Volume 19, Number 5

Print ISSN: 1078-4950
Online ISSN: 1532-5822

JOURNAL OF THE INTERNATIONAL ACADEMY FOR CASE STUDIES

Editors

Inge Nickerson, Barry University

Charles Rarick, Purdue University, Calumet

The *Journal of the International Academy for Case Studies* is owned and published by Jordan Whitney Enterprises, Inc. Editorial content is under the control of the Allied Academies, Inc., a non-profit association of scholars, whose purpose is to support and encourage research and the sharing and exchange of ideas and insights throughout the world.

The *Journal of the International Academy for Case Studies* is owned and published by Jordan Whitney Enterprises, Inc, 51 Blake Drive, Arden, NC 28704, USA. Those interested in communicating with the *Journal,* should contact the Executive Director of the Allied Academies at info@.alliedacademies.org.

EDITORIAL BOARD MEMBERS

EDITORIAL BOARD MEMBERS

EDITORIAL BOARD MEMBERS

EDITORIAL BOARD MEMBERS

TABLE OF CONTENTS

LETTER FROM THE EDITORS

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

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

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.

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

AN ELEMENT OF CONCERN IN NORTH AFRICA: THE CASE OF MOROCCO'S PHOSPHATE INDUSTRY

Charles A. Rarick, Purdue University Calumet
Gideon Falk, Purdue University Calumet
Casimir C. Barczyk, Purdue University Calumet

CASE DESCRIPTION

This case explores the geopolitical and human rights issues involved in the phosphate industry in Morocco. With an increasing global demand for phosphate, and the growing concentration of the industry in favor of Morocco, concerns over who controls the disputed territory of Western Sahara and how much power Morocco has over global sourcing have arisen. A secondary issue examined in this case is the ethical question as to whether a country has the right to maximize its prosperity at the expense of other nations. The case is written at a difficulty level of three, appropriate for junior level courses. It is designed to be taught in one class hour and is expected to require 2-3 hours of outside preparation by students.

CASE SYNOPSIS

Morocco is frequently envisioned as a mysterious and colorful place situated south of Spain on the African continent. It is a land rich in colors, cuisine, and culture – viewed by many Western tourists as a destination glimmering with sun and sand. The case examines another side of Morocco, which is capitalizing on the global demand for phosphate, an increasingly valuable natural resource. Approximately 85% of the world's phosphate reserves are found around Morocco, with much of it in Western Sahara, an occupied territory directly to its south. Morocco claims Western Sahara as its own, exerting dominance and control over this small impoverished no-mans-land. This case examines the economic, political, and ethical dimensions of the world's demand for phosphate.

INTRODUCTION

When many people think of Morocco they envision an enchanted land of unique colors, cuisine, architecture, and perhaps mystery. A popular tourist destination for Europeans seeking sun and sand, Morocco is viewed as a quick and unique escape from the ordinary lives of many Westerners. Morocco has another side – one that has recently caught the attention of both the business community and various human rights groups. A leading export for Morocco is phosphate, which is mined both in Morocco and in the disputed territory of Western Sahara. With increasing global demand for phosphate and a majority of the resource located in the disputed territory, calls for the independence of Western Sahara are becoming increasingly resonant. Equally loud are the calls for a reduction of Morocco's market position power in phosphate production. Phosphate mining has been very beneficial for the Moroccan economy. Through the progressive social and economic policies of its monarch, Morocco has advanced its economic standing and human development. This development, however, may have come at the cost of the people who live in Western Sahara, a territory held by Morocco against the decisions made by the United Nations (U.N.).

MOROCCO AND WESTERN SAHARA

The Kingdom of Morocco is located in the extreme Northwest corner of the African continent, a short distance across the Strait of Gibraltar from Spain (Figure 1). Morocco has an estimated population of 34 million people with a per capita GDP of approximately $4,500 (PPP). The government is a constitutional monarchy headed by King Mohammed VI, who while not the head of state still exercises much power over the country, including management of its natural resources. He has led a successful campaign to improve the standard of living of his people and is generally well-liked by the people of Morocco, even though his lavish lifestyle and multiple palaces may seem incongruent with the poverty that exists throughout his country. Recent unrest in the Middle East and North Africa over the legitimacy of some rulers has touched Morocco, but the protests have been moderate. The king's strategy to increase phosphate prices in an effort to provide Morocco with a higher standard of living may be having the desirable effect of enhancing the image of the regime in the eyes of the Moroccan people.

Figure 1: Map of Morocco

Source: www.state.gov

Morocco is a sovereign state, but like many African countries has a history of foreign influence. In the early 1800s Morocco was a French protectorate with Spain playing a role in the northern and southern areas of the country. Morocco became independent in 1956 but Spain continued to occupy the territory adjacent to its southern border known as Western Sahara. In 1975 the International Court of Justice ruled against the Moroccan claim to the territory. In response, Morocco sent 350,000 of its people into Western Sahara to stake its claim. This Green March changed the demographic mix of Western Sahara and was the beginning of Moroccan dominance over the territory. Morocco's claim over Western Sahara continues to be a point of conflict within the international community and at the U.N.

In 2010 riots broke out in Western Sahara over poor living conditions and a lack of job opportunities for the native people, the Sahrawi. The Polisario Front, a separatist movement, has been waging a war against Morocco, seeking independence for the native people of Western Sahara who occupy the land they call the Sahrawi Arab Democratic Republic. Tension between Morocco's government and the Sahrawi people is strong, even though Morocco has provided economic development to the Western Sahara. Morocco agreed to a vote on self-determination but debate over who would be eligible to vote has repeatedly delayed an election. There is also concern that neighboring Algeria, which supports Sahrawian independence, would eventually seize control over Western Sahara. At the moment, Western Sahara is considered an occupied territory by the United Nations. The UN has called for its independence and has maintained a small peacekeeping force in the area. Morocco has agreed to an arrangement for Western Saharan autonomy, but that proposal has been rejected by the Polisario. The issue of complete independence and control over the territory's natural resources is a major point of conflict.

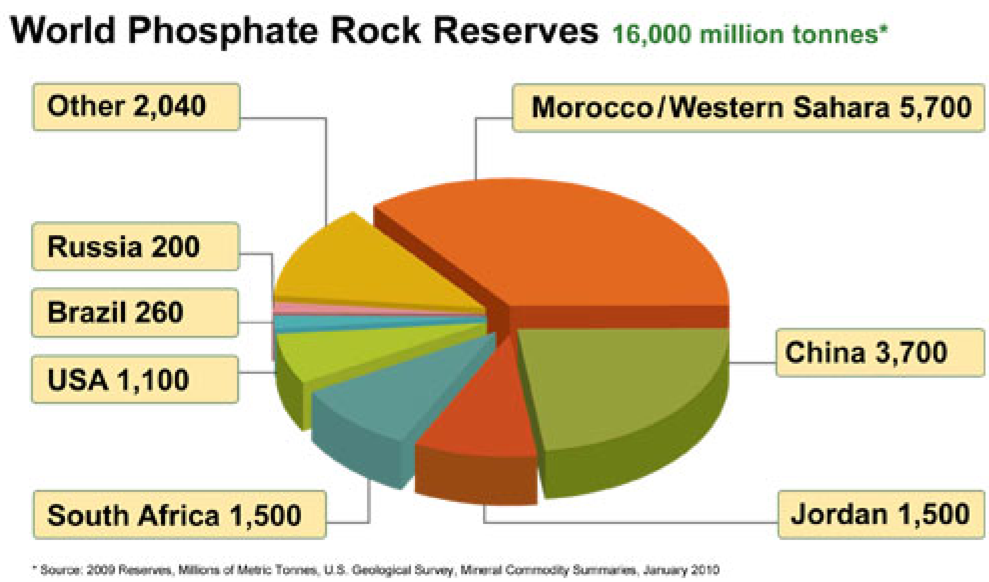
PHOSPHATE – A PRECIOUS ROCK

Phosphate and its Importance

Phosphate is a non-metallic mineral containing the element phosphorous, which is a vital commodity in the production of food and in many industrial applications. In combination with calcium, phosphorus is essential to human life. It is needed in many stages of human development – in utero, in childhood, in puberty, and in later life to maintain bone mass. Phosphate is also an essential nutrient for animal life. Over 90% of rock phosphate is used to produce fertilizers. There is no substitute for phosphate in fertilizers.

Phosphate is derived from a natural resource called phosphate rock. While phosphate rock is mined in several countries throughout the globe, Morocco currently supplies approximately 45% of the world's phosphate demand. Significant reserves still exist in China and other countries according to the U.S. Geological Survey (Figure 2). However, a troubling report by the International Fertilizer Development Center (IFDC) concerning its geological survey reveals that Morocco may possess 85% of the world's phosphate reserves, much of which is found in Western Sahara. If it were not for an increasingly valuable natural resource, the issue of independence and human rights for the people of Western Sahara would not attract much attention.

Figure 2: Estimated World Phosphate Rock Reserves



Source: 2009 Reserves, Millions of Metric Tons. U.S. Geological Survey, Mineral Commodity Summaries, January 2010.

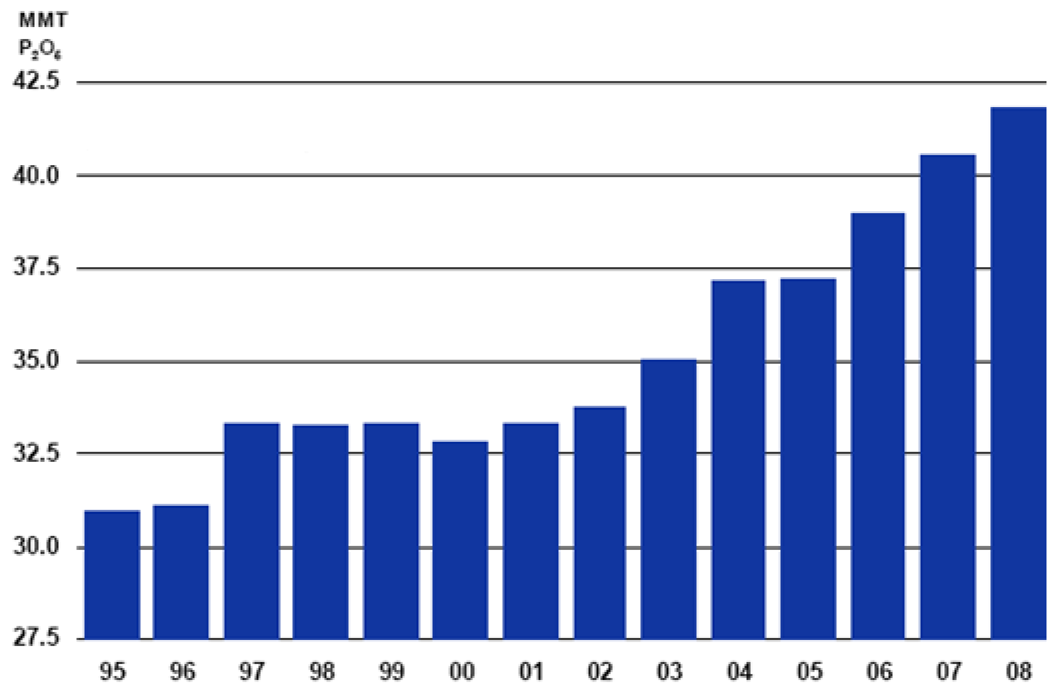
Uses

Many industries use phosphate in their manufacturing processes. It is a critical element in the production of fertilizer and most of the world's supply is used for that purpose. It is also used in detergents and cleaning products. In addition, it is used for various industrial and technical applications such as paints and coatings, ceramics, and as a food nutrient. Phosphate is a key ingredient in the production of food. Industries that produce baked goods, beverages, dairy products, egg products, canned fruit and vegetables, pasta, pet foods, poultry products and seafood all require phosphate. In addition, phosphates are used to manufacture many pharmaceutical and personal care products. Phosphate is also needed for the production of lithium-ion batteries, including those used in electric vehicles.

Demand

As the production of electric vehicles grows, it is expected that demand for phosphate will grow as well. Global phosphate demand and use has risen significantly since 1995 (Figure 3) and this growth is projected to continue in the future. With supplies of phosphate decreasing rapidly in many countries, the Moroccan supply remains stable, thus enhancing the country's market position. Phosphate supplies are expected to be exhausted in the United States in the next 40 years while Morocco, with its control over Western Sahara, has at least a 300 year supply. As a result of the shifting power of Morocco and its desire to control market prices, the cost of a ton of phosphate has gone from its decades-long price of $40 to, at times, over $500 a ton. Morocco's state-owned monopoly, the Office Cherifien des Phosphates (OCP), has pushed for higher prices in order to support the King's ambitious social and economic development plans.

Figure 3: World Phosphate Use



Source: International Fertilizer Association (IFA, 2007)

Adding to the power of the OCP is the fact that phosphate has no substitutes. While other monopolies and cartels may have substitute products to ease market dominance, no viable substitute for phosphate has been developed. Without phosphate, global food production would decrease, leading to possible mass starvation in poorer countries. While phosphate may not attract the media and political attention of other commodities such as oil, it is a precious commodity for the health and welfare of humans.

Phosphate Prices 2001- 2011

In August 2001 the price for a metric ton of phosphates was $41. From August 2001 to April 2007 prices per ton gradually increased to $45.50. Prices jumped to $54 in May 2007 and to $80 by November 2007. The prices rose to $135 in December 2007, $190 in early 2008, $323 in March 2008, and $367 in April. They reached a peak of $430 in August 2008. Prices declined to $414 in October 2008, $250 in November, $265 in January 2009 and $90 in July 2009. The price of phosphate eventually stabilized at $197.5 per metric ton in July 2011.

DIFFICULT QUESTIONS

There are a number of difficult questions concerning Morocco's political and economic involvement in the world's phosphate market. Among the chief concerns is the situation in Western Sahara. Morocco's occupation of this disputed territory since 1975 has resulted in many Sahrawi living in refugee camps in Algeria. There have been allegations of an extreme police-like state in Laayoune, a major city in Western Sahara. The government of Morocco has been accused of engaging in human rights abuses against the people of Western Sahara and ethnic cleansing.

Observers have pointed out the apparent irony in the United States' support of the Moroccan government, which is essentially an occupying country, resulting in the suppression of the right of Western Sahara's people to self-determination and its desire to become an independent republic. Morocco and the United States have a strong political and economic relationship, one that goes back to the American Revolutionary War. Morocco was the first country to request diplomatic relations in 1777 with the young government of the United States. Morocco and the United States enjoy the benefits of a bilateral free trade agreement, and the U.S. considers it an important ally in its war on terror. Morocco has at least two assets that are important to the U.S. One is the phosphate mined in the country. The second is a friendly Muslim country in a part of the world where friends for the United States are in short supply. The United States government tracks statistics on the amount of phosphate mined in Western Sahara, but does not release the data to the public, most likely for political reasons.

In August 2010, BHP Billiton, a US-Australian conglomerate, planned to acquire PotashCorp (PCS), a Canadian fertilizer firm based in Saskatoon, Saskatchewan. PCS imports phosphate from Morocco and Western Sahara, which it processes at its Canadian facilities. PCS is currently the largest fertilizer producer and the third largest phosphate producer in the world. After three months of negotiations, BPH Billiton withdrew its planned takeover of PCS, a move precipitated by the Canadian government's blockage of the acquisition because of its opposition to the Moroccan occupation of Western Sahara.

To date, no state or international organization recognizes Morocco's sovereignty over Western Sahara. The U.N. is working to decolonize Western Sahara, the last colony in Africa. In addition, the U.N. has repeatedly stated that Morocco's illegal occupation must end. Because PCS is the largest buyer of phosphates mined in Morocco and Western Sahara, its purchases support the continued Moroccan occupation. Further, PCS's business activities run counter to the U.N.'s initiatives to resolve the Western Saharan conflict.

Also of concern is Morocco's current position in the world phosphate market. Questions can be raised that an effort to drive prices as high as possible will adversely affect world food production and cause great hardship for poor nations. Morocco hopes to leverage its large phosphate reserves and its proximity to Europe to develop its economy. It has recently liberalized its economic structure and encouraged entrepreneurship among its people. Morocco is attracting foreign investment and attempting to develop competitive positions in tourism, textiles, agriculture, electronics, and aeronautical components. At the same time, there is concern over how this economic development will be funded.

REFERENCES

BBC News (September 11, 2010). *Regions and territories: Western Sahara*.

B. Borrell, & D. Grushkin (November 14, 2010). White gold. *Bloomberg Businessweek*.

Foreign Affairs (May/June 2009). *Morocco rising*.

Greenleaf Center for Servant Leadership. www.greenleaf.org.au. Accessed on December 22, 2010.

IDFC. Accessed www.ifdc.org.on December 26, 2010.

Mosaic. (January 18, 2008). *Why the surge in phosphate prices?* (IFA data).

Mundy, J. and S. Zunes (2010). *Western Sahara: War, nationalism, and conflict irresolution*. Syracuse, NY: Syracuse University Press.

Pendleton, D. (June 17, 2009). King of rock. *Forbes*.

PotashCorp. *Annual report, 2011*. Accessed www.potashcorp.com on February 28, 2012.

US Department of State. *Background Notes: Morocco*. Accessed www.state.gov on January 26, 2010.

US Geological Survey. Accessed www.usgs.gov on December 23, 2010.

Worth. R. & S. Mekhennet (December 9, 2010). Desert land in limbo is torn apart. *The New York Times*.

DOG EAT DOG WORLD: CHALLENGES OF AN ENTREPRENEURIAL START-UP

Daniel V. Holland. Utah State University
David Herrmann, Utah State University

CASE DESCRIPTION

The primary subject matter of this case concerns the stresses and challenges of an entrepreneurial start-up. Specifically, the case shows how start-ups often do not go as planned and how entrepreneurs must be resourceful in overcoming the challenges they face. For example, it gives students an opportunity to discuss potential bootstrapping techniques to scrape together much needed resources when financing falls through. Secondary issues include basic feasibility analysis and entrepreneurial ethics. The case is appropriate for junior and senior level business courses. The case is designed to be taught in one class hour and will require approximately two to three hours of outside preparation by students.

CASE SYNOPSIS

Fred Munk and Dwayne Clarke had developed significant experience and social capital in the Pet Supply industry in their region. When a large national chain purchased the company for which they worked, they deemphasized the customer service. The two nascent entrepreneurs were frustrated with the new direction of the company and recognized an opportunity to create a new competitive venture. Fred and Dwayne continued to work at the company as they tried to gather data about the viability of starting a new venture. They felt that there was potential but they were unsure about giving up the security of their employment, until their hand was forced.

With a new sense of urgency, Dwayne and Fred sought out potential financial partners, suppliers, and customers. They created a reasonably conservative plan that projected profitability in the first year. They worked hard to line up the necessary financing to execute the plan. They received pre-approval for a loan and started executing their plan. However, the promised loan was significantly reduced on signing day and Fred and Dwayne were left underfunded and overly stressed.

CHALLENGES OF AN ENTREPRENEURIAL START-UP

The Opportunity

Dwayne Clarke and Fred Munk were sitting in their weekly sales meeting with their new manager (GM) Bruce Hunter. The local pet supply company, ACME Pets, for which they both had worked more than six years, had recently been acquired by a large national company, GC Pet Supplies (GCPS). This was their 4th such meeting with the entire sales team. Dwayne and Fred had caught eyes when their Machiavellian boss, Bruce, had just announced another day and route change for delivery to a particular area. Bruce defended the change with the comment, 'who are the customers going to get their supplies from if they don't like it?' GCPS had not only purchased ACME but also their only significant competitor, attaining a virtual monopoly in the region. Independently, Dwayne and Fred both thought that perhaps 'I should be the one that the customer can go to.' After the sales meeting Dwayne and Fred privately shared their thoughts with each other.

Background

Dwayne had worked for ACME Pets for nine years, starting as a warehouse labourer while he finished college. Upon graduation, the owner approached him about taking over a sales route for a departing rep. The position was perfect for him. His warm genuine personality quickly won over his customers and eventually Dwayne grew his territory to over $2 million in annual sales, one third of that office's total.

Fred had started six years earlier as a buyer and had built a strong relationship with over one hundred vendors from whom they purchased products. Fred's philosophy was that his city was a small, expensive stop for most vendor sales reps; therefore, he was keen to give them time and listen to their presentations when they visited. He wasn't an easy mark but he gave everyone an honest shake. Fred worked hard and simultaneously pursued an advanced management degree. His efforts paid off and he moved up the company ladder rapidly and at the time that GCPS bought ACME, he was the General Manager. As such, Fred had ample opportunity to build relationships with many of the customers and vendors that worked with ACME. However, Fred rarely had contact with Dwayne's customers as they were already being serviced beyond company expectations.

Status Quo or New Venture?

As Dwayne and Fred pondered the possibility of starting a new pet supply company, they grappled with the ethics of performing any due diligence while staying employed with their eventual competitor. They decided to ask some questions and do the underlying research over the coming months. Ultimately, they had to determine at what point to terminate their employment if they felt the opportunity was worth pursuing.

After 7 months, the preliminary research looked promising. They determined that the potential enterprise had merit. However, the required financing was a significant roadblock. Both were dissatisfied with their jobs at GCPS but, as creatures of comfort, Fred and Dwayne wondered if they really wanted to leave the security that they had in their current employment. Years later, they admitted that they probably would not have acted if their hand had not been forced.

GCPS senior management had heard rumours that Fred had already started a competitive venture. Thus, they decided to fire Fred. Shortly thereafter, Dwayne resigned his position so that he could partner with Fred in the new venture. Fortuitously, Dwayne and Fred found a mutual friend who offered to help fund their new business. Out of work and armed with a new hope for resources, Fred and Dwayne developed a plan for Qualco Pet Supply.

Competitive Threat

GCPS was obviously not happy about the potential competition and it attempted to flex its muscles and discourage suppliers from selling to the budding competitor. However, suppliers and customers were quite keen about the new pet supply distributor in the area and Qualco was reasonably successful at securing commitments. In fact, the number one supplier in the industry sold and shipped product to Qualco three months before their planned opening. This provided legitimacy for Qualco that Fred and Dwayne were able to leverage. The fact that they had already procured a significant amount of product from the industry's top supplier opened doors at many other suppliers. Fred and Dwayne were able to dramatically enlarge their product offerings.

GCPS became increasingly distressed by the competitive threat and practiced open retribution on suppliers that sold to Qualco. The effect, however, was the opposite of what they intended. GCPS's tactics generated a wave of support among suppliers for Qualco, both overtly and covertly.

Preparation for Launch

While Dwayne was shoring up support from customers for the projected launch, Fred was working feverishly on business plans and projections. Fred was familiar with inventory turn rates and gross margins in the industry, being 4 and 30% respectively. He felt certain that they could increase the turn rates but he used the more conservative industry standards in his forecasts. Based on discussions with potential customers, Fred and Dwayne projected that they could capture approximately one sixth of the six million dollar market in their first year. They determined that it would ultimately take three to four hundred thousand dollars in inventory to offer a full line of products, which would be vital to achieve their long-term market share goals. However, they could not justify that many dollars in inventory for the initial launch. Thus, Fred calculated the bare minimum level of inventory that he believed would be needed to get started. If Qualco could start with $175,000 of inventory, with a 30% margin, they would be able to generate $250,000 in sales. With 4 turns, they would achieve their goal of $1 million in sales during the first year.

In addition to the inventory costs, Fred anticipated that Qualco would need $87,500 for other start-up costs. He felt that they would need to attain funding of at least $300,000 in order to cover inventory and other start-up costs, with a small cushion for operational losses and an accounts receivable balance. Monthly operational expenses were expected to be approximately $22,000, including principle and interest on a $300,000 note. They planned to push any spare monies into additional inventory. Fred knew that finances would be tight but he believed that the plan was attainable.

Rather than providing funding for the venture, their friend opted to help Fred and Dwayne secure a bank loan that would be personally guaranteed by each of the three of them. The loan would be collateralized with the value of their homes. With the assistance of their friend, Fred and Dwayne were approved for a $300,000 loan from a branch office of a large regional bank called Zinc's. The pieces were falling into place and Fred and Dwayne were well prepared for the launch of Qualco Pet Supply (or so they thought).

Always Expect the Unexpected

Armed with formal bank approval, Dwayne and Fred borrowed some short term money from friends to pay for their first few product orders and to cover some of their start-up expenses. They leased warehouse space (using personal guarantees) and hired a couple of key employees. They also used personally guaranteed loans to purchase trucks to be used for delivery.

Finally, the big day to close on the loan arrived. The much needed money would be used to pay off the short term loans and acquire the additional inventory they needed to finally open the doors. All three partners, and their wives, travelled to Zinc's to "sign their lives and homes away." As they entered the bank, they were greeted by a nervous loan officer who informed them that a "committee" had met that morning and revised their previously approved loan down from $300,000 to $175,000. The bank was unyielding, even with the threat of a lender liability suit.

