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Instructors' Notes

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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 affiliated with the Allied Academies. Both 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 notes contained in this volume have been double blind refereed, and each was required as a companion to a complete teaching case, which are published in a separate issue. 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 the Allied Academies web site. In addition, we keep the web site updated with the latest activities of the Academy and all of the affiliates of the Allied Academies. Please visit our site and know that we welcome hearing from you at any time.

Shih Yung Chou, University of Texas of the Permian Basin

Herbert Sherman, Long Island University

SWEET PEAS STICHERY: A CASE OF A START-UP MERCHANDISER- PART A

Kathleen H. Gruben, Georgia Southern University
Leslie B. Fletcher, Georgia Southern University

CASE DESCRIPTION

Sweet Peas Stitchery is an entrepreneurial venture in its infancy. The case describes how the company developed, its challenges, and realities. Abby Adams and Beth Rossi began the business on a shoestring, very under-capitalized, but it is still surviving two years later against all odds of survival. The case was developed though interviews with Abby Adams, the only partner still involved in the business. NOTE: While the story is true, the names of the business and its owners, details of the evolution of the business, and the financial report have been changed because of the sensitivity of the information.

The case provides an opportunity for students to review and analyze Sweet Peas Stitchery's financial statement from an accounting perspective. It asks the students to identify missing information and to recast the statement into proper format. It closes with a writing exercise: students prepare a memorandum to Abby Adams, the client, explaining their findings and recommendations derived from the case.

For use in the classroom, it is best used after students have been shown the financial statements of a merchandising operation and have some familiarity with common-size financial statements. Alternatively, it can be used as a stand-alone module in which students explore on their own or in teams the characteristics of merchandisers' financial reporting.

The objective of this case is to provide a situation with which the students can relate where they will use their accounting skills to advise the company owner about the organization's financial status. Because this is a privately held LLC, we have provided a copy of the financial statement as of December 31, 2012 for the instructor to provide to students. Suggested items that the students need to calculate are included in the notes.

CASE SYNOPSIS

Imagine quitting your secure job to open a new business on a mere $10,000 in a time of uncertainty. You don't have any experience in the industry nor does your partner. You are running on blind faith that your initial capital investment will be enough for the business to survive and generate enough revenue to draw a paycheck within the first six months. Sweet Peas Stitchery: An Introductory Case In Accounting For Merchandising provides an overview of the operations of such a business that opened in 2011 at a time when unemployment rates were some *of the highest in more than a decade. Several things are considered in this case, including the risks of an inexperienced entrepreneur starting a new business during a time of high unemployment and difficult economic times. The odds of success are against the owner because of her limited funds, unemployment rates, and high failure rate, what the Small Business Administration calls death rate, of new businesses. With no experience in and little knowledge of accounting, it's easy for the owner to fail to recognize when her "accountant" and "CFO" submit financial statements that are incorrect and do not make sense, which happens in this case. It requires students to recognize the errors in the company's financial statement, analyze the statement, provide insight to the owner, and give recommendations.*

DISCUSSION QUESTIONS

The discussion questions are set up in such a way that either the instructor or a graduate assistant can present the case and guide students when they have questions. We have included formulas in areas where the calculations may not be a regular teaching in the class to serve as a reminder for the instructor or assistant.

1. What information does Abby need to know to understand her current financial status?
The overview of the financial statement included as section one of the answers includes potential questions specifically about the statement that accounting students should recognize as being essential. The non-accounting students may not recognize the importance or the characteristics, depending on the depth to which they have been taught financial statements. Some of the questions in Section 1 may be more than the non-accounting students can handle.

2. Merchandisers have several specific percentages they need to be able to assess their performance compared to competitors and between departments or other stores within the company. What are the ratios and how do you calculate them?

The percentages are the ones represented in a skeletal income statement, which is the lowest level of an income statement that students learn in a marketing, retailing, entrepreneurship, or merchandising class. If Section 1 has too much specific information for the non-accounting students, this set of questions is perfect for them.

3. What do the specific percentages identified in question 2 tell the merchandiser?
The answers to each of these are presented in Section 3.

4. Now that you have conducted an analysis of the income statement, what can you tell Abby about her business and its financial status?

Accounting students should create an official memo advising Abby of her status and discuss the basis for the information. The students in non-accounting classes should write a more general memo making recommendations similar to what a consultant would write. In lieu of a memo, the class can have a discussion about the pros and cons of the situation. An example accounting memo is included in Section 4. This can serve as the foundation for the information needed in the consulting memo or class discussion.

SECTION 1 - OVERVIEW OF THE FINANCIAL STATEMENT

Examine the financial statement provided for year 2 of operations and answer the following questions.

1a. Which financial statement is it? How can you tell?

Income Statement or Profit and Loss Statement. It shows that revenue less expenses equal net income.

1b. It was prepared using the cash basis of accounting. Describe the cash basis of accounting. Is it appropriate in this scenario?

The cash basis of accounting records (recognizes) economic transactions when cash is given or received. Non-cash transactions are recorded (recognized) when the event occurs. An example is if a truck is exchanged for a piece of equipment. It is appropriate in this scenario because Sweet Peas is a small, privately held business.

1c. What is the date of or time period of the statement?

It is for the calendar year 2012, January 1 – December 31, 2012.

1d. How is this statement like an analysis of cash flows?

Both statements are for a period of time, usually one year. Because Sweet Peas' income statement is prepared on the cash basis, it is quite similar to a cash flow analysis. Both look at sources (inflows) and uses (outflows) of cash. From the cash-basis income statement we can say that Sweet Peas' cash decreased $981 during the year. Because we have no Balance Sheet information given, we cannot calculate the true ending cash balance.

1e. What column of information is missing from a standard financial statement to be used by external stakeholders of the company?

The comparative income statement should be presented. Therefore, 2011's income statement should be shown in a column after the 2012 data. Not having that information constrains the analyses that can be done.

SECTION 2 - RECASTING THE FINANCIAL STATEMENT

The section requires that you use spreadsheet software. Enter the financial statement as it should appear into a spreadsheet: Rent Expense should be distributed with 80% being allocated to Cost of Goods sold and 20% allocated to General & Administrative Expenses. Use formulas to calculate subtotals and totals. Enter the Sweet Peas heading but label the statement as its correct statement name.

2a. Enter and calculate Net Merchandise Sales.

$ 360,228; see spreadsheet in the "Additional Exhibits" section at the end of the discussion. (Gross Sales – Customer Returns = Net Sales)

2b. Enter and calculate Total Cost of Goods Sold. Identify any accounts that you had questions about what they are or were unsure of where they belong.

$ 183,560; see spreadsheet. Is freight-in or freight out part of COGS? Student answers will vary. This affords an excellent opportunity to address their misconceptions.

2c. Calculate and enter Gross Profit or Gross Margin. Does it agree with the original statement? Why or why not?

$ 176,668; see spreadsheet. Not all of the original accounts are correctly included in COGS. These excluded accounts are either Selling Expenses or General & Administrative Expenses. Excluded accounts are Commissions, Freight-out and Refunds. Included accounts are Freight-in and 80 percent of Rent Expense and of Sewing Equipment Repairs and Maintenance. (Net Sales – Cost of Goods Sold = Gross Margin)

2d. Calculate and enter Selling Expenses and General & Administrative Expenses. Identify any accounts that you had questions about or were unsure of. Does the total agree with the original statement? Why or why not?

Selling Expenses: $ 84,717; General & Administrative Expenses $ 92,932. See spreadsheet. No, some of these costs were moved to COGS. See question 8.

SECTION 3 - FINANCIAL STATEMENT ANALYSIS

This section requires the preparation and analysis of a common-size income statement. The non-accounting students may not understand the term "common-size income statement" because they are frequently taught that retailers almost always need the percentages regardless of whether they are asked or not. The percentages are the only way retailers can compare stores' or departments' performances on equal terms.

