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## LETTER FROM THE EDITORS

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

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

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

Charles Rarick, Purdue University, Calumet

# **BC FROZEN FOODS LIMITED: CHALLENGES AND CHANGE<sup>1</sup>**

**Seena Shah, University of La Verne**  
**Issam A. Ghazzawi, University of La Verne**

## **CASE DEESCRPTION**

*This case highlights the importance of change and responding to environmental challenges via creating effective business strategy that helps organizations to be more sustainable. While the needed strategy (s) must insure a continued focus on the organization's core competencies, it also must insure that the organization has to continue creating value to its customers.*

*This case has a difficulty level of three and up, appropriate for junior level and beyond. The case is designed to be taught in two class hours in an entrepreneurship, strategic management, management, or marketing management course. It is expected to require about three hours of outside preparation for students, consisting mainly of reading the case and familiarizing themselves with the business environment in Western Canada as well as with some knowledge of the agriculture and frozen food industry.*

## **CASE SYNOPSIS**

*The food processing industry has undergone massive changes due to economic, social and political influences. As a result, many companies in the food processing business were forced out of business as the economic climate became more intense and global competitors emerged on the scene. BC Frozen Foods is one such company that has felt the crunch of a changing environment. The primary challenges facing the company were increased local competition, labor shortages, weather, and economic conditions. This has led the company to rethink and develop new approaches to tackle threats to its viability. The results were major changes to its operations to adjust to the intense environment. The company has implemented an approach whereby it has begun diversifying its product line.*

## **INTRODUCTION**

It was the spring of 1989, Asad Shah, the controlling owner of S and S Fraser Valley Foods was finding it difficult to operate his business as a joint owner with Amrit Singh Naiger. The two men were not able to see eye to eye on the direction of the business. Disagreements frequently occurred on how to manage the business, on what prices to pay growers, and how much to sell the product for.<sup>1</sup>

Two years prior, the pair had opened S and S in a facility formerly operated by a defunct Westvale food. Westvale had operated in the food industry since World War II and had built a portion of the plant that BC Frozen Foods owned.

S and S was a mid-size food processing company located in Mission, British Columbia<sup>2</sup>; a city 45 minutes east of Vancouver. The company was strategically located in the Central Fraser Valley, an area that is rich in fertile soil and vegetation. Realizing the opportunities available to the company, Asad knew that the company needed the right kind of leadership to help it grow and become more profitable. A critical decision was left whether to buy out Amrit Singh's interest in the company or to continue operating as joint owners. In 1989, Asad opted to buy out Amrit's interest.<sup>3</sup>

During the 1990s, the company made some mistakes as it was still new to the food processing industry. Such mistakes included: Budgetary, seasonal labor forecasting, pricing, and costing. However, by the mid 1990s, BC Frozen Foods had emerged as a serious competitor in the local processing scene.<sup>4</sup>

Tragedy struck the company in 1997 when Asad Shah suffered a fatal heart attack. His role as the president of the company would not be easily replaced by another. Asad had a background in engineering and was able to create processing line equipment to facilitate production. When the company required a production set up or ran into an operating snag, Asad was able to masterfully craft a design to resolve the issue. After his passing, the company needed new blood to carry it through the next millennium. Yasir Shah, Asad's son, had learned a lot shadowing his father.<sup>5</sup> Yasir immediately applied what he had learned to operate the business. Although Yasir did not have the engineering background of his father, he brought a much more business savvy approach to the operation of the business.<sup>6</sup> See Appendix A for the company's organizational chart.

The company has made adjustments to a changing market. Several new industry developments have led the company to make dramatic changes in an effort to remain viable. With over thirty full time employees and about seventy seasonal employees during peak months, the company has been rethinking its approaches to these problems.

## **COMPANY BACKGROUND**

Established in 1987 as S and S corporation. In 1989, Mr. Asad Shah changed its name to BC Frozen Foods Ltd. immediately after he bought out his partner and acquired the business solely.<sup>7</sup>

A Canadian company, BC Frozen Foods Ltd. was incorporated under the laws of British Columbia. Its primary business activity was processing of fruits, vegetable, and other specialized products.

The primary fruits and vegetables processed at BC Frozen Foods in the early days included raspberry, strawberry, blueberry, cauliflower, broccoli, rhubarb and Brussels sprouts. Other crops were also processed at BC Frozen Foods, but much of the focus during the growing season (spring to fall), focused on the above mentioned produce.<sup>8</sup>

The company's clients have predominantly been located in Canada and the United States, although it isn't unusual to sell produce to clients overseas. Often, such overseas demands have

been determined by a wide variety of issues from foreign currency exchange “FCE”; weather; and to politics. For instance, in 1991, the civil war in the fertile region of Romania caused farming productivity to come to a halt. As a result, blueberries produced in that region and sold in Europe were unavailable. This caused the demand for North American blueberries to skyrocket and proved to be a very lucrative season with overseas sales increasing.<sup>9</sup>

In the early 1990s, the company expanded its line to process Roe Herring. A large contract was signed with J.S. McMillan Fisheries to process Roe Herring to be shipped to Japan. This would prove to be the company’s first steps into entering a global market.<sup>10</sup>

The company’s mission was and still “to process the highest quality fresh fruits and vegetables in the shortest time possible to ensure the capture of peak flavor and ripeness in a food safe environment with a pricing structure that is extremely competitive in today's frozen fruit and vegetable industry.”<sup>11</sup>

BC Frozen food sales in 2010 were \$7,316,028 Canadian up from \$5,676, 276 Canadian in 2009. The company’s total assets were \$5,792,863 Canadian in 2010 up from \$4,895,113 Canadian in 2009. For financial 2009 and 2010 balance sheet and statement of income and retained earnings, please refer to Exhibits 2 and 3.

## **BC FROZEN FOOD PRODUCTS AND SERVICES**

Since its inception, the company processed mainly raspberry, strawberry, blueberry, cauliflower, broccoli, Brussels sprouts and rhubarb. For the berries, there was a variety of ways they were processed. Generally, the premium berries were in the fresh market. These are simply fresh berries found in the grocery store in the produce aisle. BC Frozen Foods specialized in IQF and puree (jam). Overtime, in an effort to diversify the foods processed at the company, millions would be spent on a green bean processing area and a custom vacuum pack processing area.<sup>12</sup>

### **IQF “ INDIVIDUAL QUICK FREEZE”**

The IQF is a freezer that gives BC Frozen Foods a competitive advantage because only 3 IQF’s are located in British Columbia. This a process where the grade A produce are cleaned, inspected, and then placed on a moving conveyor belt that runs through a powerful freezer. These IQF units freeze all produce sent through it in about 10 minutes.<sup>13</sup>

The conveyor belt has a series of drops that keep all the produce separate during the freezing process. This prevents the produce from clumping together and when the produce comes out of the end of the IQF, each berry, broccoli, etc is frozen individually. This allows for the company to repack the produce in boxes for other distributors who will market the product under their labels.

### **PUREE**

Lower grade berries lack the quality to be sold in the fresh and IQF market. These berries are pureed. In essence, they simply become jam. The company also offers a 4+1 puree for

strawberry. This is a mixing process whereby the strawberry's are sliced and mixed with sugar. Every 4 lb. of strawberry are mixed with 1 lb. of sugar. The 4+1 is then filled into pails and are sold to companies that use it for making desserts.<sup>14</sup>

EXHIBIT 2. B.C. FROZEN FOODS LTD. STATEMENT OF INCOME AND RETAINED EARNINGS \*  
(Unaudited)

	YEAR ENDED MARCH 31 *	
	2010	2009
Sales	\$ 7,316,028	\$ 5,676,276
Cost of Sales	6,565,925	5,060,114
	750,103	616,162
Other Income	76	3,078
Selling Expenses		
Advertising and promotion	11,219	2,699
Brokerage fee	11,490	15,324
Telephone and fax	13,436	15,730
Salaries	60,000	60,000
Travel expense	22,049	28,808
	118,194	122,561
General And Administrative Expenses		
Amortization	23,455	19,163
Bad debts	37,083	14,178
Bank charges	12,743	32,034
Insurance	23,267	22,293
Interest expense	141,116	192,013
License and dues	7,307	3,694
Office and miscellaneous	22,058	11,642
Professional fees	23,659	68,729
Property taxes	24,592	15,679
Repairs and maintenance	139,031	-
Utilities	82,739	58,766
	537,050	438,191
Net Income For the Year	94,935	58,488
Retained Earnings, Beginning Of Year	348,769	290,281
Retained Earnings, End Of Year	\$ 443,704	\$ 348,769

\*This financial statement was prepared in accordance with Canadian generally accepted accounting principles. Fiscal year ended March 31.

Source: This financial statement was provided by BC Frozen Foods. Used with permission

EXHIBIT 3. B.C. FROZEN FOODS LTD. BALANCE SHEET\*  
(Unaudited)

	YEAR ENDED MARCH 31	
	2010	2009
<b>ASSETS</b>		
Current		
Accounts receivable	\$ 947,981	\$ 445,290
Inventory (Note 4)	2,493,578	2,226,934
	3,441,559	2,672,224
Property, Plant And Equipment	2,332,298	2,203,883
Other Receivable	19,006	19,006
	\$ 5,792,863	\$ 4,895,113
<b>LIABILITIES</b>		
Current		
Bank Indebtedness	\$ 1,179,557	\$ 579,957
Accounts payable and accrued liabilities	841,441	567,726
Due to shareholder	346,747	303,912
Due to related company	154,389	199,186
Current portion of long term debt	2,447,409	346,455
	4,969,543	1,997,236
Long Term Debt	179,616	2,349,108
	5,149,159	4,346,344
<b>SHAREHOLDER'S EQUITY</b>		
Share Capital	200,000	200,000
Retained Earnings	443,704	348,769
	643,704	548,769
	\$ 5,792,863	\$ 4,895,113

\*\* This financial statement was prepared in accordance with Canadian generally accepted accounting principles. Fiscal year ended March 31.

Source: This financial statement was provided by BC Frozen Foods. Used with permission

## CUSTOM REPACK

With the creation of a repack center, the company was able to diversify its product line. Custom Repack allows for the company to package its frozen produce into poly bags for the retail and foodservice industry. Repack also allowed for the company to mix different produce into single orders. This is often found in the freezers at grocery stores with such items like 2 way mixes (frozen peas and corn), California Blend (cut broccoli, cauliflower, and sliced peas), and Medley Blend (whole green beans, whole wax beans, whole baby carrots).

Providing such service has been beneficial to the company and allows for the company to operate year round when the fresh harvests are not being brought in. However, implementing this program was difficult. First, the cost of the machinery was expensive. The vacuum suction repack machine's cost was in excess of \$100,000. Secondly, it was a challenge getting the machine to operate in a fluid like motion. The machine is an intricate network of scales, conveyor belts, and bagging systems that took considerable time to adjust and get use to.<sup>15</sup>

To supplement local products in the custom repack, BC Frozen Foods also imports a number of frozen items from around the world. These items include fruits like bananas, pineapple and mangos.<sup>16</sup>

EXHIBIT 6. FRUIT BLENDS PRODUCED	
Fruit	Blends
Triple Berry	Raspberries, Blueberries, Strawberries
Fruit Medley	Strawberries, Blueberries, Blackberries
North West Berry Blend	Blueberries, Raspberries
Tropical Blend	Banana, Pineapple, Mango
Source: BC Frozen Food, Ltd. Reproduced with a permission.	

EXHIBIT 7. VEGETABLE BLENDS PRODUCED	
Vegetable	Blends
2 Way Mix	Peas, Diced 3/8" Carrots
4 Way Mix	Peas, Diced 3/8" Carrots, Corn, Cut Beans
3 Way Mix	Peas, Carrots, Cut Beans
Stir-fry Blend	Cut Broccoli, Cauliflower, Sliced Carrots, Onion Strips, Sliced Mushrooms, Mini Cob Corn
Winter Mix	Cut Broccoli, Cauliflower, Brussel Sprouts
California Blend	Cut Broccoli, Cauliflower, Sliced Carrots
Medley Blend	Whole Green Beans, Whole Wax Beans, Whole Baby Carrots
Source: BC Frozen Food, Ltd. Reproduced with a permission.	

## BC FROZEN FOODS HOUSE BRAND

The creation of the custom repacks line allowed for the company to test the waters in creating its own House Brand to be sold directly to retailers.

In 2000, the company began selling 5 kg bags of frozen fruit to a small local chain. The product sold well, enticing the company to concentrate more effort into selling its house brand to larger retailers. In 2008, the company's house brand was finally being sold direct to consumers at "Co-Op", a large retailer in Western Canada, and Kroger, another large retailer in the Mid-western United States. The company has received high satisfaction ratings from these retailers, furthering the initiative to expand its house brand presence in the market place.<sup>17</sup> See Appendix B for a complete list of products.

### ABOUT THE LOCATION: WHY MISSION, BRITISH COLUMBIA?

BC Frozen Foods is located in the heart of the fertile Fraser Valley. The area is world-renowned for its high quality fruits and vegetables due to the region's mild climate, fertile glacial soils and abundant rainfall. Operating BC Frozen Foods in the Fraser Valley definitely had its benefits. A wide variety of produce is grown in the region.

Mission is a small town of 35, 262 residents' located 65 kilometers east of Vancouver, a fast growing and diverse city. Mission is situated along the mighty Fraser River, next to incredible mountain vistas in the rich and fertile region of the Central Fraser Valley.<sup>18</sup> See Exhibit 8.

EXHIBIT 8. CENTRAL FRAZER VALLEY'S MAP



Source: <http://www.westerncartage.ca/assets/images/map2.jpg>

Mission is a short drive from local farms that produce a large variety of fruits and vegetables. The climate is warm during the summer and mild in the winter. All these factors make Mission a desirable place to live. Easy access to the West Coast Express, a commuter train service that goes direct to downtown Vancouver make Mission a viable option for those desiring a country lifestyle while working in the big city. Moreover, Mission is also a great place to operate a business with its close proximity to the US border (less than 15 minutes away), access to the Canadian Pacific Rail lines that run through the town, and easy access to Highways 7, 11, and 1.

Mission is an optimal location for a fruit and vegetable processing plant because its close proximity to farms provides the company with the ability to timely process the food while fresh, thus locking in all the essential nutrients. Within hours after the crops are harvested in the fields, they can be processed at the company's plant.

## **BUSINESS ENVIRONMENTAL CHALLENGES**

There is an old saying that when the wind changes, you must adjust your sails. This seems to ring true with the food industry and daily operations at BC Frozen Foods. In the late 1990s, some trends started to emerge that offered a perplexing problem to Yasir. There were changes happening in the industry that were raising eyebrows as to the future of the company. Some of the changes included a dwindling available workforce, increases in local competition in certain markets and changes to the US/Canadian exchange rate. These factors were compounded by inclement weather patterns; always posing a threat to a viable growing season.

### **AVAILABILITY OF LABOR**

The company employs over thirty full time employees. Due to the fact that much of the produce in British Columbia grows during the summer months, May to September is a peak season where the company usually operates 24 hours a day.

In the past, finding seasonal employees to work during the summer months was not an issue. Often, the company hired high school students who would work during the summer until their school resumed in the fall. The types of jobs performed included dumping produce onto a conveyor belt for inspection, inspecting produce on the conveyor belt, packing boxes with produce, and operating machinery such as pallet jacks and forklifts to store the produce in large freezers. However, starting in 2000, Yasir and other management staff noticed it was becoming more and more difficult to find labor during the peak processing season each year. Even with statutory increases in British Columbia's minimum wage, people in Mission and its neighboring city of Abbotsford (with a population in excess of 100,000), had become more reluctant to engage in such manual labor. This labor shortage was felt all across the industry in other processing plants and farms.<sup>19</sup>

Since there were no machines in place at the time to replace human workers, the company had to take extra measures to secure workers. These measures included busing in workers from cities further away (near Vancouver). Yet in spite of these measures, there was still a labor shortage. The Government of Canada realized the threat to its food processing industry and took unprecedented measures to ensure the survival of the industry. In 2006, a Seasonal Agricultural Worker Program was created that matched workers from Mexico and Caribbean with Canadian farmers and food processors during planting and harvesting seasons. BC Frozen Foods was able to secure workers from Mexico to fill the void Canadian workers refused to fill. This, of course was more costly for the company to hire Mexican workers as opposed to Canadian workers. The company's costs increased because it was required to provide full airfare and transportation to the employees and provide accommodations during their stay. Nonetheless, the use of Mexican workers have some benefits. The Mexican workers were very hard working and learned fast on the job.<sup>20</sup>

## **DOMESTIC COMPETITION**

Traditionally, the company had few local competitors in processing berries, broccoli, and cauliflower. These competitors included companies such as Snowcrest Foods, Lucerne, Abbotsford Coop, and Fraservale (Jolly Green Giant). Most of the companies, with the exception of Abbotsford Coop which specialized only in Raspberries, would carry out similar functions as BC Frozen Foods and would create similar products. However, over time, the competitive landscape began to change as berry growers started to process their own fresh market produce instead of selling it to food processors such as BC Frozen Foods.<sup>21</sup>

This trend was taking away business from the company; making BC Frozen Foods more dependent on its sales of individual quick freeze (IQF) and puree line<sup>22</sup> (see services provided). Yasir realized this threat because the company was at the mercy of a select few products and any negative change in one product could have an adverse affect on the company. In this instance, the fresh market had become so over-saturated with growers that the company needed to find new produce to process. Yasir met with his management team, and discussed ways of diversifying the product line. The region was rich and fertile; making it versatile to growing a variety of other crops. Yasir and BC Frozen Foods management agreed that exploring the possibility of processing green beans, peas and other vegetables was the proper move for the company.<sup>23</sup>

As it was explained earlier, BC Frozen Foods has its traditional competitors that are large food processing plants located in the Fraser Valley. BC Frozen Foods is one of three companies in British Columbia to have an IQF. This allows for BC Frozen Foods to provide grade ‘A’ frozen fruits and vegetables to distributors and more recently retailers. The fresh market is over-saturated with other competitors and farmers who can simply sell their own produce fresh.

## **FOREIGN COMPETITION**

As the company has expanded its operations, new competitors are emerging from Asia, mainly China. China is proving to be a big purveyor of fruits and vegetables. Chinese processors are able to capitalize on the fact that labor in China is abundant and cheap. This makes competing in a global market even more rigorous for BC processors. However, the quality and flavor of produce in British Columbia is unparalleled, even by California producers. For example, a strawberry from BC is smaller in size than the large strawberries usually found in other regions like California. The BC grown strawberries have a much sweeter taste than the foreign berries. This is due to the geography, soil, and climate in British Columbia. According To Mr. Asad Shah “although we’re comparing strawberries to strawberries, the difference in quality is like comparing apples to oranges”.<sup>24</sup>

## **THE US DOLLAR VALUATION**

Canada and the United States are the biggest trading partners in the world. In 2010, United States imported products and services worth over \$249 billion and exported more than \$277.6 billion in products and services.<sup>25</sup>

The Ambassador Bridge connecting the province of Ontario with Detroit conducts more trade each year than all exports and imports between the US and Japan. One major factor why there is such immense trading between the US and Canada is because the cost of production in Canada is generally cheaper than in the US. Moreover, Canada has a more skilled workforce than the third NAFTA member, Mexico. This allows for Canada to produce quality goods for the US at cheaper prices.

In essence, much of this is tied into the exchange rate between the US and Canadian dollars. Historically, the Canadian dollar has always been lower than the US dollar, making Canada a great place for Americans to purchase goods. A lower Canadian dollar simply means that Americans can get better value for their dollar when spending in Canada. The problem facing BC Frozen Foods Ltd. is that since 2005, the Canadian dollar has been steadily rising in value. The US dollar has also lost some of its value. In 2007, for the first time in a lifetime, the US dollar was actually valued lower than the Canadian dollar. Such discrepancies have made the purchase of Canadian goods (such as those sold by BC Frozen Foods) less appealing to American customers. The high Canadian dollar has led US customers to contract more with American Companies.

## **WEATHER**

The Pacific Northwest is a beautiful region with lush rain forests and an abundance of rich green vegetation. However, it is also a very wet region that typically receives precipitation during nine months of the year. An abnormally wet winter can result in damaged crops. On the opposite end of the spectrum, not enough rain can lead to a dry season and the yields will not be good. Unfortunately, the weather is something that the company cannot control when dealing with locally grown crops.

## **CUSTOMERS**

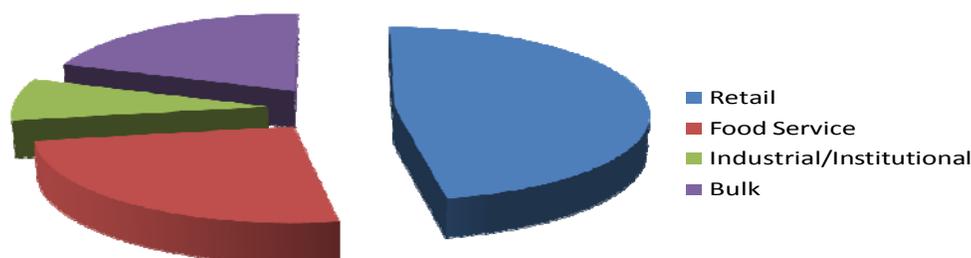
BC Frozen Foods has a wide array of customers. Most traditional customers have been Canadian and American distributors who would buy frozen produce and repack themselves.

Its customers were medium to large sized companies such as Kraft. Other customer contracts were Dairy Queen of Canada and Mario Gelato. These customers were supplied the berries used for their desserts. With the expansion of the house brand, the company added new retail clients such as Alberta based Coop and Midwest based Kroger Foods.<sup>26</sup> See Exhibit 11 for company customers by type.

BC Frozen Foods promoted its products and services at various industry trade shows. Over the years, the company attended a variety of conventions including the American Frozen

Food Institute convention held in California and the North West Food Processors Convention held in Seattle. These conventions were great marketing tools that allowed industry heads to network and forged new relationships. The company also maintained a non-interactive website that allowed for viewers to easily find the company and read about its services.<sup>27</sup>

EXHIBIT 11. BC FROZEN FOOD MARKET BY CUSTOMERS' TYPE



Source: BC Frozen Food, Ltd. Reproduced with a permission.

### CRITICAL CHALLENGES

As discussed above, there are several factors that have been threatening the viability of BC Frozen Foods. The labor shortages increased production costs since the company was forced to fly in seasonal workers from Mexico. In addition, the increased value of the Canadian dollar is making US customers less inclined to purchase Canadian products; perhaps even drawing them towards Chinese competitors. Lastly, new local competitors in the berry business saturated the field with competition.

Yasir, in conjunction with his management, have made strides to diversify the product line so that BC Foods would not be at the mercy of the berry industry. In the last 10 years, the company has developed a green bean line and opened a door to an entirely new market. This was only possible by convincing a group of farmers to plant and harvest the crops for BC Frozen Foods.

In 2001, Yasir scoured Washington State for bean harvesters to facilitate the growing process. Since then, the company has acquired 7 large harvesters (See Exhibit 9). Yasir was aware that involving the company in the growing process was an extremely tedious process; however, it was the only way to get farmers on board to process the beans. By facilitating the growing process, Yasir was able to enter a new market and diversify the existing product line.

The timing was great because the custom pack line also benefited from the in house

processing of the green beans. The new bean line was able to provide vegetables for the company's custom repacking line; offering a bigger variety to customers.

Experimenting with other produce foreign to North American markets was also another avenue the company explored with some short term success. On a personal trip to Pakistan, Sajida Shah, one of the company officers was impressed with Pakistan's Keenu Oranges. This type of orange has a unique taste from those grown in North America. Oranges have a longer shelf life before they spoil (most will not spoil during the 3 weeks it took to ship the oranges from Pakistan to Canada). Yasir and Sajida discussed the possibility of importing Keenu's from Pakistan. The major benefit of importing Keenus was that there was no processing involved. All the company had to do was store the Keenus in its coolers until they were ready to be sold.

Sajida ordered a small sample shipment and offered the shipment to several grocers. A large British Columbia grocery chain liked the oranges and preparations were made to import these oranges to Canada for the fresh market. Immediately, the Keenu Oranges were a success as the grocery chain began stocking Keenus in its produce aisles. However, after a few years of selling Keenus, other Canadian entrepreneurs of Pakistani descent followed BC Food's lead and imported Keenus. This effectively took away the company's monopoly on the Keenu market.

While the company had decent gains from the Keenu business, it has had to lower its prices to remain competitive.

## **LABOR SHORTAGE**

Labor shortage has placed Yasir and BC Frozen Foods in a difficult predicament. The lack of local workers left the company reliant upon Mexican seasonal workers. Although the implementation of the custom packing line did not require more workers, this has been handled year round by full time employees. The problem existed during the peak season when more workers were needed. Seasonal workers increased operations' costs as the company housed them and provided airfare to and from Mexico. If the company tried to attract more local workers through increasing its hourly rate, it would have to increase the rate for all current workers because complaints will be raised about preferential treatment. Additionally, such increases would further driven up production costs making the company less competitive.

The labor shortage during peak seasons gave Yasir more reason to diversify the company's production line. The logic was that being at the mercy of local seasonal fruit was risky without other lines. Yasir sat with company executives and decided to broaden the custom repack line. He felt that only processing local produce had too many variables that could adversely affect the business. One such variable was weather. According to Yasir,

*"Bad weather can mean the difference between a good and bad season.*

*Too much rain can damage crops, increase mold, and result in smaller yield.*

*Too much sun can result in less developed produce.*

*By diversifying the product line, such ups and downs in weather are mitigated because the company can use its frozen stock to keep things moving".<sup>28</sup>*

Moreover, the custom repack line kept the company viable, especially since a lot of the produce like bananas, mangos, and pineapples are not native to British Columbia and grown elsewhere. Other ways of mitigating bad weather issues was briefly considered. During a recent company's meeting, an idea was proposed that the company contract with Mexican farmers to produce crops in Mexico where the weather is consistent. The costs would be substantially cheaper with Mexican labor rates. Moreover, the transportation costs were projected to be about 10 cents per pound to ship from Mexico to Canada (which is reasonable), and the shipment time is relatively short considering it is a one day drive from Mexico to British Columbia. This idea was never acted upon simply because of the feasibility of monitoring the Mexican process. In the food business, the process must be closely and constantly monitored to ensure top quality and efficiency.

### **THE NEED FOR NEW STRATEGIC DIRECTIONS**

It was August 25, 2011 Yasir Shah met with his executive management and stated that "As we operate in a fast changing environment, BC Frozen Foods future can no longer be subject to environmental dimensions and other challenges, but has to be made by all of us". On the path toward the future, BC Frozen Foods need to be more focused and strategic. He identified some priorities that included: (1) Creating a strong local presence in British Columbia; (2) diversify product offerings; (3) capitalize on company's core competency to grow; and (4) implement necessary infrastructure to expand product line.

Executive management members were very supportive and were asked to brainstorm over these priorities and bring their ideas on the next week's meeting (i.e. September 5<sup>th</sup>, 2011), when the company wanted to make new strategic decisions.

### **AUTHOR'S NOTE**

*<sup>1</sup>This case was prepared by Issam Ghazzawi and Seena Shah of the University of La Verne as a basis for class discussion, rather than to illustrate either effective or ineffective handling of a management situation. The case is based on primary data and information provided by BC Frozen Foods Limited. The case has benefited by incisive comments from Sue Caple of the University of La Verne.*

### **EDITOR'S NOTE**

*Selected photographs have been omitted in the interest of length. Interested readers should contact the authors.*

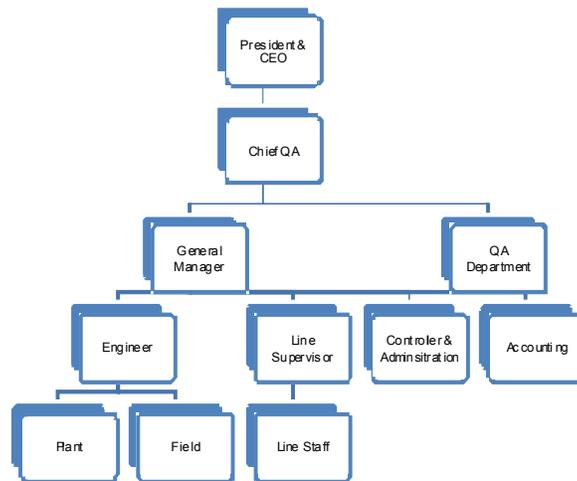
### **END NOTES**

1. An interview with Mr. Asad Shah, owner/operator of BC Frozen Foods (June 23 and 24, 2011).
2. Ibid
3. Ibid
4. Ibid
5. Ibid
6. Ibid

7. Ibid
8. An interview with Yasir Shah, general manager of BC Frozen Foods (June 25 and 26, 2011).
9. Ibid
10. Ibid
11. The mission statement was extracted from BC Frozen Foods website, [www.frozenfoods.com](http://www.frozenfoods.com).
12. For more information, please refer to: <http://www.census.gov/foreign-trade/balance/c1220.html#2010>Ibid
13. Ibid
14. An interview with Yasir Shah, general manager of BC Frozen Foods (June 25 and 26, 2011).
15. Ibid
16. Ibid
17. Ibid
18. Mission City, is a district municipality in the province of British Columbia, Canada. It is located on the north bank of the Fraser River overlooking the City of Abbotsford. Mission is the 23rd largest municipality in British Columbia, with a population of 34,505 (as of 2006). This definition and its related information were retrieved on August 26, 2011 from: [http://en.wikipedia.org/wiki/Mission,\\_British\\_Columbia](http://en.wikipedia.org/wiki/Mission,_British_Columbia).  
For more information, see: [www.mission.ca](http://www.mission.ca).
19. An interview with Yasir Shah, general manager of BC Frozen Foods (June 25 and 26, 2011).
20. Ibid
21. Ibid
22. Puree is a lower grade berries lack the quality to be sold in the fresh and IQF market.
23. An interview with Yasir Shah, general manager of BC Frozen Foods (June 25 and 26, 2011).
24. An interview with Mr. Asad Shah, owner/operator of BC Frozen Foods (June 23 and 24, 2011).
25. For more information, please refer to: <http://www.census.gov/foreign-trade/balance/c1220.html#2010>.
26. Ibid

## APPENDICES

### APPENDIX A. BC FROZEN FOODS ORGANIZATIONAL STRUCTURE



Source: BC Frozen Food, Ltd. Reproduced with a permission

APPENDIX B. BC FROZEN FOODS PRODUCTS' LIST

## PRODUCT LIST



• Mixed Vegetables	• Oriental Blend	• Blueberries
• Green Peas	• Sacramento Blend	• Strawberries
• Diced Carrots	• French Cut Green Beans	• Raspberries
• Whole Green Beans	• Cut Green Beans	• Berry Blend
• Peas & Carrots	• Broccoli & Cauliflower	• Fruit Medley
• Asparagus Spears	• Peaches and Cream Corn	• Mango Chunks
• Brussels Sprouts	• Fajita Mix	• Pomegranate Blend
• Smooth Sliced Carrots	• California Blend	• Bite Size Blend
• Baby Carrots	• Organic Edamame Beans	• Tropical Blend
• Cauliflower Florets	• Chopped Spinach	• Smoothie Blends (Tropical & Strawberry and Banana)
• Diced Red Peppers	• Asian Blend	• Saskatoon Berry
• Diced Green Peppers	• Sugar Snap Peas	• Cranberries
• Italian Blend	• Snow Peas	• Sliced Peaches
• Prince Edward Blend	• Peas & Pearl Onions	• Strawberries in Light Syrup
		• Raspberries in Light Syrup

Source: BC Frozen Food, Ltd. Reproduced with a permission

## **CASH PROBLEMS AT CAPE CHEMICAL**

**David A. Kunz, Southeast Missouri State University**  
**Benjamin L. Dow III, Southeast Missouri State University**

### **CASE DESCRIPTION**

*The primary subject matter of this case concerns managing a firm's cash flow. Case requires students to evaluate a number of proposed alternatives to address a projected cash short fall as well as develop additional courses of action. The case requires students to have an introductory knowledge of general business issues thus the case has a difficulty level of three (junior level) or higher. The case is designed to be taught in one class session of approximately 1.25 hours and is expected to require 1-2 hours of preparation time from the students.*

### **CASE SYNOPSIS**

*Cape Chemical is a regional distributor of liquid and dry chemicals. Revenues and profits have grown steadily. The sales growth has required the acquisition of additional fixed assets and current assets. Financing the additional assets has placed a strain on the firm's ability to raise capital. While the company ended last year with a healthy cash balance, there were many occasions during the year that it was necessary to obtain short-term bank loans in order to keep the company operating. As part of the firm's annual planning process, the finance and accounting staff prepare a projected income statement and balance sheet for the coming year. This year, Kathy Ford, the company's chief financial officer, directed David Bush, the firm's budget analyst, to also develop a monthly cash budget in an effort to identify potential cash flow problems. The cash budget indicated that the company would need additional cash during the third quarter of approximately \$2,000,000. The company's board of directors had previously established a target capital structure of 50% debt and 50% equity and the projected 2012 ending balance sheet indicates the company will be very close to the target. Cape Chemicals' primary bank also incorporated the target capital structure into its loan covenants. Loan covenants require a quarterly compliance report. Increasing the firm's bank debt, even for a short period of time, is not an option Ford wants to consider. Other alternatives for covering the projected cash shortfall must be evaluated.*

### **BACKGROUND**

Cape Chemical is a regional distributor of liquid and dry chemicals, headquartered in Cape Girardeau, Missouri. The company, founded by Ann Stewart, has been serving southeast Missouri, southern Illinois, northeast Arkansas, western Kentucky and northwest Tennessee for over a decade and has a reputation as a reliable supplier of industrial chemicals. Stewart's previous business experience provided her with a solid understanding of the chemical industry and the distribution process. As a general manager for a chemical manufacturer Stewart had

Profit & Loss (P&L) responsibility, but until beginning Cape Chemical she had limited exposure to company accounting and finance decisions.

To improve management of the accounting and finance area, Stewart hired Kathy Ford, an accountant who had worked with the accounting firm that conducted Cape's first annual audit. Ford has been the company's chief financial officer for the last seven years.

### **CHEMICAL DISTRIBUTION**

A chemical distributor is a wholesaler. Operations may vary but a typical distributor purchases chemicals in large quantities (bulk - barge, rail or truckloads) from a number of manufacturers. Bulk chemicals are stored in "tank farms", a number of tanks located in an area surrounded by dikes. Storage tanks receive and ship materials from all modes of transportation. Packaged chemicals are stored in a warehouse. Other distributor activities include blending, repackaging, and shipping in smaller quantities (less than truckload, tote tanks, 55-gallon drums, and other smaller package sizes) to meet the needs of a variety of industrial users. In addition to the tank farm and warehouse, a distributor needs access to specialized delivery equipment (specialized truck transports, and tank rail cars) to meet the handling requirements of different chemicals. A distributor adds value by supplying its customers with the chemicals they need, in the quantities they desire and when they need them. This requires maintaining a sizable inventory and operating efficiently. Distributors usually operate on very thin profit margins.

### **THE SITUATION**

The company ended last year with a large cash balance, but on numerous occasions during the year it was necessary to obtain short-term bank loans in order to keep the company operating. The firm's annual planning process includes the preparation of a projected income statement, balance sheet and cash flow statement for the coming year by the finance and accounting staff. Once the forecasted statements are approved, the annual information is broken into quarterly and monthly financial budgets. This year, Kathy Ford, the company's chief financial officer, directed David Bush, the firm's budget analyst, to also develop a monthly cash budget in an effort to identify potential cash flow problems.

Ford and Bush agreed on a number of budget assumptions necessary to complete the cash budget. Assumptions focused on the timing of cash inflows (collection of receivables) and timing of cash outflows (payment of vendors, operating expenses, capital expenditures, financing charges, tax payments, etc.). The cash budget indicated that the company would need additional cash (additional financing) during the third quarter (July, August and September) of approximately \$2,000,000.

Ford reviewed the cash budget with Stewart. The company's board of directors had previously established a target capital structure of 50% debt and 50% equity and the projected 2012 ending balance sheet indicates the company will be very close to the target. Cape Chemical's primary bank also incorporated the target capital structure into its loan covenants (debt ratio could not exceed 50%). Loan covenants require a quarterly compliance report. Ford

and Stewart are reluctant to increase the firm's bank borrowing even for a short period of time. Alternatives considered were:

1. Reduce inventory levels. Ford thought this option had merit. Ford noted the firm had an ongoing program to systematically review inventory levels of all items and levels were slowly being reduced, but she thought more could be done to reduce inventory. Stewart agreed that some reduction was possible but was concerned that additional inventory reductions could negatively impact sales. Stewart stated "I don't want to jeopardize sales by not carrying enough inventory."
2. Collect accounts receivables faster. Cape Chemical's selling terms are net 30. Ford thought it might be possible to increase credit standards and collection effort, but it could not be accomplished without a major confrontation with the sales staff. The sales force already feels that they are losing sales because of the company's conservative approach to granting credit (high credit standards) and an overly aggressive collection effort. Stewart was reluctant to increase credit standards but felt the credit department could increase its collection effort on accounts that were habitually late in paying invoices.
3. Delay selected capital expenditures (equipment replacement). Capital projects of approximately \$2,750,000 are planned for 2012, \$400,000 for the first quarter, \$1,000,000 for the second quarter, \$1,000,000 for the third quarter and \$350,000 for the fourth quarter. Stewart opposed delaying any capital expenditures stating, "Projected revenues are dependent upon new product lines and these lines require investment in new equipment". Ford agreed that some projects could not be delayed, but thought some replacement projects and other expenditures such as replacing a portion of the warehouse roof, replacing selected vehicles and purchasing new office computers scheduled for the first half of the year could be delayed to the second half or longer. This would require increasing maintenance on those pieces of equipment originally scheduled for replacement and maybe a temporary roof patch for the warehouse but should not disrupt operations. Stewart was not convinced. She remained concerned about the negative impact investment delays would have on operations and sales.
4. Delay paying finance charges or tax payments. Ford thought delaying payments to the bank could be arranged, but she was reluctant to approach the bank about rescheduling payments. Approaching the bank could cause the bank to be concerned about the firm's ability to manage its cash. Both Stewart and Ford agreed that delaying tax payments was not an option that should be pursued at this time.
5. Slow payments to vendors (accounts payable). During the early years of operation the company was not always able to pay its vendors according to terms. The delayed payments resulted in some vendors threatening to stop extending credit. This never happened but the lack of vendor credit would have caused substantial problems. Since that period, a concerted effort has been made to avoid late payments to vendors. Ford thought slowing vendor payment for a few months was possible. She thought it was unlikely vendors would notice a change in Cape Chemical's payment pattern. Stewart was skeptical. She did not want a repeat of earlier vendor problems.

