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JOURNAL OF THE INTERNATIONAL ACADEMY FOR CASE STUDIES

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LETTER FROM THE EDITORS

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

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

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

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

Inge Nickerson, Barry University
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CASES

GONE WITH THE WIND: HOME DEPOT IN FLORIDA

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Neil Hunt, Suffolk University
Hasan Arslan, Suffolk University

CASE DESCRIPTION

This is a field/secondary researched case that describes multiple operational issues that are faced by Home Depot store managers located in areas that have a high probability of encountering hurricane activity. The problem for the character in the case revolves around how a large retail operation can manage its inventory levels and logistic concerns while maintaining the desired service level. The surge of sales before a hurricane makes landfall helps to increase store revenues. To prevent stock out, stores need to quickly raise the inventory level of popular items; however, items not sold during the rush before the hurricane makes landfall may have to stay in the store until the next hurricane. Worse, these items may have to be shipped to other stores faced with incoming hurricanes in other geographical areas. Such additional transportation increases cost per unit item, thus reducing profits. Therein lies the potential conflict of interest between the local store manager and the regional distribution center management team.

CASE SYNOPSIS

This case focuses on the pre-hurricane planning analysis of a home material supply company located in a hurricane prone area. In the age of information, as weather information becomes readily available, stakeholders are increasingly less forgiving of mismanagement of weather risk. The conflicting goals of maintaining service quality while maintaining low cost operation is a common challenge faced by many retail industries. In this case, students are exposed to the complexity of inventory management during hurricane season at the retailers and the Home Depot distribution center. The case includes a simulation exercise with role playing as an alternative to standard in-class case analysis because of the engaging nature of the exercise. The information used in this simulation, such as strength, path, and landfall locations of each hurricane, is based on actual data from National Hurricane Center and NASA.

INTRODUCTION

It was 80° beneath the sunny and humid blue Florida sky. A gentle Gulf Coast breeze carried the smell of the ocean across the parking lot in front of the Home Depot in Ft. Myers. Seagulls drifted above the shoppers, looking for that fallen ball of ice cream or corn dog. Neil, a Florida professor of operations management, pulled into the lot and joined the flood of hurricane shoppers.

The first hurricane of the season was approaching, and the memory of what Hurricane Mitch did the previous year was still fresh in people's minds. The latest news updates from the National Hurricane Center for the entire Florida Gulf Coast projected that this hurricane would make landfall in the Lee County area. It seemed like Mother Nature and Neil's retirement home were about to collide.

A steady stream of shoppers poured into the Home Depots and Lowes stores all over Florida, looking for supplies like batteries, duct tape, plywood, and even generators, to prepare for the hurricane and its aftermath.

"What are they going to do this time?" Neil wondered. At the end of last hurricane season, Neil had observed a local store that had ordered too much plywood and other items before the final hurricane of the season made landfall. The store had carried those inventories until Christmas. Yet, the year before that, the store had had too little inventory in stock. Panicking customers cleared the store out 72 hours before a hurricane hit. Neil estimated that the lost sales were in the tens of thousands of dollars. Neil thought this was hardly the right way to manage operations under impending natural disaster, and he decided to dig deeper.

HOME DEPOT IN FLORIDA

The Home Depot, Inc. operated warehouse-style stores that sold building materials, home improvement supplies and lawn and garden products, primarily to do-it-yourselfers. In addition, the Company operated EXPO Design Center stores, which offered products and services related to design and renovation projects; Home Depot Landscape Supply stores, which serviced landscape professionals and garden enthusiasts with lawn, landscape and garden products; and Home Depot Supply stores which distributed products and sold installation services to businesses and governments (Reuters abridged business summary, www.yahoo.com, 04/01/05).

At the end of the fiscal year 2003 (ended February 1, 2004), the Home Depot operated 1,707 stores in total in the United States, Canada and Mexico. Their formula for success was a simple one: warehouse stores that featured everyday low pricing, extraordinary customer service, quality products and a very large assortment of items – each store typically carried 50,000 SKUs, i.e., Stock Keeping Unit (www.supplychainbrain.com/archives/4.98.homedepot.htm).

Home Depot had nine stores in the Lee County area of Florida (Please see Exhibit A) and operated at two levels of procurement and distribution. Due to the large amount of selling space in

each store, domestic goods typically were delivered to store without intermediate handling at a distribution center. There was a benefit to this practice. "With a domestic product, you can have regular meetings with our vendors and you have products that are unique to geographical areas," said Don Paul, Home Depot's director of import inventory management (www.supplychainbrain.com/archives/4.98.homedepot.htm).

With the growth of international vendors, Home Depot elected to operate two large import distribution centers to supply their regional locations, one on each coast. These locations acted as vendors to Home Depot stores. The Lee County stores were serviced by a 1.4 million square foot center located in Savannah, Georgia. This International Home Depot Distribution Center was about 460 miles away from Lee County, Florida. This means the average transportation time alone, from the distribution center to stores in Lee County, will be around 8 hours.

TO ORDER OR NOT TO ORDER?

At the beginning of the hurricane season, local stores typically experienced surges in sales which helped to increase revenue. Florida was visited by an annual average of four hurricanes. When the public was faced with news of an incoming hurricane, they rushed to stores like Home Depot to snatch up supplies. The sales volumes of items such as plywood boards, generators, and similar items tended to skyrocket during the last 48 hours before the hurricane landed. To prevent stock out, managers often hiked the inventory level of popular items in the face of an incoming hurricane.

Long term weather forecasts, particularly those related to hurricanes, could be highly inaccurate. Stock items that were not sold during the rush before a hurricane landfall often would remain in the store until the next hurricane visit. Sometimes, those inventories were shipped to other stores faced with incoming hurricanes. This move incurred additional transportation costs, thus reducing profits. In 2004, four hurricanes passed through southeast Florida, which helped increased Home Depot's sales. However, profit did not increase because Home Depot had to move personnel and merchandise from other areas into the stores close to the areas hardest-hit by the storms (Morse, 2004a).

In 2004, after Hurricane Charlie made landfall in Florida, Home Depot mobilized thousands of truckloads of lumber, generators, tarps and other products over a matter of weeks (Scott, 2004) and moved them into the areas under impact of the storm.

According to Robert Nardelli, chairman and chief executive of Home Depot, profit from the increased sales of supplies in September 2004 was tempered by the greater operating costs. These costs included housing more than 1,000 workers from other states to help reopen closed stores and the labor costs associated with moving product from stores as far away as the West Coast to help replenish depleted stocks.

"We are pretty well balanced out," Nardelli said in an interview. "You have the mad rush first, then you have no sales, then you have post sales that are really product specific, so you really aren't selling the whole store (Some Businesses Boom After Florida Storms, ABC News, September 9, 2004)."

Lowe's, Home Depot's largest competitor, shifted excess stock from stores to regional distribution centers to replenish products directly where they were needed more quickly. However, this meant Lowe's had to hire extra workers and had to expand storage capacity (Morse, 2004b). The preferred logistics management approach was unclear.

In early September 2004, Hurricane Frances hit Florida. On Friday morning, September 3, 2004, MSNBC announced a five-day forecast of the hurricane's path (Please refer to Exhibit B). However, since the path of a hurricane was affected by many other weather conditions such as the surface temperature of ocean and the barometric pressure of the region in front of the hurricane, the reliability of such path prediction was low. Even though a five day forecast should have allowed the store managers to prepare in advance, the uncertainty about the forecast of France's path was more than 300 miles for a forecast beyond 48 hours. So, if the store served a 30-mile radius and the path of the storm could be off by 300 miles (a factor of 10), it became doubtful how much advance preparation Home Depot could do.

LOCAL SERVICE VERSUS REGIONAL PLANNING

When a hurricane approached, Home Depot had several choices of action. They could simply ignore the potential demands. This was deemed inappropriate because of the fierce competition with other local stores such as Lowe's (http://www.lowes.com).

Prior to 2004, Home Depot's Regional purchasing system required direct shipment from vendors to Home Depot locations throughout Florida. A direct shipment method would shorten the order-to-delivery lead time from venders to stores, thus creating a more responsive supply chain. However, in 2004, Home Depot centralized the ordering and the distribution of inventory throughout Florida, particularly during hurricane season. With the centralized replenishment system, orders and delivery had to be routed through the distribution center. This centralized system improved the coordination of inventory management among stores, but slowed down the response time of the Home Depot supply chain because the distribution center was located in Georgia. It also created potential conflicts between local store managers and the regional planner.

LATER IN THE STORE…

After waiting nearly two hours in line, Neil finally got inside the store. Shoppers were hurrying in all directions to pick up hurricane items. Many shelves were already near empty. It seemed the store had once again underestimated the surge demand on some items. Neil knew

managing inventory during the hurricane seasons was complicated, particularly for chain stores such as Home Depot.

"What was the right way to prepare for unpredictable, yet known, natural disasters?" Neil wondered. "How can I be sure I can get the supplies I need in time? Could I improve Home Depot's inventory management during the hurricane season? How could I balance the potential conflicting considerations between operational cost control and service quality management? How would I handle the potential conflicting considerations between the regional manager and the local store manager?"

Suddenly, Neil smiled. "This could be an excellent discussion topic with my students…"

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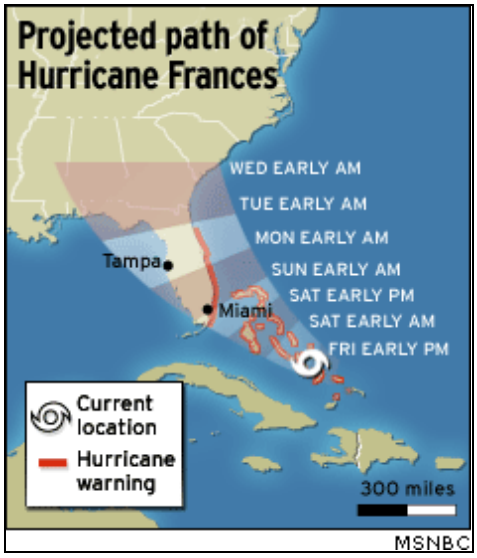
Morse, D. (2004b, November 16). Lowe's Net Rises 16% on Hurricane-Fueled Demand. *Wall Street Journal,* p. 1.

Scott, S. (2004). The Home Depot® Donates $3 Million to Aid Florida and Other Areas in Hurricane Rebuilding Efforts. Retrieved June 30, 2006, from http://www.cns.gov/news/pr/092204.html

EXHIBIT A: HOME DEPOTS LOCATED IN LEE COUNTY AREA

This map highlights locations of Home Depot stores in Lee County, Florida, in 2004.

EXHIBIT B: PROJECT PATH OF HURRICANE FRANCES



This map shows the forecasted path of hurricane Frances on Friday evening, September 3, 2004. The shaded region leading the current location of the hurricane represents the future location of the hurricane. As shown, the width of the shaded region is narrower for Saturday Early AM than that for Sunday Early AM. The widening boundary of the shaded region implies that it is more difficult to predict the future location of hurricane 36 hours in advance than 12 hours in advance.

FIDUCIARY FOLLY LEADS TO FIASCO: THE CASE OF CONSOLIDATED PIPELINE AND EQUIPMENT CORPORATION (CPEC)

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

CASE DESCRIPTION

The primary subject matter of this case involves the agency relationship between Steve Shelton, a fiduciary (the accountant) and his client and friend, Paul Jameson. Paul's son, Jim Jameson, has brought a lawsuit against Paul and Steve, because of his dissatisfaction with the recent sale of his property. Secondary issues include gratuitous agent issues, agent liability, and confidential relationship liability. The case has a difficulty level appropriate for undergraduate Business Law or Accounting courses. The case can be taught in 1-2 class hours, depending on the desired detail level for the discussion. It should take approximately one hour of outside preparation by students.

CASE SYNOPSIS

Jim Jameson, former president of CPEC Pipeline and Equipment Corporation (CPEC) has brought an action against his father and his father's accountant. His father, Paul, is the 100% owner of CPEC, and has arranged the sale of the business to a third party for $65 million. One year earlier Jim's employment as CPEC president had been terminated for alleged mismanagement. After Jim's termination Paul resumed duties as president of CPEC during the structuring of the sale of the business.

Following his termination, but prior to the sale of CPEC Jim was paid $3.8 million by CPEC (at his father's direction) for a parcel of land Paul had essentially given to Jim five years earlier. The fair market value of the land at the time of this transaction was about $1.2 million. The purpose of the purchase in excess of the actual value was to transfer an "inheritance" of sorts to Jim while avoiding the tax consequences of a gift tax. The burden of the tax was then Jim's, a further irritating aspect of the transaction.

Following the sale of CPEC Jim now claims the $3.8 million he received for the land did not represent an amount acceptable for an inheritance. Jim also felt that the land was of substantially higher value to the firm, and that the sale of the business was somehow tied to the inclusion of the

land. His conclusion was that the land is actually worth substantially more than the $3.8 million he was paid.

Interestingly, if Jim's conclusion is correct, then the amount paid does not exceed the value of the land, and there would be less suspicion of a fraudulent avoidance of taxes by Paul. If Jim is wrong in his conclusion, Paul and the firm would be suspected of fraudulent avoidance of taxes, but would have greater wealth to offer the firm's purchaser. The main question addressed by the case is whether Steve, the accountant for CPEC, owes a fiduciary duty to Jim in connection with this land sale.

BACKGROUND

The Jameson family lived in Dallas, Texas. Paul Jameson worked as a welder. Paul and his son Jim Jameson have always had a volatile relationship. Paul divorced Jim's mother when Jim was very young. Jim Jameson was raised by his mother in Oregon. Shortly before high school the family moved back to Dallas, Texas. While his son lived in Oregon, Paul Jameson built a successful business from the ground up. Paul had spent years growing and developing product lines and customers. The work was time consuming and Paul had little time for anything but work.

After Jim's arrival back in Dallas, his father tried to mend their broken relationship. After high school graduation Paul offered Jim a job a CPEC. Jim began his career as a floor sweeper. It was Paul's dream that Jim would start at the bottom and work his way up the ladder. Someday he hoped that Jim would take over the company. Through time Jim advanced in the company. He became vice president of marketing and client development. Later, Paul had a health problem that required him to take time away from CPEC. Paul turned CPEC over to Jim, making Jim president.

For a brief period all seemed well. Paul regained his health but allowed Jim to continue as president. However, one day Paul went to lunch with a couple of employees and serious concerns regarding Jim's performance arose. Paul decided to investigate the situation. He pulled previous month's financial statements. He reviewed payments made to vendors. He realized that there were several payments to companies he had never heard of before. After further investigation he realized that the companies did not exist and that the checks were in fact cashed by Jim Jameson. At this point Paul had a very serious decision to make, he had to terminate his own son's employment with CPEC.

After Jim's termination, Paul decided to sell CPEC. At his advanced age he no longer wanted the stress of running a large company. He began to look for buyers. Paul knew that he would need assistance with the sale of CPEC, so he hired his longtime accountant and friend, Steve Shelton. Steve would assist in the accounting work and serve as a liaison between the attorneys and Paul.

As negotiations began between several potential buyers Steve coordinated and structured the deal. He continued to pursue the most advantageous deal for his clients, Paul and CPEC. After almost a year of negotiations the final deal was hammered out with the internationally known

Halliburg, Inc. It was an excellent deal for Paul. Steve constructed a primarily cash deal. As CPEC's sole shareholder, Paul stood to net approximately sixty-five million dollars.

There was one final issue that needed to be resolved. Originally there were two parcels of land that CPEC owned. Parcel A was where the original facility was located. This four acre parcel has a small three thousand square foot warehouse. Parcel B was the main parcel, which included the current seventy thousand square foot office, warehouse and welding facility. At the time, Parcel A was not being used by CPEC. Parcel A was owned by CPEC. However, Paul essentially gave the parcel to Jim when he sold it to him for one dollar. As part of the original deal CPEC was supposed to include Parcel A with its sale. Paul asked Steve to talk to Jim about selling his parcel.

Steve contacted Jim regarding the sale of Parcel A. Jim was aware that Paul was in the process of selling CPEC. Jim informed Steve that he would sell, if the price was right. Through several conversations with Jim, Steve realized that Jim was trying to extort the situation. Steve informed Paul and Halliburg of the situation. Halliburg stated that owning Parcel A was not a deal breaker. It was at this point that Jim ceased to have any leverage in the sale of CPEC.

Steve had an idea. The relationship between father and son had degenerated to the point that they were almost completely estranged. Steve did not want to see Paul completely end his relationship with Jim. Steve contacted Paul regarding giving Jim an inheritance through the sale of Parcel A. If Paul purchased Parcel A, it would not be considered a gift and Jim would have to pay any tax on the profit. Paul did enjoy his relationship with his grandchildren. He believed that if he could somehow appease Jim maybe their relationship could be salvaged. Paul authorized Steve to begin negotiations with Jim.

Steve contacted Jim regarding the purchase of Parcel A. Jim appeared agreeable to selling the land. Conversations continued and a deal came together. Steve contacted an attorney to draft the sale documents. Steve calculated that even in the best real estate marked that the value of Parcel A was worth $1.2 million. He realized that the value of the land could not be too far from the sale price or the Internal Revenue Service could potentially have an issue with the transaction. The other issue that Steve had to contend with was Jim's greed. Steve believed that Jim saw this as his one last opportunity to make some money off his father.

Jim was holding fast to the belief that he could make ten million dollars from the sale of Parcel A. This was considerably more than Paul was willing to pay. Steve had a couple of very intense conversations with Jim. The conversations centered on the fact that Paul no longer required Parcel A to complete the sale of CPEC. If Jim was to make any money from the sale he needed to be reasonable. Finally, after months of negotiations the deal was finalized. Jim walked away with a check for $3.8 million from the sale of Parcel A. Jim made more than three times the fair market value of Parcel A.

After the sale of CPEC and Parcel A were completed, Jim and Paul had a major disagreement. Jim was very angry and felt that he could have made more money from his father. He sought the counsel of an attorney. He later filed suit against Paul and Steve. The suit against Paul was severed

from Steve's suit. Jim lost his suit against his father. However, it seemed that Jim was enjoying hurting anyone associated with his father.

Jim claimed in his lawsuit that Steve was his agent with relation to the sale of Parcel A. Thus, Steve owed to him all fiduciary duties that an agent owes to his master. Further, he claimed that there was a confidential relationship between the parties. The final claim centers on a charge of fraud relating to a fiduciary duty Jim believes he was owed by Steve.

THE TASK

Assume that you are an assistant to Steve's attorney. Answer the following questions in detail.

1. What duty does an accountant owe his client?

2. What is an agency relationship?

    a. How does an agency relationship begin?

    b. Who bears the burden to prove that an agency relationship existed?

    c. What liability does that pose to the agent?

3. What is a fiduciary duty?

    a. When does one owe a fiduciary duty?

    b. Can one owe a fiduciary duty even if one is not paid for his or her services?

    c. If "yes" what is the name for this duty?

4. Did Jim appoint Steve as his agent?

5. If Steve was, in fact, Jim's agent – what type of agent was he?

6. If Steve was not Jim's agent, was there any relationship between the accountant and son at all?

7. What is fraud?

8. Is there any evidence of fraud on Jim's part?

9. Is there any evidence of fraud on Paul's part?

10. If the sale of the parcel of land from Jim to CPEC for 3 times its actual value is fraud, who is liable?

11. If Paul relied on Steve's expertise in setting up the sale of the land, does Paul have any recourse against Steve?

12. Is it possible that a court could find there was no agency relationship in the sale of land in excess of its true value?

ABC COATINGS, INC.: EQUIPMENT REPLACEMENT ANALYSIS

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CASE DESCRIPTION

This case presents a simple scenario to reinforce the concept of capital financing. The case involves a small manufacturing company which specializes in the powder coating technologies for metal components for automobile industry. The company is considering upgrading its current plant & equipment that would make the process of powder coating of metal surfaces more efficient. While improvement the technical efficiency is substantial with the proposed plant & equipment, however, the improvement adds a small increment in the financial benefits. The financial savings are less due to the capital cost of the new plant as well as the added cost of an IT worker. That is, the proposed upgrades are financially unadvisable. The objective of the case is to illustrate the difference between technical efficiency and financial feasibility. The situation is a relatively simple one, appropriate for use in undergraduate production/operations management, managerial accounting or financial management courses. The case should require minimal preparation by students and should take no more than one hour to complete in-class.

CASE SYNOPSIS

The coating of industrial parts and consumer goods is one of the most commonly used techniques for metal surfaces to provide a finishing layer, to enhance protection from corrosion, to change the surface properties, and/or to add sparkle or shine. Most common coating techniques involved solvent based coating like basic painting. However, solvent-based coating has relatively poor durability. To improve the durability and reduce cost, several industries are moving towards powder coating techniques for metal surface preparation. The powder coating is increasingly used in many industries like household appliances, automotive parts, construction machinery, building material, military equipment, furniture, and others. Powder coating also has specialty usage like application of non-stick coating on pots and pans. Powder coating comprises approximately 20% of the market for metal finishing where it competes directly with traditional liquid finishes like paint.

ABC Coating is a manufacturing vendor to several automotive part manufacturing companies in the country. It operates as a turnkey vendor to these companies and provides coating services on

a variety of parts. Most of its work involves coating of metallic automotive parts. It has a turnover of about $10 million and is growing at a good pace of 2-5% per year in the last four years. Most of its growth is coming due to reduced competition, as several of powder-coating companies have closed due to overseas competition. However, this is also putting pressure on the ABC Coatings to cut cost to meet the overseas competition. This is the main justification for the ABC coating to update and upgrade its facilities. It hopes to reduce labor cost as well to improve product cycle time.

PROCESS OF POWDER COATING

The powder coating method is a process of application of a surface layer without any solvent. In general, a free flowing powder is applied to the surface of the product. This surface is subsequently heated so the powder can stick to the metal (or non metal) product surface.

The process involved three major steps

1. Surface preparation
2. Powder Application
3. Heating or Thermosetting of powder coating

Surface preparation involves cleaning of the metal part surface. The cleaning of surface is very critical for the quality of the product as coating can only adhere to clean surfaces. Mostly, for metal part chemical spray or chemical bath cleaning process is used. Product is dried out completely after the cleaning.

A dry product surface is then sprayed with the powder coating. The most metal coating use is epoxy or polyester based powder. The powder is sprayed using an electrostatic spray gun. The electrostatic property allows the powder to stick to the surface temporarily.

The product is then passed through or kept in an oven at an appropriate temperature for powder to melt and to stick to the surface. Once powder is evenly melted, the part is allowed to cool to room temperature. Time and temperature of heating depend upon the type of material and type of coating. (Wikipedia, 2007)

FACILITIES NEEDED

The company is planning to upgrade and to automate main processes related to the surface coating of metal parts. That is, the process of part cleaning, power spraying and thermosetting will be updated. Currently, it is setup as a three-station facility. These stations are independent of each other. The parts are moved from one station to another station on industrial carts.