3a. Prepare a common-size income statement from the revised data. To do this, set Net Sales Revenue equal to 100percent and calculate the other spreadsheet entries as a percentage of Net Sales.

Net Sales always = 100 percent. Example calculations is Gross Margin percent = Gross Margin/Net Sales or Net Sales percent - Cost of Goods Sold percent = Gross Margin percent. See spreadsheet in the "Additional Exhibits" section at the end of the discussion.

3b. What does the COGS percent tell you? How would you want that number to trend over the long term?

The COGS percent shows the percentage of Net Sales that is comprised of COGS. We want the percentage to trend downward so that the costs of the goods sold represent a smaller portion of the amount sold.

3c. What does the Gross Profit percent, also known as Gross Margin percent, tell you? How would you want that number to trend over the long term?

The Gross Profit percent shows the percentage of Net Sales Revenue that is available to cover General & Administrative Expenses, with the remainder being profit. We want this number to trend upward, the opposite of COGS percent in question 11.

3d. What do the Selling Expenses percent and General & Administrative Expenses percent tell you? How would you want those numbers to trend over the long term?

The Selling Expenses percent and General & Administrative Expenses percent tell us their respective share of Net Sales Revenue. We want these percentages to trend downward so that Net Income will increase.

3e. Do any of the components of COGS percent appear to be either too large or too small? Explain.

Student answers will vary. Likely candidates are Freight-in and Rent as too small. This is an opportunity to discuss business practices and stress the opportunity of using longitudinal data and/or industry data for analytic purposes.

3f. Do any of the components of Selling Expenses percent or General & Administrative Expenses percent appear to be either too large or too small? Explain.

Student answers will vary. Likely candidates are Freight-out and Merchant Account Fees are too large while Salaries and Wages are too small. This is an opportunity to discuss business practices and stress the opportunity of using longitudinal data and/or industry data for analytic purposes.

SECTION 4. REPORT TO CLIENT

4a. Write a memorandum in proper form to the client, Abby Adams of Sweet Peas Stitchery. Explain your findings vis-à-vis the adequacy of the original financial statement. Make appropriate recommendations concerning (a) the company's future financial reporting and (b) what it needs to do to become a profitable entity.

Sample memorandum follows. Student answers will vary.

Memorandum to:	Abby Adams, Sweet Peas Stitchery
From:	Student's name
Date:	Due date of the assignment
Subject:	Analysis and Recommendations of Sweet Peas' 2012 Income Statement

I examined the 2012 financial statement given to me and determined that it is correctly titled a cash-basis Income Statement. Because you are a small, privately held business, it is appropriate for you to use the cash-basis rather than accrual-basis accounting.

A number of your accounts were misclassified. I moved them to their correct sections on the attached "Cash Basis, Common size Income Statement." Specifically, I draw your attention to:
1. Freight-in
2. Freight-out
3. Refunds
4. Commissions
5. Rent Expense
Sewing Equipment Repairs and Maintenance

I recommend that you incorporate these changes into your financial accounting system.
You are in your second year of operations and report a small loss of $981. I believe you are on your way to profitability if you can better manage your costs. Professional Fees and Computer Expense may show a decline in subsequent years, if they were incurred mainly as start-up costs. However, Utilities is unreasonably low, unless electricity is included in your new lease. Salaries and Wages are also below market and would be expected to rise in the near future. You will want to keep your Cost of Goods Sold Percentage steady while you focus on decreasing you Selling Expenses and General & Administrative Expenses.
I share your expectations that Revenue will rise in 2013, since you indicated that Sales were up for the first quarter. You may be able to report a profit in 2013.
I am available to answer any questions you may have on this report or to assist you in bringing down your costs. I can be reached at 555-555-5555.

ADDITIONAL EXHIBITS

Below are three versions of the financial statement for Sweet Peas Stitchery.

Exhibit 1, Cash Basis Financial Statement, is a copy of the financial statement that the accountant and the CFO submitted to Abby Adams. It contains accounts that are misclassified, out-of-order, and incorrectly valued.

Exhibit 2, Cash Basis Income Statement, is a corrected copy of the financial statement that the accountant and the CFO submitted to Abby Adams. It correctly classifies and orders the entries but does not correctly allocate the Rent Expense accounts.

Exhibit 3, Cash Basis, Common Size Income Statement, is a corrected copy of the financial statement that the accountant and the CFO submitted to Abby Adams. It correctly classifies and orders the entries and allocates the Rent Expense accounts. It includes the common size calculations.

Exhibit 1 Cash Basis Financial Statement

Sweet Peas Stitchery
Cash Basis Financial Statement
January through December 2012

			Jan-Dec 2012
Operating Income/Loss			
Revenue			
Merchandise Sales		$361,177	
Total Revenue			$361,177
Cost of Goods Sold			
Refunds		949	
Commissions		13,764	
Temporary Manufacturing Labor		426	
Manufacturing Supplies		22,303	
Freight-out		50,339	
Cost of Goods Sold		145,071	
Total Cost of Goods Sold			$232,852
Gross Profit			$128,325
Expenses			
Interest Expense		767	
Travel Expense		1,705	
Merchant Account Fees			
Paypal Fee	4,185		
Bank Service Fee	1,916		
Credit Card Service Fees	12,355		
Total Merchant Account Fees		18,456	
Salaries and Wages			
Salaries	14,805		
Wages	20,643		
Total Salaries and Wages		35,448	
Advertising and Promotion		2,158	
Automobile Expenses		3,363	
Computer/Internet Expense		13,660	
Insurance Expense		2,675	
Meals and Entertainment		3,963	
Office Supplies		4,382	
Printing		7,065	
Professional Fees		7,759	
Rent Expense		10,752	
Sewing Equip Repairs & Maintenance		1,318	
Freight-in		5,840	
Taxes and Licenses		3,127	
Telephone Expense		2,870	
Utilities		1,042	
Total Expenses			129,306
Net Operating Loss			$(981)

Exhibit 2: Cash Basis Income Statement

Sweet Peas Stitchery Cash Basis Income Statement For the Year Ended December 31, 2012			
	Jan-Dec 12		
Operating Income/Loss			
Revenue			
Merchandise Sales		361,177	
Refunds		949	
Net Sales Revenue			$360,228
Cost of Goods Sold			
Cost of Goods Sold		145,071	
Manufacturing Supplies		22,303	
Rent expense			
Freight-in		5,840	
Sewing Equipment Repairs and Maintenance		1,318	
Temporary Manufacturing Labor		426	
Total Cost of Goods Sold			$174,958
Gross Profit (or Margin)			$185,270
Expenses			
Selling Expenses			
Freight-out		50,339	
Commissions		13,764	
Advertising and Promotion		2,158	
Merchant Account Fees			
Credit Card Fees	12,355		
Paypal Fee	4,185		
Bank Service Fee	1,916		
Total Merchant Fees		18,456	
Total Selling Expense			$84,717
General and Administrative			
Salaries and Wages			
Salaries	14,805		
Wages	20,643		
Total Salaries and Wages		35,448	
Computer/Internet Expense		13,660	
Professional Fees		7,759	
Printing		7,065	
Taxes and Licenses		4,440	
Office Supplies		4,382	
Telephone Expense		4,075	
Meals and Entertainment		3,963	
Automobile Expense		3,363	
Insurance Expense		2,675	
Rent Expense		10,752	
Travel		1,705	
Utilities		1,480	
Interest Expense		767	
Total General and Administrative Expenses			$101,534
Net Operating Loss			-$981

Exhibit 3: Cash Basis, Common Size Income Statement

Sweet Peas Stitchery
Cash Basis, Common Size Income Statement
For the Year Ended December 31, 2012

