing and such written or oral arguments as the committee, in its discretion, may allow. The committee shall make its written recommendations to the Chancellor within ten days after its hearing concludes.

(9) If the Chancellor concurs in a recommendation of the committee that is favorable to the faculty member, his decision shall be final. If the Chancellor either declines to accept a committee recommendation that is favorable to the faculty member or concurs in a committee recommendation that is unfavorable to the faculty member, the faculty member may appeal the Chancellor's decision to the Board of Trustees. This appeal shall be transmitted through the Chancellor and be addressed to the Chairman of the Board. Notice of appeal shall be filed within ten days after the faculty member receives the Chancellor's decision. The appeal to the Board of Trustees shall be decided by the full Board of Trustees. However, the Board may delegate the duty of conducting a hearing to a standing or ad hoc committee of at least three members. The Board of Trustees, or its committee, shall consider the appeal on the written transcript of hearings held by the faculty hearing committee, but it may, in its discretion, hear such other evidence as it deems necessary. The Board of Trustees' decision shall be made within forty-five days after the Chancellor has received the faculty member's request for an appeal to the trustees. This decision shall be final except that the faculty member may, within ten days after receiving the trustees' decision, file a written petition for review with the Board of Governors if he alleges that one or more specified provisions of The Code of The University of North Carolina have been violated. Any such petition to the Board of Governors shall be transmitted through the President, and the Board shall, within forty-five days, grant or deny the petition or take such other action as it deems advisable. If it grants the petition for review, the Board's decision shall be made within forty-five days after it has notified the faculty member that it will review the petition.

(10) When a faculty member has been notified of the institution's intention to discharge him, the Chancellor may suspend him at any time and continue the suspension until a final decision concerning discharge has been reached by the procedures prescribed herein. Suspension shall be exceptional and shall be with full pay. (http:// www.acs.appstate.edu/orgs/facsen/appendixa.html)

These students might therefore conclude that without due process it would be impossible to determine whether or not Dr. Chance was guilty of incompetence, neglect of duty, and misconduct and therefore should not have been replaced on those grounds.

An excellent answer would indicate that Dr. Chance's missing two weeks of class claiming he was not feeling well would have been enough cause for replacing him for the remainder of the semester but as sick leave rather than due to any issue of incompetence, neglect of duty, or misconduct. There is no evidence in that case that would substantiate the students' claims that he was negligent in his duties (i.e., grading papers, covering course material, etc.) nor did the administration take any action regarding the sexual harassment and racial discrimination charges. Again, students should indicate that faculty personnel issues, such as sick leave, are covered in faculty handbooks and/or union contracts (Anonymous, 1988) and there are procedures (due process) for applying for sick leave as well as benefits associated with taking a sick leave. See below.

The salary for a full-time faculty member (code 102) may be continued at the discretion of the Dean, subject to approval by the Office of the Provost, for absence caused by illness or disability, for up to six months. Applications are to be submitted to the Dean, who may approve leaves of up to seven days duration. Leaves in excess of seven days must be approved by the Dean and by the Office of the Provost.

Legally, an absence caused by inability to work because of pregnancy, childbirth, or related medical conditions must be treated at least as favorably as an absence caused by illness or disability for all employment related purposes. At the time a faculty member gives birth, she is entitled to an aggregate of six consecutive weeks of paid maternity leave preceding and following date of birth.

A physician's statement certifying that the faculty member is unable to work because of illness or disability and the date on which it is anticipated that he or she can return to work, may be required.

The University, in addition, may require that the faculty member be examined by a physician designated by the University at no cost to the faculty member. In cases of childbirth, no certification will be required unless the request for leave extends beyond six weeks.

A full-time faculty member who is totally disabled for more than six consecutive calendar months may claim benefits under long term disability insurance if a participant. (http://www.nyu.edu/fas/GAP/ FAS/AppointRecord4.html#4.7)

6. Was the administration's treatment of Professor Chance handled (from hiring to request for his resignation) properly? How would you have handled the request for Dr. Chance's resignation?

This question asks students to evaluate the hiring of Professor Chance, given the limited information in the case, as well as to evaluate how the university supported Professor Chance and, via the Provost, attempted to alleviate themselves of his services. Students are also asked to provide alternative solutions.

A poor answer will simply indicate the students' opinions as to whether or not or the university treated Professor Chance properly overall and, specifically, the university's request that he resign from his position. It would exclude any references or citations to outside sources. It would also include unsupported alternatives for Dr. Chance's resignation.

A fair answer would recognize that the College had hired a faculty member who had never taught in a traditional classroom environment (he had only taught through distance learning and one-on-one mentoring), and worse, had placed this person without instructional support in three sections of a capstone course. The student in this answer would then perhaps question the validity of the College's recruitment process, although not described in the case, as well as the orientation and instructional support provided to new faculty. (Salom, 1977).

In terms of the requesting Dr. Chance's resignation, the question again arises as to whether the university followed their own designated procedures (either in the faculty handbook or in a union contract) in their attempts to terminate Dr. Chance, either based upon his role in the plagiarism incident or in terms of his overall academic performance. The case does indicate that the Dean stated several times that he did not want Dr. Chance teaching in his School but does not indicate that Dr. Chance was ever brought up on any charges due to either the plagiarism incident, his perceived incompetence, or the sexual harassment and racial discrimination charges. This answer by students might then indicate that the administration should have moved ahead and taken formal action against Dr. Chance for the three aforementioned incidents (of course following their own designated procedure) in order to put some pressure on Dr. Chance. These actions could then be employed as leverage that would have made Dr. Chance's resignation a viable alternative and a way for him to avoid a possibly messy, complicated, and expensive series of court cases.

A good answer would also provide a set of guidelines for what would constitute appropriate recruitment, orientation, faculty development, and dismissal processes. The faculty recruitment process would "consist[s] of nine primary elements … : establishing position objectives, initial contact with the candidate, initial candidate interview, reference contacts, evaluation of the candidate, campus visit, decision to extend an offer, making the employment offer, and post-recruiting activity" (Morin and Kehoe, 1982.) with the intent to screen applicants by "excluding ineligible applicants, identifying candidates who have received some preferential attention, and evaluating nominees' files." (Waggaman, 1983) Applicant selection would require matching the applicant's requirements to the job description and specifications as well as to the department's and College's mission and culture. (Cole, 1995)

Faculty orientation normally involves interaction with other faculty and with senior faculty and normally includes a mentoring component. (Garrison, 2005) "The orientation program targets immediate information concerning employment and getting started in the classroom, while the mentoring program provides peer support for the duration of the employee's first years of service. The initiative is divided into three stages: (1) the initiation phase in which the orientation takes place; (2) the cultivation phase in which protégés become more involved in college activities; and (3) the redefinition phase when protégés become more self-sufficient and self-confident in their instructional role." (Howard and Hintz, 2002) Faculty support includes faculty modeling, motivating, mentoring and networking (Gmelch and Miskin, 1995) with the overall objective being to assist faculty in assessing their own instructional needs and providing them the resources in order to address those needs. (Scriven, 1980)

In terms of dismissing Dr. Chance, "private colleges and universities are held responsible for matters of contract and relevant state legislation." (Mawdsley and Permuth, 1985) In this circumstance, Dr. Chance had a two-year contract and the university would have to demonstrate that Dr. Chance had violated the clauses in that contract in order to dismiss him and break the agreement. The university was, therefore, responsible to make sure that the contract covered "these criteria for dismissing a probationary faculty member …: (1) the demonstration of professional incompetence, (2) the demonstration of moral turpitude, and (3) the gross neglect of professional responsibilities." (Holderfield and Brown, 1973) Based upon the facts presented in the case, it would appear that the University had a prima face case and would be able to move forward with their civil suit.

This answer might also include an excerpt from a faculty handbook dealing with dismissals, since the handbook may be considered as part of the employment contract. See below.

Dismissal for cause is a severance action by which the college terminates its contract with the faculty member for just cause. Any teaching contract is subject to action under this subsection. Dismissal for cause must be directly and substantially related to the fitness of a faculty member to continue in their professional capacity as a faculty member. Dismissal for cause will not be used to restrain a faculty member's academic freedom. The faculty personnel committee shall serve in an advisory capacity to the president of the college on dismissal for cause.

Dismissal proceedings may be instituted on the following grounds:

a. Professional incompetence;
b. Failure to perform job related assignments or other neglect of academic duties;

c. Breach of any term or condition of employment or other serious personal misconduct;

d. Formal or overt rejection of the fundamental mission and purpose of the college;

e. Knowing or reckless violation of the professional ethics of the college or of the rights and freedom of fellow faculty members, administrators, or students;

f. Knowing or reckless violation of established legal rights of students or employees of the college including, without limitation, any form of discrimination or harassment;

g. Conviction of a crime directly related to the faculty member's fitness to practice the faculty member's profession;

h. Dishonesty, including, but not limited to, plagiarism, falsification of credentials or experience, or the misappropriation or misapplication of funds; or

i. Failure to follow standards of the institution in respect to standards, policies, directives and guidelines within this policy manual after oral and written warnings.

The process for implementing dismissal for cause shall include the following:

a. Written notice to the faculty member from the dean of faculty, that a recommendation for dismissal for cause shall be made to the president. This notice shall contain a statement of the grounds upon which the recommendation is to be made, and a brief summary of information supporting such grounds;

b. A reasonable opportunity for the faculty member to meet with the dean of faculty to present the faculty member's defense to the dismissal recommendation before the recommendation is made; and

c. A reasonable opportunity for the faculty member to meet with the president of the college to present the faculty member's defense to the dismissal recommendation if it is accepted by the president.

The president shall make the ultimate decision regarding termination.

In any case involving dismissal for cause, the burden of proof that just cause exists shall be on the college, which proof shall be by a preponderance of the evidence in the record considered as a whole.

The decision to terminate a faculty member for cause may be the basis of a grievance before the faculty review committee, which shall review the case in accordance with procedures established in section 4.12 of this volume IV. (www.sckans.edu/policy/docstoc/vol4_index.html)

A very good answer would also point out perhaps Professor Chance was accidentally set up to fail in the first place, given the poor match between the professor's inexperience in traditional classroom and the college's needs coupled with a lack of institutional support. That being the case, the institution was morally obligated to ensure that their hiring processes produced results that would benefit its students, the college, and the newly hired faculty member. "Ethical standards in college faculty recruitment can not be taken for granted. As the recruitment process becomes more competitive and applicant numbers dwindle, the process should be carefully examined to ensure that truth, trust, and honesty are characteristic of the recruiting procedure." (Van Ommeren, 1991)

In terms of Dr. Chance's dismissal, an alternative solution might resolve the issue and employ a slightly more diplomatic approach (and perhaps even more ethical one). Offering Dr. Chance a medical leave of absence, based upon his claiming that he was not feeling well during the last two weeks he was assigned to teach the class, might be a way of mitigating possible legal action and the associated bad publicity. As noted in one university faculty handbook "in the event of illness or other difficulty that prevents meetings of classes, the chairperson should be notified as soon as possible. The chairperson is to inform students and the Dean. If the absence is to be extended, other members of the department may be asked to assist by carrying the colleague's load temporarily. Such arrangements usually suffice for emergency situations, but if the absence extends beyond two weeks a suitable replacement is sought." (http://www.berea.edu/dadf/facultyManual/responsibilities.asp) Medical leaves are usually accompanied with some form of compensation and, therefore, may be more palatable to Dr. Chance and make his departure more tenable.

An excellent answer would also note that the university needs to examine its human resource management practices (recruitment, selection, placement, orientation, training, development, compensation, and evaluation), both at the administrative and department levels, to ensure that these processes add value to a student's education, while protecting the university from possible litigation (both from disgruntled students and parents as well as from its dismissed faculty). (Rowley and Sherman, 2002) However, research on college human resource management indicates that these "new management strategies [of universities] appear to have little effect on the recruitment and termination processes, and these processes have remained traditionally based while the organization is changing under environmental influences." (Burke, 1988) It would therefore appear that a concerted, planned effort on behalf of the university is required in order to intervene in the current human resource practices of the university in order to implement effective change.

EPILOGUE

The Provost contacted the University's lawyers. They told the Provost that Chance had a bona fide contract, but that the Provost and the Dean could assign him anything. They suggested that the case would be stronger if the School sent him an evaluation and vote. The Provost contacted Barrett immediately and explained the situation. Barrett in turn contacted all members of the School Promotion and Tenure Committee. The next week they meet, discussed the matter, looked at the student evaluations, which the Dean had processed as a priority, and unanimously decided not to endorse Chance. Barrett rushed the vote and recommendation to the Provost.

The Provost subsequently contacted the university lawyers who said that they would handle it. They asked the Provost to assign Chance courses next semester. The Provost informed Barrett who was upset but agreed. Barrett had Jen assign Chance two "Introduction to Business" courses and one Business Communications course. The courses spanned four days, rather than the normal two-day schedules, and started in the morning and ended at night. Chance was furious with the assignment and had his lawyer contact the university as to his unfair treatment.

The University lawyers decided to meet with Chance and his lawyer to see if they could work things out before they went to arbitration. A deal was struck which was that Chance would resign after the next semester. The University would pay him for an additional semester. If Chance found a job in the meantime, the University would still pay him for one semester. In any subsequent follow-up by another college for a recommendation, the matter would remain confidential and a positive recommendation would be made. The Provost was informed and relayed the deal to Barrett, indicating that Chance would be teaching those courses in the spring semester.

Two weeks later, the Dean received a registered letter from Chance. It read:

> "Effective immediately, I hereby resign my position as an Assistant Professor in the School of Business. I thank you for your support and wish you and the School all the best in the coming year."

APPENDIX A

Plagiarism

"Plagiarism is a form of cheating, and within academia is seen as academic dishonesty. It is a matter of deceit: fooling a reader into believing that certain written material is original when it is not. Plagiarism is a serious and punishable academic offense, when the goal is to obtain some sort of personal academic credit or personal recognition. … plagiarism is the passing off of another person's work as if it were one's own, by claiming credit for something that was actually done by someone else." (http://en.wikipedia.org/wiki/Plagiarism)

There are two forms of plagiarism: purposive and accidental. "Intentional and obvious plagiarism, where an entire essay or research paper is copied from another source, is often blamed on stress or laziness. Accidental plagiarism is often the result of poor citation or referencing or of poor preparation, or a misunderstanding of plagiarism per se. Sometimes a student will arrive at university unprepared for the writing of academic essays and research papers, and will take a few semesters to familiarize themselves with what is required."

In order to avoid accidental plagiarism, the administration should have a standard policy, usually published in the student handbook and the college catalog, for defining what constitutes plagiarism, and an educational mechanism (be it a required course, a required learning component of a course, etc.) for insuring that students not only are taught what constitutes plagiarism but can demonstrate that they are capable of avoiding it. (http://www.unc.edu/ depts/wcweb/handouts/plagiarism.html) At the faculty level, accidental plagiarism can best be dealt with by faculty seeing "themselves less as plagiarism police and begin to converse with their students about the evolving process of idea-making." (Kraus, 2002) "Educators have attended and continue to attend to plagiarism in positive ways that help students better recognize, understand, and avoid it: we educate students on how to properly work with sources…". (Willen, 2004)

Intentional or purposive cheating requires a different approach. At the administrative level, the key to dealing with cheating would seem to be the development of an enforcement system that applies the college's standards of academic integrity both fairly and consistently. For example, "at St. Thomas University School of Law [the faculty and students] are divided over the way plagiarism charges against five students were handled. Only two of the students were found guilty and were sentenced to complete a five-page paper on plagiarism, two had the charges against them dropped before a hearing was held, and one was acquitted by a student panel. The punishments were seen by one associate professor of law as proof that the law school does not take cheating seriously." (Mangan, 1997) This perception of inequitable and loose treatment of offenders sends two inharmonious messages to students: (1) that the university really does not stand behind its policies when actually confronted with having to apply them; and (2) even when applied, the university cannot be consistent in its application. This lack of consistent and discriminatory enforcement of policy would tend, therein, to support a cheating mentality in that students would perceive a weak system of enforcement - if threats are not backed by enforcement then a system of law cannot exist. (Hart, 1994)

Purposive cheating can be dealt with at the faculty level via expectancy theory by "ensuring that students (a) understand the rules of ethical writing, (b) expect the writing assignment to be manageable, (c) expect ethical writing to lead to personally important benefits, (d) expect plagiarizing to be difficult, and (e) expect plagiarizing to lead to personally important costs." (Malouff and Sims, 1996) Again, faculty must apply the college's plagiarism guidelines, policies, and procedures in order to ensure consistent and fair application of those guidelines.

Academic dishonesty is a multifaceted phenomenon which goes beyond instructor and administrative influences and "appears related to: (1) individual characteristics such as student academic achievement, age, social activities, major, and gender; (2) peer group influences; (3) instructor influences; and (4) institutional policies." (Gerdeman, 2000) That being the case, interventions must be aimed at dealing with social influences and well as individual student influences. In that regard, "the current generations of students do not view plagiarism as theft." (Wood, 2004) Therefore the administration and the faculty have to understand that, in order to deal with purposive plagiarism; they must address the issue of academic integrity [and integrity in general] and what that means in the age of digital information.

"Academic integrity contains fundamental values and principles that reinforce educational mission and academic processes. Academic integrity focuses on standing up for academic honesty, trust, fairness, respect, and responsibility." (Drinan, 1999) The solution, is to try to develop a culture where academic integrity and honesty are highly valued, nurtured, and rewarded. From the institution's perspective, "faculty needs to teach them about standards of academic integrity; help them to understand academic culture; and explain the ramifications, both intellectual and ethical, of cheating. [To facilitate this process], some schools have developed pledges and honor codes to help cultivate an ethos of integrity on campus." (Willen, 2004)

"Faculty can build bridges to student understanding of academic values by modeling academic integrity as an institutional norm." (Wood, 2004) This requires that faculty "should move beyond a tendency to see student plagiarism as fully informed attempts to defraud the academic process" (Kraus, 2002) and "that they have a primary role in values education." (Burke, 1997)

The best way to address plagiarism at the faculty level would be for faculty to "address the problem by designing projects which make plagiarizing difficult." (Willen, 2004) More specifically, "faculty in many disciplines have even given up on assigning research papers that require students to identify, locate, evaluate, and use research materials on their own. Instead, they simply have their students write papers based on assigned, pre-selected readings." (Grassian, 2004)

At the administrative level, the administration should: "(1) communicate policies on academic misconduct regularly to students and faculty; (2) encourage faculty to discuss dishonesty with students; (3) establish non-permissive test environments with watchful instructors, spaced seating and varying exam formats; (4) enforce policies in a consistent, fair and timely manner; and (5) maintain emphasis on mature behavior, self-responsibility and proper conduct." (Gerdeman, 2000)

SAMPLE COLLEGE PLAGIARISM POLICY

Brooklyn-LIU Campus Plagiarim Policies: Undergraduate Bulletin 2004-2006 (p.28-29) & Graduate Bulletin 2002-2004 (p. 11)

Discipline: Cheating on examinations and plagiarism of any sort are unacceptable and, if proven, are cause for the most severe penalties up to and including suspension or dismissal from the University. The classroom instructor determines the rules of acceptable student conduct during examinations. Each instructor has the right to insist on procedures to ensure the integrity of those examinations- seating arrangements, no communication among students, the restriction of materials available to students during the examination, etc.

If a student is discovered cheating in a classroom examination or written assignment, either by crib notes or by receiving information from or giving information to a fellow student or by any means not stipulated by the rules of the examination, the instructor has the right to confiscate all test materials from the person or persons involved and give the grade of zero for the examination to the person or persons knowingly involved. The instructor also has the right to fail the students for the course.

Also, students who submit written or other work not their own or who submit work with sources inadequately acknowledged or with an inadequate system of documentation for a specific course assignment may be given the grade of zero for the work submitted and a failing grade for the course.

Any breach of discipline may result in disciplinary action, including suspension or dismissal. The Faculty-Student Judicial Review Board, in accordance with its procedures, may hear all cases that may result in suspension or dismissal and will recommend an appropriate course of action to the Dean of Students. (http://www.brooklyn.liu.edu/library/services/ refservices/AntiPlagiarism.htm)

Faculty Procedure for Handling a Possible Case of Plagiarism or Misuse of Sources

When you think you may have a case of plagiarism, it is essential that you document (by email and other means) the process from beginning to end. Remember that everything you write (especially email) could become a legal document, so document as if a bevy of lawyers were looking over your shoulder.

We want you to consult and follow these procedures, but as the teacher of record in these courses it will be you who decides in almost all cases what actions (disciplinary or otherwise) should be taken.

There are three parts to handling a potential plagiarism case:

1. Arranging a meeting with the student, copying documents, and arranging for a director to be present at your meeting with the student,
2. Meeting with the student and assessing the nature and severity of the case,

3. If you decide the student has plagiarized, imposing an academic consequence and contacting the Dean of Students Office.

Arranging a Meeting with the Student, Copying Documents, and Informing a Director

When you think you may have a case of plagiarism (not just misuse of sources), take care of these preliminaries (in no particular order).

- Make a copy of the relevant documents.

  In addition to copying the document in question, you may also want to copy such documents as other examples of the students' writing, the assignment, and (if you have it) the document you believe the student plagiarized from.

- Inform one of the FE Directors or the English Department Chair about the problem by email.

  Explain the case in moderate detail, including why you're questioning the work. In addition, we encourage you also to meet with one of us in person.

- Arrange for another person (director, mentor, or other colleague) to be present.

  For legal reasons and for your own protection, a director or mentor must be present during your meeting with the student. The director in most cases will be a Rhetoric and Writing director, but you can arrange to have another faculty member present. It is preferable that this director/faculty member not be your gender; i.e., if you're a female, choose a male, etc.

- Arrange a meeting with the student.

  Tell the student you need to speak with him/her about the assignment in question and arrange a meeting outside of class.

Meeting with the Student and Assessing the Nature and Severity of the Case

This is the tricky part. This is where you try to discern exactly what the problem is: Has the student deliberately and dishonestly appropriated someone else's ideas or words (plagiarism)? Did s/he make an innocent (not dishonest) mistake because she didn't know how to use sources? Or is the problem somewhere in between?

Try to maintain a coaching relationship; avoid becoming a plagiarism cop. Give the student the benefit of the doubt. To whatever extent possible, assume ignorance, not dishonesty. If it's a case of a markedly different style, assume first that the student has made a quantum leap (which does happen occasionally, thank goodness).

Here are some general guidelines:

1. Before the meeting, arrange for another person (director, mentor, or other colleague) to be present. This is for your protection. As with all student conferences, keep your door open.
2. Give the student an opportunity to explain her or his actions.
   In almost every case, you should not begin by accusing the student or showing him/her your evidence. Ask questions that will help you determine whether this is a case of plagiarism (academic dishonesty) or merely a case of misusing sources or a getting too much help.
   For instance, you might ask the student
   - how s/he went about composing this paper;
   - specifically what help s/he received with this paper;
   - what sources s/he used.
3. Explain why you're questioning the work.
   You can show the student evidence if you have it, or explain what concerns you-(e.g., a markedly different style or level of discourse; a document similar to hers that a student from another section wrote or that you found on the Internet).
   Remember that students sometimes make a leap in writing ability so marked that it only appears to be a different writer. When this happens, you can close the case and congratulate the student on his/her progress.
4. End the meeting with your assessment and (when appropriate) explain how s/he can avoid such problems in the future.
   When appropriate, use this as a teachable moment to explain, for instance, documentation practices or what constitutes too much help. Explain precisely what you want him/her to do: revise the paper (e.g., if sources are inadequately cited); re-write the paper (e.g., if the student received too much help).
   If you think harsher sanctions (e.g., zero for paper, failure of course, etc.) might be appropriate, do not at this time tell the student what further actions (if any) you will pursue. In cases where you believe the student has plagiarized, meet with a Rhetoric and Writing director.
   (If you decide the student has plagiarized) Imposing an academic consequence and contacting the Dean of Students Office.
   If you determine the student has been academically dishonest, do the following:
   1. Meet with one of the directors to discuss the case.
   2. Take one or more of the following disciplinary actions.

We can advise you about which course of action is most appropriate, but you will almost always be in control of this decision.

- Require a re-write (usually an entire re-write where the student starts from scratch).
- Fail the assignment.
- Fail the student for the course.

3. Write the student a memo explaining your actions.
4. Contact the Dean of Students Office via an email memo.

In all cases of academic dishonesty, the teacher of record (must inform the Dean of Students Office about the case. You have two options here: (1) just having the Dean of Students Office keep a record of the incident or (2) pursue a possible Student Code of Conduct violation.
In either case, write an email memo to the Dean of Students Office. Your email should do the following:

- o Request that the Office examine the students' record to determine whether there are previous cases involving the student, and inform you about their findings.
- o Provide a detailed account of the events concerning the case.
- o Summarize the academic actions you have taken against the student for the academic dishonesty.

This memo becomes a legal document, so it is vital that you stick to the facts and use a professional tone. If you're new to this, please get help from one of the directors. Should the case be serious or should the student have a history of academic dishonesty, we encourage you to have the Dean of Students Office pursue a Student Code of Conduct charges against the student. As always, you will make this decision. (http://www.unm.edu/~english/Resources/pdf/ Plagiarism.pdf)

APPENDIX B

EDUCATION ADMINISTRATION

Faculty Recruitment, Selection, and Orientation

The faculty recruitment process "consist[s] of nine primary elements … : establishing position objectives, initial contact with the candidate, initial candidate interview, reference contacts, evaluation of the candidate, campus visit, decision to extend an offer, making the employment offer, and post-recruiting activity" (Morin and Kehoe, 1982) with the intent to screen applicants by "excluding ineligible applicants, identifying candidates who have received some preferential attention, and evaluating nominees' files." (Waggaman, 1983) "Ethical standards in college faculty recruitment cannot be taken for granted. As the recruitment process becomes more competitive and applicant numbers dwindle, the process should be carefully examined to ensure that truth, trust, and honesty are characteristic of the recruiting procedure." (Van Ommeren, 1991) Applicant selection would require matching the applicant's requirements to the job description and specifications as well as to the department's and College's mission and culture. (Cole, 1995)

Faculty orientation normally involves interaction with other faculty and with senior faculty and normally includes a mentoring component. (Garrison, 2005) "The orientation program targets immediate information concerning employment and getting started in the classroom, while the mentoring program provides peer support for the duration of the employee's first years of service. The initiative is divided into three stages: (1) the initiation phase in which the orientation takes place; (2) the cultivation phase in which protégés become more involved in college activities; and (3) the redefinition phase when protégés become more self-sufficient and self-confident in their instructional role." (Howard and Hintz, 2002) Faculty support includes faculty modeling, motivating, mentoring and networking (Gmelch and Miskin, 1995) with the overall objective being to assist faculty in assessing their own instructional needs and providing them the resources in order to address those needs. (Scriven, 1980)

Faculty Responsibilities

A. Teaching Faculty

Texas A&M International University is committed to excellence in instruction, a concern for students, and the integrity of the institution. As such, all teaching faculty are expected to:

1. Make known to students in writing the goals and requirements of each course, the nature of the course content and the methods of evaluation to be employed.
2. Meet classes as scheduled.
3. Instruct so as to meet course objectives.
4. Maintain competence in teaching fields.
5. Be professional in conduct, in the classroom, and show respect for students.
6. Be available to students for consultation on course work during regular published office hours.
7. Serve as academic advisor in accordance with College policy on advisement.
8. Engage in service activities according to requirements for performance by rank as stated in Section 2.4 of this Handbook, and applicable College and Departmental policies.
9. Engage in scholarly activity according to requirements for performance by rank as stated in Section 2.4 of this Handbook, and applicable College and Departmental policies." (http://www. amiu.edu/facsenat/faculty.htm)

Sick Leave

"The salary for a full-time faculty member (code 102) may be continued at the discretion of the Dean, subject to approval by the Office of the Provost, for absence caused by illness or disability, for up to six months. Applications are to be submitted to the Dean, who may approve leaves of up to seven days duration. Leaves in excess of seven days must be approved by the Dean and by the Office of the Provost.

Legally, an absence caused by inability to work because of pregnancy, childbirth, or related medical conditions must be treated at least as favorably as an absence caused by illness or disability for all employment related purposes. At the time a faculty member gives birth, she is entitled to an aggregate of six consecutive weeks of paid maternity leave preceding and following date of birth.

A physician's statement certifying that the faculty member is unable to work because of illness or disability and the date on which it is anticipated that he or she can return to work, may be required.

The University, in addition, may require that the faculty member be examined by a physician designated by the University at no cost to the faculty member. In cases of childbirth, no certification will be required unless the request for leave extends beyond six weeks.

A full-time faculty member who is totally disabled for more than six consecutive calendar months may claim benefits under long term disability insurance if a participant." (http://www.nyu.edu/fas/GAP/FAS/AppointRecord4.html#4.7)

POLICIES REGARDING CESSATION OF UNIVERSITY EMPLOYMENT

Suspension and Discharge

The permissible grounds for the discharge or suspension of either a faculty member with permanent tenure or a faculty member without permanent tenure before a fixed term expires are incompetence, neglect of duty, and misconduct [emphasis added] of such a nature as to indicate that the individual is unfit to continue as a member of the faculty. The policy for due process before discharge or the imposition of serious sanctions, i.e., diminishment in rank, is identical to the procedure described in Section 603 of the Code." (http://www.acs.appstate.edu/orgs/facsen/ appendixa.html)

Due Process - Discharge or Suspension

"(1) A faculty member, who is the beneficiary of institutional guarantees of tenure, shall enjoy protection against unjust and arbitrary application of disciplinary penalties. During the period of such guarantees the faculty member may be discharged or suspended from employment or diminished in rank only for reasons of incompetence, neglect of duty or misconduct of such a nature as to indicate that the individual is unfit to continue as a member of the faculty. These penalties may be imposed only in accordance with the procedures prescribed in this section. For purposes of these regulations, a faculty member serving a stated term shall be regarded as having tenure until the end of that term. These procedures shall not apply to nonreappointment (Section 604) or termination of employment (Section 605).

(2) The Chancellor or his delegate shall send the faculty member by registered mail, return receipt requested, a written statement of intention to discharge him. The statement shall include notice of the faculty member's right, upon request, to both written specification of the reasons for the intended discharge and a hearing by an elected standing faculty committee on hearings.

(3) If, within ten days after he receives the notice referred to in paragraph (2) above, the faculty member makes no written request for either a specification of reasons or a hearing, he may be discharged without recourse to any institutional grievance or appellate procedure.

(4) If, within ten days after he receives the notice referred to in paragraph (2) above, the faculty member makes written request, by registered mail, return receipt requested, for a specification of reasons, the Chancellor or his delegate shall supply such specification in writing by registered mail, return receipt requested, within ten days after receiving the request. If the faculty member makes no written request for a hearing within ten days after he receives the specification, the faculty member may be discharged without recourse to any institutional grievance or appellate procedure.

(5) If the faculty member makes a timely written request for a hearing, the Chancellor or his delegate shall insure that the hearing is accorded before an elected standing committee of the institution's faculty. The hearing shall be on the written specification of reasons for the intended discharge. The hearing committee shall accord the faculty member twenty days

from the time it receives his written request for a hearing to prepare his defense. The hearing committee may, upon the faculty member's written request and for good cause, extend this time by written notice to the faculty member.

(6) The hearing shall be closed to the public unless the faculty member and the hearing committee agree that it may be open. The faculty member shall have the right to counsel, to present the testimony of witnesses and other evidence, to confront and cross-examine adverse witnesses and to examine all documents and other adverse demonstrative evidence. A written transcript of all proceedings shall be kept; upon request, a copy thereof shall be furnished to the faculty member at the institution's expense.

(7) The Chancellor, or his delegate or counsel, may participate in the hearing to present evidence, cross-examine witnesses and make argument.

(8) In reaching decisions on which its written recommendations to the Chancellor shall be based, the committee shall consider only the evidence presented at the hearing and such written or oral arguments as the committee, in its discretion, may allow. The committee shall make its written recommendations to the Chancellor within ten days after its hearing concludes.

(9) If the Chancellor concurs in a recommendation of the committee that is favorable to the faculty member, his decision shall be final. If the Chancellor either declines to accept a committee recommendation that is favorable to the faculty member or concurs in a committee recommendation that is unfavorable to the faculty member, the faculty member may appeal the Chancellor's decision to the Board of Trustees. This appeal shall be transmitted through the Chancellor and be addressed to the Chairman of the Board. Notice of appeal shall be filed within ten days after the faculty member receives the Chancellor's decision. The appeal to the Board of Trustees shall be decided by the full Board of Trustees. However, the Board may delegate the duty of conducting a hearing to a standing or ad hoc committee of at least three members. The Board of Trustees, or its committee, shall consider the appeal on the written transcript of hearings held by the faculty hearing committee, but it may, in its discretion, hear such other evidence as it deems necessary. The Board of Trustees' decision shall be made within forty-five days after the Chancellor has received the faculty member's request for an appeal to the trustees. This decision shall be final except that the faculty member may, within ten days after receiving the trustees' decision, file a written petition for review with the Board of Governors if he alleges that one or more specified provisions of The Code of The University of North Carolina have been violated. Any such petition to the Board of Governors shall be transmitted through the President, and the Board shall, within forty-five days, grant or deny the petition or take such other action as it deems advisable. If it grants the petition for review, the Board's decision shall be made within forty-five days after it has notified the faculty member that it will review the petition.

(10) When a faculty member has been notified of the institution's intention to discharge him, the Chancellor may suspend him at any time and continue the suspension until a final decision concerning discharge has been reached by the procedures prescribed herein. Suspension shall be exceptional and shall be with full pay." (http://www.acs.appstate.edu/orgs/facsen/appendixa.html)

Dismissal for Cause

"Dismissal for cause is a severance action by which the college terminates its contract with the faculty member for just cause. Any teaching contract is subject to action under this subsection. Dismissal for cause must be directly and substantially related to the fitness of a faculty member to continue in their professional capacity as a faculty member. Dismissal for cause will not be used to restrain a faculty member's academic freedom. The faculty personnel committee shall serve in an advisory capacity to the president of the college on dismissal for cause.

Dismissal proceedings may be instituted on the following grounds:

j. Professional incompetence;
k. Failure to perform job related assignments or other neglect of academic duties;
l. Breach of any term or condition of employment or other serious personal misconduct;
m. Formal or overt rejection of the fundamental mission and purpose of the college;
n. Knowing or reckless violation of the professional ethics of the college or of the rights and freedom of fellow faculty members, administrators, or students;
o. Knowing or reckless violation of established legal rights of students or employees of the college including, without limitation, any form of discrimination or harassment;
p. Conviction of a crime directly related to the faculty member's fitness to practice the faculty member's profession;
q. Dishonesty, including, but not limited to, plagiarism, falsification of credentials or experience, or the misappropriation or misapplication of funds; or
r. Failure to follow standards of the institution in respect to standards, policies, directives and guidelines within this policy manual after oral and written warnings.