The new facility will include interconnected stations connected via automated conveyor systems. These stations will perform cleaning, drying, power spraying, and thermosetting in succession. The company also owns a fleet of forklift trucks and other carts as the material handling equipment. The new facility will not need some of these material handling equipments at the manufacturing floor, as the company is planning to put an automated conveyor belt system for material handling with the shop floor. However, the fleet of forklift trucks will still be used in the shipping and receiving area.

Like any industrial plant, ABC Coating has areas for storage of raw material and finished goods as well as receiving and shipping areas. It also owns the equipments needed in the receiving and shipping area. These facilities and equipments are in good conditions and do not need any immediate investment. Furthermore, since most of the ABC's customers are from the automotive industry and the company is part of a regular supply-chain with its customers. This allows the company to carry only one week of inventory of raw material and finished goods in a normal business cycle. Given the lower inventory levels requirements, ABC Coatings does not see a need of increasing storage facilities in the near future.

Similarly, the powder and chemical storage facility also will not have any changes. The company has sufficient storage facility for the current needs as well as the future needs for 3-5 years. In the same way the waste handling systems, which are a main part of chemical cleaning processes, will not need any improvement.

COST OF NEW PLANT

The cost of new equipment is listed in the Table 1 below. The new plant upgrade relies on the computer aided tools to support the operations. The ABC Coating, Inc. does not have any significant computer expertise. Therefore, the new plant will require IT training as well as at continual annual support for the IT infrastructure from the vendor of the system.

Table 1: Estimated Cost of New Equipment and IT Installation

Item	Cost
Two semi-automated conveyor drive integrated systems for powder coating $500,000.00 each	$1,000,000.00
Automated conveyor belt systems to connect receiving and shipping areas	$600,000.00
Installation of new systems	$500,000.00
Computer control systems (turnkey) (System cost includes HW and small business MRP software)	$500,000
Training	$250,000
Total	$2,850,000

WORKFORCE

The change in the plant will change the workforce as well. The plant will move from more manual and partly mechanized machines to largely computer controlled tools and equipment. Tables 2 and 3 provide the current and proposed workforce structure. The Tables 2 and 3 also provide the salary rates of old and new workers. The workforce requirement will change in the new plant as company will require less workers and supervisors. Currently, the total workforce is 33 workers. In the new plant, less than 50% of the current workforces will be needed. However, new plant will add a new category of worker called system operator. This IT worker is not needed in the old plant. Typically, an hourly-wage worker works 2,000 hours per year. The company has not incurred any significant overtime cost in the past few years.

Table 2: Current Workforce Classification and Salary Rates

Type	Number	Salary or Hourly Rate
Pallet Movers	5	$10.00/hour
Machine Operators	12	$15.00/hour
Line Workers	10	$16.00/hour
Supervisors	3	$85,000 per year
Schedulers	3	$45,000 per year
Total	33	

Table 3: Proposed Workforce Classification and Salary Rates

Type	Number	Salary or Hourly Rate
Pallet Movers	2	$10.00/hour
Machine Operators	5	$15.00/hour
Line Workers	5	$16.00/hour
Supervisors	2	$85,000 per year
Schedulers	1	$45,000 per year
System Operator	1	$75,000 per year
Total	16	

INFORMATION TECHNOLOGY AND OPERATIONAL COST

The new plant will rely on MPR software to carry out most of the plant scheduling and control functions. The functioning of the system will be critical for the proposed plant. The company will have to buy service agreement with the software vendor after installation That is, the software company only priced in the cost of the product and installation. The service plan is not included in the system installation cost. The service agreements cost varies from $25,000 per year for full support to $8,000 per year for minimal technical support. This company has lower IT skill set hence would be buying the full service agreement after installation of the system.

Direct materials cost is expected to remain constant with the introduction of the automated assembly system. There may be some slight improvements based upon better operations, but these savings is hard to estimate at this time. It is expected that there would be an increase in electric usage of the new system. The increased in the monthly expense is expected to be about $1,500 a month.

The proposed plant will have lower payroll cost as it will need only 16 employee as opposed to 33 in the current system. The company estimates benefit cost as a percentage to the total employee payments. The benefit cost rates of the hourly workers and yearly employees are 30% and 40% respectively.

The equipment will be depreciated over a ten-year useful life. The equipment will have no salvage value. The corporate tax rate is 35%. The company's cost of capital is 8%. Also, assume that old plant is fully paid and depreciated at this time.

OTHER COSTS DISCUSSION

The firm currently spends $50,000 per year on the cleanup of minor chemical spills in the manufacturing process. The introduction of the new equipment should reduce the cost to $10,000 per year. Besides cleanups of minor spills, there is a small probability of a major chemical spill. Pressure from the firm's liability insurer and a threat of potential governmental actions concerning cleanup after a major spill are encouraging the company to look into the potential cost of a major spill. Besides most major clients also wants company to maintain high environmental management system's (EMS) standards. The cost of government mandated cleanup after a major spill may also come with substantial penalties, which the company would like to avoid. The new plant and equipment are good for reducing the chance of a major spill. There is only a one percent probability that a major spill would occur within the current system. If the new equipment is installed, the probability of a major spill would decline to one-tenth of a percent. After a review with the insurance company, ABC Coatings has learned that a major spill could cost approximately $10,000,000.00.

The new equipment would provide up to 25% increase in production capacities. At present, the company is operating at 80-85% capacity. The management is not necessarily optimistic that it can increase sales at this point beyond current rate of 2-5%. The company can hold on to the current

market share if it can control its production cost. The cost reduction is becoming increasingly important due to cheaper foreign competitors. In other words, the management is simply considering the new plant to reduce the production cost not because of potential of higher production capacity. Therefore, any increase in sales is ignored in the current calculations. The company would remain viable for the next ten years. To solve its dilemma of whether to upgrade or not, the company has also provided the last two years of its income statements and balance sheets. The income statements and balance sheets are included in the Tables 4 and 5. Also inflation considerations are ignored at this time.

Table 4: Income Statement of ABC Coatings, Inc. for 2006 and 2007 (McLain, et al. 2003).

Item	2007	2006
Net Sales	$10,315,881	$9,474,409
Cost of Goods	$8,489,024	$7,757,539
Gross Margin	$1,826,857	$1,716,870
Operating Expenses	$1,613,035	$1,587,097
Other income/expenses	$17,042	$4,743
Income Before Taxes	$230,864	$134,516
Income Taxes	$62,333	$36,319
Net Income	$168,531	$98,197
Extraordinary Item	$0	$0
Net Income after Extra	$168,531	$98,197
Preferred Dividends	$0	$0
Net Income for Common	$168,531	$98,197

Table 5: Balance Sheet of ABC Coatings, Inc. for 2006 and 2007.

Items	2007	2006
Assets		
Cash	$95,089	$41,488
Marketable Securities	$0	$0
Accounts Receivable	$544,809	$463,894
Allowance	$0	$0
Net Receivables	$544,809	$463,894

Table 5: Balance Sheet of ABC Coatings, Inc. for 2006 and 2007.		
Items	2007	2006
Inventories: (Finished, WIP, Material/Supply)	$442,588	$480,950
Other Current Assets	$0	$9,189
Total Current Assets	$1,082,486	$995,521
Investments	$0	$0
Trademarks & other Assets	$23,826	$19,581
Total Property (Land, Building, Machine, etc.)	$1,453,611	$1,292,417
Accumulated Depreciation	$876,784	$770,988
Net Property Plant & Equipment	$576,827	$521,429
Intangible Assets	$0	$0
Total Assets	*$1,683,139*	*$1,536,531*
Liabilities		
Notes Payable	$148,832	$119,489
Accounts Payable	$824,447	$674,936
Accrued Liabilities	$0	$0
Payroll & Employee Benefits	$12,298	$16,560
Advertising	$0	$0
Other Taxes	$0	$0
Income Taxes	$13,223	$10,582
Other	$0	$0
Total Accrued Liabilities	$25,521	$27,142
Current Maturities on Long-term Debt	$0	$0
Total Current Liabilities	$998,800	$821,567
Long Term Debt	$185,084	$238,133
Deferred Income Taxes	$0	$0
Other Liabilities	$0	$0
Minority Interests in Subsidiaries	$0	$0
Owners Equity		
Stockholders Equity	$499,255	$476,831
Total Liabilities and Stockholders Equity	*$1,683,139*	*$1,536,531*

CASE QUESTIONS

1. Should ABC Coating Company acquire the new machines and modernize its plant?

2. Prepare a schedule of the current system and the cost of the proposed system.

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THE BANKRUPTCY OPTION: DOES THE UNITED AIRLINES MODEL WORK FOR GENERAL MOTORS?

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CASE DESCRIPTION

This case analyzes the actions taken (or potentially taken) by two financially distressed American corporate icons. The first company, United Airlines (UAL), awash in debt, filed for bankruptcy in 2002. Until its bankruptcy filing, UAL had hoped for government loan guarantees to bail it out. When these guarantees failed to materialize, UAL was left owning a fleet of planes twice the size it needed, (Cite: Dis-united) paying wages pursuant to an uncompetitive union wage structure, and experiencing shrinking revenues due in part to lower air travel post 9/11. It filed for bankruptcy in 2002 and emerged as a new company in 2006.

General Motors (GM), the second company, also faced the possibility of bankruptcy in 2008. At that time, it operated a number of manufacturing plants manned by unionized American employees who earned tens of dollars per hour more than GM's international competitors. This considerable wage/benefit cost disadvantage coupled with a shrinking revenue base, aging manufacturing capacity, more dealers than it needed, and rising debt levels pushed GM towards bankruptcy. At the end of 2008, GM too awaited a government bailout.

This case looks at financial and operating restructuring opportunities available to a company through bankruptcy. First, the case looks at interest savings achieved by UAL after emerging from bankruptcy. The case posits the question, are these savings (attributed to UAL's lower levels of debt), available to GM if it filed for bankruptcy protection?

This case also looks at the operating cost savings demonstrated by UAL following emergence from bankruptcy. Although in a different industry, the case leads students through calculations of operating cost savings potentially available to GM through bankruptcy. These include costs such as wages, benefits, and supplier costs (if GM follows the UAL model).

Finally, the case looks at issues pertaining to organized labor and, in particular, legacy costs. These costs are credited with handicapping and diminishing the competitiveness of both American auto manufacturers and older airlines worldwide. "Legacy costs" is the term used for worker pensions and health care benefits that were negotiated in past collective bargaining agreements and incurred by the organization under different leadership or when the organization's priorities and resources were different (Cooney, 2002, 2005). Because of benefits established and enhanced

through several decades of collective bargaining, the automobile industry finds itself supporting a large number of retirees and health care beneficiaries (Cooney, 2002, 2005).

Along with legacy costs, American autoworkers remain among the highest paid manufacturing workers in the world; sometimes paid when they do not work via the "jobs bank". The "jobs bank" is a program which gives American automobile union workers most of their pay and benefits while they are laid off, eliminating the need for such employees to seek unemployment benefits (Langlois, 2009). Another potential source of financial woe for the American auto industry is executive compensation. Rick Wagoner, CEO for GM, is paid a yearly compensation totaling around 14.4 million (Farago, 2008, Forbes, 2009). Many hate to see a wealthy CEO making millions of dollars with a golden parachute for running a company that might ultimately declare bankruptcy. Therefore, this case addresses the implications of managerial decision-making especially negotiations with union representatives' demands and/or concessions that are potentially needed to ultimately keep the American automobile industry solvent and competitive.

The case has a difficulty level of 4-5 and is recommended for college seniors and first year MBA students. With three major categories of issues covered (interest savings achievable through bankruptcy, operating cost savings achievable through bankruptcy, and issues related to bankruptcy and labor unions), it is expected the case will take three hours of class time. Students aware of current business events (such as the potential government bailout of GM) will require little or no outside preparation. Students who are unaware of the potential GM government bailout will need to review current business periodical articles on General Motors. Total outside of class preparation should not exceed one hour. (Note: Whenever possible, company financial data was taken directly from company published financial reports. When amounts were not specifically disclosed, estimates were used, based upon actual disclosed data.)

CASE SYNOPSIS

It is early 2008. The GM board of directors is meeting to discuss 2007 financial results. The results are not good. The company is preparing to announce that it just lost $38 billion and is $184 billion in debt. You, as a board member, have heard management's explanations of the losses for sometime now. You know that GM has too many manufacturing facilities, but union contracts prevent it from shutting them down. You know the average hourly wage/benefit package of a GM factory worker is $30 per hour higher than its non-union competition. However, union contracts bar it from cutting employee and retiree medical/pension costs that cause the cost differential.

Management has some good news. Sales are up and cost control efforts are starting to pay off. Some of the unprofitable GM dealerships are closing which is good news as you have too many dealers. However, the company is running out of cash. Management reports that under current conditions, it may have enough cash through 2009. However, if a recession occurs, it may be out of cash in 2008. Discussion turns to government bailouts. Board members bristle at government intervention when discussion focuses on the strings which may be attached.

Finally, a board member mentions the "B" word, and suggests filing bankruptcy and getting a fresh start. (Several airlines have done it and are up, operating, and profitable.) Members squirm in their chairs as a different board member discusses her experience with another bankrupt company. You are uneasy and ask management to investigate GM's options.

This case leads students through a three pronged approach of applying the airline bankruptcy model to GM. Questions focus students on bankruptcy's potential impacts on debt and interest, operating costs, and labor unions. Income statement and balance sheet assignments are provided.

UNITED AIRLINES (2002)

On December 9, 2002, United Airlines (UAL) filed for Chapter 11 bankruptcy protection, the largest bankruptcy ever in the airline industry. UAL, the country's second largest airline, crumbled under a staggering cost structure which included the highest wages in the airline industry. In 2000, UAL had agreed to wage increases for its pilots of 22-29% over the ensuing five years, a staggering amount given the inroads being made by discounters such as JetBlue and Southwest Airlines who were using lower priced nonunion labor. Along with higher labor costs, UAL also was saddled with $7.5 billion of unfunded pension and benefit obligations, another cost not borne by the discounters (USA Today). (Under fire) Finally, UAL was burdened with billions of dollars of future obligations for aircraft and facility (e.g. airport terminal) lease payments. Annual payments on the leases were approximately $2 billion per year at the time of the filing. (Annual report) Many of the leased aircraft had been ordered years before the bankruptcy filing and were no longer needed. In fact, at the time of the filing, UAL had already parked and stored 108 of its aircraft in the desert (Air finance).

In addition to an uncompetitive cost structure, UAL's revenue picture was equally dismal. Annual revenues which were $19 billion in 2000 and $16 billion in 2001 slipped to $14 billion in 2002. Revenue passenger miles, a common metric used in the airline industry to measure sales volumes, fell from 127 billion in 2000 to 109 billion in 2002. (Annual reports) Competition was steadily growing. Discounters in 2002 carried 23% of the air passengers. Discounters had increased this from 5% of the market just 10 years prior. (Dis-united) The net result of the higher costs and shrinking revenue base was that at the time of its bankruptcy filing, UAL was losing $22 million per day (Under fire). UAL's final gasp was to ask for a $1.8 billion loan guarantee from the government's Air Transportation Stabilization Board. This partial bailout was turned down and UAL filed for bankruptcy.

United Airlines (2007): On February 1, 2006, UAL emerged from bankruptcy. As such, 2007 (which is used in this case) was its first full year of operation as a new company. Changes to UAL were obvious. Its 2006 annual report touted its efforts in reducing debt by $13 billion and reducing annual operating costs by $7 billion. More specifically, much of the company's unsecured debt had been totally eliminated. Other layers of company debt were replaced with equity as prior debt holders were converted into UAL stockholders.

Union wage agreements were restructured with employees accepting lower wages. Nonunion wages were also reduced. Long term leases on aircraft and facilities were restructured providing billions in cash savings. Additionally new aircraft, which had been ordered, were rejected and UAL avoided payment for them as well. Finally, the company's employee benefit programs were restructured. This included the replacement of an expensive defined benefit pension plan with a new lower cost defined contribution plan. UAL 2002 and 2007 income statements and balance sheets are attached as Exhibits 1 & 2.

GENERAL MOTORS (2002)

In 2002, General Motors (GM) was the largest car company in the world, manufacturing and selling more cars than any of its competition. GM was profitable as well. In 2002 it earned $1.7 billion, up from $500 million in 2001. Car buyers in 2002 were still purchasing millions of SUVs and trucks. GM benefitted from this and was making thousands of dollars on each of the SUVs and trucks it sold. Despite its profitability, there were definite signs that financial problems at GM were present and growing. Unit sales of vehicles had been flat to decreasing since the mid-1990s. GM's percentage share of all cars sold worldwide was slipping as worldwide sales were increasing due to new developing markets and GM was not successfully competing in all these new markets.

GM's balance sheet was likewise showing fatigue. GM debt was growing, a result of its slipping operations and its need to borrow to fund its wholly owned subsidiary, GMAC. GMAC accessed the capital markets to borrow funds and provided financing to potential GM customers looking to buy a car. At the end of 2002, GM's capital structure contained approximately $363 billion of debt and only $8 billion of stockholder equity.

GENERAL MOTORS (2007)

By 2007 after GM had suffered years of shrinking market share, sales began to increase. Overall unit sales of cars increased by 10% over 2002 levels while revenues decreased 3% for the same period. The revenue decrease reflected, in part, a change in the type of cars sold. By 2007, increases in fuel prices had driven many consumers away from purchasing more expensive, less fuel efficient SUVs and trucks. The year 2007 also was GM's first complete year of operations without full ownership of GMAC. As such, GMAC revenues and expenses were not reflected on the 2007 GM income statement. In an effort to reduce its debt, GM had made a decision to sell 51% of GMAC in 2006 as well as portions of its ownership in other nonstrategic assets.

GM was also involved in massive cost reduction efforts in 2007. To the extent allowed by its collective bargaining agreements, GM shuttered excess manufacturing capacity. However, these opportunities to cut costs were limited. GM's collective bargaining agreements restricted its ability to close plants and lay off workers. The average hourly wage at a unionized GM plant was estimated

to be $78 per hour taking into consideration benefits. The comparable average wage at a non-union Toyota plant is estimated to be $47 per hour. (Muller) Costs not related to its union workforce were also reduced. GM's debt stood at $184 billion at the end of 2007. This was a sizable decrease from 2002 levels but primarily reflected the removal of GMAC debt from its balance sheet (along with GMAC customer receivables). GM's car sales operations continued to operate at a deficit. Yearend stockholder equity now stood at negative $35 billion reflecting accumulated losses since 2002. GM 2002 and 2007 income statements and balance sheets are attached as Exhibits 3 & 4.

LABOR UNIONS/LEGACY COSTS

The United Auto Workers union (UAW) has been very successful at achieving some of the highest wages in the industry while avoiding a corresponding requirement for the highest productivity from its members. However, this union success has created many of the problems that have led to the destruction of American automobile makers (i.e., GM, Ford and Chrysler). According to the New York Times (2009), "a shrunken United Auto Workers union has been negotiating with a fading domestic automobile industry for a new labor contract with health care costs as the principal issue. General Motors, Ford and Chrysler have said that health care and pension expenses cost them about $1,000 for every vehicle they sell, compared to a few hundred dollars per unit for their competitors Toyota, Honda and Nissan" (New York Times, 2009). The difference is because the domestic companies, which have been unionized for decades, have hundreds of thousands of retired workers drawing pensions and health benefits (legacy costs), whereas, the foreign-based companies have only been operating in this country for about two decades, so they have fewer retirees. Furthermore, the factories of the foreign automobile companies are not unionized.

The auto industry, in particular General Motors, is oppressed by legacy costs. Legacy costs are defined as pension and health care benefit provisions of worker contracts, especially for retirees (Cooney, 2002, 2005). Legacy costs provide benefits above and beyond related public entitlements. Such benefits were negotiated by unions to encourage workers to accept workforce downsizing and productivity improvements that were deemed necessary to keep companies competitive. Now many American automakers are facing bankruptcy, thus, leaving retirees and employees facing loss of benefits. In 2005, GM provided health and income benefits to more than 450,000 retirees and their surviving spouses (Perry, 2007). Retirees and their dependents outnumbered the company's active workforce three-to-one (Perry, 2007). This problem will continue to grow since nearly a third of GM's hourly workforce signed up for payout packages in 2006 resulting in more retirees and fewer workers. Therefore, GM, a company with 300,000 employees, is supporting the number of retirees appropriate for a company with a workforce of 800,000; almost triple the size (Mandel, 2007). Whereas Toyota and Honda, both growing companies, are supporting a retired base, which is relatively small, compared to their current workforces.

General Motors has proposed a plan to shift liability for health care coverage for employees and retirees into a trust that would be administered by the union, called a voluntary employee benefit association, or VEBA. A VEBA is an independent trust fund, similar in many respects to a pension trust. Money contributed to the VEBA can only be used to provide the company's health care benefits and can never be used for any other purpose. Even if GM were to someday file for bankruptcy or be taken over by another group of owners, the money in the VEBA would be secure. This step would allow GM to remove the projected cost of providing benefits from its books. An important principle is that the VEBA must be funded with sufficient cash and other assets to provide lifetime solvency based on current levels of medical benefits, using reasonable assumptions about health care inflation, investment returns and numerous other factors. The funding level must allow the VEBA to continue to provide benefits without change for the lifetime of current and future retirees.

Along with legacy costs, American autoworkers remain among the highest paid manufacturing workers in the world; sometimes paid even when they do not work via the jobs bank. The "jobs bank" is a program which gives American automobile union workers most of their pay and benefits while they are laid off, eliminating the need for such employees to seek unemployment benefits. When GM union workers are laid off from factory jobs, they will receive state unemployment and GM supplemental pay equal to about 72% of their normal compensation (Langlois, 2009). As those benefits expire, usually after 48 weeks, workers would then qualify for the jobs bank. Until December 2008, workers were paid 100% of their salary to report to a company location even if there was no work to do. As of late December 2008, GM workers who qualified for the jobs bank were told to stay home, and received 85% of their pay instead.

EXECUTIVE COMPENSATION/BENEFIT COSTS

Another potential source of public consternation for both American airline and automobile industries is executive compensation. Rick Wagoner, CEO for GM, received a total compensation package for 2007 totaling $14.4 million (Farago, 2008, Forbes, 2009). Many disapprove of CEOs making millions with a golden parachute for running a company that might ultimately declare bankruptcy. Shareholders and their advocates have increasingly viewed the escalation in executive compensation with concern. Between 2007 and 2008, numerous proxy resolutions were introduced to Congress to address the subject (New York Times, 2009). Executive pay has risen even as share prices have plummeted making it hard to find a link between pay and performance.

Finally, both American airline and automobile industries bear the costs of the American health care system. American companies spend a great deal to insure their employees; these are costs borne by the government for companies operating in countries with nationalized health care. (Hochenauer, 2009) Young put it succinctly, "From candy to autos, Canadians can produce goods more cheaply because of their markedly lower health-benefits costs" (Young, 2005).