### THE TASK

Income Statements and Balance Sheets for Cape Chemical (historic and projected) are provided in Appendix 1. Selected industry average ratios are provided in Appendix 2.

- 1) Assume you are Kathy Ford. Prepare the report evaluating the alternatives and a recommended course of action. Use ratio analysis to support your evaluations and recommendation.
- 2) Would your recommendation change if the projected cash shortfall was for six or nine months rather than three months?

Appendix 1  
Cape Chemical Income Statement (\$000)

For the Year Ended December 31

	2009	2010	2011	Projected 2012	Ind./ Avg. 2011
Sales revenue	83,200,000	89,600,000	94,300,000	108,900,000	117,400,000
Less: Cost of goods sold	74,505,600	79,878,400	83,596,950	96,703,200	104,474,260
Gross profits	8,694,400	9,721,600	10,703,050	12,196,800	12,925,740
Less: Operating expenses					
Selling expense	3,078,400	3,404,800	3,489,100	3,974,850	4,343,800
General and administrative expenses	1,414,400	1,702,400	1,744,550	1,960,200	1,995,800
Depreciation expense	1,264,640	1,361,920	1,716,260	1,655,280	1,784,480
Total operating expense	5,757,440	6,469,120	6,949,910	7,590,330	8,124,080
Operating profits	2,936,960	3,252,480	3,753,140	4,606,470	4,801,660
Less: Interest expense	487,720	533,600	529,300	559,111	686,195
Net profits before taxes	2,449,240	2,718,880	3,223,840	4,047,359	4,115,465
Less: Taxes (rate = 30%)	734,772	815,664	967,152	1,214,208	1,234,640
Net profits after taxes	1,714,468	1,903,216	2,256,688	2,833,151	2,880,825
Dividends	734,772	815,664	967,152	1,214,208	1,646,186

Balance Sheet (\$000) As of December 31

	2009	2010	2011	Projected 2012	Ind./Avg. 2011
Assets					
Current assets					
Cash	499,200	448,000	471,500	544,500	704,400
Accounts receivable	11,055,342	11,512,986	11,781,041	11,934,247	15,374,575
Inventory	13,746,421	13,916,098	14,388,460	15,597,290	18,995,320
Total current assets	25,300,963	25,877,084	26,641,001	28,076,037	35,074,295
Gross fixed assets	10,100,480	12,113,920	13,503,760	16,258,770	18,161,780
Less: Accumulated depreciation	4,583,000	5,944,920	7,661,180	9,316,460	10,111,982
Net fixed assets	5,517,480	6,169,000	5,842,580	6,942,310	8,049,798
Total assets	30,818,443	32,046,084	32,483,581	35,018,347	43,124,093
Liabilities and Stockholders' Equity					
Current liabilities					
Accounts payable	8,863,105	8,998,904	8,822,341	9,593,487	12,468,216
Notes payable	1,300,000	1,400,000	1,000,000	1,000,000	1,774,867
Accruals	1,190,338	804,628	429,152	415,828	1,190,001
Total current liabilities	11,353,443	11,203,532	10,251,493	11,009,315	15,433,084
Long-term debts	5,510,000	5,800,000	5,900,000	6,058,000	6,901,163
Total liabilities	16,863,443	17,003,532	16,151,493	17,067,315	22,334,247
Stockholders' equity					
Common stock (at par)	5,500,000	5,500,000	5,500,000	5,500,000	7,104,176
Retained earnings	8,455,000	9,542,552	10,832,088	12,451,032	13,685,670
Total stockholders' equity	13,955,000	15,042,552	16,332,088	17,951,032	20,789,846
Total liabilities and stockholders' equity	30,818,443	32,046,084	32,483,581	35,018,347	43,124,093

Appendix 2

<b>Ratio</b>	<b>Industry Average 2011</b>
Current ratio	2.27
Quick ratio	1.04
Inventory turnover (times)	5.50
Days Invested in Inventory (365)	66.36
Average collection period (365 days)	47.15
Fixed (net) asset turnover (times)	14.58
Total asset turnover (times)	2.72
AP deferral period (days)	43.56
Debt ratio	51.79%
Times interest earned ratio	7.00
Gross profit margin	11.01%
Net profit margin	2.45%
Return on total assets (ROA)	6.68%
Return on equity (ROE)	13.86%

## **TRANSFORMATION FROM WITHIN: THE CDBG CASE**

**Scott Johnson, Northeastern State University**  
**David Kern, Northeastern State University**  
**Katie Haight, Northeastern State University**  
**Ryan Haight, Northeastern State University**

### **CASE DESCRIPTION**

*This case is designed for the study of leadership and organizational change within a unit of a larger organization. As such it provides an important learning experience for students who are already managers or who aspire to that level of responsibility. The primary learning opportunities address building a vision at the unit level, restructuring for success, overcoming resistance to change internally and across other units of a larger corporation, building support with powerful sponsors, and the importance of communication and persistence where authority is limited. The case has a difficulty level appropriate for undergraduate seniors and graduate students, and is designed for courses addressing organizational change, leading change, and leading teams. It can be covered in a one hour class. Preparation for the case is expected to require 3-4 hours.*

### **CASE SYNOPSIS**

*The case begins with the recognition by a senior vice-president that the inadequacies of a seemingly insignificant compliance unit could jeopardize the overall growth strategy of BOKF, a large regional bank holding company. Paula Bryant-Ellis agrees to take on the transformation of the CRA department into a modern Community Development Banking Group (CDBG) that will contribute to the overall strategy of BOKF, the parent banking company. The case covers the first two years of significant organizational change, with emphasis on creating a vision, restructuring the organization, and shared leadership at the unit level. For the first three months, Bryant-Ellis is learning the existing, inefficient and archaic process while she studies benchmark banking groups to crystallize a vision for the future and an initial direction for the group. Early in this process, she brings new leadership into the unit. The case chronicles the new leadership team's approach to transforming the basic functions of the group, while concurrently managing the old processes until the new ones are operable. The challenge is complicated by substantial resistance to change by executives in powerful operating divisions affected by the compliance responsibilities of the CDBG. Communication and collaboration across organizational silos and the role of powerful sponsors are key elements of the transformation. The case ends with a summary of "early wins" for the unit, and a list of challenges its leaders will face over the next few years.*

## INTRODUCTION

Steve Bradshaw, Senior EVP of BOK Financial Corporation, was concerned about the performance of the CRA Department, which had recently been assigned to him. The department was named after the Community Reinvestment Act (CRA), a federal regulation that encouraged banks to promote development in low-to-moderate income (LMI) communities through lending and investment programs. The bank had received “satisfactory” ratings over the past few years in CRA performance evaluations; however, government regulators were increasingly critical about antiquated processes, the lack of required policies and procedures, and the absence of initiative in addressing needed improvements. Failure to receive satisfactory ratings could jeopardize the growth strategies of the holding company. In effect, the performance of a single compliance-oriented department could hinder strategic action by BOK Financial Corporation (BOKF) and its subsidiaries<sup>1</sup>.

The Board CRA committee, whose members included the chairman of the board and the CEO, met quarterly to review the status of compliance in this area, an indication of the strategic issues involved. As a member of this committee, Steve Bradshaw had observed two additional concerns. The CRA Department was not profitable, and had not met BOK Financial Corporation’s expectations in serving the community. He had seen enough of the problems to know that the current approach was not working, and that little change could be expected under the existing structure.

Steve acted quickly in addressing the leadership of the department. The new leader would have to be a self-starter and work with minimal direction. Due to the poor reputation of the department and the necessity of building cooperation with the business units, a candidate would have to understand the bank’s internal culture, work across organizations and interact with senior executives. The idea of bringing in a compliance expert from the outside was discarded quickly. There were no obvious internal candidates. Paula Bryant-Ellis, although no longer with bank, fit the requirements of the position. She had worked in the high pressure lending activity, which operated under Steve Bradshaw’s direction. Paula also had gained experience in another bank and had recently been working as an executive in an organization focused on community development projects. Steve believed that Paula had the background, initiative and interpersonal aptitude that would be needed.

Paula Bryant-Ellis began her career in the accounting field before building a successful career in lending at BOK Financial Corporation and at another Oklahoma bank. In 2003, Paula had accepted a call to serve the community as a key player with Community Action Project of Tulsa. Her work in the community was rewarding, but she realized that she missed the “action” and intensity of her previous positions. The call from Steve Bradshaw was a surprise, but was intriguing. It combined the challenge of banking operations with the positives associated with contributing to the local community. The downside was that the CRA Department had a poor reputation in the bank, and was focused on compliance, which was not Paula’s strength. But Steve was convincing, emphasizing the significant potential for growth, and promising a great deal of latitude. The opportunity was compelling. Paula agreed to accept the challenge.

## THE CRA DEPARTMENT

The department had been created years earlier to deal with federal regulations of the Community Reinvestment Act (the acronym CRA was originally selected as the name of the department). Compliance is necessary for regulated banks if they wished to expand their businesses (e.g., acquisitions, branches and ATM). Banks are required to follow processes directed by CRA regulations, and provide loans and investment services to low-to-moderate income communities. Banks are required to document their compliance and periodically present their results in an examination of each bank subsidiary. The examinations involve performance evaluations of a broad range of lending and investment activities. These activities can be originated either by a community development group such as the CRA Department, or by business units within a bank. Consequently, examinations require coordination across multiple units. The responsibility for completing the reporting and providing documentation had been assigned to the CRA Department at BOK Financial Corporation. An effective approach should have included strong written procedures, experienced lending officers, and coordinated systems for reporting. This was not the case.

At the beginning of 2004, the department was only meeting the minimum requirements of the regulations. Policies and procedures within the department were deficient or did not exist. There was no interface with the bank's loan systems. This led to a manual process of reporting and documentation. Loans were originated by CRA personnel with little underwriting experience and an inadequate understanding of credit policies and procedures. Lending decisions were often made on an ad hoc basis. The result was a significant portfolio of negative return loans. Other business units also originated loans that should have been subject to examination, but often were not recognized as such by CRA personnel. There had been no attempt to correct or even document procedures and performance. No meaningful effort had been made to improve efficiency.

The department itself was a loosely organized collection of 19 people spread across five locations with the head office in Tulsa. The department focused on compliance reporting, ad hoc loan origination, and critiques of business unit practices. Attempts by CRA personnel to address compliance deficiencies in the business units were frequently presented negatively, accompanied by threats of examination failure, which ultimately led to an atmosphere of resentment and mistrust. The complaints of CRA Department personnel generally fell on deaf ears. It was no surprise that the CRA Department garnered little respect, and even less cooperation from the business units of the bank. Although the bank subsidiaries had managed to receive "satisfactory" performance evaluation ratings in previous examinations, there were warning signs that multiple problems in CRA compliance could lead to unsatisfactory ratings. Unsatisfactory ratings could restrict expansion plans of the parent company and its subsidiaries.

As importantly, the inefficient processes and lack of profitability ran counter to BOK Financial Corporation's commitment to excellence. The corporation's strategic plans embraced excellence in all operations with full support from the executive team. The CRA Department was out of step by considering satisfactory "good enough". There were no plans for improvement. The department did little to actively contribute to the growth and sustainability of low-and-moderate income communities. With acquisition and expansion essential to the overall

strategic plan, the potential failure in the CRA compliance activity developed into a strategic issue. It was in this environment that Steve Bradshaw made his decision to revamp the department.

### **BUILDING THE FOUNDATION**

One of Paula Bryant-Ellis' priorities in August 2004 was to meet with executives and business line leaders in order to understand their view of the CRA Department and the potential for cooperation in the future. This would prove to be valuable in a number of ways. The meetings increased awareness that the area was important to executive management, that there was new leadership, and that cooperation would be necessary. These sessions would begin a pattern of communication and consultation with key individuals at the executive level in various bank groups and divisions who could provide support in overcoming resistance and facilitate necessary improvements in communication and cooperation. Another early priority was to successfully complete examinations in two bank subsidiaries, which would also contribute to a third priority – to gain an understanding of the regulations and the capabilities of the existing staff.

The first three months involved long, frustrating hours working with local CRA personnel in preparing for examinations that would begin in the fall of 2004 for the Albuquerque and Arkansas bank subsidiaries. It would involve full immersion in coordinating the antiquated processes employed by CRA personnel, and in learning the compliance end of the business. The days were spent manually collecting and recording data, fighting fires, and trying to make some sense of the department. CRA Department personnel would make copies of documents and summarize on spread sheets, sometimes even by hand. The extent of the problem was driven home by a series of communications from one of the examiners who severely criticized obvious deficiencies in process and implementation. Problems in coordination and initiative within the department were typified by the lack of integration with Credit Services' recent upgrade of the bank loan system. No attempt had been made to integrate CRA activities into the upgraded system by either department. It was obvious that this was the wrong way to run a business.

Without a background or experience in the compliance elements of the regulations, Paula worked nights reading the regulations in detail, and reviewing performance evaluations of other banks that had received "outstanding" ratings. These documents provided a view of what it would take to become a high performing community development group. Excellence could only be achieved with a comprehensive approach, incorporating strong compliance processes and meaningful community development lending, investing and services activities. It was clear that the most successful banks developed profitable lending and investment strategies, effective service programs for the community, and strong compliance systems and processes.

The late night study sessions laid the groundwork for an outline that would be refined and enhanced by input from key players in the restructured group. The plan ultimately addressed four key thrusts: 1) establish a new direction; 2) build an effective group; 3) automate the arcane manual review process; and 4) create a culture of collaboration with business units. The reader should note, however, the word "ultimately" in the previous sentence. Developing the plan was a process that began with the broad, initial vision, which would gain clarity over time, and

evolve as the new leadership team learned the ropes and began to solve the problems. It was a messy process, interrupted by the necessity of fighting the daily fires, but informed by study, analysis and open discussions among the new team members.

### **THE VISION AND INITIAL STEPS**

Developing the overall direction was an important first step; however, building a comprehensive approach would involve a complex, evolutionary learning process that would take several years to produce significant results. The next step was to create a vision of what this group would ultimately accomplish. That vision would not allow continuing to operate as a cost center; nor could it accept merely “satisfactory” performance ratings. The vision focused on:

- becoming a positive force in supporting people and businesses in LMI communities;
- being recognized through the achievement of outstanding performance evaluation ratings, and
- contributing to the growth and profitability of BOK Financial Corporation.

It would take the addition of experienced colleagues and several years before this vision would be fully developed into a formal plan. The initial plan was not documented as such, but one that involved a mix of doing and planning on the run. Formal processes and planning documents would have to come later.

An essential early action in setting and communicating a new direction was to change the status and scope of the department. The CRA Department would become the Community Banking Development Group (CDBG). This name was chosen in a deliberate process that included all people in the department. The change redefined and expanded the intent and purpose of the group. The broad charge was to make CDBG an organization that fully represented the mission, vision and values of the bank, and its commitment to excellence. The change in name and status acted as a clear statement to those within the group. Externally, the new name and elevation to group status would represent both a highly visible statement of new direction, and a more powerful voice in cross-functional interactions. CDBG would be led by a senior vice-president, providing more effective access to leaders in larger, more powerful divisions and groups within the bank. This “higher” apparent status would also be important in providing position recognition when working with each of the leaders in bank subsidiaries and business units.

The leadership team’s work in the trenches and their study of successful community development organizations in other states provided an initial level of clarity to what “excellence” would mean. Three initial priorities emerged:

- achieve outstanding performance evaluation ratings, which would require substantial automation of the process and support from various business line partners;
- serve the low-to-moderate income communities more effectively and,
- aggressively build a loan and investment portfolio that would not sacrifice credit quality, have impact in the community as well as provide profitability for the organization.

This plan would require the transformation of the internal group, while the leadership team continued to manage ongoing examinations. Unfortunately, the current staff had neither the skills, nor the structure to operationalize the vision. It was essential to add new leadership in each major area of responsibility, and to develop a core group of professionals in Tulsa. The new leadership team would multiply Paula's efforts and expand upon the initial ideas for the group.

### **BUILDING THE TEAM**

The CRA Department had 19 employees spread over five locations with only a few in Tulsa. There was a void in leadership and little organizational structure. Every employee reported directly to the department manager, but much of the work was directed by the office manager. The skill set of most employees focused on clerical activities and manual preparation of reports. The current loan portfolio was unprofitable. There was little aptitude for investments and loans, which was essential in building a strong community development organization. There was no impetus for automation, which was typical of banks achieving "outstanding" performance evaluations. Other business units (e.g., Business Banking and Mortgage groups) considered the CRA Department a minor irritant, and did not welcome changes in their processes. People within the department were entrenched, and questioned the need for improvement. It was evident that minor adjustments would not suffice. The change would have to be dramatic, involving a different skill set, new leadership and a culture that embraced excellence and continuous improvement. The process started with the recruitment of two experienced managers who would drive the investment and compliance priorities.

Angela (AJ) McKean joined CDBG as Investment Manager in November 2004. She brought a wealth of knowledge and experience in loans and investments both in banking and in community development. The fact that she had worked for Bank of Oklahoma for seven years contributed to her credibility with the business units. Her most recent position as executive director of the Tulsa Industry Authority provided insight into the community. Angela's input provided an important second perspective to critical early decisions for the group. Angela also started to develop opportunities in the investment arena, working with outside experts and across units within the holding company and its subsidiaries. Her expertise and experience within the bank and the community further enhanced the image of CDBG.

In this time frame, Cassandra Burroughs was promoted from within the bank to Compliance Manager for CDBG. With seven years experience as a commercial loan officer, Cassandra contributed a strong banking background, but had little knowledge of systems and compliance. Her ability to grasp new concepts, hard work and driven personality would be essential to overhauling the manual processes. Hers would be a key area where automation was essential. The automation initiative would provide strong impetus for improving multiple procedures and performance evaluation processes involved in CRA examinations. As importantly, Cassandra eagerly sought the challenge with a high level of energy and commitment.

By the end of 2005, it had become increasingly apparent that lending operations represented an important opportunity to support compliance activities and transform a seriously

under-performing loan portfolio, and that it would need new leadership. In January 2006, Gail Banham joined the team to restructure the loan activity, and to make the changes necessary to develop a strong loan portfolio. Gail's background in commercial lending and in credit administration brought critical knowledge to the group. Gail recognized the lack of lending expertise in the group and began to build her team. Carl Shields was hired for the Texas bank subsidiary. Carl had twenty years experience in commercial, small business and community development lending. Lisa Albers, who had extensive experience in Bank of Oklahoma commercial real-estate, also joined the lending unit. The overall lending knowledge and capability of the Community Development Group was substantially enhanced.

The issues of focus and structure were also tackled. Most of the new managers would be located in Tulsa, encouraging the existing staff to develop new skills, while adding experienced personnel where necessary. There was a shift from a loosely organized collection of individuals in multiple locations to a strong central group that would begin the process of building collaboration with the business units. The restructuring of the Community Development Banking Group was completed with an overall reduction of two positions, providing salary allocations to add experienced managers. The enhancement in human capability provided the resources needed for the group to tackle existing problems, automate systems, serve newly acquired subsidiaries and begin building profitable loan and investment portfolios.

### **OVERCOMING EXTERNAL RESISTANCE**

Much of the initial effort was directed toward building a competent group with capable leaders; however, resistance to change from larger, more powerful organizations within the bank presented greater challenges. The business units continued to view CDBG as another version of the old CRA Department. CRA compliance was not their problem. This attitude was a major impediment for the CDBG leadership team, which could only be successful by working with business units and bank subsidiaries. How could a small organization with a poor reputation initiate improvements and change with large units whose key people did not share their vision and objectives? How do you lead a team to make sweeping improvements and develop new approaches and products, while operating an archaic process during the conversion?

Paula Bryant-Ellis made key decisions early that would allow her to focus effectively on cross-organizational collaboration. The group had acquired experienced leaders who developed detailed plans and executed them in concert with the overall vision. That vision and overall plan was clearly and continuously communicated to upper management and leaders in business units and bank subsidiaries. Steve Bradshaw acted as a powerful sponsor for CDBG, providing support and assistance at critical times in the process. Steve's support was particularly important in assisting Paula in building alliances with key players in business units.

Developing collaborative relationships involved a consistent approach. Paula and her key team leaders would identify an issue or opportunity. In each area, the appropriate manager would research issues and problems, develop initial ideas for solutions, and review with Paula prior to preparing reports or setting up meetings. Concurrently, CDBG unit managers would meet with business unit peers to establish a level of common understanding and begin building ongoing working relationships. The communication program operated at multiple levels. At the

initial meetings with business unit leaders, Paula provided support to CDBG unit managers to encourage broad agreement on the issues and the options for improvement. These sessions would be followed with multiple meetings and contacts involving the unit managers and their peers in the business units. The process appears to be straightforward, but it frequently involved multiple iterations, starts and stops, personality issues, and, occasionally, failure to move forward. It was often frustratingly slow and difficult. In some cases, this influencing approach worked reasonably well. In other situations, this approach was not enough to assure compliance or collaboration.

Members of the CDBG leadership team also visited key managers in the bank subsidiaries to build communications essential for a collaborative relationship. Paula would address “how we will work with you and how we operate in your market.” Unit managers would follow-up with multiple contacts. Previous successes and ongoing collaborative efforts would be discussed as examples of effective practices. Emphasis was consistently placed on working together for the benefit of the corporation and the bank subsidiary. This approach was particularly effective in reducing resistance and misunderstandings. Education and communication were the bedrock of the approach, complemented by the credibility built up with early and ongoing successes, and by the clear support of top management.

In some situations, resistance from managers in a business unit or a department became enough of an issue that outside assistance was needed. Support from senior executives was necessary to move the process forward. The communication and improvement process was often complicated by the historically negative attitudes that had been created by the confrontational approach taken by of the former CRA Department leadership. Encouraging and leading change would require multiple approaches. Progress would be uneven. The CDBG leadership team often had to balance a push for timely change with the need to build long-term partnerships.

Esprit d’ corps within the leadership team and the overall CDBG was a critical element in breaking down external and internal resistance. Paula’s collaborative and supportive approach to leadership was essential. Without Paula’s encouragement and example, the resistance and road-blocks faced each week would have been overwhelming. More than one CDBG associate commented on the effectiveness of Paula’s style in inter-division meetings, with a focus on fact-based information, structure, and open communications. Among the CDBG team leaders, expectations were agreed upon and clearly stated. Each manager was encouraged to direct their individual area of responsibility with substantial autonomy. Support and assistance was provided when requested, but the managers were expected to take the lead in their area of responsibility.

Additionally, the leadership team encouraged and supported each other. The positive internal culture of the group kept motivation high under difficult circumstances. Without the strong internal commitment to shared leadership, collaboration and support, the slow and trying process of moving resistors to compliers, and compliers to collaborators would have lead to early burn-out. The wear and tear on middle managers implementing significant change cannot be underestimated. The positive culture within the CDBG, and mutual support of the leadership team was crucial in maintaining the momentum, and in driving continuous improvement efforts.

## **BUILDING A TRACK RECORD OF SUCCESS**

Procedures were addressed early in the change process. In the first six months, Paula, Cassandra and Angela developed and documented all key procedures while dealing with CRA examinations in the Albuquerque and Arkansas bank subsidiaries. This effort required a great deal of commitment and personal sacrifice in terms of hours and intellectual engagement, but the experience created the foundation for future successes. Whenever possible, procedures were improved in business units to encourage solid banking practices.

The next major task was to embark on a comprehensive automation program that would transform the antiquated manual processes. Cassandra Burroughs took the lead as Compliance Manager, working with personnel in the CDBG compliance unit and partners in the Credit Services organization to build interfaces to the loan system. Recognizing that the task would take years with existing staffing and skill levels, external firms were engaged to accelerate the automation process. By the end of 2006, virtually all systems had been converted from the manual process. This was a major step for the group – one that had relatively wide visibility with senior executives and business line managers.

Angela McKean had to start from scratch. Under the previous management, there had been little effort to engage in community development investment activities. After policies and procedures were developed, she began work on long term investment programs. By 2006, the first of these new investments were approved. This long term approach created the foundation for building a strong investment portfolio. By developing effective investments and exploring potential opportunities in tax credit investing, CDBG began to receive support from key executives in the Tax and Finance Department. This support would be crucial for developing long term profit strategies. Educating partners in the bank about the substantial long term pay-off was as critical as identifying the investment opportunities.

The most effective banks prioritized the lending activity as an opportunity to build long-term profitable business in developing communities, usually requiring focus and leadership by the community development banking organization within the bank. This type of leadership was lacking in the old CRA Department; however, it represented a significant opportunity for the restructured Community Development Banking Group and for the corporation. This opportunity was addressed when Gail Banham hired experienced lenders who would generate profitable, credit-worthy loan business that would meet regulatory requirements. As importantly, they would work with business unit and bank subsidiary managers to build a profitable loan portfolio that met regulatory requirements. Changes in standards for profitability and new loan development set the stage for dramatic improvements that would rebuild the CDBG loan portfolio as a consistent and profitable business for the corporation.

The crowning success, however, was in receiving an outstanding rating for the flagship banking division, Bank of Oklahoma. This achievement reflected improvements in every area of CDBG, and was the “aha” moment for many skeptics in other parts of the bank. This achievement capitalized on all of the small and big successes the CDBG team achieved in two years, including documented procedures, automation, improved processes, a new investment program, a restructured CDBG organization, and an effective lending unit. Not only was it a source of intense pride for the “team”, but provided real, tangible results that would reinforce the

new image to company executives and business unit partners. The group's achievements established a pattern of consistent progress that reinforced the strategy to executive management, and enhanced motivation and resilience within the group.

### **THE CHALLENGES REMAINING**

While the leadership team could point to a number of successes, they were a long way from the vision they had created. There were deep frustrations in trying to make progress when that progress was confronted by so many obstacles. After two years, they had achieved respect and support from executive management and the board of directors, but still lacked cooperation and buy-in from several key business units and some subsidiaries. To the CDBG leadership team, the process seemed to move much too slowly, and require an extraordinary amount of effort. It was critical to recognize that the slow progress was part of a long process, which would involve successes and set-backs along the way. They would need to continue to act as change agents in telling the story, in identifying the benefits to the corporation, and in finding common ground with business partners.

Skills would have to be continually upgraded to support the strategy of the group in becoming a profit center. CDBG personnel would have to acquire new knowledge and capabilities, and most importantly, want to make the change. Experienced personnel would be added to continue to build the capabilities of the group. Integration of new associates and training would have to be done even as the workload increased. The leaders themselves would have to continue their own education to increase their knowledge of investment and lending instruments. The team also enlisted outside experts to accelerate the learning process and to assist in implementing new concepts.

The leadership team would also face two or more exams each year with each bank division involving unique problems. The team would continue to work through manual processes with the smaller bank divisions, dedicating substantial time and attention to each exam in order to maintain the momentum. Failure to achieve outstanding ratings in upcoming examinations could weaken external support and internal motivation. Although acceptance within the critical Mortgage and Business Banking divisions had improved, further efforts would be needed to achieve real cooperation. Associates and leaders in the group could face burn-out as they continued to deal with resistance.

The bottom line was that two years of hard work and a great deal of positive change positioned the team for long term success. It did not guarantee it.

### **LOOKING AHEAD**

The CDBG leadership pondered the question of how to consolidate their progress and move forward. What would it take to sustain a positive culture and continuous improvement? Should the team incorporate formal benchmarking of medium to large banks that had achieved outstanding ratings? Should they put together a "strategic plan" for the group? What other techniques, issues and questions should be considered?

## END NOTES

- <sup>1.</sup> BOK Financial Corporation (BOKF) is a \$24 billion regional financial services company based in Tulsa, Oklahoma as of January 2011. The company's stock is publicly traded on NASDAQ under the Global Select market listings (symbol: BOKF). BOKF's holdings include BOKF, NA, BOSC, Inc, Cavanal Hill Investment Management and Southwest Trust Company. BOKF, NA operates seven banking divisions: Bank of Albuquerque, Bank of Arizona, Bank of Arkansas, Bank of Kansas City, Bank of Oklahoma, Bank of Texas, and Colorado State Bank and Trust. BOKF, NA has full-service banks located in eight states. BOSC, Inc., the broker/dealer subsidiary, provides brokerage services in 10 states. At the beginning of this case in 2004, there were five bank subsidiaries: Bank of Albuquerque, Bank of Arkansas, Bank of Oklahoma, Bank of Texas, and Colorado State Bank and Trust. In January 2011, all of the BOK Financial Corporation bank charters were collapsed in to one single bank charter BOKF, NA.

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# LKT PRODUCTS; A FAILED LEAN JOURNEY

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## CASE DESCRIPTION

*The primary subject matter of this case centers on the approach for successfully implementing Lean Manufacturing in a small manufacturing facility. Secondary issues include: employee motivation, lean change leadership, management commitment, employee cross training, management/employee communication, and sustainability of achieved process improvements. This case is appropriate for junior level. The case is designed to be taught in 1.5 classroom hours and is expected to require 1.5 hours of outside preparation by students. This case study will complement current Operation Management textbooks that address the basic principles and philosophy of lean.*

## CASE SYNOPSIS

*Beginning as a basement hobby of founder/president Ronald Jefferson, LKT grew into a world class solid-body guitar case manufacture with 55 employees. LKT made mass-produced guitar cases in the molded-case department and personalized one-of-a-kind guitar cases for musicians in the custom-case department. LKT is indicative of a successful proprietorship micromanaged by its owner whose resistance to change fostered the culture of the company. Not only was implementing lean challenging to shop employees but to Jefferson himself who considered LKT his “baby”.*

*Bryan Ackers was hired by Ronald Jefferson as Plant Manager to assist in running the day-to-day plant operations. Ackers, an experienced practitioner of lean implementation at Hewlett-Packard, envisioned potential improvements from implementing Lean Manufacturing at LKT. Ackers success at Hewlett-Packard was well documented, yet he knew every lean journey begins with different challenges. He was unaware of the tribulations he was about to confront.*

*Ronald Jefferson, despite his hands-on management style, was not present during initial lean training sessions or the first kaizen event. His absence was evident to senior managers and department operators which led to skepticism and discontent within the process improvement teams. Initially Ackers focused on implementing lean in the molded-case department. Although the improvements were considered successful, operators resisted improvements and gradually returned to their old work habits unable to adapt to the concepts of lean. Not to be dissuaded. Ackers continued to follow his improvement goals in the custom-case production department.*

*The kaizen improvement event in the custom-case department showed slight improvements. Ackers was troubled by the outcome from custom-case and the deterioration in improvements from the first kaizen in molded-case. Ackers understood lean is learned by doing. Ackers apprehension continued when Jefferson verbalize his displeasure with the lean process. Shortly after, Ackers left the company with a myriad of questions of what he could have done better.*

## **LKT PRODUCTS: A FAILED LEAN JOURNEY**

In May 2005, Bryan Ackers reflected on the planning process and his managerial approach to implementing lean at LKT Products:

*“Adapting Lean Manufacturing is a challenging journey. Sometimes the concepts are difficult to execute, especially when they are totally different from how organizations currently do work. Lean implementation can fail, bringing the journey to a halt.”*

Ackers was first exposed to the concepts and methodologies of Lean Manufacturing as an operations manager at Hewlett-Packard. He was the driving force behind the implementation of lean in the manufacturing environment. However, he lacked the experience of building lean coalitions at various levels of upper management. While at Hewlett-Packard, Ackers was not always involved in the preliminary planning and strategy sessions which were focused on achieving a successful lean cultural change. Ackers was a successful manager; he was task orientated, and achieved goals easily. He had the passion and enthusiasm to succeed in everything he did. What Ackers encountered at LKT was humbling. He knew there would be challenges, but he was not ready for failure.

### **AN OVERVIEW OF LEAN**

The concepts and methodologies of Lean Manufacturing were fashioned and perfected at the Toyota Automobile Company. The concepts were initially referred to as the Toyota Production System. Lean concepts have successfully been implemented in manufacturing operations, service industries, and healthcare organizations around the world. Today, lean is commonly referred to as Lean Thinking or Lean Management. Lean is an applied management philosophy that adds value to a product or service from the perspective of the customer by eliminating non-value added activities, waste. There are seven areas of waste defined by lean: overproduction, waiting (employee and material), transportation or conveyance, over processing, excess inventory, unnecessary employee movement, and defects or scrap.

Lean systems accomplish waste reduction by improving process productivity, reducing inventory, improving product quality, and increasing worker involvement. Waste reduction has a direct effect on reducing costs and improving profitability. More importantly, eliminating non-value added activities decreases customer response time and increases product and service quality. These improvements add value to the customer and ultimately increase sales.

Value stream mapping, sometimes referred to as a process flow diagram, is a lean tool used to identify value added and non-value added process activities. Value stream mapping visually illustrates the current flow of material and information along the stream of individual processes. The real power of value stream mapping is the commitment of cross-departmental teams created to identify waste, develop a shared vision of improvement, and execute an improvement action plan. Improvement action plans are often employed using a continuous improvement tool, the kaizen event.

Kaizen events bring together key management and company employees for an intensive three or four day on-site work session. Participants map and analyze the current value stream, implement identified improvements, and create a future state value stream. Upon completion of the kaizen event, the future state value stream becomes the current state and the process is repeated thereby creating an environment of continuous improvement. By including cross-functional resources with decision making authority, improvements happen in short periods of time that might otherwise take months to accomplish. The intensity of the experience opens participants to learning new habits that are usually not possible with a traditional classroom approach.

When applied rigorously and throughout an entire organization, lean can have a dramatic affect on productivity, cost, and quality. On average, lean organizations have achieved productivity improvements of 50-75%, quality improvements of 50-90%, reduced processing space 30-50%, and reduced customer lead times by 70-90%. Lean while not a simple strategy to implement, improves processes and outcomes, reduces cost, increases customer satisfaction, and improves employee morale.

## **HISTORY AND BACKGROUND OF LKT PRODUCTS**

LKT was founded in 1963 in the basement of a Brooklyn New York row-home. Its first products were handmade, hard-body guitar cases sold to area musicians during the music transformation of the 1960's. LKT was the creation of Ronald Jefferson, an accomplished musician, who designed and produced hard body guitar cases as a hobby for acquaintances in the music industry. As the 1960's music revolution grew, so did Jefferson's business, gaining a solid reputation for quality, reliability, and durability. The personal attention Jefferson gave to the product and his customers further enhanced the success of the business. The demand for Jefferson's cases necessitated a larger production area. Jefferson relocated from his row-home basement that accommodated three employees to a neighboring warehouse. Eventually twelve full and part time employees were employed.

By the 1980's, and continuing today, LKT had built a reputation as a national brand with its line of hard-body guitar cases as well other hard-body musical instrument carrying cases. Sales forces and service centers were not developed as in traditional wholesale/retail business organizations. Demand was created in a cult-like fashion among rock-an-roll and country musicians who ordered custom made cases specific to their individual requirements. Often, Jefferson would personally deliver the finished cases when bands toured in New York City or along the East Coast. Due to family problems and security issues, Jefferson moved the business to an industrial park in Virginia where he continues to design and manufacture hard-body guitar cases while employing fifty-five employees. Despite competition from China, LKT maintained sustainable orders from guitar manufacturers like Gibson and Fender which supplemented the custom orders. Sales remained strong.

## ORGANIZATION AND CULTURE

From the beginning and continuing today, LKT was managed by the strong work ethic, individualism, and self-reliance of Jefferson who oversaw all aspects of design through manufacturing. In a sense, LKT was still Jefferson's hobby. His hands-on personal management style created a company culture apprehensive to change. Jefferson was skeptical to new initiatives and buzzword business programs.

*"LKT has been successful doing work the way we always did work. The same quality and attention to customer satisfaction that we achieved in my parent's basement will continue to sustain us in the future. It's what made us what we are today and will serve us well tomorrow"*

Despite the "doing work the way we always did" philosophy, orders for both mass produced and custom made cases continued. The strong control style of management continued to be successful; however, Jefferson realized that sustaining the business would require relinquishing some control and movement toward an empowerment management style.

In 2002, Jefferson hired Bryan Ackers as Plant Manager. Ackers came from Hewlett-Packard where as operations manager he was intimately involved in implementing Lean Manufacturing concepts at an Indiana assembly facility. Ackers recognized the need to make improvements at LKT and committed himself to leading LKT in a lean transformation. Two areas of concern were identified. First, manufacturing processes were scattered throughout the facility, spare and obsolete parts were stored everywhere, and machine and facilities maintenance was disorganized with no process established for prioritizing or responding to manufacturing needs. Secondly, management-employee relationships were strained. Process and efficiency improvements were often met with employee resistance. Jefferson was slow in recruiting a management team and he had little interest in an employee career-development processes or succession planning

Ackers realized improvements would develop slowly if his attention were divided between manufacturing and converting Jefferson's belief system. In February of 2004, Ackers hired Peter Kronbush, also from Hewlett-Packard, who was experienced with lean implementation and kaizen events. Ackers strategy was to convince Jefferson of the power and sustainability of lean throughout the entire organization while Kronbush focused on daily manufacturing concerns.

