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JOURNAL OF THE INTERNATIONAL ACADEMY FOR CASE STUDIES

Instructors' Notes

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TABLE OF CONTENTS

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 instructors' notes contained in this volume have been double blind refereed, simultaneously with their respective cases. The cases were published in a separate issue of the *JIACS*. The acceptance rate for manuscripts in this issue, 25%, conforms to our editorial policies

If any reader is interested in obtaining a case, an instructor's note, permission to publish, or any other information about a case, the reader must correspond directly with the Executive Director of the Allied Academies: info@alliedacademies.org.

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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PEANUT VALLEY CAFÉ: WHAT TO DO NEXT? INSTRUCTOR'S NOTES

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Donna Steslow, Kutztown University

CASE DESCRIPTION

The primary subject matter of this case involves the management of a quick service restaurant (QSR). The case has a difficulty level of three, appropriate for junior level courses in management or hospitality management. The case is designed to be taught in 1, 75 minute class period and is expected to require 2 hours of outside preparation by students.

CASE SYNOPSIS

This case focuses on the operational and strategic management issues faced by a family owned quick service restaurant (QSR). The case explores the operational issues with a multi-unit restaurant. What are the operational decisions necessary to effectively manage QSR facilities? What are the strategic issues facing a QSR owner?

[NOTE: This case is a fictionalized version of a real-life situation. Names and other potentially identifying information have been changed to protect identities. The applicable fact situation is true to the real case.]

SUGGESTED TEACHING APPROACH

This case can be used in a variety of undergraduate classes. The authors believe that it fits into any of the following courses: Principles of Management, Introduction to Hospitality Management, and Strategic Management.

Principles of Management/Introduction to Hospitality Management/Strategic Management Learning Objectives:

Students will be able to:
comprehend the planning function of management,
write a mission statement
perform a SWOT analysis, and
recommend a strategy

TIME:

This case is designed for 4 hours – 2 hour of student preparatory time, 2 hour of class time.

MATERIALS:

The following materials support this lesson.

Case study – Peanut Valley Café: What to do next?
Environmental Scanning handout
A handout containing the following questions.

Does Peanut Valley Café have a mission statement? If not, what benefits might be derived from having a mission statement?
What are the benefits of environmental scanning?
What are the strengths and weaknesses of Peanut Valley Café?
What are the opportunities and threats facing Peanut Valley Café?
What strategy has Peanut Valley Café been pursuing to this point in time?
What strategy do you recommend Peanut Valley Café should pursue?

TEACHING APPROACH

This case is recommended as a culminating group activity for the planning function of management lessons. The case is designed for use in a traditional face-to-face class, online, or hybrid class.

As part of the introduction to the planning function of management lessons, the students are informed they will work in teams as a management-consulting firm hired to review a company's strategic plan. The students are given time to form groups of 3 to 5 students per group. The case and handouts are distributed either physically in class or via the Web (i.e., Blackboard, WebCT, course wiki, course blog) as part of the introductory materials to the planning lessons. This will allow the groups to collaborate before the in class discussion.

Students are reminded one day before the case is due of the pending class discussion. In class, students organize by groups. The class is asked if Peanut Valley Café has a mission statement? Since the company has no stated mission statement, students are asked what benefits might be derived from having a mission statement? While the specific answers may vary, the answers should thematically state the mission provides purpose to the organization (Robbins & Coulter, 2009, p. 164). Depending on time, students may be asked to write a mission statement for Peanut Valley Café. If this option is chosen, the responses are displayed (i.e., blackboard, posters, Discussion Board, course wiki, course blog) for discussion and collaboration.

Display the "Environmental Scanning" handout. Working in groups, the students are given the following directions, "Using the case study as your frame of reference and your knowledge of business, identify specific examples of each environmental component. For example, under competitor write McDonald's. You have 15 minutes to complete this activity". After the students have completed this activity, have the groups display their responses. As part of the discussion students are asked, "What are the benefits of environmental scanning to Peanut Valley Café?" Answers may vary.

Write the words "Strength", "Weaknesses", "Opportunities", and "Threats" on the board. Continue working in groups, students are given the following instructions, "Using the case study as your frame of reference, identify specific examples of strengths, weaknesses, opportunities, and threats. You have 15 minutes to complete this activity." After the groups have completed this activity, have members of the group display their specific examples. Answers will vary.

Now that a mission statement and SWOT analysis has been completed, students should be asked what strategy should Sam use for Peanut Valley Café? Answers will vary.

[Note for the instructor] Sam made the following decisions:

> Reduced the number of menu items. Started featuring items on the menu for short periods of time similar to McDonald's approach with the McRib sandwich and the Shamrock Shakes.
>
> Sold his catering equipment because of competitive forces.
>
> Eliminated the gasoline sales at the Pleasant Valley facility
>
> Started a succession plan with the goal of retiring from the business within seven years. This plan involved a mentoring program for the current General Manager as a possible successor. Sam had decided on a two-year mentoring program. If that did not prove successful, then Sam was planning to sell the business to outside investor since no family members were interested in the business.

MANAGERIAL ISSUES PRESENTED

The planning function of management involves "defining goals, establishing strategy, and developing plans to integrate and coordinate activities" (Robbins & Coulter, 2009, p. 9). This case focuses on the issues involved with the strategic planning aspects of a small business. Specifically, the case involves the application of a strategic management process.

The strategic management process is like driving your car through a snowstorm – you know your current speed, you check the weather conditions outside, and adjust your speed to meet the new environmental conditions. Robbins & Coulter (2009) describe the initial step in the strategic management process as "identifying the current organization's current mission, goals, and strategies" (p. 164). Why does the company exist?

The second step in the strategic management process involves gathering information about the environment in which the business operates. This is typically called the SWOT analysis since one is assessing the strengths, weaknesses, opportunities, and threats. The SWOT analysis is an analysis of the environment influencing the organization. An analysis of the internal environment provides information about the firm's "specific resources and capabilities" (Robbins & Coulter, 2009, p. 165). This analysis forms the basis for determining the strengths and weaknesses of the firm. On the other hand, an analysis of the external environment provides information about potential opportunities or threats. The external environment requires managers to scan for trends in a variety of areas – societal, technological, legal, global, competitive (Andrews, 1996; Robbins & Coulter, 2009)

The third step in the strategic management process is the formulation of strategies (Robbins & Coulter, 2009). These strategies will transcend the organization and require alignment throughout the various levels. At the corporate level organizations may pursue a growth, stability, or renewal strategy (Robbins & Coulter, 2009).

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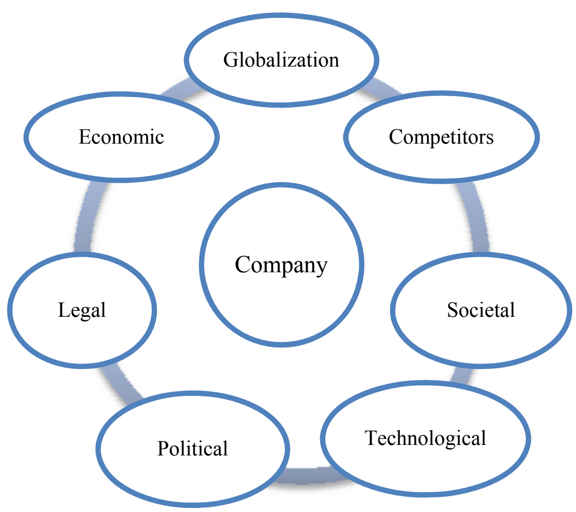
Environmental Scanning Handout



COMPETING IN THE AGE OF WAL-MART: A BOUTIQUE BUSINESS CASE STUDY

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Linda Greef Mullen, Georgia Southern University
J. Michael McDonald, Georgia Southern University

CASE DESCRIPTION

This case is intended for use in undergraduate marketing, management, fashion merchandising, entrepreneurship, or retailing courses. The purpose of the case is to demonstrate how small boutique businesses can compete against chain stores and large discounters such as Wal-Mart. Particularly, the concepts of key client management and customer delight are highlighted. Students are encouraged to evaluate the company's strategy, tactics and uncover areas of potential customer delight. Additionally, students should attempt to provide thoughts on other strategic and tactical activities the business should pursue considering the recent economic downturn. The case is designed for a one-hour class and should require two hours of outside preparation.

CASE SYNOPSIS

The Thomas Shop is a women's clothing boutique located in Effingham, Illinois. The business was started in 1936 and has since been handed down through the family with the second and third generations currently handling operations. Originally, the business offered approximately 2000 square feet of space, but was doubled in size in the early 1990's to accommodate shoes and other accessories. The store moved to its current location, (owned by the business owners) in the downtown shopping district of Effingham in the early 1970's. The town's population is approximately 20,000 and is the main shopping district for the surrounding county of approximately 35,000 residents, and further, draws customers within a fifty-mile radius. The nearest major city, St. Louis, Missouri is 100 miles to the west.

The Thomas Shop has thrived for over seventy years with superior service and merchandise adaptability. However, the recent downturn in the economy has Kathy worried. Kathy is concerned that consumers will become more and more price conscious and may gravitate to the large discounters such as Wal-Mart and other chain stores (i.e. Kohls) for price reductions, even though the merchandise quality is below that of The Thomas Shop.

RECOMMENDATIONS FOR TEACHING APPROACHES

LEARNING OBJECTIVES

Students will learn how key client management and customer delight are strategic tools boutiques can use to compete with large chains.
Students will explore the nuances of the above-mentioned tools.
Students will understand the importance of superior customer service and merchandising adaptability as a tactical tool kit to implement key client management and customer delight.

POSITION IN THE COURSE:

The case can be positioned in the course to supplement discussions on key client management, customer satisfaction/delight, marketing/extended marketing concepts, merchandising, or customer service.

STUDENT PREPARATION:

Students should expect to spend at least two hours reading the case and exploring the discussion topic questions. Outside sources of information to facilitate their understanding should be encouraged.

TEACHING METHODS:

The instructor should act as the moderator for the case discussion. The case can be assigned individually, or in groups.

The discussion can be as a whole, or in groups. If groups are chosen it is suggested that the class be brought together at the end of class to compare and contrast responses (This may extend the time past one hour).

ADDITIONAL INSTRUCTOR NOTES

Large discounters such as Wal-Mart have increasingly pressured small businesses. Drive through a small town and the absence of hardware, clothing, and other traditional independent staples such as pharmacies is evident. The decline in retail businesses in several Midwestern communities has been dramatic. Once accounting for 60% of all establishments, small retailers now make up only 33% of all business establishments (Strange, 1996). The large retail strategy of increasing SKU’s via cost efficiencies and discounted prices is not viable for a boutique, as they can never achieve the cost economies of the large chains (McCaig, 2000; Clow and Cole, 2004). So, the question becomes: How do boutique businesses compete against the large chains?

The purpose of this case is to provide two strategic points of attack that boutiques can use to outmaneuver the giants and create a sustainable competitive advantage. The focus is on combining two well-known marketing techniques: key client management and customer delight as cornerstones in a strategy to leverage the small business strengths of customer service and merchandising adaptability. Additionally, merchandising adaptability and customer service are explored.

KEY CLIENT MANAGEMENT

Key Client Management (KCM) has traditionally focused on providing an approach to dealing with the special needs of large, complex clients (Piercy and Lane, 2006). However, the concept is not new to the business community. The idea that special attention should be paid to a business's largest clients is as old as business itself (Smith, 2000). Recent research has focused on ways organizations plan for and manage their most important customers (Ryals and Rogers, 2007; Piercy and Lane 2006; Smith 2000). At the heart of KCM philosophy is the idea that while customers are important they are not all necessarily equal. In order for a firm to operate as efficiently and profitably as possible they must understand the varying degree of value that each group of customers provides (Clow and Cole, 2004). Additionally, KCM understands that firms have limited resources to direct toward customer needs and therefore must prudently allocate them among their customers based on potential return.

Some confusion arises as to what constitutes a key customer. Many substitute the term "key" for "large" which is not necessarily what KCM is about. Key accounts are those that a firm sees as being of strategic importance. Two main perspectives underlie this approach: Customer attractiveness and the customer's perception of the business's strength (McDonald, Millman and Rogers, 1996). It is true that business volume with a customer is an important feature of market attractiveness, but so are customer profitability and growth potential. Customer perceptions are important because buy-in is necessary for KCM methods to be effective (Ryals and Rogers, 2007).

The literature on KCM also devotes much to the topic of strategic partnering. While strategic partnering is generally accepted as an appropriate strategy for business-to-business firms looking to expand relationships with key accounts, this is not necessarily the case for small boutique retailers. Selling to end consumers is very different than selling to other businesses. Retailers thinking of implementing KCM should focus on maximizing profits with their most attractive customer groups. Simplistic tools such as the "80/20 rule" (80% of revenues come from 20% of customers) can be useful in this regard (Smith, 2000). Another method is to break-up your customers into groups or buckets based on characteristics such as volume, profit, growth potential and opinion leadership (Clow and Cole, 2004). The idea behind this latter method is to try to match marketing approaches to each group in order to maximize the profit potential of each.

CUSTOMER DELIGHT

Customer delight has been variously described as being a subset of customer satisfaction research (Johnston, 2004); as being a distinct construct that while related to customer satisfaction is separate and different (Berman, 2005); and as representing 100% satisfaction (Ngobo, 1999). The one thing in common with all of these definitions is that they all acknowledge that customer delight is something beyond mere satisfaction. In theory, delighted customers should be more loyal than simply satisfied customers (Hallowell, 1996). Additionally, studies have empirically shown that this relationship exists (Fornell et al., 1996; Bearden and Teel, 1983).

The differences between satisfaction and delight are centered in the customer experience. Meeting or exceeding customer expectations should lead to satisfied customers. However, delighting customers requires something beyond this: joy and surprise (Berman, 2005). When a firm satisfies a customer they have essentially met their obligation to the customer. Satisfaction is only the half way point to customer delight. Delight involves a customer's emotional involvement that ties them to the product (Edwards, 2003).

One of the ongoing debates within satisfaction/delight research surrounds the measurement of the two. Some suggest that satisfaction and delight can be measured using similar metrics such as delivery time, presence of advertised goods, and customer service perceptions (see Berman, 2005). Others suggest that totally different metrics are necessary for delight that incorporate some level of joy and surprise (Edwards, 2003). Additionally, the measurement issue has developed into a debate over the linear relationship between customer dissatisfaction versus satisfaction, and customer outrage versus delight (Coyne, 1989; Fornell et al., 1996; Ngobo, 1999; Berman, 2005). Specifically, the relationship between satisfaction/delight variables (both negative and positive) does not occur linearly on a metric continuum. Kano (1984) illustrates this by breaking satisfaction/delight into three realms: Must-Be Requirements; Satisfier Requirements; and Attractive Requirements. Essentially, the must-be requirements are those basic consumer expectations that must be met in order to avoid dissatisfaction or outrage. Satisfier requirements are those that are necessary to exceed expectations (satisfy the customer). Attractive requirements are those that are not expected by customers and therefore tend to delight the customer.

Outraged customers are those who become saboteurs of the brand via negative word-of-mouth, therefore; all customers need to have their must-be requirements met. Satisfied customers, because they have had their expectations exceeded, tend to show some level of loyalty, but do not tend to become ambassadors of the brand. Delighted customers however are those that become brand apostles (due to the emotional response generated by the experience) and are likely to spread the news to others. Lastly, it is important to note that unfulfilling the must-be requirements can have very detrimental effects, while unfulfilling satisfier requirements does not necessarily lead to dissatisfaction.

When viewed in this manner it becomes clear that organizations cannot and should not try to delight all groups of customers. A combination of key account management and customer satisfaction/delight is called for to best manage the varying groups of customers every firm deals with.

DISCUSSION NOTES

The previous case study illustrates how a small boutique business can compete and prosper in the face of large discount and chain store competition. Success is achieved not by competing head-to-head on price, but rather by exploiting the unique strengths of small retailers: customer service and merchandise adaptability. Small retailers can take advantage of smaller more controllable sales staffs to focus on key clients. This is very difficult for larger retailers to leverage. Given the large size and heavy traffic flow of the discounter/chain stores they cannot hope to offer the personalized service of the boutique businesses. Yes, some chain stores do have personal shopping services, however these services are offered with significant service charges. The small retailer can include these services for key clients without significantly increasing their cost structure (for example: it does not cost Kathy anything to bring back special items for key clients).

It is important to note that in order to provide adaptable merchandise buying and superior service without increasing the cost structure, boutique businesses must be strategic in their offerings. Relying on a combination of key client management and customer delight techniques small retailers can focus on the profit potential of various groups of customers and offer services appropriate for each group. Obviously, The Thomas Shop cannot buy specialty merchandise for all customers. They focus on the upper echelon of customers (approximately top 5-10%) for this type of service, and since this segment provides approximately 70% of sales, this extended service has a big impact. Other middle to upper tier customers receive other specialty treatments, such as special invitations to fashion shows, personalized color analysis and sales support. Also, they have focused on niches within their customer base that allow for competitive advantage and opportunities to delight. The best example would be the mastectomy fitting service.

While the mastectomy fitting service is only for a very small percentage of clients it has a carry-over effect for the entire business because of the emotional nature of the service. Women who receive this service tend to become very loyal customers and are vocal in their praise of the business. Additionally, with social responsibility receiving more and more attention this type of service makes the business more appealing to customers who may never need the service, but respect the business for offering it.

Finally, this case demonstrates how key client management and customer delight must be used in combination with one another. A business cannot and should not try to be everything to everyone. Customer delight requires soliciting an emotional response from the customer. This is best reserved for the key clients who will significantly reward the retailer for their efforts. Other groups can still receive excellent service that will satisfy their needs and encourage repeat business, and may potentially propel them to key client status. The only requirement for all groups is that service meet expectations to prevent any backlash effect such as negative word-of-mouth. If a boutique follows these simple techniques they can put themselves in a position to not only compete, but prosper.

QUESTIONS

What are the key strengths that allow a boutique business to compete with chain stores and large discounters, such as Wal-Mart?

Students should explore customer service levels and merchandise adaptability. The one-on-one service that boutiques can provide, along with being on a first name basis with top tier clients goes beyond what the chains typically provide (the exception being high-end chains with personal shoppers, but customers pay additionally for this service). Boutiques have the ability to rapidly implement merchandising suggestions from customers that the chains cannot match. Additionally, specialty purchases for key clients are beyond the scope of the chains.

How should The Thomas Shop attempt to provide for key clients?

Student should recognize that key customers provide a significant amount of store revenues (80/20 rule). Therefore, the upper tier of clients should receive superior customer service, (for example personal shopping, special access to sales and other events). Some students will be tempted to offer these services to all customers, but it should be pointed out that the strategy should be to delight top tier customers with these specialized services.

Should all customers be treated equally? Why or why not?

This question is meant to start a discussion about why some customers are more valuable than others. Some students may take a democratic view that all customers should be treated equally. This can lead into KCM discussions, the 80/20 rule, and decile reports. Students should be encouraged to understand that providing extra services to top tier clients does not mean treating other clients poorly. All customers should be treated well (except those that steal or are verbally or physically abusive) however management must skillfully provide that extra service for key clients in a stealthy manner.

How could The Thomas Shop go beyond customer satisfaction to customer delight?

This question should further the discussion on KCM. Students are encouraged to explore the marketing concept and extended marketing concept. Customer satisfaction should be discussed to make the distinction between it and delight. Students should provide similar answers as to question 1, however this allows a great opportunity to link delight with key client management.

What else could The Thomas Shop do to delight customers?

This should lead to a hearty discussion of customer service, and target marketing. Students may suggest various promotional ideas that are aimed at key clients. Some ideas may be specialty promotions for key clients, wine, and cheese after hour shopping etc…

What are some of the potential pitfalls of customer delight?

The costs associated with delighting customers should be explored and this should lead to a realization that it would be too costly to try and delight everyone. Additionally, students may express concern that delighting customers may raise expectations that may be difficult to meet.

What would you suggest they do to avoid potential pitfalls?

Following up on the previous question, students should further explore customer delight in the context of cost containment. What delight oriented activities could The Thomas Shop undertake that would not create additional expenses (i.e. specialty purchases at market)? Additionally, the management of expectations should be explored.

What would you suggest that Kathy do given her concerns about Wal-Mart in a weak economy?

Students should explore what has worked for the store in the past. The business has survived downturns and new competition. Extra effort on service for key clients should be emphasized, as should new promotional activities. Students should resist the temptation to bring on discount lines or to start any effort to significantly reduce margins as this would put the store in more direct competition with Wal-Mart. Some symbolic price promotions may be effective as a short-term fix, but the store must be careful to not go too far.

EPILOGUE

Kathy realized that a frontal assault against Wal-Mart and other discounters would never work. Instead the store would focus on their strengths. Discounters do not (and cannot afford to) offer the same level of service as department stores and particularly the small boutiques. Kathy had always focused on offering personalized service and constantly looked for ways to better serve the needs of her customers. Rather than retreat from this strategy in the face of new competition, and a declining economy she embraced it ever more tightly. Building on past successes the store would attempt to provide the highest possible level of customer service. The reality of the current economic situation is serious, but business has been steady, and Kathy has already noticed an increase in sales as consumer fears have abated.

The specialty services, such as mastectomy fittings, color analysis, style shows and one-off market purchases for top-tier clients have endeared customers to the store. Additionally, close attention to merchandising has allowed them to carry products that are unavailable elsewhere, thus allowing them to differentiate themselves. Niche business such as prom dresses has kept them in contact with the youth market which helps the store cultivate future customers. Finally, Kathy has thought about expanding into other niches such as higher end hand bags and designer perfumes. This will further increase the Thomas Shop's ability to differentiate the business and better position the store as more upscale.

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BYD OF CHINA: ELECTRIFYING THE WORLD'S AUTOMOTIVE MARKET

Charles A. Rarick, Purdue University Calumet
Kasia Firlej, Purdue University Calumet
Arifin Angriawan, Purdue University Calumet

CASE DESCRIPTION

The primary subject matter of this case concerns the move towards utilizing electricity to power automobiles and the potential of a Chinese company to become the world's largest automaker, as well as the strategic fit of its innovation with the current external environment. Secondary issues examined include issues of trade, public policy, and the environment. The case has a difficulty level appropriate for junior level students. The case is designed to be taught in one class hour and is expected to require three hours of preparation by students.

CASE SYNOPSIS

The Chinese company BYD hopes to soon become the world's largest car company. With the support of American Warren Buffett, the company which has only been in existence for a few years, mostly making batteries, has caught the attention of not only Mr. Buffett, but also many in the auto industry. This case examines the favorable conditions that are propelling the Chinese company to the forefront of the not so distant future of the auto industry.

BYD OF CHINA

With the American automobile industry facing serious financial difficulties, and the emerging importance of alternative fuelled vehicles, this case should be interesting and to students. The case is useful in showing how the global automobile industry is quickly changing and the need for speed and innovation is essential for survival. With the rise of the Chinese automobile market, companies like BYD, and maybe especially BYD, represent additional challenges to the American car manufacturers. The case asks students to do a number of things including assessing the future of electric cars and providing a strategic analysis of the Chinese producer BYD. These concepts are interrelated in that BYD has staked its future in the auto business on batteries.

TARGET AUDIENCE AND TEACHING STRATEGY FOR THE CASE

This case can be used in a number of courses including international business, strategic management, an introduction to business class, and others. The primary audience for the case is an undergraduate course, however, the case is flexible enough to serve other purposes. The case can be taught in-class or assigned as a group project. It would be helpful to require students to do some additional research into the automobile industry, however, the case can stand alone without this additional research. Students should be encouraged to think into the future of the automobile industry and the means by which vehicles will be powered. Current trends indicate that further change is likely for this industry. Students should be encouraged to think critically about the strategic direction of both BYD and the automobile industry as a whole. Assumptions should be challenged, including one that automobiles will always be manufactured in the United States, or that gasoline powered vehicles will always be needed. Propositions made by students need to be supported by reason and not opinion.

OBJECTIVES OF THE CASE

The main objectives of the case are to have students explore in greater detail the international automobile industry and to look into the potential of electric vehicles. The case points to the challenges facing American auto producers, historically a major source of employment in the United States. Students will be able to investigate through additional outside research (which is recommended for teaching this case) the causes of the downfall of the American auto manufacturing industry. Students will also become more aware of the rising threat coming from China in auto manufacturing. An additional objective is for students to see the importance of innovation and creativity in creating a competitive advantage.