The process for implementing dismissal for cause shall include the following:

d. Written notice to the faculty member from the dean of faculty that a recommendation for dismissal for cause shall be made to the president. This notice shall contain a statement of the grounds upon which the recommendation is to be made, and a brief summary of information supporting such grounds;
e. A reasonable opportunity for the faculty member to meet with the dean of faculty to present the faculty member's defense to the dismissal recommendation before the recommendation is made; and
f. A reasonable opportunity for the faculty member to meet with the president of the college to present the faculty member's defense to the dismissal recommendation if it is accepted by the president.
The president shall make the ultimate decision regarding termination.

In any case involving dismissal for cause, the burden of proof that just cause exists shall be on the college, which proof shall be by a preponderance of the evidence in the record considered as a whole. The decision to terminate a faculty member for cause may be the basis of a grievance before the faculty review committee, which shall review the case in accordance with procedures established in section 4.12 of this volume IV." (http://www.sckans.edu/policy/ docstoc/vol4_index.html)

ENDNOTES

1 The names of the characters and the college have been disguised, as per the request of the protagonist.

2 We would like to thank the reviewers for suggesting this reorganization of the parts of the case; the separation of student fairness issues, plagiarism, and administrative issues

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INFORMATICA DE SISTEMAS, S.A. EARNOUT NEGOTIATION

Dennis Zocco,. The University of San Diego

CASE DESCRIPTION

The primary subject matter of this case concerns the cross-cultural negotiation of an earnout agreement between Denshi Global Holdings, a publicly-traded Japanese company, and Informatica de Sistemas, S.A,.(IDS) a private Spanish company that Denshi is seeking to acquire. Secondary issues examined include (1) the added dimension of complexity involved in cross-cultural negotiations, 2) the issue of a valuation gap that frequently is an issue of contention between the buyer and seller in an acquisition, (3) the structure of an earnout agreement to bridge the valuation gap and to resolve the issue of which party will take on the risk of that value based on whether or not future performance exists, (4) the psychological (and emotional) elements involved in an owner giving up his company or taking on new owners, and (5) the self-interest motivations of the parties that often enter into negotiations in either a direct or subtle manner. The case has a difficulty level of four, appropriate for senior level. The case is designed to be taught in three class hours and is expected to require three hours of outside preparation by students.

CASE SYNOPSIS

Javier Portilla, a Spanish academic turned scientist/entrepreneur, received the magic phone call. Denshi Global Holdings, a publicly-traded Japanese company whose growth strategy is the acquisition of global technology companies, wants to acquire Javier's private company, Informatica de Sistemas, S.A.(IDS). The due diligence and negotiations between the two companies proceeded at a fast pace to the present impasse. Javier and Katsumi Shimura, the Denshi negotiation, disagree on the value of IDS, resulting in a "valuation gap" of €67.5 million (¥10,987; $107.1 million USD). To resolve this issue, Katsumi has proposed an "earnout agreement" with payment by Denshi to Javier of all or a portion of the "valuation gap" based on IDS performance in the future. Denshi wants Javier to prove, through future performance based on the financial projections he presented during due diligence, that the added valuation he says exists really does exist. Javier and Katsumi are about to begin discussions to craft the elements of an earnout agreement that has value for both sides, with the added challenge of navigating the often tricky waters of cross-cultural negotiations.

INSTRUCTORS' NOTES

Recommendations for Teaching Approaches

This financial negotiation case was written to be used in both undergraduate and graduate courses. The rigor and depth of material may be adjusted to reflect the skill and background of the student audience.

However, the issues are meaningful and relevant to the learning experience of undergraduates and graduates. This case is primarily designed to be used in 1) a case course in Finance or "Mergers and Acquisitions" or 2) as a supplemental exercise in a non-case course in Finance or "Mergers and Acquisitions", or 3) in a negotiations course in a business or law school. It is an experiential learning exercise based on the application of sound integrative negotiating techniques. If the case is used in a finance course, students will negotiate using their instinctive negotiating skills. A short primer on negotiating technique is contained in the PowerPoint Slides Section of this Teaching Note.

This case is designed so that it can be addressed as a discussion-based or experiential learning exercise.

Discussion-Based Approach

As a discussion-based exercise, the case can be completed in a 50- or 75-minute class or extended to a 180-minute class. In either case, students should have read the case and any supplementary reading assignments in advance of the class.

50- or 75-Minute Class. In a 50- or 75-minute class utilizing the discussion-based approach, the professor can lead the class through all or a subset of the discussion questions, or divide the class into two groups – one taking responsibility for the point of view of Katsumi, the other of Javier. As the cross-cultural aspect of the case is very significant, students should be instructed to maintain the mindset of the Japanese and Spanish cultures in discussing the approach they feel is appropriate.

180-Minute Class. For a 180-minute class, the professor can use the same approach, but with the extra time can have students break into groups to develop what they believe would be the best approach for Katsumi or Javier, whichever point of view they are assigned. This additional time will allow more focus on valuation methodologies and the reasons for the existence of a valuation gap. The rationale for earnout agreements can also be discussed in greater detail.

50- or 75-Minute Class/Session One. One class structure that has worked is for the first 50- or 75-minute class (or first half of a 180-minute class) to be devoted to a combination of in-class discussion of cross-cultural elements of negotiations and/or valuations and/or earnout agreements. Part of that first class could also be devoted to students working in teams to develop what they believe are the best approaches for Katsumi and Javier to take in the negotiation.

50- or 75-Minute Class/Session Two. During the second 50- or 75-minute class (or second half of a 180-minute class), the professor can conduct an in-class discussion of the negotiating strategy students think would be best for Katsumi and Javier, the important issues to be negotiated, the relative values each should place on those issues, the concessions they think might be appropriate, and the goals they are attempting to achieve in the final earnout agreement.

Experiential Learning Approach

In this approach, which works best in two 50- or 75-minute classes or one 180-minute class, groups of two or four students are selected. Either one or two of the students in each group take the role of either Katsumi or Javier. It usually works best to have two students share the role of either negotiator as they will have a better opportunity to discuss strategy and learn from each other.

Class/Session One. At the beginning of the class, the instructor should ask the students if they have any technical or definitional questions. Students should be pre-warned to not ask any questions in a form that would reveal any possible negotiating strategy they might have now or develop in the future. In answering questions before the entire class, the instructor must take care to not reveal any of the motivations or potential goals of any party. As a safeguard to revealing strategy, the group having the Katsumi role can be separated from the group having the Javier role. The instructor can then respond to questions from each respective group separately.

After questions are answered, each group of the two negotiators may be given a private space (a breakout room, student lounge, separate area in a classroom) to discuss their negotiating goals and strategy. The deliverable from that session is a set of issues and goals to be used as a reference document in the upcoming negotiation.

Class/Session Two. During the second 50- or 75-minute class or after a break slightly before the mid-point of the 180-minute class, the negotiation between the students or student teams taking the roles of Katsumi and Javier takes place. This will be a lively negotiation, as there are several critical issues involved that will not be easily resolved. At least 60 minutes should be allotted for this face-to-face negotiation and 20 minutes for the debriefing. An alternative to debriefing after the negotiation is to have the students complete the Debriefing and Self Assessment Report shown at the end of this teaching note. Have the students be prepared to hand in the briefing report at the beginning of the next class, at which time a portion of that class time can be taken for the debriefing. This approach will provide more time for the negotiation.

ISSUES AND BACKGROUND READING

Valuation Gaps and Earnout Agreements

The concepts of a "valuation gap" and earnout agreement used to bridge that gap are simple concepts to understand and are used often in acquisition negotiations. The case does not require students to calculate valuations. They are given in the case. The method of valuation, used in this case and predominantly in acquisitions, is an earnings multiplier. This simple calculation of valuation is the product of a multiplier (in the case, Denshi used five and Javier used seven) and an annual earnings number (in the case, IDS 2008 Net Profit). The earnings are objective, taken from the IDS financials. However, the multiplier is subjective, resulting in a valuation that is subjective. This is an important concept. Valuation is subjective with the multiplier embodying the future financial performance perspective of the person calculating their view of the valuation. Javier sees the future more optimistically and with less risk than Denshi, which is why Javier is using a higher multiplier than Denshi.

A valuation gap exists because of the difference in future perspective and the valuation gap is the difference in the respective valuations as explained in the case and below. Javier maintains that the value embodied in the valuation gap exists. Denshi says that it might exist, but there is no guarantee and to pay for it with the risk that it might not exist is not a prudent business decision. Therefore, the Denshi negotiator, Katsumi Shimura, presented the concept of an earnout to resolve this issue. In effect, Denshi is willing to pay for the added value if it exists, but only if Javier can prove it exists through performance based on the four years of financial projections Javier presented to Denshi.

The objective of the earnout agreement is simple. Agree on performance milestones, meet those milestones, and receive the additional value associated with those achievements. The task for Javier and Katsumi is to develop a structure that allocates the performance risk among the two parties in a way that provides value for both. A simple agreement might be that the quarterly net profit projections Javier presented serve as the performance milestone. If IDS performance meets or exceeds a quarterly new profit projection, Javier receives a payment equal to one-eighth of the valuation gap. If the performance does not meet the projection, no payment is made.

Variations of that structure are possible. Javier presented projections for the next four years, so the earnout period can extend to that period. In addition to net profit, performance milestones can be tied to revenue or gross profit. Milestone intervals can be annual or bi-annual instead of quarterly. Catch-up provisions can be included so that if a performance milestone in some interval is not met and no payment is received, over-performance in a subsequent period can allow Javier to recover all or a portion of a lost payment. Another variation has a graduated scale of performance, so that if Javier misses a milestone by, say, 1% or 5% or 10%, then he would not lose the entire payment but only a portion of it. There normally is a lower limit to that graduated scale so that performance less than that limit would result in no earnout payment.

Negotiating Technique and Strategy

For instructors using the case in a negotiations course, the normal course assigned reading material and class instruction focusing on cross-cultural negotiations will be sufficient for students to engage in the negotiations aspects of this case (Drake, 2001; Faure, 2002; George, Jones, & Gonzalez, 1998; Gulliver, 1979; King & Segain, 2007; Salacuse, 1998; Sebenius, 1998, 2002b; Shell, 2006; Susskind, 2004).

Additional reading drawn from the references below will provide the necessary background information for students to understand the earnout agreement aspects of the case, i.e., Caselli, S., Gatti, S., & Visconti, M. (2006); Chen (2008); Craig & Smith (2003); Frankel (2005); Kohers, N., & Ang, J. (2000); Datar, S., Frankel, R., & Wolfson, M. (2001).

For instructors using the case in a business course (finance case course or mergers and acquisitions course) that does not focus on negotiating skills, the students will concentrate more on the business issues in the case and use their intuitive skills in negotiating. However, in addition to the earnout agreement readings cited above, several supplementary articles on negotiating that could be assigned are by Sebenius (2001), Sussman (1999), and Cullinan, Le Roux, & Weddigen (2004) as well as books by Shell (2006), Thompson (2004), and Ury, W., Fisher, R. & Patton, B. (1991).

Mergers and Acquisitions

This case does not require significant knowledge of mergers and acquisitions. In fact, most of the actual M&A negotiations between Denshi and IDS have been completed by Javier and Kenji. Katsumi is being brought into the negotiations to develop the final element of the negotiation – the earnout agreement to bridge the valuation gap that evolved during the earlier negotiations. For the instructors who want to build more emphasis on this issue into the case exercise, an excellent source of introductory information on mergers and acquisitions is the seven-part online series on the subject, found at www.investopedia.com. Also see DePamphilis (2007); Carnes, Black, & Jandik (2006); Mastracchio & Zunitch (2002); and Sherman (2004).

Valuations

The valuation of a target company in any acquisition is a key negotiating issue. In this case, the business model of Denshi is to acquire high-growth companies in the technology sector. Therefore, they have developed a successful process through which they have determined a valuation methodology that is incorporated into their strategic plan. They have their own market data, based on their acquisitions prices, on which to base their negotiation. In particular, they have introduced into the negotiation three acquisitions in their recent past – Spruce, AkzeleRAM, and MigraTek – that establish market comparables. Javier has agreed to use these acquisitions as a basis for valuing his company.

However, students who have no prior instruction on company valuation methods should realize that all valuations are subjective and that any valuation is based on future, not past, performance. The past can provide some insight into future performance, but it is not an infallible mirror of that future.

The valuation methodology used by Denshi and IDS in their negotiation is the earnings multiplier approach. This approach has the negotiators searching for agreement on a number (the multiplier) that embodies the prospect of future financial performance. The agreed-upon multiplier is combined with an agreed-upon earnings number (usually the last twelve months of EBITDA, but since IDS and the three comparable companies have no outside debt and negligible depreciation, the Net Earnings number can be used instead).

The three comparable companies are all in very similar industries to IDS. They achieve the same strategic objectives of Denshi, but are dissimilar enough to also provide Denshi with company portfolio diversification. Those students who are more financially-oriented, or like to dig into the numbers to provide credibility to their negotiating positions will analyze the financials of the three comparable companies in order to develop a position on the value of IDS. The comp-companies' financials have not been set up to provide a clear-cut conclusion. There are trade-offs to be made. The table below illustrates those trade-offs.

Table 1. Analysis of IDS and comparative companies
[Growth rates are stated in past and (projected) at time of acquisition.]

	IDS[1]	AkzeleRAM[2]	Migratek[2]	Spruce[2]
Revenue Multiplier	0.9 -1.25 Range	1.0 X	1.3 X	0.9 X
Net Profit Multiplier	5 - 7 Range	7 X	6 X	5 X
Revenue Growth (%)	55.3 (41.4)	59.1 (42.9)	47.8 (43.7)	38.9 (36.4)
Gross Profit Growth; Past (%)	58.6 (36.2)	65.1 (36.9)	50.9 (38.1)	41.2 (32.6)
Net Profit Growth (%)	52.5 (42.7)	62.3 (49.5)	63.1 (46.1)	55.2 (44.7)
FCF Growth (%)	49.6 (44.5)	50.7 (50.1)	56.9 (42.6)	40.6 (43.9)
Gross Margin (%)	50	49	63	49
Net Margin (%)	18	14.8	22	18.1

[1] IDS profit margins based on 2008 financials; past growth rates based on 2000-08 period; projected grow rates in parentheses based on 2008-12 period.
[2] AkzeleRAM, Migratek, and Spruce profit margins based on 2007 financials; past growth rates based on 2000-07 period; projected grow rates in parentheses based on 2007-12 period.

Table 2. Performance and Projections Rankings of IDS and comparative companies [Growth rates are stated in past and (projected) at time of acquisition.]				
	IDS[1]	AkzeleRAM[2]	Migratek[2]	Spruce[2]
Revenue Growth (%)	2 (3)	1 (2)	3 (1)	4 (4)
Gross Profit Growth; Past (%)	2 (3)	1 (2)	3 (1)	1 (4)
Net Profit Growth (%)	3 (4)	2 (1)	1 (2)	4 (3)
FCF Growth (%)	3 (2)	2 (1)	1 (4)	4 (3)
Gross Margin (%)	2	3(t)	1	3(t)
Net Margin (%)	2	4	1	3

Endowment Effect

The endowment effect (or divestiture aversion) is a hypothesis that people value a good (in the Denshi/IDS negotiation, Javier's value of his company) more once their property right to it has been established than if they were valuing the same object without the property right. This behavioral effect often contributes to the higher earnings multiplier used by sellers. In this case, Javier feels that he is justified in his position that a multiplier of seven should be used in the valuation of IDS. Of course, the multiplier is subjective, so there is no right or wrong. However, Katsumi should be aware of the endowment effect in understanding an element of the Javier's behavior. This effect, first theorized by Thaler (1980), challenged standard economic theory which states that a person's willingness to pay (WTP) a price for a good should be the same as their willingness to accept (WTA) a price for the same good. In other words, people value something more as soon as they own it. Also see Kahneman, Knetsch, & Thaler (1991).

Employment Contracts

Javier's employment contract is related to the earnout agreement in that its term will likely match the term of the earnout agreement. As one of the advantages of an earnout agreement is to create an incentive for Javier to achieve the earnout performance objectives, the employment contract provides additional legal incentive for Javier to stay with Denshi and provide leadership in achieving performance goals. The exact terms of the employment contract purposely are not stated in the case because the negotiation of those terms is not the objective of the case. The only remaining employment contract issue for Javier and Katsumi is the term of the contract. In their roles as Javier and Katsumi, students can agree to the term of Javier's employment contract being either shorter or longer than the duration of the earnout agreement and the rationale for this makes for an interesting class discussion (Levinson, 2007).

SUGGESTED TEACHING DISCUSSION/ASSIGNMENT QUESTIONS

1. What is the motivation of Javier, as an entrepreneur, to sell his company to Denshi?

a. Javier has created significant value in his entrepreneurial and leadership efforts in building and growing IDS. His accomplishments with IDS are rare. All entrepreneurs know they will eventually be forced to take an action in order to realize the value of the company they have created.

b. With the Denshi offer to acquire IDS, Javier made a decision to realize that value by being acquired by Denshi if the terms of the agreement are acceptable. This decision is not an easy one for entrepreneurs, both psychologically and analytically. Javier would give up ownership of the company he founded and therefore, the right to the value created within IDS in the future. Denshi understands this psychological impact on the founders of the companies they acquire and buffers that impact with the earnout agreement (providing Javier with the ability to capture some of the value created during the earnout period) as well as a bonus plan for managers based on performance contributions to the consolidated performance of Denshi.

c. Furthermore, many entrepreneurs gain psychic value from the process of creating companies and the value embodied within those companies. IDS has grown 14-fold in revenues since its first year of operation and is projected to grow to 4-fold in revenues in four years. The company has grown to be one of significant size. Leading a company of that size may not provide Javier with the challenges and excitement that creating companies bring. Javier may have other ideas that he would like to monetize through new ventures, and the opportunity to sell the company to Denshi may provide him with that opportunity in the near future.

2. What are the corporate objectives of Denshi in acquiring IDS?

a. Denshi Global Holdings does not produce any product or service; the companies in the Denshi portfolio of companies do. Through the process of corporate governance that facilitates growth of portfolio companies and an acquisition policy that generates growth in the aggregate, Denshi produces growth in value (stock price) for its stockholders. The Denshi Global Holdings' M&A Division has identified IDS as a possible Denshi portfolio company. Kenji Ando, the head of Denshi Global Holdings' M&A Division, had contacted Dr. Javier Portilla to explore the potential for Denshi to acquire IDS because it was identified as having the high-probability potential for accelerating the growth of Denshi.

b. One of the main issues of the case is that Denshi has less certainty than Javier that IDS can achieve the optimistic financial projections that Javier presented. Denshi does not want to pay the higher valuation (€236.2 million) if less-than-projected performance indicates that the value represented by the "valuation gap" (€67.5 million) does not exist. They have expressed willingness to pay that value if they can be sure that it exists. Javier does not want to settle for the lower valuation (€168.7 million) if he can lead IDS to the projected performance. The earnout agreement resolves this impasse. With the earnout agreement, if projected performance occurs and earnout payments are made, Denshi agrees to pay Javier for the value that was demonstrated to exist. If performance in any or all earnout periods falls short of projections demonstrating that the value does not exist, then Denshi does not have to make the related earnout payments and therefore will not pay for value that does not exist.

3. What are the major negotiating challenges facing both Javier and Katsumi?

a. Javier. Javier faces several challenges associated with the Denshi acquisition of IDS.

i. *The Earnout Agreement*. The valuation gap troubled Javier, but he is an intelligent business person and realizes that there is risk to both Denshi and IDS in this acquisition and those risks can be shared. The earnout agreement is the means to share those risks. Javier would like to receive the valuation he believes IDS deserves, but realizes that there is no guarantee for Denshi that Javier will be able to manage IDS performance at the level of his projections. The earnout agreement is the means to share the risks associated with future IDS performance. The challenge ahead for Javier is to negotiate a structure for the earnout agreement that provides an equitable division of the risks associated with the valuation gap.

ii. *Valuation*. Although Javier is a successful entrepreneur, his background is as a scientist and an academic. IDS is his first venture and the Denshi acquisition is his first potential liquidity event. The challenge Javier faces is to understand that the value of his company, whether the valuation comes from him or Denshi, is subjective. Although valuation methodologies are quantitative in nature, the assumptions used in those methodologies are subjective and therefore, the resulting valuations are subjective. Therefore, the valuation gap, based on the respective valuations of IDS offered by Javier and by Denshi, is subjective. All acquisition prices are based on subjective valuations, and they will be the basis for Javier's negotiation with Katsumi.

iii. *Cross-Cultural Negotiation*. Although Javier has negotiated contracts with companies from other European countries, he has never negotiated contracts with a Japanese company nor has he negotiated directly with a Japanese negotiator. There is an added dimension of cross-cultural negotiations with regard to potential differences in time management, attitude toward risk-taking, preference for issue-by-issue or issue packaging negotiations, reticence or aggressiveness, and the importance of relationship building. Javier's challenge is not only to perform well in negotiating the issues, but also to evaluate Katsumi's style of negotiating, which may be culturally different than his. He must navigate to an area of comfort that facilitates communication and progress toward a value-based earnout agreement.

iv. As an entrepreneur, Javier knows that he must have some liquidity event (acquisition, IPO) to realize the value he has created in IDS. To realize that value through the liquidity event available through the Denshi acquisition, he must give up complete ownership of the company, although he will have a stock option compensation package with Denshi. He has received assurances from Denshi that he will remain in control of IDS. However, he realizes that IDS will be a Denshi company and the Denshi management team will have a major voice in the future direction of IDS. Javier has not experienced being CEO of a wholly-owned company and the challenge he faces is walking that fine line of controlling the company but having the ultimate control in the hands of Denshi.

b. Katsumi.

i. Katsumi is entering the negotiations at the final stage. This presents special challenges to Katsumi as she will only be able to learn about the past discussions from Kenji Ando, who turned the negotiations over to her when he was diverted to another project. Katsumi will not know the manner in which Javier and Kenji progressed to the point at which Katsumi assumes Kenji's position. She will not have a relationship history with Javier, but will have to build one even though Javier may have developed one with Kenji.

ii. Katsumi has never negotiated with a Spaniard, so she will have to do her research on the Spanish culture and negotiating style. She is experienced enough to realize that Javier may not fit the stereotypical Spaniard or Spanish negotiator.

iii. The valuation gap resulted from the negotiation between Javier and Kenji. She now has responsibility for crafting an earnout agreement that bridges that gap.

4. In what ways do cross-cultural negotiations differ from negotiations with someone from the same culture?

a. *Overall Culture*. Separate from the personal style that each negotiator from a different culture brings to the table, the cultural background of the person has a great influence on their thinking, actions, and attitude. A great quote about culture is that culture is what is left when all memory is lost. Without understanding the cultural background of your negotiating counterpart, you run the risk of losing value through missteps in communication and strategy as well as engaging in inadvertent offensive behavior due to the lack of knowledge on the etiquette and behavior of the other party's culture.

b. Etiquette and behavior elements include greetings, degree of formality, gift giving, touching, eye contact, deportment, emotions, silence, eating body language, and punctuality.

c. *Hofstede's (1997) National Cultural Dimensions*

i. *Distribution of Power*: Are significant power disparities accepted? Are organizations run mostly from the top down, or is power more widely and horizontally distributed?

ii. *Tolerance for Uncertainty*: How comfortable are people with uncertainty or unstructured situations, processes, or agreements?

iii. *Individualism versus Collectivism*: Does the culture emphasize the individual or the group?

iv. *Harmony versus Assertiveness*: Does the culture emphasize interpersonal harmony or assertiveness?

   v. Each of these dimensions adds a level of complexity to cross-cultural negotiations that may not be present in negotiations within the same culture. However, differences in negotiating style exist even within cultures, often based on region or even company culture.

d. The guidelines in the case point out the important aspects of the Spanish and Japanese negotiating styles. In general, areas of difference between any two cultures could be:
   i. Political and Legal Differences
   ii. International Economics
   iii. Foreign Governments and Bureaucracies
   iv. Instability
   v. Ideology
   vi. Culture
   vii. External Stakeholders

5. What is a "valuation gap" and why does one exist in the potential acquisition of IDS by Denshi?

a. A valuation gap exists when the two parties involved in a potential agreement in which a company valuation is an issue cannot come to an agreement as to the value of the company. In the case of the Denshi/IDS acquisition agreement, Denshi believes the value of IDS is €162.8, while Javier believes the value of IDS is €236.2. The difference of €67.5 is the valuation gap. It is impossible to determine whether either valuation is correct or incorrect. The valuation is subjective, based on future performance. Past performance can provide insight into the ability of the company to produce future performance, but the future is uncertain and therefore, the valuation of IDS based on its future performance is also uncertain.

b. The earnings multiplier method agreed upon by Denshi and Javier has two variables – the actual 2008 net profit and the earnings multiplier. As the net profit variable is an actual performance metric, unless there is some restatement of earnings for some reason, there is no uncertainty involved in that number. However, the earnings multiplier is a subjective number that takes into account the expectation (and risk) associated with the future performance of IDS as a Denshi portfolio company. Denshi is applying a multiplier of five to the IDS 2008 net profit, yielding a valuation of €162.8 million. Javier is applying a multiplier of seven, yielding a valuation of €236.2 million. The difference of €67.5 million represents the valuation gap.

c. This valuation gap exists because Kenji and Javier perceive different levels of risk associated with the future performance of IDS. Kenji sees higher risk and therefore, is applying a relatively lower multiplier to the IDS net profit than Javier, who sees lower risk in achieving projected IDS performance.

d. There are other valuation methodologies that could have been used to value IDS – discounted free cash flow, discounted earnings, book value, and enterprise value. However, the prevalent methodology used in acquisition valuation is the earnings multiplier approach. Usually, the multiplier is applied to EBITDA (Earnings before Interest Taxes Depreciation and Amortization). In this case, since IDS has no long term debt and very little depreciation as its major product is software, net profit and EBITA are very close which justifies using net profit as the earnings to which the multiplier is applied.

6. **What is the purpose of an earnout arrangement and how might it prove useful in the potential acquisition of IDS by Denshi?**

a. The earnout arrangement is useful in bridging the valuation gap. Denshi does not want to pay a price that encompasses aggressive performance projections when there is a risk that the performance may not meet projections. If Denshi paid a price representing the higher valuation and the actual performance was inferior to the projections, then Denshi would be paying for value that does not exist.

b. On the other hand, Javier does not want to accept a price representing the lower valuation because if IDS performance meets or exceeds projections, as Javier thinks it will, then there is value in IDS that would be going to Denshi for free.

c. Of course, if the valuation gap is very small, both Javier and Denshi would benefit from coming to an agreement on the purchase price, thereby eliminating any valuation gap and the need for an earnout agreement. In this case, both parties have determined that the valuation gap of €67.5 million is substantial enough on an acquisition of this size to require an earnout to mitigate each party's risk.

d. The issue is the risk inherent in the future performance of IDS. Neither Denshi nor Javier know with certainty what the future IDS performance will be, and they see different levels of risk associated with that future performance. The earnout agreement creates value for both sides by reducing the risk that Denshi will pay for IDS value that does not exist and that Javier will not be paid for value that does exist. The earnout arrangement assures that if value exists based on IDS actual performance meeting or exceeding projections, Denshi will pay Javier for it. If that value does not exist, then Denshi will not have to pay Javier anything above the guaranteed price.

7. **Are there ways, other than an earnout arrangement, to bridge the "valuation gap"?**

There are variations of the earnout agreement available. Javier could receive the guaranteed payment as full compensation for selling IDS to Denshi, and then receive as part of his employment contract, cash and/or stock option compensation performance bonuses. With this arrangement, Javier may not receive performance bonuses if he is no longer employed by IDS/Denshi and safeguards would have to be built into the employment contract, which makes this variation more complicated than the earnout agreement.

8. **Explain the preferences and rationale of both Katsumi and Javier on the following earnout issues:**

a. Earnout Amount

i. Given that a higher valuation (combined guaranteed payment and earnout amount) is agreed upon, Javier wants the guaranteed payment to be larger and the earnout amount to be smaller. This increases the expected value that Javier will receive. For example, if Javier believes there is an 80 percent chance that the IDS actual performance will meet or exceed projections, he will weigh the uncertain earnout amount by a factor of .8 and the certain guaranteed payment by a factor of 1.0. Scenario 1 below provides Javier with the guaranteed and earnout payments described in the case. Scenario 2 provides Javier with a greater guaranteed payment and a smaller earnout payment. Applying the probability factors to both scenarios, the expected value to Javier of Scenario 2 is greater than that of Scenario 1.

Scenario 1			
	Payment (million)	Probability Factor	Expected Value
Guaranteed	€162.8	1	€162.8
Earnout	€ 67.5	0.8	€ 30.2
Total	€236.2		€181.4

Scenario 2			
	Payment (million)	Probability Factor	Expected Value
Guaranteed	€164.0	1	€164.0
Earnout	€ 25.0	0.8	€ 20.0
Total	€236.2		€184.0

b. Earnout Term

i. Javier has provided Denshi with four years of financial projections which place an outer limit on the earnout term for the case. Earnout terms are normally between one and four years. Denshi would prefer a longer earnout period for two reasons. First, extending the earnout payments over a longer period reduces the present value of those payments. For instance, using an annual discount rate of 12%, if the earnout amount (valuation gap) of €67.5 is divided equally over 16 quarters (a four-year earnout term), the present value of those payments is €29.7. A quarterly discount rate of 3% must be used to discount the quarterly earnout payments. However, if the same earnout amount is paid equally over eight quarters (a two-year term), the present value of those payments is €33.2. Students taking the perspective of Katsumi will likely use Denshi's cost of capital as the discount rate. Those taking Javier's perspective will determine their own required rate of return as the discount rate based on the current risk-free rate and their the equity risk premium based on their perception of the risk associated with achieving the earnout performance milestones. The second reason Denshi wants a longer earnout term is that it will motivate Javier to 1) stay with the company the entire time to ensure that performance milestones are met and payments are received and 2) enhance the IDS contribution to the consolidated performance of Denshi.

ii. Javier would like a shorter earnout term for two reasons. First, it would result in a higher present value of the earnout payments. Second, it would represent a more certain period. Projections farther into the future are normally more uncertain than projections closer to the present. The longer the earnout term, the more chance that unpredicted events may adversely affect Javier's ability to achieve the performance milestones in those farther periods. Of course, Javier also would be taking a risk of putting the entire earnout amount in a short time frame. Those unpredicted events could occur in the short term as well as the long term.

c. Earnout Performance Intervals

i. Javier has explained to Denshi that the main basis for his four-year financial projections is annual performance. His experience with the quarterly performance of IDS is that there is no predictable seasonality or cyclicality. As a result, he and his CFO make annual projections and then just divide them equally among the four quarters of the year. They use those quarterly projections just as a reference metric for monitoring progress toward the annual performance goal. Therefore, Javier feels more comfortable with annual milestones. They provide a more manageable basis for achieving the performance milestones that would trigger earnout payments.

ii. Denshi, as a public company, is required to report quarterly consolidated financial performance to their shareholders and the investment community. Annual performance is only one criterion on which the company is measured, and it is not even the most important. Quarterly financial performance and its relationship to the same quarter performance the previous year is the most watched and evaluated criterion for a public company. For that reason, Denshi will want Javier to focus on quarterly rather than just on annual performance.

d. Performance Milestones

i. The negotiations that take place between Javier and Katsumi have the possibility of using revenue, gross profit, or net profit as performance milestones, although some student negotiating groups can get creative by introducing other performance milestones. For Javier, the least risky alternative is to have revenue exclusively as the performance milestone. Javier is likely in the greatest control of that financial metric, although he is still at the mercy of client budgets. Gross profit is more risky in that for those products that require a bill of materials, those materials costs are dependent upon supply and demand conditions in those materials markets as well as the relative strength of IDS as a buyer in those markets. Net profit performance is influenced by gross profit performance and Javier has some control over his expenses. However, a key expense will be employee salaries and those expenses are also influenced by supply and demand conditions in those specialized labor markets.

ii. Denshi would like to have net profit as the predominant performance metric. As a public company, analysts provide the public with their estimates of the revenue and net profit performance of Denshi, and the market is especially interested in whether management can match or exceed (positive earnings surprise) those estimates. If it exceeds expectations (positive earnings surprise), the demand for the stock may increase based on a more favorable view of future performance and the stock price may rise (all other market conditions remaining constant). If financial performance falls short of those estimates (negative earnings surprise), the analysts may begin to look unfavorably at the future prospects of the company and downgrade the Denshi stock rating. That is a negative for Denshi shareholders and for Denshi management. With the acquisition of IDS, analysts will build expected IDS quarterly performance into the estimates of consolidated Denshi quarterly performance. To align those financial performance goals with those of Javier in managing IDS, Denshi would prefer to have the earnout milestones linked to revenue and net profit.

iii. Although the case focuses on accounting measures of performance (revenue, gross profit, and net profit), an interesting class discussion can result from asking students what other performance milestones are possible. Potential answers are free cash flow, gross and/or net margin, new customer acquisition, number of contracts signed, growth rates of revenue, gross profit, and net profit.

e. Earnout Payment Currency

i. Since the earnout payments will be made in the future and the national currencies of Denshi and IDS are different, exchange rate risk exists. Since both the yen and euro are floating rate currencies, the rate of exchange between them changes over time. As the chart in the case shows, from the end of 2000 to mid-2008, the euro has appreciated against the yen by almost two times. At the beginning of that period, one euro could be exchanged into 90 yen. At the end of the period, one euro was worth 170 yen. There was some volatility during the period, but in general the trend was fairly steady. However, there is no guarantee that the trend of the euro appreciating against the yen will continue into the future.

ii. Since the guaranteed payment to Javier will occur in the very near future, there is virtually no risk that the exchange rate will change. However, since the earnout payments will be made in the future, the exchange rate between the two currencies is unknown. If the negotiation results in the earnout payments being denominated and paid in yen, the exchange rate risk shifts to Javier. He will only know how much the earnout will be worth in euros when the payment is made and the yen are converted into euros at the existing exchange rate. If the euro continues to appreciate against the yen, Javier will lose value as the yen will be worth fewer euros at that time than they are worth now. If the trend reverses and the yen appreciates against the euro, then the yen received by Javier will be worth more euros than they are worth now. Of course, the yen could remain steady against the euro. However, there is no way for Javier to know what the yen/euro exchange rate will be when the earnout payment is made, so he will be bearing the risk. Denshi has no risk as they will have no need for any currency conversion if the earnout payments are made in yen.

iii. If, however, the earnout payments are made in euros, the situation is reversed. Denshi will be taking on the exchange rate risk in that they will have to convert yen into euros at the prevailing exchange rate when each earnout payment is made. Javier will have no exchange rate risk since he will receive his payments in his national currency, euros. He will know exactly the value of each payment he receives.

iv. Therefore, Denshi will prefer that the earnout payments be made in yen and thereby shift the exchange rate risk to Javier. On the other hand, Javier will prefer that the earnout payments be made in euros, shifting the exchange rate risk to Denshi. If the students realize that there are markets (options, futures, and forward contracts) that allow exchange rate risk to be hedged, this issue will not be an important one. It is likely that Denshi has a more established company hedging process since it has a global portfolio of companies. Denshi will be more willing to take on that risk as they can easily hedge in exchange for a concession from Javier on another issue.