Exhibit #1

United Airlines: Income Statement		
For Years ended December 31, 2002 and 2007		
($000,000)		
	2002	2007
Revenue	13,916	20,143
Cost of Sales (Non Fuel)	15,007	14,103
Fuel	1,921	5,003
EBIT	-3,012	1,037
Interest Expense	601	661
Income Taxes	0	297
Other	286	324
Net Income	-3,327	403
Passenger Miles (000,000)		
EBIT Per Mile		
Total Cost Per Mile		
Fuel Cost Per Mile		
NonFuel Cost Per Mile		

Exhibit #2

United Airlines: Balance Sheet		
December 31, 2002 and 2007		
($000,000)		
	2002	2007
Current Assets	3,379	6,095
Non-current Assets	20,277	18,125
Total Assets	23,656	24,220
Current Liabilities	3,991	7,979
Non-current Liabilities	22,146	13,452
Total Liabilities	26,137	21,431
Stockholder's Equity (Deficit)	(2,481)	2,789
Total Liabilities and Stockholder Equity	23,656	24,220

Exhibit #3

General Motors: Income Statement		
For Years ended December 31, 2002 and 2007		
($000,000 Except Per Car Amounts)		
	2002	2007
Revenue	186,763	181,122
Cost of Sales	153,344	166,259
SG&A and Other Expense	23,624	19,253
EBIT	9,795	-4,390
Interest Expense	7,715	2,902
Income Taxes	533	37,162
Other	142	5,722
Net Income	1,689	-38,732
Vehicles Sold		
EBIT Per Vehicle		
SG&A Per Vehicle		
Cost of Sales Per Vehicle		
Total Cost Per Vehicle		

Exhibit #4

General Motors: Balance Sheet		
December 31, 2002 and 2007		
($000,000)		
	2002	2007
Current Assets	240,252	77,124
Non-current Assets	130,530	71,759
Total Assets	370,782	148,883
Liabilities (Non-GMAC)	153,085	184,363
Liabilities (GMAC)	210,049	0
Total Liabilities	363,134	184,363
Stockholder's Equity (Deficit)	7,648	(35,480)
Total Liabilities and Stockholder Equity	370,782	148,883

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STEVE JOBS AND APPLE, INC.

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CASE DESCRIPTION

The primary issues in this case involve business startup and management, and are appropriate for entrepreneurship and management courses. A secondary issue demonstrates how personal drive and motivation are critical components of successfully managing and growing a business, thereby making this case appropriate for discussion on the topic of strategic management. The case chronicles the life and passion of entrepreneur, Steve Jobs – illustrating the rise, fall, and current state of the Apple Computer Company. The case has a difficulty level 2 and is designed to be covered within one (75 minute) class period. The required preparation time is about 2 hours. It is appropriate for small business, entrepreneurship, or management classes. The purpose of this case is to illustrate to students how individual passion, determination, and innovation is a critical element in business start up success and also to stimulate critical thinking in terms of future direction for a company in a struggling economy.

CASE SYNOPSIS

The Apple Computer Company is arguably one of the most innovative technology companies to emerge in the last three decades. Apple, Inc. is responsible for bringing to market such products as the Macintosh computer and laptop, iPod and iTunes, and most recently, the iPhone. The success of the company can be traced primarily to a single individual - founder, Steven Jobs. Jobs and his friend, Steve Wozniak founded and built Apple into a 32 billion dollar company. The company enjoyed much success during the past decade with its stock price hitting a high of $200 in 2007. More recently, the stock has retreated to around $90 causing a massive decline in shareholder wealth. Today, Apple CEO Steve Jobs is faced with the challenge of resurrecting his once dominant company in light of weak economic conditions and sub-par personal health. The case chronicles the life of Steve Jobs, the rise of Apple, Inc. and his personal challenges as CEO of the company to continue to provide innovative products to a marketplace of technology avid consumers.

INTRODUCTION

In late 2008, amid the swirling news reports and rumors of his failing health, Steve Jobs, the co-founder, Chairman, and CEO of Apple, Inc. issued the following statement to his employees at

Apple's international corporate headquarters in Cupertino, California. *"We are in the worst economic environment since the Great Depression. However, we are determined to continue to make Apple the most innovative company in the world while increasing shareholder wealth. While hundreds of companies are firing employees, we have no intention of doing so. We will overcome this challenging economic environment and remain a strong innovative company. While others will decrease spending we will increase spending on R&D and come out way ahead of our competition in the long run."*

Jobs co-founded Apple Computer with Steve Wozniak in 1976. After founding Apple, Jobs was fired by the company's board of directors 10 years later at age 30. After his termination, he went on to create two more companies. During this period Apple went through three different CEOs and their stock price dropped to $2 a share. As a result, Jobs was invited back to join the company as CEO. Not only did Jobs rejuvenate Apple, but it flourished. Jobs led the company to the forefront with cutting edge products and their stock price grew to around $200 a share by 2007. However, in 2008 Apple's stock price had dropped to around $90 due to the recession around the world. Fortunately, Apple had an abundance of cash (approximately $9 billion) on hand with no debt. The company was one of the few companies, large or small, that was able to operate with virtually no debt.

After his speech, Jobs walked into his office and sat down. Based on current economic conditions around the world, he wondered what his next steps should be to increase shareholder's wealth. Apple never issued dividends and this policy worked well for them over the years. However, Jobs wondered what he should do next to increase the firm's profitability.

STEVEN PAUL JOBS

Steven Paul Jobs was born on February 24, 1955, in San Francisco, California. Growing up in Mountainview, the heart of Silicon Valley, he exhibited behavior problems while in elementary school. During fourth grade, Job's teacher would bribe him with candy and money in order to curb his behavior. Reflecting back on these years, Jobs recounts that if such behavior continued, it would "absolutely have landed me in jail" (Leander, 2008). He found school to be so easy that he was able to skip 5th grade and move directly into Middle School. He found middle school chaotic and persuaded his parents to move to Los Altos in 1967 where he could attend the much nicer Cupertino Junior High School. This area (Los Altos, Cupertino, and Sunnyvale), was full of engineers and with this emerged many young startup companies (e.g., Hewlett-Packard).

Job's introduction to the world of electronics came during High School with the discovery of electronic hobby kits, Jobs realized that the electric world was not as complicated as it first seemed and that electronics was an interesting field. It quickly became his passion. He began attending lectures conducted by the Hewlett Packard Company (HP). This further fueled his appetite for the field and eventually he found summer employment at HP. It was here that he met future co-founder and co-adventurer Steve Wozniak.

Jobs graduated Homestead High in 1972 and eventually attended Reed College, a small regional liberal arts school in Portland, Oregon. He lasted a semester before dropping out. Though no longer enrolled, he still attended classes that interested him. Not having a place of his own, he frequently slept at the home of friends. Collecting and recycling cans provided him with money and free meals were obtained by walking across town to the Hare Krishna temple.

Jobs eventually returned home and got a technician job at the Atari Company, which paid him a mere $5 hourly wage. He was viewed by his fellow workers as arrogant and this caused problems with several employees. As a result, he was scheduled to work the night shift when there were fewer people. This enabled him to sneak his friend, Steve Wozniak into the building so that they could play favorite video games. In exchange for this kind gesture, Wozniak assisted Jobs with the technical side of his job. Unbeknownst to either of them, this was the beginning of a partnership that would form the beginnings of Apple Computer Company.

STEVE WOZNIAK AND STEVE JOBS

Steve Wozniak's passion for electronics stemmed from his father's career as an engineer at Lockheed Martin (Wozniak, 2006). Wozniak formally studied electrical engineering at the University of Colorado at Boulder and De Anza College near his hometown in the bay area of California. Ironically however, he did not earn a degree from either college. Instead, he withdrew from college and began building computers with a friend. To help fund his interest in building computers, Wozniak learned how to construct a "blue box" from an article he read in *Esquire Magazine*. Blue boxes were handheld devices used to make free, illegal phone calls. Steve Jobs contributed to this partnership by providing the component parts. These parts cost Jobs $40 and the blue boxes were mainly sold to students in dorms and door-to-door for $150. Jobs and Wozniak shared the profits from the sale of the blue boxes. Though this venture was profitable, they ceased operations for fear of a police crackdown.

Around this same time, Atari had been gaining popularity through the sales of their video games and was looking to advance their success even further. Jobs, who was still working for the company, was approached by Atari founder, Nolan Kay Bushnell. Bushnell invited Jobs to develop the circuitry that would transform the popular game, Pong into something more innovative. Jobs was given four days to create this new game called Breakout. Knowing that this project was beyond his capabilities, he contacted his friend, Steve Wozniak to help him accomplish the task. Wozniak was excited to take on the challenge. Four days was not a lot of time to accomplish what needed to be done given that Wozniak was now working full time at HP. To accomplish the task, Wozniak worked at HP during the day and then worked with Jobs during the evenings and nights. In four days time, they accomplished what they sat out to do. They were both very proud of their work. They created a viable game that took a high level of technical skill and did it under relatively intense time pressure. The two split the $700 compensation paid by Atari, however to Wozniak the real compensation was

the sense of accomplishment and excitement realized by completing the task. Looking back on this experience Wozniak claims, *"I would have done it for a quarter*" (Linzmayer, 2004).

After the success of creating the Breakout circuitry, Wozniak and Jobs began to attend meetings of the Homebrew Computer Club together. The club consisted of other electronics enthusiasts. The meetings consisted of members presenting news of new innovations in the electronics world and discussed updates of the progressions made by members in creating their own computers. During one of these meetings Wozniak presented an apparent working model of a computer that could be viewed on a television set, as opposed to a costly monitor. Immediately, Jobs had a vision and plan for this innovation which was to sell the blue prints to a company that would manufacture the computer.

The two decided to pitch the idea to their employers at HP and Atari. Both companies were impressed, but neither had the desire to take on the project. Jobs' business-savvy took over as he persuaded Wozniak that this creation was good enough that they should try to produce and market the computer on their own. The main problem was that they lacked the capital to get the operation started. Both made sacrifices. Jobs provided $1500 by selling his Volkswagen van and Wozniak contributed $250 by selling his HP financial calculator. While driving along a strip of highway the two began to discuss what they would call their new company. Jobs, who still owned part of a 220 acre, farm in Oregon, said, *"We should call the company Apple Computer."*(Young & Simon, 2005).

APPLE COMPUTER

Apple Computer was incorporated in 1977 and went public in 1980. The atmosphere and the excitement surrounding the public offering were immense as it turned out to be the largest public offering in the last 24 years. Jobs' share of the company was worth about $82 million at the stock's lowest point in 1982 and far surpassed this as the stock price rose throughout the life of the company.

Jobs was more than just an aggressive businessman. His approach to marketing was intellectual and methodical. This approach was exemplified by the details that went into packaging of the original Macintosh (Mac) Personal Computer (PC). He gave the final approval on all software that ran on the machines and provided much input on how television ads were presented and the message that they were meant to convey.

Jobs' attention to detail, confidence, and controlling personality were his strongest assets although some also felt these characteristics were his biggest flaws). His propensity to dictate decisions and manipulate people was noticed by other executives of the company. This persona and mentality led to occasional differences of opinion and ironically, eventually led to a divorce from the company he co-founded.

Job's had an erratic temper due to his drive for perfection. According to some, the inventor and innovator was a "control freak, egomaniac, and fearsome tyrant" (Deutschman, 2000). Others described him as transforming from a charismatic leader to an ego-maniac and tyrant with a "wicked

tongue" (Kahney, 2008). In addition, Jobs thought of most people as "bozos" (which ironically led to the user-friendliness of Apple's products). All of this fueled Apple's Board of Directors decision to ask Jobs to resign from the company. Jobs was essentially forced out due to a clash of egos and a dispute about the power structure of the company between himself and CEO John Sculley. Steve Wozniak also chose to leave the company citing reasons that he felt that his efforts were being wasted in favor of new directions that upper management wanted the company to pursue.

LIFE AFTER APPLE

Jobs did not leave without a plan. He founded a new computer company to compete with Apple. The NeXT Company, marketed computer systems to schools and other teaching organizations. He began by touring campuses across the country and surveying school stakeholders to understand their needs. Jobs inquired about the pros and cons of currently used computers and learned what the ideal computer should offer to create efficiency and harmony among its users. Five key employees from Apple joined Jobs in his new venture. Apple threatened a lawsuit against Jobs for stealing employees but it was eventually settled out of court.

However, through eight years of its existence the company was only able to sell 50,000 computers. NeXT was relegated to downsizing and was solely involved in distribution of its software packages.

In 1986, Jobs bought the majority share of a puttering computer graphics company, called Pixar, for $10 million from George Lucas. Lucas, the famed creator of the *Star Wars* movies, was looking to sell of some of his assets to fund his divorce. Jobs saw a lot of promise in Pixar. At the time Pixar specialized in systems that enabled and enhanced computer graphic imaging. One of their strategies for marketing the systems was creating short movies featuring computer animation capabilities. The short films became popular in the industry and at least one of the short films won an Academy award for Best Animated Short Film in 1988 (*Tin Toy*). Though the short animations received attention and recognition, the company still had trouble selling their systems. So, in 1988 Jobs and Pixar decided to focus on developing imaging software capabilities and market them to companies to produce animated commercials (Tropicana, Life Savers and Listerine were some of the first brands to contract Pixar to produce commercials).

Pixar's big break came after approaching Disney to distribute an hour long animated film written and created by Pixar. Disney surprisingly responded with an offer for Pixar to create a screenplay for a feature length film. Disney put up a modest budget and retained most interests in the revenue earned through a three-film deal. After the release and success of *Toy Story*, Jobs took the company public and offered 6.9 million shares at its IPO. This move provided the bargaining power for Jobs to negotiate a bigger piece of the profits from Disney. In exchange for Pixar's co-financing of additional movies, Disney agreed to a new five film agreement which gave Pixar a much bigger share of revenues. Such titles such as *Toy Story* (I & II), *A Bug's Life*, *Cars*, and *The*

Incredibles highlight the impressive resume of Pixar Animation Studios under Jobs' leadership. *Toy Story* alone brought in $358 million in worldwide theatre revenue (Linzmayer 2004).

People in the industry knew that the deal was made possible because of the charisma, confidence and negotiating talents of Jobs. Pixar executive Ed Catmull said *"It took somebody of Job's stature to get us a parity deal with Disney"* (Linzmayer, 2004). Former Pixar Marketing Director Pamela Kerwin said *"He had the brains, energy, and chutzpah to protect Pixar's interest. He enabled us to negotiate as equals*" (Linzmayer, 2004). Jobs investment and financing of Pixar was rewarded handsomely. Through his investment he was awarded 30 million shares of Pixar worth around $1 billion.

JOBS RETURN TO APPLE

Although Jobs had left Apple years ago and had no official title or duties he still retained substantial amounts of stock in the company and served as part time advisor. Since his departure in 1985, there were three permanent CEOs and the stock price reached a low of $2. Subsequently, all of those CEOs were forced to resign. By 1997 and desperate for a new leader that could revitalize Apple, the board of directors approached Jobs with an offer to rejoin the company as their CEO. Reluctantly, he decided to take on some temporary leadership roles while a search for a new CEO was conducted. The position eventually became more permanent.

To bring fresh ideas and perspectives, Jobs immediately replaced almost all the board members with hand-picked people. He then embarked on entering into an agreement with arch rival Microsoft. This involved a commitment by Microsoft to produce Microsoft Office and Internet Explorer versions that were compatible with Apple's Mac. Also as part of the agreement Apple agreed to create its Mac OS with Internet Explorer as its default browser. This was seen as taboo by many Apple loyalists, however Job's view was - "If you can't beat them, join them." To this point Microsoft had outsold, outperformed and outmaneuvered Apple at almost every stage of the recent PC movement. Instead of an obstacle, he viewed Microsoft as an opportunity.

Another strategic move initiated by Jobs was the "store within a store" concept. Apple partnered with CompUSA to create an entire department in each of Comp USA's 148 stores that offered only Apple products. Upon the opening of these "stores" the new Apple Power Mac computer line was offered. These computers contained new G3 processors created by IBM and Motorola. Next, the new Apple Store were introduced an online market place where customers could customize and purchase Apple computer systems. Both of these new initiatives were immediately successful. Since the implementation of the agreement with CompUSA, Mac sales at CompUSA stores had more than quadrupled and sales from the Apple stores topped $12 million within the first 30 days of its existence.

In an effort to reduce costs, Jobs decided to outsource manufacturing of some of the component parts used in making their hardware. In addition, in an effort to reconfigure the product

distribution strategy, Apple expanded the number of outlets that it sold its computers and accessories. This move provided Apple more exposure to a larger audience. In the years to come, Apple enjoyed success with innovative products including the iMAC, iPod, and iPhone.

iMAC, iPOD, and iPhone

One of the most popular releases by Apple after Jobs took over was the iMac Personal Computer (Kahney, 2004). It introduced a stylish design that caught consumers' attention and was difficult for stores to keep in stock. This innovative product combined the tower within the monitor. The system was not only attractive (available in a variety of colors), but it was known for its high level of performance at a competitive price (Linzmayer, 2004). Despite the success of iMac, Jobs knew that Apple could not become complacent. Apple continued to update and introduce improvements to this computer line and began offering new versions of their lap tops. After just one year of Job's return to Apple, the company announced a profit of $106 million - a vast improvement compared to the $1.6 billion in losses suffered over the previous 17 months (Kahney, 2004).

Although Apple flourished in the next few years under the leadership of Jobs, they lagged in the emerging MP3 market. They entered this market in 2001 with their own brand of music purchasing. Apple's iTunes was the first to introduce an online store for selling music downloads and quickly gained market share as consumers quickly took to this new and innovative way of obtaining music (Boddie, 2005). For as little as 99 cents per song, consumers could choose music from the major record labels and thousands of independent ones (Yoffie and Slind, 2008). To further enhance its popularity, Apple created its own Mac line of computers with CD burning capabilities. This laid the ground work for Apple's introduction of the iPod - one of the most popular and adapted products worldwide.

The iPod was released to compete with traditional MP3 players. The major advantages over MP3 players were its compact size, large storage capacity, and speed of uploading music. The original iPod was sleek and small, weighing only 6 ½ ounces. It had the ability to hold up to a thousand songs in its huge five gigabyte hard drive and could load one thousand songs in as little as ten minutes. Its battery could hold a charge for up to 10 hours and it simply integrated with its popular iTunes online store.

The original iPod was compatible only with Apple systems and software, but in 2002 the decision was made to release a version that also worked with the Windows operating system. This decision increased iPod sales worldwide. Within the first nine months of its release over one million units had been sold and through 2007, this number has since increased to 100 million. Industry prognosticators predict that by the end of 2009, an additional 200 million units will have been sold. Given these projections, Apple's iPod could is on track to become the largest selling consumer electronic product of all time (Mark and Crossan, 2005).

In 2007 Apple joined with AT&T and introduced the iPhone. The iPhone was marketed as the most sophisticated "smart phone". The iPhone had built in iPod music playing capabilities, a 3.5 inch high quality interactive touch screen, a 2 mega-pixel camera, GPS capability, and access to the Internet. Alliances with Yahoo!, You Tube and Google also enabled the phone to provide customized services and video enabled capabilities. Owners of the phone could choose between using AT&T's own web network or any other publicly offered internet access (e.g., web "hot spots"). Originally a 16 gigabyte iPhone sold for $499 and a smaller 8 gigabyte model was offered for $399. Despite the initial price, sales of the iPhone far exceeded predictions. Apple sold 270,000 iPhones in the first 30 hours of its U.S. debut. The iPhone was a big hit! Through its introduction, Jobs was able to negotiate very favorable agreements between Apple and AT&T. Branding, pricing and development of the iPhone were almost exclusively under the control of Apple. Also included in the partnership was a profit sharing agreement that gave Apple 10% of the revenue from iPhone internet subscriptions. Such an agreement was ground breaking in the cellular industry.

The introduction of the iPhone was not without its challenges. One problem was that AT&T's edge network was relatively slow. Another issue was that the iPhone came equipped with a battery that was not replaceable and users were not able to increase the memory capacity. In response to customer unhappiness Apple released a new version in 2008 that ran on a faster 3G network, however the short battery life and storage capacity issues still remained unresolved. The iPhone shortcomings have allowed competitors to gain some ground in the smart phone industry. For example, Japan's cellular phone market already is inundated with high performance smart phones that rival the iPhone. Though the iPhone continued to be a huge success, competitors were beginning to catch up. To maintain and grow their share, Apple must continue to be an innovator in the smart phone industry.

THE KEYS TO JOB'S SUCCESS AND FUTURE CHALLENGES

According to Steve Jobs, the reason why his companies have become so successful is because they hire the very best people in the world to work for them (Morrow, 1995). While this strategy is definitely a huge part of the success of Jobs and Apple, it definitely is not the only reason. Jobs, from a very young age, had a tireless work ethic, particularly toward his passion, electrical engineering. His work ethic was the motivation that led him to learn about the advanced technical knowledge of the computers that Apple has been building for decades. Jobs' vision to see the potential in the opportunities allowed him to take full advantage of these ventures. Jobs envisioned a revolutionary process to bring together the world of computers and the need of consumers. His innate ability to understand human behavior helped him to predict what people desired even before they knew it themselves. His business savvy, negotiation skills, and propensity to take risks enabled him to transform technology into companies that flourished.

Steve Jobs has undoubtedly brought success and riches to Apple and Apple's shareholders. This past decade has catapulted Apple to the position of being able to compete and possibly overtake

perennial industry leader Microsoft. Company revenues have seen annual revenue increases progressively since 2003 (see Exhibit 1). The recent economic downturn has hurt Apple. The stock price has been on a steady decline. From August of 2008 to March 2009 Apple's stock price went from trading around $200 to trading around $90 (www.apple.com). In 2008 many industries, along with the U.S. economy as a whole, experienced unprecedented declines. Record high unemployment rates, and near collapses of the housing and automobile industries contributed to the current recession. Consumer confidence dwindled and as a result retail sales dipped steeply throughout the year. Job's challenge now is how to once again increase shareholder wealth for the company.