## BEGINNING THE LEAN JOURNEY

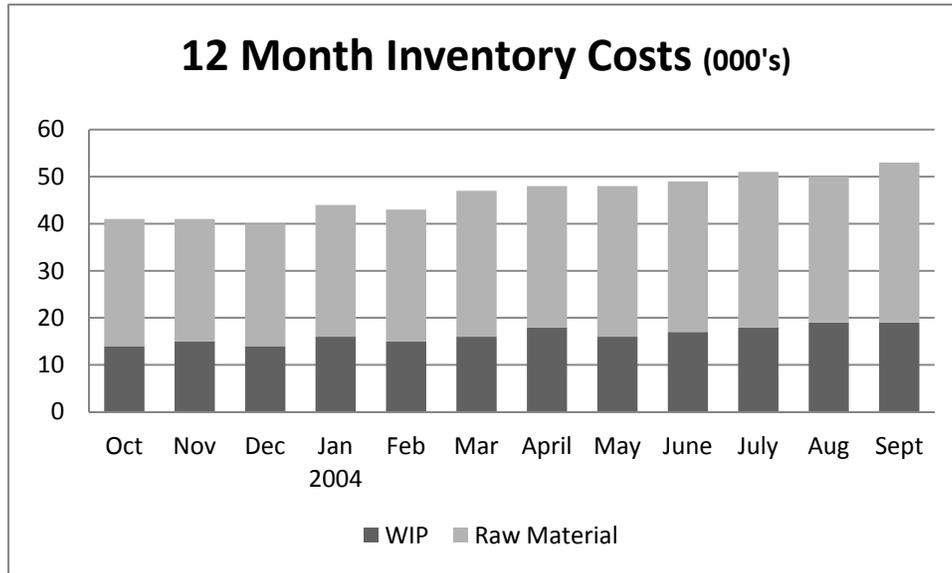
Ackers, with his strong desire to implement lean on the production floor, began the lean journey in September 2004 with a special production meeting that included Kronbush, Jefferson and several senior managers. Most of the senior managers were not familiar with the concepts of lean. Jefferson, although reluctant to embrace change in the business, had read several books on various management styles including books on Lean Thinking. Ackers laid out a series of training sessions so everyone in the organization could become familiar with the concepts of lean and understand its importance.

*"I have no doubt of the skepticism of Ronald Jefferson. But some senior managers, especially from the front office voiced concerns that "Lean was a fad" and emphasizing employee participation and self-directed work teams would raise Jefferson's skepticism. I need to change some of the old paradigms and gain support from all managers."*

The first training session was attended by a supervisor from facilities maintenance, a supervisor from molded-case production, and three select production leaders. When the training session was complete, everyone was expected to return to their respective departments and train additional employees. The seven areas of waste and value stream mapping were the topics presented in the first session. Everyone was engaged in the training. Participants were dispatched across the plant to perform mapping exercises. The team presented its findings showing areas of waste that needed to be addressed. Most of the mapping identified areas of excess inventory, a handicapped maintenance dispatch system with noticeable waiting time, overproduction, and fragmented production processes. After the first training initiative was complete, supervisors and production leaders were excited about what they learned.

Two weeks later, the second training session focused on two additional lean concepts. First, visual management which lean defines as display boards of real-time productivity measurements, and second, workplace organization or 5S; sorting, scrubbing, setting in place, standardizing, and sustaining. Positive feedback from the first training session created overflow requests for training in the second session. Production supervisors and engineering managers attended as did several production employees from the custom-case production line. After the second training, everyone continued to be excited about what they learned. Several participants commented that 5S should be implemented throughout the organization not just the factory floor.

The third and final training session focused on data collection and measurement. In the third training session, the same participants were selected who attended the first training session. The training class was divided into teams to conduct time and motion studies on the production floor. Data was compiled and analyzed from the shop floor and several support departments. For example, time and motion studies came from engineering and cost and budget data came from finance. Since the teams were made up of the same people from the mapping session, current state maps were developed for the processes where data was collected. The data identified some troubling trends: increasing departmental expenses, and declining labor productivity. Inventory costs, another performance indicator, were also analyzed and found disturbing:



<b>Operating Performance Review Budget vs. Actual</b>			
July, Aug, Sept (000's)			
<u>Department</u>	<u>Operating Budget</u>	<u>Actual Expenses</u>	<u>Variance</u>
Custom-case	45	47	(2)
Molded-case	32	29	3
Material Cutting	12	8	4
Facilities Maintenance	40	51	(11)
Administrative	8	7	1
<b>Total</b>	<b>137</b>	<b>142</b>	<b>(5)</b>

From his experience it was noteworthy to Ackers that good employee morale was essential to the success of any improvement. The teams had no way of measuring employee morale, but interaction with employees on the shop floor revealed areas of change resistance and low esteem. A production employee commented:

*“We don’t make the big bucks some people around here do. No one listened to my suggestions before. If management wants to make changes, so be it. Just tell me what you want me to do and I’ll do it.”*

When told of waste reduction and eliminating non-value tasks and operations, employees tended to be unenthusiastic. The prevailing attitude was one of cynicism and opposition when approached by the improvement teams. The lean initiative seemed to convey a fearful perspective associated with layoffs and reduction in workforce.

*“What happens when these improvements are made? I’ll lose my job. Then what would I do, I have a family to feed. I can’t afford to find another job at my age; everyone is looking for young educated employees. It’s going to be hard to support a system change with such high risk”*

Despite the non-supportive response from shop operators, the improvement teams understood Acker's drive and ambition and pushed forward with the task of implementing lean.

Ackers determination, passion, and commitment had set the ground work for the journey. Most of the organization was trained on four lean topics; visual management, waste identification, value stream mapping, and 5s. The biggest cost improvements were identified outside of the production departments, specifically in Facilities Maintenance. A decision was made to begin lean implementation in the molded-case department even though Facilities Maintenance showed the greatest opportunity for cost improvement. Molded-case improvements would address overproduction, quality, and inventory issues by redesigning some of the production lines. The overall objective was:

- \* Reduce molded-case costs by 10%
- \* Improve labor productivity by 15%
- \* Reduce work-in-process inventory by 25%
- \* Improve product quality
- \* Reduce scrap
- \* Improve delivery times
- \* Increase production flexibility to meet product mix and demand

The benefits associated with a successful lean implementation were tied directly to results in productivity and quality improvements, and reductions in finished goods and work-in-process inventory. Ackers was pleased with the progress thus far and very confident moving forward with the company's first kaizen event.

### **MOLDED-CASE KAIZEN**

At this point in LKT's lean journey, a foundation of understanding seemed to be in place. The company had made significant progress in training. Team participants were still excited about the journey. The first kaizen event was scheduled for February in the molded-case production area. Jefferson chose not to participate in the initial training and planning work. He was willing to relinquish lean management decisions to Ackers and Kronbush.

*"I've made the decision by hiring Ackers to hand over some of the management responsibilities of the business. It's often times difficult for me to do, but I believe Ackers is very capable and I have faith in his decision to implement lean."*

Jefferson felt strongly that lean improvements would be viewed more favorably by employees if they were internally driven rather than mandated from above. Ackers had his challenges on the horizon.

Two teams were established consisting of individuals with training as well as employees from molded-case production who did not receive any classroom training. On the first day of the event the two teams mapped the current value stream, collected new data and used the new data to generate improvement ideas. The new ideas had merit but were somewhat different from the ideas identified in the first training session. The change of improvement ideas irritated those who

performed the same work in the earlier training session. To bring the teams back into focus, Kronbush brought the teams together and explained they would be using the information previously collected and not the newly acquired data. Everyone was excited, but the group as a whole seemed to lose some energy.

When the teams arrived in the molded-case production area, they assessed the work content identified from the engineering department's time and motion studies. They identified what was needed to perform the work and began discarding all unnecessary items from the molded-case assembly line. One team found an area in the plant where unneeded items could be categorized and stored, the other team removed the items from the production line. After the first day of sorting and removing unnecessary items, the teams displayed a sense of accomplishment. When the sorting was completed the teams assessed their next step.

As the second day began, the teams again struggled to understand why they were not allowed to use the current information from the second data collection effort. Each team had current data from their respective areas but was told to ignore it. The teams worked mostly on their own with a few conference room meetings conducted by Ackers to evaluate the process, get status reports, offer improvement suggestions, and identify what the next steps would be. Ackers offered suggestions for improvement that were either already implemented or suggested by production employees earlier. Some team members saw merit to the suggestions because they came from Ackers. At the end of day two, the teams were progressing fairly well despite several employees who were becoming unhappy with the kaizen process.

Day three and day four found some of the same challenges faced in the first two days of the kaizen event. Each team had some solid team members and was making good decisions on their own. Team members relied on each other but were confused by conflicting perspectives from Ackers or Kronbush during conference room status meetings. On two occasions thus far, the teams worked twelve and fourteen hour days. Some team members were beginning to show fatigue yet everyone pushed ahead. By the end of day four, the teams were finishing up their work. Each team had made improvements to process lead time, workplace organization, and inventory reduction. The teams were asked to finalize reports by Friday for a presentation to Jefferson which led to a mad scramble and another late night.

On the final day, each team presented its conclusions and Jefferson was pleased though reserved with the event. Although some loose ends needed tending, the event was considered a success. Directly following the presentations, Jefferson wanted a tour of the molded-case production area which surprised the teams. Jefferson knew of the improvements being made throughout the kaizen week. Some team members were disillusioned with the changes; they all were relieved it was over.

## **LIVING WITH THE CHANGES**

Things returned to normal several days after the kaizen event. Molded-case had gone through a major change in the physical layout of the area. The old layout allowed workers to build up as much work-in-process inventory as possible in response to bottlenecks and efficiency workarounds. With the new layout production workers now worked as a team. The kaizen team

implemented work cells that processed molded cases through eight work stations and eliminated most WIP inventory.

After the redesign, the production space was more confined but still large enough for operators to work comfortably, to maneuver product, and access required tools and material. The material handler, working under the old design was only responsible for supplying the production workstations with the required material. Under the redesign, a one hour parts supply replenishment system was installed which allowed time for the material handling function to also perform some quality checks. The changes in the molded-case department required many new procedures and protocol. Of major contention was the reduction of one operator in the redesigned assembly cell. The changes were not well received by some of the line operators.

Some operators firmly resisted the modifications as did several material handling and quality personnel. With the new cell layout, working as a team and understanding several operations in the cell was necessary to maintain current production levels. Cell team members needed to be cross trained at each workstation to ensure production. This was a difficult task for the operators to accept. Workers did not understand why they continually moved between workstations rather than maintain stationary positions under the old design. There was no hands-on training for the production workers. Some operators were on the kaizen team but there was no system to bring other uninvolved operators up to speed. Consequently, after the changes were made, the operators fell back to their old way of doing things which created multiple problems for the molded-case department.

Workers would leave their work stations even though the production line was designed for single piece flow. Operators would leave the cell to retrieve their own parts because the material handler refused to accept additional responsibilities. Team work was nonexistent. Often operators would stand at their workstation waiting for parts. Under the old and new department design, the supervisor's responsibility was shared with the custom-case production area. Supervision in molded-case was thus largely nonexistent. With little responsibility and limited accountability, no action was taken to address the resistance in the department. Production operators were allowed to do as they wanted as long as production levels were achieved. In production meetings, the kaizen team members expressed dissatisfaction with how the cells were operating. The molded-case department was falling apart.

### **WORKPLACE ORGANIZATION KAIZEN – 5S**

The second kaizen event focused on the molded-case department in an attempt to create a positive perception from the operators and other department employees. During the first kaizen event the kaizen team didn't accomplish much in 5S implementation other than a few bin labels and workstation signs. With two weeks lead time, orders were placed for the necessary supplies that would be used to improve the visual effects of the department.

The second kaizen event was scheduled for the last week in April when production orders were lower and the molded-case department typically worked only twenty five to thirty hours in the week. When production was finished on Wednesday, the kaizen team and department operators moved workstations and other items off the department floor and prepared the floor for painting. After the floor was painted and dried, floor tape and other visual markings were put in

place to designate workstation locations, aisle ways, material and parts storage area, rework area and employee break area. By Friday everything was labeled on the floor with descriptions and quantities. Workstations and other production items were returned ready for the start of production Monday. On Monday morning the operators acknowledged the improvements. Other supervisors and employees questioned when their departments would be improved. Bryan Ackers was happy; he hoped it could be sustained.

### **REFLECTING ON THE IMPROVEMENTS**

On a late Friday afternoon, three months since the beginning of lean implementation, Acker and Kronbush reflected on the transformation process and deliverables. The molded-case production area had an expectation of achieving improved production efficiencies.

Although the department was more organized and workers had the tools and materials they needed to complete their jobs, the department performed poorly. Operators resisted the concept of visual production controls and work cell rules. They complained about the higher production expectations. The old line allowed them to work at their own pace and take multiple breaks when they wanted to. Workers became stubborn and resisted working as a team. Moreover, the supervisor did not enforce the new procedures, stayed away from the department as much as possible and let the operators do as they wanted. The new work rules and visual production controls made this behavior readily apparent and easily visible. The blame fell on the kaizen event changes.

A lot of time and money had been spent on improvements to the molded-case production line with very little reward. There had been a lot of initial excitement and valuable employee training up front. The implementations were slow with limited improvement. Areas that were improved during the first kaizen event slowly returned to their old way of working and discarded many of the identified improvements. One reason for the return to the old way of working was that new employees did not receive the training and understanding of the concepts of lean.

The kaizen team repeatedly communicated to Kronbush and Ackers that the operators were not being held accountable for production volume and productivity standards. In an attempt to rectify the issues, numerous meetings were held with a variety of employees. Sometimes the meetings were cancelled for lack of attendance or the perception that the meetings were unproductive. Other times participants failed to follow up on specific action items. Things were falling apart and Ackers was becoming agitated. Ackers was already focusing on the next department to begin implementing lean. Ackers couldn't understand why his employees were not committed to lean. Ackers made the decision to stop focusing on molded-case production because the department wasn't making progress. Molded-case was forgotten and left behind.

### **CUSTOM-CASE KAIZEN**

Custom-case was the dollar sales leader at LKT. Each case was designed and built to the specific requirements of the customer. Ronald Jefferson often commented,

*"If only one production line at LKT was important, it was custom-case. It's our bread and butter."*

Jefferson personally received orders for these cases from musicians. The reputation and quality of the custom cases and their individualized features allowed for premium pricing. Jefferson's lifelong work in building hard body instrument cases began with custom guitar cases. Custom guitar cases were Jefferson's contribution to the music industry. An organized, structured and well planned kaizen was needed. The custom-case kaizen was scheduled for several months in advance which allowed for additional time to analyze the process.

Unlike the first kaizen event, the teams did preliminary planning. Time was spent assessing the results of the first kaizen event which lacked management commitment and accountability. The workplace organization in molded-case was deteriorating, workstations were cluttered, work rules were not being followed, and operators were not working as a team and continued to leave the work cell. Observations were made in all areas where the first kaizen event took place in hopes of preventing similar failures in custom-case.

Training classes were held for employees in the custom-case department. When training was complete, teams were dispatched to the custom-case department. The current state was mapped and the future state was created with insight provided by operators and supervision. As the event progressed, improvements were made in accordance with the future state mapping exercise. Workstations were redesigned into cells, operator walking was reduced significantly, work was balanced and single piece flow was implemented. Coinciding with the workstation rearrangement, 5S concepts were implemented, unnecessary items were removed from the work area, the floor was painted and taped leaving no area unidentified or undesignated. There was a high sense of satisfaction with the work done and great anticipation for resuming production on the following Monday.

When production began on Monday, the kaizen team was on the shop floor giving assistance and instruction as needed. The custom-case department was doing well. Productivity and quality had improved, and the employees and operators were excited about their clean and organized work area until several production supervisor changes were announced.

At the request of Ronald Jefferson, Kronbush began making changes to the roles and responsibilities of several production supervisors in the department. One change was bringing into the department an additional new supervisor with no lean training, who Jefferson personally knew from the "old" days. This supervisor quickly moved people around, added unnecessary inspection stations and created WIP by ignoring one piece flow, all in an attempt to more "personalize" the custom case process. To address the situation, Ackers met with Kronbush and Jefferson. During the meeting, Jefferson constantly referred to the lack of improvement in molded-case department and stated repeatedly the same results would not happen to his "baby". Jefferson stated he was not happy with the way the molded-case department was currently running. He was unhappy with how the kaizen teams performed their work and the way his employees were treated referring often to material handling and production line employees in molded-case. He regretted allowing kaizen teams into custom-case and apologized for not addressing the issue sooner. The old way was just fine for him and he wasn't ready to watch his passion slip out from under his control. Ackers had absolutely no idea of Jefferson's stand; he was speechless.

## A NEW BEGINNING

Ackers was extremely troubled. What happened to cause the failure of lean implementation? How could Jefferson be so entrenched in his thinking? What could Ackers have done differently? Is there a checklist that can be followed that can ensure success? Two months after the meeting with Jefferson, Ackers left the company. What can Ackers do differently with his next opportunity?

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# **WILJAX STUDIO: A 10-YEAR ENTREPRENEURIAL JOURNEY**

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## **CASE SUMMARY**

*Will Jacks' 10-year journey from his start as a struggling entrepreneur to a seasoned entrepreneur at the cross roads of a career changing decision point are highlighted in this case. This case examines the evolution of an entrepreneur from his days as a journalism graduate student, to start up entrepreneur, to taking on and disentangling with partners and large commercial photography clients. Jacks' story provides insights into a wide array of entrepreneurial struggles, obstacles, defeats and victories.*

*Case Intended Uses: This case is designed for use in undergraduate Entrepreneurship or Small Business classes.*

### *Learning Objectives*

*To examine the importance of establishing and cultivating a vision for entrepreneurs.*

*To identify decision making pitfalls and ways that entrepreneurs can make better decisions.*

*To understand the challenges of managing relationships with both partnership and customer constituents.*

## **WILJAX STUDIO: A 10-YEAR ENTREPRENEURIAL JOURNEY**

When Will Jacks looked across the football field at Millsaps College he saw things differently. He saw things through an artist's perspective, how the players moved and interacted, how the fans rose in unison to cheer. This was unusual in the simple fact that Jacks perspective was not as a photographer, or a reporter, or even as a fan in the student section, but as a cornerback, on an island, responsible for locking down his receiver. This perspective stayed with him as he transitioned from a Spanish major in college to a two year stint as a high school football and baseball coach. This artist's perspective led him to graduate school at the University of Mississippi where he would ultimately discover his passion for photography. Little did Will know of the trials and tribulations that would take him from graduate student to entrepreneur at a crossroads over a ten year period of his life.

## **GRADUATE SCHOOL**

After graduating from Millsaps College in Jackson, Mississippi with a degree in Spanish, Will Jacks worked for two years as a football and baseball coach at Marshall Academy. His two

years in coaching left him wanting to pursue the artistic interests that he had had all of his life. He was accepted into the University of Mississippi's Graduate program in Journalism, focusing specifically on broadcast journalism.

Early in his time at Ole Miss (the more common name for the University of Mississippi) he was given an opportunity to be the business manager of the school's yearbook. This job changed the course of his life because it led him to photography. Will often was responsible for having sporting events and other university related functions photographed. Interestingly, Will often ended up shooting the photos himself because some of his undergraduate student employees proved to be less than reliable. In essence this provided Will with a forum to be a self-taught photographer.

### **A NEW BUSINESS**

Will left Ole Miss without his graduate degree in journalism but full of knowledge and experience that he decided would be best applied as an entrepreneur in his home town of Cleveland, Mississippi. Will, however, did not have a specific vision of what he wanted this business to be. He was able to obtain, through a purchase made by his father, a store on Main Street in Cleveland. Will took two months to totally renovate the space. Once completed, his space had a studio (he used his name to form the Wiljax brand for his studio) where his work was displayed along with a coffee / pastry service area complete with comfortable seating for lounging, discussion, and artistic inspiration. The remainder of the space was used for an office, storage, restroom, and dark room to develop the pictures.

Will also had \$15,000 in seed money from an earlier insurance settlement. . This money was spent on buying 35 mm cameras, digital equipment, computer gear, film scanners, and food service equipment. While it would be approximately two more years before the digital revolution would change the photography landscape, Will's foresight provided opportunities for him to become digitally competent early so he would be ready when the changes occurred.

Will's photographic work initially spanned the spectrum of possibilities from commercial photography to weddings, school pictures, portraits, and artistic photography. Along with the food service area of his studio this wide array of photography options created a "jack of all trades, master of none" feel during the first year of his business. Without a clear vision Will continued to lack the focus that was needed to have the type of success that he had initially expected.

Will quickly realized that the "coffee house" vibe that he was trying to create with his beverage and food service was not taking hold. He then eliminated this part of his business, but quickly replaced it with a one-hour photo processing lab. The only other local one-hour lab was located in the town's Wal-Mart. Not unexpectedly, Will's one hour lab only lasted a year due the competition from Wal-Mart. It ultimately took him five years to pay for this costly strategic mistake.

## **MOVE TO COMMERCIAL PHOTOGRAPHY**

Approximately one year into his operations Will was given an opportunity to work for a large furniture company. The work was photographing furniture for the firm's promotional efforts. The firm, Ballew Furniture, hired Will to photograph pictures of their Jeffrey Ray line of home furnishings. These photos were used to promote the furniture at the two high-profile furniture markets held in North Carolina each year.

Will was excited to have the opportunity but extremely unprepared for this type of client. He was quickly (on his first day) thrown to the wolves. He was charged with setting up the furniture and lighting for the catalog photo shoot. He had no experience with the type of camera that the Jeffrey Ray marketing director wanted used, had never used studio lighting, and had never photographed a product. On top of all of that, he had severely underpriced his services at \$20.00 per hour due to his lack of experience and confidence with this new type of photography. Will was able to learn enough on the job to produce a quality product. The Jeffrey Ray marketing director asked Will if he would return to photograph their furniture for the next market which would occur in six months.

In the mean time a member of the Ballew family contacted Will about providing additional services to the firm. Will's first work was just photographing the furniture. The firm was responsible for processing the film and supplying the prints. Will was encouraged to not only take the pictures but to bring the additional tasks of processing and producing prints under his company's umbrella. Ballew Furniture would then pay Will for this "package" of services associated with producing photos for the Jeffrey Ray line of furnishings. This was an exciting opportunity, because it allowed Will to have more operational control, while making more money, which was important in his fifth year (See Exhibit 1: Profit and Loss Statement).

## **CHANGE: DIGITAL PHOTOS AND PARTNERS**

Before this new arrangement began in earnest, Will convinced Ballew to switch over to the emerging technology of digital imaging. This move, which Will saw as necessary for his firm's long term success, required an additional round of equipment purchases, even though his last round of purchases (initial camera purchases, digital equipment, computer gear, film scanners, food service equipment, and one-hour photo lab) was not close to being paid off. An additional \$25,000 investment in the fourth quarter of year three yielded a new digital camera and the computer needed to produce digital photos. The printer to print the pictures was purchased in January of year four for an additional \$15,000.

Will was swimming in debt (even with frequent "loans" from his father) and needed help to keep his business alive. He realized that the work on the Jeffrey Ray collection would result in heavy workloads and income every six months. He needed other work to fill in the remainder of his year. He also realized that this additional work would provide for economies of scale and help him to offset the costs of his recent equipment purchases. So Will began looking for ways to keep his equipment running and earning money year round.

Will identified a local couple, Bill and Shirley Scott, as potential partners. The Scott's photography business was primarily school photography which included yearbook pictures,

senior portraits, and team / club photos. The partnership meant greater losses in the short-term, but Will felt that adding this dimension would smooth out the revenue for his business and help him achieve economies of scale to reduce his long-term costs. The Scotts asked for a \$40,000 per year “salary” for their services. While technically they were partners it quickly became evident to Will that the Scotts were not assuming the risk of partnership since they were insulated by their salary arrangement.

The partnership did produce business. In fact, when added to the Jeffrey Ray business the partnership was using the new equipment for six full days every week. Will also added one full-time and several part-time employees to help with the peak demand times. The increased business also forced will to purchase a second printer at \$15,000 to keep up with the demand.

By the sixth year, he decided to purchase the adjacent building he had been leasing to adequately house his partners and three employees. His business was operating at full capacity. However, Will was puzzled that he could be so busy (his business had essentially doubled in the three years since he had taken on his new partners) but yet not be making much, if any, money. He was able to cover his expenses but had little room for profit at the end of each month.

### **AT A CROSSROADS**

Will decided that he needed to reassess how his business was operated and his services were priced. He quickly realized that his “partners” were really “employees” and that he did not need to carry employees, even if they did generate business. After four years, their partnership was dissolved and Will shifted his focus on procuring a better pricing and billing situation with the Ballew family who was still employing him to produce marketing materials for their Jeffrey Ray line of home furnishings.

The firm brought in a new marketing director and Will viewed that as the perfect opening to renegotiate how his services were priced. He had learned much since that panicked day when he took his first product photos. He had the experience, the knowledge and the confidence to seek a more favorable cost structure for his services.

Even though Will was billing the Jeffrey Ray line \$200,000 plus annually he was still frustrated with his arrangement with them. The massive amount of work that Jeffrey Ray was demanding was tying up his printer as well as limiting his ability to generate new business. Will was now in a vicious circle. To make matters worse another round of equipment purchases was required to stay “current.” This purchase cycle was the most financially difficult of all: \$100,000 for a new printer, \$10,000 for a new processor, and \$5,000 for a new computer. With all of his debt payments and other expenses Will had his take home pay estimated at approximately \$25,000 on average per year. In his mind he was working at a level that should produce more than \$25,000 of income per year.

Will had begun charging for his Jeffrey Ray services at a fee of \$30 per hour to increase his total revenues. This covered his photography work as well as the price for development and processing of the pictures and supplies. Shortly after this pricing change Will was asked to help redesign their display area where all of their market photography took place. After this redesign was completed Will was preparing for his bi-yearly marathon photo shoot that would produce the pictures that the firm would use to promote their furniture at the upcoming market.

Will's eyes widened as the Vice-President for Marketing approached him. Will was told that his services were no longer needed and that they had hired a new photographer at a cost of \$25,000. Shockingly, Will was also asked to train the new photographer over the next few weeks to help facilitate the transition.

The Vice President of Marketing wanted an answer. Will knew that he had to make some drastic changes. What he did not know is that he would be pushed head first into making those changes at a much faster pace than he would have ever anticipated.

		Willax Profit & Loss Statements									
Exhibit 1: Profit and Loss Statement		Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
<b>Revenues</b>											
Corporate Clients <sup>1</sup>		\$0.00	\$0.00	\$58,054.00	\$93,256.00	\$128,047.00	\$188,302.00	\$202,154.00	\$228,610.00	\$236,511.00	\$201,154.00
Personal Clients		\$25,800.00	\$26,800.00	\$32,115.00	\$48,000.00	\$60,000.00	\$62,000.00	\$61,000.00	\$60,050.00	\$59,000.00	\$61,202.00
Miscellaneous		\$2,400.00	\$3,000.00	\$700.00	\$500.00	\$300.00	\$100.00	\$80.00	\$60.00	\$40.00	\$40.00
<b>Total Revenues</b>		<b>\$28,200.00</b>	<b>\$29,800.00</b>	<b>\$90,869.00</b>	<b>\$141,756.00</b>	<b>\$188,347.00</b>	<b>\$250,402.00</b>	<b>\$263,234.00</b>	<b>\$288,720.00</b>	<b>\$295,551.00</b>	<b>\$262,396.00</b>
<b>Expenses</b>											
Production		\$16,000.00	\$17,600.00	\$28,688.00	\$40,163.00	\$52,212.00	\$73,096.00	\$84,791.00	\$114,673.00	\$116,200.00	\$117,540.00
Supplies		\$2,303.00	\$2,200.00	\$6,001.00	\$7,927.00	\$10,231.00	\$14,492.00	\$17,957.00	\$35,059.00	\$31,798.00	\$32,554.00
Equipment		\$13,000.00	\$0.00	\$25,000.00	\$15,000.00	\$15,000.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
Labor/Salaries		\$4,480.00	\$2,240.00	\$680.00	\$65,400.00	\$66,958.00	\$120,337.00	\$125,419.00	\$95,187.00	\$96,845.00	\$42,062.00
Lease <sup>2</sup>		\$0.00	\$0.00	\$0.00	\$1,000.00	\$1,000.00	\$1,000.00	\$0.00	\$0.00	\$0.00	\$0.00
Utilities		\$9,600.00	\$9,888.00	\$10,085.00	\$10,186.00	\$10,288.00	\$10,391.00	\$10,495.00	\$10,180.00	\$10,079.00	\$9,777.00
Insurance		\$1,200.00	\$1,200.00	\$2,400.00	\$2,472.00	\$2,546.00	\$2,622.00	\$5,244.00	\$5,401.00	\$5,563.00	\$5,729.00
		\$48,583.00	\$33,128.00	\$72,854.00	\$142,148.00	\$158,235.00	\$221,938.00	\$243,906.00	\$260,500.00	\$260,485.00	\$207,662.00
<b>EBITDA</b>		<b>(\$20,383.00)</b>	<b>(\$3,328.00)</b>	<b>\$18,015.00</b>	<b>(\$392.00)</b>	<b>\$30,112.00</b>	<b>\$28,464.00</b>	<b>\$19,328.00</b>	<b>\$28,220.00</b>	<b>\$35,066.00</b>	<b>\$54,734.00</b>
Depreciation <sup>3</sup>		1500	1500	3000	5000	7333	7333	7333	7333	7333	7333
Taxes		800.00	800.00	800.00	800.00	800.00	1,200.00	1,200.00	1,200.00	1,200.00	1,200.00
<b>Net Profit</b>		<b>(\$22,683.00)</b>	<b>(\$5,628.00)</b>	<b>\$14,215.00</b>	<b>(\$6,192.00)</b>	<b>\$21,979.00</b>	<b>\$19,931.00</b>	<b>\$10,795.00</b>	<b>\$19,687.00</b>	<b>\$26,533.00</b>	<b>\$46,201.00</b>

## Notes

- 1 Corporate revenues are comprised of 100% of Ballew's business covering Will's hourly rate as well as production and supply costs
- 2 Will's father purchased the building in year 1 for Will to use rent free but retained ownership. Will's father purchased the adjacent building Will was renting in year 7 with the same arrangements
- 3 Equipment is depreciated on a straight line basis with an salvage life at year 10 of \$1,000 since most equipment was at the end of its useful life or outdated



## **RAS CONSULTANTS LIMITED**

**D.K.”Skip” Smith, Baze University**

### **CASE DESCRIPTION**

*Ever wished you had a short one-page mini-case which you could bring to class, pass out, and discuss the same day (perhaps as an example of how best to tackle and benefit from case studies) with your students? Alternatively, are you and/or your students interested in a short one-page mini-case which highlights the importance of pricing and the very substantial impact pricing and pricing policies can have on corporate revenues? If your answer to either of the above questions is “yes,” you (and they) may find interesting this true story of the Head of Administration of RAS Consultants Limited, who doubled the amount of revenue her company had expected to generate from an upcoming event by using an “out of the box” approach to pricing a training seminar RAS has organized. This mini-case can be used with students from level 1 up. While the case could be assigned as homework, it can also be distributed and taught during one 50 minute class period. Experience suggests that students are likely to need a minimum of 15-30 minutes to read, analyze, and then develop a solution for the case.*

### **CASE SYNOPSIS**

*Ms. Bonnie Jones is Head of Administration for RAS Consultants Limited (RCL). Earlier today, her Finance Director requested that Ms. Jones recommend to him a price RCL should charge International Oil Company (IOC) representatives to attend a training session which RCL will be running next month for 10 staff members of the Ministry of Environment. Ms. Jones has already collected information on the incremental costs RCL will incur by adding each additional participant to the seminar; she now needs to decide exactly how she wants to use the information she has collected to generate the recommendation she will make to her Finance Director, regarding the price each IOC representative interested in attending the upcoming seminar should be charged. Discussion of this mini-case will provide students an example of the importance of pricing and the very substantial impact pricing and pricing policies can have on corporate revenues.*

### **THE SITUATION**

Ms. Bonnie Jones, Head of Administration for RAS Consultants Limited (hence, RCL) has had a very busy afternoon. Earlier today, she had been asked by her Finance Director to recommend to him the price that RCL should charge each of the representatives of several International Oil Companies (IOCs) who had expressed an interest in attending a 5 day training session which RCL will be running next month in Birmingham for 10 staff members of the Federal Ministry of Environment. The Finance Director had indicated that:

- 1) Because each IOC would cover the transportation and accommodation and feeding expenses for each of their representatives, the recommendation which he was requesting would be limited to the tuition (that is, the price) which RCL would charge each representative to attend the training session. In other words, the price recommendation which the Finance Director has requested from Ms. Jones does not include transportation to the seminar, hotel accommodation during the seminar, or feeding in the morning (that is, breakfast) or the evening (that is, dinner).
- 2) He does not believe that RCL will attempt to develop (as an ongoing business) any additional training programs for IOC representatives. For that reason, the Finance Director believes that the objective RCL should use in setting the price for IOC representatives interested in attending the upcoming seminar is: maximize the revenue generated from IOC representatives.
- 3) It would be very useful to him if Ms. Jones could make her pricing recommendation no later than the close of business today.

### **ADDITIONAL INFORMATION**

In response to the request by her Finance Director for a pricing recommendation, Ms. Jones examined her records, to remind herself what the “per delegate” costs of the training session for the Federal Ministry of Environment had been. Her review indicated the following information, activities and costs:

- 1) Based on inquiries she has received so far, Ms. Jones expects that each IOC is likely to send one or two representatives to the training seminar, and that the total number of IOC representatives likely to attend is likely to be about 20 representatives.
- 2) Cost of printed materials which will be supplied to each representative will be approximately \$100.
- 3) “Per person, per day” cost which the hotel staging the training session will charge, each day, for each attendee, is \$75; this amount covers the use of the room where the training seminar is being held plus things like morning coffee, tea, and pastries; a meal at lunchtime; and coffee, tea, and soft drinks during the afternoon coffee break.
- 4) The cost of the “successful completion of seminar” certificates which will be presented to each participant at the end of the seminar is \$25 for each certificate.
- 5) The cost (for the entire 5 days of the seminar, including tips) of the van which will be used to transport participants from their hotels to and from the seminar venue is approximately \$2000.

### **THE CHALLENGE**

Please assume you are Ms. Jones. Please make your recommendation, regarding the price RCL should charge each IOC representative, to attend the 5 day training seminar being staged by RCL next month in Birmingham.

# **DIXIE ELECTRONICS AND INDIA: A MATCH MADE IN HEAVEN?**

**Narayan R. Sithemsetti, Jacksonville State University**  
**Patricia C. Borstorff, Jacksonville State University**

## **CASE DESCRIPTION**

*The primary subject matter of this case is analyzing international markets as possible export or manufacturing locations. This case focuses on a company investigating India as a possible expansion location. The medium sized Alabama Company should consider conducting a market assessment and analysis of India as a potential location to manufacture and export. Secondary issues include environmental scanning, to include cultural, political, legal, financial, and economic issues. The BRICS nations of Brazil, Russia, India, China and South Africa are often considered as great locations by multinational firms although there are substantive issues to consider. The difficulty level is four and five and is suitable for a senior or graduate level international business course. It can be taught in a 90 minute class with two hours of student preparation outside of class. This case could be used with an international trade and foreign investment chapter in International Business, an export chapter in International Management, or an international culture chapter in International Marketing.*

## **CASE SYNOPSIS**

*Companies are stepping up their efforts to be present in foreign markets. This case centers upon the decision whether to engage in international business. The company must decide if increasing exports and/or manufacturing overseas would be a part of their strategy. If so, they must choose the location and the form of the venture. The vice president of marketing has suggested that Dixie's future success lies in India. However, the company is small and located in a small southern town. The owners and management team are reluctant to enter such an uncertain environment. What they have heard about India is heavy government regulations, oppressive taxation, rampant corruption, deadly terrorism, and massive, unchecked population growth. However, one of the managers mentioned that India's government, in its pursuit to match or surpass China's meteoric rise as a world economic powerhouse, has reinvented itself. None of them have any international experience and, quite frankly, they do not know where to start.*

## **BACKGROUND**

More companies are looking at international markets as the recession has lingered in the US, reducing demand for their products. This has led to many internationally inexperienced companies making plans to expand. A wise firm conducts a market assessment, including an

analysis of the economic, political, legal, cultural and financial state of a potential location. The international business environment has features that are not found domestically. A company must be concerned about many new areas such as receptiveness of the foreign country, repatriation of profits, per capita income, and currency fluctuations in the country where it wishes to export or manufacture. Other areas of concern would be the level of safety and corruption at the new location. The legal and political environment must be evaluated also. This would include the political system in operation, political risk, political instability, and laws and regulations.

### **DIXIE ELECTRONICS, THE COMPANY**

Located in Northwest Alabama, Dixie Electronics is a manufacturer of small electrical appliances, such as rice cookers, toaster ovens, cans openers, mixers, and blenders and large appliances such as microwave and convection ovens and stoves. Dixie assembles these products in its Hamilton AL facility, using a number of foreign suppliers for component parts. Virtually all products are assembled with parts from Japan, Taiwan, Korea, and China. The three owners have a combined 80 years of manufacturing knowledge and skill. Their factory is equipped with new and modern machinery.

All of Dixie's production occurs in the Hamilton facility, and the company employs over 450 people. Although labor cost might be lower elsewhere, Dixie has never considered moving its production operations out of the country until the recent recession, housing debacle, and looming health care crisis. Wages and benefit costs have been moderate but the owners are uncertain how the new healthcare legislation will affect them. The work force is productive; however, with the reduced demand for their product, Dixie is considering all opportunities to reduce costs and remain in business. Dixie wonders if some product changes and increased international marketing efforts would help sell more products. Dixie has suffered from a flat US market for their products during the recent recession. Layoffs appear to be imminent and the possibility of reducing benefits looms large.

### **DIXIE'S DILEMMA**

Dixie Electronics has found itself at a crossroads with some hard decisions to make. Dixie's mission statement is: Our commitment is to make the best appliances possible, make them affordable, and make them in America. However, recently, the owners of Dixie have been discussing the possibility of expanding internationally. Some of the governing board at Dixie is concerned about venturing outside their comfort base. Also, they are on record stating that they will only make their appliances in America. Yet, Dixie has to increase profits and be competitive with others, which are core reasons why firms go abroad. The flat market demand for their product has continued over three years. So the international market has more attraction today than ever.

Rob Rodiek, the vice president of marketing, has often mentioned to the president, Mark Stewart, that their appliances would be successful in international markets. In fact, just today, Rob brought up the topic once again at their strategic planning meeting.

Mark asks, “Rob, who’s going to help us do this and where would we manufacture and sell our appliances? The world’s a big place. I have heard of BRICS (Brazil, Russia, India, China, and South Africa) countries as being the hot places to make money. I tell you what: I wouldn’t manufacture in Russia. I know nothing about South Africa except Nelson Mandela. And I read that China has had some rocky economic times recently so I don’t want to go there. That leaves Brazil and India. Do either have a middle class with disposable income so they could buy our products? We have to sell, sell, sell or risk going out of business!”