9. How would you advise both Katsumi and Javier on preparing for their upcoming negotiation?

a. Culture has a significant influence on the way people negotiate. It is uncontrived and very often uncontrollable. Herriot, the 20th century French writer and politician is reported to have said that culture is "…what remains when one has forgotten everything." Katsumi and Javier come from different cultures. They bring two important elements to their negotiations – their cultural and personal styles. Both aspects are inter-related, but not entirely overlapping.

b. The Japanese and Spanish styles of negotiation, outlined in generalized terms in the case, have strong, contrasting cultural influences. Yet both Katsumi and Javier bring their own personal styles to the negotiating table. Therefore, each must prepare in general terms for their counterpart to have a style that is very close to the cultural norm, yet also be prepared to adapt if the personal style deviates to some degree from that cultural norm.

c. Katsumi and Javier are both experienced in cross-cultural negotiations, but not with the cultures of each other. Each negotiator must research the following ways that culture can be expected to influence the negotiations:

i. the personal negotiating style of the counterpart

ii. the structure of the negotiation with respect to formality, team effort, importance of status, organizational setting, and outside influences

iii. the strategic elements of interests, values, goals, aggressiveness, passiveness, and attitude toward risk-taking

iv. the process of interaction and communication as they relate to relationship building, talking and listening, concession-making, and linear vs. circular (bundling) addressing of issues

d. Katsumi and Javier also will have to research the following country-specific factors that could influence the negotiations:

i. Political and Legal Differences
ii. International Economics
iii. Foreign Governments and Bureaucracies
iv. Instability
v. Ideology

10. Is Katsumi justified in her position of preferring quarterly performance milestones?

a. Students will be facing several conflicting elements in resolving this issue. Denshi faces quarterly financial performance requirements as a public company. From their focus on those quarterly reports, it has a corporate policy of "feeding the beast", that is, giving the investment community the performance that is required as indicated by the analyst's quarterly performance estimates. That community wants to see growth in revenue and net profit each quarter from the same quarter the previous year and also each year from the previous year.

b. Since Denshi is purely a holding company, its performance is simply a consolidation of the performance of its portfolio companies. If those companies focus on annual performance at the expense of quarterly performance, their contribution to Denshi's performance reporting goals will be less than optimal.

c. Of course, Denshi could inform the investment community that it makes long-term decisions that may compromise its ability to perform on a quarterly basis, as some high profile companies (Google, Berkshire Hathaway) have done. But it has not, and Katsumi's justification is that the company owes strong quarterly performance to its shareholders and the ability to provide that performance is enhanced by a motivation of the portfolio company CEOs also to provide strong quarterly performance.

11. Is Javier justified in preferring annual performance milestones?

a. Javier justifies his preference for annual performance milestones by pointing out that his quarterly projections are simply an even distribution of his annual projections. He has found that it is impossible to predict with accuracy quarterly performance even though a high percentage of his revenue is on a contractual basis. Basing earnout payments on achieving quarterly milestones will put Javier at risk of losing earnout payments by achieving annual but not quarterly milestones. Annual performance milestones provide him with the ability to make longer-term decisions that will be of value to the company without being overly focused on short-term performance.

b. Katsumi would counter this argument with the fact that IDS is no longer a private company and, as a Denshi company, must support the performance goal structure of the holding company. She might recommend that Javier take a closer look at his quarterly projections and instead of basing them on an even distribution of the annual projection, base them on 1) cyclical patterns that may have existed in the past or 2) contractual revenue and net profit of existing and potential clients.

12. What is the rationale for Javier's position that missing a performance milestone by a very slight amount, e.g., a few percentage points, would result in Javier losing the entire earnout payment for that performance interval? How would you address this concern if you were Katsumi?

a. As in all good agreements, no detail is left to interpretation. If Javier were to come within one percentage point of achieving a performance goal, for example, achieving €9.9 million in net profit on a net profit milestone of €10 million, he could argue that he had provided enough benefit to Denshi as represented by the €10 million milestone, and that he should receive the entire earnout amount associated with that milestone. If the earnout agreement states that the performance milestone must be met or exceeded in order for Javier to receive the earnout amount and that no earnout amount will be paid if performance falls short of the milestone, then Denshi can respond that €9.9 million does not achieve the milestone, no matter how close, and no earnout payment is required.

b. An issue of fairness comes in to play. If IDS performance falls short by a very small amount, can Denshi reasonably say that it demonstrates that no value existed, as represented by the earnout agreement? Javier would not think so and he could not be faulted for his view. Denshi must draw the limit somewhere. If 99% achievement is meeting the performance milestone, is 98% also close enough? 97%? So the students will likely get creative in developing means by which IDS performance can be at level(s) below the performance milestone. This will provide Javier with the means to capture some of the value the performance demonstrates exists in IDS.

13. Is some form of cumulative, additive, or catch-up provision justified in the earnout agreement?

a. If the earnout agreement calls for an "all or nothing" performance to receive the earnout amount in any period (for example, a quarter), then Javier will likely negotiate for some type of recovery plan so that subsequent over-performance will allow him to recover all or a portion of the lost earnout amount. One approach is to allow a cumulative effect to provide certain catch-up periods to exist. For example, each semi-annual period could be a cumulative period. If the performance milestone for quarter one is missed and no payment is made, then over-performance in quarter two to the extent that total revenue and/or net profit for both quarters combined is achieved would result in Javier receiving the earnout amount for both quarters. In effect, both quarters can be accumulated to determine performance. In this situation, the accumulation starts new in the third quarter. This would be the first quarter of the next semi-annual period. Performance in the first semi-annual period cannot be cumulated into the second semi-annual period. This approach could also be over an entire annual period.

b. Another possibility that can be used in place or in addition to a cumulative performance provision is to develop a sliding scale to allow earnout payments to be related to performance on a relative basis. For example, if performance is 90% of the milestone, 90% of the earnout payment would be received. If students negotiate this provision, the Denshi role players would have to decide whether a lower limit should be established, i.e., any performance below some percentage, say 80%, would require no payment. Another decision would be whether over-performance would be awarded with higher than the earnout amount and whether an upper limit would exist in this situation.

14. Why is it important in an earnout agreement that the performance milestones are well-defined?

a. Provisions of any negotiated agreement should be well-defined. Any agreement in which a situation could arise in the future that would require negotiations to be revisited may not be the best agreement. For an earnout agreement, there should be no question as to the requirements that Javier must meet in order to receive his earnout payment. At the end of a performance period, the issue of whether Javier will receive the earnout payment should be objectively and quantitatively determined. For this reason, every accounting, organizational, and legal element involved in defining and setting the performance milestone must be addressed and resolved. Although this case does not require students to take into account all those accounting, organizational, and legal elements as required by professionals in those areas, it does require students to clearly define the specific performance milestones that Javier must meet during each performance period.

b. In addition, all factors associated with IDS being a portfolio company that may influence Javier's ability to meet performance milestones must be identified and addressed in the agreement. For example, any charges that Denshi will be allocating to IDS to cover corporate costs or any profit margin restraints on business between portfolio companies may influence future IDS net profit. Charges of this type would not have been included in the IDS projections that Javier gave to Denshi.

POWERPOINT SLIDES

The following outline can be used for a PowerPoint presentation related to the case. The initial slides are directed toward presenting negotiating skills and techniques. The initial nine slides are derived from an excellent book I use in my negotiations courses – *Bargaining for Advantage* by Richard Shell (2006). The remaining slides are case specific. The format of the slides has been made purposely generic so that users of the case can format the slides in any style, format, or order. A PowerPoint file containing the following slides is also available upon request to the author.

Informatica de Sistemas, S.A. Earnout Negotiation Case Discussion Slides Outline

Negotiating Technique and Strategy

Characteristics Common to All Negotiation Situations
- Number of parties
- Help or hurt motive
- The better deal motive
- Parties prefer to negotiate rather than:
  - Capitulate
  - Permanently break off contact
  - Take their dispute to a third party
- Principle of Reciprocity – both sides are expected to make concessions

The Technique of Successful Negotiating

- Prepare
- Set Specific, Optimistic, and Justifiable Goals
- Develop a Flexible Strategy to Achieve Goals
- Implement Strategy, Focusing on Journey toward Agreement
- Exchange Relevant Information
- Assess Progress, Remove all Hurdles and Close
- Assess Performance and Build Knowledge Foundation

The Six Foundations of Successful Negotiating

- Style
- Goals and Expectations
- Authoritative Standards and Norms
- Relationships
- Other Party's Interests
- Leverage

Foundation 1: Developing Your Negotiating Style

- The Style Checklist
- Determine your style comfort level
- Be willing to prepare
- Set high expectations
- Have the patience to listen
- Commit to personal integrity
- Choose to be cooperative rather than competitive

Foundation 2: Defining Your Goals and Expectations

Goals are:
- Obvious or hidden
- Specific
- Optimistic
- Justifiable
- A commitment

Goals give direction

Foundation 3: Authoritative Standards and Norms

Consistency Principle: Need to appear reasonable
Reasonable; legitimate; justifiable; acceptable to other side
Survey the applicable standards and norms
Prepare supporting data and arguments
Anticipate the argument the other side will make
Prepare a positioning theme and anticipate the other side's

Foundation 4: Relationships

Increasing Trust
- Do what you say
- Stress the benefits of creating mutual trust
- Make your statements honest and accurate
- Have frequent interaction with your counterpart
- Let the other learn about you
- Develop similar goals and objectives
- Build a relationship network

Foundation 5: The Other Party's Interests

Focus on:
- Identifying the decision maker
- Look for common ground
- Look for differences
- Why might the other side say "no"?
- Search for low-cost options that solve the other party's problems while advancing your goals

Foundation 6: Leverage

Definition of Leverage

"Leverage is having something the other guy wants. Or, better yet, needs. Or, best of all, simply cannot do without." Donald Trump

Matter of perception as much as reality

Issues of the Informatica de Sistemas, S.A. Earnout Negotiation

Cross-Cultural Aspects of Negotiation
Valuation Gap
Riskiness of IDS Financial Projections
Earnout Agreement as Bridge for Valuation Gap
Risk Management Benefit of Earnout Agreement
Term of Javier's Employment Contract
Earnout Agreement Issues

Acquisitions – Denshi Strategy

Japanese diversified holding company
global software, information technology, computer science, and semiconductor technologies companies
attractive fundamentals
modest capital requirements
low cost of goods sold
high barriers to entry and switching costs
operating in the software, information technology, computer science, or semiconductor technologies industries
high rates of organic growth
potential to grow faster than the markets they serve
an international focus
strong, highly motivated entrepreneurial management team
future growth through follow-on acquisitions in same industry
stable and long standing customer relationships
deal size between $50 million and $500 million

Acquisitions – Javier Strategy

Entrepreneur's exit strategy
Realize value Javier created in IDS
Ability to control post-acquisition performance as CEO of IDS
Valuation

Earnings Multiplier Valuation Methodology
Comparable Companies - Spruce, AkzeleRAM, and MigraTek
Comp-companies financials do not provide clear-cut conclusion on IDS multiple
Trade-offs necessary
Subjective Nature of Valuation
No clear path to valuation
Assignment of multiplier is combination of art and science

Endowment Effect

Hypothesis that people value a good more once their property right to it has been established than if they were valuing the same object without the property right.

May be reason why Javier is using higher multiplier
Effect first theorized by Thaler (1980), challenged standard economic theory

Employment Contracts

Javier's employment contract is related to the earnout agreement
Term often tied to earnout term
Creates additional incentive for Javier to achieve the earnout performance objectives

Valuations

Key negotiating issue in acquisitions
Denshi has successful process based on acquisition experience
Denshi's valuation methodology is incorporated into their strategic plan
Valuations based on future performance; past performance can provide insights

1. What is the motivation of Javier, as an entrepreneur, to sell his company to Denshi?

Javier has created significant value in IDS
Entrepreneurs seek eventual liquidity (exit) event
Denshi acquisition gives Javier opportunity to realize value
Psychological barrier for Javier to get past in giving up ownership
IDS is of significant size that creative drive of Javier is not fulfilled

2. What are the corporate objectives of Denshi in acquiring IDS?

Denshi Global Holding does not produce any product or service
Growth through acquisition
Establishes environment in which portfolio companies can thrive

Growth brings value to Denshi stockholders
Denshi willing to pay for value within IDS, but does not want make certain payment for uncertain value (valuation gap of €67.5 million)
Willing to give Javier chance to earn additional value through performance
Earnout is vehicle in which risk of future performance can be managed

3. What are the major negotiating challenges facing both Javier and Katsumi?

Coming to terms on valuation difference
Negotiating the terms of the earnout agreement
Cross-Cultural Negotiation

4. In what ways do cross-cultural negotiations differ from negotiations with someone from the same culture?

Cultural differences in communication style, data-orientation, linear vs. nonlinear approach to negotiation, and speaking versus listening
Etiquette and behavior elements include greetings, degree of formality, gift giving, touching, eye contact, deportment, emotions, silence, eating, body language, and punctuality. (Sebenius, 2002a)
Hofstede's National Cultural Dimensions
    Distribution of Power
    Tolerance for Uncertainty
    Individualism versus Collectivism
    Harmony versus Assertiveness
Political and Legal Differences
International Economics
Foreign Governments and Bureaucracies
Instability
Ideology
Culture
External Stakeholders

5. What is a "valuation gap" and why does one exist in the potential acquisition of IDS by Denshi?

Exists when the two parties involved in a potential agreement in which a company valuation is an issue cannot come to an agreement as to the value of the company
Denshi believes the value of IDS is €162.8, based on a multiplier of 5 based on its view of the future
Javier believes the value of IDS is €236.2
Creates a valuation gap of €67.5
Valuations are subjective, based on future performance
Past performance can provide insight into the ability of the company to produce future performance

Future is uncertain and therefore, the valuation of IDS based on its future performance is also uncertain
Valuation gap exists because Kenji and Javier perceive different levels of risk associated with the future performance of IDS

6. What is the purpose of an earnout arrangement and how might it prove useful in the potential acquisition of IDS by Denshi?

Bridges the valuation gap
Denshi does not want to pay a price that encompasses aggressive performance projections when there is a risk that the performance may not meet projections
Javier does not want to accept a price representing the lower valuation because if IDS performance meets or exceeds projections, as Javier thinks it will, then there is value in IDS that would be going to Denshi for free
The issue is the risk inherent in the future performance of IDS

7. Are there ways, other than an earnout arrangement, to bridge the "valuation gap"?

Javier could receive the guaranteed payment as full compensation for selling IDS to Denshi, and then receive as part of his employment contract, cash and/or stock option compensation performance bonuses

8. Explain the preferences and rationale of both Katsumi and Javier on the following earnout issues:

Earnout Amount
Javier wants the guaranteed payment to be larger and the earnout amount to be smaller, increasing the expected value that Javier will receive
Denshi wants the guaranteed payment to be smaller and the earnout amount to be larger, decreasing the expected value that Denshi will pay.
Javier and Denshi must protect the relationship as IDS will be a Denshi company
Earnout Term
Javier has provided Denshi with four years of financial projections
Earnouts terms are normally between one and four years
Denshi prefers a longer earnout period - reduces present value of payments and greater motivation for Javier to stay longer
Javier prefers a shorter earnout term - higher present value of the earnout payments and represents a more certain period to meet performance goals

Earnout Performance Intervals
Denshi prefers quarterly intervals which matches its financial performance reporting requirement

Javier prefers annual intervals as it eliminates the uncertainty of short term performance requirements

Performance Milestones

Possibilities are revenue, gross profit, net profit, or some combination of those metrics

Denshi prefers net profit as it is a public company

Earnout Payment Currency

Since the earnout payments will be made in the future and the national currencies of Denshi and IDS are different, exchange rate risk exists

Both the yen and euro are floating rate currencies, the rate of exchange between them changes over time

Denshi prefers to make earnout payments in yen

Javier prefers to receive earnout payments in euros

Financial markets provide means to hedge exchange rate risk

9. How would you advise both Katsumi and Javier on preparing for their upcoming negotiation?

Pay attention to cultural differences and how they might affect the negotiations and relationship in the future

Understand the subjective nature of valuation and the risk-related reasons why a valuation gap can exist

Research the needs of both parties in negotiating the terms of the earnout agreement

Research the following ways in which culture can be expected to influence the negotiations:

the personal negotiating style of the counterpart

the structure of the negotiation with respect to formality, team effort, importance of status, organizational setting, and outside influences

the strategic elements of interests, values, goals, aggressiveness, passiveness, and attitude toward risk-taking

the process of interaction and communication as they relate to relationship building, talking and listening, concession-making, and linear vs. circular (bundling) addressing of issues

Research the following country-specific factors that could influence the negotiations:

Political and Legal Differences

International Economics

Foreign Governments and Bureaucracies

Instability

Ideology

10. Is Katsumi justified in her position of preferring quarterly performance milestones?

Being a public company with quarterly reporting requirements provides justification

Denshi could inform the investment community that they are not focused on long-term but rather on short-term performance

11. Is Javier justified in preferring annual performance milestones?

Uncontrollable circumstances could result in Javier missing quarterly performance goals and losing earnout payments
Catch-up provisions can address this risk

12. What is the rationale for Javier's position that missing a performance milestone by a very slight amount, e.g., a few percentage points, would result in Javier losing the entire earnout payment for that performance interval? How would you address this concern if you were Katsumi?

"All or Nothing" may violate sense of fairness in building relationship
Fairness rationale points to not losing entire earnout payment if milestones are missed by small amount
Katsumi can counter that investment community will penalize Denshi for "just missing" performance expectations

13. Is some form of cumulative, additive, or catch-up provision justified in the earnout agreement?

Creative solutions are possible that provide fairness to Javier and risk management to Denshi
Catch-up could be based on next quarter's performance or end of year
Sliding scale allows earnout payments to be related to performance on a relative basis
Minimum performance levels may be established to protect Denshi from paying for value that does not exist

14. Why is it important in an earnout agreement that the performance milestones are well-defined?
Prevents misunderstanding as to what is expected of Javier and IDS performance
All factors associated with IDS being a portfolio company that may influence Javier's ability to meet performance milestones must be identified and addressed in the agreement
Reduces the need to revisit negotiations
Reduces the chance of litigation over earnout agreement
Protects relationship going forward

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Informatica de Sistemas, S.A.
Debriefing and Self-Assessment Report

Negotiation Case: ____

Name: ____

Other Team Member(s) Name(s): ____

Preparation

Strategy

Performance

Critical Moments

Outcome

CON OR CON-STRUCTION?: THE CASE OF NYE CONTRACTING

Lucia S. Sigmar, Sam Houston State University

CASE DESCRIPTION

The primary subject matter for this case concerns the development of a communications strategy for a scenario where expectations have diverged between a contractor and a client concerning prior verbal and written agreements. Secondary issues include the ethical obligations of contractors to their clients, contractor expertise in bidding jobs, and effective communication between the contractor and the client. This case was designed for use in an undergraduate business communications course, but can also be easily adapted for use in an undergraduate business law or business ethics course. It could be taught in a 1½-hour session and is expected to require 2 hours of outside preparation by students.

CASE SYNOPSIS

Alex and Lauren Stewart, new to the Houston area, retained the services of a general contractor to make repairs to the home that they had just bought. Although they took great care in researching, specifying the work, and hiring Nye Contracting, they encountered problems from the start with the contractor, his various crews, interruptions and delays in the work schedule, and poor quality work. The last straw for the Stewarts was Nye's demand for additional money for materials to complete the job. He also threatened to place a lien on the Stewart's home until the additional money requirement was met. At this point, the Stewarts feel compelled to document their refusal to pay additional money to Nye and to hold Nye to the terms of their initial agreement, to clarify their position to his demands, to document the extent (percentage) of the work accomplished to date in order to calculate what percentage of the agreed-upon wages should be paid to date, to specify what jobs still need to be done, and to document the deterioration of their business relationship with Nye for possible legal action. Alternatively, however, the Stewarts are considering more positive communication in the hopes of convincing Nye to complete the job he agreed to perform initially and to maintain goodwill.

INSTRUCTORS' NOTES

Suggested Teaching Approaches

We use this case in conjunction with Lesikar, Flatley, and Rentz's *Business Communications* (11th edition) after classroom coverage of bad news and persuasive messages. This case enhances student understanding of the effective writing strategies in composing a complex message that is thorough and tactful, yet clear and concise. Ideally, it must also maintain goodwill between the parties involved. Writing strategies may involve using the indirect or direct approaches in writing bad news messages and the use of rational and/or emotional appeals to persuade. This case lends itself well to the strategic considerations involved in mild, moderate, and strong versions of bad news messages, either on the part of the contractor or on the part of the client. A series of escalating letters can be written either individually or collaboratively. Role-playing is also effective in practicing verbal and non-verbal communications skills in relaying bad-news.

DISCUSSION QUESTIONS

1. **Based on inferences drawn from this case study, comment on Nye's communications style with his sub-contractors (i.e. work crews) and with his clients. What role does his confidence play in his relationship with the Stewarts and how does this affect his communication with them?**

During the bidding phase of the job, Nye makes himself readily available and responsive to the Stewarts. He is willing to perform work that he may not have been entirely comfortable or experienced in doing. But after winning the bid and collecting the materials draw, Nye turns his attention to other jobs. Although he responds effectively to Lauren's complaint on the second day, he is not consistent in doing what he says he will do which, in turn, causes additional problems the remainder of week one and during week two with his subcontractors and the client. By the third week, Nye's communications style has changed from accommodating to defensive and demanding.

Nye's decreasing confidence in his workers and the job parallel his decrease in communication with the Stewarts. Avoiding communication is as destructive as negative communication.

2. **Consider the elements of the relationship between Nye and the Stewarts and Nye and his subcontractors. How does this "relatedness" determine the effectiveness of communication between all parties?**

This question concerns the importance of building "relatedness" with other individuals. Some students may maintain that the key relationship in this case is between Nye and the Stewarts. The communications problem, however, may actually be rooted in the "relatedness" between Nye and his subcontractors. Who are the workers to Nye? Who is Nye to the workers? The answers to these questions hinge on how connected Nye is with his workers and how connected they are to him. Nye may view his subcontractors as nameless, faceless, common laborers; and his workers may view Nye as simply exploiting them. This lack of "relatedness" will directly affect the amount of pride and motivation that they have in their work and the dedication that they have to Nye. On the other hand, Nye could respect and appreciate his workers as skilled and dedicated craftsmen.

This "relatedness," grounded in a more human dimension, will likely have a positive effect on the workers' productivity and attitudes towards Nye, and by extension, the Stewarts.

Initially, the Stewarts are satisfied that their diligent and conscientious search has resulted in a qualified, highly-recommended contractor to perform the work on their house. Nye can increase that confidence by building his "relatedness" to the Stewarts (and his work crews), by thinking about who they really are and tailoring his communication skills to meet their individual needs. In this situation, Nye appears rather to erode the relationship by failing to relate to his clients or his workers.

Students may then question whether or not Nye's references were even real or just wrong, and whether or not Nye was simply caught in a series of circumstances beyond his control.

3. What are some of the possible causes of Nye's communication problems? Of the Stewart's?

Nye may have had too many jobs going on simultaneously and may have been simply too distracted, frustrated, or overwhelmed to perform any of them well—much less to communicate to his customers about them. He may have had problems hiring, training, and retaining reliable and experienced subcontractors. He may have had difficulty communicating with the subcontractors, the majority of whom are non-native speakers of English. He may have had problems being held accountable for problems that he viewed as beyond his control. He may also have had gender-related communication problems. The Stewarts, on the other hand, may have been micro-managing the jobs causing higher expectations on their part, and causing them to become directly involved in the communication and supervision of the Nye and his work crews.

4. What assumptions on the Stewart's part may have caused communications problems?

The Stewarts may have assumed that Nye was more competent or more reliable than he actually was based upon the recommendations from those on his references list, and perhaps from their own naivety in working with trades. The positive recommendations from others may have raised the level of their performance expectations in terms of quality and efficiency. They may have also relied too heavily on the written scope and timeline without considering other contingencies like bonds for completion or possible guarantees.

5. At the end of the first week, Lauren resolves to "discuss" the unsatisfactory situation with Nye. What specific goals should her communication plan address?

Students can focus on a positive (rather than negative) problem/solution approach, in writing or documenting their concerns about the work. Here, direct or indirect order, word choice, clear and concise communication, and maintaining goodwill are key considerations. Role-playing is also effective in practicing verbal and non-verbal communications skills in relaying this information (bad-news) to Nye.

6. What responsibilities pass to the Stewarts in the absence of Nye? Specifically, should Lauren have attempted to communicate directly with the sub-contractors? What were the possible causes of her communication problems with the work crews?

Students can debate the issue of whether or not Lauren should have attempted to communicate with the work crews. Some may argue that she had no choice given the fact that Nye was not present. Others may argue that she was not the supervisor in the first place. Or some may argue that, as the client, she was actually the head supervisor whom everybody had to please, even Nye. Lauren's communication problems were language- and culture-based. She was also not their direct supervisor which may have affected their ability to listen to, rather than simply hear, her directives.

7. What actions would you recommend to either Nye or the Stewarts to assure that this does not happen again?

Answers should focus on constructive ways to improve communications between contractor and client, such as a daily progress report from contractor to client with prompt follow-up to problems or concerns voiced by the client at the end of each day.

8. What should Nye and the Stewarts do to resolve the communications deadlock?

Students should consider both verbal and non-verbal ways of initiating and promoting an atmosphere in which discussion can begin. Role-playing is an excellent means of inspiring discussion with emphasis on positive words, timing, respect, and tactfulness.

9. What are some long-term repercussions of the various communication problems for Nye Contracting?

Long-term repercussions for Nye Contracting may include loss of credibility in the industry, loss of customers and/or business. Students could also discuss how standards for client relationships, or standard costs, or a plan to disentangle the parties in the event of a disagreement, could assist contractors and clients (or complicate the issues) in dealing with similar problems.

10. How could Lauren have handled her verbal response to Nye's demand for more money better? What were her alternatives?

Lauren could have suspended her judgment a bit longer and allowed Nye to elaborate more specifically. Some students may argue that she should have been more assertive sooner.

11. How could Nye have handled his verbal request to Lauren for more money better? What impact may his other jobs have had on the Stewart's job?

Nye could have been a little less abrupt with his demands and less aggressive in his body language. He could have provided Lauren with receipts for the materials versus his estimate, and an apology for his miscalculations. He could have explained other variables like cash problems, personnel issues and the like. He could have provided Lauren with a specific plan to finish the job.

12. Was Nye ethical in demanding more money of the Stewarts after submitting his bid for the job and receiving the work? What choices could he have offered?

Students can debate the issue of whether or not Nye was ethically justified in demanding more money of the Stewarts to complete the work. Some may argue that an agreement is an agreement. Others may argue that Nye's circumstances left him little choice: his previous jobs may have left him strapped for cash, or his workers may have been unreliable.

13. Play the role of communications consultant to Nye Contracting. Make recommendations to help Nye stay in touch with his clients and workers. Explain your recommendations.

Recommendations should be based on the principles of effective non-verbal, verbal, and written communication.

14. The Stewart's letter to Nye is complex in that it needs to be thorough and tactful, yet clear. Ideally, it must also maintain goodwill between the parties involved, and both the Stewarts and Nye have an interest in seeing the job done and done well. Specify the reasons why both parties would desire a positive outcome (where they work together to accomplish the goal) as opposed to legal action (where they are forced to resolve the issue). What writing strategy accomplishes the former? What writing strategy accomplishes the latter?

Some of the more practical considerations will involve saving legal fees and engendering bad relations. Writing strategies may involve using the indirect or direct approaches in writing bad news messages. This case lends itself well to the strategic considerations involved in mild, moderate, and strong versions of bad news messages, either on the part of Mr. Nye or on the part of the Stewarts. This series of escalating letters can be written either individually or collaboratively.

EPILOGUE

Nye's behavior had caused the Stewarts to lose confidence in his ability to perform effectively in accordance with their agreement. They decided to find another contractor to complete, and in some cases, correct the work that Nye had done. But to be fair to Nye, they agreed to pay him for the work he had completed since the project start date. To calculate the percentage of the total job completed, the Stewarts reviewed the original scope of the project, and compared it to those parts of the project Nye had completed. That percentage of the original bid, less the 50% materials draw the Stewarts had already paid, was paid in full to Nye by check, and the job was terminated in writing by the Stewarts and Nye.

WE'D RATHER FIGHT THAN SWITCH: MUSIC INDUSTRY IN A TIME OF CHANGE

Harlan E. Spotts, Western New England College

CASE DESCRIPTION

The primary subject matter of this case concerns market changes experienced in the music industry with the advent of the Internet as a vehicle for distributing individual songs. The Internet, as a disruptive technology, spurred an upheaval of what had been a decades old business model for the creation and distribution of music. The music industry's desperate legal battle to preserve an out-moded distribution channel is discussed. Secondary issues examined include copyright protection for intellectual property and behavioral ethics for both individuals and companies. This case has a difficulty level appropriate for senior undergraduates and first-year graduate students (4 or 5). Appropriate courses for this case discussion include marketing management, channels of distribution and buyer behavior. The case is designed to be taught in 1.5 class hours and is expected to require 1.5 hours of outside preparation, not including supplemental readings, by students.

CASE SYNOPSIS

Imagine working in an industry that makes large profits with existing technology; an industry facing unprecedented change driven by shifting consumer demand facilitated by technological innovation. Instead of embracing change, your first strategy is to try banning the new technology. Your next strategy is to eliminate new competitors attempting to satisfy shifting consumer demand, using litigation to put them out of business. Your third strategy is to lobby for new laws restricting consumers from consuming your product in new ways. Your fourth strategy is to use technology to destroy your customers personal belongings and generally aggravate their lives. Finally, your coup de gras is to treat your customers as criminals and sue them for damages; a multi-billion industry settling for thousands of dollars in damages. This is an apt description of actions taken by the music recording industry and its trade association, Record Industry Association of America. Seeking to stave off innovation and squeeze as much profit from an out-moded production and distribution system, the music industry turned its collective back on their customers. They decided that they would rather "fight than switch!"

The music industry is been irrevocably changed by the Internet, but rather than embracing change to better satisfy their customers' needs the industry opted to continue to sell CDs. Music consumer use of the internet and innovation has figuratively dragged the music industry into the 21st century. This case provides an overview of the changes occurring in the music industry over the last decade, allowing for the discussion of innovation's influence on distribution channels, and ethics in buyer and corporate behavior.

INSTRUCTORS' NOTES

Overview

This case focuses on the effects of innovation on distribution and behavioral ethics in the recorded music industry. The music industry provides and interesting and engaging context for students as many are actively involved in downloading music, both legal and illegal. In addition to providing an interesting discussion context, it takes a macro distribution channel perspective that students are likely not to have given much thought.

The case is written as a retrospective of the music industry from the late 1990s to 2006. Compiled from a variety of sources, it describes the behavior of the recording industry in response to changing music consumption behavior by consumers. The litigation strategy used by the recording industry was really the impetus for writing the case, as it is rare that business goes after their customers with the intent of mandating a particular behavior or seeking punitive damages. From a marketing perspective this is a foreign concept, and it provides a platform for discussing how businesses should handle technological innovation and changing buyer behavior.

While not the main focus of the case, it is also possible to have an interesting discussion of behavioral ethics. Both consumers and businesses in the recording industry engaged in a set of behaviors that may or may not be legal/ethical.

Learning Objectives

The overall purpose of this case is to provide a platform for discussing basic concepts of distribution channel management in the face of innovation. Specific learning objectives include:

- For students to gain a thorough understanding of direct, indirect, and mixed distribution channel structure.
- For students to gain an understanding of distribution channel conflict and the importance of channel captains for efficient channel operation.
- For students to gain an understanding of innovation, from continuous to dynamic to disruptive, and how it affects the way in which distribution channels operate and buyers behave.
- For students to demonstrate that they can do basic analysis of historical data to gain insight on business performance and changes in buyer behavior.
- For students to discuss different perspectives on behavior ethics, for both consumers and managers.

Recommendation for Teaching Approaches

Prior to discussing the case in class students should be assigned reading on distribution channel concepts. This type of reading can be found in most marketing textbooks, with many students already having been exposed to the concepts in a marketing principles course. A brief introduction to the concept of channel maps is needed so that students understand what they are being asked to create in the end of case questions. While channel maps may not be considered important, the power of pictures to contrast differences in channel operation should not be underestimated. Finally, instructors may want to remind students of the basic types of statistical analyses that can be done on the data provided in Exhibits 1 and 3.

To start the case discussion, engage students by taking a short survey, either by show of hands or written responses, of the students' music consumption behavior. Ask the following questions:

1. How many own an MP3 player? Ipod?
2. How many download music from the internet through legal services such as iTunes, Amazon.com, etc.?
3. How many have downloaded music through file sharing services?
4. How many have taken music from CDs and converted songs to MP3 files?
5. How many songs do you have stored on your MP3 player?

Responses to these questions will give you a sense for the level of sophistication your students have as music consumers. While savvy users, they will not likely be cognizant of music distribution from an overall channel perspective. This provides an opportunity to compare and contrast the good old days of having massive and unwieldy record collections versus carrying all your music in your pocket. Most students in class have heard of, but may have never seen a vinyl LP. Vinyl records (LPs and 45s), eight-track tapes, and cassette tapes make interesting props for the class discussion.

CASE QUESTIONS

1. Why do people listen to music? What is the value/benefits associated with listening to music?

This is an interesting question that allows for direct engagement of the student in that you are asking them what value they place on listening to music. Since this case is designed for a marketing course, buyer behavior is always relevant. The ensuing discussion briefly probes this issue. A common response is listening to music is entertainment, its fun. Some students may mention mood enhancement or makes them feel better. Still others may say that listening to music is a social event that enhances their interaction with other people.

2. Why do people download music? What benefits do they seek with music downloading?

Briefly touch on the benefits that consumers are purchasing, including product, service and brand image (Best, 2009).

Product benefits focus on quality, assortment and form. Some audiophiles argue that the MP3 form may be easier to manage, but digital music is inferior to analog music in terms of quality. Downloading music for many consumers is about assortment, access to a large assortment of individual songs from hundreds of different artists is the draw.