Given the start-up expenses already incurred, that left Qualco with half the needed money for inventory and nothing for operational losses or accounts receivable. Dwayne and Fred were literally sick! They had run the numbers a million times and could not see how the business could survive with the amount of money that was available. They had already spent tens of thousands of dollars and had committed to tens of thousands more. There just was not enough money for inventories to get the job done. They were consumed with the question, "how on earth can we make this work?"

PAYMORE OR PAYLATER: INVENTORY VALUATION AND MATERIALITY

Marc I. Lebow, Hampton University
Veronique Frucot, Christopher Newport University
Janet Adeyiga, Hampton University

CASE DESCRIPTION

The primary subject matter of this case concerns the accounting treatment of vendor rebates. Secondary issues examined include materiality, auditor's independence and audit risk. Addressing the primary and secondary issues require researching the accounting and/or auditing literature.

The case has a difficulty level of three for the accounting questions, appropriate for junior level courses (students in Intermediate Financial Accounting I or II) and a difficulty level of four for the auditing questions, appropriate for senior level courses (seniors in an Auditing class). The case is designed to be discussed in two class hours (one for the accounting questions and one for the auditing questions) and is expected to require approximately four hours of outside preparation by students for each part. The case may be assigned as a group assignment or as an individual project. It may be used as a basis for class discussion, or completed as a take-home assignment.

CASE SYNOPSIS

Among accounting scandals, the problem involving Ahold NV, a grocery store chain, was unique. It involved the question of where vendor rebates to a retailer should be recorded. Vendor rebates are cash payments from the wholesaler to the retailer in compensation for large purchases of a product. Many retailers, including Ahold, treated the rebates as a reduction of Cost of Goods Sold. The alternative is to record the rebates as a reduction of inventory. This case takes that issue and puts it into a form most Intermediate Financial Accounting, Advanced Financial Accounting, and Auditing students can understand. While working the case, the students will have to address the accounting treatment of the rebates by researching the accounting literature, discuss the materiality of the amounts, and explain their recommended treatment to an audit partner. Auditing students will also have to address the independence of their partner and the auditing firm and the issue of audit risk.

PAYMORE OR PAYLATER

After graduating from college, you entered the exciting world of public accounting. Your family is very proud of you. Not only were you an honors graduate with the best degree your alma mater offered (namely accounting), you passed the CPA exam on your first attempt and started working for the large and prestigious regional accounting firm: Countem and Tickem, CPA's. You completed the mandatory firm training to be an auditor and have been working as a staff accountant for over a year now. You are enjoying the challenging work.

You are currently working on the audit of Paymore Grocery, Inc. Paymore Grocery is a large, privately owned, regional grocery chain that emphasizes service to its customers and quality foods. Originally founded in 1948, it now operates twenty large, multi-service grocery stores. Although not the cheapest source of groceries in your locality, it dominates the multi-city area and is noted for the civic support the founding family has provided to the community. Historically, the family members running the chain have been very conscious of their public image. Paymore is also known for its willingness to help all customers obtain a desired but low-volume product, for its liberal return policy (even damaged or spoiled goods can be returned without a receipt), and for its donations of goods and services to local churches and charities. The superior service provided to the customers, the positive image of the founding family members, and the appeal of supporting a local, civic-minded chain, has allowed Paymore Grocery Inc. to grow much faster than its rivals and to dominate the local grocery market.

Paymore has also been very innovative in offering new services. It was the first grocery chain in the area to have an automated perpetual inventory system, to accept credit cards, to offer 'ready-to-eat' heat-and-serve meals, and to tailor promotions to individual customers based on their buying habits as evidenced by their Grocery Identification Card. As a result, the chain has been, until now, extremely profitable.

Despite its success and dominance of the local market, the chain is fighting new competition both from other larger grocery chains and from nontraditional chains like Wal-Mart and Costco. The Paymore chain has been working hard to maintain its dominance of the local market despite the new competitors.

As occurred before, control of the chain is being passed down to the next generation: specifically to Eugene Paymore III, the grandson of the founder, Eugene Paymore. While working on the audit, you discover that the youngest Eugene is of a different mindset than his father and grandfather. You have heard from patrons of the chain that service has suffered since the youngest Paymore has taken over and that the former uniformly high quality of the foods at the stores is slipping. You suspect that this may be a response to increased competition: Paymore is feeling profit pressures and is trying to reduce costs. Indeed, you note that operating expenses have declined in 20X3 despite the increase in sales. Yet, although the chain is still profitable, the net profit and gross profit ratios have slipped in 20X3 (Table 1).

Table 1: Paymore Grocery Inc.
Income Statement
For years ended December 31, 20X3, 20X2 and 20X1
(in thousands of dollars)

	20X3	20X2	20X1
Sales	$85,800.00	$78,000.00	$72,500.00
Cost of Goods Sold	$62,634.00	$54,595.00	$50,745.80
Gross Profit	$23,166.00	$23,405.00	$ 21,754.20
Operating Expenses	$13,250.00	$13,500.00	$ 12,325.00
Operating Profit Before Taxes	$ 9,916.00	$ 9,905.00	$ 9,429.20
Income Taxes	$ 2,974.80	$ 2,971.50	$ 2,828.76
Net income	$ 6,941.20	$ 6,933.50	$ 6,600.44

Paymore Grocery Inc.
Balance Sheet
As of December 31, 20X3 and 20X2
(in thousands of dollars)

	20X3	20X2
Cash and Cash Equivalents	$ 257.40	$ 240.50
Receivables	$ 5,025.00	$5,022.50
Inventory	$ 5,500.00	$2,250.00
Prepaid Expenses	$ 412.30	$ 410.80
Total Current Assets	$11,194.70	$7,923.80
Property, Plant and Equipment		
(net of accumulated depreciation)	$33,584.10	$23,771.40
Total Assets	$44,778.80	$31,695.20
Current Liabilities	$ 8,200.00	$ 7,205.40
Long-term Debt	$18,866.17	$11,977.30
Owners' Equity	$17,712.63	$12,512.50
	$44,778.80	$31,695.20

Selected Ratios
Paymore Grocery Inc.

Year	20X3	20X2
Ratios:		
Current Ratio	1.37	1.10
Acid test ratio	0.64	0.73
Gross profit margin	27.00%	30.01%
Net profit margin	8.09%	8.89%

A second change in the company's philosophy is that Eugene Paymore III wants to take the company public with an initial public offering (IPO). Until now, the chain has been privately held and the owners have not worried about outside influences and quarterly fluctuations in profits and sales.

While working on the audit, you notice that in the work papers, Shirley Doright, the audit senior at the start of the audit, included the minutes of a meeting she had with Eugene Paymore, III. During that meeting, Paymore stated that he wanted the financial statements to reflect the profitability and strength of the chain to insure a good price for the stock when the IPO occurs. He also reported that the investment bank handling the IPO (Silvermann and Sacks) had mentioned that the stock of profitable firms with increasing sales and net income sold for higher prices than comparable firms that did not display these characteristics. Shirley notes that the auditor needs to make sure that sales are not being booked early to boost revenues, that inventory shipments and the accompanying Accounts Payables are not recorded late to make the current ratio and other ratios look better, and that operating expenses are not underreported. As documented in the work papers, additional audit steps have been taken in these areas leading the auditors to conclude that they have adequate evidence to support their opinion about the value of inventory and the completeness of sales revenue and operating expenses.

As the audit is approaching completion and the workload increases during the "Busy Season," most of the staff is reassigned to other work so only you and the audit senior remain to complete the work papers and perform the remaining administrative tasks before the audit is completed. When the remaining work is almost completed, Shirley Doright, the audit senior, starts work on another job. She states that she is confident you can handle the few remaining tasks, especially since you will be under the supervision of Isaac Countem, the audit partner for this engagement. Isaac Countem assures you that he will work closely with you to prepare the final work papers and complete the audit.

You complete the documentation of the audit tests and take the completed work papers to Mr. Countem. Going through the work papers, he compliments you on your work and comments, "I have worked with the Paymores for years, they are good people. I hope the IPO is successful. Old Eu Paymore was my godfather and I have helped him, his son and, now, his grandson by providing audit and accounting services. It is a shame that Old Eu has passed away, he would be proud of the success of his children and grandchild with his grocery store. With the IPO coming, this is a great opportunity for them to become big time. I want to make sure everything goes well as a way to pay back the kindness their old grandfather showed me when I first went into accounting. They were my first big audit client."

You take this opportunity to raise the following concern: "During my final set of analytical reviews, I noticed that while their acid test ratio went down slightly from last year, their current ratio is higher than last year. I determined that the inventory in their warehouse is much greater than normal: it is up to $5,500,000 from only $2,250,000 last year. I also found a journal entry that is very confusing. There is a debit to "Cash" for $100,000, a debit to "Accounts Receivable" for $50,000 and a credit to "Cost of Goods Sold" for $150,000. I cannot identify what it is. I am a little concerned since their net income is up over last year by so little. They did get the cash but I do not understand the rest of the entry. What do you think we should do?"

Mr. Countem quickly picks up the phone and dials a number. He hits the speaker-phone so you can hear the conversation with Eugene Paymore. The voice from the other end of the telephone yells out:

Paymore: Hello, Eu Paymore here.

Countem: How you doing? It's me, I. Countem. We got a few questions before we finish the audit. You ready to talk?

Paymore: Sure, fire away. We are real anxious with the upcoming IPO. We want everything to be perfect. I am real worried about the IPO because net income is up so little but I think we got everything where we want it. The impression I got from my talk with the account executive from Silvermann and Sacks is that for the IPO to be successful, we have to sell the public on the fact that Paymore is growing, even in these tough times.

Countem: Good. We want everything to be perfect as well. That is why I am concerned about a few little things. Here are my questions. First, why is inventory up so much in your warehouses?

Paymore: That's easy. The Fizzy Cola people gave us a good deal on their cola if we bought it before year-end. They gave us a 5% rebate on our end-of-year purchases if we bought an additional $2 million of inventory. We bought an extra $2,000,000 worth of Fizzy Cola which gave us a $100,000 rebate. We deposited the money into the bank and credited "Cost of Goods Sold." The $2,000,000 is still in inventory because we received it just one day before year end but our total sales for the entire year of Fizzy Cola is over $12,000,000. We will definitely sell all the fizzy cola before the end of February of 20X4. That is long before the expiration date on the bottles, if you were concerned about the value of the inventory in our warehouse.

Countem: That explains the $100,000 in cash that you deposited. We were concerned with that journal entry. What about the $50,000 debit to "Accounts Receivable" that is also in that journal entry?

Paymore: The Fizzy Cola folks told us that they would bump the rebate up to 7.5% if we bought another $1,000,000 of Fizzy Cola by April 1st of 20X4. The rebate will occur after year-end but relates to the 20X3 purchases of inventory – you know, the year under audit. Therefore, we put the rebate on the December 31 inventory on the 20X3 financial statements. We sell about $1,000,000 of Fizzy Cola a month so I am sure that we will qualify for the additional cash rebate and so we booked it. That is another 2.5% on the $2,000,000 in inventory that we already bought. That works out to an additional $50,000 on the cola for the year being audited. Are you worried that we won't sell the inventory or that it will go bad before we can sell it all?

Countem: No, that isn't our concern. We are OK with inventory obsolescence and inventory valuation. You used the rebates to reduce the inventory? Right?

Paymore: No, I didn't adjust inventory. Last year, when we asked about vendor rebates for 20X2, Shirley Doright told us that wasn't necessary. She said that we could include the Fizzy Cola in inventory as long as we had physical control of the inventory in our warehouse. She also said that we had always included the product purchase rebates (or vendor rebates) as a reduction of Cost of Goods Sold. I debated what to do with the rebate since the purchase occurred so close to year end and the Fizzy Cola is still in inventory. That is a first for rebates. But I assumed that doing it the same way every year is good, that is being consistent. Right? That is one of those accounting principles you guys like. We are just taking advantage of a promotion and following GAAP consistently like we did in the past. Who cares whether we reduce Cost of Goods Sold or Inventory, it all goes to the Income Statement when the inventory is sold.

You know that we are about to go public. It has been a tough year; sales were down so I ran a bunch of discount sales so that we would show consistent increases in sales for the past three years. For the IPO, I wanted sales to be up by 10%, so I had to run a lot of specials on grocery stuff. That helped sales but didn't help gross profit or net income much. So I am using the product rebates to make sure that net income increases, even if only slightly, for all three years. I don't see any problem. Do you?

Countem: If you put the rebates into Cost of Goods Sold in the past and you are being consistent, then I do not see any problem. Let me talk to the accountant handling the audit and see if everyone is on board. Even so, it is only a question of recognizing the income this year or next year when

> you finish selling all of the cola. It is probably not that big an issue but I want to be sure. I will get back to you with our final decision.

Mr. Countem hangs up, turns to you and remarks that this issue could be a major problem and that he does not want any problems with this audit. He is especially concerned with the recording of the $50,000 as Accounts Receivable. As he points out, although it is almost certain that Paymore will earn the additional discount, it has not earned it yet, and therefore, recording it this year as an Account Receivable seems questionable. He adds that although in the past only the banks read the financial statements, with the IPO, the SEC and outside investors will also be involved. He stresses that he wants to make sure that everything is above board so that the IPO goes well. You already know that the firm has several publicly traded clients and has developed expertise with Sarbanes-Oxley.

Mr. Countem instructs you to research the correct recording of the vendor's rebates and to write him a memo with your findings. He reminds you to take into consideration the fact that Paymore uses a FIFO inventory costing system. You tell Mr. Countem that you will start working on it immediately and will get back to him. You examine the income statement for the current year and the previous two years as well as the balance sheet for the current and prior year (Table 1).

ENTREPRENEURS AND THE FEDERAL DEFICIT GAP (MAKING THE CASE FOR EXPENDITURE CUTS AND/OR TAX INCREASES.)

James A. Martin, Washburn University
Kanalis Ockree , Washburn University

CASE DESCRIPTION

This case allows students, to assume the role of an owner/operator of a family owned construction company. From this vantage point, students will analyze and provide workable solutions for closing the United States Federal deficit gap for the fiscal year ended September 30, 2011. Students will also analyze macro and micro effects of their proposed solution including effects on families and the construction industry.

The case leads students through a process to close the Federal deficit gap by a combination of tax increases and government expenditure reductions. The tools provided to students when making expenditure reductions include estimated 2011 Federal expenditures for the following categories: Social Security, Medicare, Education, Defense, Welfare/Unemployment, Courts/Police, Transportation, General Operations, Interest, and Other. Also provided are explanations of what type of programs are encompassed by each category of expenditure and a five year trend analysis of these expenditures, identifying which areas have seen the greatest expenditure increases.

The tools provided students to be used when analyzing which income level or type of taxpayers should see tax increases (or decreases) in order to close the budget gap are equally robust. The case provides estimates of incremental tax revenue for a 1% increase in the Federal tax rate for the individuals in six different taxable income strata. Estimates of additional tax revenue from the following actions are also offered:

- *Increasing the Federal corporate tax rate by increments of 1%*
- *Increasing the FICA tax rate by increments of 1%*
- *Increasing the Social Security tax base (from $106,800 in 2011)*

Students are directed to propose expenditure reductions and nominal percentage increases (or decreases) for each tax strata until the $1.3 trillion gap is closed. There are no right or wrong answers. Additional probative questions are provided to allow instructor follow-

up. These questions focus on micro and macro fallout from the proposed actions by the students. Consideration is also given to the entrepreneurs and related individuals in the case study.

The case is particularly timely given the difficulties of the U.S. construction industry and the eminent 2012 national elections. With candidates and Congress reluctant to make tough decisions to raise taxes or eliminate popular spending programs, the case provides students with workable estimates of Federal expenditures, separated into familiar categories.

CASE SYNOPSIS

You are evaluating the economic viability of Creative Construction, a small construction company struggling to survive following the 2008 economic downturn. The economic downturn inspired stimulus spending by the Federal government left in its wake a considerable Federal deficit. Estimated at $1.3 trillion, the 2011 deficit pushed the overall U.S. Federal debt total above $15 trillion, mobilizing Congress to raise the U.S. debt ceiling multiple times and leading to a downgrade in U.S. debt by Standard & Poors. Your task is analyze the 2011 Federal budget deficit and make recommendations for expenditure reductions (by Federal program) and for tax increases (by type and income level of taxpayer). Additional questions will be asked related to possible impacts of your proposal on Creative Construction, its employees and the U.S. as a whole.

ENTREPRENEURS AND THE FEDERAL DEFICIT GAP

In 2008, Creative Construction, Incorporated, owned and operated by Jason Carter, thrived as a general contracting firm in the housing industry in the central part of the U.S. Jason and his crew of three employees built new houses and completed major residential remodeling projects. Jason's employees included a framing carpenter, a finish carpenter, and a carpenter's apprentice. The apprentice was Jason's 19 year old son, Todd. Jason's wife, Anne, then a housewife, had an accounting degree and kept all the financial records for the corporation. A local CPA firm completed all the corporate tax work.

Jason's primary responsibilities in the corporation included sales, design, bidding the work, consulting with clients throughout construction, and hiring and coordinating sub-contractors, and organizing and managing his own crew. During construction projects Jason hired additional employees as necessary to carry out construction functions.

By 2009, the impact of the recession had hit the country hard with a steep decline in the construction industry. After 24 very successful years of business Jason was in trouble. For the first time Jason felt he lacked control over his business decisions. Every choice was based on a survival strategy, first for the firm and then for his family. Jason struggled throughout most of the year to keep his crew together and maintain his business, but soon felt forced to lay off his men. He returned to carpentry and he and his son worked together to try and keep the business going. Jason finally laid off Todd, and found a job himself as a project manager for a major contractor.

By mid-2010, Jason sold the house he built for his family; Anne went to work as a receptionist, the only job she could find; and Todd was drawing unemployment while he struggled to find work. Todd now moved in with his parents in their rented house. He sold his car to pay for living expenses, relies on a government funded Medicaid program for minimal health insurance coverage, and rides the city bus to look for a job. Jason maintained his corporate entity by performing small jobs on weekend and other days off, always with the hope that there would be an economic recovery. Meanwhile, one of Jason's previous employees was survives on unemployment compensation and food stamps. Jason lost track of his framing carpenter and did not know how he now supported himself.

While Jason has never personally been very political he has always closely followed the economic and political news and considers himself to be an independent voter. He has voted in every election since he turned 18. Jason knows from discussion with his construction colleagues and from following the economic news that national economic trends following the deep recession of 2008-2009 are having a major impact on the futures of his business and his family.

The reports he hears are very confusing. One side espouses the view that the road to recovery can only be paved with higher taxes of various kinds so that current levels of Federal government spending in all areas can be maintained and/or increased. The other side posits that the road to recovery lies strictly in cutting Federal spending and lower taxes. Both sides declare that their favored strategy will cut the Federal deficit and control the Federal debt level both of which are believed to be blocking a normal economic recovery process.

For years, Jason and a group of contractor friends have met every Thursday evening to have a few beers and chat. When times were good the discussions focused on new technologies and developments, emerging financing mechanisms for their thriving businesses in construction and how the government was always in their business and constraining the commerce with rules and regulations. Now discussions center on survival of businesses and families and whether there will ever be a recovery for the industry.

On a recent Thursday night one of the group said he had grown tired of just talking about issues and wanted to do something, anything, rather than just talk. He presented the group with information he had gleaned from the internet about the Federal deficit [exhibit #1], Federal spending, [exhibit #2] and Federal taxes [exhibit #3]. He suggested the group look over the information and after a brief discussion, take some worksheets [exhibit #4] home and put together their personal recommendations. The following Thursday the group would meet again and attempt to put together a composite recommendation that could be sent to the group's congressman and U.S. Senator.

While Jason is not paying significant Federal taxes now he vividly recalls the sting of taxes he felt as a corporate taxpayer and as an employer. Raising corporate income taxes and personal income taxes will both affect him in a future recovery whether he rehires employees or not. He also knows how much unemployment compensation has helped his son and how food stamps and unemployment compensation have literally saved the life of his former employee and his family. In addition, Todd is a few weeks away from exhausting his unemployment benefits and wants to get out of construction and go back to school. He will be unable to pursue that course without federally subsidized student loans. If unable to return to school, Todd is considering joining the Navy. The questions in the worksheet then present a significant quandary for Jason and he believes most of his friends in the group are facing the same dilemma.

U.S. ECONOMY BACKGROUND

It is October 1, 2011. The U.S. government has just closed the books on a year which generated the largest deficit in its history. The 2011 Federal deficit of $1.3 trillion is the result of $3.6 trillion in expenditures and $2.3 trillion of tax revenue. The deficit has been funded by the Federal government borrowing an additional $1.3 trillion. This additional borrowing, when added to the Federal government's borrowing in prior years leaves the Federal government $15.5 trillion in debt. The increase in debt and the promise of continuing deficits causes Standard & Poors to lower the ratings on U.S. government debt.

There may be hope. Citing the need for fiscal responsibility and heeding the risks of unchecked deficit spending, you have been engaged to make proposals to eliminate the ongoing revenue/spending gap. Your task involves taking a breakdown of the 2011 Federal spending by program (e.g. defense, Social Security). You then use this information to recommend reductions (or increases) in spending in various programs. Additionally you will make recommendations related to a table which shows the incremental tax revenue which can be generated by increasing the income tax rate by 1% for various income levels of individual taxpayers. Use this table to recommend varying increases (or decreases) in tax rates (e.g. 1%, 2%, 10%) for each income level. Information provided about the calculation of incremental revenue from increasing taxes on corporations and from increasing FICA taxes will facilitate this process.

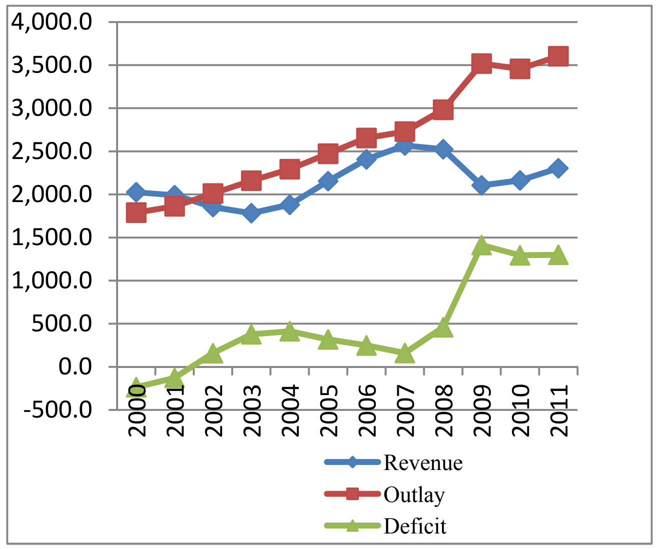
The goal is for each student or group to propose a plan for increasing taxes and/or decreasing expenditures to balance the Federal budget. Following completion of each plan, students will respond to a series of questions about the impact of the proposed changes in spending and taxes. The questions will focus on the impact of the student proposals on various affected constituent groups and the economy as a whole, impact on related business issues and also address some ethical considerations.

EXHIBIT # 1: BALANCING THE FEDERAL BUDGET

Background

The U.S. Federal government finished the fiscal year ended September 30, 2011 with an approximate $1.3 trillion operating deficit. Put another way, from October 1, 2010 until September 30, 2011, the Federal government took in $2.3 trillion while spending $3.6 trillion. The data below illustrate the relationship between Federal revenue, outlays and the resulting deficits between 2000 and 2011.

Federal Budget 2000 - 2011* [in billions of dollars]			
Year	Revenue	Outlay	Deficit
2000	2,025.2	1,789.0	-236.2
2001	1,991.1	1,862.8	-128.2
2002	1,853.1	2,010.9	157.8
2003	1,782.3	2,159.9	377.6
2004	1,880.1	2,292.8	412.7
2005	2,153.6	2,472.0	318.3
2006	2,406.9	2,655.0	248.2
2007	2,568.0	2,728.7	160.7
2008	2,524.0	2,982.5	458.6
2009	2,105.0	3,517.7	1,412.7
2010	2,162.7	3,456.2	1,293.5
2011	2,303.5	3,603.1	1,299.6
* OMB Historical Tables - Table 1.3			



The economic effects of continued deficits are clearly negative. Please examine the estimated Federal government receipts and expenditures for the fiscal year ended September 30, 2011 then make proposals to reduce (or increase) various program expenditures to help close the budget gap. Below are the major expenditure categories.

EXHIBIT #2: EXPENDITURE CATEGORIES

Social Security: These expenditures are largely for retiree and disability payments.

Medicare: These expenditures are for retiree medical claims.

Education: These expenditures are for programs from preschool through graduate school including student loan programs.

Defense: Expenditures are for ongoing military actions, veteran's benefits, and foreign aid.

Welfare/Unemployment: Expenditures are for mostly unemployment payments and welfare programs including Medicaid programs.

Courts/Police: Expenditures for courts, prisons, and police.

Transportation: Subsidies and project reimbursement for ground, air, and water transportation.