		Jan-Dec 12			Common Size	
Operating Income/Loss						
Revenue						
Merchandise Sales		361,177				
Refunds		949				
Net Sales Revenue			$360,228			100.0%
Cost of Goods Sold						
Cost of Goods Sold		145,071			40.27	
Manufacturing Supplies		22,303			6.19	
Rent Expense		8,602			2.39	
Freight-in		5,840			1.62	
Sewing Equipment Repairs and Maintenance		1,318			.37	
Temporary Manufacturing Labor		426			.12	
Total Cost of Goods Sold			$183,560			50.96%
Gross Profit (or Margin)			$176,668			49.04%
Expenses						
Selling Expenses						
Freight-out		50,339			13.97	
Commissions		13,764			3.82	
Advertising and Promotion		2.158			.60	
Merchant Account Fees						
Credit Card Fees	12,355			3.43		
Paypal Fee	4,185			1.16		
Bank Service Fee	1,916			.53		
Total Merchant Account Fees		18,456			5.12	
Total Selling Expense			$84,717			23.53%
General and Administrative						
Salaries and Wages						
Salaries	14,805			4.11		
Wages	20,643			5.73		
Total Salaries and Wages		35,448			9.84	
Computer/Internet Expense		13,660			3.79	
Professional Fees		7,759			2.15	
Printing		7,065			1.96	
Taxes and Licenses		4,440			1.23	
Office Supplies		4,382			1.22	
Telephone Expense		4,075			1.13	
Meals and Entertainment		3,963			1.10	
Automobile Expense		3,363			.93	
Insurance Expense		2,675			.74	
Rent Expense		2,150			.60	
Travel		1,705			.47	
Utilities		1,480			.41	
Interest Expense		767			.21	
Total General and Administrative Expenses			$92,932			25.80%
Net Operating Loss			-$981			-.27%

EPILOGUE

SPS has continued to grow. Its first "Sweetie" was contracted in August 2011. The number of consultants grew from 1 to 34 by the end of 2011. The group remained constant until April 2012, when Adams received the final recommendations of a student project at a local university. The students help improve the company's website and assisted in developing social media sites. Once the company was visible, the number of "Sweeties" grew at an incredible rate. By December 2012, SPS had in excess of 500 consultants. Two months later the number was close to 700. It has grown from using two introductory embroidery machines to needing four. Through the 2012 holiday season, it ran shifts around the clock to keep up with demand. SPS moved from the bedroom where it began to a small storefront, to an office building and most recently to a large warehouse.

In October 2012, the company had an opportunity that could have launched it into national competition. Unfortunately, it did not have the financial resources to allow participation.

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THE WAL-MART STORES, INC.: AN AMERICAN DREAM THAT TOUCHED THE WORLD

Issam A. Ghazzawi, University of La Verne
Marie Palladini, California State University, Dominquez Hills
Teresa Martinelli-Lee, University of La Verne

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Throughout my career, I've always emphasized performance. And I'm really proud of the performance of our team around the world and the results Wal-Mart delivered for fiscal year 2010 in a year challenged by a difficult economy in all of our markets. Our results reflect the underlying strength of our business and our strategies to improve shareholder value.

Michael T. Duke
President and Chief Executive Officer
Wal-Mart Stores, Inc.

CASE DESCRIPTION

In 2011, Wal-Mart grew through the opening of additional stores across the United States and other countries. While the company sales were strong, the U.S. operating income was sluggish with a mere 3.1% growth versus a 5.5% growth in the previous year. Looking for additional growth opportunities, Wal-Mart's strategy included a plan to open convenience stores (c-stores) in a number of markets encompassing urban and rural markets both in the U.S. and in its international segments.

This case is intended to demonstrate how Wal-Mart used its distinctive competencies and competitive advantage in the marketplace; what challenges it encountered; and what strategies it should adopt to sustain growth.

CASE SYNOPSIS

As a teenager, Sam Walton was described by his classmates as the most versatile member of his high school class. Knowing that anything was possible in America, the versatile young man lived his life based on the edict that high expectations were the key to everything (Bio True Story, n. d.). As a star quarterback at Hickman High School, an Eagle Scout, and the recipient of a degree in economics from the University of Missouri, Sam Walton was an enigma. Married 49 years to the same woman, and a father of four, this ardent huntsman and recreational enthusiast, retained a humble image favoring his red Ford F150 pickup (vintage 1979) as his mode of transportation to work. However, as a man of business, Walton, known as Mr. Sam, was an unconventional yet strategic retail pioneer. Mr. Sam was innovative, decisive, and perceptive. Walton believed among other values that to be successful in business one must *"swim upstream." He advocated that a company should "Go the other way. Ignore the conventional wisdom. If everybody else is doing it one way, there's a good chance you can find your niche by going in exactly the opposite direction" (Walton, 1993, n. p.). Finding this niche was exactly how Walton built an empire and even surpassed the famed Sears, Roebuck & Company in 1991. In fact, while the U.S. GDP plummeted between 1990 and1991, and the country's economy was stalled for nine months drudging through a recession, Wal-Mart managed to increase its sales by at least 40% (Bio True Story, n. d.).*

Most recently, Wal-Mart weathered the economic storms of the past decade and took no financial losses. In 2011, although Wal-Mart sustained growth, it did so only through the opening of additional stores across the United States and other countries. Further, while companywide sales were strong, the U.S. operating income was sluggish with a mere 3.1% growth versus a 5.5% growth the previous year. Looking for additional growth opportunities, Wal-Mart strategized the opening of convenience stores (c-stores) in a number of international and domestic markets.

As the best positioned retailer in the world, Wal-Mart's strategic plan and business model were based on a productivity loop of low prices and low operating costs, which retained its competitive advantage as the low price leader. It was deemed a powerhouse in and of itself. As the number-1 retailer in the world, the company employed 21.1 million associates in more than 8,970 stores. Wal-Mart's international division, which comprised 26% of its sales, experienced a fast growth pace. Wal-Mart readily surpassed Europe's Carrefour, Metro AG and Tesco combined. It was the number-1 retailer in Canada and Mexico and operated in Asia (owning 95% of the Japanese retailer SEIYU), Africa, Europe, and South America. Although Wal-Mart easily sustained its position as the number-1 retailer in the world, the state of its competition deserved analysis.

The continued impressive gains in Wal-Mart business were attributed to Wal-Mart's use and refinement of basic skills in purchasing, customer service, and logistics, which surpassed its competition. Additionally, Wal-Mart's logistics were stronger and more efficient than those of other large companies. Indicia of the strength of Wal-Mart's logistics were based on a sophisticated distribution system with 14 computerized facilities and a large fleet of over 6,500 trucks. As far back as 1989, then CEO Glass noted that Wal-Mart's distribution system was one of the critical elements of its success. The massiveness of Wal-Mart's operation coupled with a very efficient distribution system allowed it to continuously have a price advantage over its competitors.

Following the Wal-Mart spirit of optimism and hard work, CEO Duke shared the vision of "Building the Next Generation Wal-Mart," at the 2010 annual shareholders' meeting. He delineated four key strategies to put forth the company's continued conveyance of Sam Walton's vision and continued growth into 2015. These strategies focused on global expansion, the retail market's challenges and solutions, social responsibility, and the continued strength of the Wal-Mart culture (McShane, 2010). Duke explained that to become a larger global company, Wal-Mart had to continue to expand upon its philosophy of serving its customers as though they were patronizing a local store and needed to take advantage of its extremely competitive global supply chain.

Nevertheless, with CEO Duke's vision at the forefront, the question remained – can Wal-Mart continue to implement strategic plans while at the same time sustaining effective dividends and profits? The short-term answer is yes given that Sam Walton's vision for retaining low prices and giving back to the community continued to this day. However, the long-term answer was yet to be determined.