Service benefits may include after sale service, availability, delivery and transaction.

Music downloading is superior on service to any other form of music distribution. iTunes made downloading legal and easy. With downloading, music can be purchased any time of day from the comfort of your own home.

Brand image revolves around emotional attractions to the brand that connect with the consumer on some social and/or personal level. Music recording companies never really provided any brand benefits to consumers, other than making a large assortment of artists available for purchase. The benefits associated with the brand were always related to the artists. If an artist switched recording labels, consumers would still purchase their music.

When examining the music industry, the recording studios originally provided value by finding talent and producing a physical record that consumers could listen to. However, with the advent of technology consumers could create a product form that was better suited to their needs. Also, new players in the market provided service benefits to fill the gap created by the difference between consumer needs and the recording industry offerings.

3. How has music consumption behavior changed over the last ten years?

This question provides an opportunity for students to do some basic analysis on the case data provided in Exhibit 1.

From 1999 to 2006 Industry size (dollar value) was down 21 percent, to $11.5 billion. Consumer purchase of CDs dropped to 85.6 percent of industry sales in 2006 from a high of 90.5 percent in 2002. During this time digital downloads (legal) increased to 6.7 percent. A change in music format consumption was well underway.

Music consumption (of all legal formats) generally declined among those in the 10 to 24 age group; consumption remained relatively stable in the 25 to 44 age group; and, actually increased among those in the 45+ age group. Clearly, "legal" music consumption is declining in the younger age groups, those most likely to engage in illegal downloading activities.

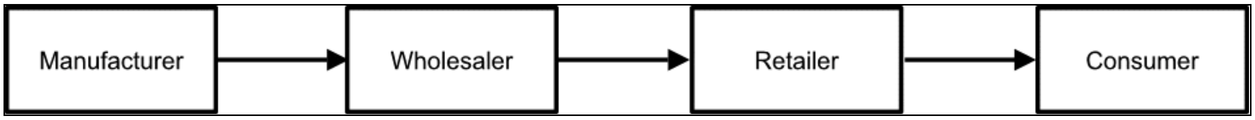
Record stores are clearly in the midst of a major decline, with their share of music industry sales declining 32 percent between 1997 and 2006. Record clubs and other outlets have remained fairly stable. The internet and digital downloads have increased substantially during this time period.

CD sales (dollar value) in particular (see Exhibit 3) declined 32 percent from 2000 to 2006. During this same time period CD unit sales declined 35 percent.

A cursory look at the numbers gives some insight into how buyer behavior was changing and why the music industry was in panic mode.

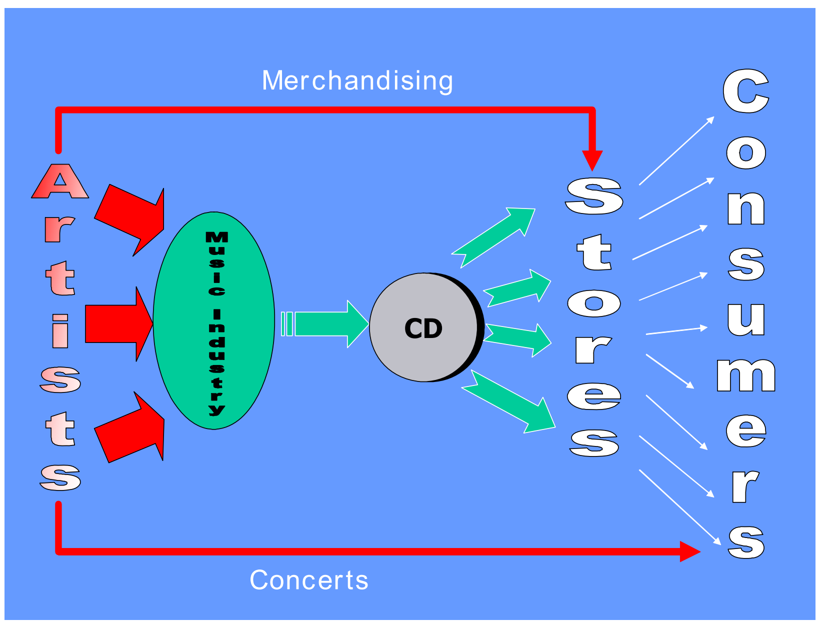
4. What would a channel map look like for the original, or pre-digital age, model of recorded music distribution?

When talking about distribution channels it is helpful to have the students complete a channel map. Channel mapping is a pictorial representation of the relevant channel intermediaries responsible for getting products from the manufacturer to the end consumer. A very basic channel map would look like the flow chart below:



This is a good point to discuss some basic distribution concepts, starting with direct versus indirect versus mixed channels. Direct channels are used to sell products directly to end consumers. This might include using direct salespeople, online marketing, direct marketing (catalog or mail), telemarketing, or agents (Best, 2009). Indirect channels include the use of wholesalers and retailers to move products through the channel to the end consumer. Mixed channels include elements of both direct and indirect channels. Manufacturers have the most control over marketing strategy when using direct channels, with the least amount of control when using indirect channels.

The initial channel map should look similar to the following picture:

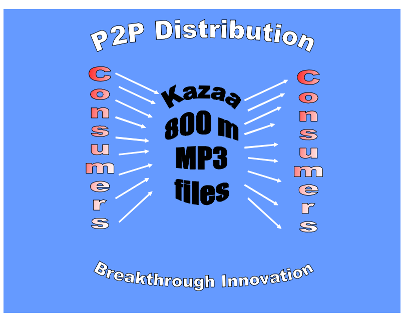


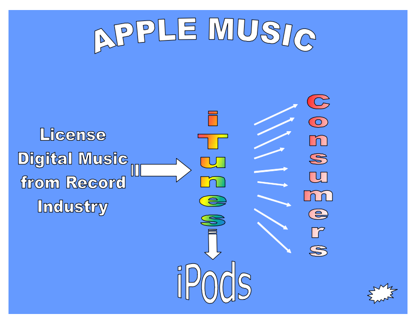
Prior to the last decade, the music industry distributed it's product in very much the same way. After artists were signed and produced music for a particular recording company, the songs and albums would be reproduced on a particular media by a manufacturing company. Over time, different types of recording media have included wax disks, vinyl records, magnetic tape, compact disks and digital files. The marketing and distribution of the music was primarily the same: the industry would allow radio stations (and eventually cable television stations) to play and promote the artists and the public would go and buy the albums and/or singles from various outlets. Product would reach these outlets via traditional distribution means: direct from manufacturer, from wholesalers, or direct marketers. These outlets included industry specific retail shops like Sam Goodie, The Wall, and Virgin. These stores would cater to the audiophile with vast numbers of artists and genres. Consumers could also purchase music products and the larger chain stores and retailers. Supermarkets (Stop & Shop, Wegmans), pharmacies (CVS, Walgreens, Eckerd's), "big name" retailers (Best Buy, Target, Walmart) and wholesale clubs (Sam's, Costco) all sold music products to consumers. There were also catalog companies offering music products to the public. Columbia House and BMG offered dozens of tastes in music from the comfort of your own home. Forms were filled out at the customer's convenience, mailed back to the catalog firm, and product was received within a week or two. There was also a number of very specialized music industry products, typically offered through a television or print commercial (or infomercial).

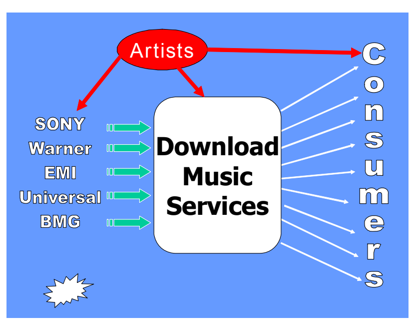
5. How would the channel map for the distribution of recorded music change as a result of technological innovation?

The original channel model can be contrasted with new channel structures that include Napster (or other file sharing network) and retailers. The shifting of channel captaincy from the recording industry to retailers, artists, or even consumers, can be discussed. The point should be made that during the last decade the distribution channel has been chaotic as consumer behavior changed and the recording industry either ignored or actively resisted it. Different entities within the channel were vying to fill the channel leader void.

Channel maps for the different distribution methods could look as follows:







These maps were developed by students:

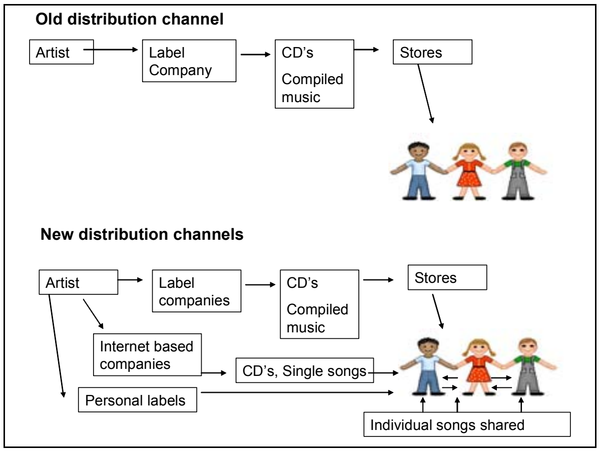
In the mid 1990's, there were major changes in the way consumers could obtain new music for their listening pleasure. One was through online websites. The internet offered an instantaneous way to shop from home. Established "Brick and Mortar" companies, along with internet specific companies, were creating websites and mechanisms for consumers to shop at their own convenience from any location using a computer. The other way consumers were gaining access to more music was through a "file sharing" process, initially introduced by Napster. File sharing allowed users access to other users' digital music collections. Users could basically copy a song file from one person, and paste it into their own library. Although Napster was taken to court and the legality of file sharing is still in dispute, many individuals still use this technology to obtain new works of music.

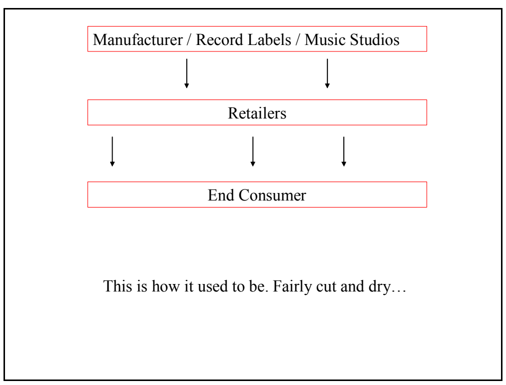
Recently, with even more advances in technology, and the reigning in of file sharing mechanisms, consumers have even more options when it comes to getting a hold of new music Many companies have licensing agreements with record labels to sell individual songs and albums, through their own internet websites, for download by the consumer. Communication companies have similar agreements to allow their subscribers access to digital libraries for use on their portable devices.

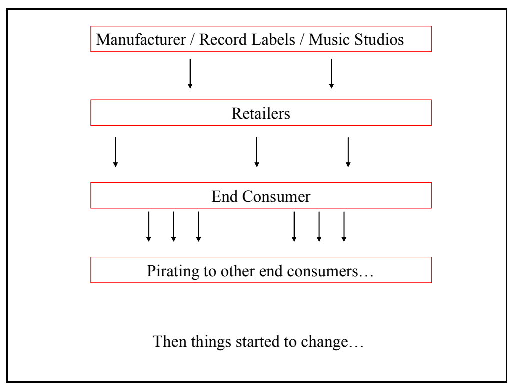
6. How would you classify the innovations that changed the music distribution channel?

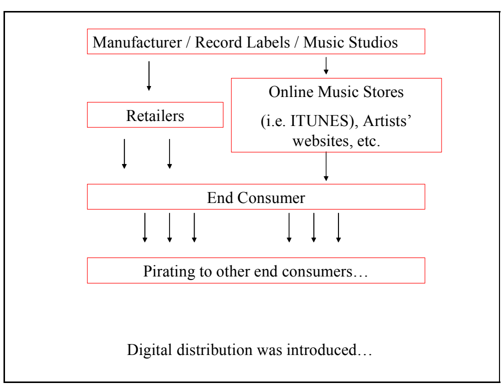
At this point it is a good time to talk about the radical change caused by the Internet. Drawing on the discussion provided by Solomon, Marshall and Stuart (2006), innovation is anything that consumers perceive to be new and different from existing products (p. 237). It can be viewed as a continuum from continuous to dynamically continuous to disruptive. Continuous innovation involves a modification of an existing product that sets one brand apart from its competitors (p. 238). Dynamically Continuous Innovation involves a change in an existing product that requires a moderate amount of learning or behavior change (p. 240). Finally, a disruptive innovation involves a totally new product that creates major changes in the way we live (p. 241). The Internet can be considered a disruptive innovation since it has had a major influence in the way people live.

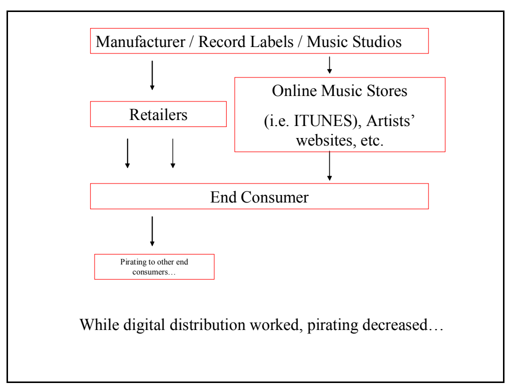
Students can discuss where music downloading falls in this continuum. It most likely would be a dynamically continuous innovation since it requires moderate changes in basic music listening behavior. The music industry has had the same business model for decades. Produce music on vinyl albums (LPs), then cassette tape, then CD. The buying process was the same regardless of the medium. With the advent of the Internet and the MP3 format, music buyer behavior changed radically. This is a good time to talk about buyer behavior and move into a discussion of distribution channels.


Old distribution channel
Artist
Label Company
CD's Compiled music
Stores
New distribution channels
Artist
Label companies
CD's Compiled music
Stores
Internet based companies
CD's, Single songs
Personal labels
Individual songs shared


Manufacturer / Record Labels / Music Studios
Retailers
End Consumer
This is how it used to be. Fairly cut and dry…


Manufacturer / Record Labels / Music Studios
Retailers
End Consumer
Pirating to other end consumers…
Then things started to change…


Manufacturer / Record Labels / Music Studios
Retailers
Online Music Stores (i.e. ITUNES), Artists' websites, etc.
End Consumer
Pirating to other end consumers…
Digital distribution was introduced…


Manufacturer / Record Labels / Music Studios
Retailers
Online Music Stores (i.e. ITUNES), Artists' websites, etc.
End Consumer
Pirating to other end consumers…
While digital distribution worked, pirating decreased…

7. Do you see channel conflict taking place in the evolution of the distribution of recorded music?

Channel conflict arises from disagreements between channel members, due to attitudes or behaviors, that prevent the channel from achieving its goals. Some conflict will always exist if for no other reason than that the interests of different channel members do not always coincide (Kotler and Keller, 2007). This conflict may be a result of goal incompatibility, unclear goals and rights, differences in perceptions, and/or over-dependence on a manufacturer or other intermediary. (Kotler and Keller, 2007). Conflict can be vertical (between members at two different levels in the channel – manufacturer and retailer), horizontal (between members at the same level within the channel – two wholesalers), or multi-channel (when manufacturer establishes two competing channels in the same market) (Kotler and Keller, 2007).

Channels of distribution need to be efficient. The more conflict that exists in a channel, the less efficient it is. Channel efficiency is affected by the power of different members in the channel. Channel power is the ability of one channel member to get another channel member to do what it otherwise would not have done (Winer, 2004). Power can be economic (derived from control of resources), legitimate (derived from legal authority), or reward or coercion (derived from control over demand).

Most every distribution channel has a leader that establishes order and efficiency. A channel leader, or captain, is a firm at one level of distribution that takes a leadership role, establishing operating norms and processes based on its power relative to other channel members (Solomon, Marshall and Stuart, 2006). In the 1950s, 1960s and 1970s manufacturers were channel leaders since they had economic and reward power due to control over brands. This changed in the 1980s and 1990s as retailers used information technology to gain power. Wal-Mart perhaps manages the most efficient channels due to their investment in distribution technology and access to consumers markets.

There is clear conflict in the recorded music distribution channel. The recording studios were the channel captain for decades due to channel power supported by economic and legitimate authority. The Internet undermined this channel power, and, in the last decade was one of a channel in search of a captain. Some channel had power due to shear size and control over consumer demand (WalMart with 14 percent of all music CD sales), while others gained power due to innovative marketplace solutions (Apple iPod and iTunes). Apple Computer has been the most effective in establishing order in the music downloading marketplace. Retailers, such as WalMart, have an opportunity control the market simply due to its size. The result of the last decade is that the recording studio has had to relinquish its power as it searched for a new business model. It is still yet to be seen if the recording studios have the will and/or expertise to change their business model.

8. What do the economics of the recorded music industry tell you? What is the profit margin on digital downloads for the recording industry? Apple Computer?

Start with the digital downloads and work into the economics of CDs. Based on data from the case, assume that retailers (iTunes, Walmart, etc.) earn a 29 cents on every digital download (a 29 percent margin (.29/.99)); thus, the recording studio earns revenue of 71 cents per download. The recording studio pays the artist a net royalty of approximately 4.5 cents, after deducting for shipping and breakage as per the contracts entered into for the development and sale of CDs. You may want to point out that there is no shipping or breakage associated with digital downloads. The recording studios are earning 66.5 cents of revenue on every digital download (a 94 percent gross margin). This is pure profit since the digital file costs virtually nothing to replicate.

Given that there is no additional data on the economics of CDs, use the relationships above to calculate the margins for retailers and record studios. Some students may argue that you cannot make this assumption, however, the recording companies continue to charge the artist for shipping and breakage on digital downloads. Further, it is likely that the studios would not enter into a contract with digital download providers that would be less lucrative (relatively) than CD contracts. If we assume that the retailer has a 29 percent mark-up on selling price and the average selling price is 15.00 (calculated from the RIAA data for 2006 in Exhibit 3 – divide dollar value by units shipped), then CD are purchased from the recording studio for $10.65. Next, deduct the artist royalty payment of 48 cents, and the recording studio's gross margin is $10.17 per CD. Unlike the digital download, recording studios need to recoup costs related to artist development, CD production and sales, and cover corporate overhead.

You may want to highlight some interesting relationships (calculated from data for 2006 presented in Exhibit 3):

1. Physical units (CDs) account for 39 percent of industry unit sales, and are down 35 percent since 1999. Physical units account for 80 percent of the dollar value of shipments.
2. As of 2006, digital single downloads account for 37 percent of industry unit sales and have increased 321 percent since 2004. Digital single downloads account for 5 percent of the dollar value of shipments.
3. Digital album downloads account for approximately 1.7 percent of industry unit sales, and have increased 500% since 2004. Digital album downloads account for approximately 2.4 percent of the dollar value of shipments.

This analysis clearly shows why the industry was in such a panic over illegal, and legal, downloading of music.

9. What options did the RIAA and the major recording companies have for dealing with the marketplace changes?

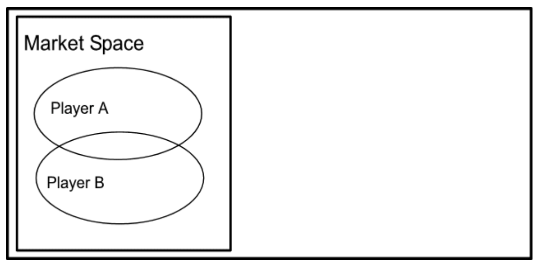
After having a good understanding of the situation and why it changed, the discussion can then focus on the options open to the recording industry and the implications of taking a different strategy in dealing with music file sharing. Some of the options open to the recording industry include:

1. developing proprietary online distribution,
2. establish relationships with intermediaries to develop legal online distribution alternatives,
3. preserve existing distribution channel through contractual or technological actions,

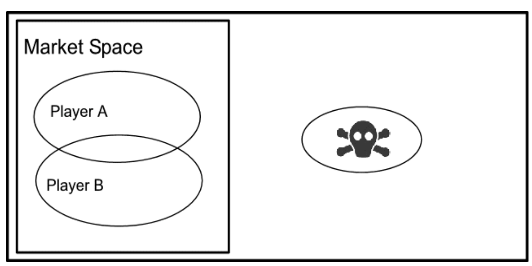
4. litigation.

You may develop some additional alternatives as well. Clearly, the RIAA chose to take legal and technological actions to preserve the existing distribution channel.

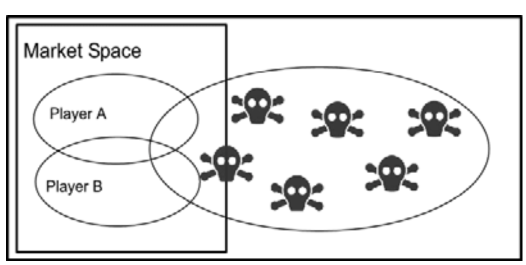
Mason (2008) provides an interesting perspective on music downloading by introducing the concept of piracy and its role in innovation. His contention is that most new innovation is the result of some level of piracy (or borrowing), regardless of industry. While his book provides many examples of piracy at work, it can be explained using the visuals below. A market space exists that is being served by a set of competitors. The market space is clearly defined with boundaries and identified "players."



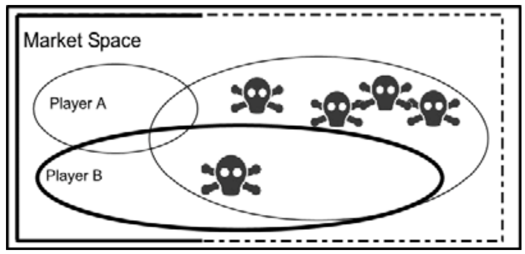
At some point a new player (the pirate) enters, but does not play by established rules and may exist outside of the currently defined market space.



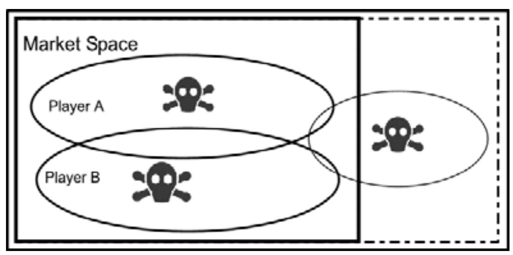
Seeing success achieved by the first pirate, additional pirates enter, now beginning to encroach on the existing market space. This is the beginning of the redefinition of the market space.



At this point the current players in the market must make a decision to respond or not. When one player responds, the market space is redefined and it begins to push the existing pirates out of the market.



Under market pressures, the remaining players must respond, effectively redefining the market space and pushing most of the remaining pirates out of the market



In a variation of the classic prisoner's dilemma, Mason creates his "Pirate's Dilemma."

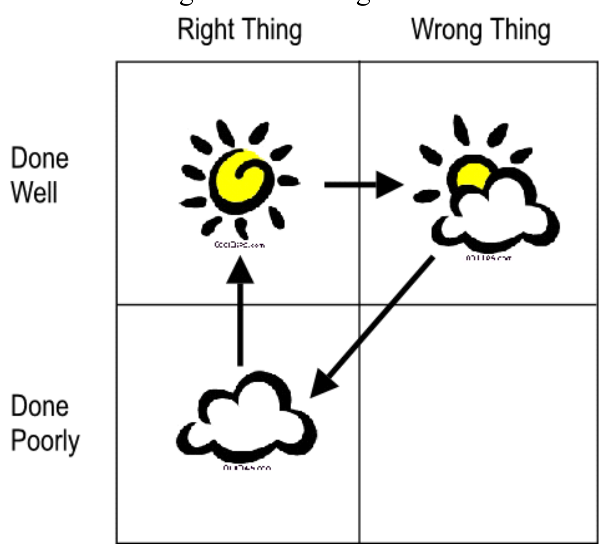
	Player B competes like a pirate:	Player B does not compete like a pirate:
Player A competes like a pirate:	1. Both gain new profits from moving into new market space. 2. Each becomes as efficient as possible. 3. Society gains maximum amount of added value	1. Player A gains share of market space, becomes more efficient. 2. Player B loses market share, stays inefficient, loses profits. 3. Society gains moderate amount of added value
Player A does not compete like a pirate:	1. Player B gains share of market space, becomes more efficient. 2. Player A loses market share, stays inefficient, loses profits. 3. Society gains moderate amount of added value	1. Both make profits in existing market space, but lose money to pirates. 2. Each stays inefficient. 3. Society gains minimum amount of added value

Applying Mason's analysis to the music industry case would imply that the recording industry should have acted quickly to embrace digital downloading rather than fight to preserve CD revenue. While not completely eliminating piracy, they could have effectively muted illegal downloads by providing legal alternatives. The studios had the technology. Further, they already had established direct relationships with consumers through the use of record clubs; a somewhat outdated concept that could have been redesigned into a digital downloading service.

10. Did the industry react as you might expect them to? the right way? How might they have reacted differently?

A common response to cases that look at company actions in hindsight is often one of, "how could that company make such a dumb mistake?" Rarely do we have the benefit of accurate foresight in business. The conversation about whether or not the music industry response could be expected is fruitful when examined in light of what we know about how companies respond to change.

Drawing on material from change management (Black and Gregersen, 2003), it can be shown that the behavior of the industry was to be expected. Using the figure below, Black and Gregersen (2003) show the evolution of change within an organization.



Starting with the upper left corner (sunny skies), a company become successful by doing something really well (producing a product or service) that is the "right thing" (exactly meets market demand). Success reinforces behavior and the company refines its business model to maximize efficiency and profitability. At some point, the company begins to encounter change (upper right, partly cloudy skies), resulting in their doing the "wrong thing" (market demand changes). Thus, the company's first reaction is to deny the reality that the market has shifted and work harder at doing the "right thing." The typical reaction is to resist change. However, once the company realizes that the market has changed, they must change what they do (lower left, cloudy skies). Change is difficult, and at first the company will do the "right thing," but do it poorly. As they move down the learning curve they will again achieve success by doing the right thing well (back to upper left).

The music industry was invested in a business model based on producing physical CDs that was very efficient and very profitable. Changes in technology and consumer needs converged to make this business model obsolete. The recording industry has spent the last decade fighting these changes, in other words, they wanted to continue doing the wrong thing.

Reference can also be made to the classic concept of Market Myopia (Leavitt, 1960). Leavitt discusses the fallacy of a growth industry; rather, successful companies organize themselves to take advantage of growth opportunities. Leavitt states,

> *The view that an industry is a customer-satisfying process, not a goods-producing process, is vital for all business men to understand. An industry begins with the customer and his needs, not a patent, a raw material, or selling skill. Given the customer's needs, the industry develops backwards, first concerning itself with the physical delivery of customer satisfactions, then it moves back further to creating the things by which these satisfactions are in part achieved. How these materials are created is a matter of indifference to the customer, hence the particular form of manufacturing, processing, or what-have-you cannot be considered as a vital aspect of the industry."*

This statement, written almost 50 years ago was prophetic at the time. It is quite applicable to the music industry over the last 10 years. As Leavitt expands on his ideas, the concept of market myopia is that companies/industries lose sight of the customer and narrowly define their market vision to the extent that they restrict their business model and succumb to obsolescence. The recording industry viewed itself as a manufacture of Compact Discs, not delivering music their customers wanted to hear on any format desired.

The discussion can now focus on whether or not the recording industry reacted the "right" way. As consumers, students will usually side against the recording industry. As one student commented:

> "I do not think the record industry acted in a professional way regarding how it approached the new digital marketplace and it's attack on the file sharing community. As a consumer and fan of many different types of music, my belief on the matter is that other consumers, like myself, were getting very much fed up with the costs of CD albums. The consuming public expected the costs of compact disks to go down as the technology required to produce them advanced and production costs decreased. Add to the mix that many albums contained a limited number of listenable tracks. As means for a cheaper and more efficient ways to obtain music increased, the record companies ignored them and the consumer reacted."

It is worthwhile taking some time to have them try and understand the situation from the industry's perspective. You may want to challenge students to place themselves in the role of a recording studio executive. What do they do?

Here the discussion can digress a bit into ethics of both the industry and consumers. Clearly, the industry has a legal right to pursue all actions against consumers. However, did they cross the line at any point? You could argue that the software solutions created by the industry crossed an ethical line, as well as legal.

What does the future hold for this industry? Below are comments from two students on this issue:

> Student #1: Based on the readings, it seems like the retailers have begun to enter the new channel, however the channel's nature (open and free distribution) will always be a challenge to overcome. Apple's iTunes method seems to be on the track to regaining control over the distribution channel by changing the characteristics and making the virtual distribution more proprietary. However with other retail names entering the market and potentially creating alternate proprietary methods, consumers may continue to use non-proprietary methods of virtual distribution. I think ultimately the industry will find a balance, but may never get back to the exclusivity level enjoyed by the industry in the past. But the future is clear for the industry, the physical distribution channel has passed the beginning of the end, which will force the music industry to ultimately enter the new channel or face extinction. One thing the music industry could do is develop a common proprietary format that could be used across all for the retailers (Apple, WalMart, Microsoft, etc.), maybe coupled with a jump into the direct method of distribution the industry could regain control over distribution.
>
> Student #2: Hopefully, the future will bring even more options to the purchase of digital music. Songs may become cheaper, and more varieties may become available. However, if the music industry becomes greedy and tries to milk more profits out of the consumer, they may face another fight with the public. But in a legal area as gray as this, they may want to rethink their strategies next time around.

The discussion can be summarized using the following points:

Summary

- Distribution channel for music undergoing massive change.
- Internet has provided consumers with great POWER.
- Internet potentially provides artists with great POWER.
- Music Industry has three basic alternatives to address the issue of music piracy.
- Litigation against consumers seeks to protect an antiquated production and distribution system.
- Music Industry suffers from Marketing Myopia.

EPILOGUE

The music industry continues to be in a state of transition. Recording companies and the RIAA have stepped up litigation activities, some in concert with the motion picture industry. The recording industry is finally accepting the fact that the distribution channel and their business model has changed, however, they are finding that they do not have the expertise to manage artists. Artists are looking for a more comprehensive management entity that will coordinate concert activities and merchandising opportunities, as well as produce records. While the recording industry has expertise in producing recorded music, they are less well suited for managing the other aspects of the artists' careers. This is unfortunate, since concerts and merchandising have proven to be big revenue generators. Concert promoters, such as LiveNation, have been signing artists to 360 contracts. The downside for the concert promoter is that they do not have expertise in producing records. Not to worry though, LiveNation has recently shown interest in outsourcing the production of recorded music back to the recording studios; a business decision that gives the studios a piece of the royalty pie and lowers overhead for LiveNation. One thing is certain, downloading of digital music files is here to stay. The challenge is to find a profitable business model.

APPENDIX

The appendix on the next page provides detailed information on the relationship between the music recording studios and the artists who create the music.

Music Industry and Artist Contracts

Artists were not necessarily in the recording industry's corner in this prize fight. Artist Neil Leyton felt that the music industry is responsible for their current plight, stating "They've built such high marketing costs to meet unrealistic sales projections, … When they're not met, they need a scapegoat, and they're pointing the finger at the consumer. It's pathological – they're alienating their own customers." (Dickie, 2004, p. 50). Some artists have released songs free to consumers. With the introduction of the early MP3 players, Tom Petty released his song, Free Girl Now, on the MP3.com site. The song was taken down two days later after Petty had received a "casual elbow in the ribs" from his recording label (Null, 1999).

Artists were getting ready for their own fight to get their share of over $270 million of the copyright infringement settlements between the music industry and Internet music download sites, including Napster, Kazaa and Bolt.com (Lauria, 2008), none of which has ended up in the artists bank accounts. This reflects a pattern in this relationship, contentious as there was dispute over a settlement between New York State and the music labels for not distributing royalties to thousands of musicians (Smith, 2004). The music industry takes care of itself, first. They will first recoup their legal expenses from any settlements (Lauria, 2008), then distribute the remaining amounts to the artists. It has been said that "Getting money out of the major labels is never easy, but given the industry's downward financial spiral it is exponentially more difficult now …The record labels are experts at transferring money around and putting the onus on the artists managers to find it." (Lauria, 2008, p. 33)

Royalties are just one part of an extremely complex, some would say incomprehensible, contractual relationship between artists and music companies. There are actually three types of royalties, performance, mechanical and synchronization (Vines, 2005). Performance royalties come from having music broadcast on radio, television and movies (Vines, 2005). Synchronization royalties are paid for specific use, where whenever a visual image is portrayed the music plays. Finally, mechanical royalties are paid for music that has been recorded on CD, which are the ones that are most hotly contested. The mechanical royalty rate is set by the U.S. government (Holland, 2001a)

Musicians really did not make money off of CD sales, rather it was live concert touring and merchandising where they made most of their money. Royalties have always been a contentious issue. Artists in Britain filed a lawsuit over the recording label's move to reduce royalties on music downloads (Harrison, 2005). Bands such as The Allman Brothers, Cheap Trick and others filed lawsuits against Sony over royalty payment disputes (Duhigg, 2006). Doing the math, an average payment to Sony for a music download was 70 cents (Duhigg, 2007). Thus, a service such as iTunes would receive the remaining 29 cents from a 99 cent download. Musicians, however, had a much different take, literally and figuratively. Statutory royalty rates are 9.1 cents for CD and downloads, up from the 2 cent royalty artists were earning in 1909 (Israelite, Bainwol, and Potter, 2007). Music labels, such as Sony, treated these downloads just like CDs, deducting 15 percent packaging and 20 percent breakage fees from the royalty payment. Artists received a 4 to 5 cent royalty payment on every music download. Thus, Sony gets the lion's share of the licensing payment, which they say is appropriate given their marketing and promotion investments and assumed risk . Major record labels would like to see the current statutory royalty rate lowered, claiming that it is set too high (Israelite, Bainwol, and Potter, 2007). Associations representing artists and the music industry, National Music Publishers Association and the Digital Media Association, had very different starting points, with the NMPA seeking 14% and the DMA looking at 6.9% of subscription revenue (McBride, 2005).

It wasn't just royalties over which the artists had issues with the music labels. The complex music contracts were a constant source of irritation as the major labels sought greater control over the artists they signed to contracts. Legal disputes have raged over the seven-year rule exemption in California that allows music labels to maintain rights to artists for excessively long periods of time (Ordonez, 2001). Music labels have controlled composition clauses that effectively allow them to control creative content and the amount of content. This clause allows a music label to pay a portion (three-quarters) of the mechanical royalty rate discussed above. This clause potentially restricts the length of song as well as the number of tracks per CD (Holland, 2001b).

Work-for-Hire rules created by the major labels assigned the copyright for recorded music to the label, not the artist (Matthews, 2001). Thus, artists did not retain control over their work once it was recorded on CD. Contracts also include, what some consider particularly pernicious, recoupment clauses, where the music company "recoups" the costs of recording the CD from the artists royalty payment (Holland, 2001b). Many artists receive advances on their music production, from which they pay to record the CD. The record labels then deduct these advances from royalty payments. Clearly, contracts have been structured to the benefit of the major labels, primarily because they controlled the channel of distribution and artists had no other choice if they wanted people to hear their music outside of a small venue.