ANALYSIS

The case asks students to answer three discussion questions. Instructors using the case should feel free to add any additional questions they feel are important for their course. While the discussion questions listed at the end of the case are ones considered important by the authors of the case, they in no way are meant to represent the only way to approach the analysis of the case.

Question 1: Do you think electric cars are a viable alternative to gasoline-powered vehicles? What is the future of the electric car? Explain your answers.

Question 1: Electric vehicles may become a viable alternative to gasoline-powered vehicles in the not so distant future, however, major changes will need to occur in order for this to happen. There are a number of problems facing the electric car including the current limited driving distance on a single charge and therefore a frequent need to recharge. While the vehicles may be introduced for urban drivers where the limited driving range is not a problem, as a replacement for all gasoline powered vehicles, major structural changes will have to be made. It seems reasonable to assume that hybrid vehicles will be a viable market in that they can run short distances without using the gasoline engine and then shift to gasoline power when on a long drive. Toyota has continued to emphasize hybrid vehicles over electric cars due to difficulties with long driving requirements in many markets. To completely remove the combustion engine from automobiles it will be necessary to build an infrastructure of recharging stations or battery replacement stations throughout the country. This will take time and a lot of capital. Improvement in battery technology will also be needed to make this a viable situation. One could make a reasoned argument that electric vehicles will eventually replace gas powered cars, but it will take breakthroughs in battery technology, infrastructure changes, and possibly a more secure source of the raw materials used to produce ion lithium batteries. The power position of the current energy companies cannot be ignored in the future shift away from gasoline as a power source for automobiles. As the new president of Toyota, Akio Toyoda stated in a recent Fortune interview, "*We are talking about a once-in-a-century transformation of the market. I believe the auto industry is now trying to face the challenges of presenting a solution to this one-in-a-century change. And what is clear to me that what is going to happen will not just simply be an extension of the past.*" (Fortune July 6, 2009). The global auto industry is clearly going to be experiencing significant changes in the coming years. Whether electric autos will dominate that future is presently unclear, however, an argument could be made for a variety of alternative vehicles emerging to at least slowly replace gasoline powered automobiles.

Question 2: What are the strengths, weaknesses, opportunities, and threats of BYD?

Question 2: The Chinese company, BYD has a number of strengths, a few weaknesses, and number of opportunities, and a number of threats. As a relative newcomer to the automobile industry the company will have to leverage its strengths in innovation to capitalize on its opportunities.

Strengths:

Lean production operations
A spirit of innovation and creativity
Management style that pays attention to detail
Competence in battery production that can be applied to automobiles

Located in the fastest growing automobile market
No "legacy costs" found with established competitors
Positioned as a "green business" in growing market
Financial backing of Berkshire Hathaway

Weaknesses:

Relatively small firm in an industry that operates with large economies of scale
Weak brand recognition outside of China
Little experience in automobile manufacturing
Strategy success dependent on acceptance of electric vehicles
Opportunities:
Market growth in China
Expansion to other Asian countries
Expansion to other emerging markets outside of Asia
Possible supplier of automobile batteries to other auto manufacturers
Partnerships with other automotive battery manufacturers
Partnerships with more seasoned auto manufacturers
Threats:
Battery technology advances do not materialize
Competitive strengths are copied by competitors, both foreign and domestic
Global economic slowdown continues to retard new car sales
Rising labor costs in China reduce some competitive advantages
Political instability in China affects the company

Question 3: What suggestions would you make to BYD in order for it to achieve its goal of becoming the world's largest automobile manufacturer?

Question 3: There are a number of recommendations that can be given for BYD to advance ahead and to continue its success, and one day become the world's largest auto manufacturer. BYD will need to establish its brand identity. Outside of China the brand has little to no recognition. BYD will need to begin to build a brand identity that is associated with the image it hopes to project to the world – a new car company with a new idea. BYD needs to create the image of being a leader in alternative vehicles which are environmentally friendly, affordable, and stylish. While the Chinese have improved the quality of many of their products, Chinese brands still do not carry a quality image. BYD may be able to distance itself somewhat from this by "localizing" the brand. Strategic alliances may also be helpful in not only creating a better quality image, but also in providing some of the strengths BYD currently lacks. BYD has done well on its own and the company should continue its efforts at battery innovation and product development. The current strategy is not a bad one but BYD faces the problem of much larger competitors copying its innovation. BYD may want to consider a strategic alliance with a more established automobile manufacturer, one that shares its spirit of innovation and possesses strong brand acceptance and has an established dealer network. Strategic alliances could also be developed with other battery manufacturers, including those in the United States, Korea, or Japan. The success of electric cars is dependent on advances in battery life. Working with other battery producers could conceivably produce some synergies. Finally, since BYD is betting the company on the success of electric automobiles, and since electric cars require batteries made of lithium ion, BYD will want to make sure that it has a reliable supply of the necessary raw material. If electric cars do become more popular, demand for lithium ion will rise and potential supply issues may arise.

BYD has an impressive track record. With the financial backing of Warren Buffet, the innovative and entrepreneurial spirit of its founder (Wang) and the growing need for alternative vehicles, BYD is positioned quite well for continued success. To move from its current market position to the world's largest car company will require continued attention to detail, continued innovation, and perhaps, partnering with more established firms.

Source: A. Taylor. *Toyota's New Man at the Wheel*. Fortune, July 6, 2009. 84-85.

PEGASUS RESEARCH INSTITUTE–THE DEVELOPMENT OF A COST ACCOUNTING AND PROJECT MANAGEMENT SYSTEM FOR A SMALL DEFENSE CONTRACTOR

Richard E. Mcdermott, Weber State University

CASE DESCRIPTION

This case addresses cost accounting for contractors, a topic neglected in many cost accounting courses. It focuses specifically on contractors who work within the defense industry. The defense industry was chosen for its rich array of incentive-based contracts, which provide unique challenges to management accountants.

The case is based on an actual firm, although names and places have been changed for the purpose of confidentiality. Although the firm explored is a defense contractor, most principles taught are applicable to contractors in other industries. The case is written in an easygoing style with language and humor intended to appeal to college students, and is designed to be covered in three one-hour class periods. Student preparation time should be approximately two hours for each hour of class. The difficulty level is five to six and is best suited for advanced or graduate cost accounting courses. The case is best worked in groups of three to five students. An appendix provides definitions of terms unique to the defense industry.

CASE SYNOPSIS

Evan Elmore, a graduate of a master's program in accountancy, has recently married and accepted a job as a chief accountant of a small defense contractor. After spending his savings to move himself and his new bride to a distant town, he discovers that his employer is on the verge of bankruptcy. Reasons for the firm's marginal performance include: (1) a lack of understanding of how to bid and later bill the various forms of incentive payment contracts awarded by the Department of Defense (DOD), and (2) an inability to produce cost reports that provide the information needed for managers to control costs. The survival of Evan's employer, and the possible viability of his own career, is dependent upon his ability to fix these problems.

INSTRUCTORS' NOTES

CASE STUDY OBJECTIVES:

To help students understand the fundamental differences between manufacturing cost accounting and contractor cost accounting.

To introduce students to the unique problems faced by the Department of Defense in contracting for state-of-the-art weapon systems.

To introduce students to the various types of incentive payment contracts used by the Department of Defense to encourage responsible cost control.

To illustrate some tools that can be used to track progress on incentive payment projects.

To illustrate the design of a Defense Contract Audit Agency (DCAA) cost accounting system for a small government contractor.

RECOMMENDED TEACHING APPROACH

The instructor may wish to begin by reviewing some of the differences between cost accounting for manufacturers and cost accounting for contractors. For example, the profitability of a contractor is highly dependent on effective project management. While many manufacturers work in continuous production environments, contractors work with discrete projects that must begin and end on time. Project managers must monitor not only 'labor spent' but 'labor earned,' a surrogate for work performed.

The instructor may wish to discuss the special challenges facing contractors who work within the defense industry. The Department of Defense (DOD) is unique in that many of the products it buys involve either state of the art technology, or technology yet to be developed. This makes it difficult or impossible to estimate in advance the cost of many new weapon systems.

Although the DOD is interested in buying weapons systems at the lowest price possible, it is not to their advantage to bankrupt highly specialized defense contractors. For this reason, the DOD often uses cost reimbursement for new weapon systems. Cost reimbursement contracts, however, provide few incentives for cost control.

The Department of Defense attempts to protect itself through incentive payment systems designed to shift the risk of excessive spending from the government to the contractor.

There are many types of incentive payment contracts. Several of these will be reviewed in this case study. Students wishing to know more about the contract types available to defense contractors should reference the Federal Acquisition Regulations (FAR) available on the Internet.

PREPARING MANAGEMENT REPORTS THAT ARE USEFUL FOR DECISION-MAKING

This case provides an excellent opportunity for students to practice designing management reports that are useful for decision making. The difference between data and information eludes many financial accountants. Data are numbers that are processed in the accounting system. Information is data that is useful for decision-making. What is information on one type of contract, may be merely data on another. The challenge to the management accountant is to prepare reports that provide only the information necessary for the manager to control cost under that contract arrangement. "One-size-fits-all" is not a viable approach when preparing reports for contracts that lose money in different ways.

In designing the management reports required by the case study, students may find the following questions helpful.

How does one make or lose money under this specific contract type?
What variables should be monitored to keep the company from losing money?
Where will the information on these variables come from?
What signals should the project manager receive on these variables?
What format should these signals take?
How timely must the information be?

Evan Elmore has accepted a job with little understanding of the problems facing his firm. Students should place themselves in the role of Mr. Elmore, as they formulate programs and design systems to save the company from bankruptcy.

ASSIGNMENT ONE

1. Prepare a list of the problems facing Pegasus Research Institute. Prioritize them in order of importance.

2. Evan's situation illustrates the importance of performing "due diligence" before accepting a job offer. Prepare a list of questions you feel accounting graduates should ask when researching a potential employer. Tell where one might find the answers.

3. President Dwight Eisenhower was the one who coined the terms "military-industrial complex" and "government-industry revolving door." Using the internet as a resource, define both terms. Explain why the practice exists, and discuss the problems it causes.

INSTRUCTOR'S SOLUTION

Problem 1: Problems facing the company include:

Indirect cost rates were not approved by DCAA prior to the award of a major cost-reimbursement type contract, which has resulted in the government stopping payments on this contract.

Bids on fixed-price contracts are not being properly prepared or reviewed.

There is no mechanism in place to keep government or Pegasus engineers from expanding the scope of work to be done on contracts without proper documentation, approval by management, and an adjustment to the contract price.

Accounting is failing to provide costing information needed for cost control on the various fixed-price and cost-reimbursement type contracts accepted by the company.

Problem 2: Students might draw on the case study, and upon principles learned in prior courses and in their own work experience in answering this question. Questions that Evan might have asked before accepting this job include:

What is the history of the company?
How long has it been in business?
Who are its customers and what are its products?
What is the training and experience of the management team?
What is the corporate culture, and is it consistent with Evan's personality?
Is the company financially stable?
Does it have a positive cash flow?
Is it profitable?
If the company is not profitable, what are the reasons? Does management have a plan to fix the problem?
Why did the previous chief accountant leave the company?
Does the company have strong financial controls?
Does the company have a DCAA approved cost accounting system?
Does the company have certified audits and what do they reveal?

Specific sources of this information might include interviews with management, employees, customers, the firm's auditor, banker, trade organizations, and perhaps even information from the internet.

If the company is publically traded, financial information can be obtained from the company's 10K report. If it is not publically traded, the applicant may wish to see a copy of the annual stockholder's report and/or audit report.

Problem 3: There are many sources of information on these two terms on the internet. Wikipedia, for example, states:

A military-industrial complex (MIC) is a concept commonly used to refer to policy relationships between governments, national armed forces, and industrial support they obtain from the commercial sector in political approval for research, development, production, use, and support for military training, weapons, equipment, and facilities within the national defense and security policy. It is a type of iron triangle.

The term is most often used in reference to the military of the United States, where it gained popularity after its use in the farewell address of President Dwight D. Eisenhower, though the term is applicable to any country with a similarly developed infrastructure. It is sometimes used more broadly to include the entire network of contracts and flows of money and resources among individuals as well as institutions of the defense contractors, the Pentagon, and the Congress and Executive branch. This sector is intrinsically prone to principal-agent problem, moral hazard, and rent seeking. Cases of political corruption have also surfaced with regularity. A similar thesis was originally expressed by Daniel Guérin, in his 1936 book Fascism and Big Business, about the fascist government support to heavy industry. It can be defined as, 'an informal and changing coalition of groups with vested psychological, moral, and material interests in the continuous development and maintenance of high levels of weaponry, in preservation of colonial markets and in military-strategic conceptions of internal affairs. [1]

Source Watch defines the "government-industry revolving door" as follows:

The government-industry revolving door puts industry-friendly experts in positions of decision-making power. Often individuals rotate between working for industry and working for the government in regulatory capacities, arrangements that are fraught with potential for conflicts of interest.

Under current law, government officials who make contracting decisions must either wait a year before joining a military contractor or, if they want to switch immediately, must start in an affiliate or division unrelated to their government work. One big loophole is that these restrictions do not apply to many high-level policy makers . . . who can join corporations or their boards without waiting. [2]

The practice exists because both the government and contractors need people with experience in government and industry defense contracting. Contractors will often hire a government employee to gain insight into the DOD procurement process, or relationships with procurement personnel.

The practice, however, is rich with potential for conflict of interest. There have been cases where procurement personnel have awarded large contracts to defense contractors after accepting a job with the contractor, but prior to announcing their departure, raising questions of objectivity and fairness in the awarding of the contract. Government employees may also take with them confidential information that might put other companies at a competitive disadvantage.

ASSIGNMENT TWO

1. From the 2009 pro forma income statement for Pegasus (Table 1), prepare forward pricing rates using the given formula.

2. Use these forward-pricing rates to calculate a bid price for a firm-fixed-price contract with an estimated $450,000 of direct labor, and $600,000 of direct materials. Assume that management wishes to earn a 10% fee or profit on this contract.

INSTRUCTOR'S SOLUTION

Problem 1

Calculation 1; Assignment 2 Problem 1; Calculation of Forward-pricing Rates for Fiscal Year 2009					
Overhead rate =	Estimated overhead/Estimated direct labor costs	=	3025000/5500000	=	55%
Materials handling rate =	Estimated material handling costs/Estimated direct materials costs	=	1170000/7800000	=	15%
G&A rate =	Estimated G&A costs/Contract costs	=	4373750/17495000	=	25%

Problem 2

Calculation 2: Assignment 2 Problem 2; Loading of Direct Costs for Bid Preparation	
Company profit or fee as a percent of total costs	10%
Direct labor	$ 450,000
Overhead applied	247,500
Direct material	600,000
Material handling cost applied	90,000
Contract costs	1,387,500
G&A applied	346,875
Total loaded costs	1,734,375
Profit or fee (10%)	173,438
Total	$ 1,907,813

ASSIGNMENT THREE

1. Explain why it is not enough to know only the labor budget and the labor dollars spent-to-date when managing a fixed price contract.

2. The cost reports previously received by project managers provided three figures: (1) budget, (2) costs spent contract-to-date, and (3) percent of total costs spent. Identify additional information that you think would be useful for a project leader managing a complex firm-fixed-price contract, and prepare a direct labor job cost report using the data from Table 2.

Table 2
Actual and Estimated Labor Dollars for Firm-fixed-price Contract FFP-0010 as of July 2009

	Contract Labor Dollar Budget	Labor Dollars Spent Contract To date	Estimated Labor Dollars to Complete Contract
Task 1	$ 85,500	$ 50,000	$ 25,000
Task 2	200,000	120,000	100,000
Task 3	20,000	25,000	500
Task 4	167,000	95,000	65,000
Task 5	205,000	200,000	25,000
Task 6	22,500	15,000	
Task 7	65,000	45,000	10,000
Task 8	90,000	55,000	55,000
Task 9	10,000		10,000
Total	$ 865,000	$ 605,000	$ 290,500

INSTRUCTOR'S SOLUTION

Problem 1

Neither figure tells the project manager how much should have been spent for the work actually done, and neither figure provides the information necessary to calculate projected cost over or underruns.

Problem 2

Labor earned and estimated projected cost over or under-runs would be useful. One possible format of a cost report broken out by tasks, and reporting labor earned as well as labor paid, is shown in Calculation 3.

Calculation 3: Assignment 3 Problem 2; Management Report on Firm-fixed-price Contract FFP-0010 as of July 31, 2009							
	A	**B**	**C**	**D**	**E**	**F**	**G**
Task	**Total Contract Labor Dollar Budget**	**Labor Dollars Spent Contract To date**	**Estimated Labor Dollars to Complete Contract**	**Earned Labor Contract To date**	**Percent Complete**	**Estimated Total Labor Cost**	**Estimated Total Under or (Over)**
Task 1	$ 85,500	$ 50,000	$ 25,000	$ 60,500	70.76%	$ 75,000	$ 10,500
Task 2	200,000	120,000	100,000	100,000	50.00%	220,000	(20,000)
Task 3	20,000	25,000	500	19,500	97.50%	25,500	(5,500)
Task 4	167,000	95,000	65,000	102,000	61.08%	160,000	7,000
Task 5	205,000	200,000	25,000	180,000	87.80%	225,000	(20,000)
Task 6	22,500	15,000	-	22,500	100.00%	15,000	7,500
Task 7	65,000	45,000	10,000	55,000	84.62%	55,000	10,000
Task 8	90,000	55,000	55,000	35,000	38.89%	110,000	(20,000)
Task 9	10,000	-	10,000	-	0.00%	10,000	-
Total	$ 865,000	$ 605,000	$ 290,500	$ 574,500		$ 895,500	$ (30,500)

Explanation of Figures in Calculation 3

Column A: This budget was estimated at the time the contract was bid. This data is given in the case study.

Column B: This information is provided by payroll. The data is given in the case study.

Column C: These numbers are estimated by the project manager at the end of each payroll period. This data is given in this case study.

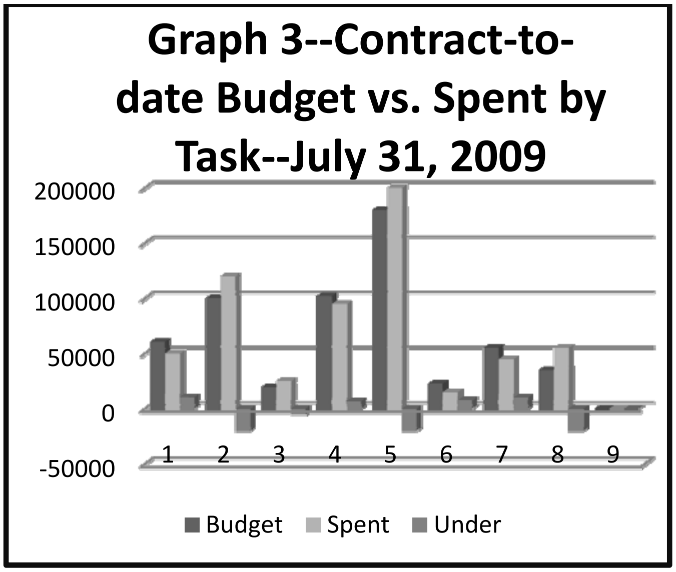
Column D: This is the amount that should have been spent, given the work actually done. It is calculated by subtracting Column C (Estimated Labor Dollars to Complete Contract) from Column A (Total Contract Labor Dollar Budget).

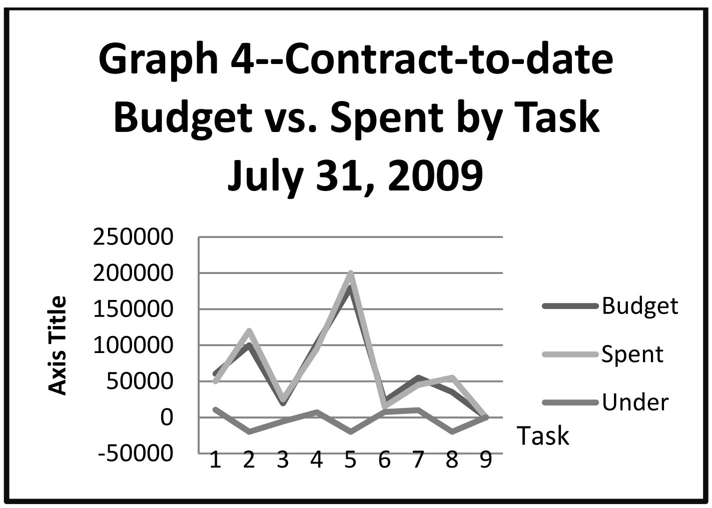
Column E: This is calculated by dividing Column C (Estimated Labor Dollars to Complete Contract) by Column A (Total Contract Labor Dollar Budget).

Column F: This is calculated by adding Column B (Labor Dollars Spent Contract-to-date) to Column C (Estimated Labor Dollars to Complete Contract).

Column G: This is calculated by subtracting Column F (Estimated Total Labor Cost) from Column A (Total Contract Labor Dollar Budget).

Students may also wish to use a variety of graphical formats to present the information from Calculation 3, two of which are shown below.





ASSIGNMENT FOUR

Assume:

1. There were no continuing contracts at the end of 2009.

2. The forward-pricing rates shown in Table 3 have been approved for 2010.

3. The following contracts (data shown in Tables 4, 5, 5, 7 and 8) were bid and won for 2010.

4. The four contracts for which data is provided will be started and completed in 2010.

From this information:

1. Calculate the bid submitted in 2009 for each contract to start Jan 2010.

2. From the bids, prepare a pro forma financial statement.

Table 3: Forward-pricing Rates for 2010	
Overhead rate	60.00%
Materials handling rate	12.00%
G&A rate	22.00%
Table 4: Estimated Direct Costs for Firm-fixed-price Contract FFP-0014, Fiscal Year 2010	
Direct labor	1,250,000
Direct materials	875,000
Fee as % of total loaded costs	20%
Table 5: Estimated Direct Costs for Fixed-price-firm-target Contract FPFT-0019, Fiscal Year 2010	
Direct labor	850,000
Overhead applied	0
Direct materials	1,300,000
Material handling costs applied	0
Contract costs	2,150,000
G&A applied	0
Total loaded costs	2,150,000
Profit	215,000
Total Bid	2,365,000
Table 6: Incentive Cost Data for Fixed-price-firm-target Contract FPFT-0019, Fiscal Year 2010	
Target costs loaded	3,435,520
Target profit	343,552
Target price	3,779,072
Price ceiling	4,417,097
Share Arrangement	
Government	**Customer**
65%	35%
Table 7: Estimated Direct Labor Costs for Labor-hour Contract LH-0016, Fiscal Year 2010	
Hourly rate hardware engineer	55
Hourly rate software programmer	34
Estimated paid hours hardware engineers	6,000
Estimated paid hours software programmers	10,000
Fee as % of total loaded costs	6.00%
Table 8: Estimated Costs Cost-plus-incentive-fee Contract CPIF-0015, Fiscal Year 2010	
Direct labor	102,459
Target fee	16,000

INSTRUCTOR'S SOLUTION

Problem 1: Calculation of bids for each contract.

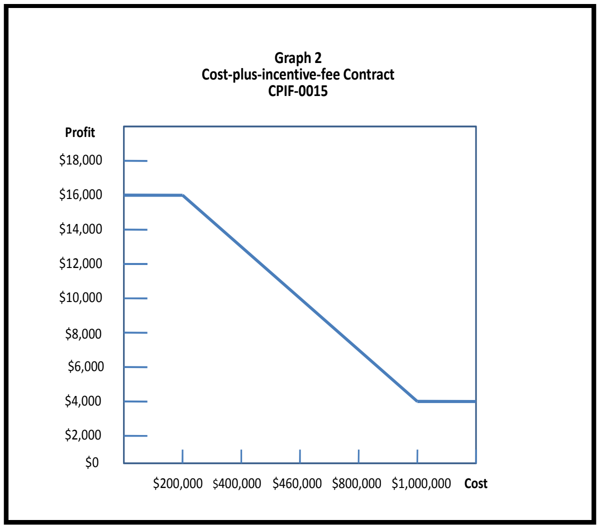
We begin by loading firm-fixed price contract FFP-0014 (Calculation 4) to calculate the bid price. To do this, direct contract costs taken from Table 4 are loaded with 2010 forward-pricing rates shown in Table 3.