Rob promises to put some numbers together for Mark. Rob is convinced that India is the perfect location. Rob just finished his MBA degree and heard how progressive India is today and the incentives they offer a company willing to relocate there. Also Rob knows that India had a middle class of 600 million which was almost twice the entire population of the US. As Rob leaves the meeting, he realizes that the task ahead is a big one. Dixie faces a borderless world but his co-workers are tied to their own small town. Rob ponders if they do not think internationally, they could go out of business.

Back at the plant, Rob tells Nate Arlington, the distribution manager, about the possibilities of going international. Nate informs Rob that they have a toe in the market already. Some of their sales personnel met agents from India at sales and trade shows. Dixie sent a few of their most popular appliances, for example, the rice cooker, to their new friends in India. Nate says that exporting can start accidentally. Rob is surprised at what he has heard and he is interested in hearing more from Nate.

Nate mentioned that the U.S. is behind most other developed countries in exporting and that small businesses in the U.S. lag those in other countries. Nate related that some ways to begin exporting include sales personnel indirectly exporting by selling to others engaged in international trade. That was the beginning for Dixie. Nate had used the Internet to answer some questions about India after the rice cookers started going out the door. Nate mentioned to Rob that India was the 9<sup>th</sup> largest economy in the world by nominal GDP, 3<sup>rd</sup> largest by purchasing power parity (PPP), and 2<sup>nd</sup> largest in population (1.2 billion). The gross domestic product (GDP) real growth rate is 10.4% (2010) and GDP/capita is \$3703 PPP, making it a lower-middle income economy. “Just think, Rob, India has a massive population and a lot of disposable income to buy electrical products if we decided to export or manufacture there. Maybe this is the solution to a big, big problem.” Nate just wouldn’t stop as he had wanted to tell everybody what he had found but was afraid to verbalize it earlier. “The population speaks English so that would be a big help to us.” Rob was stunned as he thought he was the only one ‘thinking international.’

Nate continued that Dixie’s exporting experiences have been sporadic. He warned that indirect exporting involved no learning and no control. “Listen, instead of this haphazard approach, maybe we should get our management staff and owners together and develop a market analysis. “If Dixie wants to sell products outside the U.S., the big question is where”, Rob says. Rob answers his own question, “I think India is where it’s at!”

“Great, but how do we conduct a market analysis?” Nate replies.

Rob explains that a market screening will give direction and that it is perfect for a company like Dixie. First they need to conduct an initial screening. One way to do this is by looking at whether or not a particular product is even being sold in a market. From earlier reports by salespeople, the electric mixers and slow cookers sell well across cultural lines

without needing much in the way of adjustments. Looking more closely, they found that India is the seventeenth largest exporter and eleventh largest importer in the world. Economic growth rates are projected at around 8.0 - 8.5% for the financial year 2012-2013. Exports are \$226 billion to countries such as the U.S., UAE, China, and the Hong Kong. Imports are \$358 billion (2010) from China, UAE, Saudi Arabia, U.S., and Australia. The largest exports in 2011 were engineering goods, followed by petroleum products, chemicals, agriculture products and textiles. India imported in 2010 US\$359 billion with the country's key imports being crude oil, electronic goods, machinery and gold and precious stones.

Rob sees all this as great news. There is a robust economy, India trades vigorously with the U.S., and one of the major imports is electronic goods. Maybe India is shaping up to be the solution for Dixie.

But, more information is needed. One quick way to get a feel for the U.S. export market for appliances (or most any product) is by checking with the International Trade Administration ([www.ita.doc.gov](http://www.ita.doc.gov)). By doing so, Dixie can find out if small and/or larger appliances are being exported from the U.S. and if so, where they are going. This information can be checked by using the Export Harmonized System Code. "I'm impressed. These HS code figures show some interesting stuff. What's next?" Nate remarks.

Troy McDonald, vice president of logistics for Dixie, overheard the excited conversation at the water cooler about India and trade. Troy was excited as he had been communicating with an old college friend who recently took a job at the Noritake production facility in Kentucky. Troy's friend told him that Noritake has invested in manufacturing in India and is making a 'great deal of money'. His company found several companies to partner with in India, and is now producing several products not only for the international market but also for the local Indian market. The local market was a surprise as none of them knew India had a middle class of 600 million with a lot of disposable income. After further discussion with Rob and Nate, Troy decided to tell Mark, the president, about Noritake in Kentucky. Troy decided to call his friend and get specifics about the costs and profit potential of doing business in India.

As Troy left, Rob said, "Now, we need to look at financial and economic forces, followed by socio-cultural, and political and legal forces. Finally, we probably need to personally visit markets that look good after the previous screenings". "Where do we get all this info?" Nate comments. "Well, one way is back to the web. Do another Goggle search by "country information" and see what comes up. There's some good stuff at the CIA World Fact Book ([www.cia.gov/cia/publications/factbook](http://www.cia.gov/cia/publications/factbook)), the IMF ([www.imf.org/external/country](http://www.imf.org/external/country)), and Country Reports ([www.countryreports.org](http://www.countryreports.org))," Rob comments.

Rob adds that the next issue is to determine how we are going to enter the market.

Nate responds, "What do you mean?" "Well, we're doing a little indirect exporting now. Maybe we should do some direct exporting with no middleperson. Or, we could set up a foreign sales company in a potential market to support are sales and marketing efforts for a country. We could go another way entirely with foreign manufacturing. If we did that there would be even more alternatives: a wholly owned subsidiary, liaison or branch office operations, joint venture, licensing agreement, franchising, or contract manufacturing", Rob says. "Well, the boss is pretty set on keeping the manufacturing in the U.S. Manufacturing in the U.S. is written into our mission statement," Nate remarks. "Good point, but if we find that the case for foreign

manufacturing is strong enough, we should at least pass the information of to the boss,” Rob says.

As they are busy dreaming about Dixie in India, Mark, the boss, comes in and tells them what he has found. “Hold your horses, boys! I looked at problems: poverty, inflation, corruption, and terrorism. I didn’t like what I found! Look here! The inflation rate is 12%. Eighty percent of Indians earn less than \$2 per day and every second child is malnourished. The Indian Prime Minister, Mr. Manmohan Singh, acknowledged a recent finding that 47% of all Indian children are malnourished and called it ‘a national shame’. Mark continued, “I have concerns over the impact that corruption has on business. According to Tata Motors, corruption influences license approvals, contract awards, and terms of contractual obligations. Transparency International (TI) in India found that 55% of the people had firsthand experience of paying bribe or peddling influence to get a job done in a public office. TI estimated that truckers driving across state borders paid over \$1 trillion in bribes. That is scary to me.”

Then Mark remembered his concern about terrorism and the protection of his potential workforce. Mark stated, “Terrorism is a concern to international employees. They have seen and read reports about the Mumbai and New Delhi bombings and Islamic terrorism. From what I read, the three major terrorist trouble areas are Communist Terrorism (Maoist version), Islamic Terrorism and the Kashmir Problem. Most of the overseas funded terrorism comes from groups based in Pakistan in particular. But terrorism is terrorism and I don’t ever want my employees in danger.”

Rob agrees with Mark that there are problems. Rob says, “Mark, look at this. India offers us both the opportunity to serve the demands of an increasing Indian market as well as a educated work force with good skill sets. India’s growth has largely been unaffected by the global economic recession in the last three years due mainly to strong domestic consumption. Industrial production has been rising steadily with most economic forecasters expecting its gross domestic product to continue to grow by over 8 percent. I read this in the CIA Fact Book so you know it is right!” Nate spoke up, saying, “The US had a bad recession. We came out of it but many economists are suggesting that the US has serious problems with maybe another recession coming. I think we have to look outside the US to save our company. India didn’t suffer at all from the world’s recession of 2008 so this could be out answer.” Troy joined the group and mentioned that researchers have discovered that global MNCs have enjoyed lesser product costs as a result of their Indian operations as the market is very cost-sensitive. Therefore a successful product offering in India may help drive down the costs of the same product sold globally. This is similar to what General Electric’s innovation model calls "reverse innovation", which involves developing low-cost products for emerging markets use and afterwards bringing them to the U.S. market. “Doesn’t that sound cool?” exclaimed Troy.

### **YOUR ASSIGNMENT**

Dixie is at a turning point. The owners must decide whether to engage in international business and, if so, in what capacity. The students must conduct a market assessment and analysis and then choose a course of action. Also they need to consider which form their

potential business would take in India. There are other questions for you to answer to help Dixie to determine, “Is Dixie and India a match made in Heaven?”

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## **MYSTERIOUS BROKEN CROSS-COUNTRY M&A DEAL: BHARTI AIRTEL - MTN**

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### **CASE DESCRIPTION**

*This management case is designed to explicit the implied connection between business environment, competitive & industry forces, business strategy and negotiations. In a nutshell, it imparts the domain knowledge of inorganic strategies, like joint ventures, mergers and acquisitions (M&A), in order to keep their global presence and brand loyalty in the emerging markets. Lastly, Bharti Airtel – MTN cross-country M&A case helps students to get involve in international investment decisions in the perspective of international business environment. They also come to know various sensitive issues while finalizing the deal between two unknown parties, further how deal got complicated consequently caused the deal failure in the two negotiations during two successive years.*

- *Domain knowledge: Business Policy and Strategy*
- *Elective of the case: Inorganic Opportunities*
- *Focus part: Cross-border Mergers & Acquisitions*
- *For whom: BBA; MBA (Full-time and Executive); MDP's*
- *Estimated time for discussion: 120 minutes*
- *Method of lecture: Brainstorming; Group/Team participation*

### **CASE SYNOPSIS**

*To meet the international business commitments and prepare students to craft combat strategies for achieving translational entity's objectives, the present case aims to illustrate the effect of global business environmental factors while negotiating cross-country M&A deals. It has been assisted by India – South Africa, a cross-border telecom deal. Further, it discusses key issues which have led to delay' consequently broken the inorganic negotiations that lead to strategic competitive and geographical advantage. In particular, this case builds a platform for management scholars to improve communication tactics whilst engaging in international business relationships. Conversely, it would be addressing sensitive issues in chronological*

order that how long-term negotiations would lead to collapse the cross-border relations. Exclusively, broken M&A deals help to find key failure negotiations which could be assist for choosing inorganic opportunities in future.

We now know that the “World is flat” and “Knowledge is borderless”. As such, economic changes are bound to be rapid. Complexity and disparity are possible major factors worrying world leaders and global institutions. Indian economy, today a competitive, deregulated and open economic system, is one of the major destinations for foreign investors in the world. India encourages foreign affiliates to establish operations in the country through direct investment, joint ventures, M&A and outsourcing contracts.

The objective of present case is to describe and track critical factors behind the failure of mega cross-border deal between Bharti Airtel (India) and MTN Group (South Africa) in the global telecom industry. The case covers failure of advisors role-play and how negotiations were extended and leads to calling-off deal in the second innings - 2009 after it was first attempt in 2008. It also covers the role of government and regulatory bodies of the respective countries. The alliance would have improved Bharti’s competitive position as a leading telecom company in the emerging markets. Bharti and MTN needed an excessive inward focus for a feasible merger, when competitors were trying to snatch their business.

The history of mega mergers and acquisitions attest that most combinations end up by destroying shareholders value. Mergers fail largely because of expected synergies seize longer time to deliver, price is too high, or there is no complete in-charge. Bharti and MTN could have US\$20 billion in revenues and over 200 million customers, making them the third biggest telecom company in the world after China Mobile and Vodafone. They would have spanned two continentals & able to cut costs by integrating technology and reducing overheads. After twofold negotiation talks in the two consecutive years, the deal has been broken and windup with some precautionary signals while choosing cross-border M&A by Indian entrepreneurs and other community world.

## INTRODUCTION

*"There are two kinds of people in the world, the givers and the takers. A marriage between two givers can be a beautiful thing. Friction is the order of the day, however, for a giver and a taker. But two takers can claw each other to pieces within a period of six weeks. In short, selfishness will devastate a marriage every time."*

... James C. Dobson

Mr. Sunil Mittal dream to take Bharti beyond India’s border in a big way was again put on hold. This was his second attempt to merge Airtel with South African giant MTN. Hence, the merger talks were called-off again due to dual listing proposal and demand of national identity for MTN by South African Govt. (Economic Times, Sept 16, 2009; Wall Street Journal [online], Sept 28, 2009). Thus, the deal collapsed because of African government has not approved. This was a multibillion dollar opportunity lost by investment bankers who would have earned nearly US\$48 million fee, if the proposed deal could have materialized. Investment bankers/advisory firms generally charge 0.5% – 2.0% of deal amount as M&A advisory fee.

However, every case is unique as long as fundamentals make sense, in few cases even large transactions are likely to get completed. Since, the deal was one of the largest unsuccessful transactions in the M&A history. But, it is one kind of situation and does not question the outbound merger story of corporate India and sentiment wise also is not going to affect the emerging entrepreneurs. Bharti has not worried about hurdle factors and kept expanding in international geography. After the collapse of Bharti Airtel – MTN deal in two years of successive negotiations, Bharti entered one of the few remaining large growth markets by acquiring 70% stake in Bangladesh based Warid Telecom for US\$300 million (Bloomberg Businessweek, Jan 12, 2010). It was the first Indian company investing in Bangladesh in terms of investment amount. Warid Telecom offers mobile services across 64 districts and has total subscriber base 2.9 million. Subsequently, on March 30, 2010 Bharti acquired Kuwait-based Zain Telecom operations in 15 countries excluding Sudan and Morocco for US\$10.7 billion (Times of India, Jun 8, 2010). This acquisition, besides giving Bharti's desired presence in Africa, makes the world's fifth largest wireless company, operates across 18 nations with subscriber base over 179 million.

## COMPANY PROFILE

### **BHARTI AIRTEL (INDIA)**

Bharti Airtel is one of the Asia's leading integrated telecom service providers with operations in India, Sri Lanka, Bangladesh and Africa region. Bharti Airtel, formerly known as Bharti Tele Ventures Ltd, is the pioneer and flagship cellular service provider in India with more than 118 million subscribers (Nov, 2009). It is the world's third largest single country mobile operator and sixth largest integrated telecom operator. Since, it is the first private telecom service provider in India operating in all 23 telecom circles. Mr. Sunil Bharti Mittal, Chairman and Managing Director (CMD) of Bharti Group, started his career at 18 after his graduation from Punjab University, India and founded Bharti with a modest capital in the business of distributing cycles and cycle products in 1975.

In 1992, Department of Telecom (DoT) permitted private telecom operators to provide telecom services in India. Thereafter, Bharti Airtel was founded in 1995 to offer a wide range of products in the telecom market. At 51, he heads a successful enterprise among the top five in India with a market capitalization US\$25 billion and employs over 30000 people. He has been honored with one of the India's prestigious civilian award "Padma Bhushan". In 2007, he was the co-chairman of World Economic Forum at Davos and is also a member of its international business council. Mr. Mittal has been awarded Doctor of Laws honoris causa by the University of Leeds, UK, for his contributions to business, arts, government and public life in general. The group operates in four strategic units – Mobile, Telemedia, Enterprise and Digital TV (DTH). It has grown successfully by forming joint venture with AXA International for financial services (Insurance business), with Wal-Mart for retail operations and Del Monte for agribusiness. Its subsidiary company Beetel Teletech is India's largest manufacturer and exporter of telephone terminals. Exclusively, it has submarine cable landing station at Chennai and Mumbai that

connects two submarine cable systems. Bharti Airtel has market share 22.3% in wireless services market in India followed by Reliance 17.7% and Vodafone Essar 17.4% for the year 2009.

In 2008, Airtel entered Sri Lanka under the brand name AirLanka, subsequently Bangladesh and African market in 2010. In India, average revenue per user (ARPU) for cellular services has plummeted to Rs. 278 in 2009 from Rs. 350 in 2008. Interestingly, Airtel generates 83% of revenue from GSM services. The employee base decreased by 9% from 26144 to 23789 in 2009, therefore it improved number of customers per employee by 61%. While expanding its mobile operations outside the country, Bharti is looking to acquire full/partial control in public sector companies especially in Africa and other developing countries like Nigeria through disinvestment process.

### **MTN GROUP (SOUTH AFRICA)**

MTN Group Limited is a leading provider of communication services offering cellular network access & business solutions and also listed on Johannesburg Stock Exchange (JSE). Earlier, MTN was concentrating on core business, namely Utilities later diversified into telecommunications in the year 1994. MTN operates in three regions, South Africa & East Africa (6 countries), West Africa & Central Africa (9 countries) and Middle East & North Africa (6 countries), further having a record subscriber base over 110 million in 21 countries. The group's principal activity is providing communication services such as cellular network access and business solutions. In addition to this, it provides services relating to data management and solutions, mobile banking, telemetry, corporate solutions and blackberry solutions.

MTN offers a variety of unique services include MTN Blackberry, MTN International roaming, MTN Banking, MTN EVD, MTN MobileTV, MTN Mezu, MTN CallerTunez and MTN Zone. In May 2009, MTN valued at US\$27 billion with market capitalization US\$39.2 billion and average revenue per user (ARPU) was US\$13. Alpine Trust, a constituent of MTN management and a private family was the single largest shareholder owns 23% stake in MTN. Particularly, South African government owned The Public Investment Corporation with 13.5% stake and M1 group with 10.2% stake were initially eager on the proposed merger with Bharti Airtel. The company's earnings before interest, taxes, depreciation and amortization (EBITDA) to sales were 42.2%. Amusingly, 99% of MTN subscribers are pre-paid customers as a result there is very limited possibility of bad-debts. Specifically, MTN delivers 3G services in all operating countries and reported the revenues US\$12 billion for 2008-09.

### **REVIEW: INDUSTRY AND M&A**

World telecom industry is an uprising trade proceeding to achieve two third of world's telecom connections by 2015. The leading telecom companies AT&T, Vodafone, Verizon, SBC, Bell South, and Qwest are trying to take the advantage of this growing trend. Mostly, these companies are working on broadband technologies, enhanced data rates for global evolution (EDGE), inter networking, optical networking, voice over internet protocol (VOIP) and wireless data services, etc. However, the government monopoly is being privatized and consequently competition mounted in domestic and small as well as big business markets.

China Mobile has 11.5% global market share and operates in China and Hong Kong, conversely subscriber base has 479 million. Vodafone group reached second position with subscriber base 247 million spread over 19 markets. In the developing segment, African telecom market is estimated to grow by 40%. On the other hand, India is the largest democratic country and one of the fastest growing economies in the world. Initially, Indian government signed a contract with France based Alacatel CIT to merge Indian telecom company (ITI) for setting up 0.5 million telephone lines per year. Further, policies were reformed and designed New Telecom Policy in 1994. Due to globalization and liberalization, Indian cellular firms are choosing M&A to expand operations throughout the world.

Now, there are strong private operators Bharti Airtel, Reliance Communications, Vodafone Essar (Hutch), Idea Cellular, Tata Teleservices and Uninor along with government owned BSNL and Mahanagar Telephone Nigam Ltd (MTNL). Indian Telecom industry reported 543.2 million subscribers and growing at double digit growth rate. It is third largest Tele network and second largest for Wireless connections in the world. In India, Bharti Airtel is the leading telecom player has subscriber base 116 million, followed by Reliance 90 million, Vodafone 88 million, BSNL 60 million, Idea 55 million, Tata Tele 53.9 million, Aircel, MTNL, Loop Mobile, MTS, HFCL Infotel and Uninor are the other operators.

In 2008, Indian wireless market added 113.26 million new mobile connections which is the highest in world and witnessed 50% growth rate ([workosaur.com], Mar, 2009). Government of India has been taken many proactive initiatives, include 100% FDI through automatic route, ceiling raised from 49% to 74% and mobile number portability, etc. to facilitate rapid growth in the telecom market. According to Telecom Regulatory Authority of India (TRAI) report-2009, Bharti Airtel is the telecom giant with market share 22.3% and other operators share presented in Figure 1.

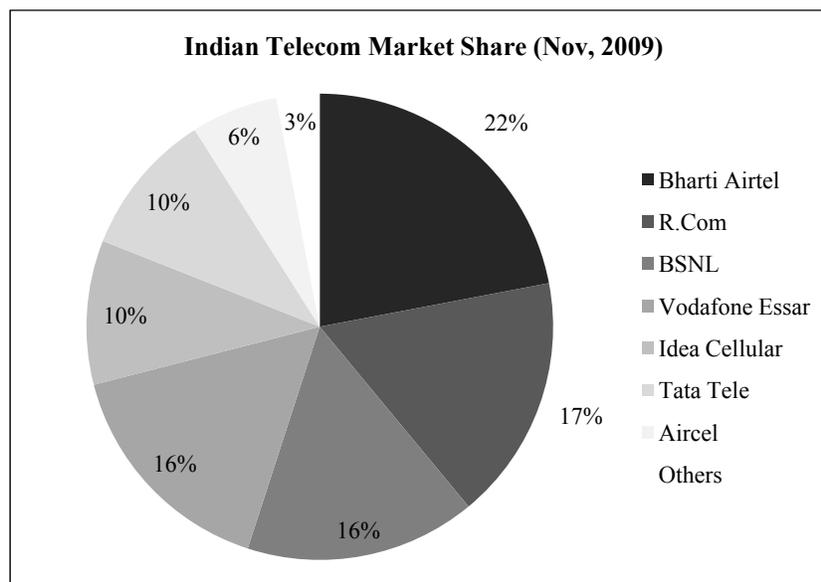


Figure 1: Indian Telecom market share, (Source: TRAI)

Indian M&A market crossed little over US\$10 billion by 267 deals for the period Jan-Dec 2009, comprised 142 domestic deals (US\$6 billion) and 125 cross-border deals (US\$4 billion) which include both inbound and outbound investments in India (Times of India, Dec 19, 2009). Miserably, deal value has been declined by 67.74% in 2009 compare to US\$31 billion in 2008. Further, number of deals also slumped by 39.2% in 2009 compare to 454 deals in 2008. Particularly, the sectors garnering high investment during Sept – Oct, 2008 in M&A are Telecom 3 deals amounted US\$2.27 billion and Pharmacy, Health Care & Biotech 9 deals amounted US\$1.76 billion. On the other hand, IT & ITES and Pharma, Health Care & Biotech sectors have 12 and 9 deals respectively (Grand Thornton, 2008).

<i>Decision Point I</i>
<ul style="list-style-type: none"> <li>♣ <i>Indian government allowed 100% FDI through automatic route, ceiling raised from 49% to 74% and mobile number portability... all these were going to compose the market more competitive - What is your understanding about telecom industry in India? Was the market stagnated or growing compares to other emerging economies.</i></li> <li>♣ <i>Bharti Airtel and MTN decided to create world's third largest telecom company, thus are their profiles really counterpart to create horizontal merger?</i></li> </ul>

### **HOW DEAL GOT COMPLICATED?**

Indian telecom operators were again wooing for MTN, South Africa telecom operator. In 2008, the proposed partnership between Bharti – MTN and Reliance – MTN was failure (Business World, May 29, 2009). In 2009, Bharti and MTN restarted merger talks to create a world class telecom entity in emerging markets (Reuters, May 25, 2009). The potential deal value in which both firms pay cash and stock for acquisition in each other was more than US\$23 billion. If the merger could have gone through, it would be created a company with 200 million subscribers spread across 24 countries in Asia, Africa and Middle East (Business Line, Oct 1, 2009). The deal also would become India's biggest cross-border deals, which was almost twice the size of Tata Steel Ltd acquisition of UK's Corus for nearly US\$13 billion in the year 2007. Hence, the deal has been structured so that both entities buy some stake in each other and consolidating MTN Group accounts with Bharti, thus indicating the preference to gain a control over combined entity. The deal structure has been presented in Box 1.

<i>Box 1: The year 2009 Deal structure</i>
<i>Deal value estimated over US\$23 billion</i>
<i>Bharti would acquire 36% of the current share capital of MTN from MTN shareholders for a consideration comprising ZAR 86 in cash and 0.5 newly-issued Bharti shares in the form of global depository receipts (GDRs) for every MTN share acquired. Each GDR would be equivalent to one share in Bharti and would be listed on the Johannesburg Stock Exchange.</i>
<i>In addition to 36% stake, Bharti will also receive further MTN shares equal to around 25% of the current share capital of MTN in part settlement of the latter's acquisition of around 36% post-transaction economic interest in Bharti Airtel (25% by MTN and 11% by MTN shareholders). This will be a fresh issue of shares for MTN (around 467.3 million shares) and will take Bharti's stake in MTN around 49% post the fresh issue. The balance consideration will be paid out in cash US\$2.9 billion. Thus, Bharti will issue an additional 731.3 million shares over and above the shares issued through GDR, which will result in MTN Group. Lastly, MTN shareholders are getting 36% stake in Bharti Airtel.</i>
<i>Source: Research, Angel Broking, May 2009</i>

Consequently, Bharti would have substantial participatory and governance rights in MTN Group, thus enabling to consolidate the accounts of MTN. The two companies will not overlap in each other's business operations, therefore Bharti will be a primary vehicle for post Bharti-MTN to pursue further expansion in India and Asia, while MTN shall be a primary vehicle for post Bharti-MTN to pursue further expansion in Africa and Middle East. However, MTN economic interest in Bharti could be equity accounted and would have appropriate representation on Bharti board (Media Statement [Bharti.com], May 25, 2009; The Hindu, May 26, 2009). The potential transaction between Bharti and MTN could combine the strengths of two leading emerging market telecom operators to create a telecom power house and serve the large population in Africa, Asia and Middle East.

First, they were engaged on May 6, 2008 to create multi-nationalized horizontal merger (Business Line, Oct 1, 2009). Later, two companies decided to call-off talks on May 25, 2008 because of who would control the merged entity. Thereafter, India's second biggest telecom operator Reliance entered negotiations with MTN on May 27, 2008. Similarly, Reliance and MTN discussions have also broken on July 19, 2008. In the voyage of 75 days, MTN could not make any successful talks with neither Bharti nor Reliance.

*Decision Point II*

- ♣ *In the journey of 75 days, MTN could not make any successful talks with neither Bharti nor Reliance... If, corporate control is a key factor to the failure of first innings talks in 2008, what was the reason behind negotiating immediately with Reliance? Does reputation is the issue of MTN group? (or) Anyhow, they want to enter in the Indian premises and making business relationships?*
- ♣ *If you are a key decision maker in the merger negotiation process, what is your role play as a MTN board member and your instant action?*

After one year, MTN and Bharti were reengaged in merger talks on May 26, 2009 (Financial Times, Sept 16, 2009). Both companies agreed to discuss potential transaction exclusively with one another until July 31, 2009. To avoid any conflict over control of the merged entity, they were likely to retain their existing management structure and to run operations in their respective regions. Once the merger was complete, Bharti would have become the largest shareholder of MTN (Times of India, Jun 29, 2009). Bharti said that funding the proposed merger was not a major issue. However, Standard Chartered was an advisory to Bharti (see Figure 2) and agreed to underwrite about US\$1 billion which is a mix of short and long term papers. Good sign that Bharti has only US\$629 million net debt for the year ended March, 2009 (Reuters, Jul 3, 2009). It represented net debt to EBITDA 0.25 times, making it easier to obtain more debt. On the other hand, company has US\$1 billion in the form of cash and short term investments. Apart from this, Bharti needed to finance the upcoming 3G auction, consequently it requires cash out-flows nearly US\$3.9 billion. Since May, 2008 Bharti market capitalization declined 5% and MTN fell 32% (Business Line, May 28, 2009).

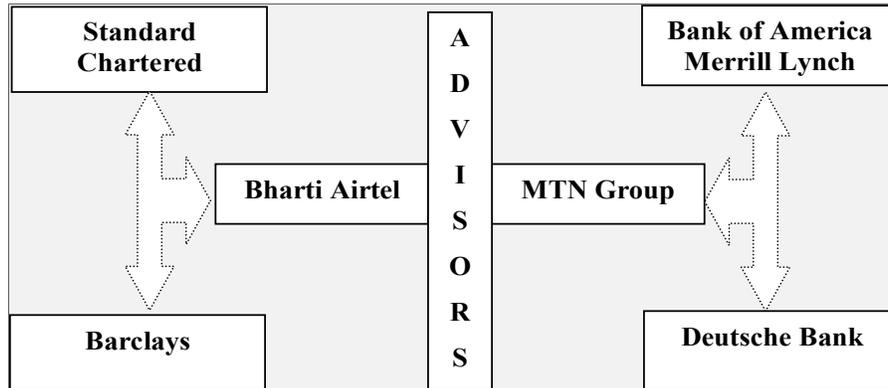


Figure 2: M&A advisors role play  
 (Source: Compiled from Business Line, Times of India and Reuters)

They discussed to synergize operations in key result areas like procurement of telecom equipment, research & development and international network sharing. Leveraging these synergies would have reduced expenses of both companies. On June 29, 2009 Department of Telecom (DoT) expressed not to favor Bharti request to audit accounts for 2007-08 and 2008-09 instead of 2006-07 (Business Standard, Jul 1, 2009). The issue was whether the company pays license fee as per regulatory rates, further DoT also appointed auditors to visit the company.

On July 6, 2009 Securities and Exchange Board of India (SEBI) informally advised Bharti that MTN would be required to make an open offer if it converts Bharti GDR's which they receive in the form of equity shares with voting rights (Business Line, Jul 8, 2009). The Corporate Affairs Minister, addressed the Loksabha on July 30, 2009 that proposed deal has not yet been finalized, if any the applicant has to approach government for necessary approval which will be examined according to applicable policy guidelines on the subject (Economic Times, Jul 30, 2009). Another time, two companies have agreed to extend merger talks till August 31, 2009.

Bharti and MTN had series of meetings with top Indian government officials seeking clarity on the existing laws and how they shall impact on merger (Business Line, Aug 4, 2009). In contrast, minority shareholders of MTN want the deal to be sweet end for them. Once again, they decided to extend negotiations for a possible merger till Sept 30, 2009 (Reuters, Aug 20, 2009). The second time exclusivity period extended from May, 2009 to Aug, 2009. No decision or agreement to acquire any shares or implement the potential transaction outlined by the boards of neither Bharti nor MTN. On Aug 28, 2009 the Securities Appellate Tribunal (SAT) dismissed Bharti shareholders appeal against the informal guidance of SEBI regarding open offer pertaining to the deal. SEBI did not pass any statutory or adjudication order but issued informal guidance. SAT reports that the matter was not a fit-case to appeal before tribunal (Business Standard & Business Line, Aug 29, 2009). On Sept 9, 2009 Bharti said that the merger talks with MTN were still on and no agreement had reached. In the second week of September, 2009 Govt. said that dual listing is not allowed in India (Times of India, Sept 16, 2009).

<i>Decision Point III</i>
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| <ul style="list-style-type: none"> <li>♣ <i>After one year, MTN and Bharti were reengaged... Why they were again in business news, what were second innings talks?</i></li> <li>♣ <i>Does their deal structure complicated or well structure?</i></li> <li>♣ <i>Bharti and MTN had a series of meetings with top Indian government... If they could have followed all regulatory provisions, what was the key legal factor that has made the cross-county deal failure?</i></li> </ul> |
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Finance Minister outreached that Indian government backed on proposed merger of Bharti-MTN and it was looking into legal aspects related to dual listing. He mentioned that the position of Govt. of India was very clear. In Sept, 2009 he met South African Finance Minister on the sidelines of G-20 summit at London and told him that we are in favor of the deal (Business Standard, Sept 27, 2009). As far as dual listing is concerned that is linked with capital account convertibility. If MTN wants voting rights for all the GDRs, then it would have post-acquisition 15% stake in Bharti, therefore MTN shall require to make an open offer for additional 20% stake (see Box 2), which will take its holding up to 35% in Bharti. Finally, MTN and MTN shareholders could acquire 46% (35+11) in Bharti ([livemint.com] & Wall Street Journal, Sept 23, 2009). On the other hand, MTN may have to pay nearly US\$5.11 billion to acquire an additional 10% stake in Bharti, if it has to make an open offer to Indian shareholders.

<i>Box 2: SEBI Takeover Code, 1997</i>
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<p><i>SEBI (Substantial Acquisition of Shares &amp; Takeovers) Regulations 1997 amended and released "Takeover Code". In detail, investor acquires 15% of Indian firm through American depository receipts/Global depository receipts (ADR/GDR) with voting rights needs to make a mandatory public offer for an additional 20%.</i></p>
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On Sept 22, 2009 the companies met Indian government officials for approvals and exemptions. On the same day, Communications & IT Minister said that ministry cannot take a call on the proposed deal, but made it clear that if the transaction needs a change in license conditions, then TRAI would be consulted. The initial announcement and proposed structure were likely to change the demands of minority shareholders that have to be met. Both companies agreed to discuss potential transaction exclusively until Sept 30, 2009. Acquiring ADR/GDR's had exempted from open offer requirements under the takeover code, until the conversion into equity shares. SEBI Chairman said that it was premature to comment on dual listing, because there is no application with concerned department (Business Standard, Sept 22, 2009). But there was request from South Africa government to allow dual listing for MTN and Bharti in both India and South Africa. A special team came from South Africa and met Indian authorities to seek lucidity on dual listing. On Sept 29, 2009 Finance Secretary, said that Indian Govt. (neither RBI nor SEBI) did not receive any formal application from either Bharti or MTN.

Hence, the broken deal will not affect long term growth of Bharti and impair the prospect of new entrants in wireless telephone market. On Oct 1, 2009, Bharti shares surged in reaction to the collapse of company's deal with MTN, thus share price had risen 11.5%, which was a gain by 4% over the previous day (Business Line, Oct 2, 2009). Since the announcement of deal in 2008, Bharti stock underperformed against Bombay Stock Exchange market index – SENSEX by 20% (Business Standard, Oct 5, 2009). Conversely, MTN Group shares on the Johannesburg Securities Exchange too surged by 657 rand (ZAR) because of deal failure. At the end of

anecdote, Chairman & Group CEO of MTN said that ‘you cannot really predict these kinds of things especially in very large deals’.

*Decision Point IV*

- ♣ *Companies met Indian government officials for approvals... What were the acting issues of special team at Indian government ministries? Does South African government have given prior permission on the deal before the team presence in India?*
- ♣ *Deal has broken because of dual listing, why it is not permitted in India? Later deal has been called-off and stock prices of Bharti-MTN started rising in the stock market - Comment*
- ♣ *Does this deal politically and informally complicated? – Synchronize the all related government officials talks...*

### SYMPATHETIC ISSUES

MTN board formerly called-off the deal and the announcement pulled-down MTN shares by 5.5% on JSE before it requests suspension of trade for rest of the day (Economic Times, Oct 1, 2009). Since merger efforts, MTN attempted seven times to participate in acquisition or strategic alliance with global communication majors. The South African Govt. also failed in discussions with Vodafone, China Mobile, Reliance and now Bharti Airtel. In 2008, MTN faced political sensitivities during merger proposal with Reliance (Reliance Insider, Jun 18, 2008).

Finance Minister, Govt. of India, observed that ‘Bharti-MTN deal is a part of Game’ (Business Standard, Oct 1, 2009). This is just the beginning and many other companies can engage for corporate buyouts. Going forward, it would be careful in handling further deals and try not to involve the state participation. If the deal had gone through, Bharti would have been stretched for resources. Growth through mega-mergers often tends to be "an in disciplined pursuit of more" because they are driven by the size illusion. It takes individuals lifetime to make marriage work, likewise mergers take many years to build. And unlike human beings who at least have time on their side, companies work in the viciously competitive world. At the end of deal tragedy, deal become as part of the game, on the other hand CMD of Bharti Airtel mapped the international market in neighboring Bangladesh and acquired Warid Telecom. Further, it also acquired Zain telecom to enter the African market for enhancing growth occasion in the touched dry market. The broken facts of the case shall give few insights to corporate world that what could and how would be negotiate in the international business transactions/deals.

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**APPENDIX**


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**Exhibit 1**


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 Operator wise wireless subscriber base in India - Nov 30, 2009 [million]
 

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	Nov-08	Dec-08	Jan-09	Feb-09	Mar-09	Apr-09	May-09	Jun-09	Jul-09	Aug-09	Sep-09	Oct-09	Nov-09
Bharti Airtel	82.9	85.7	88.4	91.1	93.9	96.7	99.5	102.4	105.2	106	110.5	113.2	116
Reliance	59.6	61.3	66.3	69.6	72.7	74.8	77.2	79.6	82	84.1	86.1	88.2	91
Vodafone	58.8	60.9	63.3	65.9	68.8	71.5	74.1	76.4	78.7	80.1	82.8	85.8	88.6
BSNL	45.3	46.2	47.6	49.2	52.1	53.2	53.6	54.4	56	57.3	58.8	59.4	60.8
Idea	36.5	38	40	41.5	43	44.2	45.5	47.1	48.5	50.1	51.5	53.4	55.9
Tata Tele	31	31.8	32.8	33.9	35.1	35.7	36.5	37.1	39.4	42.8	46.8	50.7	54
Aircel	15.4	16.1	16.8	17.1	18.5	19.6	20.7	21.8	23.1	24.4	25.7	27.7	29.4
Others	6.6	6.9	7.1	7.3	7.6	7.9	8.1	8.5	8.8	9.2	9.5	9.9	10.4
Total	336.1	346.9	362.3	375.7	391.8	403.7	415.2	427.3	441.7	456.7	471.7	488.4	506

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*Source: Telecom Regulatory Authority of India (TRAI)*


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**Exhibit 2**


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**What is Dual Listing?**

Dual listing is a process by which a company would be allowed to list and trade on the stock exchanges in two different countries.

Dual listing system precludes the need for a merger. In the case of two companies operating in different countries entering into an equity alliance, the dual listing system would allow them to retain their separate legal identities and continue to be listed and traded on the stock exchanges.

From the shareholders' perspective, they can buy and sell shares of both the companies on the stock exchanges in two diverse countries. Simply, it is a process that allows a company to be listed on the stock exchanges of two different countries. The company's shares enjoy voting rights, which can be traded on both the bourses.

Dual listing is not allowed in India.