General Operations: Costs of maintaining the executive and legislative branches (and facilities).

Interest: Interest expense offset by interest income from investments.

Other: Expenditures for housing, agriculture, mining, energy, community development etc.

Below are 2011 expenditure estimates segmented into categories listed above. Also included are 2006 expenditures (in millions) and the percentage change from 2006-2011 for your analysis. (Proposed reductions or increases should be made from the 2011 amounts.) (US Government Spending)

Expenditures ($ millions)	**2011**	2006	% Change
Social Security	**793,000**	586,000	35.32%
Medicare	**882,000**	583,000	51.29%
Education	**130,000**	128,000	1.56%
Defense	**903,000**	621,000	45.41%
Welfare/Unemployment	**482,000**	254,000	89.76%
Courts/Police	**61,000**	41,000	48.78%
Transportation	**95,000**	70,000	35.71%
General Operations	**33,000**	19,000	73.68%
Interest	**230,000**	227,000	1.32%
Other	**158,000**	127,000	24.41%
Balance Figure	**-166,000**		
Total	**3,601,000**	2,656,000	35.58%

You may also make recommendations to increase (or decrease) income tax revenues from various classes of taxpayers. The taxes you may affect are below.

EXHIBIT #3: REVENUE INFORMATION

Income Taxes

You will be provided with the amount of incremental tax revenue you can generate by increasing the tax rate by 1% for each of the following individual income ranges.

Top 1% of individual taxpayers based on adjusted gross income
Next 2-5% of individual taxpayers based on adjusted gross income
Next 5-10% of individual taxpayers based on adjusted gross income
Next 10-25% of individual taxpayers based on adjusted gross income
Next 25-50% of individual taxpayers based on adjusted gross income
Bottom 50% of individual taxpayers based on adjusted gross income
Corporate taxpayers

FICA Taxes: Incremental revenue for each of the following:

A 1% **increase** in the FICA rate.
Elimination or adjustment of the maximum limit on taxable FICA wages.

Income Taxes: Below are incremental tax revenue estimates (in $ millions) that can be collected by increasing the income tax rate for a particular class of taxpayer by 1%. (Tax Foundation) (Tax Policy Center)

	$ Millions
Top 1% of individual taxpayers	34,547
Next 2-5% of individual taxpayers	20,624
Next 5-10% of individual taxpayers	11,107
Next 10-25% of individual taxpayers	15,831
Next 25-50% of individual taxpayers	9,825
Bottom 50% of individual taxpayers	2,119
Corporate taxpayers	9,782

FICA: Below are effects (in $ millions) of increasing the FICA rate and the FICA match by 1%. Also below is the revenue effect of eliminating the maximum Social Security taxable income limit (2011 limit was $106,800).

	$ Millions
Incremental revenue from 1% increase in FICA.	124,620
Incremental revenue from eliminating FICA wage limit.	131,950

EXHIBIT #4: RECOMMENDATION WORKSHEETS
($1.3 Trillion Deficit Reduction Target)

Change in Income tax rates:	Percent Increase Decrease	$Millions
Top 1% of individual taxpayers	_____	34,457
Next 2-5% of individual taxpayers	_____	20,624
Next 5-10% of individual taxpayers	_____	11,107
Next 10-25% of individual taxpayers	_____	15,831
Next 25-50% of individual taxpayers	_____	9,825
Bottom 50% of individual taxpayers	_____	2,119
Corporate taxpayers	_____	9,782
Total Income Tax Change		
Change in FICA		
Change in Rate	_____	124,620
Change in Wage Limit (0.0-1.0) **	_____	131,950
Total FICA Tax Change		
Total Tax Revenue Change		

Expenditures		
	2011	$ Millions
	Millions	Increase/(Decrease)
Social Security	793,000	________
Medicare	882,000	________
Education	130,000	________
Defense	903,000	________
Welfare/Unemployment	482,000	________
Courts/Police	61,000	________
Transportation	95,000	________
General Operations	33,000	________
Interest	230,000	________
Other	158,000	________
Total Expenditure Reduction		________
Grand Total New Revenue and Expenditure Reduction	**($1.3 trillion)**	________

REFERENCES

Office of Management and Budget, *Historical Tables, Table 1.3*. Retrieved from http://www.whitehouse.gov/omb/budget/Historicals

Social Security Administration. *Maximum Social Security retirement benefit.* Retrieved from: http://ssa-custhelp.ssa.gov/app/answers/detail/a_id/5

Standard & Poors, *United States of America Long-Term Rating Lowered To 'AA+' Due To Political Risks, Rising Debt Burden; Outlook Negative.* http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245316529563

Tax Foundation. *Fiscal Facts.* Retrieved from: http://www.taxfoundation.org/news/show/250.html

Tax Policy Center. *The Tax Policy Briefing Book*. Retrieved from: http://www.taxpolicycenter.org/briefing-book/background/numbers/revenue.cfm

US Government Spending. *Government Spending Details.* http://www.usgovernmentspending.com/year_spending_2011USbn_13bs1n_1000508090E040#usgs302

VONAGE
AN OPPORTUNITY IN THE TELECOMMUNICATION INDUSTRY

Mohsen Modarres, Humboldt State University
Molin Jiang, Loyola University Chicago

CASE DESCRIPTION

The primary subject matter of this case concerns the opportunities and challenges faced by one of the largest Voice over Internet Protocol (VoIP) providers, Vonage. Both the internal, external and SWOT analysis from the case help explain where the opportunities and challenges are. The case also selected appropriate business-level strategy by Vonage. Productions offered by Vonage included different calling plans- domestic, international and small business plans. Those plans also have different features such as visual voicemail, 411 calling, caller ID, call waiting, call forwarding, do not disturb, and many others. The levels of difficulty in this case are4 – senior capstone classes and 5 - first year of graduate classes. The case is designed to be taught in 2 hours, and 4 hours of outside preparations by students.

CASE SYNOPSIS

Vonage is a Voice over Internet Protocol (VoIP) provider and a telecommunication industry leader. They offered the alternative to the traditional telephone industry to individual, small, large business and global internet connection. Vonage started its business in 2001 and the company was founded in Edison, New Jersey. The mission of Vonage was helping people communicate when, where and how they choose. In March of 2002, Vonage signed its first customers. During one year's time, calls completed over Vonage's network increased from 5 million to 107 million. Vonage became a market pioneer as offering the first ever VoIP service in the year of 2003. One year after, Vonage became a leader both domestically and internationally in the industry. Soon after its establishment the company realized rapid growth and expanded successfully. However, the telecommunication industry which Vonage involved needs new technology, requires broadband connection, and customer service. After much thought and consulting views, CEO Michael Snyder decided that certain percentage of income will use to improve the R&D and they will pay attention to increase the quality of the customer service. By this way, he hopes Vonage could attract more customers and keep the leading position in the industry.

COMPANY OVERVIEW AND MISSION STATEMENT

Vonage is a Voice over Internet Protocol (VoIP) provider and a pioneer in telecommunication industry. Vonage's mission was helping people communicate when, where and how they choose. They provide an alternative to the standard telephone industry to any person or small business with a broadband Internet connection. It allows the user to talk to anyone at any location by using their Internet connection rather than their standard telephone service. The culture of Vonage is creativity, passion, and revolution. According to the cultural statement on their Website, "Mediocrity is our enemy. Status quo is the bad guy. New ideas are our allies. Awesome is the guide. This is bigger than any one of us. Together, we will break through and transform the world as we know it." Jeffrey Citron and a number of others who provided venture capital founded it in 2001. They signed up their first residential customer in 2002 and officially launched in March of that year. There were 5 million calls completed over their network in the first year and 107 million in their second year. In 2003, Vonage began offering the first ever VoIP 911 call platform. In 2004, Vonage was offered in Circuit City stores nationwide, making it the first ever VoIP service available through retail locations. Vonage also successfully launched in Canada that year. There were 539 million calls completed over the network in 2004. In 2005, Vonage launched a Wi-Fi phone, allowing it to branch out into the mobile phone market. They completed over 2 billion phone calls in this year. The V-Phone was launched in 2006, officially introducing Vonage to the mobile phone market. They also acquired three key patents from Digital Packet Licensing Inc. in 2006. They completed more than 8 billion calls in this one year alone. The year 2007 was less eventful. They launched a voicemail service, as well as their "Free to Compete" campaign. Vonage teamed up with Motorola to release an Internet telephone adapter with wireless router, as well as launch V-Access. Over 9 billion calls were completed last year.

ORGANIZATOINAL STRUCTURE

On April 12, 2007, Vonage CEO Michael Snyder agreed to step down as Chief Executive Officer and resign from the company's Board of Directors. In his place, Chairman and Chief Strategist Jeffrey A. Citron will serve as Interim CEO. The company also announced plans for 10% (180) layoffs. For now, the control structure of Vonage is described as below.

According to Exhibit 1, Vonage uses functional structure. Different vice presidents control different functions. The CEO controls finance, technology, marketing, service, and product development. If Vonage decides to develop overseas markets, they should also have a divisional structure to support the new development.

BUSINESS STRATIGIES AND CORE COMPETENCE

At the very beginning, according to the market segments, Vonage's business strategy should be focus strategy. It shows from Vonage's products offering. Vonage has both residential and business plans. To enable each phone line to connect to the Vonage network, an adapter is plugged into the phone line that holds the identity of the phone number. Vonage does offer different plans, but these only change the number of minutes and types of minutes that are included. The packages range from $14.99 for 500 minutes, to $24.99 for unlimited local calls, and up to the premium package costing $34.99 with unlimited minutes anywhere in the US or Canada. There are two small business offerings, one with unlimited minutes for $49.99/month, and one with 1,500 minutes for $39.99. The business product offering is very similar to the residential offerings, but in addition the user gets a fax number with the account.

After the huge increasing number of their customers, Vonage uses an integrated low cost and diversification strategy. Compared to the traditional phone service, Vonage also uses a differentiation strategy. Some features that differentiate Vonage from traditional phone services include virtual area codes and multiple numbers attached to the user's account. Vonage offers toll free numbers for only $5 per month more. Vonage must differentiate itself and gain market share through consumer education, advertising, free trials, continued superior customer service, and innovation within the telecom industry.

CORPORATE-LEVEL STRATEGY

Telephone Service

According to the Statement of Operation Data (Exhibit 2) of Vonage, over 95% of its revenue is from the telephone service and the rest comes from customer equipments and shipping. Vonage derives most of their telephone service revenue from monthly subscription fees that they charge their customers under their service plans. They also offer residential fax service, virtual phone numbers, toll free numbers and other services, for each of which they charge an additional monthly fee. One business fax line is included with each of their two small office and home office plans, but they charge monthly fees for additional business fax lines. They automatically charge these fees to their customers' credit cards, debit cards or ECP monthly in advance. They also automatically charge the per minute fees not included in their monthly subscription fees to their customers' credit cards, debit cards or ECP monthly unless they exceed a certain dollar threshold, in which case they are charged immediately

Exhibit 2

			For the Years Ended December 31,		
(in thousands, except per share amounts)	2007	2006	2005	2004	2003
Statement of Operations Data:					
Operating Revenues:					
Telephony services	$ 803,522	$ 581,806	$ 258,165	$ 75,864	$ 16,905
Customer equipment and shipping	24,706	25,591	11,031	3,844	1,817
	828,228	607,397	269,196	79,708	18,722
Operating Expenses:					
Direct cost of telephony services(1)	216,831	171,958	84,050	23,209	8,556
Royalty	32,606	51,345	–	–	–
Total direct cost of telephony services	249,437	223,303	84,050	23,209	8,556
Direct cost of goods sold	59,117	62,730	40,441	18,878	4,867
Selling, general and administrative	461,768	272,826	154,716	49,186	19,174
Marketing	283,968	365,349	243,404	56,075	11,819
Depreciation and amortization	35,718	23,677	11,122	3,907	2,367
	1,090,008	947,885	533,733	151,255	46,783
Loss from operations	(261,780)	(340,488)	(264,537)	(71,547)	(28,061)
Net loss	$ (267,428)	$ (338,573)	$ (261,334)	$ (69,921)	$ (29,974)
Net loss per common share calculation:					
Net loss	$ (267,428)	$ (338,573)	$ (261,334)	$ (69,921)	$ (29,974)
Imputed dividend on preferred shares	–	–	(605)	–	–
Net loss attributable to common shareholders	$ (267,428)	$ (338,573)	$ (261,939)	$ (69,921)	$ (29,974)
Net loss per common share:					
Basic and diluted	$ (1.72)	$ (3.59)	$ (189.67)	$ (51.41)	$ (21.14)
Weighted-average common shares outstanding:					
Basic and diluted	155,593	94,207	1,381	1,360	1,418

Easy-Reaching Connection

Vonage has both residential and business plans. To enable each phone line to connect to the Vonage network, an adapter is plugged into the phone line that holds the identity of the phone number. For that reason, it can actually be removed and plugged into a hotel's broadband connection, or moved to a new home and plugged into the broadband modem or router without any transfer fees or calls to Vonage to transfer the number to a new location. The product instantly appeals to many market segments including the Internet generation, those disaffected with traditional local and long distance phone companies, mobile young families and military populations, and those comfortable with technology. Vonage offers fully featured, consumer-controlled packages for a fixed price, generally less than other traditional or wireless service, both of which charge extra for those features. Vonage offers its service directly on its website, through bundled packages with cable, through small telecoms, and very recently through retail outlets. Although Vonage is one of the pioneers of the VoIP service in their industry, they do not differentiate themselves with the other competitors nowadays. Therefore, the conclusion of our information is that Vonage use a highly related diversification strategy.

ORGNIZATION'S INTERNAL STRENGTHS

Vonage's internal strengths are numerous, as would be expected with a leader in any market. They have been able to gain several strongholds over their competitors through their innovation. Their first strength is the price savings. The most expensive Vonage plan is $34.99 per month and includes long distance, caller ID, call waiting, and all of the other services one typically pays extra for. The national average for local phone service is $34 and long distance is $27 more for a total of $61. This shows that Vonage is almost half the cost of traditional phone service. Vonage's ability to offer virtual telephone numbers is also an advantage. In other words, users do not have to use a phone number with an area code for the area where they live. If all of someone's family and friends live in Chicago for example, while the person lives in Kansas City, he/she can have a Chicago phone number, which will allow his/her family and friends to call him/her free of charge because it appears to be a local call. Another strength is the growth of the VoIP market. Vonage has gained approximately 1 million new customers every year since 2005 and there are no signs that this growth will slow down.

The fact that Vonage is the leader in VoIP service in the United States is also a strength for Vonage. They have clearly benefited from being the first to market, gaining new customers at an astounding rate. Vonage's simplified billing procedures are also a strength for the company. Rather than having lengthy and incomprehensive bills with multiple charges added together, Vonage simplifies this process and then offers the bills online so customers can track call history, something that is impossible with paper billing. Another strength of Vonage is that they allow users to call with a standard phone, rather than through their computer like most competitors. This allows individuals without technological skills to use the service, just like they have for years. They don't have to know how to use a computer, or learn any new skills to make VoIP calls.

ORGNIZATION'S INTERNAL WEAKNESSES

Vonage also has some weaknesses, many of which are associated with VoIP service in general, though they directly affect Vonage and its customers. The first weakness is that VoIP service is a new technology, which has been riddled with a few quality and reliability problems in its early stages. This weakness should be resolved as the technology matures. Requiring a broadband connection is another weakness. Though many houses already have broadband, those that do not are not able to use Vonage without adding an expensive broadband fee to their phone costs. One more weakness this may create is that this should allow broadband providers to offer bundled broadband/VoIP service for a discount rate, taking away some of Vonage's customer base. Another weakness is its dependence on electricity. Traditional phone lines use a dedicated power source, which makes it possible to make calls when there is a power outage. Since VoIP uses a broadband connection, any power outage or broadband outage will make it impossible to make phone calls until power is restored. Even emergency 911 calls cannot be made during these outages.

Another weakness is the pricing. While Vonage's service is an outstanding deal compared to traditional telephone service, other companies are undercutting Vonage and offering their own VoIP services for less than Vonage. Also, Vonage is unable to easily expand internationally. The European market already has a large portion of the population with broadband and VoIP so it will be difficult for Vonage to penetrate this market. Another weakness is the size and strength of the companies competing with Vonage. Many of them are well respected and known such as Time Warner, Comcast, and AT&T. All of these companies are much larger and have many more resources than Vonage, as well as already having access to user homes through other services such as cable or traditional phone service. Consumers find it is easier to use these companies to bundle their VoIP service with their current offerings, rather than go to Vonage for the service.

ORGNIZATION'S EXTERNAL THREATENS

When looking at the external environment surrounding Vonage, there are both opportunities and threats surrounding the company. The first major threat would be that telecommunication and cable companies have begun to roll out VoIP and already use it for international calls and prepaid phone cards. This is because acceptance of VoIP in general has gained ground against standard phone service. VoIP already has large acceptance in Asia and Europe, and foreign companies are poised to enter the US VoIP market if US companies do not capitalize on the market before them. Another threat would be regulatory factors. Though the current lack of regulation is an opportunity, the threat of future regulation is a certain threat. On February 12, 2004, the FCC deemed VoIP to be packet data on the Internet, and therefore unregulated information service, not a regulated voice service. U.S. phone companies pay roughly $25 billion in fees each year to send traffic over other companies' networks. The universal service fee is intended to support telephone infrastructure in all parts of the country and subsidize services such as high-speed Internet access for schools. VoIP providers, and ultimately their customers, are not required to pay these fees, giving them a distinct pricing advantage. AT&T and Vonage have proactively and even aggressively brought these issues to the FCC theorizing that the public Internet should remain unregulated.

ORGNIZATION'S EXTERNAL OPPORTUNITIES

Vonage's opportunities are rather extensive. One opportunity is that Vonage depends on the public Internet and existing broadband access, which is growing exponentially. In April of 2002, less than 16 million U.S. households subscribed to broadband Internet service. In October of 2003 it was up to 19 million. In 2007, that number had risen to 66 million US subscribers. With exponential growth like this, the future is bright for VoIP access. Another opportunity is the public's willingness to accept reduced quality and reliability for better value, unlimited long distance, and free features. Residential use of landline long distance service has declined from 97 minutes per month to 31 minutes per month between 1998 and 2007. At the same time, residential wireless usage increased from four minutes per month to 112 minutes per month. This migration will continue as wireless providers gain a larger share of the telephone market. Residential customers are using the free nights and weekends to make their long distance calls and they are willing to substitute convenient wireless services for landline services. If they choose to replace all of their telephone service with wireless phones, this will drive the wireless long distance usage higher yet, despite the lower quality and reliability of wireless. Another opportunity is that Vonage VoIP products offer solutions to growing phone service cost, poor service, and the feeling that the conglomerate companies are in total control. If VoIP is bundled with cable TV and Internet connection, this satisfies many consumers' preference for bundled services. Currently, second home phone lines are heavily taxed and small business lines are even more expensive. The younger age trend could be a factor as older adults learn to use the Internet, feel comfortable with new technology, and are willing to try new technology. Vonage bundled services could be viewed as a small indulgence because all of the extra features are free. Consumers have become increasingly intolerant of shoddy service, and even though VoIP transmission quality at this time is comparable to cell phones, the customer care that Vonage provides is far superior.

INDUSTRY ANALYSIS- POTER'S FIVE FORCES

Applying to the Porter five forces model, Vonage is facing many challenges. When considering rivalry, Vonage's main rivals are AT&T, SBC Communications, Comcast, and Time Warner. Obviously these companies share the telephone market with Vonage so that is the primary reason for their rivalry. They also carry a large portion of the broadband service in the United States, which Vonage uses to operate its VoIP service. The main aspect all of the companies have in common though is they are all broadband/telephone powerhouses. The threat of substitutes for Vonage is vast. There are currently over one thousand VoIP providers in the United States and this number is growing at a staggering rate. With that many direct competitors, the threat of losing potential customers to a substitute is a costly possibility. When looking at buyer power, it is difficult to analyze. Considering the vast amount of choices a buyer has when searching for telephone service, it would seem there is a high amount of buyer power. They have the choice and opportunity to use any telephone service provider they choose. They also have the choice of using a traditional phone service, cellular phone service, or going with VoIP service, again increasing their power as a buyer. On the other hand, supplier power is rather low. With more than one thousand competitors in the VoIP market, Vonage has very little power as a supplier. When the company first started, their power was vast, though the new entrants into the market have greatly diminished that power. Now Vonage is forced to compete with all of the other competitors, reducing their power over rates, services, and the prospective customer base. Also, the barriers to entrance into the market are moderate. While it would be difficult for a small upstart company to jump into the VoIP market, it is rather easy for a large telephone or broadband company to do the same. The technology is widespread and the access to the broadband service and telephone lines is already available to those companies. With their vast resources, it is just a matter of implementing the technology into their current service offerings.

Porter's Five Forces Model for Vonage

SWOT ANALYSIS

Strength

Low price, virtual telephone numbers, rapid growth, and others. Vonage has used innovation to popularize the notion of virtual phone numbers. This means that users can have multiple phone numbers, and they don’t have to be within the area code where they reside. For instance, users can have a New York area code in California. This has several benefits. It could reduce the costs of people that would be calling Vonage users from those areas, as they wouldn’t need to place a long distance call to reach Vonage users. It would be especially beneficial to businesses that want to give the image of a local presence in an area without having a physical office in that locale. It would also be beneficial to people whose families or friends primarily live in one location while they live in a different location.

The packages range from $14.99 for 500 minutes, to $24.99 for unlimited local calls, and up to the premium package costing $34.99 with unlimited minutes anywhere in the US or Canada. Some features that differentiate Vonage from traditional phone services include virtual area codes and multiple numbers attached to Vonage users’ account. Vonage offers toll free numbers for only $5 / month more. That is a significantly lower price compared to traditional telephone service pricing.

Weakness

New technology requires broadband connection, and customer service. VoIP is a relatively new technology to be in widespread use when compared to phone lines. The technology has not matured to provide the same quality and reliability of traditional phone lines. This is one of the greatest fears of consumers when switching to the Vonage service, coupled with the dependence on broadband connections.

Vonage’s VoIP technology is tied to a broadband connection, which means that this needs to be provided by another company. Thus it is necessary to get either DSL or cable modems for residential users to be able to utilize the service. There are a few issues with this dependence. The first is the cost of having both the broadband service and then coupling the Vonage cost on top of that. This may not important for someone because most people are switching to broadband anyway. The second issue is that it seems likely that the broadband providers would be able to offer some sort of bundling discount thereby costing Vonage some of their client base. Vonage providing their service to the broadband providers for resale can mitigate this. The final issue is when users’ broadband connection goes out they have no means of making telephone calls, thus they have an issue of how to report their outage.

Customer service is a weakness for Vonage. Vonage requires customers to cancel service by calling a toll free number, as service cancellation is not available on-line. Customer descriptions of the cancellation process frequently involve hold times of approximately twenty-five minutes, depending on call volume. Difficulties faced by customers when attempting to cancel Vonage were detailed in a May 2006 Wall Street Journal article, which related one customer's experience with a Vonage representative who refused to cancel an account unless a repair attempt was allowed by the customer. Despite marketing their service as having no contracts or long term commitments, Vonage charges customers a fee for cancellation within the first two years of service, which changed from one year on February 1st, 2007. This fee is noted in the provider's Terms of Service when a customer signs up or attempts to access their Web Account. The fee is $39.99 per physical voice line to be disconnected. This fee does not apply to dedicated fax lines, virtual telephone numbers, or the computer-based SoftPhone lines. A rebate recovery fee is also assessed if the account is canceled after the 30-day money back guarantee but before 180 days of service. This fee is the instant rebate, which is offered on the web site when signing up and is different for each device. This fee, if applied, protects the company from having bogus accounts signed up and canceled shortly thereafter for free or discounted routers that can then be sold for profit. It is the policy of Vonage to bill any customer who is discontinuing service for any reason; even if the customer is unhappy with the quality of the service, they will still be billed $39.99.

Another problem for Vonage is the lawsuit with Verizon. On 19 June 2006, Verizon filed a lawsuit charging that Vonage infringed on five of Verizon's patents related to its VoIP service. The patents describe technology for completing phone calls between VoIP users and people using phones on the traditional public switched network, authenticating VoIP callers, validating VoIP callers' accounts, fraud protection, providing enhanced features, using Wi-Fi handsets with VoIP services and monitoring VoIP caller usage. On 8 March 2007, a jury found Vonage guilty of infringing on three patents held by Verizon, and not guilty of infringing on two other patents. The jury ordered Vonage to pay fifty-eight million dollars and a royalty rate of 5.5% of every sale to a Vonage customer to Verizon. Subsequent to this jury award, there were a series of appeals and intermediate stays on payment. These appeals ended on 19 November 2007 with Vonage agreeing to pay $120 million in damages to Verizon.