Keywords: Wal-Mart, Wal-Mart Stores, Inc., Walmart, Wal-Mart Strategy, Sam's Wholesale Club, Sam Walton, Buy America Strategy, Low Cost Strategy, and Competitive Advantage

CASE ISSUES AND SUBJECTS

This case serves as an educational tool for discussing and understanding the subject of the external and the internal organization analysis-namely: The identification of opportunities and threats, distinctive competencies, competitive advantage, and profitability. It is also intended to further engage students in understanding Porter's five forces model.

This case is further intended to demonstrate how Wal-Mart uses its distinctive competencies and competitive advantage in the marketplace; what are the challenges it is encountering; and what strategies it should adopt to sustain growth.

INTENDED COURSES AND LEARNING OBJECTIVES

This case is intended for advanced undergraduate or graduate courses in strategic management, integrated strategic management and finance, or management courses. It is intended for class study application of concepts learned in the classroom and designed to complement knowledge derived from concepts in organization's external and internal organization analysis. In other words, it seeks to provide an applied, hands-on format for students to increase their understanding of this topic via a review, research, and analysis of one of the most popular global organization practices, "Wal-Mart".

Answers to the questions in the case will derive from what students learned from theories and concepts.

At the completion of this case, the student will be able to:

1. Acquire and apply an understanding of the main technique (i.e. the Porter five forces model) used to analyze competition in an industry environment.
2. Understand through an assessment of the Wal-Mart case the organization's source of competitive advantage.
3. Identify and explain the roots of the organization's competitive advantage.
4. Understand and explain the linkage between profitability and competitive advantage.

SUGGESTED CLASSROOM APPROACHES TO THE CASE

1. Introduction of the case in the class

It is recommended that the instructor introduce the script at least a week before the class discussions (duration from 30 minutes-one hour) and assign the questions derived from the case. Doing so ensures that the students have read and understood the issues of the case. While this case could be done on an individual basis, the authors found it most effective to create case study groups and request formal group answers to the case questions. If it is to be done in a group environment, please refer to groups' formation and report and presentation for more teaching instructions.

While there is no one single approach to addressing ethics and social responsibility, emphasizing student application of such constructs is extremely important to the learning process. Individually or as a five-member group, students will be asked to discuss and answer the case questions. A PowerPoint presentation and a written report of 2-3 pages should address the case questions.

Based on the authors' experience, requiring a formal response to the questions to help students enhance their written communication skills is a good approach. Please note that this formal write-up of the case requires the instructor to read and grade the students' work more critically. Because of the nature of this case study, it is suggested that the class be divided into groups of up to five students per group. The students will read the case and respond to the questions as a group.

Finally, instructors should have enough copies of the script with its instructions to distribute to students at least a week before the class discussions.

Answers to the questions in the case will derive from what students learned from the course concepts, text book and outside reading material. The case is expected to be completed and presented for class discussions.

2. Forming Groups

At least a week before the class discussions, students will be encouraged to network and get to know fellow students in order for them to decide with whom they want to team. Allow 10-15 minutes towards the end of the class meeting to submit group members' names. Initially, students need to form a group of up to five students to conduct this required study.

3. Process

Each group will start working on this case after the instructor introduces the subject of external and the internal organization analysis.

Students are expected to develop and build their responses (as a group) on their acquired knowledge. It is recommended that the instructor address and clarify case questions ahead of time with the class.

4. Use of Power Point and Audiovisuals

It is recommended that students be encouraged to create an effective group presentation. That could be achieved through the use of whatever audio-visual materials, including but not limited to power point. The case itself does not come with a video.

5. Group Report and Presentation

Each group is required to write at least a 5 page report (12 point font, double-spaced and using the APA writing style). One report is needed for each group with relevant and substantive answers. Each group is also required to prepare a 10-15 minute power point presentation explaining its answers. Students are required to use the chapters assigned for the course.

To support their responses and enhance their report, students must include outside references such as books, journals, newspapers, internet information, or a direct interview as resources for the case answers (in case of an interview, they need to include the interview questions as an appendix of the report).

6. Recommended Outline

The structure of the written report is critical. In the first part of the case write-up, students should provide salient points of the case before proceeding to answering the case questions.

In the second part of the case write-up, students present their answers and recommendations. Instructors need to encourage them to be comprehensive in their answers, and make sure that answers are in line with the previous ones so that it fits together and moves logically from one to the next.

7. Starting the Class Discussion

Before engaging in a class case discussion and presentations, it is recommended to stress to the students that they might be disagreeing with the points that are being made by other students and that this disagreement is healthy and should not be taken personally. A reminder is helpful. This clarification and reminder ensures that the disagreements/discussions remain open and inviting and do not turn into personal matters.

8. Analysis

Since this case is an application of topics covered in the subjects of the external and the internal analysis of the organization (i.e. the identification of opportunities and threats, distinctive competencies, competitive advantage, and profitability); students' understanding of these concepts will be essential.

9. Content and Grading

Students' answers and presentations should clearly and concisely demonstrate their knowledge and comprehension of the subject concepts learned in the class, as well as the individual or the group's ability to apply knowledge learned in class and through research (synthesize, analyze, and evaluate his/her/their work). Students will be graded based on the following criteria: (a) The use of innovative and creative ideas, (b) the application of concepts learned in the class, and (c) the use of outside research to support the case.
It is recommended that this case study constitute 20-30% of the student's participation grade.

CASE RESEARCH METHODOLOGY

The case is based on published secondary (i.e. published) data, articles, researches, databases, company annual reports, and other published materials.

DISCUSSION QUESTIONS

1. How would you characterize Wal-Mart's business model and Sam Walton's vision for an atypical retailer? How does this differ from the Carrefour, Costco, and the Target corporation business models?

2. Identify the resources, capabilities, and distinctive competencies of Wal-Mart as the low price leader in the retail industry. Explain how these resources, capabilities, and distinctive competencies help sustain growth and profitability at Wal-Mart while maintaining a quality that is valued by customers. Discuss how this might be countered and support your perspective.

3. CEO Michael T. Duke stated Wal-Mart's "business strength and strategies improve shareholder value." Do you agree with his conviction? Why or why not?

4. Discuss Porter's five forces model as related to what you have learned about Wal-Mart. What can you say about the state of competition in the retail industry as pertains to this model?

5. Looking at Wal-Mart sales and its last five years' consolidated income statement, what are the company's sales and the sales growth rate? What has been the growth rate in net income?

POSSIBLE ANSWERS TO DISCUSSION QUESTIONS

NOTE: The following answers provide only guidelines that are designed to assist in the case analysis process and engage students in critical thinking. These guidelines are not intended to be rigid. Therefore, each question is intended to raise issues that will be helpful in analyzing and resolving the case.

Students must be reminded that their answers to the case discussion questions should be well reasoned and supported with evidence/research when applicable. Although there are no one best answers to the discussion questions, some answers might be more appropriate than others might.

Accordingly, students should be told that simplistic answers to complex questions, situations, or problems such as in our case would never be "good" answers.

1. How would you characterize Wal-Mart's business model and Sam Walton's vision for an atypical retailer? How does this differ from the Carrefour, Costco, and the Target corporation business models?

In 1962, Sam Walton's business expertise along with the competitive alignment structure he established at Wal-Mart provided the means for the company to jettison into a flourishing retail and merchandising business. Wal-Mart employed the self-service merchandise standard modeled after the grocery store business, putting it in a position to become the most profitable and prominent business profile in America (CNN Money, 2011a). Scholarly articles have pointed out those organizational traits that create worth such as low costs as well as the distinction of outperforming the competition are business strategies that expedite profitable performance (Porter, 1980; Powell & Dent-Micallef, 1997; Peteraf, 1993). Wal-Mart's business model is a prime example of this successful organizational structure.