The Internet has changed the power structure of the channel. Now musicians are more likely to strike out on their own, seeing the Net as the "ultimate venue and distribution channel for their work." (Vernadukis, 1999).

One of the earliest was the artist Symbol, formerly known as Prince. More big name artists, such as Oasis and Radiohead, are exploring the opportunity provided by going independent via the Internet (Clarke, 2006). Further, larger bands are looking for different types of contracts with major labels, such as one album contracts.

The Internet also provided lesser known artists the ability to distribute their music to fans without having to go through the major recording labels. Garageband, an Internet music distribution site, had the goal of helping aspiring rock stars get started. Smaller bands could get advances of $10,000 to kick start their recording, with the opportunity to get additional funding if their CDs are successful (Clark, 2001).

As artists are finding new methods of distribution and make most of their earnings through live performances and merchandising they are forcing change in the industry. Artists use to earn most of their income from recorded music through the major record labels, with just one-third of their income from live performances and merchandising (Economist, 2007). This income distribution has reversed. Concert ticket sales have almost doubled to $3.1 billion between 2000 and 2006 (Economist, 2007). Naturally, the artists have devoted more time to touring and less to promoting records. The major music labels are missing out on the area of largest revenue growth, and are eager to get into the act. They have developed the 360 degree contracts that grant the major labels more rights over musician revenue streams (Butler, 2008).

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COOPERATIVE GUATEMALA, LLC: "AN EXAMINATION OF A GUATEMALAN COOPERATIVE'S STRATEGIC DEVELOPMENT"

Nickalus Johnson, DRI Energy
Steven P. Landry, Monterey Institute of International Studies
Terrance Jalbert, University of Hawaii at Hilo

CASE DESCRIPTION

The primary subject matter of this case concerns the development of strategy for confronting barriers to growth facing a small fishing Cooperative in rural Guatemala. The core issues include coming up with ways to evaluate past performance and to evaluate future options. The backdrop for these issues consists of identifying competitive advantages through diversification into identified new businesses. While this case is based on an actual, real set of circumstances, people and organizations; specific names of people, towns and the Cooperatives have been changed for proprietary reasons.

The case lends itself to student project assignments with respect to developing a strategy for "Cooperative Guatemala". Proposed solutions should follow for determining which ventures to accept with particular attention paid to the cultural implications. Furthermore, students should determine the viability of entering various markets based on incomplete information and the lack of full-time general management as identified in the case.

The case has a difficulty level appropriate for a senior course at the undergraduate level or at the graduate level. The case is designated to be taught in 1.5 class hours and is expected to require 2-3 hours of outside preparation by students.

CASE SYNOPSIS

This case explores the establishment and growth of homogenous Cooperatives in a stunted market and some challenges facing diversification of Cooperatives in rural Guatemala. Specific concerns of this case center on the development of strategy for confronting barriers to growth facing a small fishing Cooperative in rural Guatemala, with the added challenges of both strategic and operational decisions being determined solely by the Cooperative's board of directors. The cooperative faces some significant challenges including overcoming lack of education, culturally related decision-making stigmas, and poor organizational structure. These challenges fall within the context of attempting to find competitive advantages through diversification into identified new businesses. Stemming from a search for assistance, the Cooperative eventually was assigned a US Peace Corps volunteer, the viewpoint from whom this case was developed, to assist the Cooperative in providing business administration skills, such as strategy development along with financial and operational control mechanisms, and help improve profitability. A major task of the case is to develop a framework within which the Cooperative can evaluate business opportunities it should pursue.

INSTRUCTORS' NOTES

Discussion Questions

1. **What major problems can you identify (internal and external) that have influenced the Cooperative's current economic position and strategy? Would you characterize their position as weak or strong? Defend your position.**

Cooperative Guatemala is a real cooperative that is presently facing these and other issues regarding the growth and sustainability of their businesses. During the years from December 2004 to November 2006, the lead author was intimately involved in helping the Cooperative better understand its competitive position and define goals for strategic planning. The ongoing struggles within management and in the community are not uncommon among cooperatives in Guatemala. The cooperative movement has been used as a business model with varying levels of success for nearly thirty years across many industries with much more failure than success. The majority of the cooperatives have been formed by political parties throwing money at worker groups who were then left to fend for themselves.

Internally, Cooperative Guatemala is restricted in strategic ability due to the lack of formal training and low levels of education among its members. Decisions are made intuitively and draw from historic reference and experience. Rarely are decisions based on an actual plan designed to meet specific criteria or achieve set goals/objectives. In fact, the only real planning emanating from the cooperative is often done by the Accountant or INACOP to comply with the regulations for reporting of cooperative activities at the end of the fiscal year. Additionally, there is a general fear of failure among cooperative leaders. No one wishes to be the person who made the wrong decision which cost the cooperative money. Coupled with the lack of education, this leads to insecure leadership. Finally, due to lack of training in financial matters, there exists little accounting control to ensure proper cash flow and capital investment, which promulgates discretionary profit sharing, poor inventory management and burgeoning receivables.

Externally, the fishing industry as a whole is experiencing the worst scarcity in the history of Guatemala. In Isla Bonita, when Cooperative Isla Bonita (the big cooperative) prospers, there is great economic bounty, but when it suffers, there is a downturn. Cooperative Guatemala often sources from Co-op Isla Bonita thus exacerbating the overall fish scarcity and affecting the fish market both from the industrial and artisan supply chain. The growth of Homegrown Ventures is encroaching on the local market share of Cooperative Guatemala. Finally, the town of Isla Bonita has long been supported and funded by members of the FRG political party, which lost political power in 2004.

2. **What is the Board's role regarding the direction of the Cooperative? Consider the following:**
*** How are the three current business units managed and what role does the Board play?**
*** Should the Board look outside the Cooperative for a GM to manage these units and head up the expansion? If so, what qualifications are important, and how should that person be compensated?**

*** What are the pros and cons inherent in promoting someone from within the cooperative to be General Manager?**

Traditionally, the Boards of Directors of cooperatives in Guatemala have been taught to take on the management of the core businesses. This model often proves unsuccessful due to the conflict of interests for Board Members who have their own full-time professions, and receive no management incentive for making sure the cooperative is running smoothly. Some cooperatives have identified this problem and taken measures to either hire externally or give a stipend to the Board to incentivize regular effective meetings. Cooperative Guatemala has yet to implement this due to a common concern that the Board will just meet to collect their stipend and no real change will come about.

The business units are currently managed by Co-op members under the watchful eye and monthly accounting of the Board. These managing members receive a monthly salary and have control over purchasing, pricing and distribution of the business unit they control as well as the credit and terms-of-credit they extend.

It is in the best interest of Cooperative Guatemala to bring someone in as General Manager of the Cooperative only after they have established one of the new business units and can use this as leverage to *convince* the members they *need* someone's help with juggling the different business units. There is a strong resistance within the membership to bringing someone in from the outside due to long-held mistrust that outsiders will take advantage given the lack of financial controls. Qualities of such a General Manager would be: at least a high school degree with general understanding of business accounting, high threshold for uncertainty, willingness to work with the Board in decision-making processes, experience in managing other people, and must be able to live and work in a small community where his/her work will be scrutinized by non-technical onlookers.

The following is a list of pros and cons of promoting someone to General Manager from within the Cooperative:

Pros:

* Knows company policy and procedures well;
* Already has rapport with clients and members;
* Has general trust and confidence of members;
* Has a vested interest in seeing the Cooperative succeed.

Cons:

* Lack of Education;
* Poor training;
* Just like me" syndrome – no one really trusts him or wants to see him succeed because he's a member, just like them;
* Myopia regarding what works and what won't based on limited scope;
* Little objectivity;
* Continue being limited by past fears/failures and thus afraid to take risks;
* Limited vision/creativity; outside person can bring in fresh ideas and objectivity.

3. What strategic planning methods, if any, have been used by the members of Cooperative Guatemala thus far? How should Rodrigo suggest they move forward? Highlight the planning limitations facing the Board of Directors.

It does not at first appear that the Board has any formal training in strategic planning methods, but, as mentioned in the case, at least once a year they must sit down with the accountant to design the budget and work plan for the coming year to be able to present it at the annual meeting. In this meeting, they typically analyze what they did the year before, as well, to give a brief overview of accomplishments. While very rudimentary due to their lack of understanding, this has at least helped them frame some of their ideas and keep them at the forefront of conversation. They also get an idea of the amount of money they are generating and how it could be better invested.

Succession planning was mentioned briefly when Rodrigo and the Board gave training sessions on accounting and inventory for the hardware store in an effort to better prepare the Coop in working with that Business Unit and to raise up one of the attendees as the successor to Juan in the Store. Unfortunately, there seems to have been little to no succession planning in any of the jobs before this, and there is practically none done for the Board of Directors. The hand-off of responsibility has long-been a poorly addressed issue, and has resulted in the kind of discontinuity of programs and training as one might expect.

There do not appear to be a clearly defined mission, managerial goals and objectives, or a roadmap for management to follow. These are simple strategic guidelines, but they have the ability to unify the thoughts of leaders and help keep planning on track. Rodrigo should suggest that there be a bi-annual planning meeting where the Board has the specific goal of planning the following 6-12 months and setting goals and objectives for the achievement of that plan. The Board of Directors should also meet at least once-a-month for the purposes of addressing problems in the Cooperative, assessing the progress of the annual plan, and adjusting as needed the coming month(s) to achieve set goals and objectives. Also, simple things such as communicating the mission and goals to the Cooperative through meetings, letters and signs around the Co-op are ways to continuously involve the members in the Cooperative's success.

There are some limitations presently facing the Board in regards to planning. The group currently serving was not in charge when INACOP gave their training sessions, so they have not received formal training on the role of the Board of Directors and each one's part. This can be easily remedied through the help of Rodrigo or by calling INACOP back in to review this training. Also, due to the fact that each Board member has a full-time job, it is difficult to convince them to leave their paying job for a couple of hours to come to the Coop and talk. This is compounded by the fact that the Board receives no stipend for their meetings, thus they must sacrifice financial gain to serve in their capacity at the Co-op. A simple stipend incentive system could be used to motivate the members to meet on a regular basis. At the time of the case, the EFIS project was just beginning the process of liquidation, thus, there were two Boards of Directors functioning at the same time. This often led to deferment of work and planning to "the other" Board. Finally, were there someone either within the Coop or hired on who took on the role of GM, there would certainly be more continuity between formation of plans and budgets and their implementation. This disconnection between planning and implementation is probably the strongest impediment to progress and growth.

The following are some methods for planning that could be implemented in the Cooperative broken into short-term and medium-term scope:

Short-term:

* Planning meeting to outline yearly goals and budget
* Formulate a mission statement and specific goals to achieve it.
* Develop Table of Objectives for specific businesses.
* Longer term planning meetings (SWOT Analysis, Porter's Five Forces, PESTLE (Political, Economic, Social, Technological, Legal, Environmental)

Medium-term:

* Define Strategic positioning concerning competitors
* Scenario planning for each potential business opportunity
* Succession planning for the Business Units

4. Of the projects mentioned, list the benefits and constraints in a manner which would clearly identify which of the projects would be most feasible with respect to the Cooperative given time, money and knowledge boundaries. As a consultant, how would you advise the Cooperative to proceed?

The object here is clearly to get the student to choose a framework for analysis of the Cooperative's competency toward the options presented. While a case could be made for Porter's five forces industry analysis, there is probably not enough information given in the case to completely analyze the options in this manner. The firm really needs a situational analysis of its internal strengths and weaknesses in regards to the external opportunities and threats, a SWOT. In doing this, one approach might be to list the steps necessary to bring each idea to reality. Likewise, it would be helpful to set up critical success factors for each option. In the appendix is a SWOT analysis of the Cooperative done by Rodrigo in conjunction with the Board of Directors. The students can address each option business and analyze the necessary steps based on strengths and weaknesses as they pertain to each point.

The Aquaculture project appears to be a nice fit from the outset. This is a fishing Cooperative, so if they have a distinct competitive advantage it would lie in their knowledge of that industry. However, aquaculture is quite a science and requires a great deal of technical training. There are already two Board members partially trained in this area, and they have access to more training which can be made available to the entire Cooperative. Furthermore, land, which is not easy to come by in Guatemala, is already available to them at a very cheap price due to familial ties. An aquiculture project, depending on size, can require millions in investment. The Homegrown Ventures project was a Q4 million investment. Cooperative Guatemala has some financial liquidity, but this money would be better spent in financing the running of the present Business Units. However, they do have great connection with government entities, and with Taiwan pumping money into just such projects, it is likely there would be some grant or low-interest loan money available.

Finally, they would be able to take advantage of their current distribution channels to maximize growth potential.

At first glance, a Hotel would seem to be out of the scope of Cooperative Guatemala's core competency, however, the option may still represent a sound business venture. The tourism industry in Guatemala in general is growing at an unprecedented rate and ranks as the 3rd highest contributor to GDP. With such growth comes the investment of governmental and outside interests in developing sustainable tourist locations and attractions. Quite coincidentally for Cooperative Guatemala, two members sit on the Board of Directors for the Local Tourism Committee, which has curried favor with INGUAT and the National Federation of Tourism Committees, and therefore has drawn the eye of investors to Isla Bonita. The tourism industry is set to grow substantially in Isla Bonita, and this might be a great opportunity for Cooperative Guatemala to develop a competitive advantage and diversify their Cooperative product offerings while also providing employment for members and the community at large. This option would also provide another channel of distribution for the fish sales as it is traditional for beach hotels to have their own restaurant. There is the question of managing the Hotel, and at present there is no one in the cooperative with this specific competency, and it is uncertain how transferable managing the other Business Units is to this industry. This, too, would be an expensive venture, but with the connections at San Carlos University and project grants from INGUAT, the launch could be manageable. Concern lies in demand. If there is not sufficient year-round draw for tourists, and if Cooperative Guatemala cannot outperform the other hotels, margins will be suppressed. The Local Tourism Committee can help them work on offering packages from the Capital that are all-inclusive and include activities such as fishing and going to the marlin hatchery.

The gas station is less likely to be the positive option the Cooperative imagines for two reasons. First, it is run-down and would require a good deal of investment from a *renter* to turn it into a more profitable venture. Secondly, there would most certainly arise problems between the two Cooperatives due to any profit generation that may arise, noting the controversy surrounding the outstanding loan Cooperative Isla Bonita owes Cooperative Guatemala. There is little certainty that Co-op Isla Bonita will offer the option to purchase should Cooperative Guatemala turn the gas station around, and it is more likely that they would use this arrangement to their benefit to have the station upgraded at no cost to them. Perhaps a more suitable option would be to expand their current operations to an extra plot of land they own called "El Mangle" and put a gasoline depot there, as it is more strategically located for fishermen. Overall, the gas station option does not appear to be very profitable and does not fit with Cooperative Guatemala's desire to develop a core competency, as they most likely would eventually have to return the station.

5. Evaluate the concept of proposing a merger between Cooperative Guatemala, Cooperative Isla Bonita and Homegrown Ventures.

A merger between the two cooperatives (noting Homegrown Ventures is not a Cooperative) has significant potential. It is unclear whether merging with Homegrown Ventures would be feasible given its nonprofit status as opposed to the status of the other two organizations as Cooperatives. The town is quite small and as such it is difficult for such a community to sufficiently support three different operations. Moreover, the two cooperatives are quite small, apparently having only about 25 members each. Merging the cooperatives together has potential on several fronts.

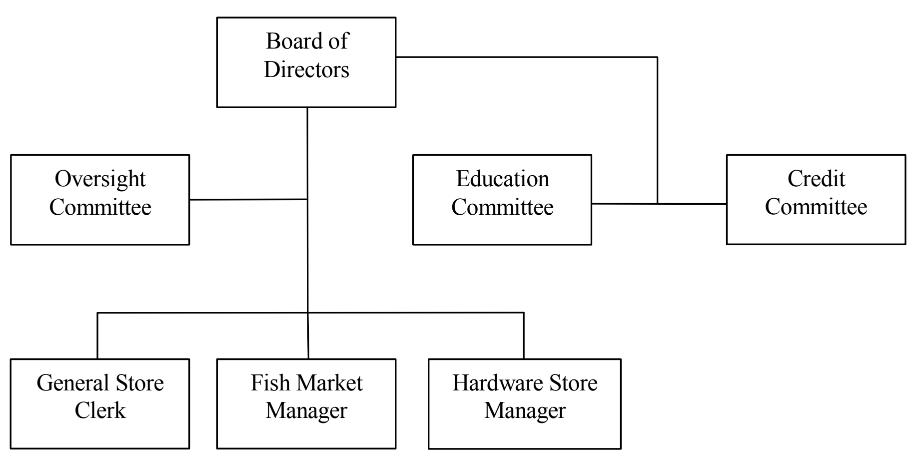
First, and foremost, merging the cooperatives together could improve economies of scale. Among other benefits, these economies of scale would improve the feasibility of hiring a professional manager to run the entire operation. A professional manager would not be related to any of the existing members and would not have conflicts of interest. This would reduce the incidence of self-interested dealings between the cooperatives and their members.

The merger of the two operations could also potentially resolve the issues related to the loan between the two cooperatives. This appears to be a messy issue that could be costly to resolve and ultimately might never be resolved. While the undocumented loan between the two cooperatives is problematic it also suggests that there is some interest in working together.

The combination of the gas station, hardware store and other ventures under one roof has the potential to create an operation with substantial additional purchasing power and presence in the community. It also has the potential to diversify the risk associated with any one operation. The cooperatives each appear to have certain traits that are valuable to the other. The new infusion of cash into the company associated with the FIS project could help expand and improve the newly combined cooperative.

There are two primary difficulties in making such a merger. Likely the most significant limitation is the negative relationship and lack of trust between the members of the two cooperatives. It seems that these trust issues extend beyond the cooperative businesses and into the personal lives and businesses of the individuals. There is no way to determine if these trust issues can be overcome. Initiating the proposal and observing the resulting responses is likely the only way that this can be assessed. Bringing in a consultant to assist the two groups manage these conflicts might be beneficial.

Cooperative Guatemala Organizational Chart



A second difficulty is that some pet projects may need to be divested in order for the entire cooperative to flourish**.** These divestures might be difficult for some members to stomach. Indeed the changes to the respective cooperatives could cause collateral damage to the members' private businesses. An unwillingness to make these changes by some members could doom the merger.

SWOT Analysis

S

* Support and training from INACOP
* Volunteer from Peace Corps
* Financing from FIS and training from FIS
* Owners of their property, own two lots in strategic locations
* Have large market share of local fish consumption
* Razon Para Quedarse – training, political connection and endorsement
* Location – tourism and fishing industries
* Skilled labor in fishing, masonry, carpentry, and sales

W

* Poor Money managers – lack of financial training
* Low level of education
* No member incentive program(s)
* No managerial controls in place – the ones they have are poorly understood or carried
* 2 different boards of directors – decisions passed off
* Lack of sufficient competitive advantage
* Membership is aging and there are no new members to provide fresh energy, ideas and hands

O

*Training from Razon Para Quedarse – Aquiculture
* Growth in Tourism – hotel project
* Investment from Government in fish farms
* Recuperate debt from Cooperative Isla Bonita and gain competitive advantage with gas station.
* Property "El Mangle" still undeveloped which sits at a major crossroads in town where much growth is occurring. Positioning prime for fishermen.

T

* Homegrown Ventures – expanding faster than Cooperative Guatemala
* Already have an aquiculture project, and have a gasoline station *on the island* that is gaining popularity and market share.
* Are in year 1 or have their own financing project with FIS and have carefully observed the problems-to-avoid committed by Cooperative Guatemala.
* 2 of the three hotels built in Isla Bonita recently are from outside investors, not Lisenos.
* Scarcity in deep sea fishing forcing businesses to expand into areas where they have no competency.
* Continued resistance to change and a lack of initiative to be proactive to the evolving market could leave Cooperative Guatemala without a competitive advantage and without members to "carry the torch".

WARREN E. BUFFETT AND BERKSHIRE HATHAWAY, INC.

Todd A. Finkle, Gonzaga University

CASE DESCRIPTION

The case is beneficial to students because of its emphasis on Buffett's core values. Students will see that Buffett is not only one of the richest people in the world, but he attributed his success to his value system. Furthermore, Buffett explains that what makes him the most happy is not money, but being surrounded by people that love him.

The case also gives an overview of the stages that Berkshire Hathaway goes through leading up to 2008. Financial statements are provided so the students can perform financial ratio analysis and evaluate the company's financial disposition. The current economic crisis facing the U.S. is evaluated. Students are required to evaluate Buffett's investment philosophy and make recommendations as to what moves the company should make.

CASE SYNOPSIS

The case discusses the history and background of one of the most successful entrepreneurs, Warren E. Buffett, and the company that he built, Berkshire Hathaway, Inc. The investment genius of Buffett who is affectionately called the "Oracle of Omaha" is examined. The progressions of Buffett's entrepreneurial endeavors are followed from his youth, college, Wall Street, investment partnership, and Berkshire Hathaway. The case discusses Buffett's keys to success, including his value system, and investment philosophy. Students are required to analyze the entrepreneurial personality of Buffett as well as perform a financial analysis on the company. Students are required to make recommendations on what Berkshire should do next in this fragile economy, which Buffett characterized as a recession.

The case gives an in-depth analysis of the background, personality, and history of Warren E. Buffett. Buffett's childhood and psychological makeup are discussed as well as the various influences in his life. The case is especially interesting because it follows the path of one of the most successful entrepreneurs of all time. Students have the ability to follow the life of one of the richest people in the world.

INSTRUCTORS' NOTES

Recommendations for Teaching Approaches

Students will find the case interesting from a number of dimensions (e.g., Buffett is the richest man in the world, yet he has a strong value system; Buffett's background, the companies Berkshire has a vested interest in, etc.). Most students will have used or eaten one of the many products associated with Berkshire Hathaway (e.g., Coke, Gillette, Dairy Queen). Instructors have the ability to integrate the entrepreneurial mindset into the case by taking students through Buffett's youth to adulthood. Instructors also have the ability to integrate Buffett's value system and integrate it into their teaching plan.

The case can be used in a variety of classes including undergraduate and graduate strategic management, entrepreneurship, and finance. The estimated time to read and answer the questions for the case is between 6-8 hours. Since the case covers material on financial statements, SWOT, and investment philosophies, instructors will have the ability to use the case in more than one session or just focus on one or more of these issues. Before teaching the case, students should be familiar with analyzing a company's financial statements.

Key Issues and Discussion Points

The case allows students to follow Buffett's path through life from his entrepreneurial endeavors at a young age, through his teens, college years, Wall Street, partnership, and the purchase and growth of Berkshire Hathaway. The case serves as a benchmark for students to follow in their own careers.

The case also allows students to evaluate Buffett's keys to success including his personal value system and investment methodology. There are many books and articles that have been written on Buffett; however few have evaluated his investment methodology in depth. The case allows students the ability to evaluate some of the factors that Buffett uses during his investment decisions. Furthermore, the case provides the current financial situation of the company. Financial statements are provided so the students can perform financial ratio analysis and evaluate the overall financial disposition of the company.

Another important contribution of the case is the examination of the current recession. Students will have the ability to examine how a company reacts to the worst economic environment since World War II.

QUESTIONS

1. What is the background and personality of Warren Buffett?

Warren Buffett was one of three children born to Howard and Leila Buffett in the heart of the Midwest in Omaha, Nebraska in 1930. His family had roots in the United States dating back to the 1600's. His family's entrepreneurial spirit can be seen with his great grandfather who started his own grocery store in 1869. Buffett's own father was a stockbroker and owned a company called Buffett-Falk & Company that sold diamonds on the side to hedge against inflation. Buffett and his future partner, Charles Munger, would later go on to work in his great grandfather's grocery store.

Buffett's life was surrounded by entrepreneurs. His mother's family was also entrepreneurial as they owned a print shop. Buffett began showing signs of being an entrepreneur at the very young age of six.

The first few cents Warren Buffett earned came from selling chewing gum. And from the day he started selling, at age six, he showed an unyielding attitude toward his customers that revealed his later style. Buffett Stated, "I remember a woman saying, I will take one stick of Juicy Fruit. I said, we do not break up packs of gum, I mean, I have got my principles." Making a sale was tempting, but not tempting enough. If he sold one stick to her, he'd have four sticks left to sell, not worth the work or the risk. He made two cents profit per pack.

After this venture he bought a six pack of coke for 25 cents from his grandfather's store and sold individual bottles for 5 cents. While this venture was ensuing, he also had a paper route, and eventually started learning about investments from his father's library. By the age of 11, he was successfully investing in stocks and went on to purchase a farm at age 14.

By the time Buffett was in junior high school, his father had moved the family to Washington D.C. because he was elected to Congress. While in Washington, Buffett continued his entrepreneurial pursuits by starting a peanut vending machine and a pinball machine business, renting a Rolls Royce he purchased, and selling golf balls he found on golf courses. In school he graduated 16th in his class of 350 at Woodrow Wilson High School. He had amassed $6,000 at the time he graduated from high school at the age of 16.

Buffett began his higher education at the Wharton School of Business at the University of Pennsylvania; however he later transferred to the University of Nebraska at Lincoln where he graduated in 1950 at age 19. After this, he applied to Harvard Business School's MBA Program, but was rejected due to his young age. As a result, Buffett applied and got into Columbia Business School. It was at Columbia where he met the great investor, Benjamin Graham. Buffett and went on to be Graham's best student.

Under Graham, Buffett learned his investment philosophy. He was exposed to Graham's two famous books, *Security Analysis* (1934) and *The Intelligent Investor* (1949). He went on to work for Graham's firm on Wall Street and eventually moved back to Nebraska to start his own investment partnership. His partnership thrived and at the age of 32 he became a millionaire. Buffett eventually liquidated his partnership and continued business as Berkshire Hathaway. Today, he is known as the most renowned investor of all time.

2. Is Warren Buffett an entrepreneur?

Students may take different sides on this question. Buffett was certainly an entrepreneur early in his life, but is he an entrepreneur today? Do his pursuits of investment opportunities classify him as an entrepreneur? Some students may say no because they classify him as an investor, not an entrepreneur. They may say, he is not creating a new business nor does he invest in startups. He is investing in well established companies with track records.

Other students may say, Buffett is an entrepreneur because he takes calculated risks with his investments. He seeks opportunities from an investment company that he founded. He searches for opportunities similar to entrepreneurs. Certainly parts of each of these responses are true.

3. What did Warren Buffett do to make Berkshire Hathaway, Inc. so successful? What was Buffett's investment philosophy?

There are a number of factors that have led to the success of Buffett and Berkshire Hathaway, Inc. First and foremost was the brilliance of Buffett. Without his intellect, none of this would have happened. Certainly Buffett's exposure to entrepreneurship and the stock market at such a young age contributed to his success.

Buffett learned a value system from his father that has followed him throughout his career. Buffett is truthful and straightforward with people. This was beneficial to his company and to his career. People know that when they talk with Buffett, they are getting the truth. As such, people place their trust in him and are more willing to invest with someone they trust.

Of course, most importantly was Buffett's expertise that he learned valuing companies throughout his career. Buffett had developed an art of realizing undervalued companies and structuring deals to benefit Berkshire Hathaway. He combined Graham's investment philosophy with his own by answering the following issues related to a potential investment:

- Is the business easy to understand and analyze? Buffett only liked businesses that he could understand. Buffett stated that if he was teaching a course on valuation, his final exam to the students would be to value an Internet company. If the student answered the question, he or she would receive an F.
- Is the company in an industry with good economics, i.e., not an industry competing on price? Does the company have a consumer monopoly within their industry (e.g., Gillette, Coke, Dairy Queen, etc.)? Coca-Cola and Gillette have what Buffett calls a moat, where the resources necessary to overcome the brands are enormous.
- How old is the company? Buffett liked to look at a 10 year track record of financial statements. He also liked to compare the company with other firms within their industry.
- Buffett preferred firms that did not require a great deal of capital. The business should not have high maintenance cost of operations, high capital expenditure or investment cash outflow.
- Does the company have a high Return on Equity (ROE)? Buffett preferred 15%, but was willing to go lower depending on the economic conditions.
- Was the company's debt-to-equity ratio low enough so the company can pay its debt obligations? Can the company repay debt even in years when earnings are lower than average?
- Does the company have a quality, ethical management team that had passion?
- Is the company free to adjust prices for inflation and still maintain profitability?
- Will the value added by retaining earnings lead to an increase in the stock market value of the company?
- Did the company have consistent strong free cash flow to maintain its current operations? Did the company retain earnings for growth and what is management's track record on those investments?
- Is the stock undervalued by at least 25%? Is the intrinsic value of the company 25% less than the market value of the company?

Buffett stated that he would talk to CEOs in an industry and ask them, if you wanted to invest in one company in your industry who would it be and why? This methodology allowed him to learn about the leaders in each industry. There was no magical test to determine the value of a company; however Buffett had a good handle on the various tactics he used to help him value companies.

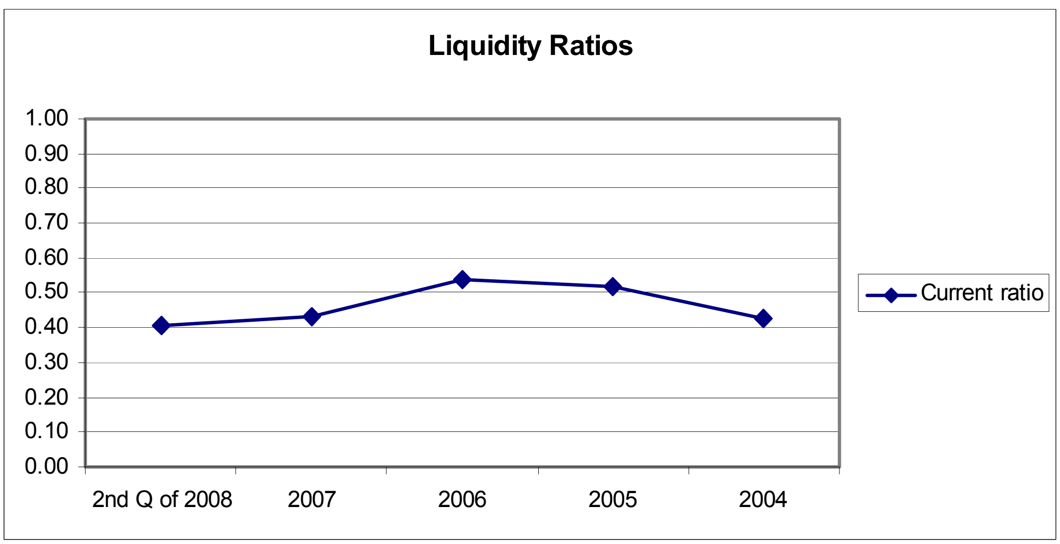
Another factor that contributed to Buffett's success was giving back to the community. For the past several years, he invited approximately 15 schools a year to his corporate office to talk about business and lessons about life. He also auctioned off a lunch with himself on eBay and gave away the proceeds to Glide Foundation, a nonprofit organization, based in San Francisco.

4. Perform a SWOT Analysis of Berkshire Hathaway.

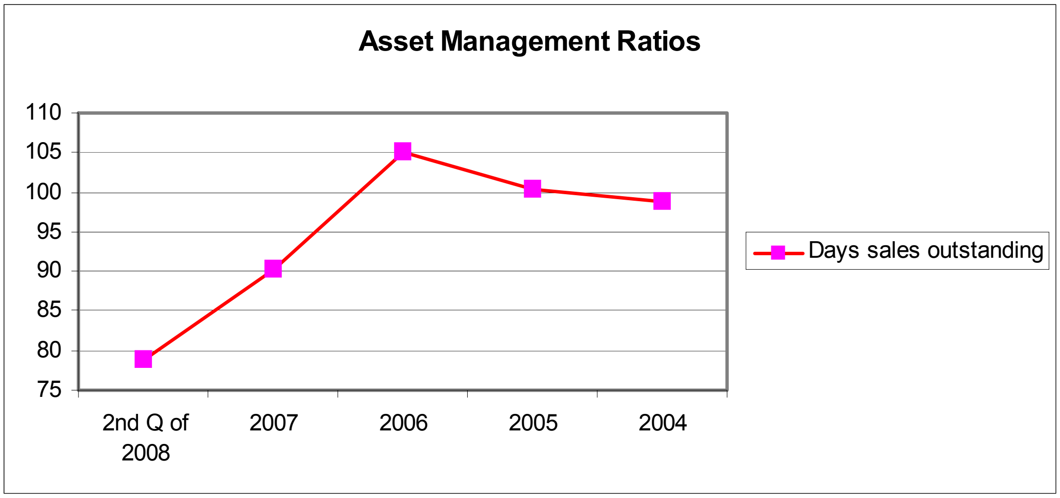
Internal Factor	Strengths	Weaknesses
Management/ Strategy	• Berkshire Hathaway, Inc. is directed by a great leader and entrepreneur, Warren Buffett. • Experienced and entrepreneurial management team • Investment strategies driven by Warren Buffett have brought success • Diversified investment strategies • BH has big companies with good health and aggressive competitive abilities	• Dependence on performance of other industries
Offerings	• GEICO and other investees offer premium products at a very competitive price	
Personnel	• Creative and committed management team	• A reliable successor for Warren Buffett's position must be found
Finance	• Revenues and cash flows growing significantly • High cash inventory	• If an unforeseeable situation occurred the financial health of BH could be damaged. For example, Katrina resulted in huge cash going out
External Factor	Opportunities	Threats
Competitive		• GEICO and investees face aggressive competition from competitors
Marketing	• A huge opportunity to increase revenues for subsidiaries as a result of increasing advertising campaigns in the domestic market	
Finance	• Acquisitions	• Recession in 2008 • Investees underperforming will significantly damage BH annual performance.