Opportunity

The growth of Internet and broadband, and the large oversea markets. There are many countries that lack of VoIP technology. Vonage can open new business to new markets. In April of 2002, less than 16 million U.S. households subscribed to broadband Internet service. In October of 2003 it was up to 19 million. In 2007, that number had risen to 66 million US subscribers. With exponential growth like this, the future is bright for VoIP access. Another opportunity is the public’s willingness to accept lesser quality and reliability for better value, unlimited long distance, and free features. This migration will continue as wireless providers gain a larger share of the telephone market. If they choose to replace all their telephone service with wireless phones, this will drive the wireless long distance usage still higher despite the lower quality and reliability of wireless. Another opportunity is that Vonage VoIP products offers solutions to growing phone service cost, poor service, and the feeling that the conglomerate companies are in total control. If VoIP is bundled with cable TV and Internet connection, this satisfies many consumers interest in bundled services.

Threats

While Vonage experiences a price advantage over the traditional phone companies, other VoIP providers are offering packages at an even lower rate than Vonage. Packet-8, for example, offers unlimited residential services for $20, which is close to half the rate that Vonage is charging. There is also the Voice over Net (VON) providers that offer free calling capabilities. Several of these services have moved from previously providing free services to pay services, which indicate that there is a paradigm shift in the technology. For example, dialpad.com now charges a rate of less than two cents per minute in the US.

Currently the VoIP services are unregulated by the FCC or state regulators, though there is growing pressure for regulation because of the popularity of the services. The CEO of Vonage remarked that bringing in regulation now would slow the market. This shows that they are not as mature as traditional phone services and would likewise not be able to compete given the same regulatory issues at this point.

Competitive Rivalry

Several of the companies that are getting into the VoIP market are much more established and respected companies than Vonage. These companies include the likes of AT&T, Time Warner, and Comcast. All of these companies have resources far in excess of Vonage, and the additional advantage of already having access to end users' houses, like being the cable provider, and being known entities that they have done business with in the past. Companies who provide the broadband connection required for VoIP have the ability to bundle the two services together, which may place Vonage at a disadvantage. Additionally, Vonage service is dependent on receiving access to all facets of the phone call lifecycle, which are controlled by many of these MSO companies. They could even attempt to raise these transfer fees to price Vonage out of the market.

FINANCIAL ANALYSIS

According to the financial data above, Vonage's operating costs are very high. Vonage spent $232.4 million in 2004 and the first nine months of 2005 combined. Of course, this spending ate into profits and revenues. Although growing spectacularly on revenue, it cannot mask the fact that losses are growing as well. Revenues were $18.7 million in 2003, $79.7 million in 2004, and $174.0 million for the nine months ended September 30, 2005. From the period of inception through September 30, 2005, the cumulative net loss was $310.0 million. The company's net loss for the nine months ended September 30, 2005 was $189.6 million. During the same nine-month period, marketing expenses were $176.3 million. More information can be found from the income statement table described below.

Exhibit 3			
	Vonage All numbers in thousands		
PERIOD ENDING	**31-Dec-07**	**31-Dec-06**	**31-Dec-05**
Total Revenue/Sales	$828,228	$607,397	$269,196
Cost of Revenue	$308,554	$286,033	$124,491
Income Before Tax	($267,246)	($338,788)	($261,724)
Net Income	($267,428)	($338,573)	($261,334)
Inventory	$19,604	$24,390	$15,687
Current Assets	$231,683	$569,772	$303,854
Total Assets	$462,297	$757,524	$446,882
Current Liabilities	$448,603	$259,928	$135,724
Total Liabilities	$537,424	$574,323	$426,940
Total Stockholder Equity	($75,127)	$183,201	($368,485)
Cash And Cash Equivalents	$71,542	$210,253	$132,549
Net Receivables	$20,105	$16,544	$7,435
Trading Security	$0	$0	$0
Interest Expense	$22,810	$19,583	$1,093
Earnings Before Interest And Taxes	($244,436)	($319,205)	($260,631)

Exhibit 4			
PROFITABILITY RATIOS			
1. Return on assets=Net income before taxes/Total assets	(57.81%)	(44.72%)	(58.57%)
2. Profit margin before income tax=Net income before taxes/Sales	(32.27%)	(55.78%)	(97.22%)
3. Total asset turnover=Sales/Total assets	179.15%	80.18%	60.24%
4. Profit margin after income tax=Net income after taxes/Sales	(32.29%)	(55.74%)	(97.08%)
5. Return on equity after taxes=Net income after taxes/Equity	355.97%	(184.81%)	70.92%
6. Return on equity before taxes=Net income before taxes/Equity	355.73%	(184.93%)	71.03%

Exhibit 5			
LIQUIDITY RATIOS (			
7. Current ratio=Current assets/Current Liabilities	0.52	2.19	2.24
8. Quick ratio=(Cash + Receivables + Trading securities)/Current liabilities	0.20	0.87	1.03
9.Net sales to working capital=Sales/(Current assets-Current liabilities)	(3.82)	1.96	1.60
10. Receivables turnover=Sales/Accounts receivable	41.20	36.71	36.21
11. Inventory turnover=Cost of sales/Inventory	15.74	11.73	7.94

Exhibit 6			
SOLVENCY RATIO (			
12. Debt ratio=Total liabilities/Total assets	1.16	0.76	0.96
13. Coverage ratio=Earnings before interest expense and income taxes/Interest expense	(10.72)	(16.30)	(238.45)

Exhibit 7			
PERIOD ENDING	**31-Dec-07**	**31-Dec-06**	**31-Dec-05**
Total Revenue	$828,228	$607,397	$269,196
Cost of Revenue	$308,554	$286,033	$124,491
Gross Profit	$519,674	$321,364	$144,705
Selling General and Administrative	$745,736	$638,175	$398,120

The gross profit looks decent. However, the operating cost is too high. Therefore, the profit was eaten by the high operating cost.

Stock Price Chart

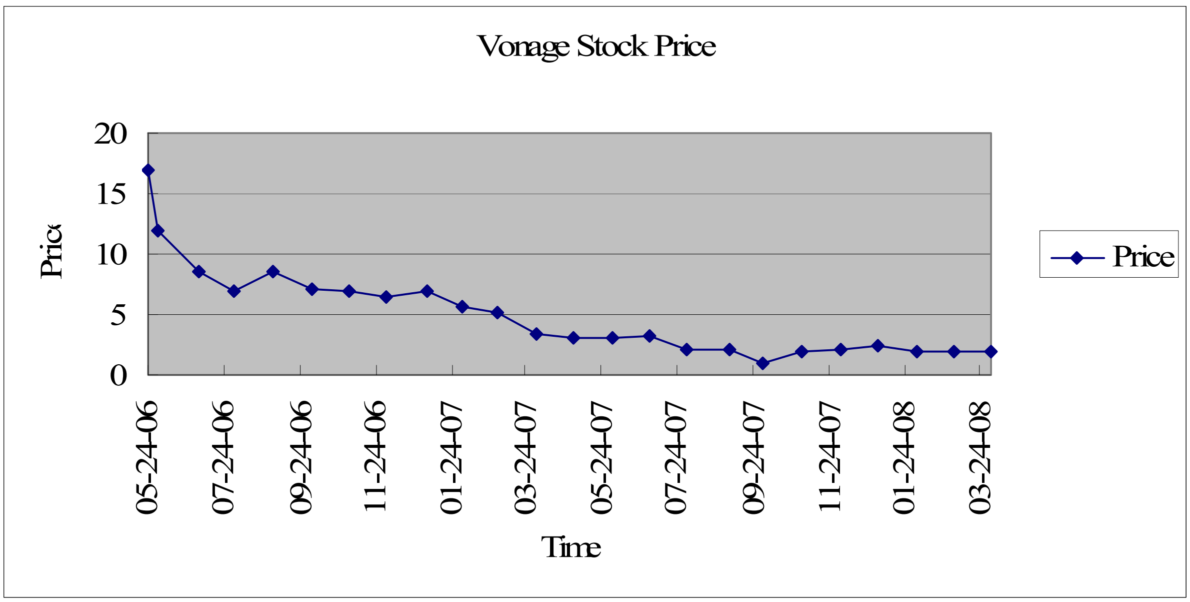
The negative net income can give the reason for the stock price dropping. The stock price table for each month is described as below.

Exhibit 8						
Date	Open	High	Low	Close	Volume	Adj Close
2008-4-1	1.89	2.05	1.73	1.95	557100	1.95
2008-3-3	1.86	2.01	1.69	1.85	687900	1.85
2008-2-1	2	2.17	1.82	1.85	796300	1.85
2008-1-2	2.35	2.43	1.7	1.99	1078700	1.99
2007-12-3	2.11	2.3	1.71	2.3	1282900	2.3
2007-11-1	2	2.7	1.95	2.11	1389000	2.11
2007-10-1	1.03	2.7	0.96	2.04	4827100	2.04
2007-9-4	2.11	2.12	0.89	1.03	1777600	1.03
2007-8-1	2.11	2.52	1.8	2.11	1336300	2.11
2007-7-2	3.16	3.19	2.08	2.13	1200400	2.13
2007-6-1	3.07	3.32	2.89	3.11	1393900	3.11
2007-5-1	3.11	3.77	3	3.01	1280700	3.01
2007-4-2	3.41	4.43	2.83	3.07	4331400	3.07
2007-3-1	5.21	5.39	2.98	3.45	2721300	3.45
2007-2-1	5.66	5.94	5.08	5.2	982400	5.2
2007-1-3	6.99	7.01	5.58	5.68	809300	5.68
2006-12-1	6.5	7.3	6.5	6.94	743400	6.94
2006-11-1	6.93	7.21	6.4	6.5	547200	6.5

Exhibit 8						
Date	Open	High	Low	Close	Volume	Adj Close
2006-10-2	7.13	7.89	6.81	6.88	601400	6.88
2006-9-1	8.56	9.07	6.63	6.88	855400	6.88
2006-8-1	6.93	8.53	6.3	8.51	995000	8.51
2006-7-3	8.59	8.82	6.5	7.09	785100	7.09
2006-6-1	12	12.6	8.25	8.59	1955800	8.59
2006-5-24	17	17.25	11.7	12.02	11516800	12.02

The stock price dropped from $17 IPO to $12 that day. Then, the stock price dropped dramatically to about $2 today. The chart for the opening stock price described below shows a better view of the substantial drop.

Exhibit 9



VIABLE ALTERNATIVES AND RECOMMENDATIONS

1. Reduce operating cost. According to the financial analysis, the operating cost is too high, even higher than the gross profit. That is a big problem. Of course, if Vonage can't pull off financing their operations, they can simply cut spending on marketing and make instant profit. On the other hand, if they can get the financing they need, at some point they could become a worldwide telecom giant. The suggestion would be cutting management high salary, high marketing expense, reducing inventory, and other unnecessary operating expenses.
2. Diversify more service and products. Vonage is facing increasing competition from other companies that offer multiple services such as cable television, video services,

voice and broadband Internet service. These competitors are offering VoIP or other voice services as part of a bundle, in which they offer voice services at a lower price than Vonage does to new subscribers. In addition, several of these competitors are working to develop new integrated offerings that Vonage cannot provide and that could make their services more attractive to customers. In order to grow, the company should roll out new services and work with chip and equipment providers to come out with unique products and services. Compared to Skype, Vonage has less to offer. For instance, Skype has mobile, accessories, web features, and others services besides VoIP phone service. Skype generates revenue through its premium offerings such as making and receiving calls to and from landline and mobile phones, as well as voicemail and call forwarding. Skype, based in Luxembourg, has relationships with a growing network of hardware and software providers and is an eBay company.

3. Oversea geographic markets. Vonage has most of their lines in the U.S., Canada, and United Kingdom, leaving tremendous growth opportunities overseas. Skype is available in 28 languages and is used in almost every country around the world. Vonage should develop their business to other countries lacking in VoIP technology. They can have more developing space there.
4. In addition, the company will improve customer service and expand distribution. Customer service is a weakness for Vonage. Vonage requires customers to cancel service by calling a toll free number, as service cancellation is not available on-line. Customer descriptions of the cancellation process frequently involve hold times of approximately twenty-five (25) minutes, depending on call volume.

NEW YORK DEPARTMENT OF REVENUE VS. QUALITY MARKETS OF AMERICA

Charles E. Frasier, Lipscomb University
Jeffrey J. Jewell, Lipscomb University
Jeffrey A. Mankin, Lipscomb University

CASE DESCRIPTION

This case was written to be useful in finance, accounting, or taxation courses at Levels 2, 3, or 4 in the undergraduate curriculum. It is also appropriate for Level 5 graduate accounting, tax, or finance courses. The rigor and depth of material can easily be adjusted for the intended audience. The case works well with traditional class discussion based case approaches, but can also be easily adapted for role-playing or debate exercises in the class. Introductory finance or accounting classes (Levels 2 and 3) can use the case to explore the differences between debt and equity and the various shades of grey that sometimes exist between the two. More advanced finance classes (Levels 4 and 5) can use the case to explore signaling theory, capital structure theory, and how firm capital structures are influenced by state and federal tax considerations. Tax accounting courses (Levels 4 and 5) can use the case to explore the concepts and calculations of state franchise taxes.

CASE SYNOPSIS

In this instructional case, Quality Markets of America (QMA), a large and successful company, is being audited by the New York State Department of Revenue over its calculation of the state's franchise tax. QMA has historically borrowed a substantial amount of money from its subsidiaries. The state tax regulations indicate that undercapitalized firms must treat debt from affiliated parties, such as subsidiaries, similar to equity for the purposes of franchise tax calculations. QMA does not consider itself to be undercapitalized, while the state does – thus leading to differing interpretations on how the firm should compute its franchise tax obligations. This case explores a wide variety of issues around the franchise tax, capital adequacy, and the state's ability to influence firms' capital structures through the tax code and regulations.

INTRODUCTION

As Brett Taylor was driving to work on a beautiful summer day, he was looking forward to his meeting with Ashley Baker, CFO of Quality Markets of America (QMA). Brett was a tax partner with KLMP, a large national accounting firm, and had been with the firm for 20 years.

He and Ashley were classmates at State University, and had both been active members of Beta Alpha Psi, the international accounting / finance society. Upon graduation, Brett joined KLMP, which maintained its national headquarters in a large office building near State University.

Ashley had joined QMA in its New York office, where she established an excellent reputation in accounting and finance. QMA had begun as a family-owned company, owning and managing grocery stores under the name of Quality Markets. QMA initially operated small convenience food markets with an excellent reputation for produce and freshly prepared breakfast and lunch foods. As the company grew it increased its reputation for convenience by adding “fuel islands” to most of its stores. Customers could stop at the store, gas up, and buy some food that was of much higher quality than typical quick-mart fare. Over the years the company experienced significant success and gradually increased the sale of oil and gas products while also increasing its reputation for convenience and quality of food products and expanding the size of its typical store. The prime location of QMA’s retail outlets, along with its reputation for high quality, allowed QMA to command higher prices and profit margins than its peer firms. Over the years the company gained national stature as a major wholesaler-retailer of petroleum products and high quality produce and grocery items. QMA currently operates in thirty-five of the fifty states through a large number of company-owned stores, as well as a significant number of subsidiary companies.

About a week prior to this meeting, Brett received an e-mail from Ashley outlining certain discussion points to be covered (see Exhibit 1). KLMP had not previously performed any services for QMA and Brett was not personally familiar with QMA’s accounting and tax processes, other than having general knowledge of its excellent reputation for quality products and services. QMA engaged a regional accounting firm to conduct the annual financial statement audit, and engaged a local accounting firm to prepare its tax filings, for both federal and state purposes.

QMA’S SITUATION

After trading phone calls with Ashley, gathering the appropriate financial documents from QMA, and researching the relevant legal issues Brett summarized the situation as below:

1. QMA was being audited by the State Department of Revenue because questions had arisen in regard to certain calculations on its state franchise and excise tax return. (See Exhibit 2 for the e-mail from the State Department of Revenue to QMA.)
2. In lieu of a state corporate income tax, the state levies a 6% excise tax on corporate “profit” and a 0.25% franchise tax on a taxable base represented by the greater of 1) corporate net worth or 2) total real and tangible personal property. The state auditor is focusing only on the franchise tax component. (See Exhibit 3 for franchise tax computation as disclosed on the state franchise and excise tax return.)

3. During the ordinary course of business, QMA (parent company) obtains funds from its subsidiary companies. At the end of any given year, the indebtedness to all affiliated companies is significant. These debts include long term debts governed by formal loan agreements between QMA and its affiliates, and also include short term obligations. The short term debts are processed in accordance with the company's accounting manual, similar to the accounting of accounts payable. The manual states that all short term debts which are incurred within the first half of a given month are to be settled by the end of the month. If incurred during the second half of a given month, the short term debts are to be settled by the 15^{th} day of the following month.
4. According to the franchise tax instructions, "to the extent that a corporation is <u>inadequately</u> capitalized, indebtedness to affiliated companies (subsidiaries) must be added back to net worth." (See Exhibits 4 and 5 for the relevant State Code and Regulations.)
5. The Regulations in this area have become known as "Rule 25." Rule 25 has been part of the state tax regulations since 1910, but appeared to have been largely forgotten by the Department of Revenue until the last five years. Since then it has been successfully used by the state to pursue additional tax payments in similar cases.
6. The state audit has raised a significant question about whether the company has "adequate capital" based on the state's strict interpretation of its code and regulations. If inadequate, the state contends that QMA's debt from subsidiaries is not really a liability, but rather, should be included as invested capital in "net worth" or stockholders' equity on the franchise tax return.
7. The media has recently reported that, due to economic conditions, many states looking for new sources of income have become very strict in their application of tax rules.
8. If QMA's affiliated debt is added to net worth, the resulting total exceeds total real and tangible property. According to the Department of Revenue, this means that QMA has inadequate capital as the state interprets Rule 25. (See Exhibits 6 and 7 for select QMA financial data.)
9. As a result of these facts and circumstances, the Department of Revenue has proposed a significant addition of QMA's affiliated debt to the franchise tax base and has assessed additional franchise tax.
10. It is clear from the e-mail that Ashley Baker thinks the notion that QMA is undercapitalized is not supportable. The following quote from the memo is particularly pointed. "We are a Fortune 500 firm and have a AA bond rating. We don't have to borrow from our subsidiaries to stay afloat; we do it because it makes economic sense. The term "undercapitalized" implies that we are struggling financially. That description doesn't fit QMA at all!"
11. In franchise tax cases not involving related-party debt, state courts have generally held that Debt-to-Equity ratios less than 4.00 indicate adequate capital.

THE MEETING

When Ashley arrived for the meeting with Brett, she felt a high level of confidence in the reputation and quality of services of KLMP. The firm was noted for many of its advisory services, which included auditing and assurance services, investment advising services, and a special department that handled state and local tax issues. Ashley had considered consulting with QMA's outside auditor, but felt a greater degree of confidence in the background and depth of services offered by KLMP and Brett in this particular area of taxes.

As the meeting began, Ashley asked Brett, "Have you had a chance to research our problem?" Brett replied, "Yes. It appears the state is doing everything it can to raise tax revenue. It looks like it has chosen to do this by aggressively pursuing new funds through application of an obscure tax law. Unfortunately, according to a strict interpretation of Rule 25 the state may have a good case."

Ashley said, "The way I read Rule 25, it only applies to firms that are undercapitalized. That is a point QMA will vigorously dispute. The state seems to be using Rule 25 to both define undercapitalization and to set policy regarding how to handle undercapitalized firms, but I don't think that's right."

Brett quickly said, "States appear to be taking a hard look at related party transactions. I realize a related party might label a transaction as "debt" even in situations where a firm may not be able to borrow from an unrelated lender."

Ashley replied, "I can understand the state needs more money and is caught in a dilemma of its own making, but our affiliated company debt is legitimate debt supported by loan agreements or other documentation consistent with true obligations. We are definitely not undercapitalized and have sufficient capital either available or accessible to us. We have a AA bond rating and could borrow from an unrelated lender if we wanted to. We can look at debt ratios or other measures to support our position."

"It seems to me," Brett said, "that the Code and Regulation are being subjected to a very strict interpretation by the state, and completely disregarding the true definition or description of the inadequacy of capital. The Code seems to first require a determination that the taxpayer-corporation has inadequate capital, and if so, then certain affiliated corporate debt must be added back to the company's stockholders' equity for purposes of determining the franchise taxable base. But Rule 25 of The Regulations boils capital adequacy down to two tests: a quick assets test and a capital assets test. These are basically two "safe harbor" situations, that if met would indicate adequate capital, and if not met indicate inadequate capital in the eyes of the state. For those firms that fail either test the state would presumably add affiliated debt to "net worth", without feeling the need to pursue other tests of adequacy of capital."

Ashley replied, "I don't have any problem with the tax code itself. It certainly makes sense that companies should have adequate capital. My problem is with the interpretation and application of Rule 25."

Ashley continued, "In any case, we don't meet either "safe harbor" situation in Rule 25 and I realize the state, therefore, is claiming we are undercapitalized and that our affiliated debt should be treated as equity. Our quick assets do not exceed our indebtedness to affiliates and the book value of our capital assets does exceed our net worth. However, I don't believe either of these "tests" says much about our capitalization levels. Regardless of what Rule 25 says, I still believe we are fully capitalized with immediate access to resources that absolutely provide evidence of not only adequate capital, but excess capital."

"I agree," said Brett, "it seems strange that a large company could be subject to being "undercapitalized" based on only these two tests, when so much other evidence supports that QMA is adequately capitalized."

Ashley replied, "It seems such a waste of time and money to possibly go to court to show just how adequately capitalized we are. There is the evidence of our AA bond rating, and our debt to equity ratio of less than two-to-one, when the state has recognized other companies as being adequately capitalized at a ratio of four-to-one."

"Unfortunately," Brett replied, "I don't think your bond rating will be accepted as proof of adequate capitalization. The bond rating is an assessment of the credit quality of your entire firm – including your subsidiaries. My understanding of the relevant tax code is that we need evidence of your capital adequacy that ignores all of the assets of your affiliates. We may need to do some financial analysis of your unconsolidated financial data."

"Well I think that's pretty silly," Ashley said. "We own 100% of our subsidiaries so there is no economic reason we shouldn't use their assets to help prove our capital adequacy. But if that's what we have to do to prove our point I'm sure we can still do it."

"Before our meeting is concluded, we probably should discuss the different attributes of debt and equity, and let's be certain we can show the obvious characteristics of debt as they relate to intercompany debt," replied Brett. He continued, "If intended debt has the major characteristics of equity, then we will have a tough time offering a counter argument to the state." "I don't believe that will be a problem," said Ashley.

EXHIBIT 1 – E-MAIL FROM ASHLEY BAKER TO BRETT TAYLOR

From: Ashley Baker <ashley.baker@qma.com>
To: Brett Taylor <brett.taylor@klmp.com>
Re: QMA Franchise Tax

Brett,
I hope you are doing well. How are the kids?

We have a little problem here at QMA. The State Department of Revenue has decided that we have underpaid our franchise tax for the last several years. The root of the issue seems to be that the Department thinks our loans from our subsidiaries should be included as equity in the franchise tax calculations. I have included a copy of the Notice of Assessment from the Department so you can see it for yourself.

It looks to me like the state is claiming QMA is undercapitalized and that gives it the right to "transform" our debt into equity for franchise tax purposes. We are a Fortune 500 firm and have a AA bond rating. We don't have to borrow from our subsidiaries to stay afloat; we do it because it makes economic sense. The term "undercapitalized" implies that we are struggling financially. That description doesn't fit QMA at all!

Please call me at your earliest convenience so we can discuss this. Obviously if you decide to help us we'll provide you with whatever financial information you need.

Thanks,
Ashley

EXHIBIT 2 – NOTICE OF ASSESSMENT FROM THE NEW YORK STATE DEPARTMENT OF REVENUE TO QMA

State Department of Revenue
1234 Anywhere Blvd
Albany, NY
12-3456789
June 3, 2012

Form Number: 970

Taxpayer Identification No.

Quality Markets of America, Inc
1000 Waterford Lane
New York, NY
NOTICE OF ASSESSMENT

Based on our audit examination of your State Franchise Tax Return, we have determined you have omitted certain indebtedness to affiliated companies from the calculation of your Net Worth. Indebtedness to be included does not include normal credit extended in short-term accounts payable.

The State Franchise Tax is imposed on corporations doing business in the state and is measured by the outstanding capital stock, other contributed capital, and retained earnings. Code Section 34-56-213 requires the inclusion of indebtedness owed to an affiliate if its capital stock is not adequate for its business needs. More specifically, Code Section 34-56-213, Subsection (b) provides that "If the capital stock of a corporation which is . . . closely affiliated therewith by stock ownership is inadequate for its business needs apart from credit extended or indebtedness guaranteed by the parent or an affiliated corporation . . . there shall be included in the measure of the tax the indebtedness owed to or guaranteed by the parent or an affiliated corporation." We have determined that your capital, as defined within this code section, is inadequate for meeting general business needs.