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Exhibit 1: Apple, Inc. Financials Fiscal Year Ended Sep. 30, 2008						
	9/30/08	9/30/07	9/30/06	9/30/05	9/30/04	9/30/03
Income Statement Analysis (Million $)						
Revenue	32,479	24,006	19,315	13,931	8,279	6,207
Operating Income	6,748	4,726	2,645	1,829	499	138
Depreciation	473	317	225	179	150	113
Interest Expense	Nil	Nil	Nil	Nil	3.00	8.00
Pretax Income	6,895	5,008	2,818	1,815	383	92.0
Effective Tax Rate	29.9%	30.2%	29.4%	26.4%	27.9%	26.1%
Net Income	4,834	3,496	1,989	1,335	276	68.0
S&P Core Earnings	4,834	3,496	1,989	1,259	164	-119
Balance Sheet & Other Financial Data (Millions $)						
Cash	24,490	9,352	6,392	3,491	2,969	3,396
Current Assets	34,690	21,956	14,509	10,300	7,055	5,887
Total Assets	39,572	25,347	17,205	11,551	8,050	6,815
Current Liabilities	14,092	9,299	6,471	3,484	2,680	2,357
Long Term Debt	Nil	Nil	Nil	Nil	Nil	Nil
Common Equity	21,030	14,532	9,984	7,466	5,076	4,223
Total Capital	21,705	15,151	10,365	7,466	5,076	4,223
Capital Expenditures	1,091	735	657	260	176	164
Cash Flow	5,307	3,813	2,214	1,514	426	181
Current Ratio	2.5	2.4	2.2	3.0	2.6	2.5
% Long Term Debt of Capitalization	Nil	Nil	Nil	Nil	Nil	Nil
% Net Income of Revenue	14.9	14.6	10.3	9.6	3.3	1.1
% Return on Assets	14.9	16.4	13.9	13.6	3.7	1.0
% Return on Equity	27.2	28.5	22.8	21.3	5.9	1.6
*Per Share Data, Income Statement Analysis, and Balance Sheet & Other Financial Date attained from https://research.scottrade.com/research/common/pdf.asp?sym=AAPL&reportType=SNPReport						

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eCAMPUS: SUCCESS! NOW WHAT?

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CASE DESCRIPTION

This case concerns the strategic management of an e-commerce business and its stages of growth. The case has a difficulty level of four, appropriate for senior level classes or higher. It can be taught in two hours of class time, with students spending six to twelve hours of outside preparation. At the request of the company, this case does not contain any detailed financial data or financial strategy.

CASE SYNOPSIS

eCampus.com is an Internet retailer of college textbooks that has resurrected itself from bankruptcy into a profitable business. The company was created near the end of the "dot.com bubble" using the typical dot com start-up business model of that time. Success came quickly for the new company due to a twenty million dollar media campaign and highly creative TV commercials that ran on three cable TV networks in August and September of 1999. The eCampus Web site quickly became one of the twenty busiest sites on the Internet. More importantly, eCampus achieved a phenomenal visitor-to-buyer conversion rate of 14%. It looked like eCampus was going to be a big success.

The "dot.com" bubble burst in March 2000 and the personal financial problems of the majority investor resulted in the company being forced into bankruptcy in June 2000. The company continued operating under Chapter 11 bankruptcy until it was sold at public auction in 2003. The new owners undertook a competitive strategy based on operating and marketing efficiency. While the process of reviving the company has been a slow and bumpy process, the company has grown, stabilized and matured.

Now, the management is turning its attention to the new competitive threats from existing rivals, low-cost imported textbooks and emerging electronic textbook publishers. Federal and state governments are pressuring higher education institutions, bookstore and publishing companies to find ways to lower textbook costs for students. Consumer groups have organized to provide low-cost or free textbooks to students in some states. New companies, such as Flat World Knowledge and Chegg, have entered the industry using a business model based on innovative use of technology that threatens to disrupt the current textbook industry. Students must analyze these competitive threats and decide what eCampus should do to survive in a highly competitive industry

INTRODUCTION

Matt Montgomery, CEO of eCampus.com, is proud of the accomplishments of his management team in turning a bankrupt dot.com company and into a profitable business. "It took seven years to turn this company around. Now, we have the challenge to keep it going in the right direction. Yes, we're a success, but we face some tough new competitive threats that weren't there two years ago. The college textbook sales business will undergo some big changes in the next five years, and we will have to change to survive. This economic downturn will force our many student to seek lower cost textbooks and that could hurt us.

eCampus.com is a provider of new and used textbooks, electronic textbooks, trade books, college emblematic and Greek apparel for men and women, electronics, computers, gifts and other services associated with the college experience. The company offers the largest in-stock selections of new and used textbooks available online. The eCampus Internet storefront is integrated with its state-of-the-art distribution facility. (Source: "What We Do")

eCampus was a late comer to the "dot.com bubble" which began in 1995. Created as an virtual storefront retailer of college textbooks, eCampus went online in August 1999. By October, it had become the number one seller of textbooks on the Internet. Initially, eCampus was a pure-play e-commerce company with an alliance partnership with Wallace's College Textbooks, Inc. (WCT). WCT was the second largest wholesale distributors of new and used textbooks in the United States. Wallace Wilkinson, principle owner eCampus and CEO of WCT, viewed eCampus as a way to sell textbooks directly to university students at prices lower than the traditional campus bookstores. However, Wilkinson's primary motivation was to take advantage of the dot com bubble to make a bundle of money with an Initial Public Offering (IPO) of its stock to ease his personal financial troubles.

The "dot com" bubble, which start in 1995 and ended in March 2000, was characterized by:

> *"A combination of rapidly increasing stock prices, individual speculation in stocks, and widely available venture capital created an exuberant environment in which many of these businesses dismissed standard business models, focusing on increasing market share at the expense of the bottom line."* (http://en.wikipedia.org/wiki/Dot_com_bubble).

While low interest rates helped to supply dot com start-ups with abundant capital, the greatest source of capital were the venture capitalists who invested huge sums of money in dot-com companies in hope of hitting the big jackpot when the company converted to a publicly held corporation and it stocks began trading in the hot IPO market. At the time, IPO stocks were fetching sky-high prices and many venture capitalists were reaping huge returns on their investments. Often, dot com start-ups were flush with money and spent millions on freewheeling marketing campaigns

to get the attention of consumers and investors. However, many of these companies had unproven business models and quickly died. (German, 2008) Those that had viable business models often returned big rewards for the venture capitalists.

The typical dot com start-up strategy was to make a big splash early, get big fast, take the company public, and reap the wealth. (Spector, 2000) These businesses spent massive amounts on advertising and sold products a prices lower than cost to build mind share and market share. While some of the dot.com companies had realistic plans and administrative ability, most did not. Yet, the novelty of the dot.com concept and potential riches attracted eager, risk-taking investors.

BACKGROUND

Wilkinson's ultimate plan was to bundle his retail campus bookstores, wholesale textbook business and eCampus into a publicly held holding company. (Jordan, 2008) The strategy was to have eCampus attract a lot of publicity as a successful e-commerce upstart, then cash-in by going IPO after the first year of operation. The IPO market was hot in the late 1990s. Investors in e-commerce upstarts were sometimes getting as much as 1000% return on the investment when the company went IPO. Wilkinson was hoping eCampus would be the "cash cow" that would cover his increasing personal debts. eCampus' other investors knew it was a high-risk gamble, but were attracted by the potential for extremely high returns if it hit the hot IPO market. According to Doug Alexander, VP of Promotion & Development, so many people wanted in on the action that many potential investors had to be turned away.

After eCampus quickly established itself as a market leader, several large venture capital investment companies put money into eCampus. In October 1999, an additional $40 million of capital came into the company. eCampus was now so flush with money that management considered the budget virtually unlimited and spent money freely with little or no capital budgeting.

Most of this new money was spent on advertising and promotional expenses for the coming year, and purchasing the warehouse facility from WTC. In its first four months, eCampus spent $20 million on advertising and promotion while generating $2 million in sales, but it successful in getting over 80% name recognition (mind share) among college students. While the strategy of having the lowest prices and not charging customers for shipping and handling costs got the company a lot of market recognition, the company lost 17% on every sale.

eCampus was forced into Chapter 11 bankruptcy in June of 2000. A year later, ABookCompany, LLC. purchased the eCampus.com name, warehouse, information system and inventory at a federal bankruptcy auction in Lexington, KY. The new owners set two goals for eCampus: (1) to achieve a positive a return on their investment in three to five years, and (2) to create a sustainable competitive advantage for eCampus.

To attain these goals, operating, marketing, labor and overhead costs were slashed by consolidating all offices and operations to the warehouse building, terminating most of employees,

cutting the advertising budget cut from $20 million to $1 million. Additionally, the information system was rebuilt to run on a less expensive computer platform and the software rewritten to make it run faster with fewer errors.

THE INDUSTRY

Approximately 17.7 million college students in the U.S. spent a total of $5.5 billion on textbooks in the 2006-2007 academic year. (NACS, 2009b) College textbooks are the most profitable product line in the publishing industry because production costs are relatively low and cover prices are high. However, 22% of all new textbooks go unsold each year and returned to the publishing companies to be recycled (Association of American Publishers, 2007). The gross margin for new textbooks is about 22 % and 35% for used textbooks (NACS 2008a).

Used texts comprise 39% of all textbook sales (Mindlin, 2006). The average full-time college students spends more than $1000 annually for textbooks, and textbook prices are increasing about 6% per year (NACS, 2009b). It is estimated that 40% of students do not purchase a textbook for at least one course each term. (Kinzie, 2006)

Brick-and-mortar bookstores sell about 13% of all new textbooks (Rappaport, 2004) and 67% of all of used textbooks (Wyatt, 2005). The NACS 2008 College Store Industry Financial Report (NACS, 2009a) states that students who buy from campus brick-and-mortar bookstores do so because of the:

- ease of returns
- the ability to pick up items for immediate use
- one-stop shopping
- accurate information on what textbooks students need for their courses

Five companies (Thompson, McGraw-Hill, Wiley, Houghton-Mifflin, and Pearson) publish about 80% of all college textbooks. The wholesale distribution market is dominated by five companies: Follett, Barnes & Noble, Nebraska, College Bookstores of America and eCampus (Koch, 2006). These wholesalers account for more than 50% of all used textbook sales and operate 35% of the college bookstores in the U.S. Publishing companies and wholesale distributors maintain their dominance by creating very high entry barriers (Koch, 2006).

The virtual oligopoly of publishers has been successful in raising prices at rates higher than the inflation rate for several years. The practice of publishing new editions of texts every couple years accounts for much of the rising costs. Also, the practice of bundling software and ancillary materials with the textbooks increases prices even more.

The dramatic rise in textbook prices has led the U.S. Congress and state legislatures to consider ways to get textbook publishers to lower the costs to students. So far, the publishers have

successfully resisted these efforts. A recent trend involves professional associations, faculty and students banding together to create nonprofit organizations that provide rental textbooks or free online textbooks. Currently, these nonprofits operate mostly in west coast states, but the practice is gradually spreading to other parts of the country.

Many students have discovered that they can save as much 70% by purchasing the international editions of textbooks from online textbook sellers instead of the hardback editions at a local bookstore. The same publishing companies that produce the full-color hardback textbooks sold domestically also print and export the black and white, paperback international editions. The international textbooks cost less to produce and their prices are based on the standard of living of the importing country. Thus, the price of a textbook sold in India might be 70% lower than the hardback textbook in the U.S. Popularity of international editions has grown since the 1998 U.S. Supreme Court ruling that U.S. copyright laws do not protect American publishers from having their books sold outside the country shipped back (repatriated) and sold in the U.S. market. International textbook sales now comprise about 10% of the college textbook market. (NACS, 2009b)

The college textbook market has limited growth potential of about 4% per year and has small profit margins. (Koch, 2006) The intense price competition instigated by the better-capitalized companies, such as eFollett.com and Barnes andNoble.com, could reduce the number of competitors, such as eCampus, through acquisition and bankruptcies.

The direct selling of electronic textbooks, or ebooks, by the publishing companies to students could disrupt in the textbook supply chain for wholesales, such as eCampus, and both online and brick-and-mortar retailers.

Wholesale distributors (e.g., eFollett.com, MBSBooks.com) and some publishing companies (e.g., Thompson and Pearson) are selling ebooks directly to students that are priced one-third to one-half less than printed and bound copies. However, students have been hesitant to buy ebooks because the ebook versions are actually licensed software that cannot be resold, copied or transferred. Additionally, ebooks become unusable once the content license expires in five to six months after purchase (Buss, 2005).

BIG SPLASH, BIG FLOP

When eCampus entered the online textbook market in 1999, its strategic advantage was the partnership it had with a large wholesale distributor of new and used textbooks, Wallace's College Textbook (WCT). WTC, the second largest distributor of new textbooks and the largest distributor of used textbooks, owned and operated a state-of-the-art distribution center in Lexington, Kentucky.

The launch phase objectives were to create the "big splash" and to establish the eCampus brand name. To the end, a twenty million dollar promotional campaign began August 1, 1999 with the airing of highly creative TV commercials on three cable TV networks popular with college students (Comedy Channel, Cartoon Network and TNT).

By late August, the eCampus Web site had become one of the twenty busiest sites on the Internet. At times, there were more than 10,000 simultaneous visitors at the Web site. More importantly, eCampus had achieved an 87% brand recognition or "mind share" rate in its target customer group and an astounding 14% sales conversion rate. These numbers attracted a lot of media and industry attention. In its first four months of operation, eCampus had achieved its three-year traffic and sales goals. The start-up company had made a big splash, and it looked like eCampus was on its way to becoming a big success.

The seeds for eCampus' demise were sown in October when Wallace Wilkinson, who was the CEO of both eCampus and WCT, arranged the self-serving sale of the WTC warehouse, equipment, inventory, and information system to eCampus for an undisclosed amount. This transaction, in effect, made WTC an outsource provider of order fulfillment services for which it charged $17 per order shipped. Since eCampus did not charge customers for shipping, this meant they lost money on money on nearly every order. Even more, the sale deprived eCampus of much needed capital.

The "dot.com bubble" burst in March 2000, just when eCampus needed to raise more capital for another massive marketing campaign and to replenish inventories for the fall 2000 sales rush. Now, the venture capitalists were backing away from dot.coms companies. An even bigger problem for eCampus were the rumors that Wallace Wilkinson was more than $400 million in debt and that his $11 million dollar promissory note held by eCampus was worthless. eCampus was unable to pay its debts. Then, several vice presidents resigned, and all the programmers and office staff were let go. In June, Wilkinson filed for personal bankruptcy protection, which, in turn, caused creditors to force eCampus into Chapter 11 bankruptcy. eCampus continued to operate under new management while the bankruptcy petition was adjudicated by the Federal Bankruptcy Court.

eCampus was purchased for $2.5 million at a federal bankruptcy auction in July 2001, by ABookCompany, LLC. Two of the four principle partners of ABookCompany, Brent Tuttle and Matt Montgomery, had been mid-level information system managers at eCampus since its founding. Matt Montgomery became President and CEO of eCampus. The other two partners were venture capital investment companies that had supplied capital for the pre-bankrupt eCampus.

eCAMPUS TODAY

Today, eCampus is both a wholesaler and an online retailer. It services over 500,000 customers a year with its fully integrated order fulfillment system. Its original target market of 17million students included full-time and part-time students, both on and off campus, at universities, four-year colleges, and two-year community and technical colleges. The company now also targets public and private K-12 schools and academies. eCampus still maintains its original value proposition to be the "easiest, fastest way to find and buy college textbooks and college-related paraphernalia at the lowest prices."

The distinct competitive advantage for eCampus is its large selection of used textbooks and its supply network for acquiring them. The company has a large number of affiliated and independent "book buyers" who go to campuses all over the country to buy textbooks from students. The profit margin on

used books generally ranges from 25%-35%, whereas the profit margin on new textbooks ranges from 12%-16% . Marketing costs comprise about 25% the price of a new textbook. Recently, eCampus has emerged as the world's largest seller of e-textbooks.

The company is now a lean, cost conscience organization that enjoys a high level of brand recognition. It has expanded its customer base to include sales to local walk-in customers at its warehouse, and lock-in contracts to provide textbooks to community colleges, universities, private K-12 school and public K-12 schools districts across the country. The sales to K-12 public and private schools in California, New York and Texas comprise its biggest orders. Contract sales have steadily increased from $2 million in 2002, $20 million in 2004 to $46 million in 2006.

Recently, eCampus instituted the "Books-by-Course Program" in which, a few community colleges and small four-year colleges include the cost of textbooks in the tuition charge. When a student registers for a course, the textbooks for the course are ordered automatically from eCampus. Then, eCampus ships the books directly to the student. This arrangement is especially advantageous to student with scholarships and grants that pay for tuition but not separate textbook purchases. Under these contracts, eCampus buys back the textbooks at the end of the term.

The eCampus Virtual Bookstore program has tripled in size over the past several years to include large universities, small colleges, two-year community and technical colleges (http://www.ecampus.com/virtualbookstore/2008/homepage.html). The program enables students to order their textbooks online through their school's customized virtual bookstore. The Web site lists the name of the institution, its courses, sections and textbooks adopted for each section. Students can purchase their books by clicking on the items listed for each class section in which they are registered.
Marketplace is an online facility provided by eCampus.com where anyone can sell their books to millions of book shoppers, students, used book wholesalers, and institutional buyers." (http://www.ecampus.com/mp/). Another distinguishing feature for eCampus is it buy-back policy states that they will buy used books that are in "Good Condition."

Campus uses several "locking in" strategies to create loyal customers and to create customer communities. The VIP Membership Card program rewards customers with points and discounts based on amount spent. The Affiliates Program is a viral marketing strategy to members who direct customers to the eCampus Web site. The Web Partner program is a revenue sharing arrangement in which high schools, colleges, online and corporate training programs get a percentage of the sales revenue generated by their students. (see eCampus.com for a more detailed description of these programs). The Faculty Administration Support Tool allows instructors can enter the textbook adoptions for their courses so students can search for their textbooks by course name and instructor.(https://www.ecampus.com/fast/) The rapid increase in sales and the continual information system upgrades have resulted in an increase in customer complaints. The buy-back operation was especially affected by the yearlong installation of a new accounting system. The old system had accounting and receiving software that had trouble tracking payments for book purchases. According to Mark Carson, Vice President of Client Services, the number of complaints dropped dramatically after the installation of the new system was completed. Now,

payments for buy-back books are made by check, in-store credit or a debit to a credit card account within 48 hours of receiving the books. "There has been only one complaint to the Better Business Bureau after we got the new system in place."(Vos, 2006).

The new accounting system allows managers to find the profit margin on each title, new or used, in inventory quickly. The system allows the instantaneous adjustment of prices based on supply and demand information, and competitor price changes. The system now produces almost error-free order fulfillment and buy back processing. Sales are rising and the warehouse capacity has doubled. The changes that eCampus made to streamline company operations have proven critical to turning the company around. However, competitors can acquired and replicated the system. The technology and processes do not provide a long-term competitive advantage.

Even though eCampus has straightened out most of their systems problems, they are still experience frequent delays in fulfilling orders. Suppliers are still hesitant to make large sales to eCampus on credit. This results in having insufficient inventory of some textbooks during the peak sales periods in August and January. Some customers do not get their books for two weeks or more after paying for them. These delays are hurting eCampus' reputation for fast, reliable service, which is an important competitive advantage for firm that can.

CEO Matt Montgomery says the company worked hard to make sure its customers get what they need, but that with 500,000 customers a year, things do go wrong occasionally. "We want to keep the customer as happy as we can. It is good for business. But, things do wrong and sometimes it's our fault and sometimes it's not." (Vos, 2006)

Although eCampus has managed to survive and turn the company around through cost cutting measures and improved operations, the bankruptcy stigma makes it difficult to raise capital. They rely on internal capitalization and innovation for maintaining and expanding market share.

DIRECT COMPETITORS

Historically, the online college textbook industry has followed the lowest price business strategy. The first companies to sell college textbooks on the Internet were Varsity.com and BigWords.com, which started in 1997 as pure play e-commerce businesses that did not own or maintain any inventory. They handle the selling of books for a network of independent companies who were responsible for shipping books to the customers.

Barnes & Nobel (B&N) is a large brick-and-mortar bookstore chain that manages college bookstores and sells textbooks books online. B&N is a highly recognized brand name and buys large volume of books from publishing companies.

Amazon is the largest online book company, but like Varsity and Bigwords, they sells textbooks for a network of independent companies who ship the books to the customers.

eFollett is a family-owned bookstore provider that has been in business for 133 years. Its Follett Higher Education Group (FHEG) manages more than 800 bookstores nationwide and provides management

systems, support services, and used textbooks to over 1,800 independently managed bookstores. (FHEG, 2009)

Follett is both a retailer and wholesale distributor of educational materials, college textbooks, collegiate merchandise that primarily concentrates on servicing libraries and K-12 schools. It operates a Web site, and sells and ships textbooks directly to large and small customers. Follett.com is the rival targets some the same market segments and operates like eCampus.

MBSbooks claims to be the largest used textbook wholesaler, bookstore systems provider, and distance learning distribution service in the United States. MBS is organized into three operating divisions-MBS Wholesale, MBS Direct, and MBS Systems-each division supports our customers with state-of-the-art technology. MBSbooks is eCampus' big competitor in the used textbook market.

The college textbook market has hundreds of small companies that sell textbooks through eBay. These companies typically focus on the textbooks in greatest demand and the international editions. eCampus does not view these companies as a substantial threat, although it does monitor their prices. Many of the small companies are not always reliable in filling orders promptly.

Competition in the form of enterprising students have created "gray markets" on many campuses by selling imported textbooks from England, India, Taiwan, Singapore, Malaysia, and other countries and selling them on campus. The low cost of the repatriated books and low overhead results in low prices for students.

A relatively new company called Chegg follows the Netflix business model in that students can rent textbooks via the Internet and have them delivered by UPS. They rent the textbook for a quarter or semester, and return the book at the end of the term. The cost savings to the student can be as much as 80 percent, compared the cost of buying a new textbook. Rivals of Chegg include BookRenter.com and CampusBookRentals.com. (USA Today, March 07, 2009)

POTENTIAL MARKET DISRUPTORS

Textbook publishing companies are always looking for ways to cut costs and lower prices. Most publishers now offer electronic versions of popular textbooks through their Web sites or through Internet companies like zinio.com and eCampus. Electronic textbooks (ebooks) are recorded on a CD, DVD, or downloaded from an Internet site and are priced about 50% less than hardcopy textbooks. Publishers often include free access to other course-related resources with the purchase of an e-book. The demand for e-books is expected to grow, especially with the dramatic decline of the U.S. and world economies.
Amazon.com has introduced the Kindle 6 wireless reader. With Kindle, a student can download ebooks from almost any Internet connection or hotspot. The device is 8 inches by 5 inch by 1/3 of an inch thick and weighs 10.2 ounces. Kindle 6 can store more than 1500 ebooks and uses the same 3G network advanced cell phones technology. Over 285,000 books plus U.S. and international newspapers, magazines, and blogs are available for Kindle users. (Say Hello to Kindle, 2009)

Follett is positioning itself in the eBooks distribution market by offering a software product, called Lycea, which allows combining digital text with integrated learning assessment and classroom management tools. Follett is targeting the more than 60,000 educators who will make the transition from print to digital textbooks. (eFollett.com, 2009)

Recently, Wal-Mart began selling textbooks in some of its super stores and online. (http://www.walmart.com/catalog/catalog.gsp?cat=582377). However, Wal-Mart does not carry a comprehensive inventory of textbooks, at this time. Instead, Wal-Mart is acting as destination site that directs textbook buyers to affiliates who buy their stock mostly from wholesaler distributors. However, because of its enormous purchasing power and highly efficient supply chain, Wal-Mart poses a potential price competition threat.