5. Analyze the financial ratios for the company. Is the firm financially healthy? Why or why not?

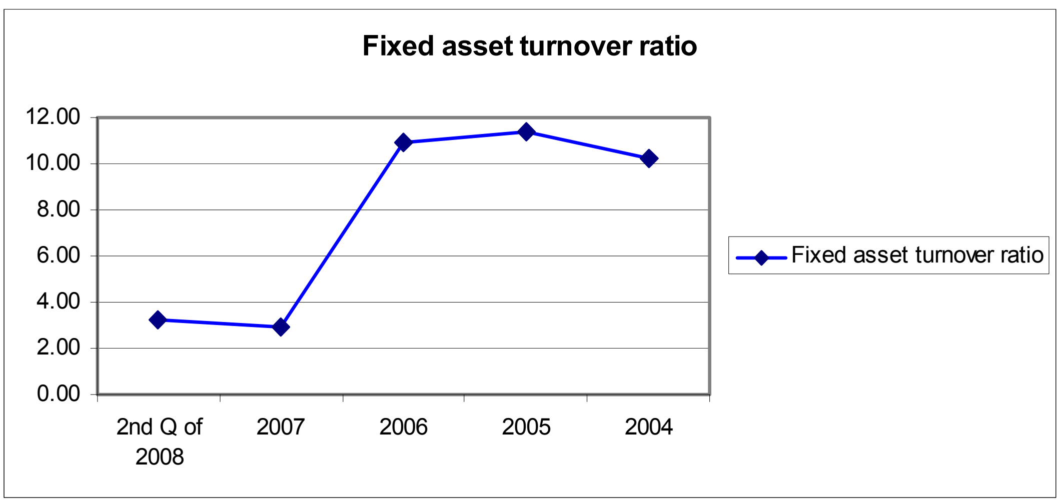
	2008 Q2	2007	2006	2005	2004
Liquidity Ratios					
Current ratio	0.41	0.43	0.54	0.52	0.43
Asset management ratios					
Days sales outstanding	79	90	105	100	99
Fixed asset turnover ratio	3.27	2.96	10.89	11.42	10.2
Total asset turnover ratio	0.43	0.4	0.41	0.39	0.35
Debt management ratios					
Debt Ratio	55.8%	56.4%	53.9%	54.5%	57.0%
Profitability ratios					
Profit margin on sales	11.2%	11.2%	10.4%	9.8%	12.8%
Return on asset	4.8%	4.4%	4.3%	3.9%	4.5%
Return on equity	10.9%	10.2%	9.3%	8.5%	10.5%

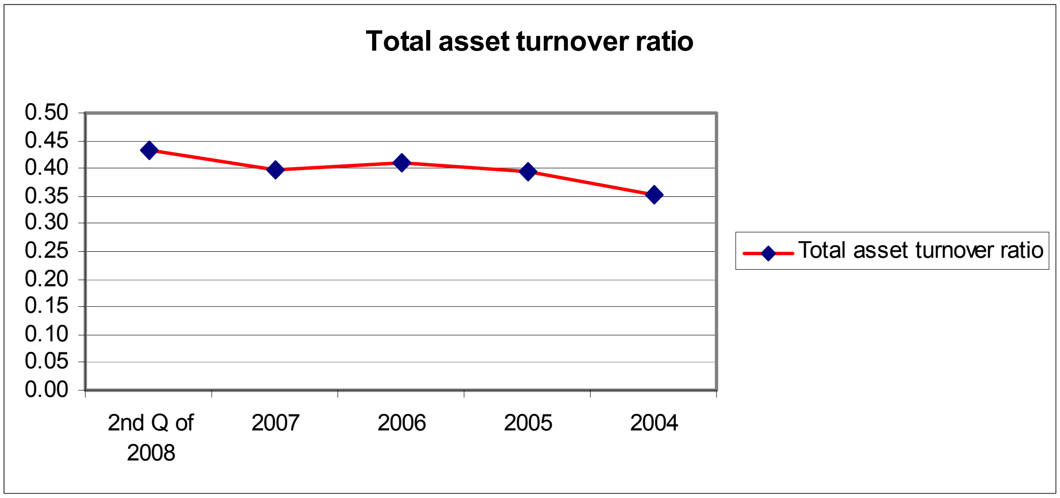


Current ratio: From 2004 to 2008, BH's current ratio did not fluctuate much. The highest amount of money tied up in non-productive assets was in 2006, the year of Katrina. Overall, Berkshire Hathaway has been trying to decrease money tied up in non-productive assets, which is shown by the current ratio being in a downward trend.

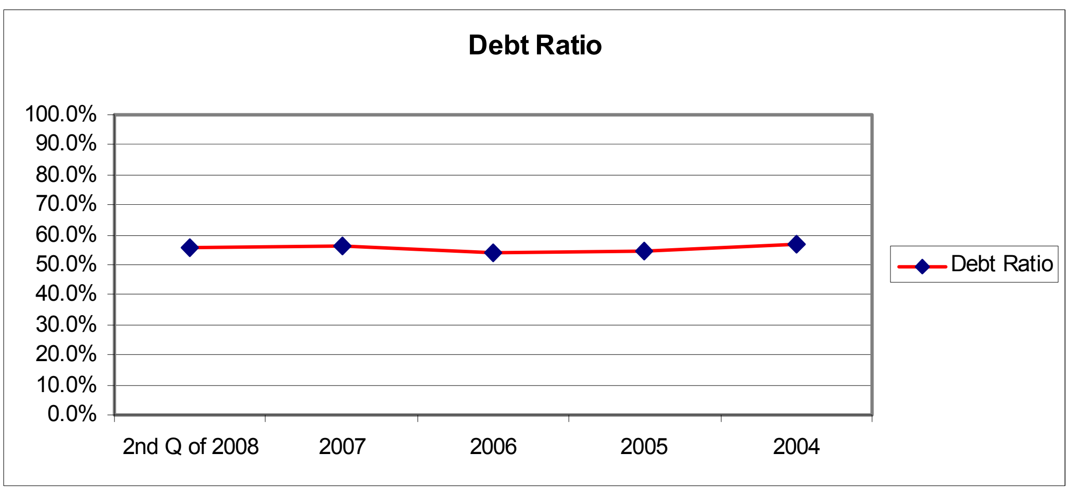


Days sales outstanding: The company's average length of time to receive cash after making a sale fluctuated widely. The length of time was lengthened significantly in 2006 with waiting time increasing to 105 days to collect cash. The number of days sales outstanding has decreased 26 days in from 2006 to 2008.

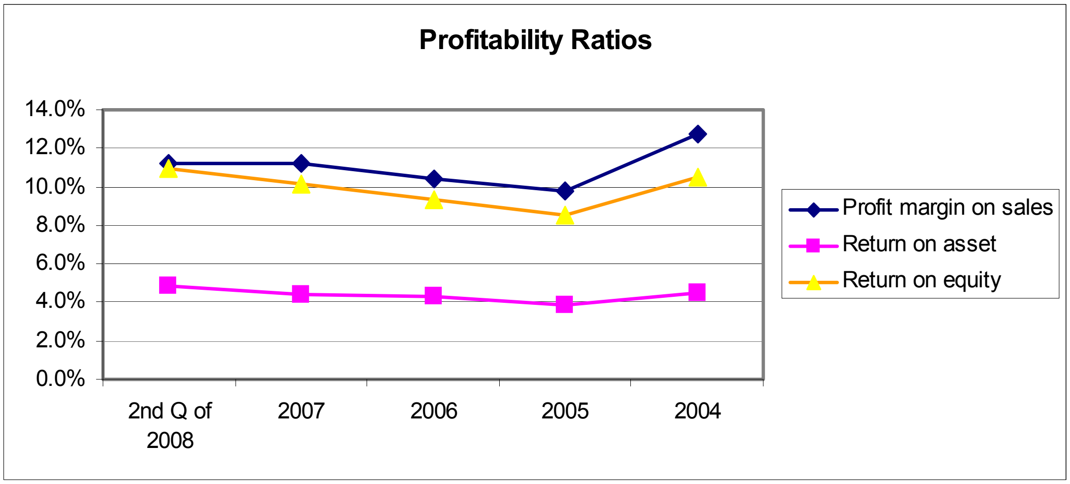




Fixed asset turnover ratio & Total asset turnover ratio: For both ratios, a high ratio means that Berkshire Hathaway uses its plant and equipment and other assets effectively. There is an opposite image of the two ratios. While the total asset turnover ratio seems to improve, fixed asset turnover ratio plunged in 2007. This could be a consequence of the economic slowdown of the U.S. The drop of the fixed asset turnover ratio should raise a concern to managers of the company.



Debt ratio: Berkshire Hathaway's debt ratio was relatively stable in the last five years. Within the period, the company's ratio ranged from 54 percent to 57 percent. In a long-term period, maintaining at this percentage range will help Berkshire to approach loans from lenders.



Profitability ratios: In term of the profitability ratios, 2004 was Berkshire's best year. The profit margins on sales, return on asset, and return on equity have been on an upward trend since 2005.

Common-size table

	2008 Q2	2007	2006	2005	2004
Revenue	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of Revenue, Total	18.85%	24.0%	20.4%	26.9%	26.3%
Gross Profit	81.15%	76.0%	79.6%	73.1%	73.7%
Selling/General/Administrative Expenses, Total	6.8%	6.0%	6.0%	6.5%	6.7%
Other Operating Expenses, Total	57.8%	51.3%	54.8%	50.7%	51.7%
Operating Income	14.9%	17.1%	17.0%	15.0%	14.4%
Net Income	11.6%	11.2%	11.2%	10.4%	9.8%

Percentage-change table

	2008 Q2	2007	2006	2005
Revenue	20.0%	20.7%	9.8%	16.5%
Cost of Revenue, Total	41.2%	-8.3%	12.3%	-1.2%
Gross Profit	14.6%	31.3%	8.9%	24.4%
Selling/General/Administrative Expenses, Total	19.7%	11.3%	6.8%	18.0%
Other Operating Expenses, Total	12.4%	30.4%	7.7%	38.3%
Operating Income	20.2%	36.8%	14.7%	-7.7%
Net Income	20.0%	29.2%	16.7%	-10.3%

The two above tables indicated that Berkshire has been a stable and healthy company. With a gross profit of over 70 percent and a net income exceeding 10 percent, the company's numbers were good. During the last five years, 2005 was probably the worst year with net income declining by 10.3 percent. This was probably due to hurricane Katrina. The net income, however, was aggressively increasing in the last three years of 2006, 2007, and the first two quarters of 2008. Overall, Berkshire Hathaway's financial health is in great condition.

6. What were the major problems and/or opportunities facing Berkshire Hathaway, Inc. in 2008?

The current economic instability in the U.S. presented a critical problem to the company. Buffett stated that the U.S. was currently in a recession. According to Buffett, *"We may not be in a technical recession," But we are in one in all other respects."* The economic slowdown can be seen in Berkshire's stock price, which dropped 48% by November, 2008. While this posed a problem to Berkshire, Buffett used these periods as times to take advantage of undervalued assets. Berkshire was a diversified firm that engaged in many industries with a large percent of companies owned being located in the United States. Many of Berkshire's current subsidiaries were firms that sought to exploit market niches providing excellent quality at a premium price.

Berkshire has traditionally been a firm that can turn problems that occur today into long term profits. With the level of insecurity currently in the market, Berkshire can find undervalued assets that could be used for long term growth. The current situation has produced a higher number of available undervalued resources, particularly on the international front where many American firms have moved operations from one country to another trying to find the lowest cost manufacturing platform. With the right strategies Berkshire can come out of this tough economic period smelling like a rose.

7. What recommendations would you make to Warren Buffett? Why? What do you recommend that Berkshire Hathaway, Inc. do over the next 5-10 years to increase shareholder wealth?

Berkshire should continue its strategy based on Buffett's investment philosophy of purchasing undervalued assets. Over the past 40 years, Berkshire has increased shareholder value by an average of 21%, twice the average of the S&P 500 over the same period. Berkshire has a time tested set of rules for the best types of companies to acquire, namely to purchase businesses for less than they are worth. Berkshire must continue this strategy in order to increase shareholder wealth.

Specifically, Buffett must use his investment philosophy that has made him so successful. He should continue to seek companies to invest or purchase that he understands and can purchase at a discount.

The economic slowdown is an opportunity for Berkshire to find undervalued assets. Within the U.S. Buffett could look at the financial industry. He could also look at purchasing assets in a few years when the housing industry recovers. Given Buffett's investment philosophy, this would be an ideal time to purchase undervalued assets and hold them for a long time.

Buffett should also be looking outside of the U.S. for investment opportunities. Brazil, India, Europe, and China are all opportunities. China's stock market is down significantly this year. This may be an excellent time for Buffett to search for bargains. Buffett should also look to other international areas for potential companies to purchase.

EPILOGUE

In late 2008, the U.S. economy was mired in a recession. Earlier in the year, Buffett stated that this will be a long and deep recession. When asked when it will end he stated that he had no idea, but it will last for at least another five months. Buffett was absolutely correct. This is indeed a long and deep recession. This is by far the worst recession since World War II.

Buffett stated that he was not in the business of making predictions. He said that he had no idea what the market will do from day-to-day. All he was interested in was buying good companies with great management at a discount. He also stated that he invested in companies for the long term.

During one of Buffett's recent talks with university students, he was asked what some good investment opportunities were. Buffett stated that China's growth was an opportunity.

In early 2008 Buffett had $28 billion to invest. Buffett went to Europe to try and find companies to invest in or purchase. He needed to find very large companies to invest in or purchase. At the 2008 shareholder meeting, Buffett told shareholders not to expect the same types of returns as the past. He stated that you can expect a return of about 2-3% above the S&P 500.

At 78 years old, Buffett stated that he loved his job and the people he worked with. He loved going to work every day and had no plans on retiring. Buffett planned to do deals in the future just as he had in the past.

In early 2008, Berkshire began purchasing Burlington Northern Santa Fe (BNI). Berkshire has also been buying Union Pacific Railroad (UP) stock. Given the price of gasoline, railways are a much more efficient way of transporting goods rather than trucking.

Recently, Buffett also purchased more railways (UP & BNI) and stock in a diversified energy company called NRG Energy. In the summer, 2008, Berkshire sold all of its position in ConocoPhillips and then late in the year he bought a big position as oil prices went down to around $40-50 a barrel. Buffett also invested in Goldman Sachs ($5 Billion) and General Electric ($3 Billion).

In August, 2008, Buffett visited the Canadian oil sands with Bill Gates (see Crippen, 2008). He stated that the oil sands could be an investment opportunity depending on what the future demand for oil is. Buffett stated that the oil sands were the biggest possibility to fill the gap needed for oil in the world over the next 10-15 years.

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ROLE OF THE AUTHOR

This case is based on primary and secondary research. The author was born and grew up in Buffett's home town of Omaha, Nebraska. The author went to high school with Peter Buffett, the son of Warren Buffett, who now runs a billion dollar foundation called NoVo. The author's brother also went to the same high school, Central High School, with Howard Buffett, Buffett's oldest son.

The author is very familiar with the places, people, and culture of Omaha. This is evident at various points in the case. Furthermore, the author has read a plethora of books, annual and shareholders reports, and articles on Buffett and Berkshire Hathaway. Last year, the author attended Berkshire Hathaway's Annual Shareholder Meeting and he plans on attending the meeting again in 2009. All of these factors have combined to make this a very informative, educational, interesting, and stimulating case study. The case has already been used in graduate entrepreneurship and strategy courses with extremely positive feedback from students.

TALENT MANAGEMENT AT THE ADV CORPORATION

Stephen A. Stumpf, Villanova University

CASE DESCRIPTION

The primary subject matter of this case is that of talent management – the attraction, on-boarding, development, retention, and re-deployment (or counseling out) of professional and managerial employees while optimizing individual and organizational performance. Discussion questions range from the specific situation ADV faces to issues of whether or not one should join a high level task force responsible for making recommendations to the CEO. The case requires significant analysis and generates useful discussion on many talent management issues including the need for targeted employee value propositions in four countries (Germany, India, UK, and US) to be able to attract, develop, and retain professional level talent. Secondary issues include the work climate at ADV and the questionable senior management support for task force recommendations. Case difficulty is 3 to 6 (junior to second year graduate, depending on issues raised and depth of analysis and discussion). The case is designed to be taught in a management, organizational behavior, or human resource management course requiring from 50-90 minutes of class time and 2-3 hours of pre-class preparation.

CASE SYNOPSIS

ADV is a $3.5 billion multinational corporation that is struggling to attract and retain professional and managerial level talent in four country markets (Germany, India, UK, and the US). You have been asked to join a task force to make recommendations to the CEO and Board on how ADV should invest an ***incremental*** *$13 million in talent selection and development for the next fiscal year. The case provides retention and job openings data by country along with a discussion of talent management issues from several perspectives: the Board's views on investing in talent management, the CEO's charge for the task force, the soon-to-depart Global Head of HR's analysis of current and past talent management practices including why she is leaving, and extensive comments from your mentor detailing how ADV has attended to or ignored talent management issues in the past. Information provided indicates that prospective employees' value different work attributes than employees two years later, and that these attributes vary by country (e.g., level of compensation, work-life balance, development opportunities, location, job impact, empowerment, quality management, etc.). Financial information is provided on the expected costs of projects and activities associated with recruiting, training, developing, and communicating the ADV talent management approach to prospective and current employees. Four guidelines for talent management are embedded in the case dialogue: (1) avoid mismatch costs through careful 'make' versus 'buy' decisions at each level in each country, (2) reduce financial and labor market risks by developing shorter forecasts of talent needs and using a portfolio approach, (3) ensure payback in employee development practices through targeted development and retention, and (4) balance employee interests and career moves with those of ADV, including re-deployment and counseling out.*

INSTRUCTORS' NOTES

The ADV Corporation case is as much an instructional paper on talent management practices as it is a description of a situation for students to analyze. Careful reading is required before group discussion, and small group discussion is recommended before classroom discussion. This process facilitates student learning about the topics of talent management without extensive pre-case lectures. As such, the case can be used in a management or organizational behavior course to address human resource issues, or in a HR course to dig more deeply via analysis of the three tables in the case so as to make recommendations to the CEO and Board.

There are likely to be several 'right' answers to many of these questions depending on the course in which the case is being used and the time devoted to analysis and discussion. Suggested responses and discussion points are noted below.

1. Should I join the task force?

Yes, no, maybe? Probe why some students (groups) would join (good career opportunity, access to other talented people, visibility, learn more about talent management); why others would not (risky, too much work, not really valued by senior management); and why still others will join under certain conditions. A frequent condition mentioned by students is that the CEO would need to make a stronger commitment to implement task force recommendations. Ask how they would get such commitment – before the CEO even has an idea of what would be recommended. How would a conversation with the CEO play out. You might be the CEO and role play this with a student who feels confident that they could get a greater commitment out of the CEO.

2. Is this work interesting enough to be of real value to company, or is it a passing fancy?

A class is sometimes split: 70% real value, 30% passing fancy. Explore why they feel the way that they do. What information, if provided, would get them to change their mind? Then explore a broader role for a task force – not just to make recommendations, but to sell their ideas and then help implement the recommendations. Also, raise the broader question as to why do students think the CEO is creating an internal task force rather than asking HR to do this work, or hiring an outside consulting firm to do it. The task force is most able to provide an 'independent' view (HR might be too close to many of the issues to offer the necessary perspective) that is meaningful and actionable quickly (a management consultancy would probably take longer, cost a lot, and may not get the buy-in of middle and senior management to implement).

The case is organized so as to provide several views of the talent management situation. Ask students what they inferred from:

The Board's interest?
The CEO's statement?
Pat's comments (note that Pat's gender is not mentioned)?
Pat's decision to leave?
The mentor's comments?
The Employee Value Proposition (EVP) by region data (Table 1)?

The People Committee's Assessment of competition EVPs (also Table 1)?
The disbanding of the People Committee?
Staffing shortfall and turnover data (Table 2)?
Cost estimates (Table 3)?

Each of these questions lends itself to lively class discussion where subtle teaching points can be made. For example, how often do the students think Boards get involved in these kinds of issues (often with respect to compensation and senior hiring, rarely otherwise)? Why might the CEO's statement be 'motherhood and apple pie'? Does Pat seem to know the HR field? Why do you think HR is struggling in the talent management area? Is Pat's leaving a red flag? Has Pat provided useful information (attesting to HR competence?)? How often do the students think the data in Table 1 is available to a firm (rarely)?

3. Can developing an employee value proposition make a difference?

Yes, if it is distinctive from the EVPs of competitors in local labor markets and effectively delivered upon. A quality EVP attracts and helps to retain who you want, and keeps away those that you do not want. It is generally 1 or 2 primary factors, and another 1 or 2 secondary factors – each highly valued by the prospective employee (for attraction) or employee (for retention). Ask students if they are aware of any organization that has a powerful EVP? Since most organizations do this poorly, you may not get many responses. Yet, consider the EVP for the US Marines? Go to the USMarines.com web site to get current recruiting information. The messages are vivid: The Few, The Proud, The Marines. *Semper Fidelis* (Always Faithful). A way of life. Intensive training, education, and an opportunity to succeed. Down load a current U.S. Marines advertisement – ask the students who it is targeting; who it doesn't want.

Also identify a couple of successful local employers that have recently done community or employment-oriented advertisements – what is their EVP? In the NYC metro area, Citigroup often runs ads that say "The Citi Never Sleeps". What is this saying to employees and future employees? Is it part of their EVP?

4. Would it be best to have different value propositions in different businesses, or regions?

Yes, with the caveat that the greater the differences in EVP by business or region, the more internal and external communication will be necessary, with greater complications if cross-business or cross-region transfers (re-deployments) are common.

The case provides only limited data on each region, imbedded in Tables 1 and 2. Table 1 data come from two empirical studies: *"How the Top 20 Companies Grow Great Leaders,"* by Hewitt Associates, (2005) and *"Attracting and Retaining Critical Talent Segments,"* by the Corporate Executive Board (2006). 374 U.S. companies participated in the Hewitt study; rigorous financial screens were used to identify the top 20 firms in terms of market and financial performance. The statistics reported reflect differences between the practices of the top 20 firms and the other firms in the Hewitt study. 58,000 respondents from 90 organizations and 20 industries from 9 countries participated in the Corporate Executive Board study; findings reflect comparative analyses done based on known participating firm characteristics.The case is not intended to be an international case or to 'answer' to the question of different EVPs by region. It is intended to introduce this possibility – particularly for multinational employers like ADV. To address cultural and employment issues in each region, students should be assigned to do a country analysis – possibly as pre-work to the ADV case discussion, or even within the class session by using web-based information.

The table below is a worked example of separate EVPs for attraction and retention by region based on the information in Table 1. **Bold** attributes would likely require additional investments (involvements, $, marketing). The number following each value is the relative ranking compared to local competitors (e.g., ADVs locations in Germany are better than the locations of other firms competing for the same talent). The table is illustrative and intended to generate discussion. One implied learning point is that using compensation as a lead element in an EVP is expensive, easily copied by competitors if they so choose, and tends to escalate until labor costs become so great that outsourcing or lay-offs are necessary.

Region	*Attract*	*Retain*
Germany	Location (1) **Dev. Opportunities (2)** Collegial Work Environ (2)	**Dev. Opportunities (2)** **Empowerment (2)** **Recognition (2)**
India	**Future Career Opp. (1)** Compensation (3) **Job-Interests Alignment (2)**	**Compensation (3)** **Job Impact (3)** **Manager Quality (2)**
UK	**Future Career Opp. (2)** **Work-Life Balance (2)** Organizational Stability (2)	Respect (1) **Job-Interests Alignment (2)** **Manager Quality (3)**
US	Compensation (3) Health Benefits (2) **Work-Life Balance (2)**	**Job-Interests Alignment (2)** Respect (2) **Manager Quality (2)**

5. How easy will it be for competitors to copy or surpass it?

Identify one or two cells from the table above to probe student responses to the ease of competitors copying your EVP. Hygiene factors (extrinsic rewards) such as compensation, health benefits, and work-life balance can be copied quickly. HR programs (development opportunities, career opportunities) take a little longer to develop and copy, and often have implementation challenges. Factors that require line managers to do things differently (empowering others, creating a collegial work environment, job-interests alignment) are the hardest to orchestrate – and the hardest for others to copy.

6. How would I invest the first year's TM budget – Recruiting? Training? Meetings and Communication? Projects?

The table below is a worked example of how one might budget the $13 million incremental dollars for talent management. It is illustrative and intended to generate discussion. This perspective places heavy weight on filling the senior level positions, and developing communications, and HR staffing. Supporting details are provided below.

TM Function	*Program/Action for 1st Year*	*Estimated Cost*
Recruiting - Mid Level	College Recruiting + Promotion from Within	$1.5M (up $.5M)
Recruiting - Senior Level	Search Firms	$3.2M (up $1.2M)
Training & Development	New Hire + On-Boarding Targeted Dev (20%)+Coaching Generic Programs	$ .12M (up $1.06M $1M) $ .83M
Communication/ HR Staff	Meetings/Off-site Increases HR Staff Increases + Communication	$1.6M $3.3M
Special Projects/Issues	PM System, 360, High Potentials, Mentoring, Leadership Academy	$4.6M increase

Recruiting Talent for ADV

- Need to fill the open positions, plus 1/3 of new positions, plus new vacancies due to turnover
- Regional differences -- in ratio of mid to senior leaders, in new positions, in turnover rates, in costs, and **competitive positioning**
- My estimates of recruiting costs for mid-level were $1.5M (mostly college recruiting and promotion from within) – last year's budget was $1M
- Estimates for senior level hires was $3.2M (mostly search firms) – last year's budget was $2M

Additional Funds Needed for Recruiting: $1.7M

Training and Development

- Include the 400 (plus 40 new due to 10% turnover) 'high potentials'
- Mid level: 261 plus 75 new hires
- Senior level: 73 plus 20 new hires
- New hire program for all new hires ($122K)
- Target a % of each group for training each year (say 20%) – but which 20%?

    - 5 days of a global program for .2(400+261) => $463K
    - 10 days of temp assignments for .2(261+73)=> $401K
    - Design and link these programs to **competitive positioning**

    - Avoid 'generic' T&D efforts; tailor them, select attendees, make people accountable for learning with real measures for success

- EMBA/MBA/MS: support 4-6 per year -- $170K
- MBA (part-time): support 45 -- $600K
- University Exec Ed: support 3 -- $60K
- Coaching: support 10 -- $200K

Total T&D: $2.0M
What about other 20% of firm not in these four regions? Add 20% => $2.4M
Last year's base was $1.4M
Additional Funds Needed for T&D: $1M

Need to Communicate and Staff

- Incremental Exec Committee Meetings: $240K/meeting (2 meetings first year)
- Senior Staff Meeting, global: $1.6M

OR Regional All Hands Meeting: $1.2M

- HR staff increases: $1.7M
- HR and T&D communications/marketing: $1.3M
- Involvement of Sr. Leadership in High Potential Programs: $.3M

Additional Funds Needed to Communicate and Staff: $5M

Need to Add or Enhance Talent Management Activities

- Revise and Validate New Performance Management System, firm wide: $2.1M
- Develop and Use 360-degree Assessment Internally: $.2M/year
- Develop and Administer Formal Mentoring Program: $.2M/year
- Develop/Deliver 'Leadership Academy' for Top Performers (8 days, 40 people/yr) $.5M/year
- 'High Potential' Career Management Program (100/year, job assignments, project work, leadership development): $1.6M/year
- Develop High Potential Incentive Compensation System

Additional Funds to Support These Projects: $4.6M

What is Not Recommended for Year 1

- No IT Budget for Distance Learning via CDs/DVDs/Web-Based: $1.5M *(this could come out of general HR budget)*
- No structural compensation adjustments for either High Potentials or India talent : $4.4-6.4M *(this could be presented as a separate issue)*

- No Incentive Compensation this year, add $2M next year
- No Assessment Center to identify High Potentials: $.4M *(not needed if managers are able to make this judgment)*
- No C-suite and Sr. Leader succession plan process development: $.7M *(political and may be too early; plan for next year)*
- Limited T&D (5 days every 5 years is 1/2 best practice firms): add $.5M to $1M for next year *(need to become more strategic and accountable for T&D expenditures)*
- Specialized programs for high-turnover regions and employees (e.g., women); add $.4M next year

7. Even if we come up with a good strategy and recommendations, will our middle and senior level managers support it? Discuss with respect to any of the above actions.

USE OF STAFF ATTORNEYS IN DEFENDING INSURANCE CASES: CAN AN ATTORNEY SERVE TWO MASTERS?

Joey Robertson, Sam Houston State University
Laura Sullivan, Sam Houston State University

CASE DESCRIPTION

This case deals with the issue of whether or not staff attorneys, employed by an insurance corporation, can legally or effectively represent an insured client in an insurance defense case. This case study will examine the practical and ethical issues involved in the case: Unauthorized Practice of Law Committee v. American Home Assur. Co., Inc., 261 S.W.3d 24 Tex.Sup. Ct. J. 590 (Tex. Mar 28, 2008)(American Home). The primary area of concern for this case is whether or not the interest of the insurance company and their insured are ever truly the same. Secondary issues in this case study will include an examination of whether or not the acts of a staff attorney constitute the acts of a corporation itself, and if they do – is this an unauthorized practice of law. An additional secondary issue is the idea that by the nature of his employment, a staff attorney's legal judgment may be influenced in that his employer controls the scope and depth of investigations, fees made available for discovery, expert testimony, and general guidelines the attorney must follow in pursuing the defense in trial.

This case is designed for use in an undergraduate business law/business ethics course, or graduate level course in management law. The various legal aspects emphasized in this case could be taught in one fifty-minute class. The assignment is expected to require approximately 1 to 2 hours of outside preparation time by the student.

CASE SYNOPSIS

Like many states, Texas has long struggled with the question of how many clients does an attorney, who has been hired by an insurer to defend an insured, have. Courts have tended to rule that these attorneys have two clients in the insurer and the insured, yet they owe an unqualified loyalty to the insured who has been sued. The Unauthorized Practice of Law Committee has sought to end or limit this practice based on concerns that a staff attorney, whose actions can be strictly controlled by his employer, will have an irreconcilable conflict of interest and be unable to give full allegiance to the insured.

In 2008 the Supreme Court of Texas reviewed a prior decision of the Court of Appeals for the Eleventh District of Texas. In American Home, the court was asked to determine if an insurance company's use of staff attorneys to defend cases filed against their insured resulted in the insurance company practicing law. If this did constitute the practice of law it would be a violation of Texas law. The Court ruled in part that the use of staff attorneys did not constitute unauthorized practice of law on the part of the insurance corporations. This case study will discuss that decision and attempt to determine if a staff attorney can avoid being improperly influenced by their nonattorney supervisors and those supervisors' duties of maximizing profit.

INSTRUCTORS' NOTES

QUESTIONS

1. In defending an insured, who is the defense attorney's "client"?

Although the Court declined to directly answer this question the ruling indicates that both the insured and the insurer may be clients.

2. Can a conflict of interest arise in having staff attorneys represent insured customers and if so, when?

Conflicts can, and do, arise. The insured is interested in the best defense possible. Any defendant in a lawsuit would like to see a "no holds barred" approach including thorough depositions, experts at the top of their fields, and sufficient time dedicated to the case to all but guarantee a victory at trial.

While the insurer would like to prevail at trial to avoid paying large awards, their ultimate interest differs from the insured defendant. The insured would like the best defense possible, while the insurer is looking for the best **value** in a defense.

3. Do the acts of a staff attorney constitute the acts of the corporation?

Here the court says no, however, many attorneys may differ. Especially in the tough economic times we find ourselves in it is hard to believe that a staff attorney would not be influenced by his nonattorney executives pressing him to watch the bottom line. While attorneys always try to be careful with their client's money, the issue rises to a whole new level when that attorney considers that he may be out of a job if he fails to follow the directives of his corporate officers. Since it is these officers, agents of the corporation, who are directing the defense it is hard to argue that the corporation is not practicing law.

4. Is it realistic to believe that a staff attorney will not factor in his obligations to his employer in the course of representing an insured?

While we would like to believe that attorneys could set aside concern for their job and well being in order to represent their insured clients to the best of their ability, it simply is not realistic. If a CEO directs an attorney to keep costs below a certain amount, most likely that attorney is not going to exceed that limit just to retain a better expert, conduct additional depositions, or have evidence analyzed just one more time.

5. When are the interests of an insurance company and their insured customers not "congruent"?

Many would argue they almost never are. The only time the interests of the parties could ever truly be congruent is when the insured's interest exactly equals the interest of the insurer. To meet this standard the "Best Defense" would have to be exactly the same as the "Best Value". The interest of the insured is limiting their own liability; the interest of the insurer is the bottom line.

6. Can the interests of an insurance company and their insured customers ever be truly "congruent" where the insured's interest is to receive the *best* possible defense and the insurer's interest is to provide the most *economical* defense?

Possibly. You would have to ask yourself how often in life is the best product the most economical option. It certainly may happen, but it is not the norm.

7. Did the court rule correctly (or consistently) in *Unauthorized Practice of Law Committee v. American Home Assurance. Co.*?

The court's ruling is consistent with the majority of states. Whether or not attorneys, who are human themselves in spite of popular jokes to the contrary, can set aside pressure from their nonattorney supervisors to stay loyal to their employer rather than their client remains to be seen.

RESOURCES

Unauthorized Practice of Law Committee v. American Home Assur. Co., Inc., 261 S.W.3d 24, (2008)

PUBLIC FUNDS VERSUS PRIVATE ENDEAVORS: CATALOGS AND CONFLICT IN ALASKA

Wayne A. Roberts, Jr., Southern Utah University

CASE DESCRIPTION

The primary subject matter of this case concerns marketing. Secondary issues include finance, quantitative analysis, and public administration. The case has a level of difficulty of three to five, depending on the depth of analysis. The case is designed to be taught in 1.5 to 2.5 class hours and is expected to require 2-4 hours of outside preparation by students.

CASE SYNOPSIS

Rural Alaska Community Action Program, Inc. (RurAL CAP), an Alaskan nonprofit organization dedicated to serving the economic and welfare needs of rural Alaskans, particularly native Alaskans, launched a new catalog operation in 1993. The catalog had several purposes, one of which was to generate funds to support other social programs. In 1995, after two years of heavy losses and the investment of more than $600,000 of public money through Alaska State administered grant programs, controversy and uncertainty swirled about the contentious new venture. Investors in a private catalog operation, including a leading state politician, were very concerned about competing against a heavily subsidized operation that clearly did not have to make a profit. In addition to competing in the same markets, the two organizations competed for the talents and products of the same producers. RurAL CAP, Inc. argued that the losses were to be expected in a start-up operation, that they needed more time and money to become profitable and further claimed that they did not compete unfairly with private enterprise.

The Department of Community and Regional Affairs, the agency responsible administering the federally funded grant programs, was unsure of what to do. Besides the discomfort associated with giving taxpayer money to an organization that competed against private enterprise, they were concerned about whether the catalog operation represented a wise investment of public money. They wondered whether or not the catalog would ever be profitable, and hired a consultant (the author) to help answer this basic question.

This case can be used to raise and address a number of interesting issues appropriate to classes in public administration, marketing, finance, accounting, and entrepreneurship. In particular, it can be used to demonstrate the power of 'running the numbers.' The teaching note will emphasize marketing and financial issues, including break-even analysis.