Under Rule 25 (Reg. 1330-6-.25), adopted as an interpretation of the above code section, "the amount of indebtedness to be included shall not exceed the greater of the following amounts: (1) Excess of indebtedness over quick assets (cash, receivables, marketable investments), (2) Excess of book value (cost less accumulated depreciation) of capital assets (including inventories) per ending balance sheet of the return over net worth (including surplus reserves). If quick assets exceed the indebtedness to an affiliated corporation and the net worth exceeds the capital assets, the capital is adequate and no part of such indebtedness need be included. If capital is inadequate, a schedule of determination must accompany the franchise tax return."

By including the affiliated indebtedness as a part of the franchise tax base, we have determined that the total amount due the State Department of Revenue is $1,547,541**.**

You are entitled to an informal conference to discuss this assessment. If this request is made in writing within 30 days from the date of the Notice of Assessment, the conference must be granted. If this request is timely made, the 90-day period for filing suit stops running until a conference decision is issued in writing. After the decision is issued, the 90-day period commences. You are not required to request a conference before contesting an assessment in court. If you do not timely file suit to contest the assessment, you may pay the assessment, request a refund, and then file suit in chancery court for a refund.

Exhibit 3: Franchise Tax Computation Instructions
Schedules A & B

SCHEDULE A	2009	2010	2011
COMPUTATION OF FRANCHISE TAX			
Total net worth from Schedule B			
Total real & tangible personal property, applicable to operations in state			
Franchise tax (0.25% of greater of line 1 or 2)			
SCHEDULE B	2009	2010	2011
COMPUTATION OF NET WORTH			
Net worth (total assets less total liabilities)			
Indebtedness to affiliated companies (if applicable)			
Total			
Ratio (percentage of business conducted in state)			
Total (Line 3 times Line 4) Net Worth for franchise tax purposes			

Notes:
a. Refer to Exhibit 7A for relevant financial information.
b. 5% of total QMA operations are conducted in New York.
c. 5% of "net plant assets" or "total real & personal property" are located in New York.

EXHIBITS 4 AND 5 – RELEVANT SECTIONS OF STATE TAX CODE AND REGULATIONS

BACKGROUND OF EXHIBITS 4 AND 5:

As is typical of most governmental due processes in the establishment of law, there is the first step of legislative action when the state legislature (or Congress at the federal level) enacts a law, referred to as the Code, which, in many cases, may be subject to various interpretations. Later, at the executive level, and with the objective of providing more uniformity in application, a state department of revenue (or the Department of Treasury at the federal level), issues Regulations which serve as interpretations of the Code. Both the Code and the Regulations have the full weight of law, and when disagreements occur over interpretations of the Code and Regulations, the judicial system must make the final decision.

Exhibit 4 and 5 provide an example of a state Code section and a related Regulation attempting to address a situation when "inadequate capital" exists within the context of determining a franchise tax. In this particular case, a question could be raised whether the Code or Regulation helps resolve the definition or existence of adequate or inadequate capital.

EXHIBIT 4 - STATE CODE SECTION 34-56-213, SUBSECTION (B)

If the capital stock of a corporation which is a subsidiary of another corporation or closely affiliated therewith by stock ownership is inadequate for its business needs apart from credit extended or indebtedness guaranteed by the parent or an affiliated corporation . . . there shall be included in the measure of the tax the indebtedness owed to or guaranteed by the parent or an affiliated corporation.

EXHIBIT 5 - STATE FRANCHISE TAX REGULATIONS KNOWN AS "RULE 25"

Rule 25 - INDEBTEDNESS-ADEQUACY OF CAPITAL. The amount of indebtedness to be included pursuant to State Code Section 34–56-213 shall not exceed the greater of the following amounts: (1) Excess of indebtedness over quick assets (cash, receivables, marketable investments), (2) Excess of book value (cost less accumulated depreciation) of capital assets (including inventories) per ending balance sheet of the return over net worth (including surplus reserves). If quick assets exceed the indebtedness to an affiliated corporation and the net worth exceeds the capital assets, the capital is adequate and no part of such indebtedness need be included. If capital is inadequate, a schedule of determination must accompany the franchise-excise tax return.

EXHIBIT 6A – QMA CONSOLIDATED BALANCE SHEET			
Quality Markets of America			
Consolidated Balance Sheet (in Thousands)			
	2009	2010	2011
Assets			
Cash	$3,782,000	$3,371,000	$1,717,750
Receivables	$3,705,250	$3,564,500	$4,278,000
Inventory	$1,723,500	$1,728,000	$2,140,250
Other Current Assets	$1,188,750	$1,222,750	$986,500
Total Current Assets	$10,399,500	$9,886,250	$9,122,500
Net Plant Assets	$14,678,000	$14,531,000	$18,853,250
Intangible Assets	$3,722,750	$4,043,750	$4,472,500
Total Assets	$28,800,250	$28,461,000	$32,448,250
Liabilities			
Accounts Payable	$4,130,250	$4,195,250	$3,722,750
Accrued Liabilities	$1,180,500	$947,250	$736,750
Total Current Liabilities	$5,310,750	$5,142,500	$4,459,500
Long-Term Debt	$9,972,250	$10,089,500	$14,460,250
Total Liabilities	$15,283,000	$15,232,000	$18,919,750

EXHIBIT 6A – QMA CONSOLIDATED BALANCE SHEET			
Quality Markets of America			
Consolidated Balance Sheet (in Thousands)			
	2009	2010	2011
Stockholders' Equity			
Common Stock	$1,230,250	$1,295,250	$1,294,750
Retained Earnings	$12,287,000	$11,933,750	$12,233,750
Total Stockholders' Equity	$13,517,250	$13,229,000	$13,528,500
Total Liabilities and Equity	$28,800,250	$28,461,000	$32,448,250
Note:			
Loans from Affiliates (hidden by Consolidation Process)	$7,925,446	$8,018,630	$11,492,284

EXHIBIT 6B – QMA CONSOLIDATED INCOME STATEMENT			
Quality Markets of America			
Consolidated Income Statement (in Thousands)			
	2009	2010	2011
Sales	$60,341,659	$64,810,250	$68,286,500
Cost of Sales	$39,460,000	$41,892,335	$44,396,715
Gross Profit	$20,881,659	$22,917,915	$23,889,785
Selling & Administrative Expenses	$13,197,250	$13,467,750	$13,625,466
Depreciation Expense	$639,920	$722,550	$842,663
EBIT	$7,044,489	$8,727,615	$9,421,656
Interest Expense	$369,500	$414,750	$438,500
EBT	$6,674,989	$8,312,865	$8,983,156
Income Tax Expense	$2,669,996	$3,325,146	$3,593,262
Net Income	$4,004,993	$4,987,719	$5,389,894

EXHIBIT 7A – QMA NON-CONSOLIDATED (PARENT ONLY) BALANCE SHEET			
Quality Markets of America			
Non-Consolidated Balance Sheet (in Thousands)			
	2009	2010	2011
Assets			
Cash	$2,307,020	$2,056,310	$1,116,538
Receivables	$2,260,203	$2,174,345	$2,609,580
Inventory	$1,051,335	$1,054,080	$1,305,553
Other Current Assets	$725,138	$745,878	$601,765
Total Current Assets	$6,343,695	$6,030,613	$5,633,435
Net Plant Assets	$9,100,360	$9,009,220	$11,689,015
Intangible Assets	$2,308,105	$2,507,125	$2,772,950
Total Assets	$17,752,160	$17,546,958	$20,095,400

EXHIBIT 7A – QMA NON-CONSOLIDATED (PARENT ONLY) BALANCE SHEET			
Quality Markets of America			
Non-Consolidated Balance Sheet (in Thousands)			
	2009	2010	2011
Liabilities			
Accounts Payable			
Accrued Liabilities	$2,271,638	$2,307,388	$2,047,513
Total Current Liabilities	$720,105	$577,823	$449,418
Long-Term Debt	$2,991,743	$2,885,210	$2,496,930
Total Liabilities	$9,324,054	$9,433,683	$13,520,334
Stockholders' Equity			
Common Stock	$1,230,250	$1,295,250	$1,294,750
Retained Earnings	$4,206,114	$3,932,815	$2,783,386
Total Stockholders' Equity	$5,436,364	$5,228,065	$4,078,136
Total Liabilities and Equity	$17,752,160	$17,546,958	$20,095,400
Note:			
Loans from Affiliates (included in Total Liabilities)	$7,925,446	$8,018,630	$11,492,284

EXHIBIT 7B – QMA NON-CONSOLIDATED (PARENT ONLY) INCOME STATEMENT			
Quality Markets of America			
Consolidated Income Statement (in Thousands)			
	2009	2010	2011
Sales	$36,536,875	$39,242,606	$41,347,476
Cost of Sales	$27,622,000	$29,324,635	$31,077,701
Gross Profit	$8,914,875	$9,917,972	$10,269,775
Selling & Administrative Expenses	$6,598,625	$6,733,875	$6,812,733
Depreciation Expense	$455,018	$450,461	$584,451
EBIT	$1,861,232	$2,733,636	$2,872,592
Interest Expense	$354,720	$398,160	$420,960
EBT	$1,506,512	$2,335,476	$2,451,632
Income Tax Expense	$602,605	$934,190	$980,653
Net Income	$903,907	$1,401,286	$1,470,979

Exhibit 8: Select Financial Data for QMA Peer Firms for 2011			
Ratio	WareMart	Bullseye	BigMart
Current Ratio	1.15	1.13	0.89
Times Interest Earned	6.13	21.54	11.50
Debt Ratio	66.09%	48.79%	62.87%
Total Asset Turnover	1.54	2.32	2.31
Return on Sales	4.12%	3.66%	5.30%
Return on Assets	7.13%	6.55%	8.79%
Return on Equity	18.95%	12.79%	22.90%
Moody's Bond Rating	A1	A2	Aa2

Ratio Formulas

Current Ratio = Current Assets / Current Liabilities
Times Interest Earned = EBIT / Interest Expense
Debt Ratio = Total Liabilities / Total Assets
Total Asset Turnover = Sales / Total Assets
Return on Sales = Net Income / Sales
Return on Assets = Net Income / Total Assets
Return on Equity = Net Income / Total Equity

Note: There are not any "perfect" peer firms for QMA. QMA competes with many small (nonpublic) grocery stores that offer very high quality. QMA also competes with large, public grocery stores that sell gasoline, but typically offer "average" quality grocery items. QMA also competes with all convenience stores, gas stations, etc. The peer firms below were selected from the group of large, public grocery chains that also sell gasoline.

BASIC QUESTIONS

1. If Company X advances funds to Company Y, and if Company Y does not sign an actual physical note, does Company Y have "equity" or "debt?" What are the common characteristics of equity and debt?
2. Does the State prefer, for taxable revenue purposes, financial "claims" of a company to be classified as debt or equity? Discuss.
3. If a company is subject to additional tax based on the size of its stockholders' equity, what can it do to avoid having debt re-classified as equity by a taxing authority?
4. Explain the difference in the consolidated and unconsolidated financial data for QMA. Why do we need both sets of numbers?
5. In Exhibit 4, what do you think is intended by reference to "capital stock?" How does use of this term affect a response to the state?
6. Use the template in Exhibit 3 to compute QMA's franchise tax liability assuming 5% of QMA's total business is in New York. The total tax liability should be a combined 3-year total for 2009, 2010, and 2011.

  a. Compute the tax as you think QMA would on its franchise tax return.
  b. Compute the tax as you think the Department of Revenue would.
  c. Compare your answers from a. and b.

7. What financial ratios could QMA calculate that would support its contention that QMA is well capitalized?
8. Discuss the dilemma of standard-setters – considering whether rules or laws should be “rules-based” or “principles-based.” Use facts and circumstances in this case as your illustration.

ADVANCED QUESTIONS

9. How does this state define “inadequate capital” for firms with debt from related parties? Be specific. What are the implications of this definition?”
10. How does Rule 25 relate to the maturity matching principle of finance?
11. Rule 25 applies only to companies with related-party debt. The state apparently has different standards of capital adequacy for firms that do not use related-party debt. Why is this? Is it “fair?”
12. The entire purpose of Rule 25 seems to be to limit the use of related-party debt. Are there legitimate reasons firms might want to use related-party debt? Explain.
13. Does the state’s definition of “inadequate capital” coincide with the general usage of the term “inadequate capital” or “under-capitalization?”
14. It is unlikely that QMA can use its bond rating as evidence of adequate capitalization. What other types of evidence or analysis could QMA produce that might be helpful to its case?
15. How does the issue of “adequate capital” relate to the issue of “optimal capital structure” from finance theory?
16. Which party do you think prevailed in this case – QMA or the State? Why?

PANDORA INVESTMENTS WURUNDI, INC.

D.K. (Skip) Smith, Baze University

CASE DESCRIPTION

Ever wished you had a case to sensitize students to some of the legal and/or ethical challenges faced by multinational businesses and businesspeople in developing markets like the BRICs (Brazil, Russia, India, and China)? While this case is not from one of the BRIC countries, it does take place in a large developing world country, and it does illustrate very clearly some of the legal and/or ethical dilemmas faced by multinational businesspeople and companies (especially U.S. and/or U.K companies and businesspeople) in developing world markets. The case is appropriate for senior-level undergraduates as well as students in MBA and Executive Development programs. It is designed to be taught in a one hour and a half class session, and is likely to require at least a couple hours of preparation by students.

CASE SYNOPSIS

Mr. Mike Adams is Vice President and General Manager of Pandora Investments Wurundi Inc., the Wurundian subsidiary (Wurundi is a real country in Africa and Pandora is a real company; for purposes of this case study, however, both the country and the company must remain disguised) of a New York Stock Exchange (NYSE) listed U.S. multinational company called Pandora Investments Group, Inc. While it is listed on the NYSE, Pandora Investments Group has very substantial operations in the UK. Pandora Investments Wurundi, Inc. (hence, PIWI) recently completed (under a contract valued at approximately $2,000,000) a gas transportation network code for the parastatal company in Wurundi called Gasco Wurundi Ltd. (hence, GWL). GWL's role in Wurundi includes creating the hard and soft infrastructure needed to move natural gas around the country. While all the key stakeholders (management of GWL, management of PIWI, etc.) agree that PIWI has successfully completed the gas transportation network code project and that all the work done by PIWI and its consultants has been truly world-class, GWL has not yet paid PIWI for its work. Earlier today, a senior executive at GWL (his name is Mr. Jonas Adorande) indicated to Adams that before he (that is, Adorande) signs off on the project (one of the required steps in GWL's payment process), Adams will need to give him (in unmarked bank notes) approximately $50,000.

Additional data and information in the case include:.

1. *Regarding the project: an explanation of what a gas transportation network code is, and why a country having natural gas needs one.*
2. *Regarding the company (PIWI): Because PIWI has in the past operated extremely successfully in a very challenging developing world market (that is, Wurundi),*

information is provided on PIWI's business model plus the company's past and current performance and factors impacting that performance over the years.

3. *Regarding the Wurundian parastatal (that is, PIWI's customer): Background information, current performance, and factors impacting that performance.*
4. *Regarding Wurundi: Like China and India and some other developing world markets, even during the current economic crisis, the economy of Wurundi has continued to grow vigorously. To give students a sense of the opportunities available in the developing world, a bit of information is provided on the country disguised as Wurundi and the performance of that country's economy over the last several years.*
5. *Regarding US and UK laws regarding the overseas behavior of US and UK corporations and executives: Summaries of the Foreign Corrupt Practices Act (FCPA) and the UK Bribery Act, plus implications of those acts for U.S and U.K. companies and businesspeople operating overseas, are provided. In addition, a discussion is provided regarding the difference between actions which are legal (or illegal) and actions which are ethical (or unethical).*

THE SITUATION

Mr. Mike Adams is Vice President and General Manager of Pandora Investments Wurundi Inc., the Wurundian subsidiary of a New York Stock Exchange (NYSE) listed U.S. multinational company called Pandora Investments Group, Inc. While it is a NYSE listed company, Pandora Investments Group has very substantial operations in the UK. Pandora Investments Wurundi, Inc. (hence, PIWI) recently completed (under a contract valued at approximately $2,000,000) a gas transportation network code for a parastatal company in Wurundi called Gasco Wurundi Ltd. (hence, GWL). GWL's role in Wurundi includes creating the hard and soft infrastructure needed to move natural gas around the country. While all the key stakeholders (management of GWL, management of PIWI, etc.) agree that PIWI has successfully completed the gas transportation network code project and that all the work done by PIWI and its consultants has been truly world-class, GWL has not yet paid PIWI for its work.

Adams has just come out of a meeting with Mr. Jonas Adorande, a senior manager at GWL. During that meeting, Adorande indicated that:

1) Before he (that is, Adorande) signs off on the gas transportation network code project (one of the required steps in GWL's payment process), Adams will need to give him (in unmarked bank notes) approximately $50,000. Based on his years of experience operating in Wurundi, Adams believes that Adorande's bosses are expecting to receive a portion of that money. In other words, Adams believes that Adorande's bosses are "in on this game" and that Adorande is expected (by those bosses) to share with them the money he receives from Adams.

2) Within the next six months, GWL will be seeking tenders (that is, bids) on a number of additional projects. Adorande indicates that because of its excellent work on the gas transportation network code project, PIWI could be well-placed to compete for (and win) some of these additional projects, each of which is worth more than $10,000,000.

ADDITIONAL INFORMATION: THE COMPANY

Pandora Investments Wurundi, Inc.(hence, PIWI) is the Wurundian subsidiary (Wurundi is a real country in Africa and Pandora is a real company; in this case study, however, both of them must remain disguised) of a NYSE listed U.S. company called Pandora Investments Group, Inc. which has very substantial operations in the UK. Many years ago, after coming to Wurundi to build the Wurundian business of a multinational trading company, Adams resigned his position with the multinational and started his own company. His new company was very successful. After a few years, Pandora Investments Group purchased Adam's company. While the name of the company started by Adams was changed to PIWI, Adams was hired by Pandora Investments Group to continue on as Vice President and General Manager of PIWI.

Over his years of working with the multinational trading company, and continuing on after he started (and then sold) his own company, Adams encountered (and made friends with) many mid-level officers in the Wurundian military. When Wurundi became a military dictatorship; these officers (many of them now quite senior) were suddenly in positions where they: 1) Were responsible for projects which required both overseas experts and overseas technologies; and 2) Were able to help Adams win contracts for those projects. As a result, over the years that Wurundi remained a military dictatorship, Adams and his company successfully completed many large and very profitable projects in Wurundi.

The business model used by Adams and his company (and at the heart of his success) was very simple: the company looked for projects which met the following criteria:1) The project required substantial amounts of world-class technical and/or specialized skills; and 2) The needed world-class technical and/or specialized skills were not available in Wurundi. In such situations, Adams would use his contacts to identify an overseas company which could provide the needed world-class technical and/or specialized skills. Having identified a provider company, Adams would then recruit that overseas provider company (by offering very attractive prices and terms) to come to Wurundi and perform the world-class services required.

Using the above model, Adam's company (and then PIWI) operated very successfully for many years. Over the last several years, however, the environment in Wurundi has changed. One of the biggest changes was that the military dictator was replaced by a democratically-elected government. As this transition took place, Adams discovered that his old military friends were no longer functioning as key decision makers and were no longer in a position to push projects his way. For PIWI, finding good projects, winning those projects, and successfully wrapping up those projects (including getting paid) became much more difficult. In one particular case, PIWI invested a huge amount of time and energy and money into a project, only to have the project run afoul of key governmental decision makers. To date (that is, several years later), that project is still in limbo and PIWI has still not been paid for its work.

ADDITIONAL INFORMATION: THE GAS TRANSPORTATION NETWORK CODE PROJECT: BACKGROUND, EXPLANATION, AND IMPORTANCE

The reasons natural gas is important in Wurundi include: 1) Wurundi has lots of natural gas; and 2) Natural gas can be used to run turbines to generate electric power; and 3) Currently, the electric power situation in Wurundi is very problematic. One power-related rule of thumb used by experts is that for every 1 million people, a country should have approximately 1000 megawatts (MW) of electric power. By that standard, Wurundi should have more than 50,000MW; in reality the country is limping along with less than 2,000MW. Wurundi's president has developed a plan to massively increase the amount of electric power in Wurundi; that plan assumes that it will be possible to move natural gas all around Wurundi and especially to urban locations with huge needs for more power.

To move natural gas around in any country (including Wurundi), at least the following two things are needed:

a. pipelines and associated equipment (central processing facilities, compressors, and so on); and
b. a set of rules and regulations regarding the quality and quantity of gas which the suppliers of natural gas (often, international oil companies) will put into the pipelines and the quality and quantity of gas which users (including natural gas-fired generating plants) will be allowed to take out of the pipeline. This set of rules and regulations is called a "gas transportation network code." Without this set of rules and regulations (that is, without the code), it is very unlikely that any private investor will be willing to invest money in the business of using natural gas to generate power in any country (again, including Wurundi).

As indicated earlier:

1) PIWI recently completed the development of a gas transportation network code for the parastatal company in Wurundi (that is, Gasco Wurundi Ltd., or GWL) which is responsible for creating the hard and soft infrastructure of moving gas around the country.

2) All key stakeholders (management of GWL, management of PIWI, etc.) agree that PIWI has now completed the project and that all the work done by PIWI and its consultants has been truly world-class.
3) Adorande indicates that within the next six months, GWL will be seeking tenders on a number of additional projects, each of which will be worth at least $10,000,000. Because of its good work on the network gas transportation code project, Adorande indicates that PIWI could be well-placed to bid for (and win) some of these additional projects.

ADDITIONAL INFORMATION: BACKGROUND ON THE COUNTRY AND ITS NATURAL GAS RESOURCES

Wurundi has about 5% of the landmass of the United States. The terrain is diverse, ranging from beaches and swamps to desert conditions. Large deposits of both oil and natural gas have been discovered. Even though much of the gas was discovered by accident (in many cases, the gas was discovered by companies prospecting for oil), Wurundi's proven reserves of gas are worth (at any reasonable price per standard cubic foot) billions of dollars.

As indicated above, Wurundi has very large reserves of natural gas. In addition, however, there are also huge amounts of gas in the crude oil which Wurundi produces. Before crude oil can be moved around safely, that gas (it is called "associated gas") needs to be removed from the crude. The process of removing associated gas from crude oil is well-understood; however, in many places around the world (including Wurundi), there was (in the beginning) no way to productively use the gas removed from the crude. Because there was no way to use this gas, it was simply burned, or "flared." The oil producing regions in Wurundi are full of gas flares; some of those gas flares have been operating 24/7 for many years. Over the years, the amount of associated gas wasted (and the value of that gas) has been huge. Efforts to reduce the amount of associated gas being flared are underway.

Data collected by Wurundi's Bureau of Statistics indicates that 70% of Wurundi's population is classified as "poor," It is also true, however, that Wurundi's Gross National Product (GNP) exceeds $100 billion. In report titled "Lions on the Move" and published by the McKinsey Global Institute, Roxburgh et al. (2010) claim that "the continent (that is, Africa) is among the world's most rapidly growing economic regions" and that "the rate of return on foreign direct investment in Africa is higher than in other developing countries." As for the country called (in this case study) Wurundi, each of the last five years the economy has grown by more than 5%. In other words, the economy is not only quite large but is growing much more rapidly than most developed world economies. For several countries which export food products, Wurundi is one of their top 5 export markets in the world.

A final point about Wurundi involves the level of corruption in the country and the economy. In its annual rankings of the most and least corrupt countries in the world, Transparency International in Berlin (TI) has always ranked Wurundi in the bottom quartile (that is, the most corrupt quartile) of all countries in the world. While it is viewed as less corrupt now than in the past, Wurundi is still ranked in that bottom (that is, most corrupt) quartile.

ADDITIONAL INFORMATION: GASCO WURUNDI LTD. (GWL)

Before agreeing to undertake the gas transportation network code project with GWL, Adams and his team at PIWI collected a substantial amount of information on GWL. One of the pieces of information they collected was a document setting forth the steps in the process GWL uses to pay for goods and services which GWL purchases. The steps in that process, and brief commentaries on some of those steps, are as indicated below:

1) The process of getting paid by GWL for work contracted by them begins by submitting invoices for review by an executive at the level of Mr. Jonas Adorande. The firm submitting the invoice needs to ask that manager to confirm that the invoices are in the proper format; if not, the firm needs to ask the executive to help make sure that the invoices are put in the proper format. PLEASE NOTE: without the assistance and cooperation of the GWL executive, successful completion of this step of the payment process could be difficult.
2) Once the invoices are in proper format and have all the proper attachments, the firm submits that set of invoices to the same GWL executive for their approval. An approved set of invoices needs either to be STAMPED or needs a HANDWRITTEN STATEMENT OF ACCEPTANCE. PLEASE NOTE: without the assistance and cooperation of the GWL executive, successful completion of this step of the payment process could be difficult.
3) Assuming the invoices align properly and completely with the contract, the GWL executive at Mr. Adorande's level will issue a PAYMENT CERTIFICATE; this document will have spaces for several signatures including his own. PLEASE NOTE: without the assistance and cooperation of the GWL executive, successful completion of this step of the payment process could be difficult.
4) The payment certificate will be sent for the approval of GWL's Managing Director. In reality, the Managing Director's technical office will approve the documents first; after reviewing the documents, a technical advisor will stamp the certificate "RECOMMEND FOR APPROVAL". Once the Managing Director receives a document with the notation "recommend for approval," he will write "APPROVED" on that document.