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*Source: Compiled from Times of India, Sept 16, 2009; Financial Express, Sept 20, 2009*


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**Exhibit 3**


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**Success story - Sunil Bharti Mittal, CMD of Bharti group**


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 1992 Consortium with Vivendi to form Bharti Cellular Ltd
 

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Acquired Goa Telecomm to manufacture wireless transmission equipment

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 1995 Consortium with Telecom Italia to bid for cellular and basic services
 

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British Telecom becomes a joint venture partner in Bharti cellular

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 1997 Joint venture with Dura-Line Corporation to manufacture HDPE Silicore ducts
 

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 2000 Acquired majority stake in JT Mobiles Ltd
 

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US\$400 million equity deal with Sing Tel

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 2001 Acquired Spice Telecom operations in Kolkata
 

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Acquired majority stake in SkyCell operations

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 2006 Bharti and Wal-Mart deal to explore retail opportunities
 

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Entered insurance sector in association with AXA group

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 2007 Joint venture with Del Monte Pacific Ltd for agri-products
 

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*Source: Business Line, May 28, 2009*


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## Exhibit 4

## Bharti Airtel and MTN Group – A Comparative Analysis

(in US\$ million)	Bharti Airtel	MTN Group
Revenues (FY2009/CY2008)	7781	12062
Revenues CAGR (2year, %)	41.3	40.9
EBITDA (FY2009/CY2008)	3193	5078
EBITDA margins (FY2009/CY2008, %)	41.0	42.1
Net profit (FY2009/CY2008)	1783	1802
Enterprise value <sup>#</sup>	33894	27887
Market capitalization <sup>#</sup>	32426	26166
Net debt (FY2009/CY2008)	1468	1721
Net debt-equity ratio (FY2009/CY2008)	0.2	0.2
Net debt-EBITDA (FY2009/CY2008)	0.5	0.3
Mobile subscriber base (million) <sup>*</sup>	93.9	98.2
Average revenue per user (ARPU) <sup>**</sup> \$/month	6.8	13.2

Source: Research, Angel Broking (India), May 2009

Note: Rupee-US Dollar conversion rate Rs. 47.5/US\$; South Africa Rand-US Dollar conversion rate ZAR 8.5/US\$; FY – financial year; CY – current year;

# Enterprise value and Market capitalization calculated, based on the respective closing prices on May 22, 2009 for MTN and May 25, 2009 for Bharti Airtel;

\* Mobile subscriber base on March 31, 2009;

\*\*ARPU calculated on the average of March 31, 2008 & 2009 figures for Bharti and on the average of December 31, 2007 & 2008 figures for MTN.

## Exhibit 5

Bharti Airtel + MTN – The combined entity		
	2010E	2011E
Mobile subscriber base (million)	237.6	286.6
Revenues (\$ million)	13011	19415
EBITDA (\$ million)	5202	7733
EBITDA margin (%)	40.0	39.8
Net profit (\$ million)	2693	3723
Existing EPS (Rs)	55.6	64.3
Post-merger EPS (Rs)	44.0	60.2
% of change in EPS	(20.8)	(6.2)

Source: Research, Angel Broking (India), May 2009

Note: E-estimates

## Exhibit 6

Bharti shareholding : Post-merger		
Shareholder	Current %	Post deal %
MTN through GDR	--	25
MTN shareholders through GDR	--	11.3
Mittal family	26.7	17
Sing Tel	30.3	19.3
Vodafone	3.6	2.3
Indian continent investment (Bharti group)	6.6	4.2
FII's	20.7	13.2
Life Insurance Corporation of India	4.2	2.7
Public	7.9	5

*Source: Business Line, May 27, 2009*

## Exhibit 7

Bharti-MTN deal - Snapshot	
May 6, 2008	Bharti-MTN were engaged in discussion for the first time
May 25	The two companies decided to call off talks
May 27	Reliance Communications entered negotiations with MTN
July 19	Reliance and MTN discussions were also broken
May 26, 2009	Bharti and MTN reengaged in merger talks up to July 31
July 30	Both companies extended till Aug 31, 2009
Aug 30	Regulatory hurdles creeping up and talks extended till Sept 30
Sept 24	South African team met Indian authorities to seek clarity on dual listing
Sept 30, 2009	Merger talks called off again

*Source: Business Line, Oct 1, 2009*



# **AFRO-CARIBBEAN CRAFT PRODUCTS: A CASE IN BUDGETING AND FINANCIAL ANALYSIS<sup>1</sup>**

**Anthony R. Bowrin, Saginaw Valley State University**

## **CASE DESCRIPTION**

*The primary subject matter of this case concerns Managerial Accounting. Specific issues examined include classifying costs based on changes in the level of productive activity, estimating cost functions, preparing budgeted financial statements, and computing and interpreting selected financial ratios. The case has a difficulty level of three. The case is designed to be taught in two class hours and is expected to require about six hours of outside preparation by students.*

## **CASE SYNOPSIS**

*Afro-Caribbean Craft Products, a sole proprietorship, which operated on an itinerant basis from the owner's home, was recently offered an attractive opportunity to lease space at an International Airport to establish a retail outlet. The proprietor (Ms. Earla John) estimated that she would need a \$40,000<sup>2</sup> loan to finance the capital and operating costs associated with the proposed retail outlet. Ms. John approached your accounting firm for help with the preparation of a set of projected financial statements requested by a potential financier. She provided a set of historical financial statements for the two most recent years and information about her expectations for the business in the coming year. Students are required to estimate the behavior of all cost items in the income statement and prepare a set of projected financial statements. They are also required to prepare a financial analysis using key ratios and to make a recommendation to the potential financier. This case helps to fill a gap in the pedagogical literature by focusing on the application of basic budgeting principles in a small scale, sole proprietorship setting. The three colleagues that have evaluated the case material all indicated that the specified objectives were effectively targeted in the case material. This case has been used in three sections of the Managerial Accounting course offered in the B.Sc. Accounting program at a medium-sized university in the Midwestern USA. Students were generally able to properly classify most of the income statements items, compute the project income statement, and projected statement of cash flow amounts and to prepare the required financial statements. Most students provided a well-reasoned recommendation regarding whether the loan should be granted to Ms. John. Students generally indicated that the case material was clear and realistic.*

## **INTRODUCTION**

Afro-Caribbean Craft Products (ACCP) was a sole proprietorship owned and managed by Ms. Earla John. The firm was founded in January 2009 and operated from Ms. John's home in

Arima, Trinidad and Tobago. It employed two direct sales representatives who marketed the products to potential customers in specially targeted geographic locations using a web-based catalogue.

Ms. John was recently offered an attractive opportunity to lease space at the Piarco International Airport, Trinidad to establish a retail outlet. The initial term of the lease would have been four years. Following the offer she met with an officer of the National Entrepreneurship Development Company (NEDCO)<sup>3</sup> to discuss the opportunity and seek a \$40,000 loan to finance the capital and operating costs associated with the proposed retail outlet. See Appendix A for details of the costs associated with the proposed retail outlet.

The NEDCO officer was impressed by Ms. John's passion for her business, and the fact that she had operated the business for some time, gaining a good understanding of her potential market and business model. The officer advised Ms. John that she needed to prepare a formal business plan as part of the loan application process. He indicated that the business plan must include historical financial statements for at least two year; a forecasted Income Statements for the upcoming year analyzed into quarters, a forecasted Statement of Cash Flows and a forecasted Balance Sheet for the upcoming year. Also, the officer advised Ms. John that she needed to submit the business plan within three days to ensure that the loan would be processed in time to meet her deadline for responding to officials at the Piarco International Airport. Additionally, the officer informed Ms. John that NEDCO based decisions on loan application on the following four criteria: (1) the ability of the recipient business to generate sufficient income and cash flows to service the requested loan, (2) the background, experience, and expertise of the firm's principals and key management personnel, (3) the financial commitment of the principals to the business, i.e., what they have invested in the business, and (4) the credit history of the borrower. Finally, the NEDCO official indicated that should the loan be approved it would accrue simple interest at a rate of 6% per annum on the outstanding loan balance at the start of each fiscal year, over a four year period. This rate, which is subsidized by the government of Trinidad and Tobago, is significantly below the prime lending rate offered by commercial banks which had ranged between 9.3% and 11.9% in 2009 and 2010. The loan principal would have to be repaid in 48 equal monthly installments.

Ms. John approached your accounting firm for assistance in completing the forecasted financial statements needed for her business plan.

## **BACKGROUND**

Ms. John graduated from the University of the West Indies where she earned an honors degree in Social Sciences. She had 15 years working experience in the corporate sector of Trinidad and Tobago and a good, but limited, credit rating having always paid her bills on time but no previous borrowings.

Ms. John started business as ACCP on January 1, 2009 to supplement her income and fulfill her desire to "help Caribbean women rediscover their ancestral heritage." She operated out of her home and used public transportation to visit potential customers at their homes and workplaces.

ACCP specialized in the sale of afro-centric jewelry and household items. Most of the merchandise inventory was purchased from a few international suppliers. Ms. John employed two sales representatives. One representative was based in Port of Spain, the capital of Trinidad and Tobago, and the other representative was based in San Fernando, the industrial hub of the country. The sales representatives were independent consultants and were responsible for their own taxes, health insurance and other statutory requirements. They were paid a 30% commission based on the invoice amount of each sale. All sales were made either on a cash basis or on a layaway<sup>4</sup> plan. The commission was earned immediately on cash sales while it only became payable to the sales representative on layaway sales when the final deposit was made by the customer.

The business and its products were promoted primarily by a web-based catalogue, the distribution of flyers at business outlets, and by referrals from customers. The catalogue was developed by Ms. John's son as a gift. He also trained Ms. John to maintain the catalogue. The catalogue was updated after each purchase of inventory and as merchandise was sold. Ms. John used a high-speed, wireless internet service to access the website. She paid a flat monthly fee for the service which was shared with her son who used it three times as often as Ms. John.

Sales representatives had access to the web-based catalogue and were provided with selected inventory items on consignment.<sup>5</sup> These items were collected by the sales representatives at Ms. John's home. When a sales representative sold an item that was not in her consignment, she notified Ms. John who packaged the item and arranged for it to be collected by, or delivered to, the sales representative. Each sales representative provided Ms. John with a fortnightly sales report with supporting invoices and receipts. Additionally, Ms. John verified the merchandise inventory held by each sales representative on a monthly basis.

ACCP's operations were conducted primarily on a cash basis. Typically, Ms. John purchased merchandise inventory every 2 months using cash from ACCP's bank account. The average markup was 200% of cost on all items. Ms. John routinely paid household expenses using business funds.

Ms. John arrived at your office with (1) income statements, balance sheets, and cash flow statements for the 2009 and 2010 fiscal years, (see Appendices B, C, and D), along with supporting documents and (2) the following summary of her key assumptions regarding the firm's operations for the 2011 fiscal year.

### **SUMMARY OF KEY ASSUMPTIONS FOR 2011**

1. Sales made by Ms. John and her sales representatives in the traditional business were expected to increase by 25%<sup>6</sup> if the loan was approved and the airport outlet opened and 10%<sup>7</sup> if the loan was not approved and the airport outlet was not opened. Sales from the traditional business were expected to be spread evenly over the four quarters.
2. Sales revenues from the airport outlet were expected to equal that projected for the existing business in 2011 due to the high volume of passengers using the airport and the presence of a dedicated sales presence at a fixed location. All airport sales would have been on a cash basis. (Despite concerns raised by the accounting firm about the reasonableness of these expectations, Ms. John was confident they were achievable given

the high volume of passengers using the airport (over 2.3 million per year) and the quality of her products.)

The following is an analysis of projected sales for the airport outlet by quarter for 2011:

	<i>(% of Annual Sales)</i>
<i>Quarter 1 (January – March) (This is a high traffic period at the airport related to the annual Carnival celebrations. The low percent of 2011 annual sales anticipated in the first quarter is due to potential teething issues related to the start-up of the airport outlet.)</i>	10
<i>Quarter 2 (April – June) (This is usually the lowest traffic period at the airport.)</i>	20
<i>Quarter 3 (July – September) (This is a high traffic period at the airport related to summer vacation travel.)</i>	35
<i>Quarter 4 (October – December) (This is usually a high traffic period at airport due to Christmas traffic.)</i>	35

3. If ACCP had received the loan and opened the airport retail outlet,
  - a. Ms. John would have employed two sales representatives at \$12.00 per hour. This rate included a charge for the employer's mandatory contribution to health insurance and social security for the employees. Each representative was expected to work 160 hours per month.
  - b. Ms. John would have incurred additional monthly rental and electricity cost of \$900 and \$100, respectively.
4. The cash elements of all fixed general and administrative expenses were expected to experience a 5% inflation rate in 2011. (Hint: This includes the fixed component of any mixed cost items and does NOT apply to depreciation expense.) Fixed expenses were expected to accrue evenly over the fiscal year.
5. Depreciation was computed as 34% of the net book value of property, plant and equipment (PPE) at the start of each year. ACCP's policy was to charge a full year's depreciation during the year in which any PPE was acquired and no depreciation during the period in which an asset was disposed.
6. No new capital expenditure, other than that related to the proposed retail outlet, was planned for 2011.
7. Ms. John was expected to reduce her withdrawals of business resources for personal use to \$24,400 in 2011. This substantial reduction was predicated on her son contributing \$1,200 per month toward household expenses and the sub-letting a room to her nephew for \$1,000 per month starting in March 2011.
8. The balances of Office Supplies, Electricity Payable and Unearned Revenues were expected to remain constant at the 2010 levels.
9. Ms. John planned on making more frequent purchases of merchandise to facilitate the increased level of forecasted sales. The ending balance of Merchandise Inventory was expected to be \$15,400 if the loan was received and the retail outlet was opened; and \$6,400 if the loan was not received.

Appendix A ACCP Proposed Use of Loan Funds	
Capital expenditure: Leasehold improvements	\$28,000
Cash register	3,000
Recurrent expenditure: Additional working capital- Inventory	9,000
Total loan requested	\$40,000

Appendix B				
ACCP				
Income Statement				
For the Periods Ended December 31,				
		2009		2010
		\$		\$
<b>Sales<sup>1</sup></b>		82,172		125,284
Less: Cost of Goods Sold		(27,390)		(41,762)
<b>Gross Profit</b>		54,782		83,522
<b>Selling Expenses</b>				
Sales commissions		(17,256)		(23,482)
<b>Administrative Expenses</b>				
Internet services <sup>2</sup>		1,320		1,320
Electricity <sup>2</sup>		620		638
Transportation (travelling)		3,568		4,490
Telephone		1,850		2,690
Rent <sup>2</sup>		10,080		10,080
Stationery and supplies <sup>3</sup>		3,890		4,192
Bank charges		1,286		1,750
Depreciation		5,168		3,411
<b>Total Administrative Expenses</b>		(27,782)		(28,571)
<b>Operating Income</b>		9,744		31,469
<b>Notes to Appendix B:</b>				
<sup>1</sup> In both 2009 and 2010 Ms. John was responsible for approximately 38% of sales.				
<sup>2</sup> Allocated based on the percentage of the service that is used for business purposes. Ms. John actually expects this cost to decline due to fierce competition among service providers.				
<sup>3</sup> Mainly invoices, receipts, packaging materials, and promotional flyers.				

Appendix C						
ACCP						
Comparative Balance Sheets						
As at December 31,						
	2009			2010		
Assets	TT \$	TT \$	TT \$	TT \$	TT \$	TT \$
<b>Current Assets</b>						
Cash		14,200			27,282	
Inventory		4,200			6,400	
Office Supplies		0			640	
<b>Total Current Assets</b>			18,400			34,322
<b>Property, Plant and Equipment</b>						
Office Equipment	12,000			12,000		
Accumulated Depreciation-Office Furniture	(4,080)	7,920		(6,773)	5,227	
Office Furniture	3,200			3,200		
Accumulated Depreciation-Office Furniture	(1,088)	2,112		1,806	1,394	
<b>Total Property, Plant and Equipment (Net)</b>			10,032			6,621
<b>Total Assets</b>			28,432			40,943
<b>Liabilities &amp; Owners' Equity</b>						
<b>Current Liabilities</b>						
Electricity Payable		460			512	
Unearned Revenue		6,248			5,588	
<b>Total Current Liabilities</b>			6,708			6,100
<b>Owners' Equity</b>						
Opening balance		0			21,724	
Investment by Earla John		60,000			30,000	
Add: Operating Income		9,744			31,469	
Less: Drawings		(48,020)	21,724		(48,350)	34,843
<b>Total Liabilities and Owners' Equity</b>			28,432			40,943

Appendix D				
ACCP				
Comparative Statement of Cash Flows				
For the Period Ended December 31,				
	2009		2010	
Cash Flows from Operating Activities	TTS	TTS	TTS	TTS
Operating income	9,744		31,469	
Add: Non-cash expenses - Depreciation	5,168		3,411	
Increase in Current Liabilities	6,708		0	
Less: Increase in Inventory	(4,200)		(2,200)	
Decrease in Current Liabilities	0		(608)	
Increase in Office Supplies	0		(640)	
<b>Net Cash Flows Provided by Operating Activities</b>		17,420		31,432
<b>Cash Flows from Investing Activities</b>				
Purchases of Property, Plant and Equipment	(15,200)		0	
<b>Net Cash Flows Used by Investing Activities</b>		(15,200)		0
<b>Cash Flows from Financing Activities</b>				
Investment by Owner – Earla John	60,000		30,000	
Withdrawal by Owner – Earla John	(48,020)		(48,350)	
<b>Net Cash Provided (Used) by Financing Activities</b>		11,980		(18,350)

## ENDNOTES

- 1 This is a factual case based on a real company and real people. The names of the companies and the key actor have been changed as requested by the owner of the firm.
- 2 All dollar amounts are in Trinidad and Tobago currency (TT\$). The TT\$ has a floating exchange rate that is pegged to the US dollar. It has traded between TT\$6.20 and TT\$6.43 to US\$1.00 during the past 5 years.
- 3 NEDCO is a state owned company which facilitates the successful expansion of small and micro enterprises by providing financing at subsidized rates. Preference is given to firms/individuals that have difficulty accessing the commercial banking sector.
- 4 Layaway, also called lay-by in some countries, involves the customer purchasing an item by making a series of payments over time, rather than paying the entire cost at once. The layaway customer does not receive the item until it is completely paid for. The seller usually sets the item aside in storage until full payment is received from the layaway customer.
- 5 Under this arrangement the sales representative pays only for what he/she is able to sell to customers and the representative returns any unsold goods to Ms. John.
- 6 Ms. John reasoned that the increased exposure of the firm and its products at the airport outlet would redound to the benefit of traditional sales in areas outside the Port of Spain and San Fernando (where most of the firm's existing customers are based). She planned on distributing calling cards and flyers to arriving passengers to facilitate this process.
- 7 The relatively modest increase in sales if the loan is not granted (compared to the 52% increase from 2009 to 2010) was based on Ms. John's realization that the reach of the existing sales representatives was nearing full capacity in their existing locations.



# **CHANGES TO ACCOUNTING FOR INVESTMENTS AND THE EMERGENCE OF PRIVATE COMPANY FINANCIAL REPORTING STANDARDS – ISSUES, CHALLENGES, AND OPPORTUNITIES**

**Marianne L. James, California State University, Los Angeles**

## **CASE DESCRIPTION**

*The primary subject matter of this case concerns proposed financial accounting and reporting changes that will affect virtually all U.S. public and private companies. The case addresses proposed significant changes to the measurement and recognition of investments and the emergence of private company financial reporting standards. Secondary, required financial reporting changes that must be implemented starting with the 2012 reporting periods are also briefly addressed. The main focus of this case is on the technical accounting changes and their likely financial statement effect, as well as short-term and long-term strategic decisions that may substantially be influenced by these significant changes.*

*This case has a difficulty level of three to four and can be taught in about 40 minutes. Approximately four hours of outside preparation is necessary for students to fully address the issues, concepts, and suggested assignments. The assignments include both case-specific questions and questions requiring research. This case can be utilized in an intermediate accounting course, but also can be utilized in a graduate level course focusing primarily on the strategic issues. The case may enhance students' technical knowledge and their critical thinking, analytical, research and communication skills.*

## **CASE SYNOPSIS**

*Significant changes to financial accounting and reporting during the next five years will affect nearly all private and public entities. One of the proposed changes that likely will affect most entities involves accounting for investments. As part of their convergence project, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are revising the accounting rules governing the recognition and measurement of investments, while attempting to develop global consistency. In addition, the Blue Ribbon Panel on Standard Setting for Private Companies (BRP) recommended to the Financial Accounting Foundation (FAF) that accounting standards for non-public entities should be developed. While this may enhance the usefulness of financial reporting by private companies, it likely will cause comparability issues between private and public companies, particularly in light of the likely implementation of IFRS by public companies during the next five to seven years. In addition, since many private companies eventually become public and public companies frequently invest in or acquire private entities, it can also affect investment and acquisition strategies, as well as*

*financing decisions. Thus, the two issues – accounting for investments and private company financial reporting – are interrelated.*

*This case addresses technical accounting issues as well as the strategic issues that may affect companies' investment and acquisition strategies. The introduction to the case provides brief background on the topics. The case was developed for an intermediate accounting course, but can also be used in a more advanced course focusing primarily on the strategic issue. The suggested assignments include case-specific as well as research questions. All questions are independent to allow for maximum flexibility; the case can be assigned as a group or as an individual project. Assigning this case may enhance students' critical thinking, research, and communication skills; as well as their technical accounting knowledge.*

## **INTRODUCTION AND BACKGROUND**

Most companies carry investments on their balance sheets. For example, based on information provided by *Accounting Trends and Techniques*, 92% of the 500 entities surveyed annually by the American Institute of CPAs included non-current investments on their 2009 balance sheets (AICPA, 2010). In addition, 35% of the surveyed companies reported current investments in marketable securities on their balance sheets (AICPA, 2010). The most common types of investments involve equity securities, corporate bonds, hybrids, and derivatives. Equity securities, which make up 63% of the surveyed entities' non-current investments (AICPA, 2010) include both publicly traded and privately-held ownership interest in other companies.

The reasons for purchasing investments vary depending on the investors' short-term and long-term objectives and strategies. Some companies view investments as the most effective and profitable method of utilizing excess cash available from successful operations or seasonal business; other companies may be primarily motivated by the desire to realize short-term gains; while other companies may purchase investment in order to accumulate the necessary funds needed for long-term projects. For some entities, investments provide the means to acquire sufficient ownership in another entity with the goal to influence or even control the decisions of the entity and to benefit from their operations. Many entities have multiple investment objectives.

Current accounting rules in the U.S. reflect these different motivations and investment objectives. Under current Generally Accepted Accounting Standards (GAAP), many investments must be measured and reported at fair market value, depending primarily on the type of financial assets and the company's investment objectives. Investments that provide the investor with significant influence over the investee's operations and strategic decisions must be measured and reported using the equity method of accounting, while controlling interest in another entity typically requires consolidation of the financial statements.

With the advent of very complex financial instruments, and the complexity of current accounting rules, the FASB and the IASB have undertaken an extensive joint project to revise accounting and reporting for all financial assets. As part of their efforts, in 2010, FASB issued a proposed accounting standards update (FASB, 2010) that would substantially change accounting for investments for many entities and likely affect companies' income and financial position. Since issuing their proposed accounting standards update (also referred to as exposure draft) and

after considering the 2,814 letters received during the comment period, FASB has reached some additional tentative decisions. New requirements under the exposure draft and additional decisions reached to date are incorporated in this case.

While changes to accounting for investments (and other financial assets) will affect the financial statements of many entities, even more pervasive changes are still on the horizon. These changes will affect both public and private companies and financial statement users, and may affect entities' investing, acquisition, and financing strategies.

For some time, non-public companies, many of which prepare financial statements consistent with U.S. GAAP and thus utilize FASB issued standards, and their financial statement users have voiced concern regarding the cost and relevance of preparing reports consistent with U.S. GAAP. This led to the formation of the Private Company Financial Reporting Committee (PCFRC) entrusted with the mission to explore the financial reporting needs of private entities and their financial statement users. Additional momentum for their efforts arose when the Securities and Exchange Commission (SEC) started considering the adoption of IFRS by U.S. public companies. Currently, it appears likely that the SEC will require at least some degree of IFRS implementation by U.S. public companies.

With nearly 130 nations currently accepting or requiring the use of IFRS, multi-national entities are expected to benefit most by an integration of IFRS since they tend to have subsidiaries that are already utilizing IFRS. For these companies, the use of IFRS would significantly simplify their financial reporting process, may make the process more efficient, and could facilitate easier access to global financial markets.

While public multi-national entities likely will achieve financial reporting efficiencies, the potential benefit is much less certain for private companies. Use of IFRS by private companies could place a significant burden on these companies. This has raised concern from private companies, policy makers, accounting groups, and others concerned about financial reporting issues.

In response to concerns about financial reporting by private companies, the American Institute of CPAs (AICPA), the Financial Accounting Foundation (FAF), and the National Association of State Boards of Accountancy (NASBA) sponsored a Blue Ribbon Panel on Standard Setting for Private Companies (BRP). The objective of the panel was to (a) consider the needs of private company financial statement users, (b) consider how accounting standards can meet those needs, and (c) make a recommendation the FAF Board of Trustees (BRP, 2011). During January 2011, the BRP issued its final report and recommendations (BRP, 2011). These recommendations likely will lead to significant changes in financial reporting and significant challenges and opportunities that may affect strategic decisions made by private as well as public companies. It may lead to very substantial financial reporting differences between private and public companies and may also strongly influence investment, acquisition, and other strategic decisions. This case addresses many of these issues, as well as those related to changes in the recognition and measurement of investments.

## FORTSCHRITT COMPANY

Karin Felder is the Chief Financial Officer (CFO) of Fortschritt Company, a successful professional networking company founded in 1996. The company went public in 2010. Initially, the company grew through internal innovation, its services capturing a significant percentage of the industry's market share in the U.S. as well as abroad. After its successful initial public offering (IPO), the company's board of directors voted to pursue further growth by acquiring several competitors during the next five years and authorized management to explore diversification opportunities related to the growing on-line games market.

### FORTSCHRITT'S OVERALL FINANCIAL POSITION

After initial financial difficulties, Fortschritt Company has been quite successful and its revenue and income have increased consistently during the past few years. For the quarter ended June 30, 2011, the company earned net income of \$7.5 million and achieved revenue of \$91 million. The company has accumulated a significant amount of cash and cash equivalents from the proceeds of its IPO and from successful operations. The company invested a significant portion of the IPO proceeds in short-term and long-term investments in equity and debt securities of other entities. In addition, the company recently acquired a significant ownership interest in two start-up companies. More detail about the company's investments is shown below.

### FORTSCHRITT'S INVESTMENTS

Fortschritt Company's most recent financial statement notes show that the company classified 35% of its investments as current and 65% as non-current. Eighty percent of the current investments are classified as "available for sale" (AFS) securities and carried at fair value, the rest is classified as "held to maturity" and reported at amortized cost. About 41% of the company's non-current investments consist of equity shares of public companies and are accounted for under the equity method, about 31% are measured and reported at fair value, and about 28% relate to ownership interest in privately held entities and are recognized at cost. Tables 1 and 2 provide additional information about the company's cash and equivalents and its current and non-current investments.

<b>Table 1</b>	
<b>CASH, CASH EQUIVALENTS, AND SHORT-TERM INVESTMENTS</b>	
<b>In thousands</b>	<b>Quarter ended, 6/30/2011</b>
Cash	\$24,000
Cash equivalents: money market funds, commercial papers and other short-term obligations	\$50,000
Investments in Marketable securities:	
Available for sale (at fair market value):	\$13,800
Held to maturity (at amortized cost)	3,450
Total cash, cash equivalents and short-term investments	\$91,250

<b>Table 2</b>	
<b>NON-CURRENT INVESTMENTS</b>	
<b>In thousands</b>	<b>Quarter ended, 6/30/2011</b>
Available for Sale Securities (at fair market value)	\$10,000
Equity method investments	13,100
Cost method investments	9,000
Total non-current investments	\$32,100

## **FUTURE ACQUISITIONS**

To support its expansion and growth objectives, the company is planning to acquire several privately held start-up companies during the next five years. The company is currently researching potential acquisition targets that are operating in the on-line games industry as well as several of its smaller competitors. The company plans to utilize its significant amount of cash and cash equivalents and cash flows from its expected continuing positive operations to finance the majority of these acquisitions.

## **FINANCIAL REPORTING ISSUES**

On October 12, 2011, Karin Felder prepares for her weekly meeting with the company's Chief Executive Officer (CEO), Robert Meier, and Chief Operating Officer (COO), Marion Kunze, to discuss financial reporting issues as well as the company's short-term and long-term strategic plans that will impact the financial results of the company. Karin, holds active CPA and CMA licenses and is very knowledgeable not only about U.S. GAAP but also IFRS; she is proactive and keeps current on new developments both in terms of global and U.S. financial reporting issues. As a frequent speaker for a continuing professional education program at the state university, she regularly uses her extensive knowledge to help accounting professionals keep informed about current and emerging financial accounting and reporting issues. Her GAAP update and FASB/IASB convergence projects seminars are always well received. She also regularly participates in professional and academic meetings and conferences to exchange ideas with colleagues both in industry and academia.

Karin has been instrumental in preparing her company and its accounting staff for the likely adoption of IFRS. She is very knowledgeable about the FASB/IASB convergence projects, which will change IFRS as well as U.S. GAAP. She is also aware of the movement toward private company financial reporting standards. While she recognizes the advantages of a simpler set of accounting standards for private entities, she is aware of the challenges it can hold for public and private companies. Karin is especially concerned about the potential effects on Fortschritt's future acquisitions and the additional financial reporting issues it may entail for the company when it acquires private entities in the future.

## MEETING AGENDA

Karin plans to provide Robert and Marion with updates of current and future financial reporting issues and discuss the potential effect of accounting changes on the company's strategic plans. The following shows the topics she placed on her informal agenda for the upcoming meeting with the CEO and COO.

### **Karin's Informal Agenda**

1. Financial reporting changes required for the 2012 fiscal year:
  - a. Comprehensive income
  - b. Fair value
2. Proposed changes to accounting for investments:
  - a. Current status of changes in accounting for investments
  - b. Potential impact on Fortschritt Company's financial statements
3. Private company financial reporting
  - a. Current status
  - b. Implications of future acquisitions of privately held entities
4. IFRS readiness update

## KARIN'S MEETING WITH THE CEO AND COO

On October 14, 2011, the company's CEO, COO, and Karin (the CFO) meet to discuss long-term and short-term strategies to achieve the company's long-term growth objectives as well as financial reporting issues that may affect these goals. Before discussing these issues, Karin first provides Marion and Robert with an update on changes that will affect the 2012 and subsequent accounting periods.

First, she explains that consistent with a recently issued accounting standards update (FASB, ASU-2011-05) the option of presenting comprehensive income as part of the changes in stockholders' equity statement has been eliminated. Instead, comprehensive income must be presented either as a combined income-comprehensive income statements, or, alternatively, as a separate statement that details other comprehensive income and also shows the sum of total comprehensive income. This separate statement must be presented immediately following the income statement. Karin favors the one statement approach, which she views as the preferred format and perceives as the long-term financial reporting trend.

The CEO and COO agree with Karin's reporting preference and Karin proceeds to update them on another recently issued FASB standard on fair values (FASB ASC 2011-04). Karin explains that the new standard will not change the items to which fair value is applied, but rather redefines fair value, converges the terminology and measurement of fair value between U.S. GAAP and IFRS, and requires additional disclosures. The new standard also specifies that the "highest and best use" concept of applying fair value is relevant only to non-financial assets. With respect to disclosures, the new standard requires that companies disclose quantitative data regarding fair value measurement inputs and include information about the sensitivity of changes

in these inputs on fair value. Currently, Fortschritt Company's only assets that are measured at fair value are financial assets. In addition, Fortschritt's financial statement notes already include the necessary additional disclosures.

After the brief update on 2012 fiscal year financial reporting changes, the executives discuss proposed major changes that likely will affect Fortschritt Company.

## INVESTMENTS

The CEO is concerned about recent fluctuations in the market value of the company's investments and the effect of these fluctuations on the company's financial position. He has heard that FASB proposed changes in accounting for investments and asks Karin to comment on this issue.

Karin explains that FASB is revising its accounting standards on financial instruments, which likely will require that nearly all of the company's current investments and a significant portion of its non-current investments will have to be measured and recognized at market value with the corresponding market adjustments recognized in income. In addition, since this is part of the FASB/IASB convergence efforts and the IASB already issued similar requirements, even if the company were to implement IFRS, the overall results would be very similar. Since changes in the market value of investments would affect the company's net income, volatile financial markets may cause significant fluctuations in income.

Prior to the meeting, Karin prepared a brief handout that summarizes current applicable GAAP with respect to investment securities, as well as the most significant changes that would affect the company's reporting of its investments.

<b>Table 3 CURRENT CLASSIFICATION AND MEASUREMENT OF MARKETABLE SECURITIES – INVESTMENTS LACKING SIGNIFICANT INFLUENCE</b>		
Initial Classification	Investment Objective	Subsequent Measurement and Recognition
Debt Securities Held to Maturity	Investor entity intends to hold debt security until it matures	Amortized Cost
Available for Sale Securities	Marketable debt or equity securities that are not classified as debt securities held to maturity or trading securities	Fair value, with unrealized gains and losses recognized as part of stockholders equity (accumulated other comprehensive income)
Trading Securities (Fortschritt currently does not have an investment strategy consistent with this classification)	Short-term investments that investor company holds primarily with a short-term gain objective	Fair value, with unrealized gains and losses recognized as part of income
Subsequent changes in categories	If investment objective changes	Changes in categories are permitted. May lead to recognition of gains and losses in income, depending on the specific change.
Sale of investment	De-recognition of investment	All realized gains and losses are recognized in income

After briefly reviewing the current classifications and measurement of the company's investments, Karin shows the CEO and COO how the classification and measurement of the company's current investments, which do not involve significant influence over the investees' operations, would change under the FASB proposed accounting standards update. She shares the following table (table 4) with Marion and Robert.

Initial Classification and Measurement	Requirements	Subsequent Measurement and Recognition
Fair value through net income (FV-NI)	Default category unless specific criteria for other classification are met. All equity securities are measured at FV-NI	Fair value; gains and losses from changes in fair value are recognized in income statement
Fair value through other comprehensive income	Business strategy requirements: At acquisition, cash is invested in order to (1) maximize returns from collection of contractual cash flows or sale of the financial asset, or (2) to manage risks associated with changes in liquidity or interest rates. Assets cannot be held for resale at time of investment.	Fair value; changes in fair value are adjusted through other comprehensive income and recognized in equity. (Initial recognition is at transaction price, rather than fair value)
Subsequent changes in categories	Are not permitted	Not permitted
Sale of investment	De-recognition of investment	All realized gains and losses are recognized in income

Source (FASB, 2011)

After reviewing and discussing the information shown in the tables 3 and 4, Marion and Robert are concerned about the effect of the proposed changes on the company's investments currently classified as "available for sale" and argue that the company may have to consider the potential effect on the company's future income.

Karin agrees that net income may become more volatile in the future if the stock market continues its current year trend, however, she points-out that the trend toward focusing on comprehensive income may mitigate the importance of the effect under the proposed changes. Karin promises to add a column to the tables to include the effect on net income and the balance sheet (statement of financial position) for each (a) the current and (b) the proposed accounting rules governing the measurement and recognition of investments. She will prepare and e-mail expanded tables to Marion and Robert after returning to her office.

Robert mentions that he recently heard that separate standards for private companies may soon be developed. He is aware that for some time, support for separate private company financial accounting standards existed and wants to hear about the current status of this movement as well as Karin's opinion regarding the outcome of this issue. Marion asks whether this could affect Fortschritt Company in any way.

## **PRIVATE COMPANY FINANCIAL REPORTING**

Karin explains that in 2009, the American Institute of CPAs (AICPA), the Financial Accounting Foundation (FAF), and the National Association of State Boards of Accountancy (NASBA) sponsored a Blue Ribbon Panel on Standard Setting for Private Companies (BRP). The BRP was asked (a) to consider the needs of private company financial statement users, (b) to explore how accounting standards can meet those needs, and (c) to make recommendations to the FAF Board of Trustees. Initially, the BRP considered seven models – five of them based on U.S. GAAP (including a new standalone US GAAP for private companies) and two based on IFRS. Early on, the panel eliminated the IFRS models and the new standalone U.S. GAAP for private companies from further consideration. In January 2011, the BRP issued its final report and recommendations (BRP, 2011). In its report, the BRP recommends that U.S. GAAP should be modified and adjusted to better meet the needs of private entity financial statement users. The panel further recommended that immediate action should be taken to tailor U.S. GAAP to those needs.

Karin believes that these recommendations likely will lead to significant changes in financial reporting and cause significant differences between private company and public company financial statements. Robert wonders why the BRP chose not to recommend IFRS for SMEs, which was developed specifically for small and midsize companies, nor the development of a stand-alone set of accounting standards specific for private companies, similar to Canada's approach.

Robert asks whether this ultimately will affect Fortschritt Company, which is no longer a private entity. Karin explains that this may affect Fortschritt's financial reporting if, in the future, it acquires a private company that prepares its financial statements consistent with (different) private company financial reporting standards.

In light of Fortschritt's plans to acquire several private start-up entities during the next five years, Robert asks Karin to prepare a brief list of points that should be considered in planning, assessing, and executing acquisitions of private companies. Karin indicates that she will also include financial reporting issues that may arise during the acquisition and the subsequent consolidation of financial statements. She will have the information ready prior to the next board of directors meeting in two weeks.

At the end of the meeting, Karin indicates that the company is well prepared for the adoption of IFRS, assuming that the SEC decides to mandate some level of adoption. After the meeting is adjourned, Karin returns to her office to prepare expanded tables on investments, as discussed during the meeting. She also prepares some questions and answers on several related issues that may be of interest to the board of directors. She plans to offer a copy of these to Marion and Robert prior to the board of directors meeting.

## **ASSIGNMENTS**

Please answer any questions assigned by your instructor. Include the proper support and references.

## CONCLUSION

Proposed changes to accounting for investments and the advent of specific accountings standards for private entities is likely to affect the majority of public and private entities. The effect will be especially significant for companies that have significant investments in debt and equity securities, companies that are currently private and are planning to become public, and companies that are planning private entity acquisitions. Students should become aware of expected changes, the effect of these changes on the financial statements, and the strategies that executives may use to address the challenges and opportunities that arise. This case addresses a number of issues that may arise and can be utilized in class to introduce and discuss proposed accounting changes and their implications for companies.