The publishing companies themselves pose a long-term threat. Publishers have ability to use Internet technology to disintermediate wholesalers and retailers out of the value chain by selling downloadable ebooks directly to students. Pearson Higher Education is already expanding and promoting direct sales of ebooks of their best selling textbooks.

Open-source textbooks is a relatively new movement to that aims to make textbook content free to students. The California Public Interest Group (CPIC) has joined with members of the Berkley faculty and the Associated Students at the University of California to demand open textbooks for students in colleges throughout the United States. (Wired.com, 2008, 09).

The Open Knowledge Foundation (OKF), a not-for-profit organization incorporated in the United Kingdom in 2004, is a leader in promoting open knowledge nationally and internationally. (The Open Knowledge Foundation, 2009) OKF encourages and supports textbook authors to by-pass the practice of copywriting and publishing textbooks through traditional publishing companies. Instead, the digital textbooks are distributed at no cost to students. Thus, disintermediating publishing companies from the value chain.

Open knowledge is defined as any content, information or data that people are free to use, re-use and redistribute -- without any legal, technological or social restriction. The main principles are:

1. Free and open **access** to the material
2. Freedom to **redistribute** the material
3. Freedom to **reuse** the material
4. No restriction of the above based on who someone is (e.g. their nationality) or their field of endeavour (e.g. commercial or non-commercial) (The Open Knowledge Foundation, 2009)

The Flat World Knowledge (FWK) is a new open source publishing company that aims to provide ebooks by leading authors that are "rigorously reviewed and developed to the highest standards." (*Flatworldknowledge About Us*) They plan to offer an expanded line of textbooks by 2010 that are either free online, or under $30 for downloadable text, audio books and chapters with self-print options. The

buyers purchase a six-month license or subscription to use the ebook or a self-print ebook. Their ebooks can be downloaded a computer, iPod, or e-reader such as Kindle.

If the open-source models, such as employed by OKF and FWK, are successful and spread, the traditional publishing companies, wholesale distributors, retailers and companies like eCampus could be virtually removed from the textbook value chain.

CONCLUSION

Ecampus currently enjoys strong brand name recognition, market share and customer loyalty. Its mission has not changed since 1999, which has kept management focused. Annual sales revenue have increased from $2 million in 2002 to over $50 million in 2008, while advertizing and marketing costs have remained around $2 million. Suppliers are now willing to extend trade credit to eCampus. In 2008, warehouse capacity was doubled and the company made a profit for the first time. Those profits were used to finance further expansion and innovation. The company still has some operational problems that occasionally delay fulfilling orders in a timely manner which result customer complaints. The new accounting system has improved order fulfillment and payments for used textbook buy backs, and gives management better and timely information about costs, sales and profit margins for each textbook title, new or used, in inventory. Management has the ability to change instantly prices based on current supply and demand information, and competitors prices.

The current information system is efficient, reliable and able to support a lean operation. eCampus is currently a well run business with an excellent management team, a growing customer base, a program for locking in large groups of customers, and is now making a profit.

The used textbook buyback system provides a large supply of used books, and eCampus continues to expand its network of alliances and partnerships with public and private K-12 schools, colleges and universities. The K-12 textbook market is large with sales of $6.4 billion in 2007, and growing 2% a year. Higher education textbook sales market is $3.7 billion and is increasing of 6.5% a year. The current federal economic stimulus program contains provisions for substantial increases in funding for higher education and student financial aid, which could further increase the demand for textbooks.

On the negative side, the strategy to use technology and efficient operations to compete does not provide eCampus with a sustainable long-term advantage because technology can be purchased and operation processes can be copied. Their wholesale competitors are rapidly expanding into e-books sales and services, and the college textbook market has limited growth potential. Although eCampus is making a profit, it is still difficult for them to tap external sources of capital. They will need to rely on internal capitalization and innovation for maintaining and expanding market share.

eCampus faces competitive threats from several sources, such as Follett, which is well capitalized and innovative. Follett is moving strongly into digital textbooks and learning materials by forming alliances and partnerships with publishing companies, schools, universities and colleges, as well as

educators, to develop and distribute digital learning materials. Follett is an innovative company that is expanding through technology leadership.

Other threats to eCampus come from the growing popularity of international editions of textbooks, especially as traditional textbooks prices continue to soar and more Internet sources sell them. The large discount chains, such as Wal-Mart, could use their purchasing power and highly efficient supply chains to undercut eCampus' prices on the best selling textbooks.

Organizations like Flat World Knowledge and The Open Knowledge Foundation that are entering the industry with an entirely different business model could completely disrupt the industry disintermediating wholesalers and retailers from the distribution channel. If successful, textbook buyers would see tremendously lower prices for their college course material. Improved, low-cost technologies such as Kindle, could encourage more students to forego the hardcopy textbooks for the ebooks.

These threats may lead to consolidation of the industry as the better-capitalized companies, such as eFollett.com and Barnes andNoble.com, cut prices and profit margins in order to drive the weaker competitors out of the market or consolidate through the acquisition of weaker competitors like eCampus. In 2008, Follett purchased Varsitybooks, which was one of the pioneers in the online college textbook industry and preceded eCampus by one year. (Varsitybooks, 2008)

The turnaround strategy of eCampus has been successful. While eCampus is beginning to turn a profit, it faces substantial competitive challenges. Matt Montgomery proudly sums up the accomplishments of his management team, "We've turned this company around. Success! Now what do we do? How can we protect our position and be more innovative at the same time? My biggest worry is that the publishing company will try to make us irrelevant."

ASSIGNMENT QUESTIONS:

Strategy Analysis Questions

1. Has eCampus been true to its mission? Review the mission of eCampus and its competitors. Which competitor or competitors pose the greatest threat?

2. Develop an industry analysis for eCampus.

3. Perform a SWOT analysis for eCampus

4. Develop a five forces analysis for eCampus.

5. Identify the resources, capabilities, and core competencies of eCampus before and after the bankruptcy.

Strategy Formulation Questions

1. What generic corporate strategies has eCampus pursued?

2. What competitive strategies are being used by eCampus?
3. Discuss whether eCampus' entrepreneurial strategy been successful?

Strategy Implementation Questions

1. How has the organization structure of eCampus changed during its life?

2. Compare and contrast the operational strategies of eCampus before and after the bankruptcy.

3. Discuss corporate governance used by eCampus.

4. What are the prospects for the long-term survival of eCampus'?

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GENESIS, INC. CASE: ASSESSING EMPLOYEE SATISFACTION

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CASE DESCRIPTION

The primary subject matter of this case is human resource challenges of creating a new corporate culture following growth from a series of mergers and acquisitions. With a difficulty level of four and five, the case is positioned for senior human resources management classes at the undergraduate level or for beginning MBA classes in human resources, organizational behavior or management concepts. The case is designed to be taught in two 60 to 75 minute classes with the first session concentrating on the survey results and the second class focusing on implementing the cultural change process. It is expected to require three hours of outside preparation by students.

CASE SYNOPSIS

Genesis is a leading global supplier of nylon and carpet backing, yarns, and cord fabric. They are also a manufacturer of industrial textiles, reinforcement materials, and yarn used in the production of artificial turf, tires, conveyor belts and webbing. Their polyester coating fabrics are the reinforcing material for tents, tarpaulins, and awnings.

Over a fifty-three year history, the company has grown throughout its seven international locations. As the specialty fibers industry has matured, the company has strategically pursued mergers, purchases, and combining plant locations. This industry consolidation is expected to continue in the future.

At one of their North American plants headquartered in Dalton, Georgia, problems with employee relations resulted from the jumbled corporate culture that evolved from a recent merger and acquisition. Employees remained uncertain and anxious about their future with the company. After reviewing the company mission and history, Genesis management agreed a baseline level of employee satisfaction was needed. With the help of an outside human resources consultant, an employee survey was administered to 253 employees to determine their level of satisfaction with the workplace and culture as well as a number of key human resource practices and issues including management communication, employee feedback, compensation and benefits, and employee recognition programs.

Students are provided the survey results and summaries of open-ended comments and are asked to make recommendations to management and suggest improvements to establish a new, single, cohesive corporate culture.

HISTORY OF GENESIS

The original company began in 1955 and was established as Genesis USA. Thirty years later in 1985, an acquisition of Gemini Industrial Products was made. In 1995, more expansion took place with the acquisition of manufacturing plants in South America, Australia, Europe, and Asia. During 2005, another merger of plants in Melbourne, Australia and Prague, and the Czech Republic was completed. The most recent acquisition occurred in 2006 with a merger of plants in Turkey, China, and Indonesia. Today, the company is a global leader with 10 operations spread over five continents, in nine countries with a workforce of approximately 5,000 employees.

In 2007, the company's net sales reached $925 million.

At the Georgia production facility, Genesis supervisors realized even though employees seemed to appreciate their jobs, productivity, innovation, and employee retention could be improved. Genesis was a top company to work for because of the great benefits offered its employees, but the perception seemed to be eroding. There was a sense that motivation and morale had declined following the latest merger. Out of necessity, changes were being made. Work shifts were reduced from 12 hours to 8 hours and overtime was eliminated. Employees who came from Global International were accustomed to working fourteen days with seven days off and working 12 hour shifts. This was changed to working five eight hour weekdays with weekends off. This seemed to be one of the biggest employee complaints. In addition, fewer benefits were provided to all employees in a cost-saving measure.

Two-thirds of the employees had been with either Genesis or Allied prior to the mergers. These employees had similar jobs and were from the same type of manufacturing background. The remaining employees (approximately one third) were new hires and had little knowledge of the previous culture or benefits except for things they'd been told through the company "grapevine." During the last merger yet a new mix of employees changed the cultures. These employees were immigrant workers from Central America and Mexico.

Generally, employees enjoyed working in the manufacturing environment with other employees but the original employees' discontent with what they perceived to be an erosion of pay and benefits seemed to be affecting the newly acquired and newly hired employees. Turnover reached a company high of 25 percent in 2008. Since the changes were recent, the executive team wanted to quickly address the issues.

Workplace injuries had increased and managers wondered if the increase in injuries was due to lack of training or supervision or due to the new hires and the merger. Reinstatement of the plant's "superior" safety record was an important goal.

Management engaged a human resources consultant for help in identifying the source of problems and for guidance on reshaping the culture. The HR consultant met with the top three directors at Genesis in Dalton, Georgia. The group included the general manager, the quality assurance manager, and the production manager. The general manager began by discussing the current corporate culture. "We are a blend of three different employee groups. The first group hired worked for Global International, which originally manufactured an automobile tire backing material before we began making carpet backing at this plant. A second core group of employees were hired to work at this plant and had only known yarn and carpet backing production. A third group of employees had been hired following the recent merger with one of our former competitors" the general manager explained. As the discussion continued, it became clear that at least three different cultures were evident and the changes had taken place in less than three years. Not only were there differing cultures but work practices and task completion steps also varied. The groups remained disparate thinking their past ideas and processes were superior to the others.

In the meeting with company leaders, the consultant realized maintaining a highly motivated workforce was the key to Genesis future success. The company requires employees who are productive, innovative, and will work to control costs while striving to be the industry leader. With the declining economy in 2009, it is important for employees to implement cost-saving measures while maintaining a high level of job performance and satisfaction. Managers felt employee satisfaction was directly related to quality and productivity. Because of the crises in the mortgage industry and the declining new home construction and automobile production, there is less demand for carpet. Demand for Genesis's carpet backing, yarn, and other products is soft. Management agrees now is the time to correct internal issues and prepare for an industry rebound in the next 12 to 18 months.

After several meetings, discussions, and a tour of the facility, the HR consultant prepared a questionnaire to gather employee data. The questionnaire was pre-tested by the leadership team and a small group of seven hourly employees before the instrument was administered to all managers, professionals, and hourly workers.

Employees were asked to rate each question on a Likert-type scale ranging from "strongly agree" to "strongly disagree" with "3" a mid-point rating for the neutral response of "neither agree nor disagree." Questionnaire categories included the job itself, key job satisfaction components of skill variety, task significance, task identity, autonomy, communication and feedback plus areas of compensation, benefits, rewards, and recognition. The results are tabulated by percentages in several tables following the original order of the questionnaire. Of the Genesis employees who participated in the satisfaction survey, ninety percent were hourly, five percent were managers and five percent were non-managerial/professional. The survey was administered during two off-site mandatory training sessions. Approximately twenty employees did not complete the survey due to illness/absence.

QUESTIONS

Based on the data provided, prepare a consultant's report. Specifically, address the following questions.

1. What are your recommendations for management to improve the culture of Genesis?

2. What specific recommendations are needed for the job, communication and feedback, compensation and benefits, and recognition?

3. What does Genesis seem to be doing right? Should these practices be continued?

4. Develop a time line and order of implementation for the recommended changes?

5. When should the company expect to see improved morale and why?

6. How can the company perpetuate the "new" culture for the future, particularly if additional mergers and acquisitions are forthcoming? How?

7. If the economic downturn and recession persists, how can the company maintain morale in light of potential layoffs and cut-backs in jobs and work loads?

8. What top changes are necessary to improve the safety/injury record at Genesis to previous levels?

9. Discuss change management and Lewin's unfreeze-change-refreeze theory of organizational change as it relates to Genesis.

10. Given the issues mentioned in the open-ended responses, what should management change or address and why?

Table 1: About My Job

	Strongly Agree	Agree	Neither Agree or Disagree	Disagree	Strongly Disagree	Did Not Answer	Total
1. Overall, I feel this is a good place to work.	52	119	48	21	9	4	253
2. I clearly understand the expectations of my job	76	143	21	7	5	1	253
3. The workload expected of me is realistic	25	103	55	47	21	2	253
4. I feel I have adequate resources and support to do my job	24	84	60	56	27	2	253
5. The orientation to my job adequately prepared me	26	104	63	31	16	13	253
6. I have the decision-making authority I need to do my job well	51	102	49	33	11	7	253
7. I feel my efforts make a positive difference in the success of this organization	60	115	44	21	11	2	253
8. I have the chance to make daily use of my abilities and skills	57	132	38	19	6	1	253
9. I enjoy performing the day-to-day activities of my job	43	86	71	32	14	7	253
10. My work schedule allows me sufficient flexibility to meet my personal/family needs	57	71	55	34	30	6	253
11.Employee relationships are based on trust	64	97	51	18	21	2	253
12. The level of cooperation within the company helps me in performing my job	20	87	87	35	21	3	253
13. I received the appropriate training to perform my job	40	114	55	24	12	8	253
14. Additional training would be useful in (write your answer in space provided):							
• troubleshooting mechanical problems, skills and procedures (28) • specific skills - packing standards, finishing spinning procedures, polymers, winders(20) • all aspects of the jobs in general – on-going, hands-on training is needed (15) • maintenance and equipment repair (6) • cross training between the 1st and 2nd floor (4) • new hire classes (4) • communication (3) • cleaning (2) • foreign language (Spanish) (2) • management and supervision (2) **Additional comments:** computer; documentation; drives; housekeeping; forklift driving; I trained myself; keep trainees off the floor until they are properly trained; listening to and understanding lies; making sure the trainers watch the employees they are training carefully; notes; train on our off days monthly possibly 1 day; one on one training; problem solving; process; project management; still in the classroom training now.						157	
Total	595	1357	697	378	204	215	

Table 2: Communication and Feedback							
	Strongly Agree	Agree	Neither Agree or Disagree	Disagree	Strongly Disagree	Did Not Answer	Total
15. Genesis regularly and effectively communicates organizational goals and objectives	20	122	64	35	10	2	253
16. New and existing policies are clear, communicated in a timely manner and easily available	13	87	73	58	20	2	253
17. I am informed about big changes in advance, instead of being caught by surprise	11	59	72	68	39	4	253
18. I receive regular and effective feedback that helps me improve my job performance	19	68	78	60	23	5	253
19. My supervisor is not specific enough when giving me feedback about my job performance	11	56	68	79	32	7	253
20. My supervisor listens to me when I have issues or ideas about improving my job	48	87	67	29	18	4	253
21. My supervisor's actions and behaviors are consistent with her words	37	86	66	38	21	5	253
22. I am satisfied with how complaints and concerns are dealt with	19	62	68	65	38	1	253
23. My supervisor is approachable and available whenever I have a need	48	106	53	24	18	4	253
24. The supervisor has a good understanding of what is happening in this facility	39	88	58	28	33	7	253
25. Communication at Genesis could be improved by:							
Representative Comments: letting people know well in advance before anything is done; not communicating at the "last minute"; telling people face-to-face instead or relaying problems or concerns; quick responses; being more up to date on issues; shift notes; communicating; actually listening to the employee's concerns; management has no real idea as to what is happening within the industrial parts of this company; newsletter to all employees; having a clear understanding of other team members jobs and responsibility; English classes are needed; responding to our question without getting mad; listening to a broader cross-section of employees instead of a select few; more team meeting; improving communication with shifts (top to bottom); eliminating "layers" of communication - go directly to those involved in needed discussion; handbook; if everybody speaks and understands English; letting people know what kind of process changes are being made; having translators; allowing operators to speak openly without rejecting their ideas as soon as they start talking; supervisors following standard operating procedures also; not waiting till the last minute to be informed about big changes (example: going to eight hour days); if you know about changes two months before time than you should let your employees know that; computer lists updated and used; allowing individuals in area to make the "call" instead of going thru several individuals before a decision is made.						144	
Total	265	821	667	484	252	183	

Table 3: Compensation and Benefits							
	Strongly Agree	Agree	Neither Agree or Disagree	Disagree	Strongly Disagree	Did Not Answer	Total
26. I feel that my contributions are appropriately compensated	19	92	65	53	22	2	253
27. I believe compensation is competitive to the local marketplace	26	111	66	32	17	1	253
28. I believe compensation is in line with the workload and expectations of the organization	22	85	68	48	24	6	253
29. I believe I understand the benefits provided by Genesis, Inc.	39	145	54	7	6	2	253
30. I believe benefits are competitive to other similar companies	38	111	59	13	18	14	253
31. I would like to see the following benefit(s) added:							
Paid sick days/earned sick leave (rather than having to use vacation days) (43) Production bonuses/incentives/stock options (18) Buy unused vacation weeks back (11) Bought vacation (7) Better dental insurance (6) More pay (5) More vacation (5) Paid disability (5) Paid disability (4) Wellness/fitness facility on-site or paid off-site or discounts (4) Pension program (3) Paid time off/personal days/flex days (4) Health insurance after retirement (2) Profit sharing (2) Day care (2) Supplemental insurance (like AFLAC) (2) Wellness program or rewards for wellness (2) Better insurance (1) Additional comments: recognition, structured pay ranges for salary grades; clear policy on "comp" time; paid time off; add auto-insurance; promotion based on skill not who you know; more money to keep up with economic standards; at least 3 sick days/year per employee; having a job at Genesis; 44 hrs not enough when on 12 hr shifts; moving away from rotating shifts; vacation days – in the past, after working five years, you accumulated another week of vacation; incentives for ideas submitted; increase 401k take; education for child; stay on 12 hr. shifts; annual cost of living raise; my money back; no money loss on serious health problem (cut to 80% after 3 months); stop taking money away; give back the money they are taking from my check and give back weekend off.						140	

Table 3: Compensation and Benefits							
32.. The benefit(s) I most appreciate is (are) the following:							
Medical/health benefits (87) 401k and 5% company match (50) Vacation (32) Dental (20) My pay in general (14) Vision (9) CAP(8); CAP – college/school assistance (7) Floating hours; flex time and schedule (5) Life insurance (5) Short and long-term disability (4) The entire benefit package (4) Holidays (3) sick days (3) EAP (2) Insurance for my children (2) FMLA (2) Additional comments: time off; working for Genesis; flexible spending; the fitness club; bonus; double time on the 7 days; the rate of topped cut pay; 12 hr. shift(3); paid holidays; EAP; 2 working days; my paycheck every two weeks; they took most of them away in the last 4 years; death in the family (3 days); holiday pay.						103	
Total	144	544	312	153	87	268	

Table 4: Recognition and Open-Ended Comments						
	Strongly Agree	Agree	Neither Agree or Disagree	Disagree	Strongly Disagree	Did Not Answer
33. Genesis, Inc. offers recognition to individuals in appropriate ways	10	54	82	63	40	4
34. Recognition or praise is something I value	94	98	47	8	3	3
35. At Genesis, Inc. recognition or praise for doing a good job is rare	63	68	57	34	12	19
36. For me, recognition or praise could take the form of (write your answer in the space provided).						

Table 4: Recognition and Open-Ended Comments						
Say Thanks (appreciation, lunch, conversation, paid dinner, recognition from supervisor, simple thanks or praise (62) Bonus (35) Money/more pay (32) Gift cards or gift or perk (19) Vacation (7) Advancement/raise/incentives (7) Awards and incentives (5) Time off (5) Respect (3) Additional comments: respect for the individual person; nothing is done right now; parking spots; add to benefit program Genesis Chat; parking privilege; comp time; pay for performance; only Jesus gets the praise; praise given before we complain about not getting any; sick day; anything at all would be better than what we have now; not taking money away from me; any; better employees; better job on their assignments; anything						116
Total	167	220	186	105	55	142
Written Comments						
37. Comments about Genesis, Inc. overall						
good company/happy/enjoy my job here (68) good pay/benefits (13) okay but needs improvement (12) bad/don't like it (9) not like the former merged/acquired company – liked it better (2) Additional comments: not family valued; needs to lighten up on the employees a little; too much for 12 hr shifts; not enough follow through; fair; getting better; expectation on workload - not realistic for 12 hr shifts; we need to improve instead of just maintain our processes; it's trying to stay in the market and I hope it can; my job has allowed my wife to stay home with our children, for this I am thankful; just needs a couple of things straightened out; I feel supervisors play favorites; continue the same policy that has began with Genesis and add more if necessary; bring back smoking; good intentions; opportunities are out there; a proving global company; just started; stop social promotions; need to treat employees better; stop adding and building things within if we're trying to save; don't take care of their moneymakers; I think they have unrealistic views on what our workload should be; terrible management; don't like the changes; poor management; like the pay don't like the pressure; too many changes - not all for the employees; take, take, take; need to value workers more; would like to see it grow; quit taking from us (money); we need to be appreciated; focus on mental not physical aspect; needs more accountability; keep on taking your time and money and giving nothing back; as long as they don't take money away from me their fine						130
38. Comments about the workload						
Representative Comments: in spinning, our workload has increased; expectations are realistic, but right now we don't have the right tools to meet expectations; we have no time to trouble shoot; fair; depends on the day; insane; good; heavy; would be easier if I were better trained; would like to see more packers where I can concentrate on the machines; very, very physical; killing my back; too much work without a packer and a trained partner; heavy; you get in situations where you need a little help; very heavy, very demanding; we are operators, inspectors, packer, housekeeper, maintenance, buggy pushers - too many tasks; too heavy for one person to take at a time.						121
39. Comments about communication within Genesis, Inc.						