Wal-Mart's global mission was to save people money so they could live better (Wal-Mart Stores, 2011a). This was Sam Walton's vision when he opened the doors to the first Wal-Mart in 1962 and it continued to be the focus of day-to-day operations. Sam Walton's vision extended the mission to Wal-Mart's organizational structure, decision-making, and leadership format allowing the company to continue to carry it out. Wal-Mart's corporate governance framework was based on the values Sam Walton placed in the company from its inception; evolving around the core value of respect – for the customers, the associates, and the suppliers. With the belief "that the shopkeeper's success is entirely up to . . . the customer," Walton paved the path to his success with a formula to insure low prices every day (Wal-Mart Stores, 2011a). The low price formula distinguished Wal-Mart from competitors such as Carrefour, Target, and Costco, and gave Wal-Mart the ability to gain an enormous competitive edge in the retail industry. Strategic and decisive planning identified Wal-Mart as both a phenomenon and a business leader with numerous tactical merits, allowing the company to weather the economic storms of the past decade, taking no financial losses. The enormous retailer survived the economic downturn with an advantage and actually sustained growth, being able to leverage prices and provide strong dividends to its shareholders (Wal-Mart Stores, 2011b). Wal-Mart chose price-based competition as a business strategy to maximize profits. Scholars have viewed Wal-Mart's success in pursuing sales volume and its precise analysis of its own costs as distinctive in the retail industry (Wexler, 2011).

One of the strategies employed at Wal-Mart to help maintain its low prices is its operational efficiencies. Wal-Mart invested in information technology, which resulted in superior logistics, distribution capabilities, and inventory control, surpassing any technology employed by its competition (Wexler, 2011).

Wal-Mart's business model is based on a productivity loop of low prices and low operating costs, which allows the corporate giant to retain its competitive advantage and continue as the low price leader. Sam Walton built partnerships and developed a vision for Wal-Mart with the force of action behind his belief that low prices would lead to better living for customers. Wal-Mart is distinguished from international competitors such as Carrefour, and domestic retailers Target and Costco, based on a number of strategies. One of its primary strategies is its ability to provide a wide assortment of products, giving Wal-Mart U.S.A. a consumer base of more than 140 million.

Wal-Mart boasts very high consumer loyalty, considering at least 82% of American consumers have purchased product from the retailer at least one time. This is because Wal-Mart carries household staples that consumers cannot without do. The need for low priced commonplace items such toothpaste, detergent, tissues, and even milk encourages consumers to regularly patronize Wal-Mart. Target and Costco may carry similar products as those stocked in the aisles of Wal-Mart, but neither store has the volume or, most important to the consumer, the low prices (Bianco & Zellner, 2003). Thus, Wal-Mart's strategy of low prices tends to mirror what consumers desire, stock it at a low prices, in proximity to where consumers live, and in so doing communicate the ease of purchase. With the belief "that the shopkeeper's success is entirely up to . . . the customer," Sam Walton cemented his success with a formula to insure low prices every day (Wal-Mart Stores, 2011a).

Wal-Mart's competitor, Carrefour, has seen a downturn in its business during the last few years. Its shares plummeted nearly two-thirds since 2007, when LVMH Moët Hennessy Louis Vuitton CEO Bernard Arnault along with U.S. real estate investment group Colony Capital spent \$5.5 billion on a 9.8 percent stake. That investment is now worth less than \$2 billion. Carrefour's decline is attributed in part to its rapid international expansion, intended to offset slow growth in France, but stretched the company too thin when it entered 24 countries during the ten year period, 1994 and 2004. In addition, since 2000, Carrefour sold off operations in 10 countries, including Mexico, Russia, Japan, and South Korea.

Wal-Mart, on the other hand, expanded more cautiously than Carrefour and was able to build a prosperous business in Mexico before it opened in South America and Asia. Different from Carrefour, Wal-Mart had the luxury of taking its time internationally due to its huge domestic market where big-box retailing thrives. In France, however, the source of 43 percent of Carrefour's sales is from hypermarkets located in older congested suburbs where zoning restrictions make it difficult to build new stores. It is a similar story in the rest of Europe, which accounts for another 31 percent of Carrefour sales. The trends show that former Carrefour customers are deserting the chain for smaller stores in more-accessible city centers, or deep-discount merchants. Those patterns, along with e-commerce, are changing the way Europeans shop, particularly for high-margin, non-food items (Wal-Mart Stores, 2011a). The numbers alone indicated that Carrefour was a distant competitor of Wal-Mart. When organizational features were compared, Wal-Mart's proven success motto to save people money so they can live better, readily distinguished it from Carrefour's "smaller is better" philosophy in its retail model. In addition, in 2011 Carrefour added labor unrest, a non-issue at Wal-Mart, to its woes in France when workers there held a one-day strike in April demanding wage increases (Roberts & Matlack, 2011).

Different from Wal-Mart, Costco's business model included a feature to sell a limited number of items. It was not uncommon for a Costco store to stock 4,000 different types of items, but included only four brands of toothpaste. Wal-Mart, on the other hand, stocked more than 100,000 types of items, and had as many as 60 sizes and brands of toothpaste. By limiting the number of options, Costco could increase the sales volume of each item, which allowed it to obtain deeper bulk discounts from its suppliers. In the warehouse retailer market, Costco was number one in market share, which accounted for about half of the sales in the industry. Costco offered its 29 million member's premium, new and seasonal merchandise that ranged from fine crystal and designer handbags to widescreen TVs, fine wines and even lobster (Roberts & Matlack, 2011).

Target had been a key performer in the retail sales market, but recently posted slower sales and earnings growth than expected. Some-store sales, were down in 2009 (-2.5%) and 2008 (-2.9%). Target's stronghold in apparel, home furnishings, and décor, continually decreased since 2007. Merchandise that included electronics, entertainment, sporting goods and toy sales were deemed flat. However, sales of consumables and household essentials rose as concerned consumers continued to only purchase the basics. Target took advantage of the new frugality among its customers and copied from Wal-Mart when it opened new layouts that allocated more space to food, especially its house brands Archer Farms and Market Pantry. Target also started offering fresh produce in 2009, and challenged Wal-Mart more openly on price. Historically, Target distinguished itself from Wal-Mart and other discounters by using exclusive private-label merchandise from big name designers (Corona, 2009). Target's business model is that of a large department store with over 1,600 locations in 48 states, combined with merchandise that is primarily everyday essentials, yet fashionable, at exceptional prices. Target's retail strategy has been refocused with a combination of bright red color, a bull's eye symbol, and a combination of soft goods, gifts, and housewares that appeal to consumers (Hoovers, 2011).

2. Identify the resources, capabilities, and distinctive competencies of Wal-Mart as the low price leader in the retail industry. Explain how these resources, capabilities, and distinctive competencies help sustain growth and profitability at Wal-Mart while maintaining a quality that is valued by customers? Discuss how this might be countered and support your perspective.

As discussed in question number 1, growth and profitability are driven by competitive advantage at Wal-Mart. This is due primarily to Wal-Mart's creation of its own unique distinctive competencies. Wal-Mart's ability to provide a well-stocked variety of consistently low-priced merchandise differentiates it from its rivals Target, Carrefour, and Costco. A company's distinctive competencies come from its resources and its capabilities (Hill & Jones, 2010). Resources are defined as the capital or financial, social or human, physical, and technological capabilities that give a company the means to generate value for its customers. A resource that is specific to a particular organization or difficult to emulate by others usually leads to a distinctive competency. Capabilities are defined as a company's ability to coordinate its resources and put them to productive use – they are part of the company's organizational structure (Hill & Jones, 2010). Wal-Mart has been able to sustain growth and profitability on a consistent basis because it has firm-specific and valuable resources as well as the capabilities to use its resources effectively.