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## AUTHOR'S NOTE:

*This case deals with a fictitious company. Any similarities with real companies, individuals, and situations are solely coincidental.*

# **M&D INC. IN THE GOVERNMENTAL SECTOR: A MARKETING CASE**

**Musab M. Ababneh, Morgan State University**  
**Nathan K. Austin, Morgan State University**

## **CASE DESCRIPTION**

*The primary subject matter of this case involves the application of service quality models i.e. 'RATER' and 'Flower of Service' in the evaluation of strategic decision choices in service industries. M&D Inc. is a multifaceted business support services company considering expansion of its diversification efforts to enter a new market. The case has a difficulty level of three or four, appropriate for introducing junior and senior marketing or business administration students to both models. It is designed for a 50-minute class period and is expected to require two hours of pre-class student preparation.*

## **CASE SYNOPSIS**

*M&D Inc. is a multifaceted business services support company focusing on the private sector. Its range of services includes mailroom management, e-commerce development, printing, and marketing. Until recently, Ron Lee was the CEO of the company, but he has had to give up the position as a result of ill-health. Prior to his resignation as CEO, Ron Lee was planning to sign a new service contract with another department of the U. S. federal government. M&D Inc. was successful in servicing its first federal government contract which was much smaller and less demanding. The new contract requires M&D Inc. to hire 250 additional employees who will be required to work extra hours every week with significant cost implications. The incoming CEO, Josh King is skeptical of M&D Inc's capability to service such a large contract, so he meets with Ron Lee to discuss the issue. At the meeting, Ron Lee suggests to Josh King to first fully familiarize himself with the operations of M&D Inc. before making a final decision.*

*NOTE: The case is a fictionalized version of a real-life organizational setting. Names and other identifying information were disguised to protect identities. The applicable fact situation is true to the real case.*

## **INTRODUCTION**

Ron Lee had been the CEO of M&D Inc. for the last 23 years, successfully expanding the business from 17 employees to 437 as of last month. However, even though the company continued growing and remained profitable, its profit and market share had begun to decline in the previous two years. The problem was mainly due to the decline in monetary donations made to M&D's clients, most of whom were relatively small non-profit organizations dependent

almost entirely on donations from the general public. As a result, many of them were spending less and even in some cases, failing to meet their financial obligations.

M&D Inc. was a multi-faceted business support services firm which provided support services directly to its client organizations and in addition served as the customer service and warehousing arm of those client companies. It thus served both the client firm and the customers of those organizations which outsourced their storage facility needs, customer orders' handling services and member subscription tracking requirements due to limited resources. Specifically, M&D Inc. maintained a large warehouse to store and to distribute client inventory and managed Call Centers, Customer Help Desks and Mailrooms for its clients. It also provided e-commerce development, printing, and marketing services.

Mr. Lee had to resign from his position due to some serious medical problems. Prior to his resignation, he was focused on new market development activities to help boost M&D's declining profits and market share. Last year, he successfully signed and managed M&D's first contract with the U.S. federal government. The contract, signed with one of the largest federal departments, required M&D Inc. to set up an onsite mailroom to manage the mail of the department. Responsibilities of the mailroom included X-ray screening of incoming mail, biological and chemical material detection, outbound mail processing, and packaging and tracking of shipments. It further required M&D Inc. to increase its workforce from 200 to 300 employees. This success led Mr. Lee to begin negotiations on a new contract with another federal department. Efforts were far advanced in signing this new contract when Mr. Lee was suddenly taken ill. The new contract would be more challenging as in addition to handling similar mailroom responsibilities, it would require M&D Inc. to serve as the department meetings and events' organizer with responsibilities for design and printing of meetings materials, registration of participants, etc. It was going to require the employment of an additional 250 employees who would have to work extra hours every week, from 7am to 6pm Monday thru Friday and from 12 noon to 5pm every other Saturday. The incoming CEO, Josh King, knowing that M&D Inc. had mainly been targeting small non-profit organizations in the private sector and thus relatively new to servicing governmental establishments, was skeptical of M&D's capacity to successfully handle the project.

### **HOW IT STARTED**

The company's success could be attributed to the vision of its founder, Robert Long who has remained the president of the company. Mr. Long got his first job when he was 16 years old. He worked as a cashier in a small grocery store in Baltimore, Maryland. Believing that he could not satisfy his ambitions by working for someone else, he started his own business after obtaining an associate degree in marketing. What he started was a small mailing and delivery business in his neighborhood. Individuals who were relocating and those needing moving or delivery services, were his main clients. His business grew quickly and he was able to hire a couple of employees within a year. With a "no matter what your need is, we will handle it for you" attitude, Robert was able to achieve considerable growth in subsequent years targeting private companies to service their mailing and distribution needs. M&D Inc. grew from a company which had one employee to one that had more than 50 employees in less than 5 years.

Robert decided to go beyond mailing and distribution services and to offer e-commerce, printing, and marketing services. Offering more services allowed M&D to achieve higher profits and growth in the size of its operations and workforce.

### **OUTGOING AND INCOMING CEOS**

Ron Lee graduated with an MBA from the University of Maryland. After receiving his MBA, he worked as an instructor at a local community college in Baltimore, Maryland for two and a half years. He met his wife Nancy who was also an instructor at the same college. Ron joined M&D as a project manager after he decided to change his career and to look for one in the private sector to improve his family's financial situation. Ron worked hard to rise through the ranks to the position of CEO in 10 years.

Josh King was born in North Carolina, but he moved to Maryland when he was 22 years old to attend Bowie State University where he received a bachelor's degree in information systems and an MBA. Josh has been married to Maria for 11 years. They have two daughters, Suzanne and Ashly, 7 and 4 years old respectively. After receiving his MBA, Josh worked for a large consulting firm in Washington, DC for 5 years before joining a large retail company as a District Manager and later he was promoted to Vice President of Operations. While searching for a better job online, Josh noticed that M&D Inc. was looking for a new CEO. He has since been hired by Robert Long, the founder and President of M&D, as the new CEO.

### **CURRENT OPERATIONS OF M&D INC**

M&D Inc. believed that permanently assigning employees to specific clients would enable such employees to become more familiar with clients' services, products, prices and proper usage of products and services. Therefore, once an organization became a client of M&D Inc., it was assigned a dedicated team headed by a project manager who supervised day-to-day project activities ensuring high quality client service. The company took pride in its client service model which emphasized the importance of pleasing clients, satisfying their needs, and building long-term relations with them. For example, to ensure convenient business transactions, M&D Inc. accepted credit cards, debit cards, PayPal accounts, and checks.

To achieve the desired level of excellence in servicing its clients, M&D Inc. created a dedicated interactive electronic link with almost every client to enable timely response to client requests. All project team members received sufficient training prior to the launch of any project. The training helped team members familiarize themselves with the project requirements including services to be provided and specific policies and procedures. For example, if a client placed an order over the phone and the client service representative had to place him or her on hold, M&D Inc. service policy required that the client service representative specifically asks the client "...may I place you on hold for a moment?" and such hold times must not exceed two minutes. M&D Inc. also believed that if the initial service employee contact with a client was satisfying, then the rest of the job would be much easier to execute. So, all client service employees including project managers had to attend a client loyalty program to enhance their

client service skills. Additionally, project managers were required to attend leadership training programs to improve their managerial skills.

M&D Inc. required all job applicants to provide three verifiable job references, pass a criminal and background check and to have at least three years of relevant work experience before they could be hired. Applicants also needed technical skills such as familiarity with a variety of computer software programs and an ability to type a minimum of 45 WPM. Successful applicants were conditionally hired. They were required to pass a 90-day evaluation to keep their jobs. The phone calls and business emails of all employees were closely monitored and using a standard assessment sheet, employees' professionalism and client service skills were regularly examined. Also, employees' performance was evaluated at the end of each year.

### PRE-TOUR MEETING

After he was hired by the founder and president of the company, Josh met with Mr. Lee, to review the new federal contract being considered. In the meeting, they had the following exchanges:

**Mr. Lee:** *It is true that we were mainly targeting private organizations for many years, but you can't put all of your eggs in one basket. I have been the CEO of this company for 23 years, and I know that our market share in the private sector has been declining and that the governmental sector represents a great opportunity to expand our business and to increase profit. Trust me, I know that we will succeed.*

**Mr. King:** *What makes you confident that we will succeed? I am worried about hiring so many employees and requiring them to work extended hours.*

**Mr. Lee:** *When this company was established 35 years ago, it had one employee, the founder, who had a "no matter what your need is, we will handle it for you" attitude, and I learned that from him. The number of employees increased from 1 to 300 within a few years. We made \$12 million in profit last year alone and now we have more than \$300 million in assets. We have always been successful in the private sector and even our only governmental project seems to be doing well. Also, the CFO has provided me with costs and profit estimates based on a 40-hour work week and they seem to be very promising (Appendix1). He had also indicated to me that if we factor in the overtime expected, our utilities expense will increase by 20 percent each month and our supplies expenditure will go up by 35 percent each month, but at the same time, our revenues will increase by 63 percent. I do, however, understand your concern, and therefore I want you to see the conditions of our company on the ground before you make a decision.*

**Mr. King:** *What do you suggest I should do?*

**Mr. Lee:** *I think you should work with the Department of Education team which is assigned to our current government project in order to familiarize yourself with our handling of governmental projects. Then, you can examine our IT Department's readiness for governmental projects and tour the facility and the warehouse. After that, you can let me know what you think.*

**Mr. King:** *It sounds good. I will be here tomorrow morning and I will let you know what I think after the tour.*

### FAMILIARIZATION TOUR

The next day, Mr. King started his familiarization tour by working with the project team servicing the existing federal contract. After listening in on a few client phone calls which were professionally handled by Chris, a 27-year old Client Service Representative who has been with M&D Inc. for 5 years, an unexpected telephone exchange with an angry client, Ms. Sally Smith ensued as follows:

**Ms. Smith:** *Our one week conference starts today. You assured us that we would have all of our books before the conference begins. We opened the boxes to set up our conference and noticed that the photography books are missing. This is completely unacceptable. Our conference starts in three hours and we need all of our books. I know that neither UPS nor FedEx offers same day delivery service, but you need to figure something out to get our books delivered to us as soon as possible. We cannot have a conference without these books.*

**Chris:** *Ms. Smith, I deeply apologize for the mistake and the trouble the missing books have caused. I definitely understand your situation and the need to have all of the books for your convention. As soon as we hang up, I will personally go to our warehouse to pack the photography books and I will have one of our drivers deliver them to your location, which is two hours away, before the convention starts. In addition, this delivery will be at no cost to you and we will deduct 10% off of your balance for the inconvenience caused.*

**Ms. Smith:** *Provided you do everything you said you will do, this is acceptable and appreciated. Thank you.*

**Chris:** *It is my pleasure Ms. Smith, and one of our drivers will see you in less than two hours.*

Mr. King was very impressed with the way Chris handled the phone call and thereafter had the following conversation with him:

**Mr. King:** *Chris, you did a great job handling the client's phone call. You were very courteous and respectful even though she was so upset and angry.*

**Chris:** *"At M&D Inc., we do appreciate our clients, and we know that without them we have no company". It is our goal to keep them happy because we want them to stay with us. On average, the majority of our clients have been with us for 7 years. Part of this success in retaining clients and building long-term relations with them is attributed to "we are a big family" notion that M&D Inc. believes in.*

**Mr. King:** *What do you mean by "big family", do you mean employees?*

**Chris:** *I mean that M&D considers its clients, vendors, employees, etc. as family members who are connected by bonds which go beyond mere economic exchanges. For*

*example, I know most of our clients by name and they know me. When we invite some clients for a site visit, we make sure that our drivers pick them up from the airport and drop them back when they are done. We also provide them with individual lockers so they can store any valuable assets they may have at the time of the visit. This is done for both prospective as well as existing clients to make sure that they feel welcomed at M&D. Additionally, M&D Inc. asks all employees to greet clients by last name or by saying Sir or Ma'am to them if they don't know their last name.*

Mr. King was delighted, observing that M&D's stated work culture of valuing, respecting, and demonstrating courtesy and genuine feelings for the client was being practically applied by Chris. Mr. King's next point of call was with Linda, the team's project manager.

Linda has recently graduated from college with an associate degree in management. She had three young children (3, 6, and 9 years old). She has been working for M&D Inc. for almost 7 years. She was hired as a Client Service Representative 3 years ago and later promoted to a Project Manager. Promoting from within is a trait M&D Inc. has always strived for to build stronger relations with its employees and to give them an opportunity to advance into managerial positions. Almost 80% of all managers at M&D Inc. were initially hired as client service representatives or warehouse clerks. Mr. King had the following conversation with Linda to get acquainted with M&D's client satisfaction and employee performance evaluation:

**Mr. King:** *I need to know if your project receives too many returned items.*

**Linda:** *You will be surprised to know that my project and the majority of other projects have a very low percentage of returned items. "I would say less than 5%". Our staff members are well trained. They know the products and services well and they can easily help our clients choose the products or services which best fit their needs. So, most items are usually returned due to mis-shipment. I can also tell you that "our double-checking system" which requires two employees to verify clients' orders helps minimize shipping errors. As a result, our refund percentage is also low. We require employees who take clients' orders over the phone to review the order with the client and to disclose the total cost to him/her before ending the phone call.*

**Mr. King:** *Could you give me an example to demonstrate this point further?*

**Linda:** *Sure. I had just processed an order for Mr. Jones Solder. Mr. Solder ordered two accounting books. Once I took his order over the phone, I said to him that each book costs \$15.00 and that his total is \$30.00. I also indicated to him that the cost of shipping and handling is \$7.50 and that his grand total is \$37.50. I then said to him that the full amount will be charged to his Visa credit card ending with 1261 and that the items will be sent to 14836 Baltimore Avenue, Laurel, MD 20707. I asked Mr. Jones to verify the accuracy of the information I provided. Once he confirmed the information, I let him know that he will receive his order via FedEx within 2-3 business days.*

**Mr. King:** *What do you tell those clients who hesitate to provide their personal or financial information over the phone or online?*

**Linda:** *At M&D, we emphasize the importance of confidentiality. As far as I know, all employees have to sign a confidentiality agreement which requires them to protect*

*clients' personal and financial information. Moreover, we never store clients' credit cards information in our computer database. Our staff members are not permitted to repeat credit card numbers to the clients over the phone. If the number needs to be verified, the client repeats it back to us.*

Mr. King then decided to visit the IT Department to find out if M&D Inc. was technologically capable of handling the new project. He began working with Sabrina, the head of the IT Department. Sabrina graduated from University of Delhi in India with a bachelor's degree in computer science. She was initially hired as an assistant to the CIO who decided to leave the company a year later to work for the federal government. Sabrina had performed well at her job and therefore consistent with the M&D Inc policy to promote from within whenever possible, she was promoted to the CIO position. Sabrina began by briefing Mr. King on the computer software programs M&D Inc. used.

**Sabrina:** *See Mr. King, we have THBI software which we started using in my second year as a CIO. We use it to manage clients' products and websites.*

**Mr. King:** *What does it do exactly? Does it store information?*

**Sabrina:** *It stores products and services' descriptions, clients' names, and addresses. It has an order entry module which is used to enter clients' orders, and it can also track purchase records.*

**Mr. King:** *Is "THBI" the only software used?*

**Sabrina:** *No. A few years ago, we purchased a new windows-based software. This software enables us to track clients' orders, memberships and conventions, and to host online book stores for them. Both software can communicate directly with our warehouse's logistics computers, so that order tracking numbers can be made available to our Client Service Department. Currently, we are in the process of replacing the windows based software with a newer version to increase the system's security and to provide our clients with a higher level of personal and financial information protection. This newer version will enable us to monitor our clients' websites to help them run their business more effectively. It will also help us identify clients whose subscriptions are about to expire, so we can send them a renewal notice.*

**Mr. King:** *How do you ensure that the IT employees are well acquainted with new software which M&D decides to buy?*

**Sabrina:** *Well, our staff members receive off-site training from the seller of the software once M&D Inc. purchases it. The supervisors also provide employees with on-site training on a regular basis. At the same time, we only hire people with IT or a related college degree, extensive knowledge and experience in computer software used in the industry or a combination of both, education and experience.*

Mr. King's last stop was the warehouse where he met with the Warehouse Manager, Jim Turner who has been married to his wife Jennifer for 23 years. Jim and Jennifer had two children, Steve and Susan. Jim made sure to stay active all the time. He exercised 5 days a week believing that staying active and exercising helped him do his job better as it required physical

strength. His job required him to carry boxes weighing 45lbs or more, fix forklifts and climb ladders. Jim started working for M&D when he was 18 years old. He was initially hired as a Forklift Operator. Then, he was promoted to a Supervisor and ultimately to a Warehouse Manager because he performed so well at his job.

The warehouse employees had the responsibility of getting client orders packed and shipped in a timely fashion. The Client Service Department updated the warehouse's computer system at the end of each working day, so that the warehouse personnel could have the orders ready early the next morning. The warehouse employees were divided into groups and assigned to specific projects to minimize errors and to improve productivity. M&D Inc. utilized several modern forklifts, pallet jacks, and shrinkage wrap machines to improve productivity. M&D Inc. required all warehouse employees who operated forklifts or heavy machinery to take several training classes and to obtain a forklift operation's certificate. While in the warehouse, Mr. King noticed that the employees were working with a great deal of enthusiasm.

### POST-TOUR MEETING

Mr. King went back to meet with Mr. Lee, as they had previously agreed, to tell him about his experience. During their meeting, they had the following exchanges:

**Mr. King:** *I can tell you that I had a positive experience and that I am more optimistic about taking on the project, but before I make my final decision, I need to know the main reason why M&D has been successful in the private sector and if we can apply this success to the governmental sector?*

**Mr. Lee:** *The main reason why we are successful is our belief that "words mean action".*

**Mr. King:** *What do you mean?*

**Mr. Lee:** *At M&D, we take pride in delivering the best type of service to our clients. Other companies make promises to gain business, but they end up losing many of their clients after a little while because they cannot keep their promises. We always avoid miscommunication and broken promises. For instance, when we solicit new clients, we invite them for a site visit. If they decide to do business with us, we arrange for a phase-in meeting to obtain project information such as expected call volume, type of service, and expected number of orders, so we can provide them with a cost estimate.*

**Mr. King:** *What happens if they decide to do business with us?*

**Mr. Lee:** *If they agree to the cost estimate, we set up another meeting with our Business Development team to determine the project's start date and the software to be used, so our IT Department can have the required software and computer systems ready before we launch the project. Then, we establish project policies such as return and payment policies. In addition, we are always responsive to our clients' suggestions and comments. I strongly think that we will be able to apply this success to the government sector.*

**Mr. King:** *Okay, I will make a decision tomorrow and I will let everyone know.*

## DISCUSSION QUESTIONS

- Question 1: Characterize the components of the service provided by M&D Inc.?
- Question 2: Evaluate the quality of service provided by M&D Inc.?
- Question 3: Based on the CFO's estimates, do you think the new governmental project is worth the risk associated with it? Why or why not?
- Question 4: What decision choices does Mr. King have? What are their probable outcomes? What do you recommend?

<b>Appendix 1</b>	
<b>New governmental project revenues and expenses estimate</b>	
ITEM	AMOUNT
Employee wages	\$13.5/hr
Manager's salary	85,000/yr
Assistant Manager's salary	65,000/yr
Rent (Warehouse & building)	37,000/mo
Utilities	6,700/mo
Supplies	5,300/mo
Delivery trucks insurance	2,237/mo
Fringe benefits	34,527/mo
Tax (% of gross profit)	30%
Overtime	1.5 regular time
Revenues	1,121,569/mo



# **SUPPLIER COOPERATION VS. SUPPLIER COMPETITION: THE CASE OF SUPPLIERS IN XINTANG**

**Bin Jiang, DePaul University**

## **CASE DESCRIPTION**

*Operations Research, Management Science, and Decision Sciences courses help students understand quantitative approaches to decision making. However, it is more important for students to learn model-formulation and model-building skills; otherwise, students cannot apply their knowledge to real practices. Modified from a real consultant project, this tutorial case study emphasizes problem formulation under conditions. The case has a difficulty level of four. It is designed to be taught in two class hours and is expected to require two hours of outside preparation by students.*

## **CASE SYNOPSIS**

*The background is Xintang International Jeans and Textile City, the largest manufacturing base of jeans in China. The specific focus is on Xintang's inferior labor conditions. This case analyzes the problems through a novel perspective: to some extent poor labor conditions are driven by suppliers' fierce competition and buyers' unfair procurement practices which trend to shorten lead times and squeeze prices. Since suppliers in the buyer-driven value chains are teetering on cannibalistic competition, it is exceedingly difficult for them to simultaneously achieve both the competitive cost advantage and the humane working conditions. This case explicates how competition and cooperation strategies impact on the behavior of rational and self-interested suppliers within Xintang. The game theory models and analyses of this case study indicate that the cooperation efforts here may point the way out for struggling suppliers to achieve the tricky balance between low prices, short lead times, and stringent working conditions.*

## **CASE BODY**

The date was October 18<sup>th</sup>, 2005. Factories in the Xintang International Jeans and Textile City, the largest manufacturing base of jeans products in China, were extremely busy to fill their international buyers' orders for the coming Christmas sale season. Located near Hong Kong, Xintang includes over 2600 jeans factories and related enterprises with about 100,000 workers, supplying for over 1000 registered global and domestic jeans brands. More than 250 million pairs of jeans were manufactured in 2004 at Xintang and approximately 85% of them were exported.

Mr. Chen Kangqiang, the Chairman of Administration and Board of Directors (ABDX) of Xintang International Jeans and Texture City, was on the hot seat. He had spent the whole morning to meet with two journalists from *South Wind Window* (Nanfeng Chuang), a popular magazine in Southern China. The journalists inquired why the labor conditions in Xintang were still miserable even after the ABDX had enforced its strict auditing process.

## LABOR CONDITIONS IN XINTANG

Throughout years, the Xintang jeans town was notorious for its sweatshop image with low worker wages and long overtime hours. In manufacturing a pair of blue jeans that was sold for \$30 in the U.S., local workers received less than 90 cents. They usually worked 24-30 hours of overtime in a week. Overtime work was more flexible and cheaper than investing in new production technology or hiring more workers, because most apparel workers were not paid by working hours but by finished pieces. Without an overtime premium, local jeans manufacturers had no direct financial incentive to reduce long hours. However, the negative effects of poor working conditions on worker welfare, safety, health, and general well-being were quite evident.

With the pressure from Western clients on acceptable labor standards escalating, the ABDX began to take steps in 2005 to demonstrate concerns for ethical issues facing local suppliers. A strict auditing system to monitor jeans manufacturers' working practices was enforced in Xintang. The audit at a factory was carried out by a panel including representatives of that factory's Western client(s) and ABDX auditors. A typical audit involved a factory inspection, discussions with managers, worker interviews, and document checks. At the end of the audit, the audit panel presented the factory managers with a list of issues to be addressed. The factory was required to correct the identified problems and support any follow-up audits. If problem areas continued to exist, the factory was subject to sanctions in the form of financial payments from the ABDX and/or a withdrawal of its client's business.

Translating the audit results into a real change on the factory floor, however, was a major challenge. Mr. Chen told the journalists, "By law, jeans manufacturers are supposed to provide time-and-a-half pay after eight hours on weekdays and between double and triple the pay for Saturdays, Sundays, and holidays. Complying with labor codes definitely raises factories' operating costs. However, the Western clients' purchasing price has not increased one penny over the past ten years."

Facing potential overhead increases and Western clients' squeezing pressure on cost, Xintang's managers felt that they had little choice but to present false data. Mr. Chen acknowledged that it was not surprising to see audit frauds in Xintang escalate to a higher degree. He said, "In order to pass the audit as well as not significantly increase operating costs, a majority of jeans manufacturers resorted to falsified book-keeping to a certain extent. Factories were becoming increasingly sophisticated in their dual book-keeping practices and in coaching workers to provide acceptable responses during worker interviews."

As factory's methods to mask problems became more sophisticated, so did audit detection methods. Xintang audits started to become unannounced so as to catch managers off guard; worker interviews were conducted off site to encourage worker openness; and auditors made surprise visits to factories late at night to investigate whether factories were operating on

unrecorded overtime. “Although these methods helped the ABDX learn more about the real conditions in factories, this further aggravated hostility between the ABDX and factories.” Mr. Chen said. Such tensions made it difficult to achieve any sustainable change. For example, while the strict audit program in Xintang dramatically reduced overtime work, this jeans town regularly lost workers to other factory towns that did not strictly enforce restrictions. The reason was that many workers were eager to earn more income, even though they had to work longer. In 2005, the average worker turnover rate in Xintang was more than 140%.

## **BACKGROUND OF XINTANG INTERNATIONAL JEANS AND TEXTILE CITY**

In Xintang, all materials and processes needed to make the final jeans products exist in a single location. Garment factories are located close to textile mills and other suppliers of various components, including yarn dealers, sewers, pressers, packagers, and freight forwarders. Purchasing from this factory town is a highly attractive proposition to Western buyers, since such a one-stop-shopping approach reduces transaction costs and enhances purchasers’ bargaining power due to stringent competition among suppliers. In fact, the average profit margin in Xintang had reduced from 30% to 5% over the past decade because of the fierce competition among factories.

Several reasons accounted for the fierce competition in Xintang. First, the entry barrier to the apparel industry was very low in terms of capital and technology. A factory operation could begin with just a few manually operated sewing machines. At the same time, there was almost endless supply of cheap labor. Large numbers of farmers left the inland countryside in droves preferring to take their chances in the new factories near Hong Kong. Second, the government granted very flexible policies for the growth and operation of these emerging apparel firms. They were much less restricted by the rules and regulations when compared to the state-owned enterprises. Third, as these firms were started by farmer-entrepreneurs in towns and even in villages, they set examples as role models to others. This resulted in a tremendous increase of such firms with same work methods and similar products being sold in the same markets. To increase their market shares, factories vehemently waged price wars. This cannibalistic competition among Xintang jeans manufacturers resulted in razor thin profit margin for firms.

Besides the fierce competition, Xintang jeans manufacturers also faced pressure from global buyers, particularly in terms of squeezing prices and tight lead times. Local factories were in a subordinate position in buyer-driven value chains where small suppliers tended to be dependent on larger, dominant buyers. The bargaining power between global buyers and local jeans manufacturers was unequal, allowing the powerful buyers to relinquish many of the responsibilities for product and process improvement at local factories. For example, global buyers often deliberately deferred a decision until the last minute in order to better understand what their competitors’ strategies are in reacting to consumer demand, either in terms of volume or product specification. Therefore, final samples of products were often subject to revisions, even after production was underway. Generally, buyers were mainly concerned with getting the right quality product at the right price and suppliers are concerned with supplying the right quality product at a profitable price. As a result, suppliers have to pass on the pressures of

buyers' demanding requirements to workers. The buyers' requirements on cost reduction forced jeans manufacturers to minimize wage expenditures and buyers' late sample approvals resulted in expanding working hours to meet the tight delivery deadline.

Mr. Chen believed that the cannibalistic competition among jeans manufacturers and the power imbalance between local factories and Western clients were the root causes of poor labor conditions in Xintang. The harsh economic realities made it exceedingly difficult to achieve both low prices and humane working conditions. Instead of imposing labor codes on factories, the ABDX should help factories improve their economic realities; otherwise, there would be little or no concrete sustainable improvements in labor practices. He told the journalists, "I am planning to persuade every factory in this factory town genuinely to adopt a strategy of cooperation instead of competition. If this strategy works out, the cannibalistic competition would be eliminated and the local jeans manufacturers' negotiation power over western clients would increase. Under the strategy of cooperation, Xintang jeans manufacturers could charge Western clients higher prices to improve their profitability and then their working conditions."

## THE CONSULTANT TEAM'S WORK

Two weeks after the *Southern Wind Window* interview, Mr. Chen hired three experts of Operations Management to help the ABDX judge the validity of his new strategy. He required the consultant team to develop profit maximization models to analyze competition and cooperation strategies based on considerations of price and delivery time guarantee, two critical dimensions of competition in the apparel industry. According Mr. Chen's description and requirement, the consultant team decided to establish the research model as following:

The objective of the model is to maximize the expected net profit per unit time subject to the reliability for the deliverable time guarantee. This model should provide an analytical framework to analyze the interrelationships between delivery time guarantee, pricing, demand, and the overall profitability of local factories under competition and cooperation. Factories compete to provide goods in a make-to-order fashion, in which the responsive demand of a factory can be modeled as a function of its own price and delivery time guarantees. Each factory chooses joint decisions in pricing and delivery time guarantee levels to maximize its own profitability while keeping a predetermined level of delivery reliability.

There are also various constraints. The first constraint states that the factory's desired delivery reliability meets a predetermined delivery time, and the second constraint identifies the factory system stability such that the arrival demand rate does not exceed the operating rate. Other constraints are specified on the price, delivery time, and demand rate.

Based on the above conditions, the model parameters and assumptions are listed as follows:

Parameters:

$\lambda_i$ : amount of orders faced by factory  $i$  per unit time;

$\mu_i$ : operating rate (i.e., size of labor force) of factory  $i$ ;

$\gamma_i$ : desired delivery reliability (i.e., the guaranteed cycle time) agreed by factory  $i$  management and its buyer ( $0 < \gamma_i < 1$ );

$p_i$ : unit price charged by factory  $i$ ;

$g_i$ : delivery time guarantee by factory  $i$  according to the contract;

$o_i$ : unit operating cost for factory  $i$ .

Assumptions:

Factory  $i$  investment function:  $I_i = w\mu_i$ . Assume workers in the labor-intensive apparel industry have identical productivity, loyalty, and mobility. Because jeans manufacturers are paid by piece rates, a factory's investment cost can be modeled as a linear function of its labor number  $\mu_i$  and the average worker wage  $w$ .

Orders arrive at factory  $i$  according to a Poisson process with mean rate  $\lambda_i$ ; the handling time of an order is decided by the factory's capacity, i.e., exponentially distributed with mean rate  $\mu_i$ .

When there are  $n$  factories fiercely competing with each other in this factory town, it is reasonable to assume that their unit operating cost and service level should eventually converge, i.e.,  $o_i = o$  and  $\gamma_i = \gamma$ .

The mean demand rate for factory  $i$  depends linearly on its own price and delivery time guarantee as well as other factories' prices and delivery time guarantees, i.e.

$$\lambda_i(P, G) = a_i - b_i p_i - c_i g_i + \sum_{\substack{j=1 \\ j \neq i}}^n d_{ij} (p_j - p_i) + \sum_{\substack{j=1 \\ j \neq i}}^n e_{ij} (g_j - g_i), \quad (1)$$

where  $a_i > 0$ ,  $b_i > 0$ ,  $c_i > 0$ ,  $d_{ij} > 0$ ,  $e_{ij} > 0$  for all  $i (i = 1, 2, \dots, n)$ ,  $j (j = 1, 2, \dots, n, j \neq i)$ ,  $P = (p_1, p_2, \dots, p_n)$ , and  $G = (g_1, g_2, \dots, g_n)$ . The parameter  $a_i$  represents the basic demand that is not related to price and delivery time guarantee and depends on other factors such as the factory's reputation or quality.  $b_i$  and  $c_i$  measure the sensitivity of each factory's demand to its own price and handling time, respectively.  $d_{ij}$  and  $e_{ij}$  measure the competition intensity among factories with regards to pricing and handling time, i.e., the sensitivity of a factory's demand to any other factories' prices and handling times. Assuming that all other parameters remain unchanged, a unit decrease in factory  $i$ 's price will attract  $(b_i + d_{ij})$  more units. A higher value of  $d_{ij}$  elevates the importance of price competition. Similar connotation can be used to explain  $e_{ij}$  for the delivery time guarantee competition. With some loss of generality but substantial gain in expositional efficiency, we assume  $a_i = a$ ,  $b_i = b$ ,  $c_i = c$ ,  $d_{ij} = d$ , and  $e_{ij} = e$ .

Because a factory always tries to maximize its profit, this behavior is described as:

$$\text{Max } \pi_i = (p_i - o)\lambda_i(p_i, g_i) - w\mu_i, \quad (2)$$

s.t.  $P(t < g_i) = 1 - e^{-(\mu_i - \lambda_i)g_i} \geq \gamma$ , (factory desired delivery reliability constraint)

$\mu_i > \lambda_i$ , (factory system stability constraint)

$p_i > o > 0$ ,  $g_i, \lambda_i > 0$ , (non-negativity constraints)

where  $t$  is the steady state actual handling time for random orders. The constraint of a desired delivery reliability must be binding at optimality, i.e.,  $1 - e^{-(\mu_i - \lambda_i)g_i} = \gamma$ . Therefore, the optimal  $\mu_i^*$  can then be expressed as

$$\mu_i^*(p_i, g_i) = \frac{-\ln(1-\gamma)}{g_i} + \lambda_i(p_i, g_i). \tag{3}$$

In China, the most populous country in the world, there is an abundance of labor force in the countryside. For labor intensive industries, manufacturers can easily optimize their capacities by using these mobile workers. Mobile workers are highly flexible and can be hired and laid off at short notice. As a result, a factory's optimal capacity is exogenously fixed in this project. Substituting (3) into (2), the profit maximization model for factory  $i$  can be rewritten as

$$\text{Max } \pi_i = (p_i - o - w)\lambda_i(p_i, g_i) + w\ln(1-\gamma)/g_i \tag{4}$$

For the competition strategy, each jeans manufacturer simultaneously and independently decides individual price and delivery time guarantee. The basic model in equation (4) can be analyzed as a non-cooperative  $n$ -person game:

$$\text{Max } \pi_i(p_i, g_i, P_{-i}, G_{-i}) = [a - bp_i - cg_i + \sum_{\substack{j=1 \\ j \neq i}}^n d(p_j - p_i) + \sum_{\substack{j=1 \\ j \neq i}}^n e(g_j - g_i)](p_i - o - A) + \frac{w\ln(1-\gamma)}{g_i}, \tag{5}$$

where  $P_{-i} = (p_1, p_2, \dots, p_{i-1}, p_{i+1}, \dots, p_n)$ ,  $G_{-i} = (g_1, g_2, \dots, g_{i-1}, g_{i+1}, \dots, g_n)$ ,  $i = 1, 2, \dots, n$ .

For the cooperation strategy, all factories decide on prices and delivery time guarantees jointly, considering that a central policy maker (e.g., the ABDX) decides on relevant variables so as to achieve total profit maximization. According to game theory, such a cooperative model is a monopolistic model (due to the collusion). The total profit maximization model is given as:

$$\text{Max } \Pi = \sum_{i=1}^n \pi_i(p_i, g_i, P_{-i}, G_{-i}). \tag{6}$$

From Equations (5) and (6), the consulting team can obtain two different strategies'  $P_i^*$  and  $g_i^*$ .

Mr. Chen agreed with the consultant team's assumptions, and eagerly waited for their analysis results.

# LARRY ELLISON AND ORACLE CORPORATION

**Todd A. Finkle, Gonzaga University**  
**Richard B. Scoresby, Gonzaga University**

## CASE DESCRIPTION

*This case makes a contribution to the field of entrepreneurship by focusing on one of the most successful entrepreneurs and companies of our generation. The case can be used in undergraduate entrepreneurship, small business management, or strategic management courses. Students will find the case study informative for several reasons. They will learn about the personality and background of Larry Ellison. What were his motivations and experience before he became an entrepreneur? Students will also learn about how Ellison founded and grew Oracle Corporation. Finally, students will examine the current problems and opportunities that confront Oracle in 2011 and they will be required to make recommendations to Ellison and Oracle.*

## CASE SYNOPSIS

*The case examines the background, personality and rise of Larry Ellison, one of the most prolific entrepreneurs of our generation. Ellison, who co-founded Oracle Corporation, was the third wealthiest man in the United States in 2011 with an estimated net worth of \$33 billion. The case further documents the startup, growth and current problems and opportunities confronting Oracle Corporation, the world's largest multi-faceted software company.*

*Ellison got his start by working on a database project for the Central Intelligence Agency (CIA). Codename: Oracle. In 1977, Ellison went into the database business for himself and founded Oracle with Robert Miner and Edward Oates. Over the last 33 years the mogul grew Oracle into a dominant player in the database, software, and server industries. The current market cap was \$150 billion and Ellison owns more than 20% of the company.*

## LAWRENCE JOSEPH ELLISON

Lawrence Joseph Ellison was born in the Bronx, New York on August 17, 1944 to a 19 year old unwed Jewish mother, Florence Spellman. Ellison's childhood began with a bout of pneumonia, at nine months of age, which drove his mother to relinquish custody to her aunt and uncle hoping to provide him with a better upbringing. Ellison was adopted by his great aunt Lillian and her husband Louis Ellison, who lived on the South Side of Chicago. Ellison did not know until he was 12 years old that he was adopted, and would not meet or reunite with his birth mother until he was 48 (Encyclopedia of World Biography, 2004).

As a boy, Larry Ellison showed an independent, rebellious streak and often clashed with his adoptive father, Louis Ellison (Academy of Achievement, 2010). His father had very little faith in Larry and saw failure around every corner for him. According to Ellison, "My father

would regularly tell me that I would never amount to anything. Oh, it was a powerful motivation. I think my dad had a wonderful effect on me. If fire does not destroy you, you are tempered by it. Thanks, Dad” (Wilson, 2002). In high school Ellison was quiet and withdrawn, an average student, but very intelligent.

After high school, Ellison enrolled at the University of Illinois in Champaign-Urbana with aspirations of becoming a medical doctor. However, he was uninterested in the subjects and found math and science stimulating. He dropped out of school his sophomore year when his adoptive mother died from kidney cancer. That fall, he enrolled at the University of Chicago. It was around this time that Ellison got into the computer business. Ellison learned how to program an IBM computer as part of a physics class assignment. He quickly realized that he had a natural talent for computer programming. He started working part-time programming for the university to earn extra spending cash. Ellison realized that he could make more money writing programs than a tenured professor made at the University of Chicago (Academy of Achievement, 1997). Ellison stated, “It was like a big game, it was like working on puzzles. So I enjoyed it. It paid extremely well, I could work at home, and I could work my own hours” (Academy of Achievement, 1997).