Table 4: Recognition and Open-Ended Comments	
Representative Comments: the communication needs a lot of work; operators are left in the dark; emails and bulletins are effective; there's no communication some of us forget we are all here for the same cause; housekeeping audits are done with no feedback; communication between operators and high level people is needed; communication is unclear sometimes; need quarterly financial meeting; needs to be better and faster; needs work; bad; each shift has different information; too much phone clutter (noise-sounds) on intercom.	134
40. Things you believe Genesis, Inc. should continue to do	
Representative Comments: have more group involvement; have annual meeting to let you know how we are doing; reduce injuries, and reward a great job done; employees feel overworked and underappreciated; shift get togethers; meetings; keeping everyone informed of business issues; keep working on the job improvements; promoting within the company; train; treat people better; leave the machines running at a good speed and leave it alone; investing money in better equipment; strive for excellence; stay on 12 hrs; continue to value their employees; training.	153
41. Things you believe Genesis, Inc. should start or stop doing	
Representative Comments: work safety; involving more people to do tasks instead of relying on same people; start communicating with the little guy; respecting the operators minds; Genesis should not penalize everyone for something 1 or 2 did wrong; start being fair to all employees; stop the meetings! too many too often; we do not get a whole lot out of graphs and pie charts; stop allowing some people to get away with breaking the rules, while punishing others. Lots of favoritism; maybe a designated smoking area; start listening to every race of people; start praising employees more; have sick days available - we are using vacation days when we get sick; stop taking and start giving back.	151
42. Comments about any of the above questions	
Representative Comments: great improvement in organization of area; spinners can tell what's happening; sorry I couldn't answer more; make people a priority; no clue; will this survey really change anything?; fair; leave our 12 hour shifts alone; I get sick of thinking where this company will be in 5 years; focus on question #37; I know my partner and quad well; questions are fine; have a suggestion box - could possibly give improvements to area	240
43. Additional Comments	
Representative Comments: seems like a great place to work so far overall, great people in general; with various cultures working in Genesis, Inc., I think that misunderstandings occur between American and international employees; some simple training/open discussion @ culture differences between these two groups could be beneficial and help us to better understand each other; changing winders is extremely dangerous due to the ramp. steel plate needs to be "flush" with concrete; more and more is asked of us with no additional people or proper supplies; operators are people too; we deserve respect; better exhaust system; good place to work; companies actions causes lack of trust from employees; Genesis should reprimand people not willing to follow company policies; blessed to have a job; glad to be going to 8 hrs; find a way to compensate for lost of wages due to hour changes if would help morale.	226
	1155

Table 5: Demographics							
44. Total number of years with Genesis	21	less than one year	179	more than one year			53
45. Previously worked for merged company	103	Yes	100	No			50
If no, skip question 46							
46. Total number of years with Genesis	61	1-5 years	21	6-10 years	18	more than 10 years	151
47. My job classification is:	162	hourly	10	non-managerial	19	management	67
Total Surveyed:	253						

BAMA DRINKS COMPANY: AN INVENTORY CASE PORTFOLIO

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CASE DESCRIPTION

The primary subject matter of this case concerns managing inventory shortages and their associated costs. Secondary issues examined include: inventory costs, inventory policies, forecasting sales, and prioritizing customers. The cases have a difficulty level of 3, junior level, for cases (A) and (B) and level 4, senior level, for cases (C) and (D). The cases are targeted to operations management, inventory management, and supply chain management courses. The cases are designed to be taught in 2 class hours and are expected to require 4 hours of outside preparation by students.

CASE SYNOPSIS

The cases address the inventory issues faced by a distributor of soft-drinks, Bama Drinks Company. The discussion about inventory policies starts when an important customer places an order and the product is not in stock. Since demand with newer customers has begun increasing, some of Bama Drinks' regular customers have been forced to accept some late shipments. This sparks the discussion about whether all customers should be treated equally and the company's inventory policy in general.

In Case (A) students are exposed to the realism of managing inventory shortages and their associated costs. Some of Bama Drinks' functional managers are introduced, and their mention is continued throughout the case portfolio.

Case (B) provides specific cost details (e.g., leasing, freight, order placement, and holding costs) and requires the students to develop inventory ordering policies (economic order quantity and reorder point). It also asks the students to determine the needed inventory storage space based on the inventory policies – a serious management issue.

Case (C) builds on the techniques utilized in Case (B) by adding the realistic complexities of predicting future sales when a trend and seasonality are present. This is essential to overcome since inventory policies are based on future, rather than historic, sales patterns. The more accurate the sales forecast, the more realistic the inventory policies can be. It also gives the students the opportunity to explore different sales forecasts using numerous mathematical formulations. The students learn the

linkage between forecasting and inventory decisions and the reality that an accurate forecast must precede.

Finally, Case (D) explores the difficult, but realistic situation of having different service levels for various customers. Prioritizing customers is necessary for they do not all represent the same economic benefit to the company. The trade-offs necessary when designing such inventory policies are explored.

BAMA DRINKS COMPANY (A)

Company Background and History

Bama Drinks is the main distributor of a raspberry-flavored soda called Crimson Soda that is sold in 20 oz. bottles with the image of an elephant on the packaging. The Bama Drinks distribution company was organized in the fall of 1993 as a joint venture between Flores, a soft-drink giant, and Sasamoto Oil, a regional company that owns a chain of convenience stores. The original idea was to sell Crimson Soda to fans of the successful Crimson Tide football program in the southern states, but the drink turned out to be more popular than anticipated. The two companies decided to join forces by setting up a dedicated distribution center, Bama Drinks, to successfully meet demand for the popular drink.

The Bama Drinks distribution center, originally an auto parts warehouse, is located in Athens, Georgia and was initially leased by Flores both to house inventory and to act as the main shipping hub. From the warehouse Crimson Soda was transported to all customers within a 200-mile radius. In turn, Sasamoto Oil supported the 20-30 employees that worked inside the central warehouse, including the management who were transferred from similar positions with Flores.

The business of selling Crimson Soda was an increasingly profitable venture for both companies until ten years later when profit began to decrease. Taking the shift in profitability as signal, and rather than spend additional money fixing some operational issues that had crept in, the two companies put Bama Drinks up for sale in 2003. A number of the employees that had been working at the distribution center since it opened in 1993, including management, formed a company and, with a business loan and some investment capital, purchased Bama Drinks.

It is now the beginning of 2009, six years after the transfer of ownership. The Crimson Soda drink is still produced, bottled, and transported by the soft drink giant to the warehouse, but the purchasing, marketing, selling, and delivery is done by the independent company, Bama Drinks. In addition, one of the biggest customers for Bama Drinks is still Sasamoto Oil, representing a significant chain of convenience stores that continues to order Crimson Soda year-round.

New Problems, Old Customers

Jamison Roberts had been the sales manager at Bama Drinks since its inception, and he smiled as another full delivery truck pulled away from the dock. He had just finished a phone call with a newer

customer that requested 100 additional cases of Crimson Soda – far more than expected. Jamison was happy to promise prompt shipment of the large order. "Our numbers this quarter will look good," he thought. Demand for Crimson Soda had been much higher than anticipated in the recent weeks, though not without some lurking problems.

The phone rang again; it was the purchasing manager for Sasamoto Oil, Agustin Menendez. "Que Pasa Jamison?" Agustin said, "I need 50 more cases of Crimson Soda." When Jamison tried to key the order into the computer he noticed that, after he promised the 100 cases to the newer customer, it left only ten cases for Sasamoto Oil, and another truck from the supplier wasn't due for a couple of days. After thirty minutes of negotiating an agreeable (yet expensive) discount for the trouble caused to Sasamoto Oil, Jamison hung up the phone and sighed, "Another close one."

Since demand with newer customers had begun increasing, Sasamoto Oil had been forced to accept some late shipments. It was getting tired of having to wait in line with the newer, less loyal customers of Bama Drinks. Jamison thought, "We'd better make sure that this does *not* happen again – Sasamoto is one of our most important customers."

An hour later, Jamison, Natalie Moore (the inventory manager), Alexander Maduro (COO) and Anneke Vandenberg (Product manager) met in the conference room. "As you all know, we had a serious inventory shortage today," Jamison began. "One of our big customers called to place a regular order for Crimson Soda, but because we didn't have enough inventory I had to give them a discount on a later order to make them happy. Luckily, I was able to resolve the issue, but it *was* expensive." He continued: "Alexander and I thought we should have this meeting to make sure it doesn't happen again."

Alexander looked at Natalie, "Maybe you should explain our current inventory policy, and then we'll go from there." Natalie explained, "When a customer places an order the system checks availability. When we have enough product available we ship it immediately, otherwise the order stays in the system until we get the next shipment from our supplier. It takes our supplier about three days to get a shipment to our receiving dock. When we have four days of expected demand left in inventory, we place a regular order with our supplier. The extra day of inventory is to make sure we place our order before we run out."

"There wasn't enough this time!" Jamison interrupted. "We'll be out of Crimson Soda for almost two days!"

Natalie ignored the comment and continued. "Because it is expensive to keep inventory, we determine our inventory levels based on a 90% fill rate. So, we *will* be short sometimes."

Questions:

1. Which inventory costs might Natalie be calling expensive?

2. What does Natalie mean by saying that they use a 90% fill rate?

3. Which inventory policy is Bama Drinks inherently using?

4. What are some alternative policies that Bama Drinks could use?

5. Which changes to Bama Drinks' inventory policy do you suggest?

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BAMA DRINKS COMPANY (B)

Back in her office Natalie Moore, the inventory manager for Bama Drinks, thought that they should rethink their inventory ordering policies. She feels that she will need to know all the costs that could impact inventory ordering and the costs that are affected by inventory. She narrows this list down to a few costs and lists them as follows:

- *the cost to place an order (purchasing and all the paperwork that goes with it is not free)*
- *the cost to hold inventory in the warehouse (we have to lease the warehouse just to hold the cases of drinks before they are shipped)*
- *he cost to ship the cases (Since Bama can choose the freight carrier for deliveries to the warehouse, they must pay the shipping charges.)*

After quickly examining the sales figures for 2008 Natalie noted that the company had ordered and sold 20,600 cases of soft drinks. Bama Drinks operates 5 days a week 50 weeks a year with a two-week vacation period. She learns from the purchasing agent, Augustin Menendez, that their average customer order size is 40 cases. Each case contains 24 drinks and is sold at wholesale for $42. Augustin mentions to Natalie that he figures that it cost the company $25 to place an order.

The warehouse that stores the cases before shipping contains 12,000 square feet, and cases can be stacked three high. To determine the cost of storing the drinks by the case Natalie emails the company accountant, Schwadin Mutamba. After some examination Schwadin calls Natalie and tells her that the total annual cost of storing a case of drinks in the warehouse is about $2.50.

Natalie next calls the company shipping manager, Ross Martin, to learn their freight cost. Within a few hours he sends an email to Natalie stating that the freight cost from the bottler to BAMA is $100 per shipment (regardless of quantity) and that the lead time is usually three days.

Natalie now feels she has enough information to begin her analysis of their inventory ordering policies.

Questions:

1. For the moment ignore the freight cost. Using the economic order quantity (EOQ) model, what would be the inventory order quantity that would provide the lowest total inventory ordering, and holding cost?

2. Now including the freight cost what is the economic order quantity that would provide the minimum total inventory, holding, and freight cost? Does adding in the freight cost make much of a difference in the economic order quantity? Does the EOQ increase or decrease? Is that what you expected?

3. Using your answer to question (1), what would be Bama's total inventory ordering and holding cost for the year?

4. Again using your answer to question (1), how many orders would Bama place per year?

5. Given a lead time of three days at what inventory level should Bama place an order?

6. Assuming that: (1) a case of soft drinks requires 2.5 square feet of floor space and (2) the case stacking conditions mentioned in the case, what is the maximum amount of storage space (floor space) Bama would need in its warehouse to store inventory?

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BAMA DRINKS COMPANY (C)

As Jamison Roberts, the company sales manager, reviewed Natalie's recommendations for the company's inventory ordering policies, he wondered if sales for 2009 would be the same or similar to that for 2008. He believed that sales had followed a noticeable upward trend over the last five or six years. To examine his beliefs he prepared an analysis of aggregate and quarterly sales for 2003 through 2008. The results are reported in Exhibit 1. Jamison called in Natalie Moore, the inventory manager, to examine the figures. Pointing to the exhibit Jamison said, "Natalie, these figures show that we have increased our sales each year and, if 2009 sales follows the trend, sales will again be higher. Can we really use the sales for 2008 to calculate the best inventory order policies for 2009? Also, it appears that we have some seasonality in our sales. First quarter sales for soft drinks are slow, as might be expected in the cold season. Sales then move up over the rest of the year. Should we somehow adjust our inventory policies for each quarter?" Natalie stared at the figures momentarily and then responded, "This

might explain why we have excess inventory early in the year and shortages later." Both Jamison and Natalie hesitated to talk further. Who would speak first?

Questions:

1. Is Bama experiencing a pattern of seasonality in its sales or are the seasonal fluctuations just random?

2. If sales are indeed increasing per year and the company sales are experiencing seasonality what should the expected sales figures for 2009 be and how should they be determined?

3. If inventory policies are tied to expected future sales, not past sales, what should Bama's inventory policies be for 2009?

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Exhibit 1: Sales Data for Bama Drinks Company
(in number of cases sold)

Year	Quarter	Quarterly Sales	Annual Sales
2003	1	2,815	
	2	2,721	
	3	2,282	
	4	4,301	12,119
2004	1	3,113	
	2	3,523	
	3	3,260	
	4	5,211	15,107
2005	1	3,633	
	2	4,121	
	3	3,965	
	4	6,922	18,641
2006	1	2,639	
	2	3,740	
	3	4,217	
	4	6,424	17,020

Exhibit 1: Sales Data for Bama Drinks Company
(in number of cases sold)

Year	Quarter	Quarterly Sales	Annual Sales
2007	1	3,934	
	2	4,676	
	3	4,633	
	4	6,981	20,222
2008	1	4,348	
	2	4,788	
	3	4,298	
	4	7,178	20,612

BAMA DRINKS COMPANY (D) CASE

Prioritizing Customers

Alexander was pleased with the description of their current inventory policy, and said, "So we *have* been out of inventory before, and when that happened we just placed an order with our suppliers and we received the product within a few days, problem solved. What's different this time?"

"This time," Jamison said, "it happened to an order from Sasamoto Oil. We cannot afford to lose them. We've made a lot of promises to keep them since the buy-out, and I don't think they will accept this again. In fact many of our long-time customers and our larger customers, Like Sasamoto Oil, Hill Co., and Exxoff, demand higher service levels. We generally have to give discounts on their late orders, which is money from the bottom line. On the flip-side, the newer customers are used to having some delays, as are most of the low-volume customers – thus delaying orders to them are not as costly.

"Could we increase our service level for Crimson Soda?" Anneke asked. "We could, but increasing the service levels is expensive," Natalie continued, "And, it is no guarantee that we will not run out of inventory in the future." "Maybe we could set a different policy for the more important customers," Alexander asked, "Jamison, how could we have handled the orders differently today?" "Well, this morning we had a large surprise order from a newer customer, and it depleted inventory," Jamison responded, "The newer customer usually buys from our competitors so I though this might be a way to get their business. But, if I had known that we would run out of inventory for one of our large customers, I would have tried to convince the newer customer to accept a later shipment."

Questions:

1. Which changes can Bama Drinks make to the inventory policy to increase service levels?

2. What trade-offs should be considered when setting service levels?

3. Based on Jamison's comment above, design a new inventory policy for Bama Drinks.

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CAPE CHEMICAL: CASH AND PROFITS

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Benjamin L. Dow III, Southeast Missouri State University

CASE DESCRIPTION

The primary subject matter of this case concerns the difference between cash and accounting profits and the problems a company can encounter if profits and cash are assumed to be the same. Secondary issues examined include the preparation and interpretation of the statement of cash flows, fundamentals of working capital management, and financial statement analysis. The case requires students to have an introductory knowledge of accounting, finance and general business issues thus the case has a difficulty level of three (junior level) or higher. 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 almost all measures, the performance of Cape Chemical has been very good over the last three years (2005-2007). Double-digit sales growth has been achieved, new product lines have been added and profits have more than tripled. But despite this apparent success, cash flow has been a problem. It has been a struggle for Stewart to maintain sufficient cash to pay obligations in a timely manner. The company reached its bank-borrowing limit at the end of 2006, but Williams successfully negotiated an additional $3,000,000 in long-term borrowings using fixed assets as security. The additional $3,000,000 was used during 2007 as well as an extra $1,000,000 provided by a working capital loan extended by the bank. At the end of 2007 the debt ratio was 71% and the TIE ratio was 1.81. The bank has refused to grant additional loans until the debt ratio can be lowered to below 50% and the times interest earned (TIE) ratio increased to above four.

BACKGROUND

Cape Chemical is a relatively new regional distributor of liquid and dry chemicals, headquartered in Cape Girardeau, Missouri. The company, founded by Ann Stewart, has been serving southeast Missouri, southern Illinois, northeast Arkansas, western Kentucky and northwest Tennessee for five years and has developed a reputation as a reliable supplier of industrial chemicals. Stewart's previous

business experience provided her with a solid understanding of the chemical industry and the distribution process. As a general manager for a chemical manufacturer, Stewart had profit and loss (P&L) responsibility, but until beginning Cape Chemical, she had limited exposure to company accounting and finance decisions.

The company reported small losses during its early years of operation, but performance in recent years has been very good. Sales have grown at double-digit rates, new product lines have been added and profits have more than tripled. The growth has required the acquisition of additional land, equipment, expansion of storage capacity and more than tripling the size of the work force. Stewart has proven to be an expert marketer, and Cape Chemical has developed a reputation with its customers of providing quality products and superior service at competitive prices.

At the insistence of Stewart, the company has promoted "next day delivery" since its inception. This requires Cape Chemical to carry a large number of products and large quantities of each item. As Cape Chemical has added new product lines, more and more dollars have been invested in inventory. Other chemical distributors can seldom provide "next day delivery" service because they don't stock the number of products and the quantity of each carried by Cape Chemical. Not surprisingly, "next day delivery" has proven very popular with its customers and has allowed Cape Chemical to capture a large market share. The sales force is also a strong supporter of the service, but because occasional inventory shortages cause sales to be missed, they are constantly arguing for even greater amounts of inventory to be maintained by the company. Stewart has tended to agree with the sales force and has over the years instructed the purchasing department to err on the side of carrying too much rather than too little inventory.

Stewart has also used a liberal credit policy to stimulate sales, and that also has been a contributing factor to the double-digit sales growth. Credit terms offered by its main competitors are net 30-days, which conforms to general industry practices. Cape Chemical also sells using net 30-day terms, but Stewart has encouraged the firm's credit manager to take a "soft approach" when collecting past due accounts. As a result, the credit department has been slow to press past due accounts for payment. The relaxed collection effort has proven to be popular with both customers and the sales force but has resulted in a increasing number of customers paying late. To further increase sales, Stewart suggested credit standards be lowered so that more customers can qualify for credit. The credit standards were lowered two years ago and again at the beginning of the 2007. The bad debt losses experienced by the firm have not changed significantly with the less restrictive credit standards.

CHEMICAL DISTRIBUTION

A chemical distributor is a wholesaler. Operations may vary but a typical distributor purchases chemicals in large quantities (bulk - barge, rail or truckloads) from a number of manufacturers. They store bulk chemicals in "tank farms", a number of tanks located in an area surrounded by dikes. The tanks can receive and ship materials from all modes of transportation. Packaged chemicals are stored

in a warehouse. Other distributor activities include blending, repackaging, and shipping in smaller quantities (less than truckload, tote tanks, 55-gallon drums, and other smaller package sizes) to meet the needs of a variety of industrial users. In addition to the tank farm and warehouse, a distributor needs access to specialized delivery equipment (specialized truck transports, and tank rail cars) to meet the handling requirements of different chemicals. A distributor adds value by supplying its customers with the chemicals they need, in the quantities they desire, when they need them. This requires maintaining a sizable inventory and operating efficiently. Distributors usually operate on very thin profit margins. *RMA Annual Statement Studies* indicates "profit before taxes as a percentage of sales" for Wholesalers - Chemicals and Allied Products (Standard Industrial Code number 5169) is usually in the 3.0% range. In addition to operating efficiently, a successful distributor will possess 1) a solid customer base and 2) supplier contacts and contracts that ensure a complete product line at competitive prices.

THE SITUATION

While profits have increased over the last three years (2005-2007), cash flow has been a problem. Stewart has struggled to maintain sufficient cash to pay obligations in a timely manner. The company reached its bank-borrowing limit at the end of 2006, but Stewart used fixed assets as collateral to successfully negotiate an additional $3,000,000 in long-term borrowings. The additional capacity was used during 2007 as well as an extra $1,000,000 provided by a working capital loan extended by the bank. At the end of 2007 the debt ratio was 71% and the TIE ratio was 1.81. The bank has refused to grant additional loans until the debt ratio can be lowered to below 50% and the times interest earned ratio increased to above four.

Stewart has been attempting to acquire an attractive specialty chemical product line since starting the company. Adding this product line will require an investment of $200,000 to acquire the necessary special handling and packing equipment. Inventory investment will require another $800,000.

Stewart has hired James Scott, a financial advisor, to provide assistance developing financing options and solving the firm's cash problems. To finance the expected sales growth for 2008, Stewart has estimated the firm will need at least $2,000,000 for additional current assets and another $1,200,000 for capital expenditures. In total, the company needs approximately $4,200,000 in new financing to add the specialty chemical line and provide the necessary resources to achieve the planned sales growth for 2008. Issuing more common stock is not an option since Stewart does not want to further dilute her ownership position. The stock is not publicly traded.

At their first meeting, Stewart provided Scott with income statements and year-ending balance sheets for the most recent three years (See Schedules One and Two). A complete analysis at the meeting was not possible, but Scott noted the increase in accounts payable and inventory. Stewart explained that a large inventory investment was necessary to support the company's "next day delivery" service and how the use of a liberal credit policy has caused accounts receivables to increase. She also stressed the importance of each to the company's continued sales growth. When asked about the firm's daily sales

outstanding (DSO) and days invested in inventory, Stewart stated that ratios are not calculated. Stewart said she really doesn't understand all those ratios and besides she doesn't need them to run the business. Since the company's inception, an outside accounting firm has prepared the financial reports based on data supplied by the firm's bookkeepers. To keep overhead expenses low Stewart has been reluctant to hire a full-time accountant. The company's accounting firm prepares a quarterly financial statements consisting of an income statement and balance sheet. No cash flow statements are prepared.

THE TASK

Assume you are an assistant to Scott. Evaluate the firm's current situation. In your analysis answer the following:

1. Explain why it is possible for a firm to be profitable and at the same time experience cash flow problems.

2. Prepare a cash flow statement for 2006 and 2007. (Complete Schedule Three). Interpret the information provided by the cash flow statements. How has Cape Chemical been using its cash and why is additional cash needed?