Calculation 4: Assignment 4 Problem 1; Calculation of Bid Submitted for Pro Forma Income Statement; Firm-fixed-price Contract FFP-0014; Fiscal Year 2010	
Direct labor	$ 1,250,000
Overhead applied	750,000
Direct materials	875,000
Material handling cost applied	105,000
Contract costs	2,980,000
G&A applied	655,600
Total loaded costs	3,635,600
Fee	727,120
Bid submitted	$ 4,362,720

It is not necessary to load FPFT-0019 because the author has done this for us.

Calculation 5: Assignment 4 Problem 1; Bid Submitted Data for Pro Forma Income Statement Fixed-price-firm-target Contract; Contract FPFT-0019; Fiscal Year 2010	
Direct labor	$ 850,000
Overhead applied	510,000
Direct materials	1,300,000
Material handling cost applied	156,000
Contract costs	2,816,000
G&A applied	619,520
Total loaded costs	3,435,520
Fee	343,552
Bid Submitted	$ 3,779,072

The profit line for CPIF—0015 (needed for the profit earned calculation) is shown in Graph 2 below.



The next step is to load the other contracts to determine the amounts bid. We will continue with Labor-hour contract LH-0016, data for which is shown in Calculation 6.

Calculation 6 : Assignment 4 Problem 1 ; Calculation of Bid Submitted Data for Pro Forma Income Statement for Labor Hour Contract LH-0016							
	Hardware Engineer			Software Programmer			Total
	Billing Rate	**Budgeted Hours**	**Estimated Dollars**	**Billing Rate**	**Budgeted Hours**	**Estimated Dollars**	
Direct labor	55.25	6,000	331,500	33.50	10,000	335,000	666,500
Overhead applied	33	6,000	198,900	20	10,000	201,000	399,900
Contract costs	88	6,000	530,400	54	10,000	536,000	1,066,400
G&A applied	19	6,000	116,688	12	10,000	117,920	234,608
Total loaded costs	108	6,000	647,088	65	10,000	653,920	1,301,008
Profit or fee 6%	6	6,000	38,825	4	10,000	39,235	78,060
Bid Submitted	14.32	6,000	685,913	69.32	10,000	693,155	1,379,068

The loading of Cost-plus-incentive-fee Contract CPIF-0015 is shown in Calculation 7.

Calculation 7: Assignment 4 Problem 1; Estimated Costs Cost-plus-incentive-fee Contract CPIF-0015 for Purpose of Preparing Pro Forma Income Statement Fiscal Year 2010	
Direct labor	102,459
Overhead applied	61,475
Contract costs	163,934
G&A applied	36,066
Total loaded costs	200,000
Fee	16,000
Bid	216,000

We now summarize the revenues and expenses of the four contracts in Calculation 8, prior to using this information in the Pro Forma Income Statement for 2010.

Calculation 8: Assignment 4 Problem 1; Total Bids for 2010					
	FFP-0014	**FPFT-0019**	**LH-0016**	**CPIF-0015**	**Total**
Direct labor	1,250,000	850,000	666,500	102,459	2,868,959
Overhead applied	750,000	510,000	399,900	61,475	1,721,375
Direct materials	875,000	1,300,000	0	0	2,175,000
Materials handling costs	105,000	156,000	0	0	261,000
Contract costs	2,980,000	2,816,000	1,066,400	163,934	7,026,334
G&A applied	655,600	619,520	234,608	36,066	1,545,794
Total loaded costs	3,635,600	3,435,520	1,301,008	200,000	8,572,128
Fee or profit	727,120	343,552	78,060	16,000	1,164,732
Total	4,362,720	3,779,072	1,379,068	216,000	9,736,860

PROBLEM 2

The data from Calculation 8 can then be rearranged into a detailed Pro Forma Income Statement as shown in Calculation 9.

Calculation 9: Calculation 8 Reformatted to Detailed Pro Forma Income Statement 2010					
	FFP-0014	**FPFT-0019**	**LH-0016**	**CPIF-0015**	**Total**
Revenue	4,362,720	3,779,072	1,379,068	216,000	9,736,860
Less contract costs					
Direct labor	1,250,000	850,000	666,500	102,459	2,868,959
Overhead	750,000	510,000	399,900	61,475	1,721,375
Direct material	875,000	1,300,000	0	0	2,175,000
Material handling cost	105,000	156,000	0	0	261,000
Contract costs	2,980,000	2,816,000	1,066,400	163,934	7,026,334
Gross margin	1,382,720	963,072	312,668	52,066	2,710,526
G&A expense	655,600	619,520	234,608	36,066	1,545,794
Income before tax	727,120	343,552	78,060	16,000	1,164,732
Note "total bid" on calculation 8 corresponds to "revenue" on student schedule 9, and "fee or profit" on calculation 8 corresponds with "income before tax" on calculation 9.					

The same income statement (without contract detail) is shown in Calculation 10.

Calculation 10: Assignment 4 Problem 1; Pro Forma Income Statement Fiscal Year 2010	
Revenue	9,736,860
Less contract costs	
Direct labor	2,868,959
Overhead	1,721,375
Direct material	2,175,000
Material handling cost	261,000
Contract costs	7,026,334
Gross margin	2,710,526
G&A expense	1,545,794
Income before tax	1,164,732

ASSIGNMENT FIVE

1. From the information provided, prepare the actual income statement for the 2010 fiscal year showing revenues and direct costs for each contract in a separate column, consistent with the following format.

Table 11
Format for 2010 Income Statement

	FFP-0014	FPFT-0019	LH-0016	CPIF-0015	Total
Revenue	$xxxx	$xxxx	$xxxx	$xxxx	$xxxx
Less contract costs					
Direct labor	xxx	xxx	xxx	xxx	xxx
Overhead					xxx
Direct material	xxx	xxx	xxx	xxx	xxx
Material handling cost					xxx
Contract costs					xxx
Gross margin					xxx
G&A expense					xxx
Income before tax					$xxx

INSTRUCTOR'S SOLUTION

Problem 1

Since actual costs are provided, the challenge to students will be to accurately calculate revenue, given the actual performance on the four contracts. Students should reference the guidelines for billing and revenue recognition prepared by Evan Elmore in the case study for his new contract administrator.

Once again, we start with Firm-fixed-price Contract FFP-0014. The revenue for a firm-fixed-price contract is, of course, the amount bid. This is what is billed regardless of actual costs. The amount of the bid (shown in Calculation 11) is taken from Calculation 4.

Calculation 11: Assignment 5 Problem 1; Revenue Calculation for Income Statement Firm-fixed-price Contract FFP-0014 Fiscal Year 2010	
Revenue	$ 4,362,720

Now we move onto the Fixed-price-firm-target Contract FPFT-0019. Revenue will be calculated by loading the direct costs for this contract (given in Table 9) with the 2010 forward-pricing rates (given in Table 3). Once again, it may be important to remind students that these contracts use forward-pricing rates (not actual rates) in loading actual direct materials and labor for the purpose of revenue calculation. Revenue must be adjusted, however, for the penalty incurred if the actual costs exceed target loaded costs as shown in Table 6.

First we must load actual direct costs with the forward-pricing rates to determine the actual loaded cost. This is done in Calculation 12.

Calculation 12: Assignment 5 Problem 1; Calculation of Loaded Costs to be Billed for Firm-price-fixed Target Contract FPFT-0019 Fiscal Year 2010	
Direct labor	900,000
Overhead applied	540,000
Direct material	1,390,000
Material handling cost applied	166,800
contract cost	2,996,800
G&A applied	659,296
Actual costs loaded	3,656,096

Our next step, therefore, is then to calculate the penalty, based on the actual direct costs loaded shown above. This is done in Calculation 13. Remember from Table 6, the contractor pays 35% of any costs in excess of target price. The government pays the other 65%.

Calculation 13: Assignment 5 Problem 1; Calculation of Fee Penalty Contract FPFT-0019 Fiscal Year 2010	
Target costs loaded	3,435,520
Actual costs loaded	3,656,096
Overage	(220,576)
Times penalty percent	0
Penalty	(77,202)
Target fee	343,552
Less penalty	(77,202)
Actual fee	266,350

Once again, a firm-price-fixed-target contract, the contractor receives full loaded costs up to the target ceiling plus a fee (profit) less penalty (if applicable). We calculate both figures, and sum them in Calculation 14 to determine the total billing which constitutes the revenue for the contract. It should be noted that if actual loaded cost had exceeded the price ceiling of $4,417,097, then the contractor would have been fully liable for costs exceeding that price ceiling.

Calculation 14: Assignment 5 Problem 1; Calculation of Actual Billing Contract FPFT-0019; Fiscal Year 2010	
Actual costs loaded	3,656,096
Actual fee	266,350
Total revenue billed	3,922,446

The invoice amount (which constitutes revenue for LH0016) was calculated in the case study by the author. This information is provided in Table 10, which is reproduced here in the instructor's notes.

Table 10
Actual Labor Costs and Actual Billing on Labor Hour Contract LH-0016, Fiscal Year 2010

	Actual			Negotiated	
Title	Actual Hours	Actual Labor Cost/Hour	Total Actual Labor Costs	Negotiated Billing Rate	Total Billing
Hardware engineer	7,600	57	431,300	0	0
Software programmer	9,800	31	303,800	0	0
Total			735,100		0

We will now calculate the invoice amount (which constitutes contract revenue) for Cost-plus-incentive-fee Contract CPIF-0015. With this type of contract, contractors are paid full costs incurred. As costs increase, the fee decreases. The instructor might note that there is no ceiling on reimbursement of contractor costs as there is with a fixed-price-firm-target contract and the contractor always receives the minimum fee. To calculate the fee or profit, we need to calculate the slope of the profit line as taken from Graph 2. This is done in Calculation 15 below.

Calculation 15: Assignment 5 Problem 1; Calculation of Slope for Purpose of Calculation of Fee or Profit on Cost-plus-incentive-fee Contract CPIF-0015; For Pro Forma Income Statement Fiscal Year 2010			
Formula for slope of line which equals the decrease in fee or profit for every $1.00 of total contract cost over $200,000.			
Slope =	Y high - Y low/X high - X low		
Decrease in profit =	12,000/800,000	=	.015
For every $1.00 contract costs exceed $200,000, the company gives up $0.015 in profit			

Since profit earned is based on total loaded cost, we calculated these in Calculation 16.

Calculation 16: Assignment 5 Problem 1; Calculation of Total loaded costs For Purpose of Determining Actual Profit on Cost-plus-incentive-fee For 2010 Income Statement Cost-plus-incentive-fee Contract 0015; Fiscal Year 2010	
Direct labor	155,000
Overhead applied	93,000
Direct materials	0
Materials handling applied	0
Contract costs	248,000
G&A applied	54,560
Total loaded costs	302,560
The profit we can bill also depends on the actual amount of loaded costs, the total of which can also be billed. Here we load actual direct costs with the forward-pricing-rate for 2010.	

Once we have the loaded costs, we can calculate the earned profit or fee as shown in Student Calculation 17.

Calculation 17: Assignment 5 Problem 1 Calculation of Profit or Fee on CPIF-0015	
Actual contract cost	$ 302,560
Minimum contract cost	200,000
Excess	102,560
Times reduction in fee per dollar overrun	0.0150
Reduction in fee	1,538
Maximum fee	16,000
Actual fee	$ 14,462
Actual loaded costs exceed the target minimum by $102,560. We multiply this by the penalty per dollar of $0.015 to determine our penalty or reduction in fee of $1,538. The target fee or profit of $16,000 less the penalty of $1,538 equals the total amount of profit that will be billed of $14,462. Total revenue, therefore, will be $302,560 of loaded costs plus a profit or fee of $14,462 which sums to $317,022	

By adding the earned fee or profit to the loaded costs, we obtain the total billing or revenue, in Calculation 18.

Calculation 18: Assignment 5 Problem 1 Calculation of Total Billing on CPIF-0015; Fiscal Year 2010	
Direct Labor	155000
Overhead applied	93000
Direct materials	0
Materials handling cost	0
Contract costs	248000
G&A applied	54560
Total loaded costs	302560
Fee or profit	14462
Actual revenue	317022

Using this data, we prepare an income statement that shows contribution by department. Since overhead, materials handling costs and G&A expense are only tracked for the company as a whole, these figures are shown in the right column only.

Calculation 19: Detailed 2010 Income Statement					
	FFP-0014	**FPFT-0019**	**LH-0016**	**CPIF-0015**	**Total**
Revenue	4,362,720	3,922,446	1,548,116	317,022	10,150,304
Less contract costs					
Direct labor	1,280,000	900,000	735,100	155,000	3,070,100
Overhead					1,730,676
Direct material	888,000	1,390,000	0	0	2,278,000
Material handling cost					255,000
Contract costs					7,333,776
Gross margin					2,816,528
G&A expense					1,525,000
Income before tax					1,291,528

Problem 2: Evaluation of the Performance of the Company as a Whole

If one compares the pro forma statement for 2010 (the budget) with actual performance as shown in Calculation 20, it is apparent that while revenue and expense increased by approximately 4%, income increased by approximately 11%.

Calculation 20: Assignment 5 Problem 2 Comparison of Pro Forma to Actual Income Statement: Calendar Year 2010					
		Budget	**Actual**	**Variance**	**% Change**
Revenue		9,736,860	10,150,304	413,443	4.25%
Less contract costs					
Direct labor		2,868,959	3,070,100	201,141	7.01%
Overhead		1,721,375	1,730,676	9,301	0.54%
Direct material		2,175,000	2,278,000	103,000	4.74%
Material handling cost		261,000	255,000	(6,000)	-2.30%
Contract costs		7,026,334	7,333,776	307,442	4.38%
Gross margin		2,710,526	2,816,528	106,002	3.91%
G&A expense		1,545,794	1,525,000	(20,794)	-1.35%
Income before tax		1,164,732	1,291,528	126,796	10.89%

One reason for this was that indirect costs increased by only a small fraction of the increase in direct contract costs. One might assume, therefore, that indirect costs are primarily fixed (they increase only slightly with increases in direct labor and direct materials, both of which are variable). As calculation 21 indicates, actual indirect rates were all approximately 6% lower than the forward-pricing rates used in preparing bids.

Calculation 21: Comparison of Forward-pricing and Actual Indirect Cost Rates; Fiscal Year 2010			
	Forward Pricing Rates	**Actual Rates**	**Percent Change**
Overhead	60.00%	56.37%	6.05%
Material Handling	12.00%	11.19%	6.72%
G&A	22.00%	20.79%	5.48%

In situations where actual indirect cost rates turn out to be lower than predetermined rates, the difference flows through to income in most of the cost-reimbursement type contracts. Remember, that while direct costs under cost-reimbursement-type contracts are billed at actual, indirect costs are billed using forward-pricing rates. An adjustment is not made, even if the actual rates are lower, unless defective pricing can be proven.

Calculation 22 indicates that over-applied indirect costs provided $128,538 in additional revenue.

Calculation 22: Dollar Impact of Lower Actual Rates for all but Fixed Price Contract			
	Actual Costs at Actual Rates	**Actual costs at Forward-pricing Rates**	**Overapplied OH and G&A**
Overhead applied	1,009,115	1,074,060	64,945
Materials handling applied	255,000	166,800	(88,200)
G&A applied	1,525,000	955,859	(569,141)
	2,789,115	2,196,719	(592,396)

Evaluation Based on Performance of Individual Contracts

Calculation 23 is an internal management report that will show management how much was made or lost on each contract, when the difference between actual indirect rates and forward-pricing rates is factored into equation. Calculation 23 loads actual direct costs with actual indirect rates to determine the actual costs which can then be subtracted from revenues to determine a form of actual profit by contract. This calculation shows that all contracts had a positive income, even though the two incentive-cost-type contracts (FPFT-0019 and CPIF-0015) were forced to give up fee or profit (as shown on calculations 13 and 17) due to cost overruns. FFP-0019 gave back $77,202 and CPIF gave back $1,538. The ability of both of these contracts to still earn profits was due to increased direct costs which were reimbursed (minus the penalties), and to lower indirect costs.

Calculation 23: Detailed 2010 Income Statement Loaded with Actual Indirect Cost Rates

	FFP-0014	FPFT-0019	LH-0016	CPIF-0015	Total
Revenue	4,362,720	3,922,446	1,548,116	317,022	10,150,304
Less contract costs					
Direct labor	1,280,000	900,000	735,100	155,000	3,070,100
Overhead	721,561	507,348	414,390	87,377	1,730,676
Direct material	888,000	1,390,000	0	0	2,278,000
Material handling cost			0	0	255,000
Contract costs	2,988,964	2,952,945	1,149,490	242,377	7,333,776
Gross margin	1,373,756	969,502	398,625	74,645	2,816,528
G&A expense					1,525,000
Income before tax					1,291,528

It should also be noted, that the one cost-type contract type for which there is no penalty for direct cost overruns is the labor-hour contract. Not only are additional direct costs fully reimbursed, but they are loaded with the forward-pricing rates, and additional fee. This also helped compensate for the small direct cost overruns on the firm-fixed price contract.

SUMMARY

Although the company lost profit or fee due to direct cost overruns on their firm-fixed-price contract, and lost some fee or profit on their fixed-price-firm-target, and cost-plus-incentive-fee contracts due to direct cost (also due to cost overruns), these losses were made up by over-applied overhead, materials handling and G&A, and additional work fully reimbursed with additional fee on the labor-hour contract.

Since it is doubtful that the company can continue to count on the negotiation of forward-price-rates that exceed actual rates to generate additional revenue, it should continue to refine its bidding and cost-control procedures on all fixed price, fixed-price-firm-target, and cost-plus-incentive-fee contracts to prevent future overruns.

ENDNOTES

1 Military-Industrial complex, Wikipedia, http://en.wikipedia.org/wiki/Military-industrial_complex, downloaded March 21, 2009.

2 "Government-industry revolving door, Source Watch, http://www.sourcewatch.org/index.php?title=Government-industry revolving door, downloaded March 22, 2009.

AUSTRALIAN DREAM: AN AMERICAN DREAM

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CASE DESCRIPTION

The primary focus of this case is on how a small business that has been successful selling an over-the-counter arthritis cream in a regional market can refocus to compete in a national market. The secondary issues include marketing, strategic management, entrepreneurship and e-commerce issues.

Students are provided a scenario of a small business that is on the verge of taking off. The case requires students to do a SWOT analysis, analyze the market environment using Porter's five forces model, and to analyze the business philosophy and practices of an emerging company. Students could be assigned the critical task of developing a plan for moving the firm's product from a regional market to a national market and to generate sufficient sales to stay on the store shelves of a major retail chain.

The case has a difficulty level of four and is appropriate for senior level classes or higher. It can be taught in two to three 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

Phil and Mark Maddox formed a small company, Nature's Health Connection (NHC), to market a skin cream that was being sold through Phil's pharmacy. NHC own the small company that makes the skin cream with the distinguishing ingredient of emu oil. In 2000, an FDA approved ingredient was added to the cream to create Australian Dream® Arthritis Relieving Cream (AD).

Over the last ten years, managing the company has been difficult and at times nerve racking. However, growth has been steady due to learning from mistakes, a little luck, and the sheer determination of the brothers. Phil is the entrepreneur and risk taker, while Mark is more conservative. The brothers have an excellent personal relationship and compliment each other's strengths.

Their initial strategy was to market AD to independent pharmacies in the southeast United States. The product has a high price relative to its competitors, but provides an attractive profit margin for the pharmacies. Advertising has been limited to in-store displays and local *newspaper ads. The product has a loyal customer base and appears to be recession proof, but sales have not grown much recently.*

A year ago, Walgreens began stocking AD in some of its stores across the country. Once this happened, AD was quickly picked up by a few other large chain stores. The capital investment required to meet the sales quotas of the chain stores has almost caused Phil to throw in the towel. Going national requires costly changes in advertising strategy that seem insurmountable. However, Phil and Mark are adapting quickly.

NHC's growth has caught the attention of a business broker who represents a group of venture capitalists that might want to buy NHC or to provide needed capital for NHC to go national. Phil strongly believes NHC will be worth a lot more if they can create a national brand image, introduce other products, and expand their distribution through other national and regional chains. The big questions facing NHC is: How to do it? Should they go it alone? Bring in investors? Sell NHC now, or wait for the company establishes itself as a national brand?

INSTRUCTOR'S NOTES

The instructor might want to ask or assign students to answer some or all of the following eleven questions.

1. What is entrepreneurship?

The students will find many definitions of entrepreneurship in the research, many of which are too vague and imprecise to be useful. However, the definitions generally include the common characteristics of an entrepreneur: creating and innovating, seeking gain or growth, and risk taking.

2. What entrepreneurial characteristics do the Maddox brothers possess? Which one is more entrepreneurial?

Both Phil and Mark have an entrepreneurial nature, although Phil is more so than Mark. Phil is the "big picture guy" who thinks about marketing strategy, product development, finances, and is more of a risk taker. While Mark is more of a detail guy who likes to do the "face-to-face" interaction with brokers and pharmacy managers, and is somewhat risk averse. However, they do make a good team because they balance their feelings about risks. Rolling the dice, as opposed to taking calculated risk, is not a characteristic of a good entrepreneur.

3. What knowledge and expertise have Mark and Phil acquired through experience? How has their expertise helped them in creating and growing Nature's Health Connection?

Entrepreneurial expertise results from the knowledge and skills learned from experience which is a key component in successful new venture formation (McEwen, 2002; Reuber & Fischer, 1999; Child, 1997 and 1972; Chandler, 1996; Bull & Willard, 1993).

“. . . the exercise of strategic choice by organizational decision-makers (sic) refers to a process in which the first stage is their evaluation of the organization's position--the expectations placed on it by external resource providers, the trend of relevant external events, the organization's recent performance, how comfortable the decision-makers (sic) are with its internal configuration, and so on. Their prior values, experience and training are assumed to colour this evaluation in some degree. A choice of objectives for the organization is assumed to follow on from this evaluation, and to be reflected in the strategic actions decided on. . . . Externally oriented actions may include a move into or out of given markets or areas of activity in order to try and secure a favourable demand or response that will be expressed by a high consumer valuation of the organization's products or services” (Child, 1997)

Environment, competence and experience of the entrepreneur have a direct effect on new venture performance through the strategic choices that are made. Entrepreneurs make a difference because they use their experiences, competencies, and background to choose the business strategy and organizational environment (Weick, 1979). The motivation to achieve and entrepreneurship has a strong positive relationship (Hornaday and Aboud, 1971).

According to Gartner (1985) model (Figure 1) for new venture creation is an interaction between individual characteristics, the organization’s strategy, the environment, and environmental constraints.

4. Explain how NHC fits Gartner’s New Venture Creation Model (Figure 1).

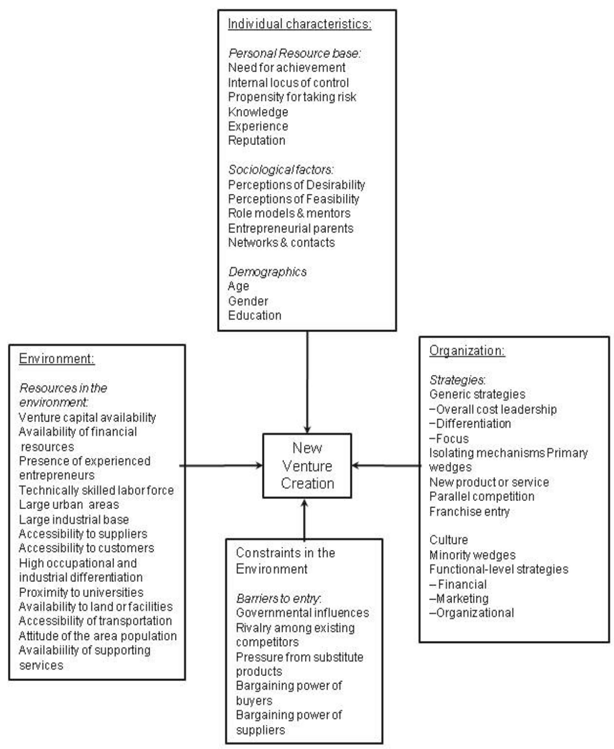
NHC seems to fit Gartner’s model of new venture creation. Both brothers appear to be internally controlled, risk takers, knowledgeable about the market they are in, and both have a wealth of experience based on their individual backgrounds.

They had an excellent role model in their father and they have experience working in their father’s clinic and the pharmacy. They liked helping customers and had a strong desire to start a business together. They were able to make numerous business contacts that have proven helpful in developing and marketing AD.