Wal-Mart implemented the self-service supermarket business model initially developed for grocery stores and extended to general merchandise. Wal-Mart's capabilities included its concentration on small town markets, previously disregarded by its competitors, and its innovative application of information systems and logistics. Wal-Mart's resources included the development and implementation of a product tracking system that used barcodes and checkout scanners thus allowing it to track what consumers were buying and adjust its inventory accordingly (Hill & Jones, 2010). In addition, Wal-Mart's logistics were stronger and more efficient than were those of other large companies. Indicia of the strength of Wal-Mart's logistics were based on a sophisticated distribution system with 14 computerized facilities and a large fleet of over 6,500 trucks (Shaw, Schneier, Beatty, & Baird, 1995). Wal-Mart's distribution system is one its distinctive competencies, surpassing any of its rivals. As far back as 1989, then CEO Glass noted that Wal-Mart's distribution system was one of the critical elements of its success (Huey, Smith, & Morrow, 1989).

An analysis of Wal-Mart's business strategies and capabilities is critical to understand its ability to sustain growth and profitability. Corporate strategies are the primary reasons for the success or failure of an organization. Organizational strategy is the process that guides a corporation by providing direction for its goals as well as specific strategies for its functional components. Strategies provide focus for the company's decision-making (Stevenson, 2012). In its simplest form, a strategy is a set of related actions that managers take to increase their company's performance. For the majority of businesses, the critical challenge they face is the attainment of top-quality performance as compared to their rivals. When a company is fortunate enough, like Wal-Mart, to experience superior performance, it is described as having competitive advantage. Wal-Mart's strategies resulted in superior performance for the nine-year period from 1994 to 2003, which allowed it to lower its cost structure and charge lower prices, ultimately becoming more profitable than do its competitors (Hill & Jones, 2010).

At Wal-Mart, as in all corporations, the important decisions faced by management are the strategic ones. These include decisions on business objectives and on the means to reach them. A critical part of the decision making process is the assurance that decisions reached in different parts of the business are compatible with each other and the overall goals of the company (Drucker, 1993). Wal-Mart's leadership culture and its governance structure guarantee that strategic decisions by management are congruent with the company's goals. Obviously, Wal-Mart's strategic leadership plan is extremely successful.

Strategic leadership is concerned with how to most effectively manage a company's strategy making process with the goal of creating competitive advantage (Hill & Jones, 2010).

Strategy formulation is best explained as the company undertaking to select certain strategies, as compared to strategy implementation, which is the job of putting the strategies into action. This encompasses, among a number of things, improving the efficiency and effectiveness of the business operations, a task successfully implemented at Wal-Mart from its inception. It is evident that strategic leadership is focused on managing the strategy formulation and implementation to increase the company's performance, which will increase the value of the business to its owners and shareholders (Hill & Jones, 2010). Wal-Mart closed out its fiscal 2011 with $16.39 billion in net income, which was a 14.33% in net income growth over 2010 (Hoovers, 2011.) With $11 billion in free cash flow in 2011, the company delivered a 25.11% return on equity (Wal-Mart Stores, 2011b). Its stock price grew to $56/share in 2011 up from $47/share in 2007. In order to increase shareholder value, business managers must implement strategies that increase profitability of the company to guarantee that profits grow. Wal-Mart has accomplished this year after year and is able to outperform its rivals due to its competitive advantage.

One of Wal-Mart's goals was to maximize shareholder value, because primarily, shareholders provide the company with the risk capital needed to purchase the resources to sell its goods and services. So long as shareholders have confidence in the strategies of the company to give them a good return on their investment, they will invest in the company and provide risk capital. In addition, Wal-Mart's strategy implementation is a guiding force to its shareholders, since they are the legal owners of the company and their shares represent a stake in the profit the corporation generates (Hill & Jones, 2010).

Profitability is defined as the result of how efficiently and effectively managers use the capital at their disposal to produce goods and services that satisfy their customers' needs (Hill & Jones, 2011). Simply stated, Wal-Mart is profitable because it uses its capital efficiently and effectively, thus making a positive return on invested capital. The profit growth of a business is measured by the increase in net profit over a period. During the ten-year period between 1994 and 2004, Wal-Mart increased its net profit by a whopping 277 percent - from 2.68 billion to 10.1 billion! This is exemplified by extremely efficient and effective use of its capital accomplished by a number of strategies: it took market share from rivals; it expanded by establishing stores in foreign countries, generating 41 billion dollars in sales; and it expanded into the grocery business. This increase in net profit caused Wal-Mart's earnings per share to increase from .59 to 2.35 per share. Thus, each share became considerably more valuable.

Through the pursuit of strategies that led to high and continued profitability and profit growth, Wal-Mart rewarded shareholders for their decisions to invest in the company (Hill & Jones, 2010). It is noteworthy that different from its international competitor, Carrefour, Wal-Mart had a global strategy in place when making decisions related to the global market. It designed strategies that factored in the issue that what works in one country or region may not work in another (Stevenson, 2012).

When making strategic decisions, managers must evaluate the state of competition for customers, with a goal to achieve competitive advantage. In order to maximize shareholder value, the corporation must formulate and implement strategies that empower it to outdo its rivals. A company has a competitive advantage over its competitors when its profitability is greater than the average profitability of all other companies competing for the same customers (Hill & Jones, 2010).

Competitive advantage is understood by looking at how strategic managers build activities in a company over a period of time that distinguish it from its competitors and provide a means to consistently outperform them. A business model is a strategic manager's idea of how the company's strategies should weave together to produce superior profitability and profit growth. Wal-Mart's business model is founded on the belief that costs could be lowered by substituting a full service retail layout with a self-service layout, providing a wider selection of merchandise, sold in a large warehouse type store with limited improvements. This allows the savings to be passed on to the consumer via lower prices, allowing revenue to grow for the company which can attain further cost reductions from the cost advantages realized through its expansion.

The self-service supermarket business model came into existence in the 1950s in grocery stores. It was improved upon when Wal-Mart expanded it to include general merchandise (Hill & Jones, 2011). The continued impressive gains in its business were attributed to Wal-Mart's use and refinement of basic skills in purchasing, customer service, and logistics, which surpassed its competition. Wal-Mart was very focused on its purchasing abilities. It further used its buying power to outdo terms negotiated by its competitors. Some analysts regarded Wal-Mart's purchasing practices as being too tough on manufacturers, while others viewed it as an example of the company's ability as a leader in its predictable goal to make the economy more efficient. This process pushed manufacturers all over the world to enter into valid international competition (Lohr, 20013).

The massiveness of Wal-Mart's operation coupled with a very efficient distribution system allowed it to continuously have a price advantage over its competitors. Because Wal-Mart purchased large volumes of goods, it put itself in a position to demand the best price and terms from its suppliers. It had a very advanced distribution system that allowed it to move merchandise from a warehouse through its checkout line more efficiently than any other retailer in the world did. Wal-Mart's goal was to be the price leader in all markets, and it was able to meet this goal through huge sales volumes, a full-proof distribution system, and the best terms from suppliers. Since 1988, Wal-Mart's expansion included Supercenters that provided a large selection of groceries. Grocery sales per supercenter placed those at Wal-Mart close to twice the sales volume of Super Targets. When the supercenters were first opened, Wal-Mart sold limited quantities of groceries and grew to hold the position of the largest grocery retailer in the U.S.
In its 2011 shareholder meeting, CEO Mike Duke explained, "We continue to prioritize growth, leverage, and returns in our commitment to increase shareholder value"(Business Wire, 2011, para. 4). It is important to keep in mind that Wal-Mart's business model was built on a promise that customers can rely on the company to provide low prices every day, which ultimately leads to customer loyalty and higher sales.