3. Calculate the return on equity for 2005, 2006 and 2007 using the extended DuPont equation. Interpret the results. What does the equation reveal regarding the company's profitability, use of assets and sources of financing?

4. Evaluate the company's performance for 2005, 2006 and 2007 using ratio analysis. Calculate the following ratios and evaluate performance. (Complete Schedule Four).
   a. Current ratio
   b. Accounts receivable turnover
   c. Average collection period (ACP) or Days sales outstanding (DSO)
   d. Inventory turnover - using cost of goods sold in the numerator
   e. Inventory conversion period- using cost of goods sold
   f. Accounts payable deferral period
   g. Fixed asset turnover
   h. Total asset turnover
   i. Times interest earned ratio (TIE)
   j. Debt ratio
   k. Basic earning power
   l. Profit margin

m. Return on assets
n. Return on equity

5. Calculate the company's cash conversion cycle for 2005, 2006 and 2007.
   a. Use the cash conversion cycle to evaluate the firm's working capital policy.
   b. Explain the goals of inventory management. Evaluate Cape Chemical's inventory management.
   c. List the components of a firm's credit policy. Evaluate Cape Chemical's credit policy.
   d. Discuss the tradeoffs associated with working capital management.

6. Based on answers to questions 1-5, summarize why the firm is experiencing cash problems? Provide your recommendations to improve the cash situation.

7. What alternatives are available to the firm to acquire the $4,200,000 financing required to add the specialty chemical product line and finance the projected sales growth for 2008?

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Schedule One
Cape Chemical
Income Statements (000's/$)

	2005		2006		2007	
	$	%	$	%	$	%
Revenue	18,675	100.00	28,675	100.00	48,845	100.00
Cost of Goods Sold	15,932	85.31	24,393	85.07	42,007	86.00
Gross Profit	2,743	14.69	4,282	14.93	6,838	14.00
Operating Expenses						
Selling	1,251	6.70	1,851	6.46	2,734	5.60
General & Administrative	1,090	5.84	1,590	5.54	2,192	4.49
Total Operating Expenses	2,341	12.54	3,441	12.00	4,926	10.09
Operating Profit	402	2.15	841	2.93	1,912	3.91
Interest Expense	210	1.12	510	1.78	1,059	2.17
Earnings Before Taxes	192	1.03	331	1.15	853	1.74
Income Tax Expense	67	0.36	116	0.40	299	0.61
Earnings After Taxes	125	0.67	215	0.75	554	1.13

Schedule Two
Cape Chemical

Balance Sheets (000's/$)

	2005		2006		2007	
	$	%	$	%	$	%
Current Assets						
Cash	25	0.29	20	0.17	10	0.05
Receivables	1,712	19.79	3,412	28.76	6,454	33.55
Inventory	1,582	18.29	2,958	24.94	6,490	33.73
Other current assets	44	0.51	64	0.54	39	0.20
Total current asssets	3,363	38.88	6,454	54.41	12,993	67.53
Fixed Assets						
Land	590	6.82	590	4.97	590	3.07
Gross plant,property & equipmen	5,078	58.72	5,600	47.21	6,929	36.02
(less accumulated depreciation)	(382)	(4.42)	(782)	(6.59)	(1,273)	(6.62)
Net plant, property & equipment	4,696	54.30	4,818	40.62	5,656	29.40
Total fixed assets	5,286	61.12	5,408	45.59	6,246	32.47
Total Assets	8,649	100.00	11,862	100.00	19,239	100.00
Current liabilities						
Account payables	1,019	11.78	2,019	17.02	4,656	24.20
Short-term notes payables	300	3.47	1,300	10.96	2,500	13.00
Accrued liabilities	312	3.61	280	2.36	241	1.25
Total current liabilities	1,631	18.86	3,599	30.34	7,397	38.45
Long-term liabilities	2,300	26.59	3,330	28.07	6,355	33.03
Total liabilities	3,931	45.45	6,929	58.41	13,752	71.48
Shareholders' equity						
Common stock	4,500	52.03	4,500	37.94	4,500	23.39
Retained earnings	218	2.52	433	3.65	987	5.13
Total equity	4,718	54.55	4,933	41.59	5,487	28.52
Total liabilities & equity	8,649	100.00	11,862	100.00	19,239	100.00

Schedule Three
Cape Chemical

Statements of Cash Flow (000's/$)

	2006	2007
Cash flow from operations		
Net Income	215	554
Plus depreciation expense		491
Change in accounts receivables		
Change in inventory		
Change in other current assets		
Change in account payables		
Change in accrued liabilities		
Total cash flow from operations	(1,513)	
Cash flow from investing activities		
Change in land		
Change in fixed assets	(522)	
Total cash flow from investing activities		
Cash flow from financing activities		
Change in short-term notes payables		
Change in long-term liabilities		
Change in common stock		
Dividends paid		
Total cash flow from financing activities		
Net cash flow	(5)	(10)
Plus beginning cash	25	
Ending cash	20	

Schedule Four Cape Chemical Ratios			
	2005	2006	2007
Current Ratio			
Accounts Receivable Turnover		8.4	
Days Sales Outstanding (DSO)			
or Average Collection Period (days)	33		
Inventory Turnover			
Inventory Conversion Period (days)			
Payables Deferral Period (days)			39.9
Fixed Asset Turnover			
Total Asset Turnover			
Times Interest Earned (TIE)		1.65	
Debt Ratio	45.45%		
Basic Earning Power			
Profit Margin			
Total Asset Turnover		2.42	
Return on Assets (ROA)	1.45%		
Equity Multiplier			
Return on Equity (ROE)			

THE CUPBOARD IS BARE

Curtis A. Richards, Bellarmine University
John T. Byrd, Bellarmine University
David Collins, Bellarmine University

CASE DESCRIPTION

The primary subject matter of this case concerns an entrepreneur's investment in an established business. Secondary issues examined include both a pre-investment and a post-mortem financial statement analysis of an equity investment and how a successful entrepreneur might miss important financial clues when making equity investment decisions. The case has a difficulty level of four, appropriate for a senior level course. The case is designed to be taught in two to four class hours and is expected to require four to six hours of outside preparation by students.

CASE SYNOPSIS

This case profiles Charles "Chip" Riley, a successful entrepreneur in numerous business ventures, analyzing what went wrong with his purchase of the MHC Cabinet Company. He recently sold it at a loss from his original investment, and he was not happy about losing money. His intention is to do a thorough post mortem evaluation of what went wrong so it does not happen again! When he invested in MHC, Chip thought that the "cupboard was full" but it did not take long before he began to realize that the "cupboard was bare." Although the financial loss was only a small portion of his net worth, the situation at MHC did not make sense. Because of his previous successes in business ventures, Chip considered himself wise in the ways of investing and he wanted to understand where he went wrong in his initial analysis of the company. Based on that analysis, MHC should have been a successful investment opportunity.

This case was developed to show how a successful business experience can distort business judgment in future ventures. It is different from traditional cases that discuss successes or failures, in that it demonstrates how success in one venture can be a major influence for failure in the next venture. The case also provides students an opportunity to perform financial statement analysis both before and after a failed investment. The first part of the case illustrates how an investor might perform a less-than-complete analysis that could lead to an investment decision that proves to be wrong. The second part of the case performs a "post-mortem" to determine what was missed in the first analysis and how the new data might have influenced the original investment decision.

MHC CABINET COMPANY

MHC Cabinet Company was founded in 1990 by Michael Carlisle. Michael had spent 20 years designing and building products for a national company that supplied "stock" kitchen cabinets to the big-box DYI stores. Michael tired of the restraints imposed on him and desired to design and build high-end and custom cabinets for discriminating customers.

MHC had two primary product lines. The first, which provided less than one-third of company sales, were truly custom-built cabinets for a variety of residential and commercial installations (kitchens, closets, offices, sales displays, etc.). Although not a large part of total sales, MHC's marketing efforts focused on this business segment since it was the most visible to potential customers and the most profitable for the company.

The second product line provided high-end builders with several choices of "custom" cabinets that can be offered to customers as upgrades in their homes. Because of Michael's design expertise, this product line competed well with similar offerings from other cabinet companies; including the national suppliers. With growth coming mostly from this area, MHC had grown to a mid-size company with annual sales above $4 million. By the middle of 2002, Michael was confident that the relationships he had developed with area builders would push sales over $5 million within two years.

Late in 2002 disaster struck; at least for Michael. He was involved in an automobile accident that prevented him from continuing in the business he had started and nurtured to success. To properly address his personal health issues, Michael needed to sell MHC Cabinet and he needed to sell it quickly. That is when Michael's lawyer introduced him to Jim *JT* Thomas.

JT was a successful entrepreneur who had started and sold several successful businesses and was currently looking for his next investment opportunity. JT specialized in taking equity positions in companies that had achieved a good level of success but needed his financial expertise to take them to the next level. Once there, JT's exit strategy was to sell his stake, either to the original owner or, if that owner also wanted an exit, to sell the company to a larger firm.

JT met with Michael and carefully reviewed the operating and financial history of MHC Cabinets. He was very impressed with the work that Michael had done and with the competitive position that MHC Cabinet was in. Had Michael been able to stay with the company (and remained in charge of operations) this would have been a no-brainer for JT. It was exactly the type of investment opportunity that he reveled in and one that he could have brought to a profitable exit within three to five years.

But, Michael could not remain with the company. This meant that JT would need to meet the company's operational needs, in addition to its financial needs – his more familiar territory. Still, his analysis had shown him (and Michael had assured him) that current customer orders would carry the company's operations through at least the next two years. This would give JT time to find someone with the necessary operating expertise to help him out.

CHIP'S INVOLVEMENT WITH MHC

Chip was a seasoned business entrepreneur who had created a very profitable custom cabinet company and had recently sold it to one of the national companies for enough money to retire. But at 46, he decided it was too early to retire, and his entrepreneurial instincts led him to look for new investment opportunities. It was about this time he met JT Thomas, who had recently purchased MH Cabinet Company and who was looking for a business partner.

Chip met JT on the golf course via a mutual friend. Chip liked that JT also was a successful business entrepreneur who had owned and sold several businesses and they enjoyed discussing business opportunities with each other. During those discussions it was natural for JT to discuss his situation at MHC. Because of his own operational background, the possibility of joining JT at MHC Cabinet intrigued Chip.

Chip asked if he might visit MHC and JT agreed. During that initial visit JT asked Chip if he would review MHC's operations and provide an analysis of the company's needs. Chip agreed to do so and JT promised an appropriate consulting fee. Chip was excited about returning to the operating floor of a successful woodworking plant; he could almost smell the wood chips as he thought about this consulting gig.

Chip spent about four weeks working with the plant manager and was able to make a number of recommendations for tracking job production and customer installations. Chip felt at home in the business, liked the people he met, and was interested in continuing with MHC in some capacity. For his part, JT was impressed by Chip's knowledge of manufacturing operations and his ability to get along with the employees and engage them in the improvement process.

Both men recognized that Chip's operational experience blended well with JT's financial expertise. Desiring to continue their business relationship they began to seriously discuss an equity opportunity for Chip. It seemed like a good match and Chip was excited to take a closer look at the company's financial condition. Although Chip's personal area of experience was operational, he understood financial statements. After all, he had experience managing and selling a successful company. He also had an MBA from a respected private university.

Chip reviewed the financials for the previous two years; the years that JT owned the company:

Exhibit 1: MHC Cabinet Company Financial Statements		
Balance Sheet (in 000s)	2003	2004
Cash	314	182
Accounts Receivable	423	831
Inventory	767	1178
Prepaid Expenses	77	10
Current Assets	1581	2201

Exhibit 1: MHC Cabinet Company Financial Statements		
Balance Sheet (in 000s)	2003	2004
Property, Plant, Equipment	5411	5411
Accumulated Depreciation	225	450
Net PPE	5186	4961
Total Assets	6767	7162
Accounts Payable	61	34
Short-Term Loans Payable	211	255
Current Liabilities	272	289
Long-Term Debt	4581	4544
Total Liabilities	4853	4833
Stockholders' Equity	1914	2329
Total Liabilities 7 Stockholders' Equity	6767	7162
Income Statement (in 000s)	2003	2004
Sales	4350	5110
Cost of Goods Sold	2569	2614
Gross Profit	1781	2496
Operating Expenses	1401	1629
Operating Profit	380	867
Income Taxes	76	260
Net Income	304	607

He was quite impressed by MHC's apparent financial condition and prospects for the future. One concern was that the financial results for the first two months of the current year were not available. JT assured him that MHC regularly prepared quarterly results and that they would be ready for review at the end of the 1st quarter. This seemed reasonable to Chip. He knew that smaller businesses did not complete financials as timely as larger companies did and that the early months of the first quarter were especially difficult as most small businesses were still trying to close the previous year.

A second concern was that JT did not want Chip talking to any of MHC's customers before his equity investment was complete. JT explained that, since he had purchased the company only two year prior, he did not want to alarm existing customers with another change in ownership and management until the deal was done. Chip, a stickler for due diligence, recognized that not contacting current

customers was a problem. Still, this was not an unusual request for small business owners and one that he himself had made in his prior businesses.

Pushing his feelings of caution aside and feeling quite sure of himself – and his "investor savvy" – Chip purchased a 50% equity interest in MHC and JT enthusiastically welcomed Chip into the business.

CHIP'S INVESTMENT IN MHC SOURS

Using standard discounted cash flow analysis Chip had determined that the market value of MHC's equity was approximately $2.4 million at the end of 2004. This was only marginally higher than MHC's $2.3 million book value, but Chip had expected that. JT's very recent purchase of the company certainly suggested that reported book value would be very close to estimated market value. However, to reduce his downside risk, Chip negotiated a 50% equity interest for only $1 million. While Chip was pleased with himself for being such a skilled negotiator, but events would very quickly turn the taste of pleasure sour.

By the end of March, 2005, Chip had settled in at the factory. JT had retained the CEO title, but Chip had taken on the role of COO and the factory was all his. JT was looking to Chip's operational expertise to keep the factory running well. Chip was very comfortable in that role and left running the rest of the company to JT.

Based on Chip's earlier analysis – and JT's continued assurances – that sales growth was expected, Chip began to modernize the plant and increase productive capacity. This increased fixed operating expenses, but both Chip and JT agreed that it was a necessary step to prepare for the expected sales growth. But while, over the next six months, sales did remain good (in the $5 million per year range) they did not grow to the levels necessary to support the larger plant and its higher operating expenses.

To make matter worse, during the same six months, Chip discovered that MHC's cash flows were slower than he had expected and that JT was beginning to have difficulty meeting the company's financial needs. This caught Chip by surprise and by the end of his first six months with the company, the lack of expected sales growth and the cash flow difficulties soured Chip on his investment and he sold is equity back to JT for $500,000 – a 50% loss to Chip.

Now, he is searching for what made him blind to the fact that "the cupboard was bare." What did he miss during his initial evaluation of the company? Chip decided to hire an accountant to help him determine – even without the information he did not have access to – what he missed that would have influenced his decision to invest in MHC.

Exhibit 2: Selected Industry Values for 2004	
Percent Change in Sales (2003 vs. 2004)	8%
Working Capital (% of Total Assets)	7%
Cost of Goods Sold (% of Sales)	72%
Operating Expenses (% of Sales)	20%
Gross Profit (% of Sales)	28%
Operating Profit (% of Sales)	8%
Net Income (% of Sales)	5%
Debt to Asset Ratio	30%
Return on Assets	9%
Return on Equity	11%

Exhibit 3; Selected Industry Values for 2004	
Cash (% of Total Assets)	10%
Accounts Receivable (% of Total Assets)	15%
Inventory (% of Total Assets)	8%
Accounts Payable (% of Total Assets)	18%
Current Ratio	1.50
# of Days in Accounts Receivable	40
# of Days in Inventory	28
# of Days in Accounts Payable	48
# of Days in Cash Cycle	20

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STUDY QUESTIONS

1. During Chip's initial review of MHC's operations he performed what he considered necessary financial analysis and sufficient due diligence. First, he selected industry data to compare MHC's financial results (Exhibit 2). Chip reasoned that if MHC could compare favorably to the industry, then it likely was a sound investment.

2. Based on the industry data in Exhibit 2, develop similar values for MHC Cabinet Company using the financial data in Exhibit 1. (Because he only had two years of data to work with, except for the percent change in sales, Chip used the two year average for the other data measures.)

3. Based on this analysis, why did Chip consider MHC to be a good investment?

4. Based on this analysis, would you consider MHC to be a good investment?

5. During his post-mortem review of what went wrong, Chip wondered what other red flags he had missed. Since his initial review mostly took an Income Statement approach – concentrating on operating results, which had convinced him that MHC was enjoying strong success – Chip's accountant convinced him to turn to the Balance Sheet for his answers. Hindsight reminded Chip that good operating results might not be sufficient if a firm is built on a shaky foundation.

6. Based on the industry data in Exhibit 3, develop similar values for MHC Cabinet Company using the financial data in Exhibit 1. (Because he only had two years of data to work with, Chip used the two year average for the data measures.)

7. What impact might this analysis have had on Chip's original investment decision?

8. What did Chip learn from this experience?

THE FANTASTIC BRAND: A TEACHING CASE ON STRATEGIC DECISION-MAKING

Lynne A. Patten, Clark Atlanta University

CASE DESCRIPTION

The primary subject matter of this case concerns strategic decision-making. Secondary issues examined include how companies use strategic and financial objectives to make good business decisions. This case has a difficulty level that is appropriate for senior level students in an undergraduate business program. The case is designed to be taught in less than three class hours and is expected to require 2 to 4 hours of outside preparation by students.

CASE SYNOPSIS

In this case, students are challenged to make an everyday business decision using strategic decision-making. Specifically, students must analyze and recommend the best promotion, while making sure the promotion meets the brand's established guidelines and ensuring that it generates the maximum profit. At first this decision may seem somewhat straightforward, but making sure the decision meets all of the established guidelines and brand objectives may challenge some students. That's because students will need to select the appropriate promotion by evaluating the promotional programs, brand guidelines, available product sizes, trial estimates, redemption rates and product contribution margins to ensure they recommendation the best promotion for the Fantastic Brand.

This is a practical case based on a real-life scenario. Managers are faced with decisions on how to spend or allocate company resources everyday. It is important that managers ensure that all of the activities result in the resources being used effectively and efficiently. In order to do this, companies need to have established guidelines and objectives that are used by managers when making everyday decisions that utilize company resources. This can be accomplished by implementing an effective strategic management framework that can help an organization provide clarity, align employees to organizational objectives and improve decision-making. Overall, this case provides a straight-forward example on how using strategic decision-making can help managers to make good business decisions.

INTRODUCTION

Jennifer works for a very successful company called Prector & Goods. It is a billion dollar consumer products company with over 40 brands in numerous categories. Jennifer is an Assistant Brand Manager on the Fantastic brand, which is a fairly new brand. The Fantastic brand was introduced two

years ago and is currently #4 in the shampoo category. The introduction of the brand went very well and Prector & Goods would like to begin doing more programs to ensure the continued growth of the brand. The Brand Manager, Troy, has been allocated an incremental $200,000 in this effort.

Troy is excited about the additional funding and has some good ideas. The Fantastic brand had some success with coupon and sampling programs during the brand introduction. He is confident that one of these programs will generate new trial and help the brand continue to grow. However, he is not sure which program is the best. He decided this would be a great project for Jennifer. Troy set up a meeting with Jennifer to discuss the opportunity. During their meeting, Troy stated,

> *"Hi Jennifer, please come into my office and have a seat. As you know, the Fantastic brand has been doing pretty well since its introduction. As a result, the brand has been allocated an incremental $200,000 to invest in a program that will help to continue to grow the brand."*

Jennifer replied,

> *"Wow! That's good news and I agree. The brand has done pretty well since its introduction. I am sure the additional funding will help the brand to continue to grow. Hopefully, we can use the funding to generate some new trial."*

Troy continued,

> *"You must be reading my mind! I think generating more trial is the right way to go. During the brand introduction, the coupon and sampling programs went very well. I think we should look at doing one of these programs. Unfortunately, $200,000 is not enough money to do both programs. Therefore, we need to decide which program will be best use of this funding. I'd like you to conduct an analysis and recommend which program we should do."*

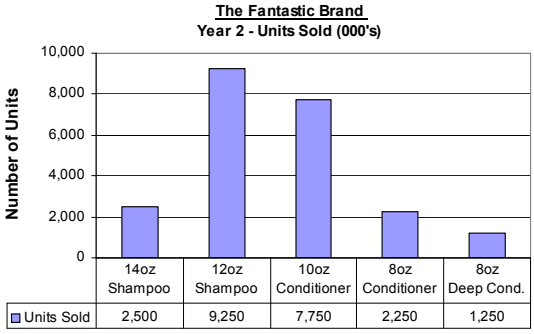
Jennifer is also excited about the opportunity. But she isn't sure which program will be the best either. There are a lot of factors that need to be taken into consideration. The program that she recommends needs to meet financial objectives, strategic objectives, adhere to the brand strategy and be the best investment. What program should Jennifer recommend? What factors should be considered in her decision? How can Jennifer make the best strategic decision for the Fantastic brand?

BACKGROUND

The Fantastic brand was launched two years ago. Although the category is very competitive, the launch of the brand went very well. The brand has a broad target, offers shampoos and conditioners and

the products have good profit margins. The discussion below provides detailed information on sales, revenues, market share, the brand strategy, the coupon and sampling programs and the product contribution margins.

Not only did the launch go well, but the brand continues to perform well in the marketplace. In Year 2, the Fantastic brand sold 23 million units, which brought in more than $72 million in sales revenues. Please see the chart below for the units sold for each product.



Currently, the Fantastic brand is #4 in the shampoo category. This category is fairly competitive and has two major players. The category is measured by both shampoos and conditioners. As a result, the top brands have a strategy where a shampoo and conditioner are typically promoted and merchandised together. The most successful brands in this category are the Clean & Shiny and Electrify brands, which are #1 and #2 in the category, respectively. Together, these two brands make up more than 45% of the market. The top six brands dominate the segment and have more than 80% of the market share. However, the top two brands are the clear category leaders. Please see Table 1 for the market share of the top six brands in the shampoo and conditioner category.

Table 1: Past 12 Months Market Share for Shampoo and Conditioner Category

Rank	Product	Market Share
1	Clean & Shiny Brand	23.50%
2	Electrify Brand	21.90%
3	Sheek & Shimmering Brand	15.60%
4	Fantastic Brand	14.90%
5	Glossy Brand	4.80%
6	Private Label	3.80%
	Total	84.50%

Prector & Goods is a well-established company. It has a long history of product introductions and sustaining successful products. Over the years, the company has become very strategic. Each brand goes through an annual review where the brand strategy is reviewed and brand objectives are developed. This ensures that all of the brand activities meet the company guidelines. The assessment includes a review of the brand strategy, target segments, spending, merchandising, promotional activities, etc. The information below provides an overview of the current Fantastic brand strategy.