Phil and Mark also demonstrated their entrepreneurial skills and ability to work together in the office coffee machine venture, and again later on when they developed and sold AD in their pharmacy. Both have management and marketing skills and use their college and work experiences in starting and operating NHC. They already had a customer base when they started selling AD and expanded on this base. The customers they targeted had a very positive attitude towards the cream. There are plenty of suppliers available for the materials they need. The Maddox’s believe their cream is different because of the emu oil base they use. They outsource the production and have developed a suitable distribution system. The home office of NHC is close to several universities and interstate highways in Kentucky.

There certainly are barriers to entry into the arthritic pain market, but it is evident that it is relatively easy to introduce a new pain relief product based on the number of products and services currently found in the market. The market for pain control is huge. Customers have a lot of choices. The pain is real, and customers seek a remedy that can ease the pain. AD apparently satisfies its users who are willing to pay a price that is three greater than the other creams they could buy. AD's ingredients are readily available, so the suppliers have little bargaining power.

Figure 1



Source: Adapted from W. Gartner (1985). A conceptual framework for describing the phenomenon of new venture creation. Academy of Management Review, 10(4), p696-707.

NHC has pursued a differentiation strategy by adding emu oil as a prime component and selling point of their arthritis cream. It has a special benefit of acting as an analgesic without the negative side effects (Appendix A). Consequently, they can charge more for their product. They do not have a focused strategy per se, because they basically target a large group of customers who are the primary buyers of arthritic remedies. The only isolating mechanism they have created so far is loyalty from people who have purchased and used their product. By providing a good product, creating a brand name, selling in independent pharmacies and advertising in local newspapers, NHC has created a brand loyalty on a local level.

NHC's primary wedge is not a first mover strategy. They did not create an innovative product. The wedge into the market would be considered parallel competition. AD is essentially a "me too" product that customers perceive as a better value and are willing to pay a premium price for it.

5. Do a SWOT analysis of NHC

Strengths
- The brother's expertise
- Good team work
- Proven product
- Good reputation
- Loyal customer base
- Outsourcing
- Low costs

Weaknesses
- Capital base for expansion
- Many competitors
- Reliance on other companies
- Possible contamination
- Just one product
- Just two managers
- Rely on one manufacturer

Opportunities
- Create a national brand
- Expand to large chains
- Create and market a new product
- Sell out
- Float an initial IPO
- Develop economies of scale

Threats
- Unreliable supply sources
- No sales increase
- Poor quality/contamination
- Government regulations
- Cost of ingredients
- Introduction of a similar product

6. What is a "growth strategy," and how well has NHC followed this type of strategy?

New ventures use their resources and expertise to grow their firms. Very rarely is the growth smooth. Emerging organization advances incrementally (MacFarlane, 2004) in a series of spurts and then levels off when they hit rough spots. The rough spots are largely determined by the level of resources possessed by the firm such as capital, technology, or labor. The most important limitation is probably management expertise. New ventures must have the capacity to run the firm at its current size and have the capacity to grow the firm. It is something like a yo-yo where management is both an accelerator for growth and a retardant. There are periods of fast growth followed by slow growth.

This is described by Phil when he says that the work can be gut wrenching at times. NHC has gone from serving a local market, to a small regional market, to the entire south east, and is now pursuing a national market. This has been accomplished through a trial and error process on the part of Phil and Mark that ultimately resulted in some wise moves based on their previous experiences. Some times their decision and consequent actions worked quite well other times not so well.

7. Should NHC expand its product line by before AD is firmly established as a national brand?"

One of the first things a new venture must do is acquire the resources it needs to introduce and insure the survival of its products and services. Once this is done the firm needs to secure a foothold in the market on which they can build. This means a loyal customer base needs to be established. Then the firm must establish an intelligence network to forecast environmental trends, changes in the market, technological developments, and competitors' moves.

NHC has been successful in acquiring the necessary resources and establishing a loyal customer base, but it has yet to establish a highly reliable intelligence network. Phil and Mark rely on gut feel, what their customers and product reps tell them.

Many industries go through a life cycle and as they do, consolidations take place where larger firms buy out smaller firms. When this does not occur the market remains fragmented. In a fragmented industry there are ample opportunities for small firms to grow large.

There has been a lot of consolidation in the drug industry; however, the arthritic market remains fragmented, which provides NHC the potential for continued growth. As it grows, NHC will change also.

MacFarlane (2004) states that "All emerging organizations show a simultaneous process of horizontal and vertical extension …" NHC's expansion into the national retail chain stores is a vertical integration and developing a new product targeted at the same market would be a horizontal expansion. MacFarlane (2004) further states that emerging businesses ". . . change in character from simple to complex. This change increases its power and capacity to express its force of action."

8. Compare entrepreneurship with marketing.

Marketing and entrepreneurship are interdependent concepts concerned with identifying and satisfying customer needs, identifying, developing and evaluating new products and services, gathering market data, and building networks of relationships with other organizations. Marketers and entrepreneurs often make the mistake of thinking their markets will continue to expand indefinitely, that their product is unique, that cost will decease while sales volume increases, and are preoccupied with product issues rather than competitive strategy. They tend to develop a false sense of sustainability and invulnerability.

To an extent, this is the case with NHC. It is obvious there is plenty of room for growth; however, NHC does not have a sustainable competitive advantage. Their philosophy of standing behind their product by giving a top-notch guarantee will not guarantee the firm's long term success. They do have is a good product, a loyal customer base, an established distribution system, the potential for further growth with AD, and the potential to add a second product using their current business model. However, they need to develop a strategy to take them to the next level.

9. Discuss the importance of market intelligence as NCH strives for a larger national role in the OTC analgesic market.

Market intelligence is the sum total of information gained about a given market. While it is true that Phil has a good intuitive sense of the market, the process of capturing market intelligence is more formal, and involves what some senior marketing executives refer to as a marketing information system.

It should be pointed out that marketing information systems go way beyond computers and computer networks; it integrates electronic data with judgments made by responsible people who analyze and make sense of a flood of information. The information in question ranges from economic factors (aggregate incomes, for example), to consumer preferences, to supply chain issues (raw material availabilities for instance), channel management, the regulatory environment, potential shifts in target markets as time goes on, and the list could be endless.

Ensuring thorough market intelligence collection and analysis will be integral to NHC's bid to be a real force in the market. This is because the market contains a whole host of unknowns that at various points may have a major impact on NHC's operations. A well developed market intelligence system can furnish management with the ability to sense shifts in the marketplace and revise its competitive strategies before their competitors can.

10. What evidence is provided that NHC is market oriented?

Market orientation is defined by Kohli & Jaworski (1990) as a systematic collection, dissemination, and response to market intelligence. While Phil and Mark have their entrepreneur's "ear to the ground," that is not a systematic process of managing market intelligence. One could point to several statements in the case that connote that strategic decisions are made on a "feeling" of the market, but there is no evidence of solid information that had been garnered in a systematic way. It is important for students to acknowledge that the intuitive sense of the market that the owners have is in no way unreliable. One must only point to the success experienced so far as solid support for the fact that Phil and Mark have been able to leverage strengths to gain success in the market place.

Becoming market oriented would signal NHC's a shift from a small local (regional) marketer to a real player in the national OTC analgesic market. Developing systematic processes for collecting, analyzing, disseminating, and reacting to market intelligence will allow management to respond far more quickly to market conditions. In addition, becoming market oriented could allow management to identify formerly unknown opportunities, accelerate the exploitation of existing opportunities and strengths, and ward off presently unknown threats and shore up weaknesses.

11. As NHC seeks to appeal to a wider (national) audience with its communications, what positioning strategies could be considered?

Positioning is essentially how the target market views one's brand in relation to other brands. For example, Volvo is positioned as the "safe" car, while Ford pickup trucks are positioned as the "tough" truck. Students could come up with any number of positioning strategies. The instructor should stress is that positioning decisions are often unattainable because once a position has been established; changing that position is highly unlikely to be successful. One example from retailing is K-Mart, which for years had been positioned as the discount retailer where price was the primary driver of sales. Later, when K-Mart was squeezed by Wal-Mart, it tried to change its position by upgrading its image, which never really caught on.

Some possible positioning strategies might include positioning against the competition, such as an "in your face" presentation of why AD is different from other analgesic creams, by occupying an un-owned position (like V.W. being the "ugly" car), etc. Given that the market in which NHC operates is highly competitive, students could be encouraged to think "outside the box" toward positioning strategies that might a unique image in the mind of consumer.

12. Assume you are the Marketing Director at NHC, with the task of making AD a national brand. What do you do?

This question should be seen as one that highlights the process and procedure of decision making. The purpose of this process is to maximize the impact of any marketing decisions that are made, given the resources that are allocated to accomplish the goal.

With this in mind, students should focus on the importance of setting objectives. In this case, NHC must establish a national awareness of the brand before true brand-building can be begin. It is vital to set objectives for raising awareness that have three qualities. First, the awareness objective must be measurable and initially quantified with a simple awareness study to establish a baseline. Second, the objective must have a timetable associated with it. Third, the objective must be achievable. While it is desirable to achieve 100% awareness among the target audience, it rarely happens. Finally, the objective for awareness must take into account current awareness rates, the budget for building the brand, and media options that will work to achieve a realistic objective.

Other important decisions regarding product positioning must be also. Positioning of the product could start with a media blitz to raise awareness. This decision should be based on information gathered and analyzed in the marketing information system. Students should realize at this point why big mistakes are made in the marketing decision-making process –decisions are typically made without sufficient or good-quality information, or the information is improperly analyzed.

Once objectives and positioning decisions are set, a plan is devised to establish how the promotion mix is to be applied. The promotion mix includes advertising, professional selling, public relations and publicity, sales promotion, direct marketing, and viral marketing. Instructors can point to the fact that nothing in the case indicates an extensive use of any of the promotion mix variables, except for professional selling (Phil and Mark making presentations to major customers). Students may make mention of the print advertising noted in the case, but on a national stage, the level of advertising noted is relatively minor.

Given the goal of establishing a national brand, the Marketing Director must allocate his/her budget in view of the reality of media effects. Namely, two concepts will weigh heavily on how the plan is constructed - reach and frequency. Reach is defined as the number of consumers in the target audience that were exposed to the message. Frequency refers to the number of times that members in the target audience were exposed to the message. Reach and frequency are on opposite ends of a dichotomous continuum. Specifically, one can allocate a large budget for reach (i.e., Super Bowl advertising with hundreds of millions of viewers) or frequency (the same ad on spot cable, but aired almost constantly). Both options would consume roughly the same budget, but with different effects.

Once the plan is established, it must be executed. In the execution of the plan, the continuous interface between the market and the information system is crucial. It is this information that can clue management in to whether the plan is effective or needs adjustment. The last step is to evaluate the results and repeat the process in light of the revised circumstances. It should be emphasized that this is why good objectives are so important. Without specifically specific, measurable objectives, it is impossible to know whether a marketing plan has succeeded or failed. Furthermore, it would be impossible to make proper adjustments to the marketing plan to make it more successful.

It should be noted that NHC is unlikely to launch a comprehensive marketing and continue doing what they have done in the past because of limited resources. Also, implementing such a plan would require major financial investments in advertising, information systems and consultants beyond what NHC can afford without outside investors. Since Phil does not want to give up ownership in the company at this point, expanding sales will continue at a slow pace and generating resources to build a national brand will be even slower.

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CHIROPRACTIC MARKETING: MARKET SEGMENTATION & GROWTH STRATEGY

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CASE DESCRIPTION

The primary subject matter of this case concerns changing trends within the chiropractic industry in which the Segmentation-Targeting-Positioning (STP) process becomes the main emphasis for understanding consumer behavior as well as assessing markets. Secondary issues examined include: competitive advantage, differentiation, social trends, and consumer behavior. The case has a difficulty level appropriate for senior level. The case is designed to be taught in two (2) class hours and is expected to require three (3) hours of outside preparation by students.

CASE SYNOPSIS

In January 2008, Roseville Chiropractic changed its name to Roseville Family Chiropractic (RFC) to provide a more family-oriented chiropractic and health wellness appeal in an uprising, metropolitan area of Sacramento, California. Being in practice for close to 10 years, RFC's stifling growth brought about a need for rethinking the marketing strategy. High volumes of competition are beginning to encroach on the market and RFC is in need of differentiating its services in order to secure their market share.

Kevin Sherwood, RFC's current Director of Marketing, is looking to discover the environmental and behavioral changes of its consumers as well as identify potential target markets for future sustainability. Based on the researched information, he is expected to recommend segmentation, positioning, and communication strategies to the partners of the practice.

The following case study provides a thorough look for discussion of the chiropractic industry, a niche, but fragmented industry that is interesting to explore. It emphasizes and explores STP concepts that are essential for entrepreneurial and marketing students to understand in order to be competitive in today's markets. This study includes the major marketing concepts arising within study today, such as: consumer behavior and social trends among different generations, traditional marketing converging on digital and social networking techniques, the need for strategic repositioning to attract new markets, and the development of differentiating elements in order to assist in sustaining market share.

CASE REVIEW

In June of 2008, Kevin decides to leave his real estate position and concentrate on rebuilding the business strategy of the partnership business that his wife, Dr. Jennifer Cox, owns. He began to think of all the redundancies and inefficiencies there were in the current marketing plan and realized a disconnect between the practice and the market. If Kevin wanted to further the growth of the practice, new market segments must be clearly researched. He also had to provide realistic segmentations of the current and potential new markets in order to determine which were primary as well as the sustainability of each over a category of years based upon the social trends, consumer behaviors, and assumed medical needs of the markets specific to their allowable services. In addition, Kevin had to determine the need for repositioning the practice from a strategic marketing standpoint based upon the new services the practice would be offering in order to stay competitive as well as build it for future growth based upon new trends. A new marketing strategy, complete with goals, objectives, marketing mediums, etcetera, was needed to show the practice's differentiation qualities in order to sustain it above the competition.

CASE GOAL AND OBJECTIVES

The goal is to investigate the trend of utilizing only traditional services in an industry-specific practice versus the trend of merging traditional and differentiated services to create a hybrid, non-industry specific practice. Potential problems may arise within a practice's marketing strategy where items, such as the desired target market, needs to be redefined and the strategy of the practice as a whole may need to be repositioned to capture and sustain market share. Issues facing chiropractors today include a lack of awareness of their profession through social stereotypes, cost of healthcare and practice maintenance, and the need for competitive advantages that differentiate each practice from others.

"Chiropractic Marketing" may be used in an undergraduate senior level Principles of Marketing or Marketing Management course and seeks to serve four primary opportunities:

to discuss the observable changing trends in the chiropractic industry

to emphasize the importance of understanding the customers needs and assess potential market segments and opportunities

to explore the evolution of a service offering, demand for which is largely derided from the result of the social trend and consumer behavior

to consider potential target segments

RECOMMENDATION FOR TEACHING APPROACHES

The instructor should focus on the key decision in the case, whether Kevin's new role should be to focus on the existing target market or seek potential segments. Additionally, the digital component of the business should be set up quickly given the vast influences and growth on the Internet. Students participating in this discussion should be required to state their preferences of the primary target market and provide sound reasoning.

Another important issue for discussion is reaching these different target segments requires different promotional mix and the appropriate resources. Despite the desire to reach other potential markets and further grow the practice, most students support the decision to sought after the segment in preventive care, thoroughly researched consumers' needs and the distinct benefits that the practice can provide to the particular segment. Students may start questioning the actual value of chiropractic care whether chiropractors are "qualified as primary care providers" and services are medically necessary.

In the final segment of the discussion, instructors can divide students into groups and create the marketing mix program details that would be consistent with reaching the new target market. Additionally, students can focus on creating a niche and a distinct positioning by forming perceptual maps and positioning statements.

Going beyond the scope of a senior-level Principles course as an additional challenge, introduce Integrated Marketing Communications (IMC) techniques that allow the students to use all aspects of the marketing mix – product, price, place, promotion. As an individual project, the students can design and present an IMC campaign using a specific promotional mix tool that RFC could use for marketing to a new and/or potential target market, such as a print advertisement for a magazine or radio spot. This allows the students to not only think beyond the basic marketing principles, but to be able to apply essential IMC techniques to those basic. Students will show understanding of the basic principles and how they are used in every marketing design application.

ASSIGNMENT QUESTIONS

1 What changes are occurring in the chiropractic industry? Assess the competitive position of RFC. What are the differentiating elements that RFC has to the competition? Can RFC incorporate any other elements and/or build upon current ones that would give them a strong, sustainable competitive advantage? If so, explain those elements.

2 How is the market segmented? Compare consumer (patient) behavior for benefits sought and value creation.

3 What are the risks for seeking a preventative segment and moving away from the traditional segment?

4 What marketing recommendations would you make to Kevin? Utilize the current situation and design the following to support your recommendations:

Marketing Mix
SWOT Analysis
Perceptual Map

RECOMMENDED ASSIGNMENT ANSWERS

QUESTION 1

What changes are occurring in the chiropractic industry? Assess the competitive position of RFC. What are the differentiating elements that RFC has to the competition? Can RFC incorporate any other elements and/or build upon current ones that would give them a strong, sustainable competitive advantage? If so, explain those elements.

INDUSTRY GROWTH

The chiropractic industry is growing, as it is the third largest doctoral-level health care profession after medicine and dentistry (American Chiropractic Association, 2008). In the US, between 2006 and 2016, there is a projected 14 percent increase expected in practitioners; a change that is faster than any other occupational average (Bureau of Labor Statistics, 2007). Of all alternative medicine services, which include chiropractic care, there is a projected growth of 88 percent between 1994 and 2010 – which is 72 percent higher than the expected growth of physician care during the same period (Stevens, Mansfield, & Loudon, 2005).

Since it is a niche market among an already niche-based alternative care industry, the trends today are proving that chiropractic is becoming integrated among other practices in order to provide as many services as possible in one place. This trend has been occurring for years, but has become more prevalent today with social trends changing consumer behaviors in how consumers deem “wellness” for themselves, to include anything from plastic surgery, rejuvenation, massage, and holistic treatments. All of which many practices are providing in one office as a part of the growing service or value marketing trend, which many are using as their differentiating element to the competition.

CONSUMER (PATIENT) CHANGING VALUES AND INTEGRATED HEALTH CARE PERCEPTIONS

With increasing levels of education, accessibility to information, greater need to be involved, and dissatisfaction with conventional medical system, there is a growing popularity of complementary and alternative (CAM) medicine. CAM covers a range of therapies, which includes acupuncture, physical therapy, herbal remedies, and chiropractic. Patients are becoming more informed of various forms of CAM therapies and turned to them for effective care. They are more involved in various approaches to maintaining health and are more empowered to choosing among various treatments, either in combination or in lieu of mainstream conventional medicine (Spence & Ribeaux, 2004). Given such patient empowerment, CAM is becoming more consumption-oriented and demand-driven, which may require a greater out-of-pocket expenditure from patients/consumers.

Perceptions of the chiropractic industry are beginning to change in a positive manner, in which the profession has become more acceptable as a legitimate treatment for health. This is shown through a proven record of accomplishments for its successful treatments of specific ailments. The increased acceptance of chiropractic by consumers and the “mainstream” health care industry has been important to its growth. Other health care professionals have been known to refer their patients for chiropractic treatments. It is also perceived that chiropractic patients spend more “face- time” with their practitioner, since the treatment is hands-on and done so by the practitioner, rather than by a medication given by another health care provider. If a patient’s treatment is successful in improving their way of life over traditional methods, they are more inept to continue the same pattern rather than change back.

The integration of health care professionals to cross-refer their patients is an important step to the growth and sustainability of the industry. Chiropractors have also integrated as a health care professional into organizations that are dominated by traditional medicine as an additional and alternative treatment for patients. Health insurance companies, whom have controlled the acceptance of what “treatments” are considered acceptable for patient care, have also come to accept this non-invasive treatment as a legitimate part of patient care through specific coverage allowability and payment for patients and practitioners, respectively.

RFC’S NEED TO FOCUS ON DIFFERENTIATION

Any business in any industry is never “perfect” in terms of competitive advantage. Businesses have to consistently think of the “next best thing” in order to sustain strong market share as well as the advantage over its competition – RFC is no exception. RFC is competing within the local industry utilizing typical traditional services, but very few differentiating services that the other competition has built their practices upon, i.e. massage therapy, cryotherapy, and cellular detoxification. Their wellness boutique provides a large number of products for outside patient wellness as a preventative segment, which is unique to their practice, but does not bring in the patient-base exclusively. Their website, as seen from the accompanying perceptual map, shows that it is about average to the available compared competition, but does not standout to give them enough of a competitive advantage. The industry is changing by integrating such services as acupuncture and massage therapy as a norm, ones in which RFC does not offer, which decreases their competitive advantage within the local industry.

RFC can build strong, competitive advantages by focusing on specific differentiating qualities that other practices may not focus on while expanding to more highly competitive qualities. Simple differentiating factors can include placing more emphasis on the "family" aspect of marketing, developing a tagline that coincides with the title and placing on all materials. RFC is in a prime location, near schools, recreational parks, and a major transportation corridor and is able to focus on the convenience of their location. The practice also has two "female" practitioners, one of few in the regional industry. This focus can be used to increase the segment that may be reluctant to go to a male chiropractor and/or feel more relatable going to a female for treatment. Another would be the focus on "extreme" service marketing from water bottles given to patients when coming into the practice to a follow-up call to see how the patient is fairing the next available day.

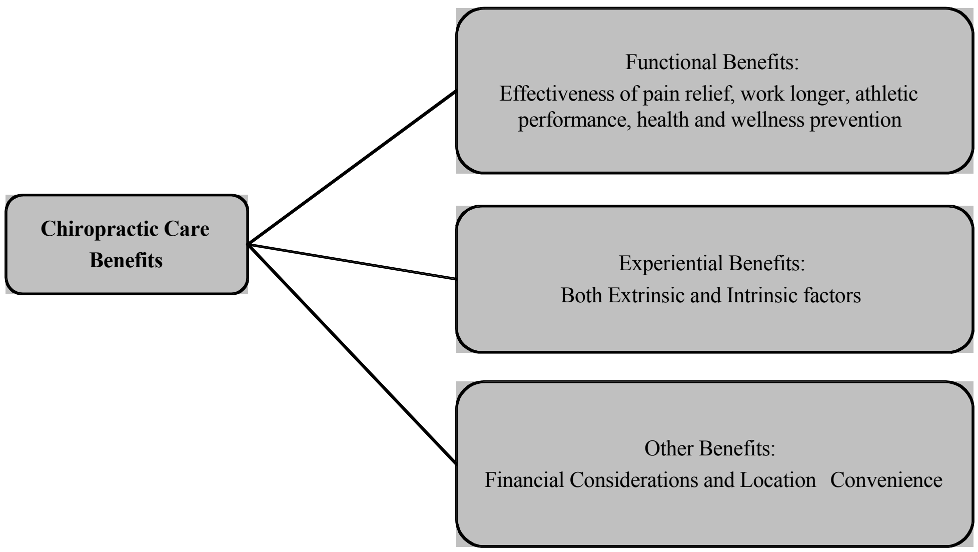
After differentiating factors are recognized and executed properly, other elements that would take a longer period to manage, but would prove to be highly competitive, can be developed. This includes a simple redesign of the website to have a more personal feeling and reflection of the practice as the first digital marketing presentation of RFC to their current and potential target markets. In addition, an integration of complementary and/or unique services, i.e. ultrasound, massage therapy, wellness courses, acupuncture, etcetera. Technology integration is also a large competitive advantage, especially when it is state-of-the-art that makes treatments more efficient and patience care more effective. RFC can also contract and consult with local schools and recreational organizations to gain exclusivity of treatment to these patients, which give RFC the advantage of strong brand recognition with its community visibility.

QUESTION 2

How is the market segmented? Compare consumer (patient) behavior for benefits sought and value creation.

Market segmentation is one of the most important steps for a business to sustain a successful marketing strategy. It allows the organization to focus their resources and efforts on the right consumers and provide synergy in the execution of the marketing mix. Marketing textbooks and theories have suggested numerous ways of segmenting the market with distinct characteristics, geographic locations, psychographics, behaviors, or needs. A more patient-centered segmentation method would be to focus on the ailment/benefits that these (existing and potential) patients commonly sought. As such, compared with the underlying needs and benefits, the practice can serve a more niche market with products that match their needs. The type of benefits that patients generally seek from chiropractors can be conceptualized into three (3) categories.