Unfortunately, Ellison dropped out of the University of Chicago after the first semester. His adoptive father was convinced that Ellison would not become successful. However, Ellison had learned the rudiments of computer programming in Chicago. He took this skill, headed out to California in 1966, ending up in Berkeley. Ellison stated, “I thought I would just figure out what I would be when I got there” (Wilson, 2002). Over the next few years, Ellison hopped from job to job doing computer-related work at companies like Wells Fargo and Fireman’s Fund. Ellison married, however, over time his wife had low expectations for Ellison’s future. During their marriage of seven years, he switched jobs constantly. What compounded problems for Ellison were his lavish spending sprees. In 1974, his wife filed for divorce. According to Wilson (2002) it was at a session with a marriage counselor while Ellison and his wife were breaking up that he decided to become a millionaire. He had never talked about money or any concrete success before. His wife advised him to go make his million for his own sake; she was leaving anyway.

Ellison continued to work with computers. While working at a small company called Ampex, Ellison met Robert (Bob) Miner and Edward Oates, who along with himself eventually became the founding partners of Oracle. At Ampex the three worked on writing a database program for the Central Intelligence Agency (CIA). In that era, computers stored lots of information, but managing it and recalling it was difficult. Ampex was working on a way to maintain a database of information on videotape as opposed to traditional magnetic tape. The Ampex machine could search and rewind videotape at high speed. Miner, Oates, and Ellison wrote the program for the Ampex video database, which was called Oracle (Encyclopedia of World Biography, 2004).

Ellison left Ampex for a vice president position of a small firm called Precision Instruments Company. Precision Instruments was working on a project similar to that of Ampex, trying to find a way to store and retrieve masses of data, this time on microfilm. Precision Instruments needed to hire a contract company to program its software. Even though he did not have a business plan, Ellison decided to create his own company. He had a strong motivation and

desire to be his own boss. According to Ellison, “I knew that I could never really survive in a conventional corporation” (Wilson, 2002).

## **BACKGROUND OF ORACLE CORPORATION**

Ellison convinced Miner and Oates to go into business with him, and the three formed Software Development Laboratories, Inc. in 1977. Ellison, who had instigated the venture, took 60 percent of the shares, with Oates and Miner each taking 20 percent (Encyclopedia of World Biography, 2004).

The company was one of the first businesses to provide a relational database for business and governmental information management. The name was changed to Relational Software, Inc. (RSI) in 1979 and later to Oracle after its flagship database product. The name was also meant to differentiate Oracle from one of its main competitors at the time, Relational Technology, Inc. (RTI). From the beginning the company was aggressive in sales, pushing to capture market share and eliminate competition (Wilson, 2002).

In 1980, Oracle had eight employees and revenues of less than \$1 million. A year after developing it, Oracle became the first company to start selling a relational database management system, two years before IBM introduced its own program. Oracle rapidly became profitable and by 1982 the company, with only 24 employees, reported annual revenues of nearly \$2.5 million. IBM itself adopted Oracle for its mainframe systems, and Oracle's sales doubled every year for the next seven years. The million dollar company was becoming a billion dollar company (Academy of Achievement, 2010).

Over the next 12-15 years, Oracle experienced rapid growth, exceeding 100% revenue increases in many of those years. This was largely the result of a highly competitive culture and aggressive sales techniques, sometimes even promising features that were still in development and gaining a reputation for under-delivering or delivering upgrades late. However, because Oracle was based on the original IBM concept and technical language, industry standardization helped Oracle by reducing competition that was based on other (and some would say superior) technology (Wilson, 2002).

In March 1983, RSI changed the name of the company to Oracle to align itself better with its primary product, Oracle Version 3. On March 12, 1986, Oracle went public. The company experienced 100% or better growth in earnings in eight out of nine total years. During Oracle's first decade of existence, its relational database system was developed for use on approximately 80 separate hardware systems.

Oracle's growth was more behind the scenes. Its database program made possible such things as computerized hotel and airline reservation systems, inventory tracking for chain stores, and management of supplier and client databases for large manufacturers. By 1986, Ellison was a millionaire several times over, as were many of the top people at Oracle. Oracle's revenue that year was more than \$55 million, and Ellison's stake in the company was valued at \$90 million (Encyclopedia of World Biography, 2004).

By 1990 Oracle posted its first losses. The company's market capitalization fell by 80 percent and the company appeared to be on the verge of bankruptcy. Accepting the need for drastic change, Ellison replaced much of the original senior staff with more experienced

managers. For the first time, he delegated the management side of the business to professionals, and channeled his own energies into product development. A new version of the database program Oracle 7 was released in 1992 and swept the field, making Oracle the industry leader in database management software. In only two years the company's stock had regained much of its previous value (Academy of Achievement, 2010).

As Oracle's internet business applications continued to take major corporations by storm, they saw rapid raises in their net worth during the 1990s, as more and more companies became reliant on the company's database applications. With the growth of electronic commerce in 2000, Oracle saw net profits jump by 76 percent in a single, quarterly, reporting period. According to the Academy of Achievement web site; as success and net worth continued to rise from Oracle's advancements in database management, Ellison began engaging in strategic acquisitions of large and small companies that also developed software for "managing data, identity, retail inventory and logistics", until they had invested over \$25 billion during the first 36 months alone. Oracle's "first major acquisition was PeopleSoft, purchased at the end of 2004 for \$10.3 billion".

In 1997 Ellison took a new tack, pushing Oracle to get more involved in so-called applications software. Applications run on top of existing programs, doing things like billing. While the market for database programs was shrinking, the applications market was expected to continue to grow well into the 2000s. Oracle's new applications software, 11i, debuted in 2000 but was full of problems. The company's stock price fell, and 2001 also turned out to be a poor year for Oracle (Encyclopedia of World Biography, 2004).

In 2003, Oracle's revenue had risen to \$9 billion, and the company was still profitable despite an overall downturn in the technology industry. Ellison repeatedly predicted that the personal computer was dead, and that the network computer would surpass it. He seemed determined to keep Oracle growing, and in 2003 he launched a hostile bid to take over a rival company called PeopleSoft. PeopleSoft was run by a former Oracle executive, Craig Conway. Ellison and Conway displayed a lot of personal animosity over the deal (Encyclopedia of World Biography, 2004).

Since its inception, Oracle Corporation has been a major component in several industries, including those outside of software and programming. Its vast list of products offered to customers in a multitude of industries includes: database and file management software, computer hardware, servers and mainframes, mass storage systems, and magnetic disk storage.

Oracle was able to establish itself in all major markets by developing software applications for an assorted number of industries. The Oracle Database's main function was to consolidate business applications onto fast, reliable, and scalable grids. Its ability to lower IT costs, and the high quality of service offered at Oracle, were what has made the company superior to competitors. Oracle Fusion Middleware is an application infrastructure foundation that enables enterprises to create and run comprehensive business applications and maximize IT efficiency by making the most of modern hardware and software structures.

Oracle also offered a complete and integrated set of tools for developing applications and databases which supported a variety of approaches, technologies and operating systems. Additionally they sold a business application suite, The Oracle E-Business Suite, which included financial, manufacturing, and human resource related software. One distinctive feature offered was Oracle on Demand, which allowed customers to choose how they utilized their software

based on their organization's individual needs and budget allowances. This added value to customers by lowering costs and reducing risk, as well as by offering flexibility and choice. Oracle Corporation also offered a wide range of services to its customers. Oracle Advanced Customer Service was a global business unit within Oracle Support. It focused exclusively on facilitating the continual operational improvement of customers' products throughout the life of their use.

Consulting was another major service offered by Oracle. These consultants helped customers define their businesses strategies and goals, and implement solutions using Oracle products. Consulting also managed systems for clients and helped identify business-streamlining improvements and any cost savings.

Oracle also offered its customers financing support. The financing department helped customers acquire IT products from Oracle and its partners, by working with them in providing individual plans such as leasing, or long-term financing. Oracle's main competitors were: SAP, Microsoft SQL Server, IBM with DB2 and Informix, and Sybase with their Sybase System.

### **INDUSTRY ANALYSIS**

The software industry was a labor-intensive industry with relatively few capital requirements. Because the computer hardware industry was mature, and many of the supplying industries had strong competition with multiple competent suppliers, they did not have strong bargaining power. In addition to hardware requirements, Oracle required substantial input from labor. Software and computer engineers were not only employees, but also suppliers of the knowledge that Oracle required in order to compete. With so many potential employers, the bargaining power of suppliers of the labor and knowledge (employees or independent contractors) was medium in a strong economic environment, but currently lower considering the continued weak economy and strong demand for jobs.

Oracle stated that "substantially all of our customers, including customers from acquired companies, renew their support contracts when eligible for renewal" (Oracle Annual Report, 2010). Many of Oracle's customers depended on its solutions for day to day operations in their businesses, and even if they wanted to switch, the barriers to replace Oracle's products were very high because changing a information management system can be very time consuming and prohibitively expensive. In addition, Oracle was a leader in innovation, so new buyers would often look to them for potential solutions.

In today's global economy, computers are necessary to compete. Although the software and applications may be delivered in a variety of ways, there was no real substitute for the solutions offered by Oracle and its competitors.

The threat of new entrants was medium. New companies faced a competitive environment where both branding and knowledge-base requirements posed significant barriers. However, small companies did have the ability to provide customer service, which might pull some market share away from Oracle and other established companies.

Among companies that could enter the larger enterprise applications market in the future are Intuit, which currently offered small business solutions, and Google, which may expand its product offering in the future to become more of a competitor to Oracle. Both Intuit and Google

have the history and resources to compete on a larger scale against Oracle in some segments. Many other companies in various segments of the technology industry may also provide increasing competition to Oracle. The risk of new entrants into the database market was low.

The high profit potential of technology firms attracts many new entrants, and many startups are acquired by industry leaders before they become serious competition. Oracle has acquired 71 companies since 2005. It has purchased companies that will expand its product and service offering, and allow the company to diversify (Oracle.com, 2011). Although the threat of new entrants does exist, Oracle's acquisition strategy provided the company with many opportunities to expand, rather than surrender market share. In this way, the threat of new entrants was partially controlled. So what might have been a high threat was reduced to medium.

Industry rivalry in the enterprise software industry was of medium strength. Microsoft and IBM were Oracle's two main competitors in business software solutions, with SAP AG (Germany) and CA Technologies also providing significant competition. Salesforce.com was an example of a newer company that provides a Customer Relationship Management (CRM) platform to companies ranging from a few employees to major banks and corporations. Oracle's industry leadership and customized solutions help the company maintain its leadership position in relational database management. Competition from smaller companies has created some pricing pressure and risk of market share loss for Oracle (Datamonitor, 2010). Many companies offer solutions that competed with Oracle, although few could offer the comprehensive variety that Oracle had.

Because switching costs were high for customers, competition was focused more on new customers that were entering the market for enterprise software solutions. Once a relationship had been established, companies generally stayed with their current provider. This reduced the strength of industry rivalry from strong to medium. Rivalry was higher in growing areas than in established markets, although there were some companies who did switch to new providers. Rivalry was intense in some areas of Oracle's operations, but because it was such a strong industry leader, rivalry was lessened for Oracle than it was for smaller competitors.

## **INDUSTRY LIFE-CYCLE**

The technology industry was relatively mature, but with many areas of the world still developing, there was still much room for growth. Although both Oracle and Microsoft were major global corporations with market caps of \$166 billion and \$246 billion, they still maintained gross margins of 78.5% and 80.2% respectively. The strong margins suggested that competition was not yet too strong, and that a growing customer base provides sufficient demand to maintain solid margins.

The software industry was still experiencing significant growth both domestically and worldwide. It was also an innovation-driven industry where start-up companies could succeed if they were able to develop the right technology. Because of the drive for constant innovation and the remaining opportunity for growth, the industry acted much more embryonic than many established industries. While rivalry was of medium strength and strong enough to deter new entrants into some areas, there were many niche opportunities that led to increased competition over time.

Because of the costs of switching enterprise software providers, customers were also fairly stable. Oracle did especially well with its technological leadership and strong focus on service. Software license updates and product support accounted for nearly 50% of all revenue, which showed Oracle's ability to retain customers.

### **ORACLE CORPORATION**

Oracle's main industry was enterprise software, and it was the leader in relational database management solutions (RDBMS). Oracle provided custom, in-house database solutions to companies of all sizes. In the RDBMS space, Oracle held 48% of the market share, more than the combined total of its next four largest competitors (Graham, Sood, Sommer, and Horiuchi, 2009).

Oracle's in-house database solutions provided companies with powerful computing and customizable service. Although new competitors were entering the database market, Oracle's established practice still held considerable strength. Facebook CIO Tim Campos' felt that Oracle would hold its position in the market. He stated, "I do not really see a replacement for Oracle. The only reason Oracle exists in-house was for companies that want on-premise databases (Lynley, 2010)."

As the original first-mover and strong current leader in the relational database market, Oracle held a strong competitive advantage with the history, technology, and resources to continue its leadership role in RDBMS.

### **COMPANY SEGMENTATION**

Oracle focused on providing the best and most complete enterprise technology package available. That technology was offered to business and governmental customers worldwide. There were two ways that Oracle segmented its market: by product category and geographically.

Oracle's three major product lines were software, hardware systems, and services. The segments were further divided into sub areas. Oracle's software business was divided into new software licenses and software license updates and support. Software generated 67.5% of Oracle's 2011 revenue. Hardware was divided into hardware systems products, and hardware systems support. Hardware systems sales tripled year-over-year, generating 19.5% of Oracle's 2011 revenue. The services business includes consulting, On Demand, and education. Services generated 13.0% of Oracle's 2010 revenue. All three segments showed revenue growth in 2011. Although Hardware data was not included prior to the acquisition of Sun, every product segment and sub-segment reported by Oracle has produced positive margin in each of the years from 2009 to 2011 (Oracle Annual Report, 2010-2011). For a review of Oracle's financial statements see Exhibits 1-3.

**Exhibit 1: Oracle Corporation**  
**Income Statement**  
**Years ended May 31, 2009-2011**  
*(in millions, except per share data)*

	2011		2010		2009	
<b>Revenues:</b>						
New software licenses	\$9,235	26%	\$7,533	28%	\$7,123	31%
Software license updates and product support	14,796	42%	13,092	49%	11,754	51%
<b>Software revenues</b>	<b>24,031</b>	<b>67%</b>	<b>20,625</b>	<b>77%</b>	<b>18,877</b>	<b>81%</b>
Hardware systems products	4,382	12%	1,506	6%		
Hardware systems support	2,562	7%	784	3%		
<b>Hardware systems revenues</b>	<b>6,944</b>	<b>19%</b>	<b>2,290</b>	<b>9%</b>		
<b>Services</b>	<b>4,647</b>	<b>13%</b>	<b>3,905</b>	<b>15%</b>	<b>4,375</b>	<b>19%</b>
<b>Total revenues</b>	<b>35,622</b>	<b>100%</b>	<b>26,820</b>	<b>100%</b>	<b>23,252</b>	<b>100%</b>
Operating expenses:						
Sales and marketing	6,579	18%	5,080	19%	4,638	20%
Software license updates and product support	1,264	4%	1,063	4%	1,088	5%
Hardware systems products & support	3,316	9%	1,303	5%		
Services	3,818	11%	3,398	13%	3,706	16%
Research and development	4,519	13%	3,254	12%	2,767	12%
General and administrative	970	3%	911	3%	785	3%
Amortization of intangible assets	2,428	7%	1,973	7%	1,713	7%
Other expenses	695	2%	776	3%	234	1%
<b>Total operating expenses</b>	<b>23,589</b>	<b>66%</b>	<b>17,758</b>	<b>66%</b>	<b>14,931</b>	<b>64%</b>
Operating income	12,033	34%	9,062	34%	8,321	36%
Interest expense	(808)	-2%	(754)	-3%	(630)	-3%
Non-operating income (expense), net	186	1%	(65)	0%	143	1%
Income before provision for income taxes	11,411	32%	8,243	31%	7,834	34%
Provision for income taxes	2,864	8%	2,108	8%	2,241	10%
<b>Net income</b>	<b>\$8,547</b>	<b>24%</b>	<b>\$6,135</b>	<b>23%</b>	<b>\$5,593</b>	<b>24%</b>
Earnings per share:	\$1.69		\$1.22		\$1.10	
Shares outstanding	5,048		5,014		5,070	
Dividends declared per common share	\$0.21		\$0.20		\$0.05	

**Exhibit 2: Oracle Corporation****Balance Sheet****May 31, 2009-2011***(in millions)*

<b>ASSETS</b>	<b>2011</b>		<b>2010</b>		<b>2009</b>	
Current assets:						
Cash and cash equivalents	\$16,163	22%	\$9,914	16%	\$8,995	19%
Marketable securities	12,685	17%	8,555	14%	3,629	8%
Receivables	6,628	9%	5,585	9%	4,430	9%
Other current assets	3,698	5%	2,950	5%	1,527	3%
<b>Total current assets</b>	<b>39,174</b>	<b>53%</b>	<b>27,004</b>	<b>44%</b>	<b>18,581</b>	<b>39%</b>
Non-current assets:						
Property, plant and equipment, net	2,857	4%	2,763	4%	1,922	4%
Intangible assets, net	7,860	11%	9,321	15%	3,411	7%
Goodwill	21,553	29%	20,425	33%	3,858	8%
Other non-current assets	2,091	3%	2,065	3%	19,644	41%
<b>Total non-current assets</b>	<b>34,361</b>	<b>47%</b>	<b>34,574</b>	<b>56%</b>	<b>28,835</b>	<b>61%</b>
<b>Total assets</b>	<b>\$73,535</b>	<b>100%</b>	<b>\$61,578</b>	<b>100%</b>	<b>\$47,416</b>	<b>100%</b>
<b>LIABILITIES AND EQUITY</b>						
Current liabilities:						
Payables	\$1,851	3%	\$3,920	6%	\$1,272	3%
Accrued compensation and related benefits	2,320	3%	1,895	3%	1,409	3%
Deferred revenues	6,802	9%	5,900	10%	4,592	10%
Other current liabilities	3,219	4%	2,976	5%	1,876	4%
<b>Total current liabilities</b>	<b>14,192</b>	<b>19%</b>	<b>14,691</b>	<b>24%</b>	<b>9,149</b>	<b>19%</b>
Non-current liabilities:						
Notes payable and other borrowings	14,772	20%	11,510	19%	9,237	19%
Income taxes payable	3,169	4%	2,695	4%	2,423	5%
Other non-current liabilities	1,157	2%	1,483	2%	1,162	2%
<b>Total non-current liabilities</b>	<b>19,098</b>	<b>26%</b>	<b>15,688</b>	<b>25%</b>	<b>12,822</b>	<b>27%</b>
<b>Total liabilities</b>	<b>33,290</b>	<b>45%</b>	<b>30,379</b>	<b>49%</b>	<b>21,971</b>	<b>46%</b>
<b>Total equity</b>	<b>40,245</b>	<b>55%</b>	<b>31,199</b>	<b>51%</b>	<b>25,445</b>	<b>54%</b>
<b>Total liabilities and equity</b>	<b>\$73,535</b>	<b>100%</b>	<b>\$61,578</b>	<b>100%</b>	<b>\$47,416</b>	<b>100%</b>

**Exhibit 3: Oracle Corporation**  
**Cash Flows**  
**Years ended May 31, 2009-2011**  
*(in millions)*

	2011		2010		2009	
<b>Cash Flows From Operating Activities:</b>						
Net income	\$8,547	100%	\$6,135	100%	\$5,593	100%
Depreciation and amortization	2,796	33%	2,271	37%	1,976	35%
Allowances for doubtful accounts receivable	164	2%	143	2%	118	2%
Deferred income taxes	(253)	-3%	(511)	-8%	(395)	-7%
Stock-based compensation	510	6%	436	7%	355	6%
Tax effects of stock compensation	110	1%	93	2%	58	1%
(Increase) decrease in assets	(728)	-9%	101	2%	365	7%
Other, net	68	1%	13	0%	185	3%
<b>Net cash provided by operating activities</b>	<b>11,214</b>	<b>131%</b>	<b>8,681</b>	<b>141%</b>	<b>8,255</b>	<b>148%</b>
<b>Cash Flows From Investing Activities:</b>						
Purchases of securities and other investments	(31,009)	-363%	(15,703)	-256%	(9,315)	-167%
Proceeds from securities and other investments	27,120	317%	11,220	183%	8,404	150%
Acquisitions, net of cash acquired	(1,847)	-22%	(5,606)	-91%	(1,159)	-21%
Capital expenditures	(450)	-5%	(230)	-4%	(529)	-9%
Proceeds from sale of property	105	1%				
<b>Net cash used for investing activities</b>	<b>(6,081)</b>	<b>-71%</b>	<b>(10,319)</b>	<b>-168%</b>	<b>(2,599)</b>	<b>-46%</b>
<b>Cash Flows From Financing Activities:</b>						
Payments for repurchases of common stock	(1,160)	-14%	(992)	-16%	(3,972)	-71%
Proceeds from issuances of common stock	1,376	16%	874	14%	760	14%
Payments of dividends to stockholders	(1,061)	-12%	(1,004)	-16%	(250)	-4%
Proceeds from borrowings	4,354	51%	7,220	118%		
Repayments of borrowings	(3,143)	-37%	(3,582)	-58%	(1,004)	-18%
Other, net	150		148	2%	44	1%
<b>Net cash from financing activities</b>	<b>516</b>	<b>6%</b>	<b>2,664</b>	<b>43%</b>	<b>(4,422)</b>	<b>-79%</b>
Effect of exchange rate changes on cash	600	7%	(107)	-2%	(501)	-9%
Net increase in cash and cash equivalents	6,249	73%	919	15%	733	13%
Beginning cash and cash equivalents	9,914	116%	8,995	147%	8,262	148%
<b>Ending cash and cash equivalents</b>	<b>\$16,163</b>	<b>189%</b>	<b>\$9,914</b>	<b>162%</b>	<b>\$8,995</b>	<b>161%</b>
<b>Supplemental schedule of cash flow data:</b>						
Cash paid for income taxes	\$2,931		\$2,488		\$2,170	
Cash paid for interest	\$770		\$652		\$627	

## **COMPANY STRUCTURE**

As of November 1, 2011, Oracle employed 108,500 workers globally. Because Oracle has made so many acquisitions over the last 15 years, and continued to operate many of them as separate businesses, it used permanent teams at each subsidiary with integrative roles as necessary. Some acquisitions led to fully integrated technologies, with previous operations assimilated into Oracle's existing operations, so not all acquisitions did become subsidiaries with separate operations.

## **DISTINCTIVE COMPETENCIES**

Oracle's distinctive competencies included its innovation and ability to acquire and assimilate other companies. In fiscal year 2010, Oracle spent approximately \$4.5 billion on research and development to develop new technologies and enhance existing products. This investment continued a three year trend of approximately 12-13% of Oracle's annual revenue being invested in R&D. It was also a reason that Oracle was one of the top 50 ranking companies for patents in 2010.

Since 1994, Oracle also invested billions of dollars in recent years to acquire and assimilate companies, technologies, and products that support and expand its existing offerings. This investment has supported the company's growth through knowledge, resource, and customer acquisition (Oracle.com, 2011).

The two main barriers to imitating Oracle's competencies was the ability to develop software on a major scale, and the financial strength that allowed Oracle to acquire new entrants into the market. With its vast array of enterprise solutions, the development necessary to compete broadly with Oracle would be very difficult due to the resources required to develop so many solutions. However, many companies have developed solutions that competed with Oracle in a narrower scope. Many of these competing products have ended up as Oracle acquisitions.

The other main barrier to Oracle's strategy was the ability to acquire and assimilate technologies and companies. Unless a company had significant financial strength, it would not be able to acquire as easily. Also, without sufficient research and development capability, it might not be able to assimilate new technology into its own product line.

## **RESOURCES**

Between cash and marketable securities, Oracle had \$28.8 billion in liquid assets that it could use for acquisitions and other strategic uses. That balance was greater than the total of Oracle's operating expenses in 2011 (Oracle Annual Report, 2011). In short, Oracle had the cash to weather almost any storm or make any strategic move that the company chose.

In addition to assets held by the company, Oracle had a portfolio of customers that included all 100 companies from the Fortune 100 list. That client list led to more than \$13 billion in 2010 revenue from software license updates and other client support, nearly half Oracle's total

revenue for 2010 (Oracle Annual Report, 2010). Because it was difficult for database clients to switch service providers, Oracle held a strong position that continued to generate revenue for the foreseeable future. This continuing revenue stream helped Oracle weather economic downturns and other misfortune that may face the company or the software industry.

### **OPPORTUNITIES AND CHALLENGES FOR ORACLE IN 2011**

Some conditions in the current technology market provided opportunities for Oracle to expand its market share. Current opportunities for Oracle included internet technology, increasing IT spending, an expanding market for software-as-a-service (SaaS), and the recent acquisition of Sun Microsystems (Datamonitor, 2010). SaaS is a software delivery method that provide access to software and its functions remotely as a Web-based service, usually through cloud computing (Webopedia, 2011). When a person searches for a book on Amazon, posts an item for sale on Ebay, or makes any online purchase using a credit card, the technology used in the transaction was likely to be from Oracle. While the internet has made products, services, and information provided by companies available to consumers in their own living rooms, that data has to be stored somewhere, and Oracle's databases provided the perfect solution. Growing internet use increased companies' needs for Oracle's systems and provided a major opportunity for Oracle to expand its market share. Particularly with Oracle's processing and cost reducing potential as demonstrated by the Transaction Processing Performance Council (TPC), Oracle had the capability of providing both the highest quality and lowest-cost solution for companies doing business online (SearchSOA.com, 2011).

In 2010 it was estimated that 240 million people, or 77% of the US population, regularly used the internet. This represented 152% growth over the number of people using the internet in 2000, and still had room to expand. Among the top 20 countries ranked by the number of internet users, the US was in second place behind China, which had 420 million internet users, which was just 32% of its population. With Chinese internet users expanding by 1,767% from 2000 to 2010, it was estimated that the China market would experience significant growth for years to come. Ten of the top 20 internet-using countries experienced greater than 1,000% internet use growth over that decade. Also, among the top 20 countries, the total growth was 417%, but has still reached just one third of the combined population of those countries. Worldwide, internet use expanded by 448% and has only reached 29% of the total world population (InternetWorldStats.com, 2010).

If the growth of the internet were to increase 100% over the next 10 years, the total number of internet users would be approximately four billion people, just over 50% of the world population. As Oracle continues to improve its offerings, it will have a massive opportunity to provide the technology necessary to run those systems. The technology to be used includes Oracle products beyond databases, including server hardware and SaaS.

With the acquisition of Sun Microsystems, Oracle had hardware available to its customers. Along with meeting the needs of an expanding internet-using population, Oracle could also sell that technology to governments, universities, and other enterprises. Many large organizations had technology filing systems that utilized servers and large mainframe computers, and Oracle could meet that need on and off the internet.

Further capitalizing on expanding internet use, many software solutions were being developed to be used as a service through a monthly or annual licensing relationship. Oracle provided multiple on-demand software solutions as services, as do many other companies. SaaS therefore provided software revenue opportunities to Oracle, and hardware revenue opportunities by meeting the needs of many other SaaS providers.

Both an opportunity and potential threat to Oracle was the economic expansion in Asia. While markets and demand are growing, so was the number of software engineers that are capable of developing competing systems. India, for example, was quickly gaining a reputation for competent technological innovation at a lower price than US companies have been able to offer. As the industry becomes increasingly more global, competition will continue to increase, but may provide a way for Oracle to seek qualified talent at a lower cost.

## **CHALLENGES**

In recent years, Microsoft and other competitors have worked to compete effectively with Oracle in the database market space. Although a late entrant into the database market, because of its strong position in PC software, Microsoft has both the resources and credibility to compete effectively in databases. It was estimated that Microsoft may have had as much as 22% of the worldwide database market (SeekingAlpha.com, 2010). This was particularly significant as the world becomes increasingly global, and technology levels the field of competition in favor of small businesses that are more likely to use Microsoft than Oracle. Microsoft was forecasted to increase its database market share at a faster rate than Oracle through 2017, although Oracle's market share was forecasted to increase to approximately 54%.

Although Oracle had a strong first-place position in RDBMS, competition from companies including Microsoft was growing and may eventually begin to take market share from Oracle. As of 2011, Oracle was still capturing market share, but it must continue to work to maintain its position.

As demonstrated by its recent lawsuit with Google, a major risk in the technology industry was that patents and technology can be infringed upon, eroding the value of a company's intellectual property. Recently, Oracle was in a lawsuit related to Java (Gralla, 2010), which was acquired along with Sun Microsystems and may have been one of the primary benefits of the acquisition. It was possible for further Oracle-owned patents to be infringed upon, or for Oracle to be accused by other companies of infringement. Either of these scenarios could lead to financial loss, productivity loss, and the erosion of competitive advantage.

Oracle was a leader in providing technology and software solutions, and relied on constant research and development to remain competitive. The industry was dominated by the most recent, most innovative solutions as well as providers with established systems already in place. As an early leader in the industry, Oracle became a leader in relational database solutions for both private industry and governmental customers, and had expanded its expertise in middleware and applications. Regardless of size, every company must constantly improve its product offerings and innovation to solve ever-evolving problems faced by customers. If Oracle failed to innovate, it would lose market share.

Although an internal consideration, another threat to Oracle may be the risk that something happens to remove Larry Ellison from his longtime leadership role at the company. At age 66, he may not have too many more years to remain at the helm of the company he built. When the day comes that he was no longer able to lead, it is unknown who will replace him, or the effect that it may have on the company whose culture so strongly reflects the personality of its primary founder.

## **ORACLE IN 2011**

Ellison grew Oracle into a dominant player in the database, software, and server industries. The current market in November 2011 was \$150 billion (Yahoo Finance). Ellison owned more than 20% of the company and has rarely sold shares. Oracle had acquired 57 companies in the previous 5 years. In January, 2010, Oracle purchased Sun for \$7.4 billion. Ellison also owned 52% of business software company Netsuite (Bertoni, 2010).

In 2011, Oracle was the gold standard for database technology and applications in enterprises throughout the world. The company was the world's leading supplier of information management software and the world's second largest independent software company. The acquisition of Sun gave Oracle a leadership role in the hardware arena as well. Oracle technology was now found in nearly every industry and in the data centers of all of the Fortune 100 companies. Oracle was the first software company to develop and deploy 100 percent internet-enabled enterprise software across its entire product line: database, business applications, application development, and decision support tools.

Before the acquisition of Sun was final, Oracle and Sun introduced the Sun Oracle Database Machine, the world's fastest machine for any type of database workload. Today, Sun servers and storage, Oracle Real Application Clusters, Oracle Applications, Oracle Grid Computing, support for enterprise Linux, and Oracle Fusion, were all fueled by a commitment to innovation and results that has defined Oracle for thirty years.

## **ELLISON'S DECISION IN 2011**

Ellison had his principal home in Woodside, California. He served as President of Oracle from 1978 to 1996, and undertook two stints as Chairman of the Board, from 1990 to 1992, and again from 1995 to 2004. Since its founding, he has been Oracle's only Chief Executive Officer (Academy of Achievement, 2010). Ellison was the heart and soul behind Oracle's drive to become one of the most dominant companies in the world.

Yet, as he relaxed at his Japanese-inspired home, he pondered what the next moves should be for Oracle. How would Oracle increase its growth in the future? What direction should the company pursue and how should it do this? Ellison stated, "Our goal was to become #1 in middleware and #1 in applications, just as we have in database. And we will provide our customers with complete, open solutions integrated from the disk to applications software that meet their business needs and solve their business problems. And, we will continue to innovate and to lead the industry, while always making sure that we focus solving the problems of the customers that rely on our technology" (Oracle, 2010).

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# **DRINKING UP THE PROFITS: A FORENSIC ACCOUNTING CASE**

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## **CASE DESCRIPTION**

*This case introduces students to several forensic and cost accounting techniques. Students will read along as Dr. Scott Graham performs a forensic investigation at Sullivan's Bar. Students will be exposed to determining expected sales based on inventory usage, invigilation, observation, and other general accounting techniques. The case is targeted for students in an undergraduate forensic accounting class or cost accounting class. The case may be used as an in class discussion mechanism or assigned as a take home project. The case can be discussed fully within a one hour class if students have pre-prepared for the case. Students should expect to spend about 3-6 hours of preparation time outside of class.*

## **CASE SYNOPSIS**

*This case is based on happenings at Sullivan's Bar, a drinking establishment owned by Frank Sullivan. Over the past few years Frank has noticed a decline in profits from Sullivan's Operations, even though there seems to be more customers in the bar. Frank asks one of his regulars at the bar, Dr. Scott Graham for help. Dr. Graham is an accounting professor at the local university and teaches accounting information systems. Dr. Graham challenges a few of his graduate students to help determine what could be causing the decline in bar revenues.*

*The case features Dr. Graham and his students as they explore operations at Sullivan's Bar. To determine where the lost profits may be hiding, Dr. Graham and his students examine the financial records, document operations, brainstorm on ideas, and do an onsite investigation and invigilation at the bar.*

## **MONDAY AFTERNOON SULLIVAN'S BAR**

Its four o'clock Monday afternoon at Sullivan's Bar. There are currently only two people in the bar: owner Frank Sullivan and longtime regular Scott Graham. Sullivan's is a casual drinking establishment in a coastal college town. The bar has two types of clientele: during lunch time and in the afternoon and evenings many of the locals stop in for a drink during lunch breaks and after work, at night, the crowd is mostly young college students.

Scott Graham is an assistant professor of accounting at the local university. From time to time Scott sneaks out of his office to go have a drink at Sullivan's. He visits the bar a couple days a week because he likes the people and the beer is fresh. Scott's students know they can

often find him down at the bar if they missed him during office hours. Today Scott decided to head to Sullivan's to finish grading his auditing class' exams.

"Hey professor, are you going to have your usual today," says Frank.

"Absolutely," says Scott with stress in his voice. "I have so many exams to grade but I need a drink before I start. I procrastinated grading these things all weekend. Now I will probably be up most of the night grading."

Frank brings Scott his drink and Scott begins unpacking stacks of exams from his case. Frank is busy shuffling his own papers around him. "God I hate Monday afternoon" Frank says to Scott as he shuffles papers from one part of the bar to another and taps on the keyboard in front of him.

Scott replies "What did you say Frank? I was daydreaming and didn't hear what you said."

"I just said I hate Monday afternoon was all. Nobody comes to a bar on Monday afternoon" replied Frank.

Scott sheepishly lifts up his glass and replies "Here's to nobodies!" and then takes a swig from his glass!

"Sorry, that wasn't aimed at you." Frank says. "It's just that there is very little business here on Monday afternoon and I end up becoming more of a boring accountant than an exciting bar owner. I opened this place 20 years ago with the idea that running a bar would be fun. Back then, I thought that if I owned the bar I could hang out with the customers, pay people to make the drinks and laugh all the way to the bank."

"Every business owner is an accountant" Scott says, "Some just don't know it yet. That's what I always tell my students".

For a brief second there is an uncomfortable moment of silence as Frank thinks about his assessment of accountants and about Scott's last statement.

"I know you work at the university, but I never did ask you what you taught." Frank says hesitantly.

"I'm an accounting professor!" Scott says with a defiant grin on his face. "That'll probably explain why I'm here drinking a lot during the day. You know, to get away from my boring job and my nobody life!"

"Touché" Frank replies lifting his own drink and taking a swig.

Frank and Scott have the common bartender-patron relationship. Whenever Scott's in the bar they usually talk about sports, politics or whatever's in the news. But today's conversation was drifting into a different direction.

Frank is sitting at the bar across from Scott with cash register tapes, supply orders, and other papers and bills around him. Frank says:

"Twenty years ago I would record all this information manually on a \$.50 notebook pad. Now all my information is somewhere in this \$2,000 notebook computer. Up until 4 years ago I didn't even know how to turn one of these things on." Scott barely acknowledges the comment as he is focused on his own papers sitting in front of him.

"Scott, you mind if I ask you an accounting question? I hope you don't mind talking shop outside of work."

“Ok. You got me on a good day. I’d rather do anything other than grading these exams right now. What’s your query?” Scott says while sipping his drink.

“My what... what did you just call me?” Frank says with a little anxiety in his voice.

Scott realized he just used a word Frank was not familiar with. He always tried to speak to the level appropriate for his for his audience. He thought for a second about what he said and then rephrased his statement. “Your question, Frank, what is your question?”

“Oh. Oh yeah” Frank says as he pretends he just didn’t hear the first question. Frank then begins to describe his problem.

“I’ve been running this bar for over twenty years now and I have always done well. However, in the last few years the bar seems to be doing worse and worse. I don’t understand why. I’ve been doing everything the same way I always do, I have more customers than ever, and yet what I get to keep after paying all the bills seems to be heading in the wrong direction. What do you think it could be?”

Scott says, “Frank, that’s a million dollar question with a million possible answers. I couldn’t just give you a flat-out answer based on what you told me. I would have to investigate it further.”

Scott returns to grading his exams trying to figure out where he just left off. Scott is mumbling to himself as he grades each question. “Duh that was revenue recognition... Ugh, they still don’t know separation of duties by now! Well, I guess you can lead a horse to water..”

Just then Frank begins to ask a question “Would you....?” But stops short of completing his thought.

“Would I what?” Scott replied looking kind of lost, having forgotten what topic they were just discussing.

“Would you look into things in my business further?” Frank inquires of Scott.

Scott looks up and repeatedly strokes his beard with his finger and thumb slowly while looking deep in thought. He then replies “Well, I guess it could be a good project for my grad assistants. If you are willing to let us investigate your books we can spend a few hours looking for problems. “ Scott thinks to himself that it’s probably just a managerial issue, but figures it would be a good discussion for his class.

“Thanks” says Frank, “I really appreciate it and in honor of your help, this drink is free.”

“Oh thanks. I’ll cherish this ONE drink.” Scott says sarcastically. “Of course, I’ll expect at least a two-drink minimum.”

Franks answers with a grin, “Ok, ok. Just help me find the problem and we’ll talk about that second drink.

“I am on it, right after I finish grading these exams. That should be around next Tuesday!” says Scott as he pantomimes shooting himself in the head with a gun made out of his finger and thumb.

“Don’t do that in here”, Frank says smiling “There is only one way to kill yourself in this bar...SLOWLY.” As Frank lifts up his glass and takes a sip.

## A MEETING OF THE MINDS

The following Monday morning Scott is sitting in his office to preparing for class when Julie knocks on the door.