5) The clerk at the Managing Director's office will send the approved form plus the original invoice to the Director of Finance of the unit of GWL from which the invoice emanated. That individual will make a note "approved for further processing," and send this approved invoice on to the Director of Finance for all of GWL.
6) The Director of Finance for all of GWL will make a note on the invoice (please process) and then forward the invoice on to GWL's Director of Budgets & Projects. Accountants reporting to GWL's Director of Budgets & Projects will generate a document called a "Payment Voucher."
7) GWL's Director of Budgets & Projects will sign the Payment Voucher. Having done so, he will send this Payment Voucher to the department for whom the project was done. Once the individuals in that department (including executives such as Mr. Adorande) have signed, the Payment Voucher goes back to GWL's Director of Budgets & Projects. PLEASE NOTE: without the assistance and cooperation of the GWL executive, successful completion of this step of the payment process could be difficult.
8) At this point, the Payment Voucher is sent to audit. Everything is reviewed again; in addition, accounts are checked to see if funds are available. After receiving approvals from audit, the Payment Voucher is sent back to GWL's Director of Projects & Budgets.
9) GWL's Director of Projects & Budgets sends the Payment Voucher to the treasury. If the invoice is denominated in local currency, a deputy manager of banking will issue payment instructions and transfer funds from a GWL account to the company or individual which submitted the invoice. If the invoice is denominated in dollars or some other foreign currency, payment instructions signed by GML's Director of Finance and GML's Director of Treasury will be issued, so that the transfer into the account of the individual or organization who submitted the invoice can be made.

Another document about GWL discovered by Adams and his team is a study conducted by a major research organization in the U.S. which assessed the role and performance of GWL. Findings from that study included the following:

1) The role of GWL in Wurundi includes: Sector manager and regulator, buyer and seller of natural gas, and service provider to the natural gas industry in Wurundi.
2) GWL is neither competent commercially nor effective as a regulator. GWL employees have few incentives tend to act in the interest of the company or the nation; however, there are many incentives for private action/corruption. GWL

operations focus on functions which offer opportunities for private/personal benefit.

3) Additional observations about GWL include:
   a. GWL performs badly at the task of maximizing long-term natural gas revenue for Wurundi . By tying operators up in red tape, GWL imposes massive costs and burdens on the natural gas sector of the Wurundian economy.
   b. GWL functions well as an instrument of patronage; each transaction generated by its huge bureaucracy provides opportunities for individuals to profit by being gatekeepers (that is, by giving or withholding permission for private companies to move forward on natural gas-related initiatives).
   c. GWL will be difficult to reform. Patronage and corruption multiply the number of transactions required to accomplish anything, and each transaction creates multiple opportunities for personal gain for GWL employees.

ADDITIONAL INFORMATION: LEGAL CONSIDERATIONS

As indicated earlier, Adams works for a NYSE-listed U.S. multinational company with very substantial operations in the UK. As such, he is subject to both the Foreign Corrupt Practices Act (FCPA) and the UK Bribery Act. Appendix 1 overviews major provisions of the FCPA; Appendix 3 and Appendix 4 overview major provisions of the UK Bribery Act. It may be worth noting that while the FCPA allows "facilitating payments" (that is, payments to officials to expedite routine governmental action):

1) Under the UK Bribery Act, such payments are illegal.
2) Appendix 2 indicates that the U.S. Department of Justice and the U.S. Security and Exchange Commission have "pressed a narrow view of the exemption" and that "companies that permit facilitating payments face an increased risk of FCPA liability in today's enforcement environment."

THE CHALLENGE

Please assume you are Mr. Mike Adams. What actions will you take, to ensure that PIWI is paid for the world–class work PIWI has done for GWL?

APPENDIX 1: EXERPTS FROM A SUMMARY OF THE FOREIGN CORRUPT PRACTICES ACT

FCPA Summary: The Foreign Corrupt Practices Act (FCPA) controls bribery in two ways: 1) prohibits any U.S. person, real or corporate, from bribing a foreign official; and 2) mandates record-keeping standards for publicly-held corporations registered under the Securities Exchange Act of 1934.

Record-keeping requirements are two-fold: 1) all issuers are required to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer;" and 2) mandates corporations to create a system of internal accounting controls which provide "reasonable assurance" that transactions are properly authorized. "Reasonable assurances" and "reasonable detail" are defined under the "prudent man: standard to mean a "level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs."

The minimum accounting and international record keeping procedures apply only to "Issuers" of securities, which the Act defines as either (1) corporations with a class of securities registered under section 12 of the 1934 Act (all stock issuers who engage in interstate commerce, whose securities are traded on a national stock exchange, whose assets exceed one million dollars, and who have more than 500 shareholders), or (2) companies required to file reports under section 15(d) of the 1934 Act (issuers required to file form 10-K reports and quarterly 8-K reports, unless exempted by satisfaction of registration provision of section 12). Therefore, issuers with securities held of record by fewer than 500 persons or less than one million dollars are exempt from the FCPA's record-keeping requirements. Criminal liability under the Act as modified by the 1988 amendments applies only to those persons who "knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book record or account." Penalties will not be imposed for "insignificant or technical infractions" or "inadvertent conduct."

The anti-bribery provisions are similar to the domestic bribery statute. The FCPA explicitly prohibits **all** firms (whether subject to SEC regulations or not) from: 1) directly, indirectly or through a third-party bribing a foreign official, foreign political party, party official or candidate in order to obtain or retain business; 2) using the mail or interstate commerce "corruptly in furtherance of an offer or payment of money or anything of value to a 'foreign official'"; 3) prohibits the giving or promising to give anything of value to foreign officials or foreign political parties to influence any act within their "official capacity" or to induce foreign officials to violate their "lawful duty.". All prohibits the indirect or third-party bribery of foreign officials, political parties, or candidates. . .
. **Enforcement**: The Department of Justice (DOJ) has the jurisdiction for all criminal enforcement under the VCPA and the SEC is responsible for some aspects of civil enforcement. Both can bring an action against the corporation, its officers, directors, stockholders, employees and agents. . . Foreign officials who receive bribes from American companies remain outside the reach of the FCPA. However, the few cases that the DOJ has brought under the bribery provisions have involved egregious violations of the FCPA, such as the Pemex cases. In the Pemex cases, bribery payments were so blatant that knowledge, under either the pre- or post-1988 amendments, was not even an issue. The defendants either guilty or nolo contendere and paid fines. One corporation was fined $3,450,000; its president $309,000 and other defendants $235,000. None of the defendants received prison terms.

Penalties: Violations of the bribery and recordkeeping provisions of the FCPA result in a base offense level of eight under the Sentencing Guidelines. Sentence lengths accrue depending upon the amount of money involved when the amount is greater than $2,000. Other factors which may increase the sentence term are whether the offense involved the use of foreign bank accounts or transactions to conceal the true nature of the conduct; whether the offense substantially jeopardized the safety and soundness of a financial institution; and whether the defendant has a prior criminal record. In addition to criminal punishment, the Act provides for civil penalties of up to $10,000. In order to maximize the effectiveness of the penalties, **companies are prevented from indemnifying their officers and employees against liability under the Act**.

Source document: www.bennettlawfirm.com/fcpa.pdf

APPENDIX 2: FCPA ADDITIONAL COMMENTS

The Illusory Facilitating Payments Exception: Risks Posed By Ongoing FCPA Enforcement Actions and The U.K. Bribery Act (Summary only)

Richard W. Grime
Sara S. Zdeb
O'Melveny & Myers LLP

The views expressed here are those of the authors and do not necessarily reflect the views of the firm or any of its clients.

Consider the following scenario: a publicly-traded American software company launches operations in India, hoping to take advantage of the country's burgeoning information technology sector. After conducting business there for some time, the company believes it is entitled to a corporate tax refund; despite submitting the requisite paperwork, however, the company's refund is not forthcoming – and the process of obtaining it lags for several months. The company eventually learns that a low-level employee of the Indian Income Tax Department is demanding 5,000 rupees – just over 100 U.S. dollars – to process the paperwork and ensure that the refund is approved. Frustrated by the delay and after attempting to escalate the issue to no avail, the company approves the payment. The process is repeated multiple times in the coming years.

Situations like this are hardly uncommon, and companies will increasingly confront them as they expand operations across the globe. The drafters of the Foreign Corrupt Practices Act ("FCPA") recognized that such demands for "grease payments" are a reality in many countries, and accordingly made clear that certain payments made to expedite the approval of permits or licenses, or to prompt the expeditious performance of similar low-level ministerial duties, fell outside the ambit of the statute's anti-bribery provisions. Yet that exception for "facilitating payments" – enacted during the FCPA's 1988 amendments – is becoming harder and harder to rely on.

As we discuss in this article, the Department of Justice ("DOJ") and the Securities and Exchange Commission ("SEC") have pressed a narrow view of the exception in recent years, and businesses and other defendants, reluctant to test the law's boundaries at trial, have settled their cases instead. Whatever force the facilitating payments exception retains in this environment has been further eroded by the recently-enacted U.K. Bribery Act, which lacks any comparable exception and applies broadly to individuals and companies as long as they carry on some business in the United Kingdom. If the hypothetical company above conducts business in the United Kingdom, it could be subject to liability under the Bribery Act – even if its payments to the tax authorities fell squarely within the FCPA's facilitating payments exception. For these reasons, companies that permit facilitating payments face an increased risk of FCPA liability in today's enforcement environment and because such payments typically violate local law.

Source document: ***seclawcenter.pli.edu/wp.../Grime-Risks-Posed-by-Ongoing-FCPA.pdf***

APPENDIX 3: EXERPTS FROM AN OVERVIEW OF THE UK BRIBERY ACT

What is covered by the Act? The Act is concerned with bribery. Very generally, this is defined as giving someone a financial or other advantage to encourage that person to perform their functions or activities improperly or to reward that person for having already done so. So this could cover seeking to influence a decision-maker by giving some kind of extra benefit to that decision maker rather than by what can legitimately be offered as part of a tender process. The Act is not concerned with fraud, theft, books and record offences, Companies Act offences, money laundering offences or competition law. .

When could my organization be liable?

1) Your organization could be liable if a very senior person in the organization (for example, a managing director) commits a bribery offence. This person's activities would then be attributed to the organization.

2) Your organization could also be liable where someone who performs services for it – like an employee or agent – pays a bribe specifically to get business, keep business, or gain a business advantage for your organization. But you will have a full defense for this particular offence, and can avoid prosecution, if you can show you had adequate procedures in place to prevent bribery. . .

3) It is important to note that no one can be prosecuted in England and Wales unless one of the two most senior prosecutors (the Director of Public Prosecutions or the Director of the Serious Fraud Office) is personally satisfied that a conviction is more likely than not, and that prosecution is in the public interest.

What do I need to do to rely on the defense?

You will not commit the offence of failing to prevent bribery if you can show that your organization had 'adequate procedures' in place to prevent bribery. What counts as adequate will depend on the bribery risks you face (for 'How do I assess risk?' see page 5) and the nature, size and complexity of your business. So, a small or medium sized business which faces minimal bribery risks will require relatively minimal procedures to mitigate those risks. The following six principles will help you decide what, if anything, you need to do differently:

1 Proportionality: The action you take should be proportionate to the risks you face and to the size of your business. So you might need to do more to prevent bribery if your organization is large, or if you are operating in an overseas market where bribery is known to be commonplace, compared to what you might do if your organization is small, or is operating in markets where bribery is not prevalent.

2 Top Level Commitment: Those at the top of an organization are in the best position to ensure their organization conducts business without bribery. If you are running a business, you will want to show that you have been active in making sure that your staff (including any middle management) and the key people who do business with you and for you understand that you do not tolerate bribery. You may also want to get personally involved in taking the necessary proportionate action to address any bribery risks.

3 Risk Assessment: Think about the bribery risks you might face. For example, you might want to do some research into the markets you operate in and the people you deal with, especially if you are entering into new business arrangements and new markets overseas ('How do I assess risk', see page 5).

4 Due Diligence: Knowing exactly who you are dealing with can help to protect your organization from taking on people who might be less than trustworthy. You may therefore want to ask a few questions and do a few checks before engaging others to represent you in business dealings.

5 Communication: Communicating your policies and procedures to staff and to others who will perform services for you enhances awareness and helps to deter bribery by making clear the basis on which your organization does business. You may, therefore, want to think about whether additional training or awareness raising would be appropriate or proportionate to the size and type of your business.

6 Monitoring and Review: The risks you face and the effectiveness of your procedures may change over time. You may want, therefore, to keep an eye on the anti-bribery steps you have taken so that they keep pace with any changes in the bribery risks you face when, for example, you enter new markets.

How do I assess risk?

Many organizations will face little or no risk of bribery, especially if their business is undertaken primarily in the UK. If you operate overseas, the risks may be higher. Factors such as the particular country you want to do business in, the sector which you are dealing in, the value and duration of your project, the kind of business you want to do and the people you engage to do your business will all be relevant.

Do I need complex procedures in place even if there is no risk?

No. If there is very little risk of bribery being committed on behalf of your organization then you may not feel the need for any procedures to prevent bribery.

Do I need to do due diligence on all my suppliers?

You only have to think about doing due diligence on persons who will actually perform services for you, or on your behalf. Someone who simply supplies goods to you is unlikely to do that. It is very unlikely, therefore, that you will need to consider doing due diligence on persons further down a supply chain.

Do I need to employ consultants or lawyers to provide advice on the risks I face, the procedures I adopt, or the level of due diligence I should undertake?

No. There is no duty to engage lawyers or consultants in helping you assess what risks you face, what procedures you might adopt or what sort of due diligence you undertake - especially where you consider the risks to be low or non-existent. The Act does not require external verification of any bribery prevention measures you have put in place.

Can I provide hospitality, promotional or other business expenditure under the Act?

Yes. The Government does not intend that genuine hospitality or similar business expenditure that is reasonable and proportionate be caught by the Act, so you can continue to provide . . . tickets to sporting events, take clients to dinner, offer gifts to clients as a reflection of your good relations, or pay for reasonable travel expenses in order to demonstrate your goods or services to clients if that is reasonable and proportionate for your business.

What about facilitation payments?

Facilitation payments, which are payments to induce officials to perform routine functions they are otherwise obligated to perform, are bribes. There was no exemption for such payments under the previous law nor is there under the Bribery Act. As was the case under the old law, prosecutors will carefully consider all the facts and surrounding circumstances of cases which come to their attention to assess whether a payment amounts to a bribe and, if so, whether a prosecution is in the public interest. You can continue to pay for legally required administrative fees or fast-track services. These are not facilitation payments.

Source document: UK Ministry of Justice, UK Bribery Act, Quick Start Guide

APPENDIX 4: UK BRIBERY ACT (OPENING COMMENTS ONLY)

The **UK Bribery Act** has come into force as the coalition government attempts to clamp down on business corruption.

The government has said it wants the UK to take a leading role in the global fight against bribery.

Who does the Act apply to?

It applies to both individuals and companies. Both UK and foreign companies are covered, provided they have some operations in the UK, and could be prosecuted by the Serious Fraud Office (SFO).

It is a criminal offence for an individual to give or receive a bribe.

It is also a corporate offence if a business is found to have failed to prevent bribery.

What are the penalties?

Individuals can face up to 10 years in prison and an unlimited fine.

Companies can also face unlimited fines.

What counts as bribery?

In its **guide to the Bribery Act**, the Ministry of Justice says:

"Very generally, [bribery] is defined as giving someone a financial or other advantage to encourage that person to perform their functions or activities improperly or to reward that person for having already done so."

Facilitation payments, whereby officials are paid to speed up routine services they are obliged to carry out, are bribes. These type of payments were illegal even before the Bribery Act.

For instance, a facilitation payment may involve giving cash to customs officials abroad to get goods through.

In practice the SFO will make sure that a prosecution is in the public interest, and it is not expected that cases will be brought that concern small amounts of money. For larger sums though, experts say a tough line will be taken and companies will have to tolerate some delays.

Hospitality is not prohibited by the Act. This had previously been unclear and the legislation, which had been due to come into force in April, was delayed after the government issued additional guidance.

Source document: BBC News, 1 July 2011

HEDGING WITH FOREIGN CURRENCY FUTURES AT TRANSCEND INC

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

CASE DESCRIPTION

The primary subject matter of this case is hedging foreign currency exchange rate risk using foreign currency futures contracts. Secondary issues examined include assessing transaction exposure and estimating profit margin exposure. The case requires students to have an introductory knowledge of accounting, statistics, finance and international business thus the case has a difficulty level of four (senior level) or higher. The case is designed to be taught in one class session of approximately 3 hours and is expected to require 4-5 hours of preparation time from the students.

CASE SYNOPSIS

Transcend Inc is a US based company specializing in corporate travel services. Recent product line additions have exposed the company to more significant foreign currency exchange rate risks. In addition, the unique structure of Transcend's business model has led the company president, Mike Travis, to consider using foreign currency futures contracts in addition to traditional forward currency hedges. Transcend would like an evaluation of the company's increased foreign currency exposure and a proposed strategy for eliminating unwanted exchange rate risk before the next earnings conference call.

BACKGROUND

Employees engaged in corporate sales make up approximately 12% of the fulltime workforce in the United States. Corporations spend over one trillion dollars annually on sales force expenditures, more than they spend on any other promotional method. Given the high cost and importance of the personal selling function, a key managerial concern is about motivating people to achieve higher levels of performance. Incentives like sales contests are generally seen as an important tool to motivate sales people to achieve goals that surpass those associated with normal compensation, enhance job satisfaction, and increase corporate profits. Sales incentives promotion is an industry that exceeds $150 billion annually. Awards associated with sales contests generally fall into one of three categories -- cash, merchandise, and travel. Growth in travel awards exploded during the1990's, only to drop off as the technology industry fell apart in

2000 and the 9/11 terrorist attacks of 2001 made travel as a reward less appealing. However, the all-expense paid vacation for employees achieving specific benchmarks is making a comeback as a popular incentive award. The Incentive Marketing Association estimates that corporate America spent about $40 billion on travel rewards alone in 2011. In addition, there has been a significant change in the destinations and type of activities people are doing with incentive travel. The trend in this industry is shifting to a desire for more adventurous international travel options.

Transcend Inc is an Atlanta based company specializing in corporate travel services. Their focus is primarily on incentive initiatives, customer loyalty programs, and meetings and event management. Founded in 1986 by Mike Travis, Transcend Inc has two main divisions. The corporate event group is a higher volume/lower margin division that specializes in large group travel outings, such as training seminars, conferences, and annual meetings. The incentive travel group is a lower volume/higher margin division that provides travel packages mostly associated with sales contests, customer loyalty programs, and other reward based promotions. In a typical sales contest, a company may set a specific goal for its sales force. Possible objectives may be to increase sales, generate new accounts, launch new products, liquidate inventory or expand into new territories. The company will then define precisely what the sales force needs to accomplish, whether its percentages, number of units, profits or some other concrete measurement and employees who achieve stated goals will earn rewards such as travel packages.

THE SITUATION

By and large, the incentive travel division at Transcend works off a catalog business. The main catalog is published twice a year (January and July) and allows customers to choose from a variety of travel rewards associated with employee incentive programs. Destination trips are grouped into tier levels and vouchers for tier levels are sold from the catalog at a guaranteed price. For example, Tier One vouchers are currently priced at $1000 per person and included popular domestic destinations such as Orlando, Las Vegas, and San Diego and usually incorporate activities such as spa treatments or rounds of golf. Higher tier levels, offered at higher prices, include both domestic and international travel destinations such as New York, Hawaii, Europe and Asia. Between the various destinations offered at each tier level, the current catalog contains over 60 destination options.

A typical client of Transcend might design a sales incentive program where points are awarded for achieving specific sales goals. The more points an employee earns, the higher the tier voucher. For example, a Transcend client might have a sales force of 100 employees. It is possible that 20 out of 100 may earn enough points to be eligible for a Tier One voucher award, 10 out of 100 might earn a Tier Two voucher, and 5 out of 100 may be eligible for Tier Three vouchers. The company would then purchase 35 travel vouchers (20 Tier One, 10 Tier Two, and

5 Tier Three) from Transcend. Eligible employees awarded vouchers would later redeem them for their preferred destination within a year with Transcend handling all of the travel arraignments.

When a new catalog is printed, the travel division does not know exactly how many vouchers will ultimately be sold nor do they know which trips offered within tier levels will ultimately be chosen. However, Transcend meets regularly with marketing and operations managers to discuss sales forecasts and events that might affect sales. In addition, these managers are responsible for monthly sales forecasts, which provided good estimates of expected volume.

Mike Travis, CEO of Transcend Inc, talks almost daily with Amanda Martin, vice president of the incentive travel division. Most of their recent discussions have dealt with properly managing the newer foreign travel package options among the higher tier levels in the company's upcoming January 2012 catalog. Martin has been working for the last 2 months with Brazilian hotel operators and tour guides on a new package that covers the Rio de Janeiro Carnival in Brazil. The popularity of Brazil as a travel destination has increased substantially in the last 5 years with over 5 million visitors in 2010. With the recent announcements of the 2014 World Cup and 2016 Summer Olympics in Brazil, Transcend is hoping to develop relationships with Brazilian hospitality companies to include additional travel packages in the near future. Transcend would like to include a package that includes the Brazil Carnival in 2013 and later add World Cup options in 2014 and eventually Summer Olympics in 2016. One of the main concerns Transcend has is foreign currency exchange rate risk. Award recipients who choose Brazil as a travel destination implies that Transcend will receive payment in US dollars, but incur costs in Brazilian real. If the Brazilian trips turned out to be as popular as Martin envisioned, Transcend would face significant exchange rate risk and potential margin erosion if the Brazilian real were to significantly strengthen in value.

Foreign currency exchange rate risk itself does not worry Travis, as he is familiar with hedging techniques frequently used by the corporate event division. For example, the corporate division organized a 400 participant annual meeting for a client in Paris last year. Although the client paid Transcend in US dollars, the expenses incurred by Transcend were in Euros. Because of the size of the European expense, the corporate division simply purchased Euros forward equivalent to 90% of projected expenses once the contract was signed. Because the timing and approximate amount of Euros needed was known 10 months in advance, the forward contract eliminated a majority of exchange rate risk that would arise if the Euro strengthened over the exposed time period. Unfortunately, in offering a new destination for the first time, the amount of currency exposure to be hedged will not be large enough to use forward contracts. However, the exchange rate risk is significant enough to impact margins for the Incentive Travel division. Transcend explained the difference to Martin using a few simplifying assumptions.

Our next catalog will be published on January 1, 2012. You have included the Brazil Carnival offering under the Tier 3 category based on current exchange rates. Your team will sell travel vouchers out of the catalog over the next few months. However, the final volume of vouchers sold will not be known until July 1, 2012. All vouchers sold are priced in US dollars. However, eligible employees will redeem their vouchers for various travel destinations throughout the remainder of the year. We have included a special provision in the Carnival option stipulating that recipients who choose the Carnival option must do so by October 15th, 2012. We will have to pay deposits of approximately one half of the total on October 31st, 2012, with the remainder of the payments to be made on January 31st, 2013. We have to set our prices on January 1, 2012. The total number of vouchers sold will be known on July 1, 2012. The total number of Carnival trips redeemed will be known by October 15th, 2012. Deposits in real will have to be paid on October 31st, 2012 and the final payment in real will be made on January 1st, 2013.

300 days of FX exposure-				
				360 days of FX exposure
1-1-12	7-1-12	10-15-12	10-31-12	12-31-12
Catalog	Vouchers sold	Total Carnival	Initial deposit	Final payment
distributed	US$ revenues received	vouchers redeemed known	in R$ made	in R$ made

Travis explained further:

Let's take a look at the Tier 3 offerings and make some simplifying assumptions. The options now include New York, San Francisco and Brazil. We sold about 2,000 Tier 3 (priced at $3,000) vouchers over the last 6 months out of the July 2011 catalog. Our costs average about $2,300 per domestic trip and our anticipated costs are 4,000 R$ for the Carnival in Brazil trip. If we assume the same level of sales for the January 2012 catalog and your marketing research is correct in predicting a 20% acceptance rate on the Carnival trip, then we can assume about 400 Carnival trips will be selected.