(The benefits mentioned herewith should enable students to think about the benefits that chiropractic patients value)



FUNCTIONAL BENEFITS

Functional benefit refers to benefits that patients perceived necessary or desirable. In most cases, patients seek a chiropractor for the core functional benefit or validation of treatment such as neck and lower back pain relief. The effectiveness of pain relief matters a great deal for patients who are seeking this as the core functional benefit from the visit. Additional functional benefits may include athletes who desire a better performance, office workers who desire to work longer hours without pain, and holistic patients who are looking for health and wellness prevention. In an economic sense, Tylenol and other pain reliever medications cost much lower than chiropractic visits, unless in extreme pain cases, these patients believe in alternative medicine treatment and are willing to pay for chiropractor visits rather than taking painkillers or self-managed care.

EXPERIENTIAL BENEFITS

Experiential benefits refer to the physical sensations and emotional feelings that patients experience during the treatment. Extrinsic cues include the touch of the chiropractor, physical feelings after the adjustment, and sensory-atmosphere of the practice (smell, sight, feel, audio, etcetera). Intrinsic cues include the pain sensations before and after the treatment, perceived effectiveness of the adjustment, trust/relationship patients have with the practitioner, and other feelings caused from the visit. In addition, psychosocial benefits or desires may play a role in patients seeking chiropractic care. These patients desire to have a healthy spine, look and feel attractive, and exude a beautiful posture. Resulting positive experiential benefits for the patient may reinforce stronger bonding and loyalty between the patient and practitioner, thus resulting in frequent visits and increased revenue as a result for the practice.

OTHER BENEFITS

Other benefits refer to influencers that would narrow the chances of returning patients, such as financial considerations and the convenience of the practice. The practice cannot easily manipulate these often-uncontrollable factors without incurring additional costs and risks. Financial situations limit the patient's ability to pay for services, especially in difficult economic times. A treatment with a low-cost has the potential to improve a patient's financial situation, but may incur a negative perception of the treatment and/or not give the total utilitarian benefit needed by the patient. In addition, a treatment that is mostly funded through health insurance has annual expenditure limitations as well as the risk of none-payment due to policy coverage limitations.

Convenience and the location of the practice would also have an impact on the decision for treatment and frequency of visits. The majority of RFC's patients who seek chiropractic care are between the ages of 30 to 54-years-old, working professionals, female, and earn between $30,000 to $100,000 annually. These patients (55 percent) often frequent the practice as often as 6 to 10 times per month. As a result, location convenience becomes a critical deciding factor on the frequency of the patient's visit.

According to Sarvary (2006) from Harvard Business, segmentation requires the following steps:

Understand the benefits that customers seek

Segment the market and develop prototypical customer profiles based on the customer benefits

Find the observable variables (such as demographics characteristics) most likely to discriminate among the benefit segments to identify membership in specific segments

Patients who seek chiropractic care are involved, to varying degrees, in the maintenance of their health. Uninvolved patients are probably suffering from acute symptoms and/or injuries and are largely motivated by the therapeutic benefits. Highly involved patients are motivated by chronic conditions. This segment appears to be more driven by long-term functional as well as experiential benefits. Additionally, the wellness prevention segment appears to be gaining more attention for the following reasons:

> Among aging baby boomers, there is an increase in long-term health maintenance. They are interested in a wide range of health products including vitamins, herbal supplements, and other natural products for the purpose of preventive diseases and pain.
>
> A range of new health products in ergonomics is on the rise. These focus on the preventive benefits, including therapeutic mattresses, contour pillows, ergonomic mouse, and keyboards
>
> An increase in consumer income and socio-economic status gave consumers the power to make more informed decisions for themselves and self-help activities.
>
> In Europe, the United States, and Australia, up to 50 percent of the population uses some form of complementary and alternative medicine, and this has been reported to be an upward trend (Spence & Ribeaux, 2004).
>
> In the United States, 75 percent have used some form of complementary and alternative medicine (Huggins, 2005).
>
> There is a growing trend of consumer wellness - a $60 billion industry in the United States (Janoff, 2000).

QUESTION 3

What are the risks for seeking a preventative segment and moving away from the traditional segment?

The traditional segment for any industry is the “comfort zone” of the business. Having to make changes to the way a business operates or the target markets of the business can be challenging, even putting the business at risk. When seeking a new segment, the business must perform strategic marketing research on areas such as: proposed market segmentations, ROI, growth sustainability, competitors, needed differentiation for market capture, etcetera. The business also has to understand the consumer behaviors of the new segment so that when seeking the target market, it looks attractive to the consumer base over the competition. Social trends would be advantageous to understand to see where the segment is heading into the future, if the segment is to be kept for sustainable growth. If the plan is executed correctly and at the precise time after understanding internal and external factors, the business can potentially increase revenue as well as break into the segment and capture the market share. In addition, the business can introduce new competitive advantages as well as develop differentiating factors to sustain growth in both the traditional and preventative segments for the long run.

Some risks for seeking a preventative and moving away from the traditional include, but are not limited to:

Not understanding or anticipating the internal and external factors of new segment

Loss of business if preventative segment fails in the long run and the negative outcome of such - loss of revenue and/or consumer base from traditional by putting too much focus on preventative

If consumer-base is beginning to move toward the preventative segment and away from the traditional; seeking new market cancels out

Not understanding the needs and wants of the preventative segment consumers

Cost associated to enter into a new segment

Long-term revenue generation of new segment versus original investment – ROI

Trends within the preventative segment not conforming to the operational ability of the business to operate successfully within

Target market sustainability in the preventative when consumer behaviors change based on trends, i.e. social trends

Not positioning within the preventative segment correctly

Loss of focus overall on traditional to competition, which is the sustainable growth segment and business foundation for the long run

Attempting to market to the preventative the same as the traditional segment and not understanding the consumer segmentations; assuming without research

Competitive advantages and/or differentiating elements of the business are already captured in the preventative segment, resulting in the cost to develop specific "attractive" advantages

New segment is highly saturated with similar competition

Preventative segment may not be a sustainable segment, but rather a short-term trend segment that peaks and exhausts one large target market that then moves to a new "segment"

QUESTION 4

What marketing recommendations would you make to Kevin? Utilize the current situation and design the following to support your recommendations:

Marketing Mix
SWOT Analysis
Perceptual Map

TACTICAL STRATEGIES

Kevin can implement simple tactical marketing strategies in order to organize the overall plan to secure its effectiveness over time. For example, he should first create timely, obtainable goals and objectives to implement through a value proposition framework. This framework would be something that the entire office could use as a direct focus and management as a benchmark. In addition, Kevin should assess which point-of-difference(s) are available for use immediately and use those as a focus for RFC. There should also be knowledge of what new target markets are available through defined segmentation of patients that will build sustained growth. These markets can be focused on through the strategic marketing plan. Kevin should also go to the patient-base for tactical support in developing a marketing plan - provide a survey to patients at random to complete (with an incentive) to obtain vital information from a patient's perspective of the practice as well as services they would like to see.

STRATEGIC STRATEGIES

From a strategic standpoint, Kevin can begin his marketing plan from inside the practice and then outward. By highly emphasizing on service marketing from within the practice to patients, this will create a value differentiation for RFC, i.e. welcoming of patients to follow-up calls to new patients after service. This can also include discounts for new patients as well as discount cards, for example, for returning patients. In addition, Kevin can use the website as a marketing source. By utilizing social networking sites to capture new markets as a free advertising basis as well as increasing digital marketing, i.e. exclusive and increased keyword searches for RFC, for immediate presence. Increasing the overall functionality of the website for patients to use as an information and communication site will become the personalized reflection of the practice and not just a platform. Materials used to promote the practice within and out, such as designing promotional items (print and digital form) that are congruent throughout to reflect the indirect message of the practice, i.e. business cards, letterhead, pamphlets, water bottle wraps, logo on uniforms, promote RFC and build brand recognition in the community. Other community involvement can include becoming involved with Chamber of Commerce for direct marketing abilities during events and developing internship program with local colleges for patient care and marketing to promote RFC. From a more financial marketing strategy, by increasing and integrating services that would provide differentiation and increase target markets, i.e. massage therapy, holistic, acupuncture, this will put RFC at the same level of the competition or beyond depending how niche they build these services within the practice as well as its overall promotion.

a. The marketing mix implications of selecting a traditional segment or a wellness prevention segment should be explored thoroughly by the practitioners. A traditional segment refers to the patients seeking chiropractors mainly for the core functional benefits (mainly musculoskeletal). Depending upon the segment(s) chosen, the implications on treatment can be described using the table below:

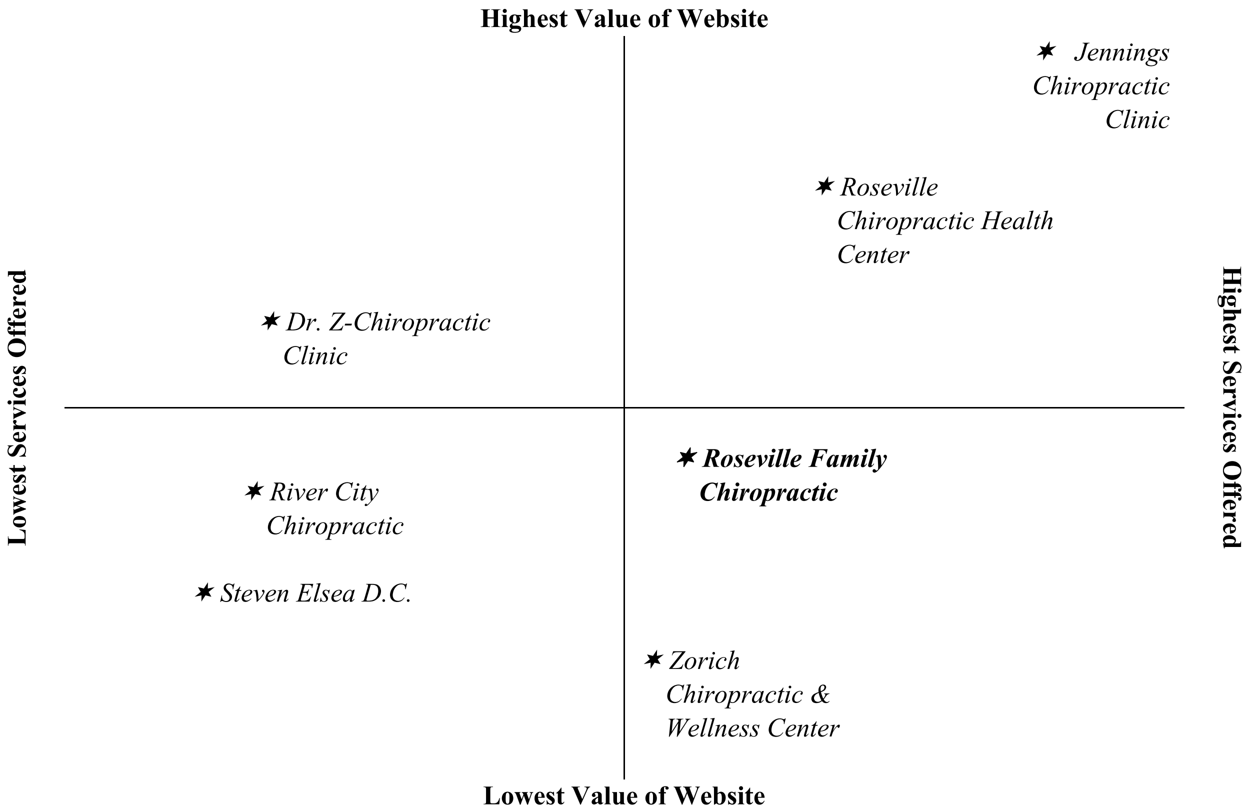
	Traditional Segment	Wellness Prevention Segment
Product Decisions: Treatments	Therapeutic treatment; adjustments; therapeutic machines	Therapeutic treatment; adjustments; therapeutic machines; emotional care; coaching
Product Decisions: Medication/Related Products	Herbal pain killers; therapeutic support supplies	Herbal wellness prevention; nutritional supplements; posture adjustment support supplies
Price Decisions: Insurance	Insurance-based; worker's compensation-based	Insurance based is less important; more out-of-pocket preferred
Price Decisions: Condition	Acute condition; patients need short term treatment; insurance coverage matters in decision making	Chronic condition; patients need long term treatment and care; may require greater out-of-pocket expenditure
Placement Decisions: Distribution	Practice-based only	Practice-based only for selected; Internet availability through exclusive website for products that can be brought out of the practice
Promotional Decisions: Advertising	Patients are less sensitive to regional and location convenience of the practice; advertise targeting corporations; consider collaborate advertise with attorneys for worker compensation cases	Patients are sensitive to regional and location convenience of the practice; advertise can focus on local residents
Promotional Decisions: Differentiation	Focus on evidence/functional based treatment; develop strong alliances with laborious corporations and attorneys practicing in worker's compensation	Focus more on the experiential factor; create strong relationships with patients; focus more on the nurturing family appeal; long-term care prevention methods and strategy; conduct lectures/sessions for wellness management

b. SWOT Analysis – Examples for Analysis, but are not limited to the following:

Strengths * Two female practitioners * "Family" atmosphere for patient care * Convenience of location * Well-rounded informative website * Wellness boutique * Community participation	Weaknesses * No clear marketing plan to place into market * No focus of marketing strategy and promotions * Local advertising absent * Search engine optimization absent * Inefficiencies of operations * Lack of patient awareness of overall practice
Opportunities * Service marketing * Increasing amount of "Baby Boomers" * Educational organization partnerships * Industry "exclusivity" * Development of wellness boutique * Integration of complementary services * Interactivity on the website for patient-use * "Family" emphasis for large target market * Focus on operation efficiencies	Threats * Patients seek other alternative methods * External factors: cost as "luxury" item * Internal factors: availability, staffing * Encroachment of competition * Other practices having high differentiating services * Expense of investing on competitive advantages * High competition of chiropractic offices in the city * Third-party web hosting service controls content

c. Perceptual Map - Refer to Exhibit D for example; allow students to design Perceptual Map using their own variables to support their recommendations.

EXHIBIT D
Perceptual Map: Chiropractic Websites versus Services



(Casewriters, 2008)

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ST. LOUIS CHEMICAL: COST OF CAPITAL

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CASE DESCRIPTION

The primary subject matter of this case concerns the issues surrounding a firm's weighted average cost of capital (WACC). Case provides a review of cost of capital issues. The case requires students to have knowledge of accounting and finance, 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 2-3 hours of preparation time from the students.

CASE SYNOPSIS

The case tells the story of Don Williams, President and primary owner of St. Louis Chemical. By most measures, the performance of St. Louis Chemical has been very good over the last three years, with sales and income increasing each year Business growth has been steady but a recent increase in demand has placed a strain on existing operations. To keep pace with demand, the capacity of the current warehouse and packaging operations need to be increased. The cost of the facility expansion has been estimated to be $900,000 by St. Louis Chemical's operation manager.

Since beginning operations, Williams has been reluctant to borrow funds. He has been content with limited growth, financed with internally generated equity.

Recently hired Edison Hesselbach, the company's first finance professional, has recommended borrowing the required funds. Williams indicated he may be willing to consider a change in his long-standing policy against debt, but wants more information regarding using debt in the firm's capital structure.

CASE USE

The case as written includes discussion questions to aid the student in their analysis of St. Louis Chemical's current situation. The case can be made more difficult by omitting the discussion questions.

CASE OVERVIEW

As the case opened Don Williams, the President of the St. Louis Chemical, a regional chemical distributor, headquartered in St. Louis, Missouri, is in need of additional assets and financing to support future growth. To keep pace with demand, the capacity of the current warehouse and packaging operations need to be increased. The cost of the facility expansion has been estimated to be $900,000 by St. Louis Chemical's operation manager.

Williams has also followed a conservative financing policy. Since beginning operations, he has been reluctant to borrow funds, content with limited growth, financed with internally generated equity. The only long-term debt on the company's balance sheet reflects the financing associate with vehicles. If the facility is to be expanded, additional external financing will be necessary. St. Louis Chemical's income statement and balance sheet for the years 2007-2009 are provided in Schedules One and Two, respectively.

Hesselbach has recommended borrowing the required funds. Williams indicated he may be willing to consider a change in his long-standing policy against debt, but wants more information regarding the advantages of using debt in the firm's capital structure.

Hesselbach, using input from an investment-banking firm, has estimated the company's cost of equity to be 14%. A St. Louis bank has indicated a long-term bank loan can be arranged to finance expansion at an annual interest rate of 10%. The bank would require either loan to be secured with expansion and other company assets. The loan agreement would also include a number of restrictive covenants, including a limitation of dividends while the loans are outstanding. Only a small amount of long-term debt is included in the firm's current capital structure, the firm's debt ratio at the end of 2009 was 21% and long-term debt was only .28% of total assets (see schedule 2). Hesselbach calculated that if a long-term bank loan was used to obtain the needed $900,000, the firm's debt ratio would increase to 30%. He believes a 30% debt and 70% equity capital mix would be conservative and a starting point for introducing long-term debt into the firm's capital structure. Last year the company's federal-plus-state income tax rate was 35%. Hesselbach does not expect the income tax rate to change in the foreseeable future.

DISCUSSION QUESTIONS

1 Prepare a presentation for Williams regarding the concept of a firm's weighted average cost of capital (WACC).

Simply stated the weighted average cost of capital WACC is the cost the company is paying to finance its assets. As its name indicates, it is a weighted average of the costs of the various sources of capital (debt and equity) used in the firm's capital structure. What is not so readily apparent by its name is that the WACC is an after-tax cost. In other words, it is calculated using the after-tax cost of each source of capital. Interest paid by a business is tax deductible, thus the cost of debt needs to be converted to an after-tax cost by multiplying the before-tax interest rate by one minus the firm's marginal income tax rate. The firm's WACC is also referred to as the firm's marginal cost of capital or what a firm must pay for its next dollar of capital. Another point that should be made is since the WACC is used by businesses to evaluate possible long-term expenditures (capital projects) only long-term capital sources are included in the calculation. Thus, most firms do not include the cost of short-term debt in the calculation.

To determine WACC a firm must 1) calculate the cost it must pay for each source of capital and 2) determine the target mix of debt and equity to be used by the firm. The cost of each source of capital and the target capital structure are provided in the case. St. Louis Chemical's before-tax cost of debt is given as 10% and its cost of common equity is given as 14%. St. Louis Chemical's target capital structure is given as 30% debt and 70% equity. For a detailed discussion of how a firm calculates its cost of debt and cost of equity see Eugene Brigham and Joel Houston's "Fundamentals of Financial Management," Concise 6th edition, Thomson South-Western, a part of the Thomson Corporation, 2009 or a number of other finance textbooks.

2 Calculate St. Louis Chemical's WACC using a 30% debt and 70% equity capital structure.

WACC formula:

$$WACC = w_d\,(r_d)\,(1\text{-}t) + w_s\,(r_s)$$

Where:
w_d = weight of debt in the company's target capital structure
r_d = before-tax cost of debt
t = marginal income tax rate
w_s = weight of equity in the company's target capital structure
r_s = cost of equity

WACC = .30 (.10) (1-.35) + .70 (.14)
= .0195 +.0980
= .1175 or 11.75%

3 Recalculate St. Louis Chemical's WACC (round to the nearest whole number) using a 40% debt and 60% equity capital structure.

WACC = .40 (.10) (1-.35) + .60 (.14)
= .0260 +.0840
= .1100 or 11.00%

4 Explain the difference between your answer to questions 2 and 3.

The use of debt lowers the cost of capital because lower cost debt capital is substituted for higher cost equity capital. Using more debt in the firm's capital structure will substitute more low cost debt capital for high cost equity, thus the cost of capital with the 40% debt and 60% equity is less than the 30%/70% structure.

In reality the increased use of debt in a firm's capital structure will cause the cost of debt and the cost of equity to increase. The cost of debt increases because of the increased risk to the lender due to a higher debt ratio and times interest earned (TIE) ratio. The cost of equity increases due to the higher financial leverage.

5 What arguments should be made to convince the Williams of the advantage of using long-term debt in the firm's capital structure? What are the disadvantages?

The best argument that can be made to convince the Board to use debt capital in its capital structure is to calculate the firm's WACC with and without debt. Without debt the firm's cost of capital is 14% (cost of capital and cost of equity are the same) and with 30% debt, St. Louis Chemical's cost of capital is 11.75%.

The use of debt lowers the cost of capital because lower cost debt capital is substituted for higher cost equity capital. Debt has a lower cost than equity because to the holder of debt there is less risk. Debt has less risk because the certainty of payments associated with debt (interest and principal) is greater than the payments associated with equity (dividends and stock appreciation). Interest and principal payments are legal obligations associated with debt thus are paid before any payment to equity shareholders. Because there is less risk associated with debt, the providers of debt are satisfied with a lower but more certain return. The downside of debt is the fixed nature of the payments, thus the use of debt by a firm increases its financial risk. The greater the percentage of debt used in a firm's capital structure, the greater the financial risk or financial leverage. The introduction of debt into a firm's capital structure will at first cause the WACC to decline, but eventually the use of large amounts of debt will cause the WACC to increase. What businesses attempt to achieve is a capital structure which provides the lowest cost of capital because it is at that point the value of the firm is maximized.

6 Explain why an accurate WACC is important to a firm's long-term success.

A firm's WACC is used to assess investment decisions. Assets must return at least the firm's cost of capital (what it must pay for the capital to acquire the asset). If an asset's return is less than the WACC, shareholders will not receive their required return. If a firm under estimates its WACC then it may invest in assets (projects) that do not yield the necessary return. If a firm over estimates its WACC then it may not invest in assets that would yield the necessary return (missed opportunities). Either error will result in problems. If the WACC is under estimated, the firm risks losing equity capital when dissatisfied investors take their funds elsewhere or will have difficulty raising capital in the future. If the WACC is over estimated, the firm risks missing profitable growth opportunities.

Schedule One
St. Louis Chemical
Income Statements (000's/$)

	2007		2008		2009	
	$	%	$	%	$	%
Revenue	14,378	100	16,470	100	17,970	100
Cost of Goods Sold	12,145	84.47	13,916	84.49	15,172	84.43
Gross Profit	2,233	15.53	2,554	15.51	2,798	15.57
Operating Expenses						
Selling	756	5.26	842	5.11	885	4.92
General & Administrative	588	4.09	701	4.26	791	4.4
Total Operating Expenses	1,344	9.35	1,543	9.37	1,676	9.32
Operating Profit	889	6.18	1,011	6.14	1,122	6.25
Interest Expense	6	0.04	4	0.02	2	0.01
Earnings Before Taxes	883	6.14	1,007	6.12	1,120	6.24
Income Tax Expense	309	2.15	352	2.14	392	2.18
Earnings After Taxes	574	3.99	655	3.98	728	4.06

Schedule Two

St. Louis Chemical

Balance Sheets (000's/$)

	2007		2008		2009	
	$	%	$	%	$	%
Current Assets						
Cash	25	0.42	22	0.34	23	0.32
Receivables	1,432	24.07	1,654	25.24	1,876	26.36
Inventory	1,682	28.27	1,898	28.97	2,013	28.28
Other current assets	32	0.54	37	0.56	46	0.65
Total current assets	3,171	53.29	3,611	55.11	3,958	55.61
Fixed Assets						
Land	443	7.45	443	6.76	443	6.22
Gross plant,property & equip	3,318	55.77	3,627	55.36	3,989	56.05
(less accumulated depreciation)	(982)	(16.50)	(1,129)	(17.23)	(1,273)	(17.89)
Net plant, property & equip	2,336	39.27	2,498	38.13	2,716	38.16
Total fixed assets	2,779	46.71	2,941	44.89	3,159	44.39
Total Assets	5,950	100.00	6,552	100.00	7,117	100.00
Current liabilities						
Account payables	839	14.10	947	14.45	1,043	14.66
Short-term notes payables	-	0.00	-	0.00	-	0.00
Accrued liabilities	421	7.08	480	7.33	441	6.20
Total current liabilities	1,260	21.18	1,427	21.78	1,484	20.86
Long-term liabilities	60	1.01	40	0.61	20	0.28
Total liabilities	1,320	22.19	1,467	22.39	1,504	21.14
Shareholders' equity						
Common stock	2,000	33.61	2,000	30.53	2,000	28.10
Retained earnings	2,630	44.20	3,085	47.08	3,613	50.76
Total equity	4,630	77.81	5,085	77.61	5,613	78.86
Total liabilities & equity	5,950	100.00	6,552	100.00	7,117	100.00

FEMSA 2007: THE FINANCIAL STATEMENT ANALYSIS IMPACT OF DIFFERENCES IN MEXICAN AND US GAAP

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CASE DESCRIPTION

The primary goal of this case is to have students recognize the impact that the use of a different set of generally accepted accounting principles (GAAP) may have on the analysis of an international company's financial statements. Another goal of the case is to reinforce to students that in order to make sound judgments when evaluating the performance of any corporation that the financial information analyzed needs to be prepared on a consistent basis. This case has a difficulty level of three to five and is targeted for use by accounting or finance students in any of the following: 1.) the last course of the intermediate accounting sequence; 2.) a senior level international accounting course, 3.) an undergraduate or graduate level financial statement analysis course or 4) a graduate level financial accounting course. One hour of class time should be sufficient to handle the case discussion and students should budget 1-3 hours of time for the preparation of case responses.