3. CEO Michael T. Duke stated Wal-Mart's "business strength and strategies improve shareholder value." Do you agree with his conviction? Why or why not?

Offering a variety of retail products as well as services including in store services such as automotive, photographic, pharmaceutical, hearing, and vision gives customers a one-stop center when shopping at any Wal-Mart. In the European and Asian markets, global competitor Carrefour does not offer similar services. On the other hand, stateside competitor such as Costco and Target offer some services but not all. For example, Target offers photographic and pharmaceutical services but not in every store. Whereas, Costco offers only tire services as far as automotive is concerned, as well as the other noted services. However, Costco customers must have annual fee based membership to receive such services.

These conditions thus leave Wal-Mart with several competitive strengths over Costco, Target, and Carrefour. Wal-Mart customers have a one-stop advantage for services as well as low price retail shopping. Such strategy maximizes shareholder value in that revenues and profitability are leveraged against operational efficiencies. By carefully controlling costs in the area of product and services, Wal-Mart is able to implement new strategies to fuel future growth and expansion. For example, an important competitive strength is being present in every continent as well as across the U.S., whereas Carrefour serves primarily in France, continental Europe, Latin America, and Asia (Roberts & Matlack, 2011). While Costco too operates on a global level, its units are found only in the UK rather than the whole of continental Europe. Its Asian markets include Taiwan, Korea, and Japan, with a few stores in Australia (Corona, 2009).

An international and domestic retailer, Wal-Mart operations have increased substantially over the past decade having consolidated with either existing retail venues or outright acquisitions (Wrigley & Lowe, 2010). Having diversified its revenue base for both domestic and international sales has given Wal-Mart a distinctive competitive advantage. The ability to integrate revenue diversification in planning and marketing has permitted Wal-Mart to counterbalance its revenue fluctuations and thus reduce any profit volatility. This again leverages profitability and is valuable for shareholders.

With attractive cost structures that take advantage of assets and productive personnel, Wal-Mart is able to retain wages and labor costs static. Using a lean system of process improvement, Wal-Mart has been able to eliminate production and process activities that do not add value such as in inventory, logistics, procurement, and distribution. Such practice of managing the supply chain alternately reduces production costs and improves efficiency. For example, by eliminating outside transportation costs Wal-Mart has been able to reduce costs lower than its competitors. With its own fleet of trucks and distribution systems, Wal-Mart can replenish store shelves faster than its competitor often at a rate four times faster (Chandran, 2003).

Implementing lean practices further offers important benefits for shareholders, because Wal-Mart is able to establish clear challenges and the potential for achievements in terms of resources, properties, and other assets. With strong team branding, Wal-Mart is able to optimize strategy through a combination of flexibility to reduce product capacity and the adaption to rapid market changes and conditions. Through its growth and expansion, Wal-Mart has built a strong financial portfolio and remained a consistently profitable retailer.

4. Discuss Porter's five forces model as related to what you have learned about Wal-Mart. What can you say about the state of competition in the retail industry as pertains to this model?

The question offers a detailed assessment of the forces that shape Wal-Mart competition in the retail industry environment using Porter's Five Forces Model as an overall framework. Porter's Five Forces Model. The model was devised by Michael Porter to describe forces that shape competition within an industry and help to identify strategic opportunities and threats. Such forces limit or help companies' ability to freely increase price and pursue more returns (Hill & Jones, 2010). In the presence of stronger forces, established companies are limited in their ability to increase prices and allow greater profits. Accordingly, a strong competitive force may be a threat because it depresses profits. On the other hand, a weak competitive force is an opportunity because it allows the company to raise prices and achieve greater returns.
A very important note is that industry conditions are ever changing. As a result, strength of forces may change.

Porter has identified Five Forces Model. These forces are: (1) Potential competitors; (2) rivalry; (3) the bargaining power of buyers; (4) the bargaining power of suppliers; and (5) substitute products. These forces will be discussed below in more details (Hill & Jones, 2010; Bamford & West, 2008).

(1) The Potential Competitors. Potential competitors are referred to companies that are currently not competing in the industry but have the potential and the capability to do so (Hills & Jones, 2010). As new competitors surface, they increase industry's supply. As consequences to that, they usually depress prices and profits. Established companies in the industry often discourage potential new entrants out of fear that these entrants may constitute a threat and might gain market share.

Accordingly, a high risk of new entry constitutes a strategic threat to the profitability and the market share of the established companies. On the contrary, a low risk of new entry constitutes an opportunity for established companies and allows such companies to raise their prices. In some instances, established companies may attempt to acquire potential threat and gain more market share. It is important to clarify that the risk of entry by potential competitors is characterized by the function of the height of barriers to entry (Hill & Jones, 2010). These barriers to entry are determined by several factors:

a. **Economies of scale:** A consequence of falling unit costs as result of a firm expands its output. Sources of economies of scale include: "1) cost reduction gained through mass-producing a standardized output; 2) discounts on bulk purchases of raw material inputs and component parts; 3) the advantages gained by spreading fixed production costs over a large production volume; and 4) the cost savings associated with spreading marketing and advertising costs over a large volume of output" (Hill & Jones, 2010, p. 44). Wal-Mart successes were attributed to Wal-Mart's use and refinement of basic skills in purchasing, customer service, and logistics, which surpassed its competition. Additionally, Wal-Mart's logistics were stronger and more efficient than those of other large companies.

b. **Brand loyalty:** Loyal customers would discourage potential competitors. Wal-Mart customers are loyal as long as the company continues providing its products at the lower price (Hill & Jones, 2010).
c. **Absolute cost advantage:** Potential competitors are also discouraged as results of established companies enjoy an absolute cost advantage over potential entrants. According to Hills and Jones (2010), "cost advantages might include factors such as patents, control of a specific raw material, or access to cheaper funds" (p.44-45). Wal-Mart is a proven case of a company that has a greater control of retail products than its competitors and an access to cheaper funds.
d. **Customer switching costs:** That means if costs that accrue to a customer as result of switching product offering of an established company to the product offering of a new entrant are high, potential new entrants are discouraged. This barrier is not relevant to Wal-Mart customers. What they buy at Wal-Mart is either readily available somewhere else or constitute a substitute product that customers' can easily find alternatives (Hill & Jones, 2010).
e. **Government regulations:** In some countries (not in the U.S.), some governments tend to protect its established firms (and/or industry). Such protection (regulations) constitutes a barrier to entry. As industries are deregulated, new entrants usually proliferate (Hill & Jones, 2010).

    To address this threat, Wal-Mart made many acquisitions of smaller retailers that might constitute a potential threat nationally and internationally. For instance, in September 2005, Wal-Mart acquired more than a 33 percent interest in Central American Retail Holding Company (CARHCO) from the Dutch retailer Royal Ahold NV (Wal-Mart Stores, 2011a). Additionally, in March 2006, Wal-Mart became the majority shareholder by increasing its interest to 51 percent and changing the CARHCO name to Wal-Mart Centroamérica (Wal-Mart Stores, 2011a). Today, Wal-Mart is the region's largest retailer, with stores in Guatemala, El Salvador, Honduras, Nicaragua, and Costa Rica.

In December 2009, Wal-Mart Mexico acquired Wal-Mart´s operations in Central America from Wal-Mart Stores and two minority partners and as the transaction was completed in early 2010, Wal-Mart México became Wal-Mart México and Central America with its Centroamérica headquarters located in San Jose, Costa Rica (Wal-Mart Stores, 2011a).