INSTRUCTORS' NOTES

1. **Do you believe it made sense to forego a detailed feasibility study and instead actually put together a catalog operation, complete with products, contracts with fulfillment houses, etc.? What are the dangers of pursuing such a strategy? What are the benefits? Under what conditions does acting, rather than analysis, make sense? Under what conditions do analysis, prior to acting, make sense?**

In general it makes sense to act, rather than pursue information collection, when the optimum course of action is clear, when the costs associated with collecting and analyzing data exceed the costs associated with action, or when alerting competitors through information collecting activities will place the organization at a disadvantage, or when, for other reasons, the window of opportunity may close. In calculating costs one needs to consider opportunity costs, and the costs associated with extracting oneself if the action turns out to be inappropriate.

A real danger in pursuing action before data collection and analysis is that viable alternative courses of action will not get generated or considered. Another danger is that the risks associated with the action will be either undetected or underestimated. For RurAL CAP, it could be argued that they should have devoted some time to generating and considering alternatives. While not clear, it appears an employee generated the catalog project idea, and the decision was simply to forge ahead, without thinking through other ways in which the goals of the catalog could have been achieved.

2. Are there other ways RurAL CAP could achieve the objectives and goals set out for the catalog? In other words, what other marketing strategies could be considered as competitors to a catalog operation? Do you believe that a catalog is the best means for achieving the identified goals?

Clearly there are alternatives. The challenge to students is to think of some. For example, to help develop markets for native arts and crafts RurAL CAP could have focused on acting as a liaison organization for retailers, or could have sponsored shows in urban centers. These actions might have helped retailers, and could have helped insure that rural natives were not underpaid for their wares. Another alternative would be to open their own retail store(s), although this might cause some howling from existing retailers.

With regard to creating value for the subsistence way of life, it is not clear that providing catalog shoppers with subsistence information is the best way to achieve that objective. Are such shoppers interested? Would it impact people other than upscale socially conscious shoppers? What about middle class citizens not interested in cultural collectibles? As an aside, in choosing rental lists for mailings, the ONLY consideration that was used was likely sales levels: the objective of creating value for the subsistence way of life had no impact on decision-making. On the face of it, it would seem that other activities and strategies would be better suited for educating and enlightening people about the subsistence lifestyle.

3. RurAL CAP decided to target individual, upscale, socially conscious consumers. What other target groups could have been chosen or considered?

Again, the challenge is for students to come up with other target groups. They could have targeted retailers, in essence acting as a wholesaler/distributor. They could have targeted the educational market, the museum shop market, tourists in Alaska (including foreigners), and perhaps others.

4. Examine the results for 1993 and 1994 (Tables 1 and 2). Do the results bode well for the catalog operation? What conclusions can you, as an analyst, draw from these data? Does your examination of the pro formas in Table 3 support your expectations?

The fundamental conclusion is that if things don't change, then the operation will be a money loser, and RurAL CAP should consider closing shop. The operation is hemorrhaging money. This should be clearer given the answer to the next questions.

5. **Complete the break-even analysis begun in Table 4. In doing so, assume only 2 categories of lists: outside runs (rented names), and House Buyer File names. Further, assume 9 outside run names need to be obtained for every House Buyer File name (this is necessary to replace House Buyer File customers who cease to be interested in the catalog's products). Finally, assume the average sales/book for House Buyer names is $4.14, while the average for rented lists is $1.00. The $4.14 figure represents the sales/book for 1994 for those sent to names in the House Buyers File. The $1.00 figure is admittedly on the high side for the rented names, but will suffice for this exercise.**

If we assume 10% of our catalogs are mailed to House Buyer File names with an average sales/book of $4.14, and 90% to rented names with an average sales/book of $1, we can calculate the average sales/book, and the average cost/catalog, as follows:

Average sales/book: (10%)*$4.14 + (90%)*$1.00 = $1.31

Average cost/catalog: (10%)*$.38 + (90%)*$.52 = $.51

Using these numbers, $.51/$1.31= 38.93% represents the percent of sales that goes to producing and sending out catalogs in a mailing. Surprisingly, when we subtract this percentage from the (partial) contribution margin indicated in Table 4, we find that the overall contribution margin is

31.04% - 38.93% = -7.89%

Therefore, if they want to maintain the size of their House Buyer File list the contribution margin is negative: The average variable cost/item exceeds the average sales revenue/item!

NOTE: Students may wonder where the 9 rented names/1 House Buyer File name comes from. They can either be asked to figure this out under some assumptions, or shown to them. This reinforces the notion that quantitative analysis provides real value and insight to managers, and it is dangerous to avoid it.

The fundamental relationship is that enough catalogs must be sent to rented names on outside runs to compensate for current House Buyer File customers who are invariably lost over time, because they have moved, died, or just lost interest in the catalog's products.

Let:

HB = number of names in the House Buyer File
R = number of names in outside runs
d = depreciation (or decay) rate among customers listed in the House Buyer File buyers (% that no longer are viable customers after each mailing)

c = conversion rate from outside runs lists (equal to the response rate)

Then the relationship is as follows IF the House Buyer File size is to remain constant:

(HB)*d = R*c

If we assume that the house file is a given, then outside run size can be solved for:
R = (d/c)*HB

In the *Aurora Catalog* instance, if the depreciation rate/mailing, every six months, is 10%, which is what the catalog consultants indicated is a typical figure, and the conversion rate (response rate) in outside runs can be increase to 1%, then we have

R = (.10/.01)*HB = 10*HB

This means that 90.91% of the names in a mailing need to be from outside runs, and 9.09% from the House Buyer File list in an equilibrium setting. In the problem this was simplified to 90% and 10%.

It may be helpful to share the following tables with students:

Table 5: Relative size of outside runs necessary to maintain a given House Buyer File given different depreciation rates and conversion rates

	DEPRECIATION (DECAY) RATE						
CONVERSION RATE		5%	7.50%	10%	15%	20%	25%
	0.75%	6.667	10	13.333	20	26.667	33.333
	1%	5	7.5	10	15	20	25
	2%	2.5	3.75	5	7.5	10	12.5
	2.50%	2	3	4	6	8	10
	3%	1.667	2.5	3.333	5	6.667	8.333

Clearly, if *Aurora Catalog* decided to reduce the size of outside runs below the 9 to 1 ratio the size of the House Buyer File would begin to dry up. For a new catalog operation the outside runs need to be higher than this ratio since it is important to build up a good House Buyer File. Presumably investing in building up a House Buyer File represents a positive net present value. That topic is introduced in the following question and answer.

Table 6: Percent of a mailing that must be to outside names in order to maintain the House Buyer File for different depreciation and conversion rates.							
	DEPRECIATION (DECAY) RATE						
CONVERSION RATE		5%	7.50%	10%	15%	20%	25%
	0.75%	86.96%	90.91%	93.02%	95.24%	96.39%	97.09%
	1%	83.33%	88.24%	90.91%	93.75%	95.24%	96.15%
	2%	71.43%	78.95%	83.33%	88.24%	90.91%	92.59%
	2.50%	66.67%	75.00%	80.00%	85.71%	88.89%	90.91%
	3%	62.50%	71.43%	76.92%	83.33%	86.96%	89.29%

6. **A useful analysis is to compute the customer acquisition cost, and the contribution from each customer, over the customer's lifetime. These numbers can be used to generate customer lifetime values. When answering the following ignore all taxes.**

   a. **How much money will *The Aurora Catalog* lose or make on a mailing to 1000 rented names? How much per acquired customer? Consistent with *The Aurora Catalog*'s experience, assume i) the marginal cost of renting names and mailing a catalog to each person is \$.52, ii) the response rate is .9%, iii) the average order size is \$76, and iv) the contribution margin is 31.04%.**

With a .9% response rate, 9 out of the 1000 recipients will, on average, become a customer and purchase an average of \$76 worth of goods. The cost of the mailing will be 1000*\$.52, or \$520. With a contribution margin of 31.04% we get the following:

Table 7: Acquisition cost calculations: 1000 rented names	
Number of new customers (1000*.009)9	
Revenues (9*\$76)	\$684.00
Variable costs before mailing expenses ((1-.3104)*\$684)	\$471.69
Gross Margin (.3104*\$684)	\$212.31
Less mailing costs (\$.52*1000)	\$520.00
Net Profit/9 names	(\$307.69)
Cost/acquired customer	\$34.19
Aurora Catalog will lose \$307.69 by renting and mailing a catalog to1000 names. They will acquire 9 customers, at a cost/customer of \$34.19.	

   b. **Once a person becomes a customer costs go down and response rates and sales/book go up. Compute how much money RurAL CAP will make or lose, on average, the next time they**

send customers acquired from the initial list of 1000 a catalog, assuming i) the cost of sending a catalog to each customer is $.38 (note the cost is lower because the names are not rented), ii) the response rate is 4% (that is, there is a 4% chance each customer will buy), and iii) the average order size is $102. Further, assume that the contribution margin remains 31.04%. These figures, of course reflect *The Aurora Catalog*'s experience. Determine how much RurAL CAP will net on this mailing, as well as how much they will net per acquired customer.

On a subsequent mailing the 9 customers will be sent a catalog, and there is a 4% chance they will spend $102 on goods. With a contribution margin of 31.04% and a cost of mailing a catalog, we have the following results:

Table 8: Net revenues in subsequent mailings for customers acquired through renting 1000 names	
Revenues (9*.04*$102)	$36.72
Variable costs before mailing expenses ((1-.3104)*$36.72)	$25.32
Gross Margin (.3104*$36.72)	$11.40
Less mailing costs ($.38*9)	$3.42
Profit/mailing to 9 customers	$7.98
Profit/customer	$.89

Using these assumptions subsequent mailings will be profitable, but not largely so.

c. **If we assume that the 4% response rate will be good for 2.5 years (5 mailings), and that the average order size remains at $102), compute the net present value of renting a list of 1000 names using a discount rate of 5%/half year. Under the assumptions implied in this analysis, is renting names a good investment strategy for The Aurora Catalog?**

The net present value is the present value of $7.98 cash flows every 6 months discounted at 5%, or $34.55, less the cost of the first mailing of $307.69, or a negative $273.14. Clearly renting names has not been a good investment strategy so far.

7. **In addition to the quantitative analyses relating to RurAL CAP's experience, what else would you want to know before making a judgment as to whether this catalog has a chance of becoming profitable? If you were part of RurAL CAP's management team, what would you recommend?**

A very important consideration, in fact the overwhelming one, is what RurAL CAP is planning to do given the results so far. What alternatives have they considered, and what are they going to do? Another critical concern is how well informed they are about how they are doing. Do they realize that given their results the more they sell the more they lose? How much analysis did they do, or plan to do, to analyze their results to date? Other issues concern the expertise they have in-house, how they would manage for growth (given their projections, the scale of operations were expected to increase rapidly, which could outstrip the ability of the rural community to supply product, and the ability of the employees to manage the business). Recommendations from students can be quite varied and generate a lot of discussion.

8. When do you think public money should be used to support for-profit forays by nonprofits? Should DCRA continue to support the catalog? Under what conditions? If you were the Commissioner of the Department of Community and Regional Affairs what would you recommend?

This is a thought question with no 'correct' answer. Clearly it is exasperating for an operation like *The Great Alaska Catalog* to have to compete with an organization like RurAL CAP. From one perspective, the private citizens are being taxed to finance competitors with no bottom line responsibility. Before getting too carried away with this, students should be reminded that special programs exist for private firms. The entire U.S. Small Business Administration focuses on helping small private businesses, which compete with larger businesses, for example. Or consider the special loans that have been extended to firms like Chrysler, or special rental rates cities and states give to large companies. Also, think about the government help provided to J. P. Morgan Chase to swallow Bear Stearns and Co. The list of programs and instances of bailouts and other help is quite extensive. The fundamental question is, what is the role of the government, which represents all citizens, in the private sector?

Another interesting perspective is from the standpoint of the natives. What if the expertise and the abilities of the private firm(s) are not adequate? Should they suffer simply because the firm(s) is private? What if prices, due to a lack of competition, are held low? When, and how, might a non-profit funded through grants help the situation?

CJ MCLAINE'S DELI & BAKERY, LLC: A SMALL FAMILY BUSINESS CASE STUDY

Catherine C. Giapponi, Fairfield University
Roselie McDevitt, Mount Olive College

CASE DESCRIPTION

The primary subject matter of this case concerns small business strategy. Secondary issues examined include: family business strategy, start-up businesses, changes caused by external forces, and small business sustainability. The case is appropriate for undergraduate small business and entrepreneurship courses, a family business course, or an introductory management or marketing course. It would also be appropriate for a use in studying small business strategies in a business policy and strategic management course. The case is designed to be assigned for reading prior to class, discussed during one 75 minute class period, and is expected to require one and one-half to three hours of outside preparation by the student (depending on whether the discussion questions are assigned for discussion purposes or written submission).

CASE SYNOPSIS

CJ Mclaine's Deli and Bakery, LLC, a family owned small business venture, operated in the town of Evergreen, Colorado. The Italian style deli and bakery focused primarily on its lunch business but also offered a limited breakfast menu, a dinner takeout menu, and general catering services. The business was launched in 2004 and gained significant momentum in its first year of operation. This initial success encouraged the family owners. During its second year, however, changes in the competitive environment and an economic recession created new obstacles that affected the business' sales and bottom line. Somewhat discouraged, the owners recognized that strategic alternatives had to be considered if the business was to survive. The case demonstrates the difficulty of starting a business and sustaining its growth and momentum. It highlights the vulnerability of the small business to changes in the macro environment, especially changes in economic factors, and changes related to industry and competitive forces.

INSTRUCTORS' NOTES

Small businesses are an important part of the U.S. economy, with approximately 23 million firms in the United States classified as small businesses and over 50% of the private sector workforce employed by such firms (Ibrahim, *et al.*, 2008). There is also a significant failure rate. U.S. Small Business Administration statistics indicate that of the businesses founded in a given year only 50% will remain in business four years later (Headd, 2003). This case demonstrates some of the challenges faced by one such business as it entered its third year of operation.

LEARNING OBJECTIVES

1. Identify factors that contribute to the initial success of a small business as well as the challenges confronting small business owners post start-up.
2. Identify the challenges in running a family owned business.
3. Develop an understanding of the nature of competition in the small deli/restaurant business.
4. Develop an understanding of the potential impact of external environmental forces on small business owners.
5. Develop an understanding of the difficulty of managing a business start-up through the first three years of operation.
6. Learn how to apply and use SWOT analysis to assess small business strategy.
7. Learn how to apply Michael Porter's (1990) competitive strategy framework to a small family business.

COURSES AND TOPICS

This case is well suited for use in an undergraduate small business and entrepreneurship course, a family business course, or an introductory management or marketing course. It would also be appropriate for a use in studying small business strategies in a business policy and strategic management course.

CLASSROOM DISCUSSION QUESTIONS

1. How would you assess the business "idea" of opening an Italian style deli in Evergreen, Colorado in 2004? Was there sufficient opportunity for a successful start-up and were there adequate skills and resources to launch the deli?

External Opportunities

Students can identify and evaluate the opportunities in the market. They may identify several location attributes that would support this type of business in Evergreen, Colorado. The character of the area with its open space and mountain parks, recreational areas, and a public lake fosters outdoor types of activities. Healthy take-out foods and sandwiches would appear to serve the needs of people spending time in these parks and recreational areas. The ten bed and breakfasts and six cabin complexes located in the town also appear to provide a market opportunity for the deli owners, particularly for lunch service.

The population of the town, at 41,000 people, appears to be of substantial size to support a business of this type. This would reduce the deli's exposure to risks associated with fluctuations in the area's tourist business. Further, the town appears to be a young and economically viable community with its median age of 42, median household income of $98,000 and the average selling price of its homes at $475,000.

The students may note that there is a commercial area in the town that might provide business for this venture. However, most of the businesses in this part of town served the tourist industry and included restaurants, coffee shops and an ice cream parlor.

Students may examine the competition in the marketplace. They may note that the restaurants and grocery stores in the town's retail areas might pose a threat for this business venture. However, there are no authentic delicatessens of this type in the area. In addition, the location of the deli is convenient for a large part of its customer base. Those who want the kind of food served by CJ Mclaine's may be willing to travel to get it.

The students may discuss other external opportunities. For example, the presence of an active Chamber of Commerce in Evergreen may be identified as an opportunity for this small business start-up. The owners could distribute marketing and promotional information through the Chamber group. The Chamber of Commerce could also provide opportunities for networking with other business owners as well as contacts for their business insurance.

External Threats

The students may discuss the competition as an external threat. The barriers to entry are relatively low in this type business/industry. This is something that the partners should be aware of as they start the business. From a family perspective, however, the investment and capital requirements may prohibit entry.

Internal Strengths

The financial backing by one of the partners may be seen as a strength. It appears that the business would have adequate funding from one of the partners, Josephine. This is certainly an advantage over securing bank loans and would enable the partners to shorten the time horizon for starting the business. The only downside to partner financing is that the owners would not be required to develop a more formal business plan as they would by banks or financial institutions. Such plans can be useful in providing a final check on the potential viability of the venture.

The partners bring the right skill sets to the venture. The internal strengths of the partners appear to support and "fit" this business opportunity. The combination of skills, expertise and abilities of the partners appeared to provide a sound business foundation and adequately met the organizational needs of the new venture.

Angela possessed strong management and organizational capabilities that were developed through her experience managing a bed and breakfast. These skills would be important in building the deli business. Her background also included food preparation which is a good fit with the new business venture. Angela is not only creative, but a hard worker. These are attributes that are necessary for any small business owner.

Dina's work in food service was extensive. Her expertise in restaurant management and meal planning, as well as her background as a cook/chef, counter server and waitress, would be vital to the deli business envisioned by the partners. Like Angela, Dina's work ethic would be important to the success of the small business.

Josephine's importance to the business extends beyond her contribution of start-up capital. As a CPA, she brings financial expertise to the business. Josephine's expertise and accounting support would be a valuable organizational asset. In addition, her success and experience with prior small entrepreneurial ventures would also strengthen the knowledge base of the start-up.

Internal Weaknesses:

There are no apparent weaknesses in terms of the skills and capabilities of the partners, as they each bring valuable skills and expertise to the venture. The students may note disadvantages related to Josephine's home on the East coast and the absence of her physical presence at the deli. Although, her contribution to the business in terms of the accounting and financial reporting could easily be handled long distance through the electronic transfer of information. Another issue that might be raised relates to the life cycle position and family responsibilities of the Angela and Dina. Angela has young children and Dina is a single parent. Students may note that starting a small business requires a significant commitment of time and the partners may encounter personal conflicts given their family responsibilities.

2. **Based on Michael Porter's generic competitive strategies (Porter, 1980, 1990), how would you describe CJ Mclaine's Deli and Bakery, LLC's competitive strategy and position in the market?**

The instructor can engage students in a discussion of Michael Porter's generic competitive strategies which consist of low cost leadership, differentiation, cost focus and differentiation focus (see Porter, 1980, 1990). A low cost strategy is based on a company's ability to provide a service or produce a product more efficiently than its competitors. Low cost leaders compete on price. Differentiation strategies are adopted by companies that provide a unique product or service and compete on the perceived superior value of the product or service (quality, features, etc.). The perceived value of the unique product or service reduces customer sensitivity to price. Porter (1990, 37-40) proposed that these two "generic" strategies are further defined by competitive scope, the breadth of the target market. A low cost leadership strategy and differentiation strategy seek competitive advantage by targeting the broad mass market while the cost focus and differentiation focus strategies target a narrow market niche.

CJ Mclaine's Deli and Bakery has adopted a differentiation focus strategy. It has focused on a narrow segment of the market, specifically the geographic market of Evergreen Colorado. It seeks to serve the needs of this market with high quality Italian style deli food, breakfast items, and limited dinner takeout and catering services. It seeks to differentiate itself from the competition based on customer responsiveness and authenticity of principles. The partners understood what a true Italian deli is and offered homemade ethnic products that appealed to their customer base. They were also wise enough to offer local favorites like breakfast burritos.

3. **What led to the early success of the business?**

The hard work, enthusiasm and commitment of the partners appeared to play a significant role in the venture's early success. Angela and Dina solicited the help of friends and family in marketing and promoting the business. Eager to please, they responded quickly to customer requests and pursued every opportunity to expand their customer base by addressing customer needs (food platters for real estate agents, take-out family style dinners, breakfast burritos). They also developed a website for the business.

As the business grew, Dina and Angela addressed efficiency issues. They developed a fax ordering system to reduce wait time for large lunch orders. They also extended the service hours to early morning and later afternoon. There was already personnel coverage during these periods so no additional labor costs were incurred and the added business helped cover the business's fixed costs.

In terms of workers, their first hire was a hardworking person with experience in food service. For small businesses, this type of employee is not always easy to find.

Angela and Dina quickly built a reputation for "good" food. They also were effective in dealing with customers. The partners not only met their product needs but they were popular because of the solid business relationships they built with their regular customers. They had developed a cadre of regular lunch customers. In addition, they were building a sound reputation for catering and were beginning to see repeat business on this front as well.

4. Develop a SWOT analysis based on the situation that the partners are facing at the close of the case. Identify the strengths and weaknesses of CJ Mclaine's Deli and Bakery, LLC? Does CJ Mclaine's have any core competencies? Identify the opportunities and threats facing CJ Mclaine's Deli and Bakery, LLC.

Strengths

- ♦ Owners/Partners Expertise (food service, cooking, management, accounting)
- ♦ Owner/Partner Work Ethic
- ♦ Strong Customer Service
- ♦ Quality Product/Food
- ♦ Financial Backing
- ♦ Location (office buildings, fire house, school, and parks in close proximity)

Weaknesses

- ♦ Human Resource Issues (employee turnover, inability to cover all open hours with owners
- ♦ Management Discouragement (need for defining new goals and differences in opinion over strategic direction)
- ♦ Physical Facility (small, limited seating – not a destination location)
- ♦ Location (turnover of tenants in office building and shopping center)

Opportunities

- ♦ Sit down meal service – destination location rather than takeout
- ♦ Business meetings - lunch or breakfast meetings (larger facility)
- ♦ Internet business/mail order business
- ♦ Socio-cultural – beer and wine with meals (increase market reach)

Threats

- ♦ Competition (low barriers to entry; (1) deli within a half mile – also sold convenience items, longer operating hours, (2) entry of catering business – chef from famous culinary institute with shop opened to the public, and (3) former customer vertically integrates backward – coffee kiosk makes own pastries in new larger space)
- ♦ Buyer/Customer (tenants leave large office building – loss of large customer base, and increase in number of competitors gives customers greater choice/power)
- ♦ Substitute Product/Service (more people eat at home because of the recession)
- ♦ Economic (economic recession/downturn in the Denver area, decline in housing market, and significant drop in home sales caused a reduction in real estate agent business)

5. Assess CJ Mclaine's Deli and Bakery, LLC financial performance.

A review of the Deli's financials indicates a 12.1% decrease in sales and a 17.2% decrease in gross profit in year ending December 31, 2006. (See Solution – Table 1 for details of this review.) This decrease in sales may be related to the loss of business resulting from tenants moving out of a nearby office building, the entry of new competitors into the local market, and the economic recession that had affected the real estate market. Cost of sales increased as a percentage of sales, from 48.81% in 2005 to 52.80% in 2006. Although operating expenses decreased in year 2006, as a percentage of sales, operating expenses increased from 26.36% in 2005 to 28.64% in 2006. The largest increases in operating expenses were in gross payroll, which rose by 30.4%, and advertising expenses, which increased by 295%. There was a large decrease in office expenses which may be related to the initial start-up investment that occurred in 2005.

Although CJ Mclaine's Deli and Bakery's financial performance was not strong, there was positive operating income in both years – 2005 and 2006. The amount of the partner's draw, however, left CJ Mclaine's with a net operating loss in both years.

CJ Mclaines Deli and Bakery
Comparative Statement of Operations
For the Years Ended December 31,

	2006	% of Sales	2005	% of Sales	Increase Decrease	% Change
Sales	$ 212,757	100.00%	$ 242,026	100.00%	$ (29,269)	-12.09%
Cost of Sales	110,199	51.80%	118,140	48.81%	(7,941)	-6.72%
Gross Profit on Sales	102,558	48.20%	123,886	51.19%	(21,328)	-17.22%
Rent	17,463	8.21%	18,681	7.72%	(1,218)	-6.52%
Gross Payroll (including payroll taxes)	20,501	9.64%	15,715	6.49%	4,786	30.45%
Discounts, Credit Card Charges, and Bank Charges	4,862	2.29%	5,105	2.11%	(243)	-4.76%
Utilities and Telephone	9,042	4.25%	7,867	3.25%	1,175	14.94%
Insurance	2,703	1.27%	1,765	0.73%	938	53.14%
Office	2,874	1.35%	7,258	3.00%	(4,384)	-60.40%
Advertising	2,379	1.12%	602	0.25%	1,777	295.18%
Supplies	676	0.32%	6,216	2.57%	(5,540)	-89.12%
Miscellaneous	431	0.20%	582	0.24%	(151)	-25.95%
Total Operating Expenses	60,931	28.64%	63,791	26.36%	(2,860)	-4.48%
Income before Depreciation and Partner Compensation	41,627	19.57%	60,095	24.83%	(18,468)	-30.73%
Depreciation and Amortization Expense	9,105	4.28%	12,516	5.17%	(3,411)	-27.25%
Partners Guaranteed Draw	51,910	24.40%	78,084	32.26%	(26,174)	-33.52%
Net Loss	$ (19,388)	-9.11%	$ (30,505)	-12.60%	$ 11,117	-36.44%

6. What are the critical issues confronting the company?

The most critical issues confronting CJ Mclaine's Deli and Bakery involve changes in the external environment that have negatively affected sales. This small business started with great momentum in its first year of operations with strong sales of $242, 026 in 2005. But in 2006 the Deli was confronted with major challenges on multiple fronts. Competition entered the market and a previous customer vertically integrated backward becoming its own supplier and a new competitor. In addition, a large part of their customer base was comprised of employees from an insurance company housed in a nearby office building. With the insurance company's move out of Evergreen, CJ Mclaine's lost a number of customers. With the economic recession, the partners were left to wonder when new tenants would fill the office space, bringing business back to the Deli. The economic recession and downturn in the Denver area had more far reaching implications for CJ Mclaine's. With the recession, it was possible that people in the area would cut back on eating out and prepare more meals at home to save money. In addition, the related decline in the housing market and drop in home sales had taken away another portion of their business, specifically the trays of food the Deli and Bakery provided for the real estate agents for their open houses. These external forces left CJ Mclaine's in a vulnerable position, particularly given their recent entry into the market.

These external factors also had an impact on the partners themselves. There was disappointment and some discouragement over the turn of events. The excitement and enthusiasm over the success of the first year gave way to concern over the future and survival of the venture.

7. Based on your SWOT analysis and identification of critical issues, which alternative course of action considered by the partners do you consider "best"?

The alternatives involving major change would all require significant financial investment and risk. The partners should consider the time it would take to implement these strategies and the payback period for the investment required. A list of some alternatives involving major change in strategic direction follows.

1. Internet Based Company: Undergraduate students, as part of an internet savvy generation, may favor growth through internet marketing. The instructor should point out that competitors must differentiate themselves and their product whether they are sold through brick and mortar retail outlets or through the internet. CJ Mclaine's would have to develop a product that could deliver greater value than other internet marketers. They would also have to develop an efficient logistics and distribution system necessary to deliver perishable food items.

2. Toward a Full Service Restaurant: The second alternative would involve moving the business to a new location and larger facility. CJ Mclaine's would provide sit down meals, specifically business lunches and breakfast meetings but also food for other customers seeking a destination for a sit down meal. This alternative would require significant capital investment, including increased rent and overhead for a larger space, the cost of leasehold improvements, and potential increased equipment and staffing requirements. There is high risk attached to this alternative, especially given the high failure rate for new restaurant businesses. With regard to the partners' propensity toward risk, students should consider whether they perceive the partners to be "entrepreneurs" or small business owners.

3. The Food Truck: The alternative to add a food truck to their business that would service the parks and recreation centers might help smooth out the Deli's business cycle and also help cover fixed costs. Given the quality of their product offerings, CJ Mclaine's may be able to differentiate their truck service from their competitors. This alternative would also require a fairly sizeable investment with respect to the purchase of the truck, as well as ongoing maintenance costs, or perhaps they could pursue a lease agreement. The partnership would also have to secure trustworthy part-time staff to man the truck at the park locations. They have to consider the difficulties they're currently encountering with respect to employee hiring and turnover. Securing the necessary permits may take some time.

The alternatives involving minor change would require smaller financial investment and less risk. Here too, the partners should consider the time it would take to implement these strategies and the payback period for the investment required. A list of some alternatives involving minor change in strategic initiatives follows.

1. Product Diversification: The product diversification alternatives require less financial investment and are lower risk. They may help CJ Mclaine's to increase customer traffic and expand their market.

2. Selling beer and wine may attract a broader customer base and given the margins on alcohol it could substantially improve CJ Mclaine's margins. But this alternative comes with some risk. Underage drinking may be a concern and town officials may be reluctant to issue a liquor license given its location in such close proximity to a school. Further, the facility's limited seating may reduce the potential impact of offering beer and wine to its customers.

3. Selling both newspapers and lottery tickets appear to provide low investment, low cost, and low risk strategies to increase foot traffic and product sales. The sale of lottery tickets would also bring in substantial revenues for the business, estimated at $5,000-$10,000 annually. Both of these alternatives would help keep the Deli in business over the short term and give the partners time to continue building customer loyalty and market share. It would also afford more time to develop long term strategies and build revenues to support future growth.

4. Other Options: The other alternatives mentioned include increasing advertising. With CJ Mclaine's in only its second year of operation, it may need to continue advertising to build the brand. Brand awareness is critical for firms adopting differentiation strategy.

Although the Deli is recording a net loss, its operating revenues are positive. The partners draw and guaranteed salaries put the company in the red. However, given the sudden and dramatic changes in the economic and competitive environment affecting CJ Mclaine's business, their overall financial performance doesn't seem as bleak as one might think. Closing the store would seem to be a bit premature. The idea, however, of "waiting" until new tenants move into the empty office building or "waiting" until the economy turns around are not viable alternatives. CJ Mclaine's must take a proactive approach and seek out solutions that will help them maintain their long-term viability, smooth the business cycles, reduce their exposure to risk, and ultimately grow the firm.

8. Beyond the alternatives being considered by the owners, what strategy would you recommend for CJ Mclaine's Deli and Bakery?

The instructor should allow the students an opportunity to brainstorm and develop ideas for alternative strategies.

CASE LESSONS

The case demonstrates the difficulty of starting a business and sustaining its growth and momentum. It highlights the vulnerability of the small business to changes in the macro environment, especially changes in economic factors, and changes related to industry and competitive forces.

CAPE CHEMICAL: CAPITAL BUDGETING ISSUES

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

CASE DESCRIPTION

The primary subject matter of this case concerns the issues surrounding evaluation of capital expenditures. Case provides a systematic approach to evaluating capital expenditures including a review of alternative capital budgeting methods and the relationship between the cost of capital and capital budgeting. The case requires students to have an advanced knowledge of accounting, finance and general business issues thus the case has a difficulty level of four (senior level) or higher. In particular, an understanding of capital budgeting practices and cost of capital issues is necessary to solve the case. The case is designed to be taught in one class session of approximately 1.25 hours and is expected to require 3-4 hours of preparation time from the students.

CASE SYNOPSIS

The case tells the story of Ann Stewart, President and primary owner of Cape Chemical. By most measures, the performance of Cape Chemical has been very good over the last three years. Double-digit sales growth has been achieved, new product lines have been added and profits have more than tripled. The growth has required the acquisition of equipment, expansion of storage capacity and increasing the size of the work force.

The unexpected withdrawal of one of Cape Chemical's competitors from the region has provided the opportunity to increase its blended packaged goods sales. However, Cape Chemical's blending equipment is already operating at capacity. To take advantage of this opportunity, additional equipment must be obtained, requiring a major capital investment. It is estimated that Cape Chemical must increase its annual blending capacity by 800,000 gallons to meet expected demand for the next three years Annual capacity of 1,400,000 gallons is necessary to meet projected demand beyond the next three years. The firm has no systematic capital expenditure evaluation process.

INSTRUCTORS' NOTES

Case Use

The case as written includes discussion questions to aid the student in their analysis of Cape Chemical's current financial position. The case can be made more difficult by omitting the discussion questions. The case can be made easier by including partially completed schedules to aid the students in their calculations.

Case Overview

As the case opened Ann Stewart, the President of the Cape Chemical, a regional chemical distributor, headquartered in Cape Girardeau, Missouri, is considering the opportunity to increase its blended packaged goods sales. The company's blending equipment is operating at capacity, thus to take advantage of this opportunity, additional equipment must be obtained, requiring a major capital investment. It is estimated that Cape Chemical must increase its annual blending capacity by 800,000 gallons to meet expected demand for the next three years Annual capacity of 1,400,000 gallons is necessary to meet projected demand beyond the next three years.

Stewart is considering two alternatives proposed by the company's engineer. The first is the acquisition and installation of used equipment that will provide the capacity to blend an additional 800,000 gallons annually. The used equipment will cost $105,000 to acquire and $15,000 to install. The equipment is projected to have an estimated life of three years. The second option is the acquisition and installation of new equipment with the capacity to blend 1,600,000 gallons annually. The new equipment would cost $360,000 to acquire and $60,000 to install and have an economic life of seven years. The new equipment is more efficient thus the cost to blend is less than the blending cost of the used equipment. Stewart asked Kate Clarkson, the newly hired financial officer, to lead the evaluation process. The company does not have a formal evaluation process for capital projects.

Clarkson thinks the used equipment could be obtained without new bank debt. The acquisition of the new equipment would require new bank borrowing. The evaluation of each alternative requires an estimate of the financial benefits associated with each.

The learning objectives of the case include: 1) Introducing students to a systematic approach to capital budgeting decisions 2) Examining how firm's cost of capital is calculated and financial theory regarding a firm's optimum capital structure 3) Examining the relationship between a firm's cost of capital, capital budgeting and long-term financial performance 4) Examining capital expenditure evaluation techniques (Cash Payback Period, Discounted Cash Payback Period, Net Present Value (NPV), Internal Rate of Return (IRR) and Modified Internal Rate of Return (MIRR) and 5) Exploring non-financial issues that need to be considered when evaluating capital expenditures.

DISCUSSION QUESTIONS

1. **Calculate Cape Chemical's weighted average cost of capital (WACC). Note: round to the nearest whole number. Discuss the theory used by Clarkson to determine Cape Chemical's optimum target capital structure is 30% debt and 70% equity.**

Simply stated the weighted average cost of capital (WACC) is the cost the company is paying to finance its assets and reflects the riskiness of the firm or the firm's assets. As its name indicates, it is a weighted average of the costs of the various sources of capital (debt and equity) used in the firm's capital structure. What is not so readily apparent by its name is that the WACC is an after-tax cost. In other words, it is calculated using the after-tax cost of each source of capital. Interest paid by a business is tax deductible, thus the cost of debt needs to be converted to an after-tax cost by multiplying the before-tax interest rate by one minus the firm's marginal income tax rate. The firm's WACC is also referred to as the firm's marginal cost of capital or what a firm must pay for its next dollar of capital. Another point that should be made is since the WACC is used by businesses to evaluate possible long-term expenditures (capital projects), only long-term capital sources are included in the calculation. Thus, most firms do not include the cost of short-term debt in the calculation.