CASE SYNOPSIS

Recently graduated from college you are hired as a Financial Analyst. Your first task is to evaluate FEMSA, the largest beverage company in Latin America, as a potential investment for your firm. Browsing through FEMSA's Annual Report you note that the company produces and bottles several well known brands of beer and soft drinks such as Carta Blanca, Tecate, Sol, Dos Equis, Coca-Cola, Sprite, Fanta, Fresca, and Power Ade. You discover almost immediately that the financial statements have been prepared in accordance with Mexican GAAP, not the US GAAP that you learned in college and are familiar with. Furthermore, the major financial statements have been issued in constant Mexican pesos for comparative purposes with a translated US dollar amount for the most recent year. Thus, you have a challenging task ahead of you. Do you analyze the financial statements prepared under Mexican GAAP and in constant Mexican pesos? Or do you analyze the financial statements prepared under Mexican GAAP but using US dollars? If so, you don't have the comparative financial information. Is the information available for you to analyze FEMSA's financial statements based upon US GAAP? Does it matter which financial statements that you use or which currency?

INSTRUCTORS' NOTES

Although the SEC has mapped out a path to adopting international accounting standards for use by U.S. companies, that goal is still five years or more away. Until then there will be the problem of evaluating financial performance among companies that report using different GAAP.

The primary objective of this case is to have students recognize the impact that a different set of GAAP may have on the financial statement analysis of an international company. A secondary objective of the case is to have students recognize that in order to make sound judgments, when evaluating the performance of corporations, the financial information needs to be prepared and presented on a consistent basis

This case poses such a problem by using FESMA's 2007 annual report and the financial statements which have been prepared in accordance with Mexican GAAP, not US GAAP. Furthermore, the major financial statements have been issued in constant Mexican pesos for comparative purposes with a translated US dollar amount for the most recent year. By posing the following questions to the case reader, the reader then begins to see that potential for problems exist. By addressing the specific questions in the case the students can then see that differences in GAAP can pose a problem because different GAAP can result in different financial statement relationships.

REQUIREMENTS WITH ANSWERS

Compute the following ratios for 2007 using the financial statements prepared using Mexican FRS and expressed in pesos. [Assume the weighted average number of shares outstanding is 17,891,000]

Current Ratio:	Current assets/Current liabilities
Inventory Turnover:	Cost of Goods Sold/Average Inventory
Profit Margin on Sales:	Net Income/Net Sales
Debt to Assets Ratio:	Total Liabilities/Total Assets
Book Value per Share:	Common Stockholders' Equity/Outstanding Shares

The answers for this question can be found in the second column of Answer Table [labeled "#1."] See notes and explanations at the bottom of the table.

Compute the same ratios listed in 1 using the amounts expressed in US$. What are the implications for international financial statement analysis?

The numerical answers for this question can be found in the third column of Answer Table [labeled “#2.”] See notes and explanations at the bottom of the table. The implication is that choice of currency does not affect the ratios since all financial statement elements were translated from constant Mexican pesos to U.S. dollars using the same end of the year exchange rate.

Compute the same ratios listed in 1 using the financial statements prepared using the financial statements prepared using US GAAP. Compare these results to those obtained in 1. What causes these differences?

The numerical answers for this question can be found in the fourth column of Answer Table [labeled “#3.”] See notes and explanations at the bottom of the table. The causes for difference in ratios must be caused by differences between Mexican and US GAAP discussed in Note 26 to the financial statements. There are at least 10 differences between Mexican and US GAAP discussed in the notes including differences in consolidation. Under Mexican GAAP Coca-Cola FEMSA is consolidated but under US GAAP it would not be consolidated. See Note 26.

Determine the percentage difference between the results of your computation in requirements #1 and #3 by using #1 as the base [ie., (#3 -#1) /#1]. Which ratio has the biggest difference? Smallest difference? What difference in US and Mexican GAAP do you suspect had the biggest impact on financial statement differences? What are the implications of differences between US GAAP and foreign GAAP for international financial statement analysis? Do you think the cause of the biggest difference here is unique to FEMSA?

The numerical answers for this question can be found in the last column of Answer Table [labeled “#4.”] See notes and explanations at the bottom of the table. Both the debt to assets ratio and the book value per share changed 28% with the debt/asset ratio decreasing 28% while the book value per share increased 28% resulting in the largest % changes in ratios. The smallest change was in inventory turnover which was different between GAAPs by 4%.

Students may differ on the biggest impacting difference. The consolidation issue is likely to have had the biggest impact overall although it may not have changed the structural relationships the most percentage-wise.

Ultimately the point is that the choice of GAAP impacts structural relationships! How many other consolidated companies might be affected by Emerging Issues Task Force (“EITF”) 96-16, “Investor’s Accounting for an Investee When the Investor Owns a Majority of the Voting Stock but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights,”?

Obtain through your library, internet sources or others resources some analyst reports on FEMSA. Determine how their reports are prepared: based upon Mexican GAAP or US GAAP. If they report using Mexican GAAP do they report using the Mexican Pesos or translated US$? Which form of analysis would you prefer to have?

Different companies use a different approach to analysis but most of the reports that the authors obtained utilized FEMSA's Mexican GAAP based statements using U.S. dollars..

> *Reuters ProVester Plus Company Report uses FEMSA's Mexican GAAP pesos in FS comparisons but not ratios*
>
> *S&P Quantitative Stock Report uses FEMSA Mexican GAAP in US $.*
>
> *Reuters Company Research uses FEMSA Mexican GAAP in US $ in FS comparisons and ratios*
>
> *Value Line doesn't report on FEMSA but based upon other foreign companies trading on the US as ADRs they report financial data in US$ but the financial information is translated using constant exchange rate on Foreign based GAAP*
>
> *Hoovers (Dunn and Bradstreet Company) provides financial statement data in millions of US$ in what appears to be based upon US GAAP*
>
> *Datamonitor which provides an analysis of revenues uses the Mexican GAAP statements and reports both pesos and US$ based on the Mexican GAAP statements*

The choice of reporting used would naturally be influenced by the decision being made and where it is being made. It is logical to assume that case preparers in the U.S. will prefer U.S. GAAP based financial statements, because they are more familiar with them.

Answer Table							
Requirement:		**#1**		**#2**		**#3**	**#4**
Item		Mexican FRS in Pesos		Mexican FRS in US$		US GAAP	[#3-#1]/#1
A. Current Assets	1	33,485	2	$3,067	3	17,007	-49%
B. Current Liabilities	4	33,404	5	$3,060	6	18,579	-44%
C. Current Ratio (A/B)		1.002		1.002		0.915	-9%
D. Cost of Sales	7	79,801	8	$7,310	9	48,788	-39%
E. Average Inventory	10	9,371	11	858	12	5,969	-36%
F. Inventory Turnover (D/E)		8.516		* 8.516		8.17	-4%
G. Net Income	13	11,936	14	$1,093	15	8,557	-28%
H. Net Revenues	16	147,069	17	$13,472	18	82,887	-44%
I. Profit Margin on Sales (G/H)		8.10%		8.10%		10.30%	27%
J. Total Liabilities	19	76,142	20	$6,975	21	41,471	-46%
K. Total Assets	22	165,795	23	$15,187	24	124,775	-25%
L. Debt to Assets (J/K)		45.90%		45.90%		33.20%	-28%
M. Common Stockholders' Equity	25	64,578	26	$5,915.00	27	82,606	28%
N. Outstanding Shares		17,891		17,891		17,891	
O. Book Value Per Share (M/N)		3.61		$0.33		4.62	28%

Notes and Explanations
1. Consolidated Balance Sheet – Total current assets in pesos (column 2) for 2007
2. Consolidated Balance Sheet – Total current assets in dollars (column 1) for 2007
3. Financial Information Under U.S. GAAP (Note P.) – Total current assets in dollars (column 1) for 2007
4. Consolidated Balance Sheet – Total current liabilities in pesos (column 2) for 2007
5. Consolidated Balance Sheet – Total current liabilities in dollars (column 1) for 2007
6. Financial Information Under U.S. GAAP (Note P.) – Total current liabilities (column 1) for 2007
7. Consolidated Income Statements – Cost of sales in pesos (column 2) for 2007
8. Consolidated Income Statements – Cost of sales in dollars (column 1) for 2007
9. Financial Information Under U.S. GAAP (Note P.) – Cost of sales (column 1) for 2007
10. Consolidated Balance Sheet – Inventories (column 2 + column 3divided by 2)
11. Cost of sales - $7,310 divided by Inventory Turnover Ratio (see * below) equals Average Inventory
* Inventory Turnover Ratio is the same for dollars and pesos – both prepared using Mexican FRS and constant $
12. Financial Information Under U.S. GAAP (Note P.) – Inventories (column 1 + column 2 divided by 2)
13. Consolidated Income Statements – Consolidated net income in pesos (column 2) for 2007
14. Consolidated Income Statements – Consolidated net income in dollars (column 1) for 2007
15. Financial Information Under U.S. GAAP (Note P.) – Net income (column 1) for 2007
16. Consolidated Income Statements – Total revenues in pesos (column 2) for 2007
17. Consolidated Income Statements – Total revenues in dollars (column 1) for 2007
18. Financial Information Under U.S. GAAP (Note P.) – Net sales (column 1) for 2007
19. Consolidated Balance Sheet – Total long-term liabilities in pesos (column 2) for 2007
20. Consolidated Balance Sheet – Total long-term liabilities in dollars (column 1) for 2007
21. Financial Information Under U.S. GAAP (Note P.) – Total liabilities (column 1) for 2007
22. Consolidated Balance Sheet – Total Assets in pesos (column 2) for 2007
23. Consolidated Balance Sheet – Total Assets in dollars (column 1) for 2007
24. Financial Information Under U.S. GAAP (Note P.) – Total Assets (column 1) for 2007
25. Consolidated Balance Sheet – Majority interest in pesos (column 2) for 2007
26. Consolidated Balance Sheet – Majority in dollars (column 1) for 2007
27. Financial Information Under U.S. GAAP (Note P.) – Stockholders' equity (column 1) for 2007

ANDERSON'S DEPARTMENT STORE: A COSMETIC DILEMMA

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CASE DESCRIPTION

This case describes the unexpected conflicts that arise when a heretofore smoothly functioning cosmetic department is asked to temporarily alter its work routines. It could be readily used to demonstrate the benefit of using multiple perspectives to analyze a situation. Secondarily, it could be used to elicit discussion related to motivation, leadership, structure, or politics. The case has a difficulty level of three, appropriate for junior level students. It could be used in a principles of management, organizational behavior, or organization theory class. The case is designed to be taught in one class hour and is expected to require three hours of outside preparation by students.

CASE SYNOPSIS

In this case a successful, locally owned department store initiates a remodeling and expansion project of its cosmetics department. To save money on the upgrade, the store manager solicits the help of cosmetic department employees in dismantling old shelves and equipment and relocating products. A former employee was hired on a temporary basis to help with the move, and the department manager, Mellissa Hart, thought she could rely on her tight knit employees to pull together and finish the project with little supervision. Unfortunately this was not the case. As the project proceeded, employees started grumbling about the extra work, and shirked the remodeling task, leaving Hart and the temporary employee with the bulk of the work. Even worse, morale broke down as employees competed for diminishing commissions. At completion the cosmetic department had a very nice physical space, but its employees were full of hostility and morale was non existent. The entire store was questioning Hart's handling of the project and she was left wondering what she could have done to prevent the problems.

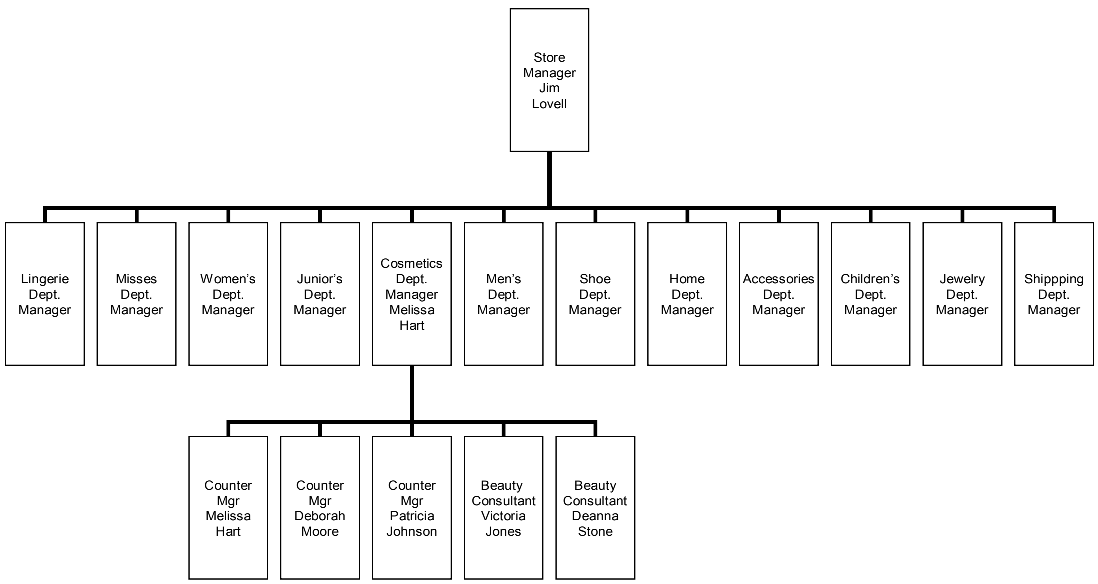
QUESTION 1

Prepare an organizational chart of the Anderson Department Store showing its chain of command and personnel, with special reference to its cosmetics department.

ANSWER 1

Figure 1 found below presents an organizational chart of this company.

Figure 1: Anderson's Department Store- Organization Chart



As shown in Figure 1, the company has twelve departments, including the cosmetics department. Ms. Melissa Hart, the cosmetics department manager, also works as one of the counter managers in the department—along with four other employees.

The students should note that the organization is flat, with a relatively wide span of control at the store level. This type of structure is often associated with decentralized approach to decision making and an open system of communication. However, the facts of this case suggest a centralized, top down approach to decision making.

QUESTION 2

Do you see any weaknesses in the process of decision making and communication at the Store and/or departmental level? Please recommend strategies/tactics to remove these weaknesses.

ANSWER 2

STORE LEVEL

At the store level Lovell demonstrates what might be described as an autocratic approach to decision making. While it is normal for a major decision such as upgrading facilities to be initiated at the store manager level, Lovell takes this a step further and makes unilateral decisions about how to implement the upgrade. It was Lovell's decision to have existing personnel move the merchandise and his decision to hire a former employee to aid in the move. The case suggests that Mellissa Hart's only choice was related to staffing assignments. Of course the weakness in autocratically imposed decisions is that they are less likely to be sensitive to their impact on other people and systems at lower levels. This is clearly demonstrated in this case, as Lovell's decision to involve cosmetic department workers in the move has dire consequences for employee morale.

Poor decision making on the part of Lovell is exacerbated by the fact that communication at the store level seems to be strictly a top down, one way affair. Despite clear evidence of problems with the decision, Hart never offers any feedback to Lovell, or informs him of the situation. This precludes any hope of correcting the problem in a timely manner.

DEPARTMENTAL LEVEL

At the departmental level Ms. Hart takes a very delegative approach to decision making. The case states that her workers normally approach their job in a professional manner and require little direct supervision. The work of selling cosmetics (as well as most other department store goods) is rather limited in scope; i.e. there are not a lot of decisions that need to be made. Furthermore, most decisions that are encountered are likely to be programmed in nature; i.e. they are pretty well defined and have established routines and policies for dealing with them. Also, workers are motivated to stay on task because they are paid largely by commission. For these reasons, a delegative approach to decision making makes a great deal of sense for the cosmetics department under normal circumstances. In short, we see no weaknesses in decision making and communications at the departmental level *under normal circumstances*. It was only when employees were asked to do tasks for which they were not suited and that were not properly matched with existing incentives that problems began to crop up.

RECOMMENDATIONS

At the store level, several changes could be made that may help to avoid problems such as this in the future. First, Lovell needs to employ a more participative approach to decision making at the store level. Department managers should be given leeway to make certain decisions that are departmental in scope. This empowers departmental managers and is likely to result in better decisions.

Second, Lovell should provide feedback loops or special communication channels that offers lower level employees the opportunity to express their thoughts and feelings to management. In this case, perhaps an open door policy would have been an effective way to encourage supervisors or lower level employees to communicate. Other means of encouraging feedback would include regular meetings between managers and subordinates (at both the departmental and store level), and an anonymous suggestion system.

QUESTION 3

Identify the multitude of problems relating to morale and work performance that you noticed in the case. What were the causes of these problems?

ANSWER 3

MORALE/WORK PERFORMANCE PROBLEMS

Workers shirking the remodeling tasks - Cosmetics employees resented being asked to perform duties that were clearly not part of their job description and showed their resentment by shirking remodeling tasks. Eventually, Hart and her temporary assistant Angela Jones were left to do the bulk of the work. This, in turn, led to anger and resentment by Hart toward her employees.

Increased competition over commissions - The remodeling tasks, combined with the disruption caused by the move, reduced the opportunity for cosmetics department employees to earn commissions. This resulted in increased competition between workers for commissions, which led to resentment toward each other. Tension in the department was manifested by gossip, general complaining, and silence between employees.

Storewide preoccupation with the events in the cosmetics department - The events in cosmetics became the topic of conversation throughout the store and undoubtedly impacted overall store morale and productivity.

IMMEDIATE CAUSAL FACTORS

An interesting aspect of this case is that it can elicit multiple arguments for the cause of the problem. For example, it could be argued that the root cause was an inappropriate leadership style on the part of Ms. Hart. Another argument could be made that the root cause was self interest on the part of employees (i.e. political behavior). There is some degree of merit for these arguments, however, the argument that has the most traction goes back to the decision by the store manager to use cosmetics employees to dismantle fixtures and move stock. This type of work is far outside the usual job description for these workers, and perhaps most importantly, not properly matched to existing incentives. Workers were asked to engage in activities that they did not desire to do and for which they were unsuited. Also, no incentives were offered for them to engage in this work. Furthermore, by engaging in this work they were kept from making sales and commissions that were their mainstay. In essence, there were incentives for them to NOT do the work they were being asked to do. This led directly to shirking and increased competition, and indirectly to damaged relationships and ripple effects throughout the store.

SECONDARY CAUSAL FACTOR

Of course, a larger causal factor relates to structural factors that led to a unilateral and perhaps hasty decision making process at the store manager level. The problem was then exacerbated by the failure to provide feedback to management. (These issues were more fully discussed in Q2.) If Ms. Hart had been allowed to offer suggestions regarding the department upgrade it is likely she would have been more sensitive to the needs of her employees than Mr. Lovell (although this is certainly open to debate). Feedback mechanisms could also have informed upper level management and, perhaps, minimized the problems.

QUESTION 4

What can Ms. Hart do to solve these problems and bring normalcy in her department?

ANSWER 4

At this point, the project has been completed but two issues remain. The first lies in how to deal with the immediate fallout; i.e. damaged relationships within the department and low morale that may serve to impact performance. The second lies in the longer term issue of how to prevent such an outcome from occurring again.

THE IMMEDIATE PROBLEM

We suggest that a crucial first step is for Ms. Hart to gain an objective view of the situation in order to resolve her own feelings of resentment. Following this, she must find a way to deal with the lingering ill-will felt by her employees. Finally she may also need to consider how to restore her somewhat damaged reputation with top level management.

Gaining Objectivity - Toward the end of the case it was apparent that Ms. Hart was very resentful toward her employees. In the past her workers had behaved in a mature manner, but when asked to go "the extra mile" for a few weeks they seemed to become self serving. Their behavior forced Ms. Hart to take up the slack and made her look bad in the eyes of other managers. In short, Ms. Hart seemed to interpret the behavior of her employees as an act of personal betrayal. Of course, continuing to blame her employees offers no solutions and will simply result in lingering resentment.

Employee behavior in this case was actually a pretty normal response to a change in working conditions. As noted above, workers in the cosmetics department were experiencing a coerced change in their job description, and mismatched incentives. Although their behavior was not exemplary, it is understandable. Even more important, it was not personally motivated. Understanding this should go a long way toward helping Ms. Hart overcome her own resentments and for helping her come up with a plan for resolving the issue.

Dealing with Employees - While her options are limited, Ms. Hart should probably start with an admission of her own failings in the situation and offer an apology to her employees for placing them in this situation. This, and time, may in itself go a long way toward correcting the situation. However, Ms. Hart's may consider going a step further. Because part of the issue with her employees had to do with lost commissions during the transition, she may consider negotiating with Mr. Lovell to obtain a small bonus for employees to partially make up for the losses. Considering the lack of effort put forth by the employees during the transition, this may be considered by some to be overly generous and actually rewarding bad behavior. This point has some validity, and the pros and cons of this suggestion could make for an interesting discussion.

Dealing with Management - Finally, Ms. Hart needs to initiate a frank discussion with Mr. Lovell. She should make him aware of the entire situation (even though he has probably heard of the problems from other sources), share her insights into the problem, and discuss alternatives for dealing with the situation. Admitting her own failures (and indirectly Mr. Lovell's failures as well) and showing that she has analyzed the situation and learned from it, is likely to make a positive impression on upper management.

THE LONG TERM PROBLEM

This larger issue to be resolved lies in the approach to decision making and communication at the store level. This issue was discussed in Q2 and Q3. In summary, the failure to anticipate the problems in this case and to deal with them effectively as they began to surface can be traced largely to an autocratic decision making approach and one-way communication channels by store management. Whether or not the store manager will be open to changing his approach is questionable. It may be incumbent on Ms. Hart (and other managers) to be aware of the problem and find ways to upwardly manage Mr. Lowell as future situations unfold.

SUMMARY

Ms. Hart finds herself in a situation where there are limited options. To deal with the immediate problems she needs to objectively analyze the situation, come to an understanding of her part in causing the problem and admit her errors both to superiors and subordinates, offer apologies where needed, and look for ways to possibly provide some sort of restitution. To prevent future occurrences she needs to be aware of the underlying causes and be prepared to upwardly manage Mr. Lowell when appropriate.

MIXED SIGNALS AT GABBA ENTERPRISES

Kurt Jesswein, Sam Houston State University

CASE DESCRIPTION

This case requires the student to understand how a statement of cash flows is related to and can be derived from a company's income statement and balance sheets. Students must produce a complete statement of cash flows using both the direct and indirect methods. The student must then interpret the results of the cash flow statement in light of other information provided in the case and the other financial statements in terms of its impact on the feasibility of financing a major expansion of a business enjoying tremendous growth and expecting continued success. The case has a difficulty level of four to five as it would be appropriate for either senior level or graduate level courses. The case is designed to be taught in two to three class hours and is expected to require three to four hours of outside preparation by students.

CASE SYNOPSIS

Gabba Enterprises began operations some ten years ago when its founder, Joey Mareno, an experienced and accomplished tool and die maker, decided to start his own business. The company has thrived ever since to the point where the company is planning to undertake a major expansion. Despite its previous successes, the company does not believe it can fund its future growth on its own so Joey has gone to his primary banker seeking the necessary financing. Providing the bank with balance sheet and income statement data along with his well thought out business plan for the future, he was surprised to discover that he also needed to produce a statement of cash flows to help document how the company would generate sufficient cash flows to repay the loan. Given information provided in the case the student is required to create a cash flow statement and then interpret the results. It provides a good review of basic accounting relationships and, more importantly, evidence of how cash flow statements provide important insights into a company's operations that cannot easily be seen from examining balance sheets and income statements alone.