We can estimate that we will need to buy a total of 1.6 million R$ over the next year. 800,000 R$ will need to be purchased by October 31st, 2012 and the remaining 800,000 R$ will need to be purchased on December 31st, 2012. Given current exchange rates of about $0.53/1BRL, the profit margins are slightly higher on the Brazilian offering compared to the domestic offerings. However if the real were to strengthen to its 52 week high of $0.65/1BRL, our costs per trip would rise from $2,120 to $2,600 with gross margins eroding from over 29% to just over 13%. Of course, exchange rate risk works both ways, and if the real were to weaken over the next 12 months, our margins would improve. However, the incentive travel division needs gross margins to average 20% along with target revenues to meet your division forecast. I would suggest that you take a look at using foreign currency futures contracts as means of *hedging the exchange rate exposure. I am not saying we have to hedge this risk, but we should at least determine our exposure first and then decide if we would like to use futures contracts as a part of our risk management strategy.*

After the meeting with Travis was over, Martin went back to her office to consider the best course of action for including the Brazilian trips. She needed the Carnival trips to be included in the catalog in order to develop relationships with Brazilian hospitality providers. Developing relationships today should pay big dividends when it comes to putting together the very best packages for the 2014 World Cup and 2016 Olympics in Brazil. If she can differentiate Transcend from other corporate travel providers in this area, Transcend might be able to gain market share in the already competitive environment. She had spent a lot of time putting together the Carnival package and her instincts led her to believe the Brazil offerings could drive top line revenue growth for at least the next four years. However, Martin also knew that her compensation was linked with bottom line profits not top line sales. Before any major bonus compensation was paid, Martin would need foreign currencies to remain stable or weaken relative to the dollar if the currency risk was not hedged. Top line revenue growth is nice, but not at the expense of margin compression. Martin would need to access the risk associated with the current Carnival in Brazil offering and devise an appropriate hedging strategy if required.

SUGGESTED REFERENCES

Chicago Mercantile Exchange, http://www.cmegroup.com.

Financial Times, http://www.ft.com.

Madura, Jeff, *International Financial Management*, 11th Edition, Thompson/South-Western, 2012.OANDA.com, http://www.oanda.com.

Robin, J. Ashok., *International Corporate Finance*, Mc-Graw Hill, 2010.

DEMAND MEDIA, INC.

J. Richard Anderson, Stonehill College
Gary Blumenthal, Adlife Marketing & Communications Co., Inc.

CASE DESCRIPTION

The primary subject matter of this case concerns the corporate financial reporting policy of a company as it approaches its initial public stock offering. The case has a difficulty level of three: appropriate for college juniors and above. The case is designed to be taught in one to one and one-half class hours and is expected to require two hours of outside preparation by students.

CASE SYNOPSIS

As Demand Media, Inc. approaches its initial public stock offering, analysts begin to raise questions about its accounting for Media Content Costs, which are the small fees it pays to independent contractors to write or film the millions of "how to" articles and videos that form the basis of the company's numerous websites. Unlike some of its competitors, Demand Media has chosen to capitalize these costs and amortize them over a five-year life. The student is asked to debate the relative merits of capitalization versus expensing these costs, and then is encouraged to discover the importance of this single accounting decision in understanding recent trends in the company's net income, cash flow from operations, and its own internally-developed non-GAAP measure of performance. Then students are presented with an unusual development: a decision by Google to change its search engine algorithm which causes an immediate sharp decline in the number of visitors to Demand Media's sites, and thus triggers possible declines in the economic value of its massive library of articles and videos. This new event can then lead to a discussion about the possible impairment of their large Media Content asset. Instructors who wish to go further can then provide (or require students to provide) updates on the company's fortunes after its public offering.

DEMAND MEDIA, INC.

The following headline appeared in CNNMoney.com on December 23, 2010:

Demand Media IPO Stalls Amid Accounting Questions

"Online content creator Demand Media filed for an IPO back in August, but the company is still answering regulators' questions about its unorthodox accounting practices. Demand CEO Richard Rosenblatt has been insisting for years to media outlets, including Fortune, that his company -- which churns out vast amounts of low-cost content optimized to grab search-engine clicks -- is

> profitable. But in its IPO filing, Demand disclosed that it was more than $6 million in the red for 2010 as of August. It posted a net loss of $22 million in 2009, a $14 million loss in 2008 and a nearly $6 million loss in 2007. All Things D reported Thursday that regulators are taking a closer look at Demand's unusual accounting practices. Demand Media filed an amended Form S-1 to the Securities and Exchange Commission (SEC) on Tuesday that shed more light on its accounting…"

Having previously raised $355 million in private funding, in late 2010 Demand Media tried to become the first internet-related company to go public with a valuation of over $1 billion since Google in 2004. Their initial public offering involved selling 7.5 million shares of its common stock for $125 million, thus creating a total market capitalization for the firm of $1.5 billion. However, the SEC has ultimate jurisdiction over the accounting methods used by publicly-owned firms and its questions can cause investors to shy away from new securities offerings, especially if they suspect that the accounting methods used may be obscuring a company's true performance. After the dot.com craze of the late 1990's when buyers paid very high prices for stock in internet firms that never made any money, wary investors have demanded either demonstrated current profits or at least a discernable trend in that direction as a precondition for investment in new public offerings. Was Demand Media a rising star among internet-related investments, or simply an eye-catching idea chasing elusive profitability?

COMPANY HISTORY

Richard Rosenblatt, a quintessential serial entrepreneur, founded Demand Media, along with Shawn Colo, in June 2006. Rosenblatt, no stranger to Internet ventures, had previously founded iMall and later became affiliated with such startups as Great Domains and Web Million, as well as drkoop.com. In addition, he partnered in Superdudes and served as CEO of Intermix as well as the hugely-popular MySpace.

This background was a springboard for the formation of Demand Media, which in its IPO prospectus describes itself as "a leader in a new Internet-based model for the professional creation of high-quality, commercially valuable content at scale." Critics, on the other hand, have described it as a "content farm", where an army of amateur writers contribute materials of questionable quality to a continually-growing library of over 3 million articles and 200,000 videos.

Demand Media "identifies, creates, distributes, and monetizes in-demand content." The company accomplishes this through two very different businesses: it earns fees as a registrar for internet domain names, and it produces media content for sale to customer-owned websites such as AOL, as well as for distribution on its own portfolio of websites, the most popular of which is e-How. Through a proprietary algorithm, it pinpoints the most popular search keywords on the Internet and tailors its written or video content to meet that demand for practical information. For example, using the eHow website a consumer may want to know how to fix a flat tire. By typing in "how to fix a flat tire", the user is directed to a YouTube video produced by Demand

Media. Here is where revenue is created, as companies such as Goodyear are willing to buy advertising space on the same page, knowing that they are reaching an audience with tire-repair problems. Every time a reader "clicks" on the site, ad revenue is generated, which either goes directly to Demand Media or is split with search engines such as Google, who has the power to drive web traffic to the content/advertiser site.

While they will occasionally partner with high-priced celebrities such as Rachael Ray or Tyra Banks to provide specialized cooking or skin care content, in order to fill its cavernous daily need for 6,000 new text articles and videos the company cunningly taps into the desire of thousands of free-lance writers to see their work in print and assigns them topics involving search-friendly keywords at commissions averaging $20 per article. In 2010 Demand Media spent $42.8 million acquiring over a million articles or videos (labeled "Media Content") from over 10,000 independent contractors. Interestingly, the quality of the written text is not considered a key factor in Demand Media's success; as long as the company's search engine optimization techniques work effectively, traffic is drawn to the sites (and revenue earned) simply by determining what web surfers are interested in reading and the types of audiences advertisers are interested in reaching.

Demand Media's strategy is to avoid topical news articles and focus on creating web content that has a "long tail;" articles with a staying power that will bring searching users back at any point in the future simply by typing in a search term. Thus they argue that their enormous collection of media content is not made up of one-hit wonders, but rather represents a revenue-producing annuity which they expect will last an average of five years. Using their algorithm, they assert that they can estimate the ad revenue-generating ability of their content before it is even produced, and then track this revenue-generation daily as users are steered by search engines to its articles and videos.

THE ACCOUNTING ISSUE

As can be seen in Exhibit 1, the twin businesses of managing internet domain names and selling advertising built around consumer-driven articles and videos created almost 50% revenue growth from 2008 to 2010, but were not successful in producing any profits. Those who like Demand Media's basic strategy and are looking to buy shares of its IPO will then try to justify their investment by looking at alternative measures of success: are its net losses decreasing, is it producing positive operating cash flows, and is its performance improving using pro-forma non-GAAP measures of profitability? Using Demand Media's 2010 10-K report, the surface answers to these questions are all reassuring:

The company's net loss before preferred stock dividends declined from $22.4 million in 2009 to $5.3 million in 2010.
The 3rd and 4th quarter income statements for 2010 show the first profits in its history.
Operating cash flows improved from $39.2 million in 2009 to $61.6 million in 2010 (see Exhibit 3).

> "Adjusted OIBDA" (Adjusted Operating Income before Depreciation and Amortization) increased from $38.6 million to $62.0 million in the past year (See Exhibit 4).

However, with the reporting by CNNMoney and others of "unorthodox accounting practices" in December 2010, investors must carefully consider how profits and operating cash flows were calculated before placing any reliance on these encouraging positive trends.
When the SEC reviewed Demand Media's public stock offering registration statement, it raised the following question regarding the commissions paid to the thousands of article-writers and video-makers who create the company's media content inventory:

> "Explain why you believe that capitalizing media content as an intangible asset instead of expensing as incurred is appropriate. Cite the accounting literature that supports your accounting. In this regard, explain why articles and video can be directly linked to revenue being earned from your websites or to customer."

As Exhibit 5 shows, Media Content Costs formed the largest and fastest-growing part of the Intangible Assets account in Demand Media's balance sheet.

CONCLUSION

On January 26, 2011 Demand Media completed a successful public offering at $17 per share, and enthusiastic investors quickly bid the stock up to a high of $25 per share, which gave the company a market valuation of $1.5 billion. Two weeks later Google introduced a major change to its search algorithm with the goal of moving better quality content to the top of Google search results and a corresponding reduction in ranking for low-quality sites or sites with unoriginal content. In spite of Richard Rosenblatt's assertion that the algorithm change would not hurt his company's results, in the following two months the percentage of people who navigated to a Demand Media site after a Google search fell sharply from .57% to .34%. Possibly as a result of Google's algorithm change, Demand Media's second-quarter 2011 Content and Media Revenue fell 4% to $49.8 million from $51.8 million in the first-quarter, the first quarter-to-quarter decline in the company's history. From a high of $27 in April, Demand Media's stock price had fallen to about $7 per share when the firm's second-quarter results were released in mid-August, 2011.

EXHIBIT 1
Demand Media, Inc. and Subsidiaries
Consolidated Statements of Operations
(In thousands, except per share amounts)

	Year ended December 31,		
	2008	2009	2010
Revenue	$170,250	$198,452	$252,936
Operating expenses			
Service costs (exclusive of amortization of intangible assets shown below)	98,184	114,536	131,332
Sales and marketing	15,310	20,044	24,424
Product development	14,252	21,657	26,538
General and administrative	28,070	28,479	37,371
Amortization of intangible assets	33,204	32,152	33,750
Total operating expenses	189,020	216,868	253,415
Loss from operations	(18,770)	(18,416)	(479)
Other income (expense)			
Interest income	1,636	494	25
Interest expense	(2,131)	(1,759)	(688)
Other income (expense), net	(250)	(19)	(286)
Total other expense	(745)	(1,284)	(949)
Loss before income taxes	(19,515)	(19,700)	(1,428)
Income tax benefit (expense)	4,612	(2,771)	(3,897)
Net loss	(14,903)	(22,471)	(5,325)
Cumulative preferred stock dividends	(28,209)	(30,848)	(33,251)
Net loss attributable to common stockholders	$ (43,112)	$ (53,319)	$ (38,576

EXHIBIT 2
Demand Media, Inc. and Subsidiaries
Consolidated Balance Sheets

Dollars in Thousands	**December 31, 2009**	**December 31, 2010**
Assets		
Current assets		
Cash and cash equivalents	$ 47,608	$ 32,338
Marketable securities	2,300	—
Accounts receivable, net	18,641	26,843
Prepaid expenses and other current assets	6,371	7,360
Deferred registration costs	36,563	44,213
Total current assets	111,483	110,754
Deferred registration costs, less current portion	7,087	8,037
Property and equipment, net	30,642	34,975
Intangible assets, net	88,834	102,114
Goodwill	224,920	224,920
Other assets	4,824	7,667
Total assets	$ 467,790	$488,467
Liabilities, Convertible Preferred Stock and Stockholders' Deficit		
Current liabilities		
Accounts payable	$ 5,991	$ 8,330
Accrued expenses and other current liabilities	20,853	29,570
Deferred tax liabilities	13,339	15,248
Deferred revenue	52,339	61,832
Total current liabilities	92,522	114,980
Revolving line of credit	10,000	—
Deferred revenue, less current portion	12,912	14,106
Other liabilities	1,681	1,043
Total liabilities	117,115	130,129
Convertible Series A Preferred Stock, $0.0001 par value.	122,168	122,168
Convertible Series B Preferred Stock, $0.0001 par value.	17,000	17,000
Convertible Series C Preferred Stock, $0.0001 par value.	100,098	100,098
Convertible Series D Preferred Stock, $0.0001 par value.	134,488	134,488
Total convertible preferred stock	373,754	373,754
Stockholders' deficit		
Common Stock, $0.0001 par value. Authorized 500,000 shares; issued and outstanding 14,525, and 15,372 shares at December 31, 2009 and 2010, respectively	1	2
Additional paid-in capital	23,673	36,721
Accumulated other comprehensive income	169	108
Accumulated deficit	(46,922)	(52,247)
Total stockholders' deficit	(23,079)	(15,416)
Total liabilities, convertible preferred stock and stockholders' deficit	$ 467,790	$488,467

EXHIBIT 3
Demand Media, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
(In thousands)

	Year ended December 31, 2008	2009	2010
Cash flows from operating activities			
Net loss	$ (14,903)	$ (22,471)	$ (5,325)
Adjustments to reconcile net loss to net cash provided by operating activities			
Depreciation and amortization	43,710	47,115	52,016
Deferred income taxes	(5,085)	2,208	2,980
Stock-based compensation	5,071	7,171	9,329
Other	742	(311)	394
Change in operating assets and liabilities, net of effect of acquisitions			
Accounts receivable, net	(854)	(4,172)	(8,344)
Prepaid expenses and other current assets	(665)	892	(181)
Deferred registration costs	(3,719)	(3,608)	(8,600)
Other assets	900	1,345	545
Accounts payable	2,554	1,100	1,237
Accrued expenses and other liabilities	(1,254)	4,247	6,886
Deferred revenue	9,445	5,715	10,687
Net cash provided by operating activities	35,942	39,231	61,624
Cash flows from investing activities			
Purchases of property and equipment	(20,103)	(15,327)	(21,400)
Purchases of intangible assets	(19,317)	(22,701)	(47,196)
Purchases of marketable securities	(68,701)	(48,916)	(975)
Proceeds from maturities and sales of marketable securities	88,837	64,069	3,275
Cash paid for acquisitions, net of cash acquired	(60,128)	(525)	—
Other investing activities	550	609	—
Net cash used in investing activities	(78,862)	(22,791)	(66,296)
Cash flows from financing activities			
Proceeds from line of credit	55,000	37,000	—
Payments on line of credit	—	(82,000)	(10,000)
Repayment of notes payable	(4,000)	(10,000)	—
Capital lease obligation principal paid	(24)	(581)	(546)
Proceeds from issuances of common stock, restricted common stock and exercises of stock options	376	591	1,552
Windfall tax benefit from exercises of stock options	—	—	34
Proceeds from issuances of preferred stock	35,000	—	—
Issuance costs related to debt and equity financings	(208)	—	(1,577)
Net cash provided by (used in) financing activities	86,144	(54,990)	(10,537)
Effect of foreign currency on cash and cash equivalents	—	169	(61)
Change in cash and cash equivalents	43,224	(38,381)	(15,270)
Cash and cash equivalents, beginning of period	42,765	85,989	47,608
Cash and cash equivalents, end of period	$ 85,989	$ 47,608	$ 32,338

EXHIBIT 4
Demand Media, Inc. and Subsidiaries
Calculation of Adjusted OIBDA (Adjusted Operating Income Before Depreciation and Amortization)
(In thousands)

	Year ended March 31, 2007	Nine Months ended December 31, 2007	Year ended December 31, 2008	2009	2010
Non-GAAP Financial Measures:					
Content & Media revenue	$ 18,073	$ 49,342	$ 84,821	$ 107,717	$ 152,910
Registrar revenue	40,906	52,953	85,429	90,735	100,026
Less: traffic acquisition costs (TAC)	(5,087)	(7,254)	(7,655)	(10,554)	(12,213)
Total revenue ex-TAC	$ 53,892	$ 95,041	$ 162,595	$ 187,898	$ 240,723
Income (loss) from operations		$ (7,081)	$ (18,770)	$ (18,416)	$ (479)
Add (deduct):					
Depreciation		3,590	10,506	14,963	18,266
Amortization		17,393	33,204	32,152	33,750
Stock-based compensation		3,670	5,970	7,736	9,689
Non-cash purchase accounting adjustments		1,282	1,533	960	779
Gain on sale of asset		—	—	(582)	—
Adjusted OIBDA		$ 18,854	$ 32,443	$ 36,813	$ 62,005

EXHIBIT 5
Demand Media, Inc. and Subsidiaries
Intangible Assets Account Detail

(Dollars in Thousands)	12/31/08 BALANCE	2009 ADDITIONS	12/31/09 BALANCE	2010 ADDITIONS	12/31/10 BALANCE
Gross Intangible Assets:					
Owned Website Names	$ 36,275	$ 6,336	$ 42,611	$ 3,483	$ 46,094
Customer Relationships	21,946	2,409	24,355		24,355
Media Content	***41,611***	***11,981***	***53,600***	***42,812***	***96,412***
Technology	34,259	-	34,259		34,259
Non-Compete Agreements	14,248	181	14,429		14,429
Trade Names	11,173	(194)	10,979		10,979
Publisher Relationships	2,113	(21)	2,092		2,092
TOTAL	$ 161,625	$ 20,860	$ 182,325	$ 46,295	$ 228,620
	12/31/08 BALANCE	2009 AMORTIZATION	12/31/09 BALANCE	2010 AMORTIZATION	12/31/10 BALANCE
Accumulated Amortization:					
Owned Website Names	$ 20,377	$ 9,200	$ 29,577	$ 6,441	$ 36,018
Customer Relationships	9,987	4,116	14,103	3,550	17,653
Media Content	***12,378***	***6,932***	***19,310***	***14,895***	***34,205***
Technology	8,719	5,541	14,260	5,258	19,518
Non-Compete Agreements	9,069	3,653	12,722	1,584	14,306
Trade Names	1,580	1,014	2,594	1,021	3,615
Publisher Relationships	694	231	925	266	1,191
TOTAL	$ 62,804	$ 30,687	$ 93,491	$ 33,015	$ 126,506

AN ACCOUNTING CHANGE AT AMERICAN ROCK SALT COMPANY

Allen K. Hunt, Western Kentucky University
Brad J. Reed, Southern Illinois University Edwardsville
Gregory E. Sierra, Southern Illinois University Edwardsville

CASE DESCRIPTION

This case explores the events of an accounting change. The case involves American Rock Salt Co.'s (ARSC) accounting change as documented in filings with the Securities and Exchange Commission (SEC). Students examine the process for a change in accounting principles, estimates, and error corrections. Standard filings by the ARSC provide relevant information as do correspondence between the ARSC and the SEC. The student will produce a memo presenting answers to questions regarding accounting changes. The case is appropriate for a junior or senior level financial accounting course. This case has a difficulty level of three out of five.

CASE SYNOPSIS

A change in accounting method is treated as a change in accounting principles if the change is made from one acceptable principle to another. The application of an accounting principle sometimes involves the estimation of certain parameters such as the useful life of assets. In this case ARSC changed from the straight-line method of accounting for depreciation on mine-improvements to the units-of-production method for a year in which the annual report had already been filed with the SEC. Of added interest, the FASB had issued SFAS 154: Accounting Changes and Error Corrections- a replacement of APB Opinion No. 20 and FASB statement No. 3, which became effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

The student is put in the position of an accountant at a company that is considering acquiring ARSC. The student is then asked to respond to a series of questions to help gain an understanding of the financial statements and accounting changes at ARSC.

HISTORY

ARSC is a private company that registered securities with the SEC in 2004 to comply with the covenants of its secured senior notes. ARSC's primary asset is the Hampton Corners

Salt Mine located in New York, serving industry and northwestern municipalities (road salt). The mine's construction was essentially complete in 2001, and operations grew in 2002. By the end of 2003 the Hampton Corner's mine had attained full production capability.

According to the September 30, 2004 annual report; mine development costs were being depreciated over a 20 year life. According to ARSC mine development costs included:

> …engineering; site preparation and earthwork; site utilities; roads and paving; surface buildings; surface material handling; truck and rail loadout; railroad work; emergency generator; electrical systems; substation; hoists and headframes; service and production shafts; fans and ventilation; and underground development (ARSC a, p. 4, 2006).

In 2004 the ARSC reported that there were approximately 70 years of proven and probable reserves at the Hampton Corners Salt Mine. According to a SEC filing ARSC relied on its interpretation of a publication written by a big four accounting firm that opined on allowable depreciation methods for mining companies to justify its use of straight-line depreciation for mine improvements (ARSC b, p. 4, 2006). Most other public salt mining companies, however, were using the units-of-production method.

SFAS 154 was issued to provide guidance regarding accounting changes. Accounting changes include changes in estimate, changes in principle and correction of an error. The following is taken from the new pronouncement:

SFAS 154 was issued in May 2005 and became effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. SFAS 154 specified that: Early adoption of an accounting pronouncement, when permitted, shall be effected in a manner consistent with the transition requirements of that pronouncement (FASB p. 4, 2005).

With respect to the early adoption of SFAS 154 itself, the FASB stipulated:

> This Statement shall be effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. Early adoption is permitted for accounting changes and corrections of errors made in fiscal years beginning after the date this Statement is issued (FASB p. 11, 2005).

The explanatory notes of ARSC amended 2005 10-K contained the following information related to the new method of depreciating its mine development costs.

This Amendment No. 1 to the Company's Annual Report on Form 10-K (this "Form 10-K/A") for the fiscal year ended September 30, 2005, initially filed with the SEC on December 27, 2005 (the "Original Filing"), is being filed to reflect the retrospective application of the Company's new method of amortizing its mine development costs. This change affects the

Company's Balance Sheets at September 30, 2005 and September 30, 2004 and its Statements of Operations, Statements of Changes in Members' Equity (Deficit) and Statements of Cash Flows for each of the fiscal years ended September 30, 2005, September 30, 2004, and September 30, 2003. The Company has elected to change its mine development cost amortization to the units-of-production method, instead of a 20-year amortization life as the Company had previously used. The Company has adopted Statement of Financial Accounting Standards No. 154 ("FAS 154"), effective as of October 1, 2005, and in accordance therewith, retrospectively applied the change in amortization approach as a change in accounting principle to the financial statements included in this Form 10-K/A. (ARSC p. 2, 2006)

The change that ARSC made in the amended 2005 10-K resulted in increases to income of $1,934,000 in 2005, $2,036,000 in 2004 and $2,919,000 in 2003.

ACCOUNTING ISSUE

Harley Merle is the Controller for Interstate Mining Company (IMC). The Executive Committee of IMC has decided to look at diversifying into salt mining, and they asked Harley to look at the financial statements of ARSC to provide any feedback that he might have. After examining the 2005 annual report and a few other SEC filings Harley was intrigued by a few issues.

Harley puzzled over the accounting change that was discussed in the explanatory notes of the September 30, 2005 10-K/A. After reading through the relevant parts of the 2005 annual report Harley wanted to find out what sort of accounting change was made. In the 2005 annual report Harley found the following statement.

> The financial impact of this accounting change is a reduction of annual amortization expense as the mine development assets are effectively amortized over a longer useful life (ARSC, p35, 2005).

Harley made the following notes. The treatment for a change in an accounting principle differed between ABP Opinion No. 20 and SFAS 154. Under APB No. 20 a change in accounting principle was treated retrospectively. Under APB Opinion No. 20. a change in depreciation method was treated as a change in accounting principle, not as a change in estimate.

Under SFAS 154 voluntary changes in accounting principles resulted in a cumulative adjustment to income in the year of change. Under SFAS 154 a change in depreciation method is treated as a change in estimate that is effected by a change in accounting principle. SFAS 154 specifies that a change in estimate should be accounted for prospectively, with no retrospective adjustment to retained earnings or prior year numbers. A correction of an error receives similar treatment under APB Opinion No. 20 and SFAS 154 in that an error correction results in a retrospective adjustment to retained earnings with a change to prior year numbers.

Harley is concerned that the accounting change implemented by ARSC has distorted ARSC's income. Since the acquisition price is often influenced by the target company's income, Harley has determined that an investigation of ARSC's accounting change is warranted. After reviewing the two accounting standards, Harley realized that ARSC could have used either APB Opinion No. 20 or it could have adopted SFAS 154 early to account for the change documented in the annual report.