“Dr. Graham, I’m here in regards to your email about a project you wanted me to work on,” Julie says while standing at the door. Julie, a Masters of Accountancy student at the university, has been working for Scott Graham for the last 2 semesters. Like most students in the accounting program, Julie is about 23 years old and has gone directly from her bachelor’s degree to her graduate program.

“Yes, Julie. Please come in.” As Julie walks into his office, she tries not to knock down, step on or sit on any of the papers. Everywhere she looks there are piles of books and papers from the floor to the desk. However, she knows better than to touch anything, as Dr. Graham has a “system” in place and seems to know where every piece of paper is located.

Scott Graham begins the conversation with an odd question. “Julie, have you ever been to Sullivan’s Bar?”

Julie looks quite puzzled and answers with hesitance in her voice, “Umm... yes. Why are you asking me this? Dr. Graham, I am not sure I am comfortable with such a personal question.” Julie says.

“Well, your new assignment is going to be dealing with Sullivan’s Bar. Frank Sullivan, the owner of the bar, has been running the bar for twenty years and in the last few years, his business has not been performing as he would like. He asked me to do a financial analysis of the bar, but I believe the problem is more than just a numbers issues. I believe there are some weaknesses in the internal controls and operations.”

“Oh”, says Julie, I guess your question makes sense now. I am sorry I...”

“It’s okay” Dr. Graham says to Julie. “I think this is going to be a fun learning experience.”

“Do you want me to draw a flowchart of the business like we did in class? That was a fun project!” said Julie.

Dr. Graham looks up at Julie in slight disbelief of her statement and says “No, I don’t think we need a flowchart just yet. We really need to see if there is a problem first before we spend more time than we need to on this project. Instead, I want you to come down to Sullivan’s with me this afternoon. It’s Monday afternoon so Frank Sullivan is the only person working. We need to look at Sullivan’s financial statements before we do anything else.

## THE SEARCH BEGINS

Later that day, Scott and Julie return to the bar to start the investigation. As promised, Frank gives Scott full access to the bar’s accounting books and records. Scott and Julie walk to the back office. Julie is carrying a laptop and briefcase and places them on the floor. The office is a small hole in the wall covered with beer posters and shelves filled with folders and paper notebooks. On the desk is an outdated laptop computer with and paper records thrown about the desk.

“Where do we start Dr. Graham?” Julie says.

After gathering his thoughts, Scott decides what his starting point should be and says to Julie “Well, we need to look at the financial statements, but I am wondering how accurate they could be. Frank told me he isn’t really all that good with computers and it is possible that he just doesn’t really have great records. See if you can generate financial statements using the accounting software Frank is using.”

Julie approaches the outdated computer and attempts log into the accounting software.

“I need a password to access the software” Julie says.

Scott looks over at Julie and the computer and sees a post-it note stuck to the computer that reads “Sully123”. Try “Sully123 with a capital S” he says to Julie.

“How do you know his password?” asked Julie as she turned and looked at Dr. Graham.

Dr. Graham points to the post-it note and slightly nods his head from left to right. Julie smiles and nods her head up and down in acknowledgement.

Julie spends a few minutes getting familiar with the software and finds the reporting package and uses it generate financial statements. Frank has only been using the software for the last two years, so the number of computerized financial transactions is limited.

“I have them. They are printing right now” Says Julie.

“Great, now download the transaction history for the last two years” says Scott.

“But why do we need the transaction data? I have the financial statements you wanted right here” Julie asked.

Scott replied “For comparative purposes we are going to use transaction listings for the past two years of operations to produce our own copy of the financials. I want you to take this transactional information home tonight and create your own financials from the data.”

The next day Julie stopped by Dr. Graham’s office as instructed with the financial statements. To Scott’s surprise there were no discrepancies between the sets of financial statement printed by Frank’s software and the set Julie created.

“That’s good” said Dr. Graham.

“I don’t get it”, says Julie “They are the same, why is that good? Aren’t we looking for something wrong?”

“Yes we are,” Scott replied. “The fact that they are identical eliminates the possibility that the reporting package of the accounting software is inadequate or that the reports were set up incorrectly. We need to eliminate the possible causes of the business problems in a systematic fashion. Now that we know we have a reliable set of financials in hand, we can perform a statement analysis.”

“Dr. Graham, when you say ‘we’?” Julie hesitates. “Well, last time you said ‘we’ you then instructed me—”

“Yes, when I say ‘we’ I mean you” Dr. Graham replies grinning.

“So what do I need to do first Dr. Graham?” Julie asks.

Dr. Graham replies “Well I want to analyze the gross margins, so ‘we’ need to determine the standard costs and standard sales prices for the different categories of products.”

“Where will I find the standard costs and standard prices?” Julie asked.

“Now now Julie, you should know how to calculate this information, you are in a Master’s of Accounting Program” Dr. Graham mockingly said to Julie.

“I know HOW to calculate the gross margin. We did that hundreds of times in my cost classes. They just always gave us the data. Where would I get this information in real life?” asked Julie.

“Where would you expect to find the data on how much his products cost him?” Dr. Graham asked Julie. Julie thought about the problem for a while and then stated “Well, I could find out how much they pay for beer by the case and divide it out by bottle. That cost should be on the invoice from the distributor. They sell different types of bottled beer. Do I need to calculate this individually for each product? Julie asked Dr. Graham.

“No, you can do averages for each type of product. We should get a good overview of the operation just using averages. If this were our business we would want that kind of data for each specific product” replied Dr. Graham “But what else do they sell?”

“Well they sell beer from kegs. I know I can find the price per keg of beer, but I am not sure how to calculate how many glasses they sell from each keg. I guess I could purchase a keg of beer and have a party this weekend and count the number of glasses we get out of the keg? Or I guess I could divide the volume of beer in a keg by the average volume of beer in each glass.” As Julie continued, Dr. Graham interrupted her, holding up a pamphlet he found in some of Frank’s paperwork. “We can also just look at the information given to Sullivan’s by the distributor; it has the measurement right here on this brochure. It says one keg holds 15.5 gallons of beer and should fill 164 sixteen ounce glasses.”

“Ah”, says Julie “that is much easier. Although probably not as fun as the keg party.” Julie continued, “So for the liquor, how do I calculate that?” Julie asked Dr. Graham. He replied, “Well most bars put one shot of liquor in each mixed drink...” Julie interrupted Dr. Graham and said “Ah, so I can just measure the number of shots per bottle and the cost of each bottle!”

“I think you have the hang of it now” said Dr. Graham.

Seemingly confused, Julie asked “But what about the standard sales price? Where do I get that information?”

“Oh yeah” said Dr. Graham, seemingly perplexed by Julie actually asking her question. Dr. Graham then replied and sounding quite sarcastic

“It’s too bad Sullivan’s does not have a list of all of their products and the normal price they charge for them anywhere in the bar. That information could be quite helpful to people ordering drinks.”

“Uhhhh,” Julie said as she sank her head in momentary shame “you mean I can use the menu to get the standard prices for each drink. I want the price of each drink before tax if tax is already included in the menu price, correct? “

“Bingo” said Dr. Graham “tomorrow bring me a comparison of the individual product cost and sales price for each of the three categories of products: 1) Draft Beer, 2) Bottled Drinks, and 3) Liquor drinks.”

The next day Julie walked into Dr. Graham’s office and had the following comparison of product markups. The two of them looked over Julie’s work and commented on the markups.

“I was surprised how high the markup was on each product” Julie said.

### COST ANALYSIS BY PRODUCT TYPE

#### KEG OF BEER

Measure: Keg of Beer: 15.5 Gallons	
Average Cost of Keg:	\$75.00
Servings Per Keg	164
Cost Per Serving	\$0.4573
Sale Price	\$2.50
Markup Per Drink	546.67%
Sales in Dollars	\$410.00
Gross Margin Per Keg	\$335.00
* Assuming 16 Ounce Glass with standard pour	

#### BOTTLED BEER

Measure: 24 Twelve Ounce Bottles	
Average Cost Per Case	\$15.00
Servings Per Case	24
Cost Per Serving	\$0.6250
Sale Price	\$3.50
Markup Per Drink	560%
Sales in Dollars	\$84.00
Gross Margin	\$69.00
* Twelve Ounce Bottles 24 to a case	

#### Liquor Drinks

Measure: 1.5 Liter Bottle	
Cost Per Bottle	\$36.00
Shots Per Bottle	50.72
Cost Per Shot	\$0.7098
Sale Price	\$5.00
Markup Per Drink	704.44%
Sales in Dollars	\$253.60
Gross Margin	\$217.60
* Assuming 1 ounce shots per drink	

“Well, the overhead is pretty high for Sullivan’s, he has to mark those drinks up to cover the cost of rent, utilities, salaries, insurance, and other expenses” replied Dr. Graham.

Gross Margins Standards			
	Cost	Sales Price	Markup %
Draft Beer (avg.)	\$0.46	\$2.50	546.67%
Bottle Bvg.* (avg.)	\$0.63	\$3.50	560%
Liquor(shot) (avg.)	\$0.71	\$5.00	704.44
*Note: Bottle includes beer, Malt, Wine and etc...			

“So what do we do now with this information? Julie asked Dr. Graham who promptly responded “Well, we now know how much they expected to make off of each drink they sell. We can estimate the number of drinks they should have sold based on the inventory used during the year. Then based on the gross profit percentages we have calculated we can come up with an estimate of total sales for the business.”

“Do you want me to check to see if the inventory records and purchase records are on the computer system at Sullivan’s” Julie asked.

“Sure” replied Dr. Graham. “See if you can you print out the beginning and ending inventory for this year as well as all of the purchases of inventory by category”.

“I’m on it” Julie replied.

Julie returned the next day with the inventory information that follows.

“Okay, so with the inventory balances and inventory purchase figures from Sullivan’s records I was able to determine the amount of inventory that was used by the business. I began with the beginning inventory, then I added the inventory purchased during the year, then I just subtracted out the current inventory balances” Julie proudly told Dr. Graham.

“That’s great!” replied Dr. Graham. “So we know the estimated cost of each item and we know the prices of each item. We also know how many items they could have sold. With this information we can determine the amount of sales Sullivan’s should have had based on the inventory they used. I want you to take the information from the financial statements about sales and the cost of sales and compare that with our estimated sales figure based on the inventory used during the period. Can we do that Julie?”

“Yes sir!” replied Julie “We can.”

<b>Inventory Figures Sullivan's Bar</b>					
<b>Beginning Inventory 1/31</b>			<b>Ending Inventory Year to Date</b>		
<b>Product Type</b>	<b>Count</b>	<b>Cost</b>	<b>Product Type</b>	<b>Count</b>	<b>Cost</b>
Kegs of Beer	50	\$ 3,750.00	Kegs of Beer	53	\$ 3,975.00
Cases of Beer	200	\$ 3,000.00	Cases of Beer	195	\$ 2,925.00
Liquor Bottles	100	\$ 3,600.00	Liquor Bottles	105	\$ 3,780.00
<b>Total Beginning Inventor</b>	<b>350</b>	<b>\$ 10,350.00</b>	<b>Total Ending Inventory</b>	<b>353</b>	<b>\$ 10,680.00</b>
<b>Inventory Purchases During the Year</b>			<b>Estimated Inventory Used During the Year</b>		
<b>Product Type</b>	<b>Count</b>	<b>Cost</b>	<b>Product Type</b>	<b>Count</b>	<b>Cost</b>
Kegs of Beer	932.02	\$ 69,901.83	Kegs of Beer	929.02	\$ 69,676.83
Cases of Beer	3169.17	\$ 47,537.50	Cases of Beer	3174.17	\$ 47,612.50
Liquor Bottles	1356.77	\$ 48,843.88	Liquor Bottles	1351.77	\$ 48,663.88
<b>Total Inventory Purchased</b>		<b>\$ 166,283.21</b>	<b>Total Inventory Used</b>		<b>\$ 165,953.21</b>

Julie returned later in the day with the following schedule showing the differences in Sullivan’s estimated annual financial performance and the actual financial performance. Excitedly Julie ran into Dr. Graham’s office ignoring the undergraduate student who was taking a make-up exam in the corner. Julie shouted “Dr. Graham, Dr. Graham, you have to see this, I think we have some type of FRAUD! There is over THREE HUNDRED AND FIFTY THOUSAND DOLLARS MISSING!!!”

“Well, let’s look at what you have”, curiously Dr. Graham replied. As he took the schedule from Julie’s hands he noticed two other young ladies pouring into his office.

“Can I help you two?” Dr. Graham asked the two female students.

“They are with me.” Julie said. “These are my friends Karen and Tricia; both are Masters of Accountancy students. I was so excited about finding this fraud I had them look over my numbers to make sure I did not just make a stupid mistake.”

“And you all agree this is fraud then” said Dr. Graham rather amused at the interest the students were taking in the project.

“Yes” said Tricia.

“Absolutely” said Karen. “I think this is a managerial fraud. I believe the owner is cooking the books trying to hide revenue from the IRS!”

Before Dr. Graham could answer he noticed the undergraduate student shaking his head up and down and writing profusely on his exam. Dr. Graham remembered that managerial fraud was the answer to a question on the exam. He then said:

“Ladies, I am glad you all have an interest in helping Julie and I with the Sullivan’s assignment but we are going to have to continue this conversation at a later time. Why don’t the three of you meet in my office at 5:00 pm? This young man will be finished with his make-up exam and our conversation won’t distract him...or help him. Between now and then I want you three to come up with some ideas on why we might have the differences we are seeing between the expected sales and actual sales.”

SULLIVAN'S ANNUAL FINANCIAL PERFROMANCE				
		<u>Sales</u>	<u>Cost of Sales</u>	<u>Markup %</u>
Draft Beer	<u>Expected</u>	\$380,900.00	\$69,676.83	547%
	<u>Actual</u>	228,214.84	69,676.83	328%
Bottle Bvg.	<u>Expected</u>	266,630.00	47,612.50	560%
	<u>Actual</u>	240,233.63	47,612.50	505%
Liquor(Shot)	<u>Expected</u>	342,810.00	48,663.88	704%
	<u>Actual</u>	164,589.35	48,663.88	338%
Total	<u>Expected</u>	990,340.00	165,953.21	597%
	<u>Actual</u>	633,037.82	165,953.21	381%

## THE TEAM BRAINSTORMS

At 5:00 pm the three graduate students, Julie, Tricia, and Karen return to Dr. Graham’s office. Each student has a pad and pen. Dr. Graham can see they all have notes scratched on their pads. Dr. Graham has been looking over the financial performance report as well but he has no notes scratched down. He picks up his copy of the report and skims over it once again. He looks at the three students and says: “Okay team, who wants to tell me what we have here?”

Julie states “Well, we can easily see that the sales that should be recorded just aren’t on the books. The actual sales recorded are way less than they should be.”

Dr. Graham looks over at Karen and states “Karen, why do you think this is a management fraud?”

“That’s easy” replied Karen, “this is a small business that deals with a lot of cash and the owner doesn’t really care what his financial statement’s look like. If he can hide some of this revenue and not pay taxes on it, I am sure he is going to do it!”

“I disagree” said Julie as Karen roller her eyes and shook her head in disbelief. Julie continued “If Frank Sullivan were cheating the IRS he would never ask us to look over his books for him. What good what it do him to have us find out he was cheating the IRS? If he was engaged in some type of tax evasion he would never ask an outsider to come look through all of his records.”

“I agree with Julie” said Tricia.

Dr. Graham then looked at Karen and said “Well Karen, how do you feel now about your diagnosis?”

Karen replied defensively “I never knew the owner asked you to do this! That changes things a bit.”

“Okay then”, said Dr. Graham as he looked at Julie. “Well the costs are right in line with what we expected, Julie can you explain this?”

“Well sure” said Julie, “that was expected. I used the actual costs as my expected costs. I then took the actual cost of inventory used to determine how much we should have in total sales.”

“Okay, so we aren’t going to focus on the costs right now” said Dr. Graham. “So what could account the sales being so much lower than expected?”

The three graduate students now felt a little intimidated to state an answer after Karen’s solution was shot down so quickly. Realizing this Dr. Graham looked at the students and said “Why don’t we have a brain storm session? Each of us will shout out possibilities to explore. We will write down each idea without debate. Any idea will do, sometimes a bad idea can generate a better idea from someone else. Who wants to go first?” he said as he grabbed a pad and pen and looked at each of the students in his office.

“Do we need to raise our hands?” asked Tricia.

“Nope, just shout them out!” said Dr. Graham.

“Well someone is using inventory and not ringing up sales!” said Karen.

“Bartenders could be drinking the profits away” said Julie. Without hesitation Tricia says “Well, I don’t know about you two but I rarely pay for my drinks at a bar.”

“That’s because guys buy you drinks all the time” said Julie. Those drinks are being purchased and should show up in the sales figures.”

“No, sometimes the bartenders just give me drinks! I thought that was normal” replied Tricia.

“Someone could be stealing inventory!” said Karen.

“Good” replied Dr. Graham. “Anything else?”

“Well, I was at a bar once with a guy who rang up a big bill and ran out the door without paying. Doesn’t the bar write those items off?” asked Karen.

“Well, they should account for those items in their records somehow” stated Dr. Graham. “They don’t write them off their taxes because they are cash basis so they shouldn’t claim the income to begin with.

“But they lost the revenue so shouldn’t they get a tax break” Karen asked?

Dr. Graham replied “Well, they never booked a sale to then write the bad debt against. The inventory used for these sales increases their cost of goods sold expense. So that reduces their net income a bit.

“Is that it?” Dr. Graham said as the three students were quite for a few minutes. The three students just kind of looked at each other and agreed they were out of ideas. Dr. Graham looked over the list and thought for a few minutes and said “Okay, I think we have a good place to start the investigation. We need to know how Sullivan’s handles inventory and we need to get more familiar with their bar operations. Let’s give Frank Sullivan a call right now and find out a bit about how he handles his inventory.”

Dr. Graham picked up the phone in his office and dialed Frank Sullivan’s cell phone. After a few seconds Dr. Graham began talking into the phone. “Frank this is Dr. Graham.”

“Who” replied Frank?

“Oh yeah, Frank this is Scott” said Dr. Graham. “I have you on speakerphone with my crack team of graduate students. We have a few questions about how you handle your inventory at Sullivan’s. Specifically we were wondering who has the authority to order inventory, receive inventory, pay for invoices, and how the inventory is stored. Do you have a minute to give us a good run down of the operations?”

“Sure” says Frank. “I don’t think you will find a problem with Inventory at Sullivan’s. Our inventory all comes from one supplier. We pretty much have a standard order in place every week. One thing about Sullivan’s is our demand is pretty constant. I think that’s because of the large number of regular customers we have. In fact inventory is so predictable I have my lead bartender Jeremy place the order.”

“Who is Jeremy?” asks Dr. Graham.

“Jeremy has been working with me for the last 3 years. He’s a great kid putting himself through law school. I’ve even helped him out with his tuition, he’s almost like a son to me” replied Frank. “I know what you are thinking about Jeremy but there is no way he could steal from me. We do a quick physical count of all products each week and we will tweak the standard purchases just a bit if we need more or less of an item. I try to keep two weeks’ worth of inventory on hand at all times, just in case there is a problem with the supplier. I don’t want to lose a sale for not having enough inventory on hand. I pay all the invoices and I would notice if there are any large differences in the orders.”

“Where is the inventory stored?” Dr. Graham asks Frank.

Frank responds “The inventory is stored in a locked storage room. I am there when it comes in and I am usually the one who brings it out to the bar when the bartenders are running out of an item.”

“Sounds like you are pretty confident no one is stealing from your inventory while it is in storage” Dr. Graham asks Frank.

“I don’t think my employees’ would steal from me” replies Frank.

“Someone is stealing!” shouts out Karen, interrupting the conversation.

“What?” asks Frank, “What did you find?”

“It’s nothing concrete right now Frank.” Dr. Graham replies. “I think we are getting ahead of ourselves. Do you mind if I call you back in a few days. I don’t want to get you upset over nothing.”

“Why not tell him what we found?” asked Karen.

“There goes that “we” word again” mumbled Julie as she looked at Dr. Graham.

“What” Karen turned to Julie.

“Nothing, it was an inside joke” replied Julie.

“I would like to know what you found.” replies Frank. “If something is going on in my business I want to know about it!”

Dr. Graham responded “Okay, this is just preliminary but we did a comparison of sales for the last year. Based on the inventory you used we would have expected sales to be higher.”

“How much higher?” inquired Frank.

“About \$357,000 higher” said Dr. Graham.

“MY EMPLOYEES STOLE \$357,000!” exclaimed Frank.

“Whoa! We don’t know what happened yet. Don’t get too excited just yet. This could all just be an error in the analysis” said Dr. Graham.

“That’s a big error Scott!” said Frank, “do I need to bring in the police?”

“No, no, no. Not yet” said Dr. Graham. “Please let us continue our investigation before we jump to conclusions.”

“Okay. Anything you need, you just let me know” said Frank.

Karen and Julie were still kind of glaring at each other over the misunderstanding earlier. The students then turned their attention to Dr. Graham as he was grinning over the banter between the students but also looked like he was scheming up something.

Dr. Graham said “Well I don’t think we have all of the facts just yet. We still need to determine what is causing the difference between expected sales and actual sales. If someone is stealing, I want to be able to tell Mr. Sullivan how they are doing it and who is responsible. All we have right now is an idea something is wrong.”

“Are we going to go interrogate all of the employees and see if any of them will tell us something” Julie asked.

“INTERROGATE? No, I have something even better.” Dr. Graham says with a grin on his face. “Over the next two weeks there are two things I want you to do. First, I want the three of you to go to the bar at night when it is very busy with large crowds, and take notes on how the bar operates. Observe the bartenders making and selling drinks. Second, I want you to try and see how many free drinks you can get out of the bartenders. I want you to do your best flirting with them.”

“Why?” Julie asks.

“If the bartenders are giving out free drinks to all the flirty girls, then we might have a real problem. I know this may seem like a weird assignment, but this will give you great experience with forensic accounting research and internal controls.”

Julie says with a smile, “Ok. No problem. I’ll call Karen and Tricia and we’ll start on it this weekend. So...are you going to pay our bar tab for the next two weeks?”

Dr. Graham answers, “No, but good try. Let me know how it goes and if you have any questions.”

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## GIRLS NIGHT OUT

Julie, Karen and Tricia visit the bar on a Friday night. As usual for Friday nights, Sullivan's Bar is very busy and full of college students. The girls mingle and find a spot at the bar where they can familiarize themselves with the personnel and operations. Jeremy, the lead bartender, approaches the girls.

"What can I get you ladies tonight?" Jeremy says with a smile.

Julie says, "Hmm, we will have three Vodka Tonics."

Julie observes closely as Jeremy pours the drinks. He reaches for the vodka bottle from amongst the row of liquors behind the bar. She first notices that Jeremy does not use a measuring device and pours the drink by sight. Jeremy brings the drinks to the girls and tells them the price is \$12.75.

"Can we start a tab? We're planning on being here a while." Karen says.

"Ok. Do you girls have a credit card I can hold?" Jeremy says.

Karen smiles and says "No. But we're not going anywhere and we're an honest bunch do I look like I would steal anything from you...other than your heart?"

"Ok. But don't forget to pay me. I can get in trouble for this." Jeremy says.

As the girls sip their drinks, they watch the other bartenders at work. Julie notices that none of the bartenders do their jobs consistently. Some bartenders ring up the drinks before they pour them, and some wait until they receive the cash. A few of the bartenders seemed to leave the till in the register open just a bit. As people paid some of the bartenders it appeared they just made change and left some of the money in the register. The bar is very busy and Jeremy doesn't seem to notice the other bartenders as he tries to keep his customers happy.

At one point in the night there was a small group of well dressed people in their upper 30's sitting next to Julie and Karen. The group was a little loud and they were ordering a large quantity of top shelf shots and drinking high end drinks most of the night. Julie and Karen both felt a bit funny as Frank appeared behind and almost walked straight at the two girls. Julie feared Frank was going to blow her cover. Instead Frank walked over to the group next to the girls and introduced himself as the bar's owner. Frank noticed instructed Jeremy to give the group a round of drinks on the house. Julie noticed as Jeremy followed Frank's orders filling the drink order and then just going to the next order. It did not appear that Jeremy rang anything into the register.

As the evening passes, Tricia starts to flirt with one of the other bartenders. Her goal, as previously instructed by Dr. Graham, is to get a drink out of him without paying. As the flirting continues, the bartender notices her drink is empty. The bartender makes a fresh drink and gives it to Tricia.

"How much do I owe you" asks Tricia?

"Don't worry about this one. It's on the house," says the bartender.

Tricia notes this instance and continues to chat with the girls and the other patrons around them. Just then a group of guys come up to the bar and order four draft beers. The bartender makes haste in filling each of the glasses to the very top, spilling a bit of beer in the process. The bartender put their drinks on the bar and said "That will be ten bucks."

One of the guys leaves a ten dollar bill and a quarter on the bar. The bartender shakes his head in disbelief as he sees his quarter tip. He grabs the money off the bar stares at it for a few

seconds and throws it all in his tip jar. Tricia also overhears one of the guys speaking to the others.

“This is why I like this place. They always fill the glass to the very top!” says one of the guys.

“I like a standard one inch head on my beer. When I was stationed in Germany I think the one inch head was almost law. That’s why there is this little line on the glass. The head on the beer adds the aroma of the beer to the experience” says a second guy.

“What a geek!” replies the first guy.

As the night passes, the students notice that the bartenders are becoming more lax with ringing up drink sales. She observes that the amounts one bartender is placing into the tip jar are getting bigger and bigger. She also notes that Tricia was just one of many to receive a free drink.

### **THE GIRLS REPORT TO DR. SCOTT GRAHAM**

Monday morning Julie, Karen and Tricia go to Dr. Graham’s office. “We went to Sullivan’s Bar on Friday night, and I think you will be very interested in our findings.” Julie says with excitement in her voice.

Scott answers, “Okay ladies, let’s hear it.”

Julie starts, “First of all, Tricia was able to flirt a free drink out of the bartender.”

“Did it take much effort on your part, Tricia?” asks Scott.

Tricia adds, “No. We just spoke a little during the night and later on he brought me the drink.”

“OK, good. Were you the only one to receive a free drink?” asks Scott.

Tricia says, “No, but the others who received the free drinks seemed to be all girls.”

Karen jumps in, “That’s not true. I saw them give drinks to guys too. It appeared that those guys were friends of the bartenders.”

“That’s good ladies. Did the bartenders make any note of this or did they ring it up as a no sale in the register?”

Julie answers, “No. They just poured the drinks. I also noticed that when they poured the mixed drinks, they didn’t use a shot glass, but did it by sight.”

Scott responds, “I see. We might need to look into this a bit further. What else happened that night?”

Julie responds, “As it got later in the night, we noticed the bartenders were not ringing in all the sales.”

“What do you mean? Were the bartenders ringing up the sales when they had a chance or just not at all?” Scotts asks.

Julie says, “It seemed like sometimes they rang up the sales and sometimes they didn’t.”

Tricia adds, “I even saw one bartender pocket the cash from some of the sales and not ring up the sale. There is something else, I overheard some customers talking about how they like the fact the beer glasses are filled to the very tip of the glass. The bartender seemed to spill beer trying to fill the glasses up to the top. Well, one of the guys was disappointed his beer didn’t have a head on it!”

Julie says, "I also saw a few of the bartenders make a drink for someone and it appeared they made the wrong drink or the customer did not like the drink made. The bartender just threw out the first drink and poured another one for the customer."

Tricia adds, "I saw one bartender ask Jeremy to look in the cooler below the bar. Jeremy pulled out a few bottles of beer that were broken and he just threw them away."

Karen says, "We also saw Frank Sullivan giving away drinks!"

"It's his bar, he can do that" replied Dr. Graham.

"Yes but there was no record made that drinks were given away, they didn't ring them up or account for them in any way" said Karen.

"Oh, then that could be a problem" replied Dr. Graham. "We are going to have to investigate these items in more detail. I'd like to see what actual sales are without the bartenders stealing."

"How do we do that?" asks Julie.

"Now Julie," replied Dr. Graham, "you should remember from when you took my auditing class that we can use a process called invigilation in a situation like this."

"I remember that word! I missed that question on the exam. How does it work again?" said Julie.

"Invigilation works by implementing controls so tight we remove the employees' ability to steal for a certain period of time. We then compare the results of operations from the period without controls and the period with the controls in place. That should give us an idea on how much theft may be happening at Sullivan's. I'll have Frank tell the bartenders that next week there will be people observing them while they work. I am also going to instruct Frank to have the bartenders ring up the complimentary drinks Frank tells them to give out so we can track them. We can have Frank set up a special key on the register for his comps. Remember, we want the bartenders to know they are being watched like hawks."

"Oh, okay. That sounds good." The girls exit the office and head to the library.

## **THE FOLLOWING FRIDAY NIGHT**

As planned, Dr. Graham and his team go to the bar to observe the Friday night operations. Scott feels out of place, since he's twice the age of the majority of the crowd. Jeremy notices that Scott and Julie are sitting at his bar early on before the place is crowded.

"Are you here with your friends tonight?" asks Jeremy.

"No. I'm here with Dr. Graham. We're here to observe how you guys do your jobs," Julie says with a professional tone.

"Yeah, I heard that some people were coming into the bar tonight to observe us. I didn't know it was you. Well, I better get back to work." Jeremy walks to the other end of the bar to serve a customer. After he serves the customer, he quietly whispers to each individual bartender, nodding his head towards Scott and Julie.

Karen and Tricia take up positions around the bar to observe other bartenders each has a notebook pad and pen in hand. Scott and Julie sit at the main bar and Julie tells Scott that the bar is just as busy tonight as it was the previous Friday. She recognizes many of the same people in the crowd from the previous weekend and points them out to Scott. Julie watches the bartenders'

interactions with these specific customers, since they were the ones who had received the free drinks before. Tonight, however, the bartenders do not give out any drinks. All sales are recorded, and all cash is collected properly. The cold stare of Scott's eyes and the threat of being watched forces the bartenders to perform their jobs precisely.

Before Scott leaves, he places a note on Frank's desk. The note requests copies of the sales receipts and inventory records for the evening, along with those from the previous Friday night.

### **SCOTT'S REVIEW AND PRESENTATION**

The following Monday, Scott receives the requested copies for the previous two Friday nights. He emails the information to Julie along with a note that says "We need to do a comparison of sales from week one to week two." A short time later he receives an email response from Julie that says "We will get right on that!"

A few hours later Julie sends the following schedule via email to Dr. Graham. With a message that says:

"Well this shows that with enough supervision Sullivan's bartenders will ring up almost all of the drinks they pour! There was a \$1,475.86 difference in sales from one Friday night to the next. That's a 12% increase in sales over the course of the year.

While it appears we found some of the differences, if you recall, last year actual sales were only 64% of total sales. That means 36% of expected sales were missing. We still haven't accounted for the other 24% of unrecorded sales. That's approximately \$238,461 dollars that have not been explained.

<b>Sales Comparison</b>			
	<b><u>1st Friday</u></b>	<b><u>2nd Friday</u></b>	<b><u>Difference</u></b>
<b>Beer</b>	\$4,388.75	\$5,156.78	\$768.03
<b>Bottle Bvg</b>	4,619.88	4,966.37	\$346.49
<b>Liquor</b>	3,165.18	3,545.00	\$379.82
<b>Total</b>	\$12,173.80	\$13,668.15	\$1,494.34
<b>*Inventory use was held constant</b>			

Scott believes he now has some sufficient information to give Frank about the poor performance of Sullivan's Bar. Scott gathers his paperwork and heads to the bar to report his finding to Frank.

Scott enters the bar and approaches Frank. "You got a minute? I need to talk to you about the project."

"Did you find who is stealing from me?" replies Frank? The two men walk back to the cramped office and sit in the squeaky chairs around the desk.

"So what happened to my \$350,000? Who stole it?" Frank says excitedly.

“Frank, it is not that easy. We reviewed your operations and financial statements, I believe there are some components of fraud in your business,” Scott says with a serious tone.

Frank answers excitedly, “Some fraud... \$350,000 is a lot of fraud!”

Scott says “Look, the \$357,000 number isn’t the amount of theft in your business. I think you misunderstood the analysis I was discussing on the phone. We looked at the amount of inventory you used last year. We then take the amount of inventory used, divide it up into the expected number of drinks and then multiply the result by the average sales price of a drink. That tells me what we would expect your sales to be. Your actual sales were \$350,000 different than that estimate.”

“So my employees stole \$357,000 from me? Isn’t that what that means? Frank said.

Scott replies “Once again, it does not mean there is \$357,000 of theft. Look we did invigilation—”

Frank interrupts, “A WHAT?”

“Invigilation” says Scott. “We compared the results of your actual sales from one Friday night where the bartenders didn’t think they were being watched with sales from the Friday night where we watched the bartenders like a hawk. There was a difference in sales of about \$1,476 dollars. Part of that was employee theft and part was the unaccounted for complimentary drinks you give away.”

“Tell me about the employee theft” Frank said.

Scott replied “Well, the bartenders are essentially stealing in a couple different ways. The first theft method is what we call skimming. Skimming is when the bartender sells the drink but does not ring it up and pockets the cash from the sale. Many times the bartender would place the money in the register so it didn’t look like they were pocketing cash. Any account reconciliation you perform will not detect this fraud because there is not an audit trail of the sales transaction and the receipt of cash.”

“I can’t believe this is happening in my business. What else did you notice? Frank frantically says with shock in his voice.

“Another issue is sliding. Sliding is when the bartenders give free drinks to friends, family and people they’re attracted to without the permission of management or the owners. My graduate assistant watched this happen many times and her own friend was able to get a free drink by flirting with a bartender. All of these issues have a negative financial effect on your business.” As Scott describes the effect he shows Frank the financial statements he prepared at the beginning of the project.

“What about the rest of the missing money,” asked Frank, “who stole that?”

“I am not sure there was anything else stolen” replied Dr. Graham. “There was an overall difference in expected sales and actual sales of \$357,302. We estimated that 12% of sales were lost to thefts, which accounts for \$118,840. That leaves \$238,461 expected sales that were not realized.”

“Well, \$238,000 unrealized sales sounds like theft to me” replied Frank!

“Frank I hate to tell you this but I believe it is actually a measure of inefficient management, rather than theft!” Scott says.

“What do you mean inefficient management? Now you are getting personal!” replied Frank.

Scott began “Well, there were some observations made by team that may help explain the remaining unrecorded expected sales. First and foremost, the team noticed that there is some normal shrinkage of inventory. We didn’t take that into account when we ran our numbers. When pouring drinks there is some spillage and some of the bottled beverages are breaking in the cooler. Also, it seems sometimes the bartenders just make honest mistakes in pouring the wrong drink. We didn’t account for shrinkage in our analysis.

Secondly, we also noticed the bartenders are free pouring the liquor. Your company policy is a single 1oz shot per drink but your bartenders are pouring about 1.5oz into each drink.

We also noticed your bartenders also fill each draft beer up to the rim. In most establishments it is customary to only fill the glass to within one inch of the rim. Once again, that may not seem like a big difference but by pouring beer up to the rim your only getting at most 124 glasses per keg.

Also, you need to be more certain that your employees follow the bar’s specific policies and procedures. For example, when my grad assistant requested a tab, Jeremy did not require a credit card as back up. This type of behavior can add to your losses if customers skip on the bill. More specifically, I believe you have been too lax with your employees and I think your employees are taking advantage of this.

“Wow, that is a lot to think about!” said Frank. “I mean my customers like the drinks they get here. If I change how we pour beer and mixed drinks I could lose customers! But now my employees on the other hand, I am going to start watching them like a hawk.

Frank sighs heavily, “Damn, I got a lot to think about. Thanks so much for all your help. I guess I will have to take action to correct these problems.”

“Now about that free drink...” said Scott.

Frank sheepishly replied “Is this a test? I thought you just got through telling me to not give away drinks in my bar!”

## CASE QUESTIONS

### 1. Revising the Estimate:

In their original analysis Dr. Graham and his team made a few errors in their assumptions. These assumptions were critical to the analysis. Using the following assumptions; recalculate the expected sales for Sullivan’s Bar.

Assumptions:

- a. The estimated spillage for draft beer is about 10%.
- b. The estimated spillage for bottled beer is about 5%.
- c. Assume that bartenders have been pouring 1.5 ounce shot drinks.
- d. The bartenders are pouring beers with no foam head at the top.

Based on the revised assumptions above, what were the expected sales for the year?

## **2. Comparing Estimates:**

Using the recalculated expected sales, compare your calculations from question 1 to the actual results Sullivan's Bar achieved for the year.

Make sure you detail the differences between the original estimate and the revised estimate for each category of product.

## **3. Investigate the Invigilation:**

Using the answer you calculated from question 2, answer the following question: Did the amount of theft estimated by the team using the invigilation process explain the difference between expected sales and actual sales?

## **4. Differences?**

Examine your answer to question three. Are there any differences? What could possibly cause these differences?

## **5. Policies:**

How should Frank address the issue of the employees not following the policies? Specifically address different steps Frank can take fix this issue.

## **6. Controls:**

List and describe some controls Frank can put in place to fix the issues at his bar?

## **7. Freebies:**

Discuss the impact of Frank giving some of his customers free drinks from the both the point of view of the bartenders and of the owner. Should Frank discuss his behavior with his employees?

## **8. Sliding:**

In the case sliding was considered fraud. However, some experts do not agree. Do you consider sliding fraud? Should Frank give him employees some latitude in giving out complimentary drinks?

## **9. Bartender Fraud:**

Why was it so easy for the bartender to get away with fraud in this particular case?

**10. Other types of fraud schemes I:**

An additional type of fraud that has been discovered in the hospitality industry is bartenders selling drinks from their own bottles. What would be the effects of this type of fraud on the financial statements compared to skimming or sliding? Make sure you discuss the specific accounts that would be impacted and the ratios that would be affected.

**11. Other types of fraud schemes II:**

What other types of fraud schemes could happen at a bar like this? List at least three schemes and the impact they would have on the various financial statements and managerial measurements. How would the fraud likely be committed and how would it be prevented and/or caught.

**12. Frank's Perspective:**

Assume that Frank is correct and that he will lose some business if he starts pouring beer with a 1 inch head and 1 ounce liquor drinks. Frank estimates he will lose 10% of his customers. From the financial perspective, if Frank makes this change, would Sullivan's Bar be more or less profitable?

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