To determine WACC, a firm must 1) calculate the cost it must pay for each source of capital and 2) determine the target mix of debt and equity to be used by the firm. The cost of each source of capital and the target capital structure are provided in the case. Cape Chemical's before-tax cost of debt is given as 12% and its cost of common equity is given as 18%. Cape Chemical's target capital structure is given as 30% debt and 70% equity. For a detailed discussion of how a firm calculates its cost of debt and cost of equity, see Eugene Brigham and Joel Houston's "Fundamentals of Financial Management," Concise 5th edition, Thompson-Southwestern Publishers or a number of other finance textbooks.

WACC formula:

$$WACC = w_d\,(r_d)\,(1\text{-}t) + w_s\,(r_s)$$

Where: w_d = weight of debt in the company's target capital structure
r_d = before-tax cost of debt
t = marginal income tax rate
w_s = weight of equity in the company's target capital structure
r_s = cost of equity

Cape Chemical's WACC = .30 (.12) (1-.30) + .70 (.18)
= .0252 +.1260
= .1512 or 15.1% use 15%

A firm's WACC is minimized when its capital structure (mix of debt and equity) is optimum. Simply stated, a firm's value is maximized when its WACC is minimized; therefore, firm's try to determine the capital structure which will minimize its WACC.

The use of debt lowers Cape Chemical's cost of capital because low-cost debt capital is substituted for high-cost equity capital. Debt has a lower cost than equity because to the holder of debt there is less risk. Debt has less risk because the certainty of payments associated with debt (interest and principal) is greater than the payments associated with equity (dividends and stock appreciation). Debt payments are legal obligations thus are paid before any payment to equity shareholders. Because there is less risk associated with debt, the providers of debt are satisfied with a lower but more certain return. The downside of debt is the fixed nature of the payments, thus the use of debt by a firm increases its financial risk. The more debt a firm has, the greater the financial risk or financial leverage. The introduction of debt into a firm's capital structure will at first cause the WACC to decline, but eventually the use of large amounts of debt will cause the WACC to increase. What businesses attempt to achieve is a capital structure which provides the lowest cost of capital because it is there the value of the firm is maximized.

2. **Since the used equipment will be financed with internal capital and the new equipment with a bank loan, should the same discount rate be used to evaluate each alternative? Explain.**

The discount rate used to evaluate the project reflects the risk level of the project, not the cost of the financing. The cost of capital represents the risk level of the firm's assets, and since both alternatives appear to have the same risk level as the firm's existing assets, the cost of capital should be used to evaluate each alternative.

3. **Explain why an accurate WACC is important to a firm's long-term success.**

A firm's WACC is used to assess investment decisions. Assets must return at least the firm's cost of capital (what it must pay for the capital to acquire the asset). If an asset's return is less than the WACC, shareholders will not receive their required return. If a firm underestimates its WACC, it may invest in assets (projects) that do not yield the necessary return. If a firm overestimates its WACC, it may not invest in assets that would yield the necessary return (missed opportunities). Either error will result in problems. If the WACC is underestimated, a firm risks losing equity capital as unsatisfied investors take their funds elsewhere or will have difficulty raising capital in the future. If the WACC is overestimated, a firm risks missing profitable growth opportunities. Making investment decisions based on informal analysis is an unacceptable process and will not result in an effective allocation of the firm's scarce resources.

4. **Evaluate the strengths and weaknesses of the Cash Payback Period, Discounted Cash Payback Period, NPV, IRR and MIRR capital expenditure budgeting methods. Prepare**

a recommendation for Stewart regarding the capital budgeting method or methods to use in evaluating the expansion alternatives. Support your answer.

Cash Payback Period is the number of years it takes a firm to recover the original investment. For example, if a capital project requires an investment of $10,000 and is expected to return $5,000 for each of the next four years, the Payback Period would be two years. The advantages of the Payback Period include: 1) easy to calculate and explain, 2) focuses on future cash flows, and 3) places a premium on liquidity (i.e. a quick return of the investment). Disadvantages: 1) ignores time value of money (i.e. a dollar received in year three is assumed to be worth the same as a dollar received today), 2) ignores cash flows beyond the payback period, and 3) does not include an accept/reject feature.

Discounted Cash Payback Period was developed to correct one of the weaknesses of the Cash Payback Period (ignoring the time value of money). The Discounted Cash Payback Period is the number of years required to recover the original investment, but in this case the present value of future cash flows are determined (using the firm's WACC as the discount rate) before the payback period is calculated. The advantages of the Discounted Payback Period include: 1) focuses on future cash flows, 2) incorporates time value of money and 3) places a premium on liquidity (i.e. a quick return of the investment). Disadvantages: 1) ignores cash flows beyond the payback period, and 2) does not include an accept/reject feature.

Net Present Value (NPV) method is determined by 1) calculating the present value of the future cash flows (using the WACC as the discount rate) and 2) deducting the project's cost from the present value of the future cash flows. If the present value of the future cash flows exceeds the project's cost, the project is said to have a positive NPV. Stated another way, if the project's value (the present value of its future cash flows) exceeds its cost, the project is a good investment and should be accepted. Advantages of this method include: 1) focuses on future cash flows, 2) takes into account time value of money, 3) considers all cash flows associated with the project, 4) assumes cash flows associated with the project are reinvested at the firm's WACC (the WACC reflects the current risk level of the firm) and 5) includes an accept/reject feature. Disadvantages: 1) relatively difficult to explain and calculate, and 2) requires knowledge of a firm's WACC.

Internal Rate of Return (IRR) method is calculated by determining the discount rate that will cause the present value of the future cash flows to equal the project's cost. The discount rate is the project's internal rate of return (IRR). If the IRR exceeds the firm's WACC, the project should be accepted. Advantages of this method include: 1) focuses on future cash flows, 2) takes into account time value of money, 3) considers all cash flows associated with the project, and 4) does not require knowledge of a firm's WACC. Disadvantages: 1) relatively difficult to explain and calculate, 2) if the project's future cash flows include some years with cash outflows rather than cash inflows, multiple IRRs may result and 3) assumes the project's cash flows are reinvested at the project's rate of return rather than the firm's WACC. A more reasonable assumption is that cash flows are reinvested at the firm's WACC.

Modified Internal Rate of Return (MIRR) method was developed to correct the reinvestment rate assumption associated with the IRR. The IRR is calculated by determining the discount rate that will cause the present value of the project's terminal value (the future values of the project's cash flows, compounded at the firm's WACC), to equal the project's cost. Like the IRR, if the MIRR exceeds the firm's WACC, the project should be accepted. Advantages of this method include: 1) focuses on future cash flows, 2) takes into account time value of money, 3) considers all cash flows associated with the project, and 4) does not require knowledge of a firm's WACC. Disadvantages: 1) relatively difficult to explain and calculate, and 2) if the project's future cash flows include some years with cash outflows rather than cash inflows, multiple IRRs may result.

Recommendation should include the use of all evaluation methods because each provides valuable information regarding a potential project. Priority should be given to the results of the NPV method because it compares the projects value (the present value of future cash flows, determined by using the firm's WACC as the discount rate) to the projects cost. If a project's value exceeds its cost, it is a good investment. For a more complete discussion of the superiority of the NPV method over the other techniques, see Eugene Brigham and Joel Houston's "Fundamentals of Financial Management".

5. **Calculate the Cash Payback Period, Discounted Cash Payback Period, NPV, IRR and MIRR for each alternative. For these calculations, assume a WACC of 15%. Based strictly on the results of these methods, should either option be selected? Why? Solution requires preparation of a spreadsheet.**

See Schedules One and Two for complete calculations. Results are:

Annual Sales Growth Rate 15%		
Evaluation Method	Used Equipment	New Equipment
Cash Payback Period	2.66 years	4.72 years
Discounted Payback Period	*	*
Net Present Value (NPV)	$24,391	$44,802
Internal Rate of Return (IRR)	22.20%	17.50%
Modified Internal rate of Return (MIRR)	20.30%	16.51%
*Discounted Payback Period indicates cash is not recovered until the project is terminated. Terminal cash flows from the sale of the equipment and recovery of working capital are required to recover invested cash.		

The Cash Payback Period and the Discounted Cash Payback Period assume annual operating cash flows are received evenly over the course of the year while the NPV, IRR and MIRR assume operating cash flows are received at the end of the year. *Based on the results of the evaluation methods, the new equipment would be selected because of the higher NPV.*

6. **Stewart is concerned that the projected annual sales growth rate of 15% for incremental blended material may be optimistic. Recalculate the Cash Payback Period, Discounted Cash Payback Period, NPV, IRR and MIRR for each alternative assuming the annual sales growth rates of 10% and 5%. Assume a WACC of 15%. Does the change in growth rate alter the recommendation made in question 5? Solution requires preparation of spreadsheets. Explain.**

See Schedules Three Four, Five and Six for complete calculations. Results are:

Annual Sales Growth Rate 10%		
Evaluation Method	Used Equipment	New Equipment
Cash Payback Period	2.68 years	4.94 years
Discounted Payback Period	0	**
Net Present Value (NPV)	$19,572	($3,009)
Internal Rate of Return (IRR)	20.93%	14.82%
Modified Internal rate of Return (MIRR)	19.29%	14.89%
*Discounted Payback Period indicates cash is not recovered until the project is terminated. Terminal cash flows from the sale of the equipment and recovery of working capital are required to recover invested cash.		
**Discounted Payback Period indicates invested cash is never recovered.		

Based on the results of the evaluation methods, the used equipment is the superior investment opportunity because of the higher NPV.

The conflicting investment decisions will force students to examine the analysis before recommending a course of action. The used equipment meets investment criteria with all growth rates. The new equipment has the higher NPV with the 15% growth rate but has a negative NPV when growth rates of 10% and 5% are used. The key to success with either option is the accuracy of the projected increase in blended package material; however it is highly unlikely that future sales volume will exactly equal projected sales. Students will need to offer an opinion regarding which growth rate is more accurate.

7. **The projected cash flow benefits of both projects did not include the effects of inflation. Future cash flows were determined using a constant selling price and operating costs (real cash flows). The cash flows were then discounted using a WACC that included the impact**

of inflation (nominal WACC). Discuss the problem with using real cash flows and a nominal WACC when calculating a project's NPV or IRR.

In general, using "real" future cash flows and a "nominal" WACC will result in an understated NPV and IRR or both will have a downward bias. If inflation is neutral, impacting revenues and costs equally, the NPV and IRR will be underestimated. Because revenues are usually greater than costs, revenues will increase by a greater dollar amount than costs. The exact impact of combining "real" cash flows and a "nominal" discount rate can only be determined by removing the impact of inflation from the discount rate or adding the impact of inflation to the future cash flows.

8. What other issues should be considered before a final decision regarding the expansion alternatives is made?

As discussed in the answer to question six, the growth rate assumption is key to the analysis. Before a decision is made, the growth rate assumption needs to be revisited. Stewart appears to understand this and requested additional analysis based on an annual growth lower than the 15% provided by the marketing department. Incorporating an assumption regarding future inflation rates would also improve the analysis. The point of this question is to illustrate to the students that the financial analysis is only part of the decision-making process.

REFERENCES

Brigham, Eugene and Joel Houston, *"Fundamentals of Financial Management,"* Concise 5th edition, Thomson South-Western, a part of the Thomson Corporation, 2007.

Brigham, Eugene, and Michael Ehrhardt, *"Financial Management: Theory and Practice,"* 12th edition, Thomson South-Western, a part of the Thomson Corporation, 2008.

Schedule One (page 1) **Used Equipment/ 15% Growth Rate**

	Year 0	Year 1	Year 2	Year 3
Incremental Blended Sales Volume (gallons)		600,000	690,000	793,500
Selling Price (per gallon)		$ 4.05	$ 4.05	$ 4.05
Blending Cost (per gallon)		$ 0.20	$ 0.20	$ 0.20
Material Variable Cost (per gallon)		$ 3.53	$ 3.53	$ 3.53
Total Production Variable Cost (per gallon)		$ 3.73	$ 3.73	$ 3.73
Selling and Adminstrative Expenses (per gallon)		$ 0.20	$ 0.20	$ 0.20
Tax Rate		30%	30%	30%
WACC		15%	15%	15%
Working Capital (WC) as Percent of Sales		2%	2%	2%
Required WC	$ 48,600	$ 55,890	$ 64,274	
Required Increase in WC		$ 7,290	$ 8,383	$ (64,274)

	Year 0
Acquisition Cash Flows	$
Equipment Cost	105,000
Installation Cost	15,000
Increase in WC	48,600
Total Project Cost	168,600

Operating Cash Flow Projections

	Year 1	Year 2	Year 3
	$	$	$
Sales	2,430,000	2,794,500	3,213,675
Variable Costs	2,238,000	2,573,700	2,959,755
Gross Profit	192,000	220,800	253,920
Selling and Adminstrative Expenses	120,000	138,000	158,700
Depreciation Expense	39,600	54,000	18,000
Earnings Before Taxes	32,400	28,800	77,220
Income Taxes	9,720	8,640	23,166
Earnings After Taxes	22,680	20,160	54,054
Depreciation Expense	39,600	54,000	18,000
Operating Cash Flow	62,280	74,160	72,054
Increase in WC	(7,290)	(8,383)	-
Annual Cash Flow	54,990	65,777	72,054

Schedule One (page 2) **Used Equipment/ 15% Growth Rate**

	Year 3
Terminal Cash Flows	$
Sale of Equipment	9,000
Book Value	8,400
Taxable Gain	600
Income Taxes	180
Cash Flow From Sale	8,820
Liquidation of WC	64,274
Terminal Cash Flows	73,094

	Year 0	Year 1	Year 2	Year 3
Cash Flows	$ (168,600)	$ 54,990	$ 65,777	$ 145,148

Cash Payback Period	2.66
Discounted Cash Payback Period	3.00
NPV	$ 24,391
IRR	22.20%
MIRR	20.30%

	Cash Flow	Cumulative CF	
Year 0	$ (168,600)		
Year 1	$ 54,990	$ (113,610)	1.00
Year 2	$ 65,777	$ (47,834)	1.00
Year 3	$ 72,054	$ 24,221	0.66
			2.66

	Cash Flow	Discounted CF	Cumulative CF	
Year 0	$ (168,600)		$ -	
Year 1	$ 54,990	$ 47,817	$ (120,783)	1.00
Year 2	$ 65,777	$ 49,736	$ (71,046)	1.00
Year 3	$ 72,054	$ 47,377	$ (23,669)	1.00
Terminal CF	$ 73,094	$ 48,060	$ 24,391	3.00

Schedule Two (page 1) **New Equipment/ 15% Growth Rate**

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Sales Volume- Total (gallons)		600,000	690,000	793,500	912,525	1,049,404	1,206,814	1,387,836
Selling Price (per gallon)		$ 4.05	$ 4.05	$ 4.05	$ 4.05	$ 4.05	$ 4.05	$ 4.05
Blending Cost (per gallon)		$ 0.17	$ 0.17	$ 0.17	$ 0.17	$ 0.17	$ 0.17	$ 0.17
Material Variable Cost (per gallon)		$ 3.53	$ 3.53	$ 3.53	$ 3.53	$ 3.53	$ 3.53	$ 3.53
Total Production Variable Cost (per gallon)		$ 3.70	$ 3.70	$ 3.70	$ 3.70	$ 3.70	$ 3.70	$ 3.70
Selling and Adminstrative Expenses		$ 0.20	$ 0.20	$ 0.20	$ 0.20	$ 0.20	$ 0.20	$ 0.20
Tax Rate		30%	30%	30%	30%	30%	30%	30%
WACC		15%	15%	15%	15%	15%	15%	15%
Working Capital (WC) as Percent of Sales		2%	2%	2%	2%	2%	2%	2%
Required WC	$ 48,600	$ 55,890	$ 64,274	$ 73,915	$ 85,002	$ 97,752	$ 112,415	
Required Increase in WC		$ 7,290	$ 8,383	$ 9,641	$ 11,087	$ 12,750	$ 14,663	$ (112,415)

Acquisition Cash Flows	Year 0
	$
Equipment Cost	360,000
Installation Cost	60,000
Increase in WC	48,600
Total Project Cost	468,600

Operating Cash Flow Projections

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
	$	$	$	$	$	$	$
Sales	2,430,000	2,794,500	3,213,675	3,695,726	4,250,085	4,887,598	5,620,738
Variable Costs	2,220,000	2,553,000	2,935,950	3,376,343	3,882,794	4,465,213	5,134,995
Gross Profit	210,000	241,500	277,725	319,384	367,291	422,385	485,743
Selling and Adminstrative Expenses	120,000	138,000	158,700	182,505	209,881	241,363	277,567
Depreciation Expense	58,800	105,000	71,400	54,600	37,800	37,800	37,800
Earnings Before Taxes	31,200	(1,500)	47,625	82,279	119,611	143,222	170,375
Income Taxes	6,240	(300)	9,525	16,456	23,922	28,644	34,075
Earnings After Taxes	24,960	(1,200)	38,100	65,823	95,688	114,578	136,300
Depreciation Expense	58,800	105,000	71,400	54,600	37,800	37,800	37,800
Operating Cash Flows	83,760	103,800	109,500	120,423	133,488	152,378	174,100
Increase in WC	(7,290)	(8,383)	(9,641)	(11,087)	(12,750)	(14,663)	
Annual Cash Flows	76,470	95,417	99,859	109,336	120,738	137,715	174,100

Schedule Two (page 2) **New Equipment/ 15% Growth Rate**

Terminal Cash Flows	Year 7
	$
Sale of Equipment	60,000
Book Value	16,800
Taxable Gain	43,200
Income Taxes	8,640
Cash Flow From Sale	51,360
Liquidation of WC	112,415
Terminal Cash Flows	163,775

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Cash Flows	$ (468,600)	$ 76,470	$ 95,417	$ 99,859	$ 109,336	$ 120,738	$ 137,715	$ 337,875

Cash Payback Period	4.72
Discounted Cash Payback Period	7.00
NPV	$ 44,802
IRR	17.50%
MIRR	16.51%

	Cash Flow	Cumlative CF	
Year 0	$ (468,600)		
Year 1	$ 76,470	$ (392,130)	1.00
Year 2	$ 95,417	$ (296,714)	1.00
Year 3	$ 99,859	$ (196,855)	1.00
Year 4	$ 109,336	$ (87,519)	1.00
Year 5	$ 120,738	$ 33,219	0.72
			4.72

	Cash Flow	Discounted CF	Cumlative CF	
Year 0	$ (468,600)			
Year 1	$ 76,470	$ 66,496	$ (402,104)	1.00
Year 2	$ 95,417	$ 72,149	$ (329,956)	1.00
Year 3	$ 99,859	$ 65,659	$ (264,297)	1.00
Year 4	$ 109,336	$ 62,513	$ (201,784)	1.00
Year 5	$ 120,738	$ 60,028	$ (141,756)	1.00
Year 6	$ 137,715	$ 59,538	$ (82,218)	1.00
Year 7	$ 174,100	$ 65,451	$ (16,767)	1.00
Terminal CF	$ 163,775	$ 61,569	$ 44,802	7.00

Schedule Three (page 1) **Used Equipment/ 10% Growth Rate**

	Year 0	Year 1	Year 2	Year 3
Incremental Blended Sales Volume (gallons)		600,000	660,000	726,000
Selling Price (per gallon)		$ 4.05	$ 4.05	$ 4.05
Blending Cost (per gallon)		$ 0.20	$ 0.20	$ 0.20
Material Variable Cost (per gallon)		$ 3.53	$ 3.53	$ 3.53
Total Production Variable Cost (per gallon)		$ 3.73	$ 3.73	$ 3.73
Selling and Adminstrative Expenses (per gallon)		$ 0.20	$ 0.20	$ 0.20
Tax Rate		30%	30%	30%
WACC		15%	15%	15%
Working Capital (WC) as Percent of Sales		2%	2%	2%
Required WC	$ 48,600	$ 53,460	$ 58,806	
Required Increase in WC		$ 4,860	$ 5,346	$ (58,806)

Acquisition Cash Flows	Year 0 $
Equipment Cost	105,000
Installation Cost	15,000
Increase in WC	48,600
Total Project Cost	168,600

Operating Cash Flow Projections

	Year 1 $	Year 2 $	Year 3 $
Sales	2,430,000	2,673,000	2,940,300
Variable Costs	2,238,000	2,461,800	2,707,980
Gross Profit	192,000	211,200	232,320
Selling and Adminstrative Expenses	120,000	132,000	145,200
Depreciation Expense	39,600	54,000	18,000
Earnings Before Taxes	32,400	25,200	69,120
Income Taxes	9,720	7,560	20,736
Earnings After Taxes	22,680	17,640	48,384
Depreciation Expense	39,600	54,000	18,000
Operating Cash Flow	62,280	71,640	66,384
Increase in WC	(4,860)	(5,346)	-
Annual Cash Flow	57,420	66,294	66,384

Schedule Three (page 2) **Used Equipment/ 10% Growth Rate**

Terminal Cash Flows	Year 3 $
Sale of Equipment	9,000
Book Value	8,400
Taxable Gain	600
Income Taxes	180
Cash Flow From Sale	8,820
Liquidation of WC	58,806
Terminal Cash Flows	67,626

	Year 0	Year 1	Year 2	Year 3
Cash Flows	$ (168,600)	$ 57,420	$ 66,294	$ 134,010

Cash Payback Period	2.68
Discounted Cash Payback Period	3.00
NPV	$ 19,572
IRR	20.93%
MIRR	19.29%

	Cash Flow	Cumulative CF	
Year 0	$ (168,600)		
Year 1	$ 57,420	$ (111,180)	1.00
Year 2	$ 66,294	$ (44,886)	1.00
Year 3	$ 66,384	$ 21,498	0.68
			2.68

	Cash Flow	Discounted CF	Cumulative CF	
Year 0	$ (168,600)		$ -	
Year 1	$ 57,420	$ 49,930	$ (118,670)	1.00
Year 2	$ 66,294	$ 50,128	$ (68,542)	1.00
Year 3	$ 66,384	$ 43,649	$ (24,893)	1.00
Terminal CF	$ 67,626	$ 44,465	$ 19,572	3.00

Schedule Four (page 1) **New Equipment/ 10% Growth Rate**

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Sales Volume- Total (gallons)		600,000	660,000	726,000	798,600	878,460	966,306	1,062,937
Selling Price (per gallon)		$ 4.05	$ 4.05	$ 4.05	$ 4.05	$ 4.05	$ 4.05	$ 4.05
Blending Cost (per gallon)		$ 0.17	$ 0.17	$ 0.17	$ 0.17	$ 0.17	$ 0.17	$ 0.17
Material Variable Cost (per gallon)		$ 3.53	$ 3.53	$ 3.53	$ 3.53	$ 3.53	$ 3.53	$ 3.53
Total Production Variable Cost (per gallon)		$ 3.70	$ 3.70	$ 3.70	$ 3.70	$ 3.70	$ 3.70	$ 3.70
Selling and Adminstrative Expenses		$ 0.20	$ 0.20	$ 0.20	$ 0.20	$ 0.20	$ 0.20	$ 0.20
Tax Rate		30%	30%	30%	30%	30%	30%	30%
WACC		15%	15%	15%	15%	15%	15%	15%
Working Capital (WC) as Percent of Sales		2%	2%	2%	2%	2%	2%	2%
Required WC	$ 48,600	$ 53,460	$ 58,806	$ 64,687	$ 71,155	$ 78,271	$ 86,098	
Required Increase in WC		$ 4,860	$ 5,346	$ 5,881	$ 6,469	$ 7,116	$ 7,827	$ (86,098)

Acquisition Cash Flows	Year 0
	$
Equipment Cost	360,000
Installation Cost	60,000
Increase in WC	48,600
Total Project Cost	468,600

Operating Cash Flow Projections

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
	$	$	$	$	$	$	$
Sales	2,430,000	2,673,000	2,940,300	3,234,330	3,557,763	3,913,539	4,304,893
Variable Costs	2,220,000	2,442,000	2,686,200	2,954,820	3,250,302	3,575,332	3,932,865
Gross Profit	210,000	231,000	254,100	279,510	307,461	338,207	372,028
Selling and Adminstrative Expenses	120,000	132,000	145,200	159,720	175,692	193,261	212,587
Depreciation Expense	58,800	105,000	71,400	54,600	37,800	37,800	37,800
Earnings Before Taxes	31,200	(6,000)	37,500	65,190	93,969	107,146	121,640
Income Taxes	6,240	(1,200)	7,500	13,038	18,794	21,429	24,328
Earnings After Taxes	24,960	(4,800)	30,000	52,152	75,175	85,717	97,312
Depreciation Expense	58,800	105,000	71,400	54,600	37,800	37,800	37,800
Operating Cash Flows	83,760	100,200	101,400	106,752	112,975	123,517	135,112
Increase in WC	(4,860)	(5,346)	(5,881)	(6,469)	(7,116)	(7,827)	
Annual Cash Flows	78,900	94,854	95,519	100,283	105,860	115,690	135,112

Schedule Four (page 2) **New Equipment/ 10% Growth Rate**

Terminal Cash Flows	Year 7
	$
Sale of Equipment	60,000
Book Value	16,800
Taxable Gain	43,200
Income Taxes	8,640
Cash Flow From Sale	51,360
Liquidation of WC	86,098
Terminal Cash Flows	137,458

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Cash Flows	$ (468,600)	$ 78,900	$ 94,854	$ 95,519	$ 100,283	$ 105,860	$ 115,690	$ 272,570

Cash Payback Period	4.94
Discounted Cash Payback Period	NA
NPV	$ (3,009)
IRR	14.82%
MIRR	14.89%

	Cash Flow	Cumlative CF	
Year 0	$ (468,600)		
Year 1	$ 78,900	$ (389,700)	1.00
Year 2	$ 94,854	$ (294,846)	1.00
Year 3	$ 95,519	$ (199,327)	1.00
Year 4	$ 100,283	$ (99,043)	1.00
Year 5	$ 105,860	$ 6,816	0.94
			4.94

	Cash Flow	Discounted CF	Cumlative CF	
Year 0	$ (468,600)			
Year 1	$ 78,900	$ 68,609	$ (399,991)	1.00
Year 2	$ 94,854	$ 71,723	$ (328,268)	1.00
Year 3	$ 95,519	$ 62,806	$ (265,462)	1.00
Year 4	$ 100,283	$ 57,337	$ (208,125)	1.00
Year 5	$ 105,860	$ 52,631	$ (155,494)	1.00
Year 6	$ 115,690	$ 50,016	$ (105,478)	1.00
Year 7	$ 135,112	$ 50,794	$ (54,685)	1.00
Terminal CF	$ 137,458	$ 51,676	$ (3,009)	7.00

Schedule Five (page 1) **Used Equipment/ 5% Growth Rate**

	Year 0	Year 1	Year 2	Year 3
Incremental Blended Sales Volume (gallons)		600,000	630,000	661,500
Selling Price (per gallon)		$ 4.05	$ 4.05	$ 4.05
Blending Cost (per gallon)		$ 0.20	$ 0.20	$ 0.20
Material Variable Cost (per gallon)		$ 3.53	$ 3.53	$ 3.53
Total Production Variable Cost (per gallon)		$ 3.73	$ 3.73	$ 3.73
Selling and Adminstrative Expenses (per gallon)		$ 0.20	$ 0.20	$ 0.20
Tax Rate		30%	30%	30%
WACC		15%	15%	15%
Working Capital (WC) as Percent of Sales		2%	2%	2%
Required WC	$ 48,600	$ 51,030	$ 53,582	
Required Increase in WC		$ 2,430	$ 2,552	$ (53,582)

Acquisition Cash Flows	Year 0 $
Equipment Cost	105,000
Installation Cost	15,000
Increase in WC	48,600
Total Project Cost	168,600

Operating Cash Flow Projections

	Year 1 $	Year 2 $	Year 3 $
Sales	2,430,000	2,551,500	2,679,075
Variable Costs	2,238,000	2,349,900	2,467,395
Gross Profit	192,000	201,600	211,680
Selling and Adminstrative Expenses	120,000	126,000	132,300
Depreciation Expense	39,600	54,000	18,000
Earnings Before Taxes	32,400	21,600	61,380
Income Taxes	9,720	6,480	18,414
Earnings After Taxes	22,680	15,120	42,966
Depreciation Expense	39,600	54,000	18,000
Operating Cash Flow	62,280	69,120	60,966
Increase in WC	(2,430)	(2,552)	-
Annual Cash Flow	59,850	66,569	60,966

Schedule Five (page 2) **Used Equipment/ 5% Growth Rate**

Terminal Cash Flows	Year 3 $
Sale of Equipment	9,000
Book Value	8,400
Taxable Gain	600
Income Taxes	180
Cash Flow From Sale	8,820
Liquidation of WC	53,582
Terminal Cash Flows	62,402

	Year 0	Year 1	Year 2	Year 3
Cash Flows	$ (168,600)	$ 59,850	$ 66,569	$ 123,368

Cash Payback Period	2.69
Discounted Cash Payback Period	3.00
NPV	$ 14,895
IRR	19.63%
MIRR	18.29%

	Cash Flow	Cumulative CF	
Year 0	$ (168,600)		
Year 1	$ 59,850	$ (108,750)	1.00
Year 2	$ 66,569	$ (42,182)	1.00
Year 3	$ 60,966	$ 18,785	0.69
			2.69

	Cash Flow	Discounted CF	Cumulative CF	
Year 0	$ (168,600)		$ -	
Year 1	$ 59,850	$ 52,043	$ (116,557)	1.00
Year 2	$ 66,569	$ 50,335	$ (66,221)	1.00
Year 3	$ 60,966	$ 40,086	$ (26,135)	1.00
Terminal CF	$ 62,402	$ 41,030	$ 14,895	3.00

Schedule Six (page 1) **New Equipment/ 5% Growth Rate**

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Sales Volume- Total (gallons)		600,000	630,000	661,500	694,575	729,304	765,769	804,057
Selling Price (per gallon)		$ 4.05	$ 4.05	$ 4.05	$ 4.05	$ 4.05	$ 4.05	$ 4.05
Blending Cost (per gallon)		$ 0.17	$ 0.17	$ 0.17	$ 0.17	$ 0.17	$ 0.17	$ 0.17
Material Variable Cost (per gallon)		$ 3.53	$ 3.53	$ 3.53	$ 3.53	$ 3.53	$ 3.53	$ 3.53
Total Production Variable Cost (per gallon)		$ 3.70	$ 3.70	$ 3.70	$ 3.70	$ 3.70	$ 3.70	$ 3.70
Selling and Adminstrative Expenses		$ 0.20	$ 0.20	$ 0.20	$ 0.20	$ 0.20	$ 0.20	$ 0.20
Tax Rate		30%	30%	30%	30%	30%	30%	30%
WACC		15%	15%	15%	15%	15%	15%	15%
Working Capital (WC) as Percent of Sales		2%	2%	2%	2%	2%	2%	2%
Required WC	$ 48,600	$ 51,030	$ 53,582	$ 56,261	$ 59,074	$ 62,027	$ 65,129	
Required Increase in WC		$ 2,430	$ 2,552	$ 2,679	$ 2,813	$ 2,954	$ 3,101	$ (65,129)

Acquisition Cash Flows	Year 0
	$
Equipment Cost	360,000
Installation Cost	60,000
Increase in WC	48,600
Total Project Cost	468,600

Operating Cash Flow Projections

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
	$	$	$	$	$	$	$
Sales	2,430,000	2,551,500	2,679,075	2,813,029	2,953,680	3,101,364	3,256,432
Variable Costs	2,220,000	2,331,000	2,447,550	2,569,928	2,698,424	2,833,345	2,975,012
Gross Profit	210,000	220,500	231,525	243,101	255,256	268,019	281,420
Selling and Adminstrative Expenses	120,000	126,000	132,300	138,915	145,861	153,154	160,811
Depreciation Expense	58,800	105,000	71,400	54,600	37,800	37,800	37,800
Earnings Before Taxes	31,200	(10,500)	27,825	49,586	71,596	77,065	82,809
Income Taxes	6,240	(2,100)	5,565	9,917	14,319	15,413	16,562
Earnings After Taxes	24,960	(8,400)	22,260	39,669	57,276	61,652	66,247
Depreciation Expense	58,800	105,000	71,400	54,600	37,800	37,800	37,800
Operating Cash Flows	83,760	96,600	93,660	94,269	95,076	99,452	104,047
Increase in WC	(2,430)	(2,552)	(2,679)	(2,813)	(2,954)	(3,101)	
Annual Cash Flows	81,330	94,049	90,981	91,456	92,123	96,351	104,047

Schedule Six (page 2) **New Equipment/ 5% Growth Rate**

Terminal Cash Flows	Year 7
	$
Sale of Equipment	60,000
Book Value	16,800
Taxable Gain	43,200
Income Taxes	8,640
Cash Flow From Sale	51,360
Liquidation of WC	65,129
Terminal Cash Flows	116,489

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Cash Flows	$ (468,600)	$ 81,330	$ 94,049	$ 90,981	$ 91,456	$ 92,123	$ 96,351	$ 220,536

Cash Payback Period	5.19
Discounted Cash Payback Period	NA
NPV	$ (44,288)
IRR	12.16%
MIRR	13.38%

	Cash Flow	Cumlative CF	
Year 0	$ (468,600)		
Year 1	$ 81,330	$ (387,270)	1.00
Year 2	$ 94,049	$ (293,222)	1.00
Year 3	$ 90,981	$ (202,241)	1.00
Year 4	$ 91,456	$ (110,785)	1.00
Year 5	$ 92,123	$ (18,662)	1.00
Year 6	$ 96,351	$ 77,689	0.19
			5.19

	Cash Flow	Discounted CF	Cumlative CF	
Year 0	$ (468,600)			
Year 1	$ 81,330	$ 70,722	$ (397,878)	1.00
Year 2	$ 94,049	$ 71,114	$ (326,764)	1.00
Year 3	$ 90,981	$ 59,821	$ (266,943)	1.00
Year 4	$ 91,456	$ 52,290	$ (214,652)	1.00
Year 5	$ 92,123	$ 45,801	$ (168,851)	1.00
Year 6	$ 96,351	$ 41,655	$ (127,196)	1.00
Year 7	$ 104,047	$ 39,115	$ (88,081)	1.00
Terminal CF	$ 116,489	$ 43,792	$ (44,288)	7.00