INSTRUCTORS' NOTES

PEDAGOGY

The focus of the case is the creation of a statement of cash flows using both the direct and indirect methods of presenting the cash flow from operating activities. After producing the statement, the student must interpret the results, some of which appears to contradict the impressions they may have had about the company from initially reading through the case. The student must take the perspective of an analyst having to correctly develop a cash flow statement from scratch as well as having to explain the results. The case would be appropriate for senior-level and graduate students with sufficient accounting background to understand the interrelationships among accounts represented on the balance sheet, income statement and cash flow statement. The case is designed to be taught in two class hours and is expected to require two hours of outside preparation by students.

TEACHING PLAN

Class discussion should begin with a review of the various accounts summarized on a company's balance sheet and income statement, moving on to how the cash flow statement is needed to fully understand the financial situation within any reporting entity. Instructors may wish to structure the case discussions as follows:

1. Review the key accounts found on the balance sheet and the income statement.

2. Describe the need for a cash flow statement to help understand changes occurring with the firm that are not sufficiently provided by the balance sheet and income statement.

3. Review the three primary components of the cash flow statement, and describe the similarities and differences between presenting the cash flow from operating activities from both a direct and an indirect perspective.

4. Develop cash flow statements for the company from both direct and indirect perspectives.

5. Interpret the cash flow statement in terms of its affirmation or rejection of the situation presented by the borrowers to their bankers.

TEACHING PLAN SOLUTIONS

1. Summarize the key balance sheet and income statement accounts.

Although it would be impossible to completely review all elementary accounting principles necessary for completing the case, depending on the level of knowledge students have, a quick overview of the primary balance sheet and income statement accounts may be required. Students could also be directed to review their accounting textbooks or to review online sites such as principlesofaccounting.com or accountingcoach.com. Nonetheless, a concise review of typical balance sheet and income statement accounts could include the following:

The balance sheet is comprised of assets, liabilities and equity. The assets are divided into several distinct accounts that may include:

Cash and cash equivalents, which represent the actual cash holdings of the company.

Accounts receivable, which represents the amount of credit outstanding that has been provided to customers in purchasing goods or services from the company.

Inventory, which represents the goods or services the company has acquired or is making available for sale. If inventory is being produced by the company, the value of the inventory would represent the direct costs of acquiring the necessary raw materials and components as well as any related labor costs. The value of the inventory would also include indirect costs of production such as utilities, rent, and other overhead costs and noncash depreciation charges for the equipment used in the production process.

Prepaid expenses, which represent items such as insurance or rent, that have been paid for but whose value has not been received nor for which an expense has been charged.

Fixed assets, such as property, plant, and equipment, which represent the main capital investment used in the company's operations. It is shown as the total costs of initially acquiring the assets less the amounts that have been written off over time in the form of depreciation, leaving a net amount referred to as net book value.

Intangible assets such as patents and goodwill that do not have a physical presence but nonetheless represent items that provide value to the firm.

The liabilities are also divided into several distinct accounts that may include:

Accounts payable, which represents the amounts of credit the company has received from suppliers that is typically related to the acquisition of inventory.

Accrued expenses, such as wages and taxes payable, in which an expense has occurred but has not yet been paid for as of the balance sheet date.

Various forms of short-term debt that are related to the financing activities of the company (rather than its operating activities) but for which payment is due within one year.

Dividends and interest payable, which represent the amount of cash dividends that has been declared or of interest expense that has been recognized as an expense on the income statement, but has not yet been paid for.

Long-term debt, which represents long-term financing, usually in the form of bank loans or bonds, which the company must repay in the distant future.

Deferred taxes, which represent the amount of tax expense shown on the income statement that will be deferred beyond one year. This often occurs because of differences in financial and tax reporting such as the case of straight line depreciation being used for financial reporting but accelerated depreciation used for tax reporting.

The equity accounts are also divided into several distinct accounts that may include:

Capital stock and addition paid-in capital, which represents the amount of investment that was initially provided to the company by the owners.
Retained earnings, which represents the accumulated amount of earnings generated by the company from its inception that have not been paid out in the form of dividends but have instead been reinvested in the company by the owners.
Treasury stock, which represents the costs that the company has undertaken to repurchase its own shares back from its owners.

The income statement summarizes the results of activities that occurred over a specific period of time and may include the following items:

Sales, which represents the amount of revenue the company has recognized from the sale of its goods or services.
Cost of goods sold, which represents the cost of acquiring or producing the goods or services that were sold.
Operating expenses, such as selling, general, and administrative costs that are directly charged off against the revenues they helped produce or charged off on a periodic basis if there is no direct relationship to the revenues generated.
Interest expense, which represents the financing charges associated with using funds borrowed from external sources such as through bank loans or bonds.
Gains and losses arising from selling or disposing of fixed assets or other investments for amounts which are greater or less than their book values.
Tax expense, which represents the amount of income tax charged against the company’s reported accounting earnings, and which may or may not coincide to the amounts actually paid or owed to the taxing authorities.

2. **Explain why a cash flow statement is needed.**

Neither the balance sheet nor the income statement adequately indicates the full extent of changes in the cash holdings of a company. The balance sheet indicates the position of the firm at a particular point of time and some limited information about the sources and uses of cash can be obtained by comparing consecutive balance sheets. Likewise, the income statement shows the income or loss for a period of time, but it does not indicate how much actual cash was generated by operations. Neither statement summarizes the cash flows related to investing or financing activities. Thus, there is a need to summarize the cash activities of the company in another statement.

3. Review the three primary components of the cash flow statement. Compare and contrast the direct and the indirect method of presenting the cash flows from operating activities.

The statement of cash flows is divided into three sections: cash flows from operating activities, cash flows from investing activities, and cash flows from financing activities. It may be interesting to note that among the current activities of the U.S. Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) is a movement to change the presentation of future balance sheets and income statements to also incorporate this three section approach (e.g., assets/liabilities or income/expenses from operating activities, from investing activities, and from financing activities).

The section summarizing the cash flows from operating activities is arguably the most important of the three for most users of financial statements, particularly creditors such as banks, and current and potential investors. It shows how revenues are related to actual cash receipts and how expenses charged are related to actual cash disbursements.

There are two standard methods of summarizing the cash flow from operating activities known as the direct method and the indirect method. Both are acceptable under GAAP although there tends to be a disconnect between the accounting profession, which argues in favor of the direct method, and the users of financial statements, which tend to argue in favor of the indirect method.

As its name indicates the direct method evaluates items that have a direct bearing on cash. It documents the actual inflows of cash received from customers and from any other operating activities and the direct outflows of cash paid for inventory items, to employees, to other providers of services (rent, insurance, advertising, etc.), for interest on financing, and for income taxes. This information is summarized in Appendix B of the case.

The indirect method is a way of relating the profitability of the company's operations as documented in its income statement against the actual cash flow generated by those operations. Its starting point is the accrual-based net income reported on the income statement, which is then essentially converted to a cash-based income amount. Noncash expenses such as depreciation of fixed assets and amortization of intangible assets are added back to reported net income as well as any increases in deferred taxes reported during the period (reductions in deferred taxes would be subtracted as this would reflect a company actually paying more in taxes than it reports as an expense). In addition, gains and losses recognized from the sale or disposal of assets are removed (gains are subtracted, losses added back) because the full cash flow impacts of the sales or disposals are accounted for in other sections of the cash flow statement and this eliminates double-counting of those amounts. Lastly, changes in individual current asset and liability accounts are also included. For example, increases in accounts receivable reflect increases in sales revenue for which cash has not yet been received, thus requiring a negative adjustment to operating cash flows. Decreases in accounts receivable reflect reductions in the amount of outstanding credit above and beyond the amount generated by the current level of sales and thus require a positive adjustment to operating cash flows. Additional information on changes to other current asset and liability accounts (e.g., inventory and accounts payable) is summarized in Appendix B of the case.

The second section of the cash flow statement documents the net inflows from and outflows for investing activities. The actual amount of cash used for purchases of equipment and other long-term capital assets, financial investments, or intangible assets would be reflected as cash outflows. Actual amounts of cash received from the sale or disposal of capital assets, investments, and intangible assets are reflected as cash inflows. Additional information is summarized in Appendix B of the case. Note that any acquisition of capital assets that is not paid for with cash but instead is financed from external sources would not typically be accounted for under cash flow from investing activities nor would the financing be accounted for under cash flow from financing activities. Because neither side of the transaction involves the use or receipt of cash, the company would instead be required to provide an additional schedule or secondary disclosure describing these activities.

The third section of the cash flow statement shows the net inflows from and outflows for financing activities. Any new capital issued, whether in the form of short- or long-term debt or of new equity capital, would reflect cash inflows. Repayments of debt, repurchases of equity, and the payment of dividends are shown as cash outflows. Additional information is summarized in Appendix B of the case.

4. Develop cash flow statements for the company using both the direct and indirect methods.

The basic procedure for creating a statement of cash flow is summarized in Appendix B of the case. The specific solution for the case is summarized below with a statement of cash flows using the indirect method followed by a summary of the cash flows from operating activities using the direct method. A line-item by line-item explanation follows.

Cash Flows from Operating Activities (indirect method)	
Net income	$194,650
Add (deduct) adjustments to cash basis:	
Add back depreciation	87,000
Add back amortization of intangibles	15,000
Add back increase (subtract decrease) in deferred taxes	19,800
(Subtract gain) add loss on equipment sale	-30,000
(Increase) decrease in receivables	-191,800
(Increase) decrease in inventories	-65,600
(Increase) decrease in prepaid expenses	-32,000
Increase (decrease) in accounts payable	7,000
Increase (decrease) in accrued expenses	89,950
Increase (decrease) in taxes payable	5,500
Net Cash Flow from Operating Activities	$99,500
Cash Flow from Investing Activities	
Purchase of fixed assets	-1,131,700
Sale of fixed assets	165,750
Net Cash Flow from Investing Activities	($965,950)
Cash Flow from Financing Activities	
Net proceeds from issuance (purchases) of long-term debt	600,000
Net proceeds from issuance (purchases) of short-term debt	175,000
Issuance (purchase) of capital stock	-45,000
Payment of dividends	-20,000
Net Cash Flow from Financing	$710,000
Net change in cash	($156,450)
Cash Flows from Operating Activities (direct method)	
Cash from sales	$2,762,800
Cash for inventory	-2,066,950
Cash for operating costs	-403,450
Cash for interest	-90,700
Cash for taxes	-102,200
Net Cash Flow from Operating Activities	$99,500

Cash Flows from Operating Activities (indirect method)
Line-item by line-item description
* The net income of $194,650 comes from the pro forma income statement.
Add (deduct) adjustments to cash basis:
* The depreciation of $87,000 is reported on the income statement and is *added* back to net income because it does not represent a cash outflow.
* The amortization of the patents of $15,000 is also *added* back for the same reason.
* The increase in deferred taxes of $19,800, as documented by the change in the value of the deferred tax account on the balance sheet, is *added* back because it represents a portion of the tax expense that was not paid for in cash.
* The $30,000 gain from selling the old equipment is *subtracted* because the full proceeds from the sale are accounted for under the investing cash flows.
* The $191,800 increase in accounts receivable is *subtracted* because it represents sales recognized as revenue that have not yet been converted into cash.
* The reported inventory increased by $74,100 represents expenditures made for inventory that has not yet been sold. However, because the value of the inventory includes $8,500 of depreciation expense already accounted for with the adjustment for depreciation, the actual amount *subtracted* is the net amount of $65,600 ($74,100 minus $8,500).
* The $32,000 increase in the value of the prepaid expense account is *subtracted* because it represents an expenditure of cash for which no expense has yet been recorded.
* The increase of $7,000 in the value of accounts payable account is *added* because this represents purchases of inventory items that have not yet been paid for in cash.
* The increase of $89,950 in the value of the accrued expenses account is *added* because it represents various operating expense items that have not yet been paid for in cash.
* The increase of $5,500 in the taxes payable account is *added* because represents a portion of the tax expense that was not paid for in cash.
* The sum of these items ($99,500) represents the total amount of cash generated by the operating activities of the company for the year.

CASH FLOW FROM INVESTING ACTIVITIES

The cash expended for purchasing new equipment was $1,131,700, which is the cost of $1,356,700 described in the case less the $225,000 that was financed through the vendor. Note that students may wonder why this figure cannot be directly taken from changes in the balance sheets. For example, the change in the value of net fixed assets is $1,125,450 and the change in gross fixed assets is $1,157,450. The reason for this is that not only was new equipment purchased, but also old equipment was sold, and depreciation expenses were taken.

If the students or the instructor is interested, it can be shown that one can arrive at the $1,356,700 figure using data taken from the financial statements. For example, if you begin with the $1,125,450 differential in the net fixed asset account and add the amount of depreciation charged against fixed assets for the year ($95,500, the sum of the $87,000 depreciation expense reported and the $8,500 of deprecation charged to inventory) and add the net book value of fixed assets sold during the year ($135,750), one ends with $1,356,700.

The cash received from selling the old equipment was $165,750 as described in the case.

The difference between the cash expended to purchase new equipment and the case received from selling the old equipment (-$910,950) represents the total amount of cash used for investing activities.

CASH FLOW FROM FINANCING ACTIVITIES

The cash received from new long-term debt (the bank loan for which the company is applying) would be $600,000.

The cash received from new short-term debt (represented by the company utilizing its bank line of credit) would be $175,000, the amount of additional financing the company is expecting above the $25,000 already borrowed. Note that borrowing $225,000 from the vendor to purchase the specific component of new fixed assets would not be accounted for in the cash flow statement because it does not generate cash, just as the $225,000 acquisition of the assets would be excluded because cash would not be used. The company would need to make some sort of memorandum entry or subsequent disclosure to explain these non-cash transactions.

The cash paid for dividends was $20,000, which represents the amount that was declared in 2009 but not paid until the subsequent year. The $30,000 of dividends to be declared in 2010 are not be expected to be paid until the following year, which is why the current liability account of dividends payable is not accounted for within the cash flow statement. The instructor may also wish to discuss the apparent inconsistency of the accounting rules for cash flow statements in which interest paid on debt is considered an operating cash flow while dividends paid to equity holders is a financing cash flow. This could lead to interesting discussions about accounting rulemaking and the actual practice of financial reporting.

The cash paid for acquiring the treasury stock was $45,000, as stated in the case.

The difference between the cash received from issuing new debt and the cash used to repurchase stock and pay dividends ($710,000) represents the total amount of cash received from financing activities.

NET CHANGE IN CASH

Combining the three segments of the statement of cash flows (the $99,500 from operating activities plus the $710,000 from financing activities minus the $965,950 used for investing activities) equals -$156,450, the same amount by which the cash account on the balance sheet is expected to fall as seen in the pro forma balance sheet.

CASH FLOWS FROM OPERATING ACTIVITIES (DIRECT METHOD)

The cash received from sales activities was $2,762,800, which consisted of the sales revenue reported on the income statement ($2,954,600) less the amount by which the accounts receivable increased during the year ($191,800).

The cash paid for inventory was $2,066,950, which consisted of the cost of goods sold recognized on the income statement ($2,095,350) plus the amount by which the value of inventory increased during the year ($74,100) minus the amount by which accounts payable associated with the acquisition of inventory increased ($7,000) and minus the amount of depreciation that was charged against the cost of goods sold ($87,000 reported on the income statement plus $8,500 still held in inventory for a total of $95,500.)

The cash paid for other operating costs was $403,450, which consisted of cash operating expenses recognized on the income statement ($476,400 minus the $15,000 of amortization expenses for a total of $461,400) plus the additional prepaid expenses made during the year ($32,000) minus the amount by which accrued expenses rose during the year ($89,950).

The cash paid for interest was $90,700, which consisted of the interest expense recognized on the income statement ($90,700). Had there been any interest payable at year-end, the amount by which the payable increased (decreased) during the year would have been subtracted (added) to the expense amount.

The cash paid for income taxes was $102,200, which consisted of the tax expense recognized on the income statement ($127,500) minus the amount by which taxes payable increased during the year ($5,500) and minus the amount by which deferred taxes increased ($19,800). Had either taxes payable or deferred taxes decreased during the year, the amount would have been recognized as an increase in the cash paid for taxes.

The sum of these items ($99,500) represents the total amount of cash generated by the operating activities of the company for the year and is identical to the amount documented on the indirect method of documenting the cash flow from operating activities.

5. Interpret the cash flow statement in terms of its affirmation or rejection of the situation presented by the borrowers to their bankers.

The pro forma balance sheet and income statement appear to show a very healthy company. Net income is expected to increase by over 48 percent from $131,600 to $194,650. But from the banker's perspective, the situation does not appear to be as rosy.

Using the 5 Cs of credit as a framework, bankers would typically assess five key variables: the character of the borrower, the capacity of the borrower to service the obligation, the capital of the borrower, the collateral used as a secondary means of repaying the loan, and any specific conditions, positive or negative, that would cause the loan to be more or less likely to be repaid in a timely manner.

Although there is insufficient information to make a complete assessment, it is likely that at least four of the criteria would be sufficiently met. The long history that the Marenos have had with the bank would speak well of their character. They have been successful in the past and appear to have sufficient capital at risk in this venture (although the payment of dividends and use of company funds to repurchase stock from a family member might raise some questions). The Marenos state that they are willing to provide personal guarantees, if necessary, so collateral would likely not be a serious issue. And because the loan is simply structured to help finance the growth of a company with past success, no unusual conditions appear to be present.

This leaves one factor, capacity, or the ability to generate sufficient cash to repay the new level of borrowing, which is arguably the most critical of the five because it represents the primary source of repayment of the loan. This is where interpreting the cash flow statement would become paramount.

The cash flow statement provides a different view than might be gleamed from looking solely at the income statement. Despite the forecasted 48 percent increase in net income to almost $200,000, cash flow generated from operating activities will actually only be about one-half of that amount. While it remains a significantly positive number, given the anticipated growth of the company and the amount of new financing expected, the relatively low level of operating cash flow would likely be a cause of great concern for the bankers.

Furthermore, large amounts of cash resources are expected to be tied up in accounts receivable and inventory. The expected doubling of sales is associated with a doubling of the amount of receivables and nearly a doubling in the amount of inventories. While this is not necessarily cause for alarm because there is typically a close relationship in the growth of these variables, the bankers may question whether the company should reexamine its credit policies and its inventory management situation. Furthermore, such a strong relationship does not appear to exist between sales growth and the increase in accounts payable. Although growing, it appears that the company either does not take advantage of or has not investigated the possibility of using credit from suppliers of its inventory items. The bankers might suggest the company examine this as a possible way of improving its cash flow situation.

Another concern the bank might have is the true long-term commitment of resources on the part of the owners. It appears that the company is not generating sufficient cash from its operating activities, cash that could be used to repay the loan or otherwise improve the operations of the company. Yet at the same time it is using precious amounts of cash to pay dividends to shareholders and to repurchase stock from family members.

Lastly, it should go without saying that all of the figures used to construct the pro forma balance sheet, income statement, and cash flow statements are based on projections. These are estimates that may or may not reflect reality, and conditions could certainly change. In addition, the projections only cover a one-year time period and the bank would likely expect a long-term business plan and associated cash flow estimates. Although it is probable that the figures and the limited amount of information provided in the case would be insufficient for the bank to make an actual credit decision, seeing how the statement of cash flows provides additional information useful for this type of decision-making should be worthwhile for the students to observe.

Appendix B
Dee Dee Ritchie's Notes on Basic Steps to Preparing a Statement of Cash Flows

1. To compute cash flows from operating activities using the indirect method:

A. Begin with net income as reported on the income statement.
B. Add back noncash expenses such as depreciation and amortization, stock compensation expense, bad debt expense, and add back increases (subtract decreases) in deferred taxes.
C. Remove gains and losses from disposing of or selling assets (add back losses, subtract gains)
D. To offset the impacts of accrual-based accounting
add decreases in current asset accounts (other than marketable securities) and increases in current liability accounts (other than short-term debt), and
subtract increases in current asset accounts and decreases in current liability accounts.

2. To compute cash flows from operating activities using the direct method:

A. Begin with cash receipts from customers by adjusting reported sale revenues by any changes in accounts receivable reported on the balance sheets (subtract increases in accounts receivable occurring during the period and add decreases).
B. Add any other cash received from income sources (e.g., dividends and interest received).
C. Subtract cash payments made to acquire inventory by adjusting reported cost of goods sold by any changes in inventory and accounts payable reported on the balance sheets
add increases in inventory occurring during period and subtract decreases
add decreases in accounts payable occurring during period and subtract increases
D. Subtract cash payments (not noncash expenses such as depreciation and amortization) made for operating expenses reported on the income statement after making adjustments arising from accrual accounting.
add cash payments made prior to the recognition of an expense (add increases in prepaid expense items reported on the balance sheet and subtract decreases)
subtract expense items that have not yet been paid for in cash (subtract increases in accrued expenses such as accrued payables and add decreases).
E. Subtract cash payments made for interest. Adjust the amount of interest expense reported on the income statement by changes in interest payable (subtract increases in interest payable reported on the balance sheet and add decreases).
F. Subtract cash payments made for income taxes. Adjust the amount of tax expense reported on the income statement by changes in taxes payable and/or deferred taxes (subtract increases in taxes payable and/or deferred taxes and add decreases).

3. To compute cash flows from investing activities:

A. Add the cash proceeds from selling or disposing of any fixed assets, investments, and/or other noncurrent assets.
B. Subtract the amount of cash expended to acquired any fixed assets, investments, and/or other noncurrent assets

4. To compute cash flows from financing activities:

A. Add the cash proceeds from issuing new notes payable or other short-term debt, long-term debt, and preferred or common stock.
B. Subtract the amount of cash expended to repay any short-term or long-term debt, repurchase stock (e.g., treasury stock), or for the payment of dividends (subtracting any increases in dividends payable or adding any decreases).

HSN, INC.: WEATHERING THE RETAIL STORM, INSTRUCTOR'S NOTES

Alexander Assouad, University of South Florida St. Petersburg
William T. Jackson, University of South Florida St. Petersburg
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CASE DESCRIPTION

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

The case allows the instructor the flexibility of concentrating on one strategic issue, or as a means of examining the entire strategic management process as well as complicated financial accounting reporting. The major focus within the strategic analysis as well as excellent stand alone modules is in the area of legal/political influence, economic, accounting, or the ability to survive in an unattractive industry. The instructor should allow approximately one class period for each element addressed. Using a cooperative learning method, student groups should require about two hours of outside research on each element researched. The case also provides opportunity for the instructor and the class to discuss in detail the disruptive effects of technological change and how the internet and online retailing is changing the retail landscape for good.

CASE SYNOPSIS

This case is a library, popular press and internet case which examines HSN (The Home Shopping Network). A company that built itself on what was considered a pervasive and dominant technology, yet is today experiencing first hand the disruptive challenges posed from the proliferation of the internet. Some introduction to online retailing and mail order, how it started, how it has become much of an oligopolistic industry and how as with other sectors and markets the internet is changing the face of home shopping is necessary. Likewise research into the other main competitors in the sector and how consolidation has occurred will also help to create an appropriate framework from which to analyze the environment.

INTRODUCTION

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

GENERAL ENVIRONMENT

There are numerous issues that can be explored within the general environment. This level of the external environment will provide opportunities and threats that must be faced by all firms. In light of the fact that the issues arising from this level of the external environment are out of the control of individual firms, it is critical to position a firm to grasp emerging opportunities as well as avoid potential threats. Below are some pointers and or discussion points that may be used as a springboard into a full analysis of not only the attractiveness of the industry but also for its long-term viability.

THREATS

The internet: the internet is perhaps the single biggest threat for HSN and the other players in the TV Retail industry. As the characteristic of their particular demographic changes and the customer base are becoming more and more computer literate whilst more time starved. Potential customers are turning to the internet as a major alternative to TV retail as well as in many cases high street shopping.

Related to the above threat, is that of internet providers moving into the TV shopping arena through what is described as user defined home shopping, an example of this is Talk Market, now partially owned by Amazon,

> *"…customers can create their own personalized shopping channel and click on videos to make purchases. "The Talk Market is a user-generated TV shopping platform that allows businesses to create broadcast-quality product presentations and gives consumers an entertaining shopping experience"(*Amazon Invests in User-Generated TV Shopping Channel, www.dmwmedia.com/news/2008/06/09)

Other threats stem from alternative technologies and other ways to capture consumers attention while they are doing other things, for example shopping while playing online games, Second Life the famous online gaming environment also has a virtual online shopping presence "SLCN.tv"

Other direct marketing techniques, from email to sponsored podcasts and free to air shows that carry commercials to cover costs.