QUESTIONS

1. Make a table of the correct accounting treatments according to SFAS 154 of 1) a transition to a new accounting standard, 2) a voluntary change in accounting principle, 3) an error correction and 4) a change in estimate. For each of these four columns, describe the method of transition accounting, whether or not the comparative numbers are changed and if disclosures of the change are required. The table should be formatted as follows:

Type of Change	Transition to a New Accounting Standard	Voluntary Changes in Accounting Principles	Error Corrections	Changes in Estimate
Transition Accounting Method?				
Change Prior Years Numbers on Comparative Columns?				
Disclosures Required?				

2. Discuss which type of accounting change treatment matches ARSC's accounting for the change in the Amended September 30, 2005 Annual Report. Also, discuss the circumstances of the accounting change that ARSC made to the September 30, 2005 amended 10-K.

3. Was it appropriate for ARSC to apply SFAS 154 to the accounting period beginning October 1, 2005; which is before SFAS 154 became effective?

4. Does ARSC's income increase or decrease with a change from the straight-line depreciation method with a twenty-year useful life to the units-of-production method, given full production?

5. Do you think a retroactive adjustment to ARSC's income is appropriate in this circumstance? What is a possible motivation for ARSC to treat the change in this manner?

6. What did ARSC mean when it wrote the following with respect to the September 30, 2005 amended 10-K?

   The Company has adopted Statement of Financial Accounting Standards No. 154 ("FAS 154"), effective as of October 1, 2005, and in accordance therewith, retrospectively applied the change in amortization approach as a change in accounting principle to the financial statements included in this Form 10-K/A. (ARSC p. 2, 2006)

7. What is your opinion of the explanatory notes to ARSC's 10-K/A as presented on page four above?

Table 1 Summarized Data from ARSC's Amended 2005 Annual Report				
Balance Sheet Data				
	2005	**2004**	**2003**	**2002**
Current Assets-Non Inventory	$ 10,113,969	$ 8,780,155	$ 10,113,969	$ 8,780,155
Inventory	32,039,685	25,142,023	33,052,672	26,019,678
Property and Equipment	84,263,151	81,011,121	75,456,780	74,274,773
Other Assets	9,538,386	10,359,242	9,538,386	10,359,242
Total Liabilities	124,567,223	100,149,742	24,186,150	24,893,352
Equity	(12,798,182)	249,447	(20,591,556)	(5,609,246)
Income Statement Data				
Sales	104,612,612	96,502,199	104,612,612	96,502,199
Cost of Sales-Freight, etc	$ 46,006,339	42,417,385	$ 46,006,339	42,417,385
Cost of sales-Inventory	28,053,439	25,556,298	29,988,131	27,592,302
Other Expenses	(11,303,873)	10,716,030	(11,303,873)	(10,716,030)
Net Income	11,015,209	11,178,579	90,808,517	9,142,575
Statement of Cash Flows Data				
Net Income	$11,015,209	$11,178,579	$ 9,080,517	$ 9,142,575
Depreciation	4,262,041	4,134,820	6,332,065	6,125,371
Change In Inventory	(6,897,662)	(6,080,084)	(7,032,994)	(6,034,631)
Other Op. Cash Flows	(1,904,921)	4,866,385	(1904921)	2,916,929
Investing Cash Flows	(12,724,574)	(3,320,970)	(12,724,574)	(3,320,970)
Financing Cash Flows	5,381,994	(16,773,799)	5,381,994	(16,773,799)
Total Cash Flows	(867,913)	(5,995,069)	(867,913)	(5,995,069)

Table 2 Changes in Equity		
	Amended 2002-2005	**Original 2002-2005**
Equity-September 30, 2002,as reported	$ 13,096,271	$ 13,096,271
Cumulative effect of change	903,828	-
Net Income	16,470,770	13,551,909
Equity-September 30,2003	30,470,869	26,648,180
Net Income	11,178,579	9,142,575
Distribution to Members	(41,400,001)	41,400,001)
Equity (deficit)-September 30, 2004	249,447	(5,609,246)
Net Income	11,015,209	90,808,517
Distribution to Members	24,062,838	24,062,837)
Equity (deficit)-September 30, 2005	$ (12,798,182)	$(20,591,566)

REFERENCES

American Rock Salt Company LLC, Correspondence (ARSC a), April 18, 2006, filed April 19, 2006. Retrieved August 19, 2010 from http://sec.gov/Archives/edgar/data/1073713/000119312506083201/filename1.htm

American Rock Salt Company LLC, Correspondence (ARSC b), August 4, 2006, filed August 4, 2006. Retrieved August 19, 2010 from http://sec.gov/Archives/edgar/data/1073713/000119312506161783/filename1.htm

American Rock Salt Company LLC, 10-K/A, September 30, 2005, filed October 10, 2006. Retrieved August 19, 2010 from http://sec.gov/Archives/edgar/data/1073713/000119312506213795/d10ka.htm

American Rock Salt Company LLC, 10-K, September 30, 2004, filed December 27, 2004. Retrieved August 19, 2010 from http://sec.gov/Archives/edgar/data/1073713/0119312505248993/d10k.htm

Financial Accounting Standards Board (FASB), Statement of Financial Accounting Standards 154: Accounting Changes and Error Corrections- a replacement of ABP opinion No. 20 and FASB statement No. 3, May, 2005. Retrieved August 19, 2010 from http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs

DESIGN PROTOTYPES INC. PROJECT MANAGEMENT (A): SELECTION OF THE PROJECT TEAM

Patricia A. Lapoint, McMurry University
Carrol R. Haggard, Fort Hays State University

CASE DESCRIPTION

The primary subject matter of this case concerns project management. A secondary issue examined is office politics. This case can be used in Project Management, Operations Management, or Quality Management courses. The case has a difficulty level of three. The case is designed to be taught in two class hours and is expected to require four hours of outside preparation by students.

CASE SYNOPSIS

Raef Conley has just been assigned his first major project. Having worked on several small projects since joining Design Prototypes Inc., 9 years ago, Raef has never taken on a major project. This is a significant opportunity for him, one that could advance his career in many ways. Although he is excited about the opportunity, he is also somewhat anxious. as while there is the potential for career advancement, he is also cognizant of the fact that failure could mean the end of his career at Design Prototypes. Raef's first task is to assemble a project team. Raef needs to assemble a team of seven individuals selected from a pool of eleven. While all of the candidates have strengths, some appear to be better suited to the project than others. Three of the candidates have political connections which could influence their selection. Another candidate has a strong personal connection to Raef. While uncertain about his actual motives, Raef has a feeling that his boss has clear preferences toward two of the candidates. The case revolves around the questions of: How does Raef weigh technical competence with personal and political considerations? Who should Raef select for the team?

DESIGN PROTOTYPES INC. PROJECT MANAGEMENT (A): SELECTION OF THE PROJECT TEAM

Raef Conley has just been assigned his first major project. Having worked on several small projects since joining Design Prototypes Inc. 9 years ago, Raef has never taken on a major project. This is a significant opportunity for him, one that could advance his career in many ways. Although he is excited about the opportunity, he is also somewhat anxious as while there is the potential for career advancement, he is also cognizant of the fact that failure would mean the end of his career at Design Prototypes.

Raef joined Design Prototypes Inc. after receiving his B.S. degree in Electrical Engineering from a well-known university in the South. The first projects Raef worked on required applying his academic knowledge and training. As a project team member, Raef approached his responsibilities as a team member with enthusiasm. He contributed his expertise to the technical requirements of the project and served as an informal team leader. His technical expertise and his ability to work effectively with diverse team members were no doubt factors in his selection as project manager. Although he was confident he could successfully meet the challenges as project manager, he had concerns.

His role in the new project was very different than his involvement in previous projects. This project required less hands-on in the application of his technical skills, rather it demanded project management skills. While he was confident that he could apply his technical knowledge to any project, actually managing the project is an entirely different skill set requirement; a skill set for which he was concerned that his university education had not directly prepared him.

"Where should I begin", Raef thought. Drawing upon a course in his engineering program, Raef remembered Professor Bentley's discussions of project management. He searched through his old textbooks in Dr. Bentley's course (which he thankfully had kept), and found the topic on Project Management. He felt a good starting point would be the Project Management Process Model (See Figure 1).

Figure 1: Project Management Process Model

Selection → Initiation → Planning → Delivery → Closure

According to the model, his immediate task was to assemble a project team (Initiation Stage). What criteria should he use to select the team? Considering the purpose and goals of the project (Table 1) and referring to the Project Team Selection Process (See Table 2), Raef believed that these factors should drive the team member composition.

Table 1: Project Purpose And Goals
Purpose: to design the electronic components for **a** new product
Goals: 1) to develop a timeline for each phase of the project
2) to complete the project on time
3) to complete the project on budget
4) to meet customer specifications and requirements

Table 2: Project Team Selection Process
1. Assess the knowledge and technical requirements of the project
2. Diversify the team according to knowledge, skills, departmental representation, background/ experience, and vested interest in the project
3. Assess ability of the team to work together; team synergy
4. Establish team size
5. Determine time availability
6. Determine team Co-location or virtual

Based on the purpose and goals of the project and the team selection process, Raef felt that a team of 6-8 persons would be sufficient. The following are brief biographies of potential team members:

1. Michael Matson: 6 years with the company; B.S. in Civil Engineering; no previous project experience; strong performer; motivated; eager to take on new assignments; home department—Civil Engineering
2. Elroy Bennett: 22 years with the company; worked for 2 major engineering firms prior to Design Prototypes Inc.; no degree; project experience; home department— Existing Products Development
3. Alison Whitley: new graduate with a B.S. in Electrical Engineering from Raef's alma mater (Raef was part of the recruiting team for Alison and has been serving as an informal mentor to Alison); young, energetic; home department—Electrical Engineering
4. Daniel Swenson: B.S. degree in Marketing; graduated with honors; experienced in new product design; 4 years with the company; home department— New Products Development
5. Robert Brandon: 15 years in project management; worked on 6 major projects for the company; no degree; home department—Operations Administration
6. Pierce Kennedy: 7 years with the company in the Manufacturing Division; M.B.A. in Operations Management; home department—Electronics Assembly
7. Margaret Sobel: 18 years with Design Prototypes Inc.; B.S. in Management; experience working on small projects; leadership role in 3 different areas of the company; home department—Project Administration
8. Philip Lowery: B.S. degree in Electrical Engineering; 12 years with the company; worked for 2 major Fortune 100 companies prior to joining Design Prototypes Inc.; Very good friend of Jonathon Wright, Raef's manager; home department— Electrical Engineering
9. Billy Brown: 32 years with the company; no degree; worked his way through the ranks of the company to his current position as Materials Management Director; home department—Materials/Purchasing
10. Simon Wright: son of the VP of Engineering Division; 2 years with the company; B.A. in English and M.A. in Economics; home department—Public Relations

11. Rae Beth Merson: Director of Environmental Safety and Quality; M.S. in Environmental Quality; 16 years with the company; previous positions prior to Design Prototypes Inc. include Inspector for the EPA, Environmental Impact Analyst, and Feasibility Studies Coordinator/Director; home department—Environmental Safety and Quality

Raef decided that he should pare down the 11 individuals based upon specific criteria. Therefore, he established the following criteria to screen each of the 11 individuals:

a. At least 3 of the team members need the technical engineering expertise required for the project.
b. Project experience preferred

Raef also felt that there was great value in having a diverse team, so, beyond these criteria, team diversity would be an additional factor in making the selections.

In order to prepare for the interviews, based upon the team member selection criteria, Raef decided to initially place each of the candidates into 3 groups: 1) those that seemed to fully meet the criteria (Elroy Bennett), 2) those that seemed to partially meet the criteria (Michael Matson, Alison Whitley, Daniel Swenson, Robert Brandon, Margaret Sobel, Philip Lowery,), and 3) those that did not seem to meet either criteria (Pierce Kennedy, Billy Brown, Simon Wright, Rae Beth Merson).

As part of the process, Raef contacted managers in each of the relevant home departments in order to solicit their support for the project and to negotiate that candidate's time for the project. Realistically, Raef knew that he would only get a percentage of a candidate's time to work the project since the home department's work would also need attention. Some of these negotiations are still in progress. Raef proceeded to contact each person on the list, schedule an interview appointment, and e-mail a copy of the FACT SHEET for the project prior to the interview. The FACT SHEET is as follows:

Figure 2: FACT SHEET

ALPHA PROJECT FACT SHEET

Thank you for your interest in the Alpha Project. The following is a basic description of the ALPHA Project. At this stage of the development process, we are still working with the conceptual product prototype, but as the project unfolds, more specific details will develop. The ALPHA Project involves the design of an electronic component with multiple versatile market applications. The basic target markets are business-to-business. The objective of the design team is to take the conceptual prototype design and create the specifications for a commercial product which is targeted to launch 2 years from now.

Senior management is very excited about the prospects for the new product and expects the members of the project team will be up to the challenge. The final team size will be 6-8 members, chosen from a well-screened list after the selection interviews are completed.

Again, thank you for your interest, and I look forward to meeting with you at the interview.

Regards,

Raef Conley

What follows are excerpts from several interviews.

Interview with Elroy Bennett:

Raef: "Good morning Elroy. Please be seated. As you probably know I am assembling a project team to design the electronic components for one of our new products (Alpha C306). Your name was recommended to me by your supervisor, Gavin Dodd. Did Mr. Dodd fill you in on any of the project details"?

Elroy: Dodd was sketchy on the project details." I did, however receive the Fact Sheet."

Raef: "Good. The project requires significant engineering expertise as well as marketing, and manufacturing expertise. Your 22 years with the company in the engineering department as well as your previous experience at 2 engineering firms and project experience make you an ideal candidate to work on this project. The team will begin its work with a conceptual prototype design of the electronic component. The task of the project team is to develop the specifications for the ALPHA C306 with a target launch date in 2 years. That is about as specific as I can get right now. We have a reasonable project budget to work with. Do you think you might be interested?"

Elroy: "I think so". Will I have to also do my job in the department as well?"

Raef: "We are still working with supervisors on that issue, but I feel confident that something can be arranged to free up some of your time to work on this project. I expect that the project will take about 20 months to complete, but not everyone on the team will be committed for the entire project life. Do you have any other questions?"

Elroy: "No, not at this time".

Raef: Well, thank you for your time and I will let you know one way or the other if you are selected for the team."

Interview with Alison Whitley:

Raef: "Good to see you Alison. Please have a seat. How has the job been going?"

Alison: "It is great! My supervisor, Blake Thompson, is so supportive and wow, is he ever smart. I feel so fortunate to work with a man like Blake. My coworkers are highly talented and very easy to work with and of course, you have been a tremendous source of support and have provided invaluable guidance. I feel like a real part of a team."

Raef: Thank you, I can see your level of enthusiasm has not waned since coming on board. As you know, I am assembling a project team to design a new product. The new product has the potential to become one of the biggest selling products for the company; it could over time develop into a new division of products. That is why I thought you should join the project Alpha team."

Alison: "Absolutely, yes, yes". When will the project begin?"

Raef: The actual dates have not yet been determined, but my best guess is within the next 3 months. I need to have the 7-member team selected and in place by then."

Alison: "I know I am new to the company, but I believe I have a lot to contribute to the team. It sounds like an amazing opportunity to learn. I know my degree in Electrical Engineering will be useful to the project, but I also know that I can work with anyone."

Raef: "I think you could contribute to the successful completion of the project. It would certainly be a developmental opportunity for you and who knows there could be career advancement opportunities later on."

Alison: "I like the sound of that". When do you think you will make your decisions?"

Raef: I need to conduct several more interviews, but expect to have the selection decisions made within the next 3 weeks." Do you have any questions?"

Alison: "Not at this time, but can I call you later if I do?" I would also like to know more about this new product Alpha C306. Is there any information available I could read or someone I might speak with about the product concept?"

Raef: "I see you have done your homework; very few people know the product name. Let me get back to you on that. Product development projects are highly confidential, so there may be some sensitivity to how much information is available."

Alison: "I understand. I look forward to your call."

Interview with Daniel Swenson:

Raef: "Hello Daniel. I hope that our interview over lunch works for you. This has been an incredible week. I have interviewed several people for the project team. I did not realize that picking a project team was so time intensive. I am learning. From your credential search I see that you have experience in product design. Can you describe that experience for me?"

Daniel: "Of course. I majored in Marketing at the university, graduating with honors. My honors project involved designing a prefabricated electrical switch, digital, of course, for electrical energy usage. The other team members had specialized electronic backgrounds. We worked with a major customer in the community. Our product design was so favorably received by the customer that the local government decided to fund the project for further research and development. Our team worked with component parts suppliers to help us identify cost savings for materials used in the product. Until I worked on this type of product design team I did not realize how important diverse expertise is to the design of the product. It can make a significant difference to the costs of materials, manufacturing, and to the costs of distribution."

Raef: "This project appears to be very complex. Were there times during the project where you felt you were overwhelmed, over your head that is?"

Daniel: "To be honest, yes. After all, I was only a student; I did not have 'real world' experience at that point. The project team leader was someone with experience and I felt very comfortable going to her for any issues I had."

Raef: "That is a solid testimony for good leadership skills for any project manager. Do you have any questions about the project or about me?"

Daniel: "Just one. If I were selected for the team and decided to participate, how much autonomy might I have?"

Raef: " What do you mean by autonomy, Daniel?"

Daniel: " Some project managers allow you the discretion to make some decisions related to the work you are doing; others may not. What approach would you take managing this project?"

Raef: " Well, I would like to think I could give team members enough flexibility to work their parts of the project, but at the same time, when circumstances arise, I may have to make the final decision. Do you think you can live with that?"

Daniel: " I expect I can if I am allowed some freedom to make some decisions over those parts of the project assigned to me."

Raef: " Good. I will be contacting everyone shortly about my team selection decisions. Thank you for coming to lunch with me. My treat!

Interview with Robert Brandon:

Raef: " Good morning Robert. I hope the traffic from Corporate was not too stressful. I usually take the I-645 loop each morning and that traffic can be brutal."

Robert: " Actually, it wasn't that bad except for a 2-mile section of construction. It always seems as if some roadway in the area is under construction; there is no way to avoid it."

Raef: " That is absolutely true. I am appreciative that you took the time from your busy schedule to interview for the project team. Do you have any comments or questions related to the Fact Sheet information sent to you previously?"

Robert: " I read on the Fact Sheet that the product design is still in its conceptual stage. As you know, I have had extensive experience working on projects, large and small, and in various stages of development. Senior management's goal of having the product ready for commercial application is only 2 years. At this stage of product development that timeline seems a bit too optimistic to me. From my experience in the company working on product development projects in the earlier conceptual stages it generally takes anywhere from 2.5-4 years to launch a new product. Is there any flexibility in the timeline, Raef?"

Raef: " It may be possible to squeeze another 6 months out of management, but certainly not much more than that. I have evaluated the project requirements and I believe that with the right combination of people, we can meet the goal. Clearly, it will not be easy; it will require a strong commitment of time and energy from each team member, as well as the resources to pull this off. But when we do, the rewards will be significant not only for the company but also for those of us who contributed to its successful launch. I can also tell you that senior management has committed a realistic budget for the project for which I fought most vigorously."

Robert: "I do not want you to think I am hesitant to join the team, but I have some serious concerns about the strict timeline for product launch; I thrive on the challenge of working on projects especially those that can have a strong impact on the company's growth. But I need to tell you that I am working on my degree and my wife and I are expecting another child in 5 months."

Raef: "Congratulations. Robert!"

Robert: "Thank you. This is our third child and we are hoping for a boy this time".

Raef: "There is no question that family and college take a lot of time. Do you think we can work through the time demand if you were chosen for the team, Robert?"

Robert: "As much as I would like to join the team and I know I can make a valuable contribution, I am not 100% sure. I don't want to make a promise that I am not able to keep."

Raef: "I appreciate your honesty, Robert. Take a few days to consider the invitation and get back with me with your decision. Does that sound OK with you?"

Robert: "Definitely-- more than reasonable! I will call you in a couple of days. Thank you for your time Raef."

As Robert turned to leave the office, Raef shouted "Watch out for that traffic!"

Interview with Simon Wright:

Raef: Good morning Simon, it is nice to meet you. As you may know, I am assembling a ….

Simon: Dude, I know all about the project and I am here to tell you that I am your man. In fact, I have already started working on it. When I learned of the project 3 weeks ago, I started looking into Design Prototypes history on project development. Applying my economics background, I found a somewhat disturbing pattern; the company has a tendency in initially under funding development projects, so the pattern is that it takes much longer than is necessary to finally develop the project. Being able to take this data to the right person, sometimes it is nice to be connected, I was able to negotiate a much larger budget than has been the pattern. (The amount Simon mentioned was $100,000 less than what Raef had been promised.) The only downside is that we have to finish the project in 18 months, but, it should be doable. When do you start?

Raef: Well, Simon, it looks like you understand the project, do you have any questions?

Simon: No, I am on top of things, besides, I probably know more about the project that you do. I think that I have made my major contribution to the project in securing funding, although if you run short, I might be able to get another $40-$50,000.

Raef: Thanks for coming in, I will get back to you on the composition of the team.

Interview with Philip Lowery:

Raef: Good morning Philip. As I am sure you know, I am assembling a project team to design the electronic components for one of our new products.

Philip: Yes, I am aware of the project, since we work in the same department; it is hard to keep something like that a secret.

Raef: The project requires significant engineering expertise as well as marketing and manufacturing expertise. Obviously, you were invited to be considered as part of the team due to your engineering expertise, that and I appreciate the way that you mentored me when I first started at Design Prototypes.

Philip: Thanks for that, I appreciate your confidence in me. From what I have heard and read about the project, thanks for the Fact sheet by the way, it was informative, I think that I could make some significant contributions to the project. You envision the project lasting 2 years, is that correct?

Raef: That is correct.

Philip: While I wouldn't want this to get out,… can I trust you?

Raef: Certainly, what you say here stays here.

Philip: As you may know, I am 63 and I am seriously considering retiring in the next 18 months. I am starting to 'feel my age' as they say, and my wife and I would like to do some traveling while we are still physically able to do so. So, while the project certainly sounds exciting and something that I am very interested in, I am afraid that I won't be able to commit to seeing it completed. However, if I am part of the team, I will give it my best effort as long as I am here.

Raef: Thank you for your honesty. You can be assured that your plans are safe with me. Do you have any other questions?

Philip: Not at this time.

Raef: I will be making my decision in the next few weeks and will let you know.

Interview with Rae Beth Merson:

Raef:	Good morning, Ms. Merson. Please be seated. Did you have any trouble finding my office?”
Rae Beth:	“No, your directions were very good. I didn’t even have to use my Garmin.”
Raef:	“As you know, I am putting together a project team…”
Rae Beth:	“Yes, I heard about this from the VP of the Engineering Division last week at the annual benefit for Neglected and Abused Children. Isn’t Mary Beth, his wife, lovely?”
Raef:	“I have never had the pleasure of meeting her.”
Rae Beth:	“Oh, you should. She is so heavily involved in community activities; I do not know where she finds the time. I am sorry, you were saying.”
Raef:	“I am putting this project team together for a new product and quite frankly, Ms. Merson, your credentials are impressive. The product will fill a need in the energy sector. As you are aware, we are very environmentally conscious at Design Prototypes, and all of our products need to meet or exceed environmental standards. How do you think you can contribute to this project team?”
Rae Beth:	“As you stated, I believe my credentials speak for themselves. I have dedicated myself professionally and personally to environmental issues. Over the years I have worked in both the public and private sectors in Environmental Quality. I have learned that if products are designed with environmental quality in mind, then the usage for those products will help to serve our long-term environmental goals as a nation. This project seems to serve as furthering those long-term societal goals.”
Raef:	“I could not agree with you more, Ms. Merson. Do you have any questions about the project?”
Rae Beth:	“No, I think I have the information I need to make a decision should you select me for the team.”
Raef:	“Thank you for your time, and I will be in touch.”

Raef was glad that Rae Beth Merson was his last interview. As he reflected on all of the interviews, one thing became very clear. All of these individuals had something to offer the team. It would be easy to select them all, but he knew he could only select 7 of them. Which 7 would he choose?

At that moment, Jonathan Wright, Raef’s manager popped into his office.

Jonathon: "Hey Raef, how's it going? I understand you have completed all of the interviews for the project team. I had a call from the Engineering VP about his son, Simon. I was also curious what you thought of Philip Lowery."

Raef: "Well, I haven't had a chance to evaluate each of them yet; that is my next step."

Jonathon: "Can you give me some preliminary sense of Simon's and Philip's chances of being on the team?"

Raef: "They both have something to offer the team. Philip has the specialized technical knowledge in Electrical Engineering, and Simon's knowledge of economics might be useful in cost determination of the best components to use in the design. That is about all I can say at this point. But I am on a short deadline to make the team member decisions soon."

Jonathon: "I trust you will make the 'right' decisions, Raef."

As Jonathon left Raef's office he couldn't get Jonathon's words out of his head. What did Jonathon mean by the 'right' decisions?