- The Fantastic brand target is males and females between the ages of 18-49.
- All programs must be executed to the brand target.
- All programs must generate a profit or, at a minimum, break-even.
- All programs must incorporate at least one shampoo and one conditioner.
- Unless a compelling case can be made, the 12oz. shampoo and 10oz. conditioner should be used in all promotional activities. Exceptions can be made for promotions like (a) a new item introduction or (b) a promotion that targets a specific segment (i.e. club warehouse or dollar store).

Since the Fantastic brand is relatively new, it has a limited number of SKUs. Currently, the brand carries two shampoos and three conditioners. There is a 14oz. shampoo, 12oz. shampoo, 10oz. conditioner, 8oz. conditioner and 8oz. deep conditioner. For details regarding the market share, retail pricing, and contribution margin for each of these products, please see Table 2.

Table 2: Fantastic Brand Product/SKU Information

Product	Market Share	Retail Price	Contribution Margin
Shampoo – 14oz.	1.60%	$3.99	$1.09
Shampoo – 12oz.	5.90%	$2.99	$0.99
Conditioner – 10oz.	5.10%	$2.99	$0.99
Conditioner – 8oz.	1.50%	$2.59	$0.69
Deep Conditioner – 8oz.	0.80%	$4.99	$1.49
Total	14.90%		

COUPON PROGRAM DETAILS

Since Prector & Goods has been in business for many years, they have numerous vendors. One company that Prector & Goods has a strategic alliance with is a preferred vendor called Couponing for America. This is a well-establish company, with a good reputation, and a solid history of executing well. This company does the majority of the coupon programs for Prector & Goods.

As expected, this vendor has provided the best proposal to the Fantastic brand. The coupon insert will feature one shampoo and one conditioner, each coupon will have a value of $.25 and the program will reach 5 million households. The targeting is based on zip codes and can easily reach the brand's target segment. The coupon program costs $100,000, which does not include redemption costs. However, redemption and trial estimates have been provided for each SKU. Please see Table 3 for details regarding the proposed coupon program.

Table 3: Coupon Program Information

Product	Redemption Rate	Value of Coupon	Est. Trial Generated
Shampoo – 14oz.	0.80%	$0.25	40,000 units
Shampoo – 12oz.	2.50%	$0.25	125,000 units
Conditioner – 10oz.	2.00%	$0.25	100,000 units
Conditioner – 8oz.	1.00%	$0.25	50,000 units
Deep Conditioner – 8oz.	0.50%	$0.25	25,000 units

SAMPLING PROGRAM DETAILS

Another strategic partner of Prector & Goods is the Sampling Corporation. This company is also a preferred vendor and the Sales Representative has put together a very good proposal for the Fantastic brand. Although sampling tends to be expensive, the programs have good reach and reasonable prices.

There is a minimum order of 300,000 samples for all programs. Each sample will cost $.96/unit to distribute and includes one sample of shampoo, one sample of conditioner, and one direct-to-consumer insert. The insert will feature a shampoo and conditioner and tell consumers why they should purchase the Fantastic brand's products. Please see Table 4 for details for the cost of sampling program.

Table 4: Sampling Program Information

Sample	Cost
Shampoo Sample – 2oz.	0.27
Conditioner Sample – 2oz.	0.41
Direct-to-Consumer Insert	0.05
Distribution Costs	0.23
Total Sample Unit Cost	0.96

Similar to the coupon program, the estimated trial is based on the product that will be featured on the insert. Please see Table 5 for the trial estimates.

Table 5: Sampling Program Trial Estimates	
Estimated Trial	Units
- Shampoo - 14oz.	45,000 units
- Shampoo - 12oz.	130,000 units
- Conditioner - 10oz.	105,000 units
- Conditioner - 8oz.	55,000 units
- Deep Conditioner - 8oz.	27,000 units

CONCLUSION

Since the Fantastic Brand is doing relatively well in the marketplace, one of these programs can help to continue to grow the brand. However, Jennifer needs to determine which program is better for the brand. Is it the sampling or the coupon program? What products should be featured in the program? Do these programs meet the brand guidelines? Which program will generate additional trial, while still being a good use of the incremental funding? When making her decision, Jennifer needs to think strategically and consider all of the factors presented in the case. This will help to ensure that she recommends the program that will benefit the brand the most.

THE RETIREMENT CASE OF PROFESSOR PAUL

Edward J. Stendardi, St. John Fisher College

CASE SYNOPSIS

This case deals with the retirement plans of Professor Paul. Professor Paul is a composite of many of my faculty colleagues who I have encountered during my teaching career. He has been diligently planning for his retirement and believes that he that he has amassed sufficient assets to enable him to retire early and comfortably. An analysis of his situation using a retirement income planning model that I have developed indicates that he is very wrong!

Professor Paul is a professor of humanities at a small liberal arts college in New England. He is 54 years old and he is beginning to seriously consider the phased retirement program that his college offers. He is eligible to enter the program any time after age 55 but he is ambivalent because while he still enjoys his career, he is also anxious to enter the next phase of his life and to escape the cold and snow which he no longer enjoys.

Professor Paul believes he will have the ability to consider phased retirement as early as age 55 because he has been investing for retirement for his whole career and he has accumulated what he considers to be significant retirement related assets.

An analysis of this case utilizing a comprehensive retirement income planning model reveals that he is far from financially prepared for retirement and that he must consider multiple retirement options to make his retirement plans work

CASE DESCRIPTION

The retirement of Professor Paul is a case that I have utilized in my FINA 464 – Retirement Planning course with a lot of success for the last two years. It is a case that is geared for junior and senior level finance students, although it could be used in any course that teaches financial analysis using Excel.

This case deals with the retirement plans of Professor Paul. Professor Paul is a composite of many of my faculty colleagues who I have encountered during my teaching career. He has been diligently planning for his retirement and believes that he that he has amassed sufficient assets to enable him to retire early and comfortably. An analysis of his situation using a retirement income planning model that I have developed indicates that he is very wrong!

The methodology that I use is to assign the case after I teach that the basic format of the analysis. I expect the students to spend about three hours outside of class reading the case (which is not long) and considering and analyzing the various options that they believe are worth considering. In the following

class we discuss the advantages and disadvantages of the options that the students have come up with. After discussing their options for about an hour I present the analysis that I did (this is contained in the Excel file that accompanies this case). After viewing that various options, I present a possible solution and we discuss the tradeoffs involved with that.

INTRODUCTION

Professor Paul is a professor of humanities at a small liberal arts college in New England. He is 54 years old and he is beginning to seriously consider the phased retirement program that his college offers. He is eligible to enter the program any time after age 55 but he is ambivalent because while he still enjoys his career, he is also anxious to enter the next phase of his life and to escape the cold and snow which he no longer enjoys.

Professor Paul believes he will have the ability to consider phased retirement as early as age 55 because he has been investing for retirement for his whole career and he has accumulated what he considers to be significant retirement related assets. At the present time his retirement assets includes a 403-b account with a $400,000 balance; he adds $10,000 to this account annually. This amount is in addition to the $5,000 annual match that his employer provides. He also has a traditional IRA account, which has a present balance of $120,000, which he add $2,000 a year to. He also has taxable investments, which he plans to use for retirement; these investments have a present value of $200,000 and he adds $6,000 a year to these investments.

Professor Paul is a life long bachelor. He has taught at his present college for over 20 years. He earns a salary of $60,000 and he wants to be able to maintain his same standard of living in retirement. He plans to take early Social Security benefits at age 62 which he estimates to be $17,000 per year (indexed to inflation). He plans to keep his present home while he is in the phased retirement program (he has one year remaining on his mortgage) and purchase a second winter home in a warmer climate close to the outdoor activities that he enjoys. The phased retirement program offered by his college allows him to select the portion of his prior salary that he would like to earn and in turn he has to provide the proportional amount of service (he is planning on 50%). While he can stay in the program for up to five years, he plans to stay in the program for three years and then fully retire form his college. At this point he will decide what he wants to do with the rest of his life and where he would like to live full time.

Professor Paul is uncertain whether his existing retirement assets will be sufficient to provide him with the type of retirement that he desires. He comes to your retirement planning firm to determine whether his plan will work.

Questions to Consider

1. Will Professor Paul be able to retire in the way that he intends on his existing retirement resources? Develop a retirement planning spreadsheet to determine whether he can retire the way

that he plans. Explain what assumptions need to be made in order to complete this analysis and justify the assumptions that you make.

2. If Professor Paul's existing retirement plan does not work, what options can he consider. Develop multiple retirement planning worksheets to show the impact of these various options.

3. What other retirement planning issues does Professor Paul need to consider.

4. Professor Paul is considered about all of the news concerning Social Security. How will likely future Social Security reforms impact Professor Paul?

5. Professor Paul wants advice about asset allocations. Make a recommendation about his present target asset allocation. Explain how this asset allocation should change over time.

THE MERGER OF AOL AND TIME WARNER: A CASE STUDY

David Malone, Weber State University
James Turner, Weber State University

CASE DESCRIPTION

The purposes of this case are several, and the potential uses fairly rich. From an accounting perspective, the assignment of a value to the transaction will directly affect the goodwill assigned to the merged firm's financial statements. From that, students can be given the opportunity to discuss such topics as measurement, earnings management, and efficiency with respect to analysts' capacity to filter through non-cash flow effects.

Interesting questions arise with respect to the adequacy of information about the probability of merger completion. Evidence suggests that analysts assigned a fairly high probability to the chance that the merger would not be completed. The fairness of this probability allows for speculation as to whether or not information available in the market, including that disseminated by the firm, was adequate to the task of assigning that probability.

Finally, because the case involved two very widely held firms, there are rich opportunities for students to research the wealth of information that exists on this merger.

At its highest level, the case is rich enough to be used for Masters of Accounting students and MBA students who have taken an MBA-level corporate finance class. Upper division accounting and finance students who are familiar with analysis of mergers and with theories of asymmetric information could also benefit from analyzing the case.

CASE SYNOPSIS

When AOL and Time Warner announced their proposed merger in January 2000, the securities of both firms experienced significant price adjustments. Initially, prices of both securities rose on the news. When details of the proposal became clear, the security price of Time Warner fell back somewhat, but remained approximately 30% above its pre-announcement selling price. AOL shares, however, retreated to a price about 15% below its pre-announcement price. Both of these prices were significantly below consensus price targets set by analysts.

Of special interest is the relative price level at which the two securities settled soon after the announcement. The merger proposal called for the issuance of a new security representing common

ownership in the new firm. One share of the new security would be issued for each share of AOL, while each share of Time Warner would be exchanged for one and one-half shares of the new security. As weeks passed beyond the announcement date, the ratio of the Time Warner shares to the AOL shares ranged from just less than 1.4:1 to 1.5:1 (rather than settling at and sustaining the 1.5:1 ratio one would expect from the agreement.)

This case presents the circumstances surrounding the merger of AOL and Time Warner, including their respective business strategies, markets, financial structures, and price movements during the period leading up to the merger.

INTRODUCTION

Very early on Monday, January 10, 2000 news began to appear on wire services suggesting that an announcement was forthcoming of the merger between America Online (AOL) and Time Warner (TWX). At that time, the capitalized market values of AOL and TWX were $164 billion and $97 billion respectively. Value of the combined company was estimated at $361 billion (based on the $110/share value assigned to TWX in the merger agreement), making it one of the ten largest firms in the world as measured by capitalized market value. The $190 billion in stock AOL agreed to issue to acquire Time Warner made it the largest merger in U.S. history at that point in time. Together, AOL and TWX offer significant brand recognition including AOL, Warner Bros., HBO, NetScape, Time, CNN, TNT, CompuServe, Warner Music Group, Sports Illustrated, Fortune, People, and numerous others. TWX also brought with it a broadband distribution platform from which to expand significantly AOL's interactive market. As was later mentioned in the combined firm's annual report for fiscal 2000, executives felt the merger had the potential to "combine the power of the Internet with the world's most trusted information and entertainment brands."

A BRIEF COMPARATIVE ANALYSIS OF AOL AND TIME WARNER

AOL was founded in 1985 as Quantum Computer Services. After a name change in 1991, AOL underwent its initial public offering in 1992. As mentioned before, AOL was and continues to be the world's largest internet service provider, with in excess of 20 million customers. At a P/E ratio of 245 in early January, 2000, an investment in AOL stock prior to the merger was one reliant on persistent growth in cash flows. During the period between 1996 and 2000, AOL realized an 86% compound annual growth rate in revenues and 106% in stock price.

By comparison, Time Warner was more established and far more complex. During the same four years referred to above, TWX realized compound revenue and stock price growth of 18% and 36% respectively. As a result of the combination of Time Inc. and Warner Bros., TWX not only had an established history of operations, but had diversified into media industries including published, broadcast and other entertainment media. The company listed in its 1999 annual report five businesses as its principal sources of revenues: cable networks, publishing, music, filmed entertainment, and cable

systems. Selected statistical and financial data prior to the merger announcement are provided in Appendix A.

A telling comparison between the two firms comes from an examination of their respective cash flows. From its previous year-end cash flow statement, AOL had cash flows from operations of $1.1 billion, compared to $1.8 billion for TWX. AOL, however, used $1.8 billion in cash for investing activities compared to $353 million listed as ***sources*** of cash from investing activities for TWX (i.e., TWX was actually realizing a net disinvestment from its holdings. In years before the most recent one, TWX did have cash outflows from investing, but those were negligible.) As one might deduce, AOL supplemented its investing activities through additional financing, with a source of cash of $886 million by financing activities. TWX, in contrast, was using its operating cash flows to pay down its substantial debt and to pay dividends. Cash used by financing activities for the year amounted to $2.4 billion.

FINANCIAL EFFECTS OF THE MERGER ANNOUNCEMENT

The merger agreement between AOL and TWX called for the issuance of a new stock, to be named AOL Time Warner. For each share held of AOL, shareholders were to receive one share of AOL Time Warner. For each share held of TWX, investors in that stock would receive 1.5 shares of the new security. On the day of the announcement, although it opened with an initial surge, AOL closed at 72 5/8. The following day, the price fell to 64. TWX surged in pre-market trading and never looked back, gaining 27.5 points to close at 92 1/4. The ratio of prices of the two securities at the end of that first day following the announcement was 1.27:1, far short of the ratio of 1.5:1 established by the merger agreement.

Over the next few days, as the market digested the implications of the merger, arbitrageurs began seizing on what appeared to be a profit opportunity, effecting a January 11 closing price for AOL of 64, down 8 5/8, with TWX closing at 86, off 6 1/4, leaving the ratio at 1.34:1. Two weeks after the initial announcement, shares of AOL were trading at 62, with TWX at 87 5/8, a ratio of 1.41:1. Two weeks later AOL was at 57 13/16 while TWX was at 84 5/8 (closing prices, Friday, February 4) for a ratio of 1.46:1. Appendix B shows the ratio of prices as they emerged in weeks following the merger announcement. The mean value of the ratio in the two months following the announcement was 1.42:1, with a standard deviation of 0.05.

Following the announcement date, several key news reports by both company and government officials were issued that would serve to mollify concerns over potential antitrust conflicts or other reasons the merger might not be completed. SEC Chairman Arthur Levitt in a January 11 interview with Reuters news service, labeled the combination of AOL and TWX as "smart." On January 12, Jon Friedman of CBS MarketWatch reported that several large shareholders of AOL had endorsed the concept of the merger. AOL, in past years, had petitioned the FCC to require cable companies to open their broadband networks to competitors in order to enhance competition. On January 19, FCC Chairman William Kennard pointed to the merger of AOL TWX as an example where the market could solve its own problems with threats to competition. Shortly thereafter, AOL TWX announced that they

would open their cable systems to competitors (offering additional evidence that competitiveness in the cable media markets would be enhanced rather than inhibited). On February 3, Joe Wilcox of CNET News concluded, from interviews with several legal experts, the merger between AOL and TWX would very likely pass through antitrust scrutiny without difficulty. Senator Orrin Hatch (R-Utah), however, offered a cautionary note. Hatch, in a public statement reported by Bloomberg News on January 12, pointed out that internet combinations such as that represented by the AOL TWX merger could pose the same antitrust threats as those encountered in both railroad and oil industry combinations at the end of the 19th century.

EPILOGUE

Problems arose almost as soon as the merger was completed. The merger was finalized on January 11, 2001; shortly after, in 2002, the internet bubble burst, taking down share prices of internet companies generally, even those with positive earnings like AOL. The share price of the merged firm, which closed at $47.23 the day the merger was completed, fell to a low of $9.64 on July 25, 2002.

Time Warner shareholders initially seemed to be receiving a huge premium for their shares in the merger. (Under the terms of the merger, AOL's shareholders would take ownership of only 55% of the new firm, even though AOL's share of the combined market capitalization of the two firms was 65% at the time the merger was announced.) After the merger, former Time Warner shareholders saw the value of their investment fall precipitously, with share prices of the combined firm dropping 90% from their peak value. (Economist *AOL Time Warner: A Steal?* Oct 24th 2002) Several shareholders filed lawsuits claiming that AOL executives deliberately and fraudulently inflated the value of AOL shares prior to the merger, partly by covering up steep declines in advertising revenue. At about the same time, news came out that 14 AOL Time Warner executives had sold hundreds of millions of dollars worth of shares shortly after the announcement of the merger. AOL eventually paid $2.4 billion to settle these claims.

In the intervening years, several business publications analyzed the merger, with several calling it the "worst deal in history." Most writers faulted the execution of the merger or its timing however, rather than the logic behind the merger itself. The two companies had very different corporate cultures and there was serious friction after the merger between AOL executives and employees and Time Warner executives and employees. Very few executives from either company had been in on the merger negotiations and Time Warner executives in particular (other than the very few who worked on the merger) were reluctant to work with AOL. In fact, the original idea behind the merger, pairing Time Warner's content with AOL's delivery capabilities was turned on its head – the AOL website was the one place that Time Warner content could not be found.

When the internet bubble burst, it took down nearly any and all companies that had participated in the earlier internet craze; AOL Time Warner was no exception. Because of this it is difficult to untangle the effect of the merger alone on company value from the effect of the general market downturn.

As much as five years later, Steve Case continued to defend the logic behind the merger, noting that "AOL needed Time Warner for its cable division," while accepting blame for the failure of execution.

On May 28, 2009 Time Warner Inc. announced that it would spin off AOL; the news came as no surprise. At least one publication again defended the concept of the merger, noting that while the merger may have been the worst deal in history, it didn't have to be. The day Time Warner announced the AOL spinoff, Steve Case, no longer with Time Warner, posted a Twitter entry that said, "Thomas Edison: 'Vision without execution is hallucination' - pretty much sums up AOL/TW - failure of leadership (myself included)."

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Questions

1. What synergies exist in the combination of AOL/TWX?

2. What evidence of capital market efficiencies or lack thereof existed in the circumstances surrounding the AOL/TWX merger announcement and subsequent price fluctuations?

3. Discuss the difficulties of initially estimating the negotiated exchange value in the merger of a volatile, highly growth oriented firm with a stable, moderate growth firm?

4. In this merger only stock was exchanged. Under the purchase method of accounting for business combinations, goodwill must be recognized and amortized. What are the implications for earnings of the merger?

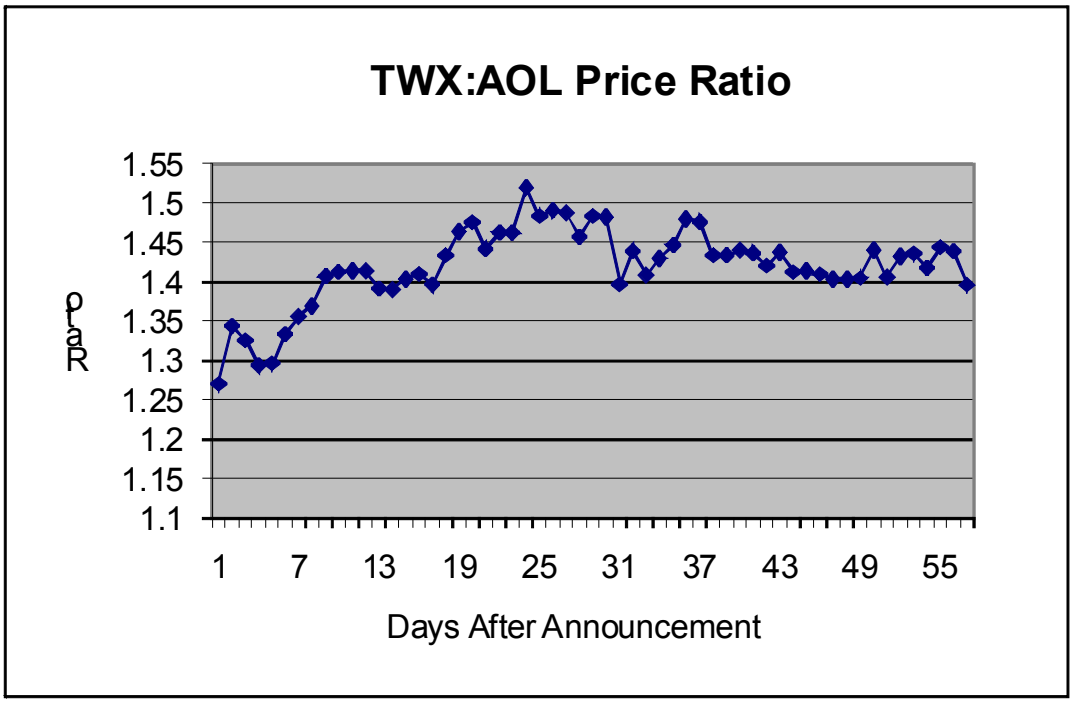
5. Referring to Appendix B, one observes that the ratio of TWX:AOL prices ranged from just below 1.4:1 (allowing for an initial settling period) to above 1.5:1. What implications for accounting are there in the seeming persistent lack of stability of that ratio?

6. Which firm is left better off? Is there a "winner" and/or a "loser"?

APPENDIX A

Selected Statistical and Financial Information		
	AOL	Time Warner
Friday, January 7, 2000 Closing Stock Price	73 3/4	64 3/4
Shares Outstanding, January 10, 2000	2,278 Million	1,375 Million
Market Capitalization January 7, 2000	$164 Billion	$97 Billion
Market Capitalization February 11, 2000	$129 Billion	$108 Billion
4-year Compound Annual Growth Rate: Revenues Stock Price	 86% 106%	 18% 36%
Total Revenue (FYE 1999)	$4.8 Billion	$27.3 Billion
Net Earnings (FYE 1999)	$762 Million	$1.95 Billion
Earnings per Share (FYE 1999)	$0.298	$1.42
Total Assets (FYE 1999)	$10.3 Billion	$48.4 Billion
Total Liabilities (FYE 1999)	$4.1 Billion	$39.6 Billion
Annual Dividend	$0	$0.18

APPENDIX B
Price Ratio Following Announcement



APPENDIX C
Share Prices Following Announcement