The high street: standard brick and mortar retailers vie for market share through special "in store" offers, discounts and deals, through continuous communication with consumers through email and other online offerings

The poor economic environment, these shopping outlets seemed to have a lot of demand generated by, "spur of the moment" decisions. During this economic downturn it is going to become more and more difficult to convince people to purchase items, they may not really need. Being an on line retailer HSN is dependent on sales armchair buyers; however, this demographic is rapidly changing. Basically their market is dying off and being replaced by consumers a lot more tech savvy whilst physically more capable.

HSN is subject to various regulations that are ever changing thus requiring considerable time and efforts on the part of the company. In addition, HSN is already on the watch list for the FCC due to prior actions by the company.

In conclusion however the most significant threat comes from the changes in technology as well as the change in demographics (age group) of the target markets traditionally aimed for by all the TV shopping retailers. We can see HSN adjusting to this through the pursuit of alternative methods to market products, in particular HSNi and the Internet.

OPPORTUNITIES

Technology: Likewise while the Internet is a threat to HSN standard way of doing business it has also become an opportunity for diversification. They recognize the power of the Internet and with HSNi are now attempting to take full advantage of this new media.

Cost of transportation, as gas prices increase and it becomes more and more of an issue to move around, consumers are going to turn towards retailers that can offer not just the value added service of delivery but the actual shopping experience itself.

Time: as with gas, time is becoming a commodity of value that people have to budget for more and more. By offering home based shopping both through the internet and through other media vehicles HSN can potentially save the average consumer large amounts of time while shopping. "what you want, when you want it, where you want it."

Consumers are seeking out "best value" opportunities in their purchase decisions. These same consumers are often driven by the convenience of on-air, on-line purchase options.
Traditional retailers have been forced to scale back inventory levels due to the recession thus offering less choices to consumers.

THE INDUSTRY ENVIRONMENT

To allow for an affective industry analysis we must first define a framework specifying which groups of companies may be brought together to constitute an industry. Simply put an industry can be considered a group of companies that not only produce similar products or services that are targeted at the same customer base, but also compete directly with each other not just for those consumers but also for the required supplies and resources.

It is then possible for us to use the framework of Porters 5 forces to engage the class in discussions designed to stimulate understanding and a starting point whereby students may begin to develop perspective needed to understand corporate and business unit level strategies. Likewise the basic fundamentals of competition, demand, supply and substitute products addressed by the discussion on Porters 5 forces will provide tools for the students to complete and compare their own analysis of other cases or use for the own projects.

Threat of new entrants
Bargaining power of suppliers :
Bargaining power of Buyers :
Substitute products
Competitive rivalry

THREAT OF NEW ENTRANTS.

In entering a new industry the investor must look at capital needed, distribution capabilities and infrastructure, government regulations, economies of scale and the threat of retaliation of present competition. These constitute the threat of new entrants.

The threat of new entrants is pretty low, It is a high investment industry where there are few players, a large investment in not just administration and research (finding the appropriate products) but the actual TV network/broadcasting infrastructure itself does not lend itself to new competitors easily being able to enter the industry. Therefore due to the shear size in investment needed, public broadcasting requirements and compliance issues, huge economies of scale needed, (the company has to broadcast close to 24 hours a day) we can therefore easily deduce:

HIGH BARRIERS TO ENTRY

BARGAINING POWER OF SUPPLIERS

Based primarily on the number of suppliers a firm has to deal with we can measure the bargaining power of those suppliers. Simply put the more the suppliers a firm has the less power each one of the will hold with respect to that firm, likewise whether or not there are substitute products (the more substitutes the less power each supplier has) for those being supplied and the costs a firm would incur to switch suppliers, (the higher the switching costs, the more power the supplier has.)

As HSN generally supplies a wide range of products from household appliances to jewelry, perfumes, cooking utensils and really just about anything their product range can be considered to have little differentiation, also the broad lines of products offered means not only are they not dependent in any way on individual suppliers, they are not even dependent on product categories or even industries.

Suppliers are definitely in the weak position with respect to HSN, the products offered are so varied that no one producer/supplier really has much advantage and or bargaining position. Likewise there are so many potential suppliers vying for the "airtime" that frequent wholesale discounts given to HSN are above the retail norm. However, consumers are seeking out those "best value" options and the firm that represents those products will garner the needed customer appeal.

Two other supplier groups represent considerable concerns for the company—pay television operators and credit lenders. For the first group, HSN is in continued negotiations with many of those providers with a large percentage of contracts expiring between 2009 and 2011. It is imperative that HSN be near the top of the channel selections to fully utilize the digital capabilities of the programming. Many networks are working furiously to gain those same slots.

For the second group, the lenders, concerns are just as great. With the decline of the economy lending has become even more conservative. Due to the results of the spin-off, HSN is facing increased scrutiny in this area. The same can also be said of the average consumer in regard to their credit card arrangement.

It is know that airtime on HSN is an almost sure path to at least short run success, therefore that benefit has the suppliers in a very weak position.

BARGAINING POWER OF SUPPLIERS – MODERATE WITH VENDORS, STRONG FOR CREDIT AND TV PLATFORMS

BARGAINING POWER OF BUYERS

Similar to the bargaining power of suppliers, the bargaining power of buyers is determined by the cost of switching products for the consumer, the differentiating factors offered by the product, the amount of substitutes available to the consumers and the actual quantities or volumes purchased by individual consumers. Again we can draw similarities between Wal-Mart and HSN. They are volume movers, selling large quantities of individual items to individual customers. The consequence of this is that no particular customer as much power. While customer care and support is of course important, it is purely a numbers game and as long as the majority of the customer base remains satisfied HSN maintains the upper hand.

Another important consideration in looking at the power or lack of power of the buyers is the degree of competition and or alternatives for the consumers. Again we see the TV/Retail sector as being made up of a handful of suppliers, (Shop NBC and QVC being the only ones of note in the North American market) There fore we may consider the market to be almost captive, a lot of these buyers are addicted to process itself, (shopping though TV)

BARGAINING POWER OF BUYERS - WEAK

SUBSTITUTE PRODUCTS

Do other industries offer consumers similar convenience and similar service than that of the TV retailer, the answer is of course is yes, the Internet and online shopping. This growing industry is rapidly not only becoming a replacement for the TV Retailer but also becoming a threat for the brick and mortar retail market. While there is some argument that in the short run the make up of the customer base (a demographic of 40+ years, women) is pretty well protected, the long term is destined to change that demographic and inevitably shift the focus of all TV retailers. This can be seen in HSN's introduction of "HSNi" and a new focus internally on becoming a significant player competing with the likes of Amazon and other online product aggregators.

Consequently however there is a significant threat of "substitute products" overall and the rapidly adapting environment should produce much material for in class discussion as to who exactly will become substitutes for the TV retail business

THREAT OF SUBSITITUTES - HIGH

RIVALRY OF EXISTING FIRMS.

Competition and or lack of defined through the amount of other competitors; internal direct costs involved in running the business, (storage, fixed costs, exit costs etc) and growth rates of the industry itself define how competitive any industry is. The TV retails sector categorized by few firms and low growth, in fact it could be considered an oligopoly with the lions share of the business divided between the big three players, (HSN, Shop NBC and QVC) Likewise the cost in liquidating and or existing a TV channel based company could be excessive. The industry is therefore marred with intense rivalry specifically for the same audience.

HIGHLY COMPETITIVE INDUSTRY

IN CONCLUSION

This is not a particularly attractive industry, especially for new competitors to enter. Although in both the cases of the bargaining power of suppliers and buyers, the firm has the upper hand, the initial investment, knowhow and presence of the present competition would probably put off most investors.

Secondly the demographics of the target group of consumers is decreasing rapidly whilst the industry itself is under major attack from other alternative retail options, primarily the internet, therefore negatively weighting the industry's strengths in the factors of power of buyers and suppliers.

Therefore it would be reasonable for us to deduce based on the 5 forces that this industry is highly unattractive.

ORGANIZATIONAL DIRECTION

COMPANY VISION:

> *"To be an original brand experience that becomes a disruptive force on the retail and cultural landscapes"*

COMPANY MISSION:

> *"Deliver the joy and excitement of new discoveries every day:*
> *Discover new products – "You will find things that you can't get anywhere else"*
> *Discover new ideas – "I get so many ideas…how to make things work for me, how to solve problems"*
> *Have Fun – "Its light its fun, it's my time, just for me"*

From both the vision and mission statements, we can see that the company is highly undecided on where it is going exactly. In fact we may see that the vision and mission statements reflect a level of confusion that can be inferred.

From what was once a specialized TV Retailer to now becoming an online product aggregator, the statement of providing…"disruptive force" seems a somewhat entangled position. Is the company aiming at still maintaining some level of superiority in the TV Retail industry or is it looking to find and or provide a completely new shopping experience, even something not provided by present online merchants?

Likewise having a mission statement that is simply and set of declarations of what customers want rather than how that will be achieved again reflects not only confusion but lack of specific direction.

These poorly authored statements dictate that the company is in a high state of flux with regards to organizational direction. A recent spinoff from a mother company (IAC Group) and the subsequent shake up in conjunction with labor cutbacks seems to reflect this situation.

A discussion on creating thoroughly lucid, specific and relevant vision and mission statements should be easily prompted and this example would reflect an organization that is presently failing to provide such basic organizational backbone.

STRATEGY FORMULATION

CORPORATE LEVEL STRATEGY

Corporate level strategy may be defined as a set of actions an organization will pursue to gain a competitive advantage in the market place. These strategies may further more be classified by the degree to which each of the business units operating under the umbrella of the corporation are related to each other and the levels of synergies that may be attained.

Until recently HSN has employed a strategy of growth through acquisitions and partnerships, (see purchase of Cornerstone, a major home catalogue service.) This has allowed them sell other products and retail services that they were not doing through their TV outlet. Likewise diversification into specialized websites, (Smith + Noble, The Territory Ahead, Travel Smith etc.) and 26 brick and mortar retailers has allowed further diversification. However all activities remain within in the retail/consumer sector and therefore we may define their corporate level strategy as “related diversified”

Furthermore, their continued foray into the online world of e-tailing through HSNi whilst not through mergers and acquisitions, rather through in house development, complements their corporate strategy and shows a consistent approach.

Most importantly however is to stir discussion into how this strategy is creating value through implementation of their strategy? The “related diversified” position allows them to use their corporate competencies of media knowledge, marketing and product management and effectively transfer those competencies with very little additional cost into building managing their other business units. For example the same skills needed for actors and directors from within the organization can be simultaneously used to produce clips and streams for their e-commerce website.

Likewise their value chain capabilities in areas such as distribution/shipping, storage the physical plants, studios etc, internal networks and call center capabilities can also be directly utilized for the e-commerce and online retail markets as well as other consumer delivery requirements that they need.

BUSINESS UNIT LEVEL STRATEGY

The dominant strategy is to sell consumer products to end users through the medium of the TV retailer. By exploiting their core competencies in consumer product markets, particularly, home furnishings and fashions, jewelry, basic electronics and targeted women’s fashions they aim to leverage their competitive advantages in TV and channel production to drive sales to that target demographic**.**

“HSN, Inc. (NASDAQ: HSNi) is a leading interactive multi-channel retailer, with eight unique, proprietary and compelling lifestyle brands. HSNi offers innovative, differentiated retail

experiences on TV, online, in catalogs, and brick and mortar stores. The Company's two operating segments, HSN and Cornerstone, have exceptional direct-to-consumer expertise"

Again we may formulate a perspective to define exactly what is this strategy, is the business cost focused? Is it differentiated? Or is it a combination strategy.

Taking the business model alone, we could say their strategy is between, "Focused Differentiation" as they focus on women and simultaneously offer product lines that to some extent indicate a cost leadership approach, as they promote the "incredibly low prices" they offer, deals that cannot be found anywhere else. Therefore taking both product lines and their business models together we could say they are aiming at an integrated cost leadership/differentiation set strategy.

STRATEGY IMPLEMENTATION

LEADERSHIP

Leadership at HSN has numerous challenges ahead of it. While the style of the leadership has been grounded in a participative approach, the hard times facing the company has resulted in many centralized decisions to salvage the company after the spin-off. It is unclear which direction the very capable leaders of the organization will be forced to take in the future. The company has already seen a considerable number of firing and top manager changes in the past year.

CORPORATE SOCIAL RESPONSIBILITY

It has been and is becoming more so critical for large organizations in particular to "give back" to the community. Discussions on there being in fact not one bottom line but rather a "triple bottom line" are now widespread and that the summation of three really define long term sustainability for a business. Notwithstanding while there are many ongoing studies examining the correlation between an organization that is active in being socially responsible and ongoing sustainability and profitability, there is as yet not much empirical evidence as to a strong correlation. However while these studies are inconclusive it is widely accepted that an active and socially responsible strategy in place does not have any negative impact on the bottom line.

HSN does take part in "giving back" to the community. There are community days where employees spend the day providing a volunteer service for the local area and people. Likewise they do take part in volunteer and community service projects. However, based on their website coverage of these activities we can assume that neither are they wholly active nor do have they chosen to develop their CSR capabilities as an important marketing tool.

STAKEHOLDERS

As well as discussing CSR, it is vital today for strategy students to also define and discuss who a corporation's stakeholders are. Especially in such a litigious climate it become increasingly critical for the senior management to define the direct as well as the non direct stakeholder and to prepare strategies in dealing and engaging with those groups.

Obviously most students will be aware of the direct stakeholders being, employees, management, customers, shareholders/owners, government agencies, suppliers, vendors, debtors and the like. A good classification of stakeholders can be found in *Strategic Management* (Hitt, Ireland and Hoskisson) where they are divided as follows; capital market stakeholders, product market stakeholders, organization stakeholders, as the major groups.

We should also invite ideas as to who the non-direct stakeholders may be, such as the local community, the environment and other entities with non-direct interaction with the corporation.

From basic research it does seem that HSN maintains a reasonable balance between her stakeholder groups, not obviously favoring one more than another. It remains an opportunity for discussion whether or not benefiting particular groups above others would require strategic redirection and or have alternative outcomes.

ORGANIZATIONAL CULTURE

The company culture has been, and may return to one of being a maverick in the industry. Currently, the company has been forced to adopt a survival mode in light of the economic conditions and the impact of the spin-off. Only time will tell whether the disruptive force mentality that the company possessed for many years will return.

STRATEGIC CONTROL

There are numerous ratios that can be analyzed relating to the specialty retail industry. Some would argue, however, that analysis of these ratios would be skewed by the recent spin-off results especially as it relates to the write-off of goodwill as well as the concurrent impact by the economy. While the majority of this instructor note focuses on goodwill and the economy, below are a few ratios that the students would be expected to explore and compare directly against QVC as the most representative reference group.

Gross Profit Margin: This ratio is calculated as net sales less the cost of goods sold expressed as a percentage of sales. The intent of the ratio is to reflect a company's operational efficiency.

Operating Profit Margin: This ratio is calculated by taking the gross profit margin and subtracting operating expenses (usually includes selling and general administrative expenses and excludes interest payments and other non-operating expenses.

SWOT	
STRENGTHS	WEAKNESSES
Weak power of buyers Weak power of buyers Well known business – strong brand awareness Turnkey Operations Distribution network Marketing and sales	Losing core customer base Large capital overheads Dominant organizational structure Negative brand association for some demographics (HSN – elderly housewives)
OPPORTUNITIES	THREATS
High entry barriers Increasing fuel costs Decreasing delivery/distribution costs Online presence – leverage distribution competencies	Alternative home shopping models – internet Alternative technologies Poor economic environment User defined shopping (cookies and profiles) Smaller more flexible competitors Strong suppliers in pay television operators Numerous legislative concerns

Debt to Capital Ratio: This measure is usually used in the specialty retail industry to measure the firm's ability to meet short-term obligations (Liquidity).

Inventory Turnover: This ratio is calculated by adding beginning inventory and ending inventory, dividing by 2 and dividing this result by total sales. This measure is generally a reflection of the efficiency of the operations in terms of inventory management.

GOODWILL HUNTING

One of the more mysterious assets that appears, and then sometimes disappears, on a company's balance sheet is goodwill. What is goodwill anyway? How does a company acquire goodwill? Does it amortize goodwill as an expense over time? What happens if the goodwill becomes worthless? Does the company record this as a loss? The recent history of HSNi and its former parent IAC provides insight into all these questions.

WHAT IS GOODWILL?

Goodwill is an intangible asset that represents the value of a company over and above the sum of the fair market value of its specifically identifiable assets, e.g., land, buildings, inventory, cash, receivables, etc. It is an asset that cannot be separated from the company as a whole. [Financial Accounting Standards Board (FASB), Statement of Financial Accounting Standards 141R, *Business*

Combinations, December 2007)]. For example, ABC Company's specifically identifiable assets may have a total fair market value of $10,000,000. However, if another company, say XYZ Company, offers to buy ABC Company intact, with the intent of continuing its historic business, it may be willing to pay $15,000,000 for ABC. The excess amount of $5,000,000 is considered goodwill.

Why would XYZ Company pay this extra $5,000,000? XYZ probably recognizes that there are certain synergies that will occur if ABC and XYZ are combined. These synergies may the marketing skills of XYZ combined with the product development team of ABC. Standing alone in their separate companies they do not have the value they bring to a combined entity by working together. Goodwill could also simply be the existence of some value that only ABC has that XYZ wants to acquire, such as brand loyalty or even favorable government regulation. Goodwill thus represents an intangible asset that gives the ABC-XYZ combined entity a unique value beyond the mere existence of its assets.

RECORDING GOODWILL

Goodwill can only be recorded, i.e., "booked," by a company when it acquires another company. In the ABC-XYZ example above the new combined entity will initially record goodwill at $5,000,000, and this amount will continue to be shown in the consolidated financial statements.

How does all this affect HSNi? Before the spin-off by IAC of HSNi in August 2008, the consolidated financial statements for IAC included $2.9 billion of goodwill that resulted from IAC's acquisition of HSN and the latter's acquisition of Cornerstone. The vast majority of this goodwill, nearly $2.4 billion, was attributable to the IAC's 2002 acquisition of the remaining minority interest in HSN, which gave IAC complete 100 percent ownership of HSN. The remainder of the consolidated goodwill, approximately $500 million ($0.5 billion), was attributable to HSN's acquisition of Cornerstone in 2005. Because all three companies were part of a larger consolidated entity, all of this goodwill, totaling $2.9 billion, was reported as an asset in the consolidated financial statements of IAC.

The spin-off of HSNi as a new public company was accomplished by transferring HSN and Cornerstone to HSNi as subsidiaries of the new parent company, HSNi. Consolidated financial statements for HSNi now include the financial results for both HSN and Cornerstone. The transfer of HSN and Cornerstone also brought to HSNi the goodwill account of $2.9 billion that had previously been shown on the consolidated financial statements of IAC and its subsidiaries. These two former subsidiaries, HSN and Cornerstone, in essence took their goodwill with them. But could they keep their goodwill? That became the next issue to resolve.

THE IMPAIRMENT AND WRITE-OFF OF GOODWILL

Recall that goodwill is an asset that represents a synergy among companies in a combined setting that might not exist if the companies existed separately. The spin-off of HSN and Cornerstone, out of the umbrella of IAC, led to a consideration by HSNi management as to whether any of this goodwill existed anymore. After all, there is only HSN and Cornerstone in the new combined entity. There is no longer any fusion with the synergies that IAC and its other subsidiaries might have brought to HSNi. What are the financial accounting requirements that companies face when they have goodwill on the balance sheet?

The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards 142 (SFAS 142), *Goodwill and Other Intangible Assets*, in 2001. This standard requires companies to revalue its goodwill at the end of each fiscal year. If it has been determined that goodwill has been impaired, i.e, declined in value, since the beginning of the year, then this impairment must be recorded as a loss in the financial statements. The actual methodology for valuing this impairment is complex and beyond the scope of this case study. (See the note following this analysis for a conceptual explanation). However, in its first set of financial statements after the spin-off, for the period ending December 31, 2008, HSNi recorded a loss on impairment of goodwill of the entire balance of $2.9 billion that was initially recorded on its balance sheet at the time of the spin-off. As of December 31, 2008, HSNi no longer has any goodwill listed among its assets.

In addition there was a one-time loss of recorded for the permanent impairment of value of other intangible assets of slightly over $300 million ($0.3 billion). This brought the total loss, or write-off, in the HSNi consolidated financial statements for 2008 to nearly $3.2 billion. These other intangible assets that were considered no longer of any value were such items as trade names and trademarks of various brands associated with HSN and Cornerstone. The financial statements did not disclose which of these trade names and trademarks were considered valueless.

This write-off of nearly $3.2 billion obviously had a major impact on the operating income reported by HSNi in its December 31, 2008 income statement. The loss from continuing operations for 2008 was $3.1 billion, and included the $3.2 billion write-off. If this write-off is not included HSNi would have operating income of $100 million. Even when considering the tax benefit of the write-off, the net after-tax loss on the income statement was nearly $2.4 billion.

Why did HSNi write off the entire amount of its goodwill, rather than just a portion of it? Why did it write off the entire value of the other intangible assets? A review of its annual report (Form 10-K) filed with the Securities and Exchange Commission is instructive here. Note 3 to the financial statements explains the reasoning behind the write-off. Basically the write-off was due to macroeconomic conditions. The deepening recession and its negative implications for the retail sector led HSNi to conclude that any synergies that may have existed between HSN and Cornerstone no longer had any value. For the same reason the company felt that its intangible assets represented by trademarks and trade names that it owned also have no value any more. Generally accepted accounting principles, as outlined in SFAS 142, required the company to write-down the value of goodwill and the other intangible assets to -0-.

ADVANCED EXPLANATION:

SFAS 142 requires a company to write-down goodwill and other intangibles by using a complex two-part process. Conceptually, the process works as follows.

1) The company, using principally discounted future cash flow analysis, estimates the fair market value of the "reporting unit," e.g., HSN or Cornerstone. From this total fair market value of the reporting unit, the fair market value of the specifically identifiable assets (other than goodwill and the other intangibles) is subtracted. The difference is the current value of goodwill and the other intangibles. It is a residual amount in the calculation.

■ For example, assume RST Company is a reporting unit of a larger consolidated group. At the end of the current year RST has a total fair market value of $5,000,000. The fair market value of its specifically identifiable assets, e.g., property, plant, and equipment, cash, receivables, inventory, etc. is $4,500,000. The implied value of the goodwill and other intangibles is $500,000. It is a residual amount in the process.

2) Next, the new value of goodwill and the other intangibles is compared to the carrying value of these intangible assets on the books of the reporting unit at the beginning of the year. If it is less than the carrying value, goodwill and the other intangibles are written down to their new values, which become the carrying values of these intangible assets to start the next year. The process is repeated next year. However, there can only be write-downs. If this process shows that goodwill has increased in value, there is no write-up to a higher carrying value. The goodwill (and other intangibles) remain at their previous written-down carrying values.

■ Continuing with the RST example, if the carrying value of goodwill and the other intangibles at the beginning of the year was $800,000, RST has an impairment in value of $300,000. This amount is written off as an expense in the consolidated income statements for the combined group which includes RST. The new carrying value for goodwill and other intangibles is $500,000.

Evidently, when HSNi performed this process the total fair market values of the both reporting units, HSN and Cornerstone, were less than the sum of the fair market value of their specifically identifiable assets. This is not surprising given the sharp decline in stock values (and thus the value of the HSNi as a whole). When the value of the specific assets was subtracted from the value of the company as a whole, there was no residual amount left over for goodwill or the other intangible assets. Thus the entire amount was written off in the 2008 income statements.

QUESTION REPONSES

Coverage of this answer should focus on three main areas for HSNi. Clearly the economy is the most significant uncertainty facing the firm. This is closely followed by Social with its interconnection with the economy. Of significant importance is technology as it has not only allowed the filter of make this industry viable, but also with its advancements allowing for increased competition. As discussed in the case, legal and political threats also exist.

Refer to the above discussion for the five industry forces to address this answer.

Refer to the SWOT above to address this answer.

Refer to the Control Section above to address this answer.

Refer to the section above on Goodwill Write-Off to address this question.

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