(2) **Rivalry among Established Firms.** Another of Porter's five forces is rivalry among established firms. As rivalry among established firms is getting strong, it tends to lower prices and raise costs. As a result, it does constitute a threat to established companies. On the other hand, a weak rivalry creates an opportunity by helping firms to earn greater returns (Bamford & West, 2008). Many factors contribute to the extent of rivalry among established firms including:

a. **The industry competitive structure**- is the number and size distribution of companies within an industry. In a consolidated industry where number of rivals are small-the case of the aerospace, beer, soft drink, automobile, pharmaceutical, and stockbrokerage firms;

rivalry is so high. In a consolidated industry, a competitive action of one company directly affects the profitability of its competitors and forces a response from them. The possible result is a price war like those of the airline industry. While the retail industry is not consolidated and a price war is not familiar, a competitive price is always rule. On the contrary, a fragmented industry that is characterized by low entry barriers and commodity-type-products those are hard to differentiate. These characteristics tend to result in flood of new entrants, excess capacity, and price wars. As a result, it may lead to low profits and potential exit from the industry-very common in retail.

b. **Demand conditions** have major impact on the intensity of rivalry among established companies. Increasing demand for instance, moderates competition via facilitating growth and expansion. On the other hand, a weak demand escalates competition as companies fight to preserve revenues and market share. While the retail's market fluctuates, the demand on its products is still strong.

c. **Cost conditions** are another factor in determining rivalry between firms. High fixed costs lead to a focus on volume of sales in order to cover these costs. The firm's focus on volume may lead to intense rivalry when demand weakens and/or more firms are getting involved in providing the same products. This end result is the focus on lowering pricing in the industry by firms in order to maintain sufficient sales to cover its costs. Wal-Mart, Sam's Club, and other international affiliates are spread everywhere in the world to sell and leverage the high volume purchases.

d. Today's retail industry market tended to relate to the relative maturity of the industry. First and foremost, a number of stores were constantly competing for attention from U.S. consumers. Secondly, as a result of a weak economy and demographic changes, consumer spending grew slowly. As a result, that led to a rivalry among established retailers (Wal-Mart, Target, Carrefour, and others) - rivalry among established retailers is the second force in Porter's five forces model. As this rivalry among established firms is getting strong, it tends to lower prices and raise costs as customers demand better quality service and products.

(3) **The Bargaining Power of Buyers.** A third factor in Porter's five forces model is the bargaining power of buyers. While buyers can be individual consumers, businesses, wholesalers, or retailers; they can bring about a major competitive threat to the firm when they demand a price decrease or when they force a cost increase by virtue of demanding a higher quality product and/or service. In fact, the ability of buyers to bring about threat via demands on lowering price or improving the quality depends on their power relative to that of the firm (Bamford & West, 2008). They tend to be powerful when:

- "They are in industries that are more highly consolidated than the company's industry.
- They purchase in large quantities or constitute a significant buyer for that industry.
- Supply industry depends on the buyers for a large percentage of its total orders.
- Buyers can easily switch to a substitute product or an alternate supplier.
- When it is feasible for buyers to purchase an input from several companies at once, buyers can readily produce the product themselves" (Hill & Jones, 2010, p. 51.).

In fact, when Wal-Mart started in the early 1960 and was a small retailer with little purchasing power; it depended on nationally branded merchandise to generate traffic (Hill &

Jones, 2010). While the buyers (individuals and small businesses-in the case of Wal-Mart) were not as interested in shopping as they might have been 10 years ago. These days' shoppers are looking for value and migrated to those retailers that offered the best price/value options.

(4) **The Bargaining Power of Suppliers.** A fourth factor in Porter's five forces model is the bargaining power of suppliers. While **s**uppliers are those organization that supplies products, raw materials, services, or labor (such as labor unions) to various firma; they can be a major threat when they are able to increase the price the firm must pay for their products, materials, or services (Bamford & West, 2008). They can also be a threat when reducing the quality of supplied products or materials. It is important to note that suppliers' ability to make such demands on a firm is relative to their power as compared with that of the firm. Suppliers tend to be powerful when:

- "The supplier's product has no substitutes or is vital to the company.
- The company is not important to the supplier.
- The company has a switching cost to change suppliers.
- Suppliers can readily enter the company's industry.
- The company cannot readily enter the supplier's industry" (Hill & Jones, 2010, p. 51).

Accordingly, from what we know so far, Wal-Mart has no foreseen problem whatsoever as suppliers bargaining power. Wal-Mart in addition to the top retailers is very important to suppliers. The bargaining power of suppliers is only applicable to much smaller firms than Wal-Mart.

(5) **The threat of substitute products.** A fifth and a last factor in Porter's five forces model is the threat of substitute products. As the existence of adequate substitute products are readily available in the market, it limit the price that companies in an industry can charge without losing market share (own customers) to producers/providers of substitutes' products (Hill & Jones, 2010). The threat of substitutes tends to be greater when:

- The substitute product is a close one. It provides equally adequate customers' needs.
- The price of the substitute is equal to or less than the firm's products' price (Hill & Jones, 2010).

As described in the case, the retail industry has been defined as the composition of companies that sell merchandise to customers. Retail customers were known to drive the level of expected customer service as evidenced through their spending habits. A strategy employed by every retailer has been the ability to fulfill whatever service was demanded by the consumer. A prime example in today's economy was depicted by the fact that consumers shopped in retail stores that appealed to convenience and price sensitivity. Consumers spent less time in stores leading retailers to the realization that on-shelf availability was critical. Such changes in consumer spending habits led general merchandise stores, such as Wal-Mart, which carried a wide product range, as revenue leaders in the retail industry (Chiles & Dau, 2005).

5. Looking at Wal-Mart sales and its last five years' consolidated income statement, what are the company's sales and the sales growth rate? What has been the growth rate in net income?

As it is clear from Tables 1 and 2 below, Wal-Mart has a steady sales growth year after year. Its net sales have grown from $344,750M in 2007 to $418,953M in 2011. This trend is an indication that the company's sales are very strong. Although Sam's Club had minor sales decreases from $47,806M in 2010 as compared to $47,976M in 2009, it recovered in 2011 when it reached $49,459 in 2011.

Table 1
Growth Net Sales 2007-2011 (Dollar amounts in millions)
Fiscal Years Ended January 31

	2011		2010		2009		2008		2007	
	Net Sales	**Percent of Total**	Net Sales	Percent of Total	Net Sales	Percent of Total	Net Sales	Percent of Total*	Net Sales*	Percent of Total
Wal-Mart U.S.	**$260,261**	**62.1%**	$259,919	64.2%	$256,970	64.0%	$238,915	63.9%	$226,294	65.6%
Wal-Mart Intl.	**109,232**	**26.1%**	97,407	24.0%	96,141	24.0%	90,570	24.2%	76,883	22.3%
Sam's Club	**49,459**	**11.8%**	47,806	11.8%	47,976	12.0%	44,336	11.9%	41,582	12.1%
Net Sales	**$418,952**	**100%**	$405,132	100%	$401,087	100%	$373,821	**100%**	$344,759	100%

(Wal-Mart Stores, 2011b)
*Authors noted minor figures' differences when checked the various annual reports. These differences could have been resulted from a later financial reconciliation and or audit. Authors were not able to confirm.

Table 2
Wal-Mart Revenue Versus Net Income (Amounts in millions) as of and for the Fiscal Years Ended January 31
(based on information provided in the case's Table 5)

Year	**Revenue**	**Net Income**	**Net Profit Margin**
2011	$418,952	$15,355	4.00%
2010	$405, 132	$14,449	4.00%
2009	$401,087	$13,235	3.00%
2008	$373,821	$12,841	3.00%
2007	$344,759	$11,224	3.00%

(Wal-Mart Stores, 2011b)

As per information provided in the case, Wal-Mart consolidated net sales increased by 3.4% and 1.0% in fiscal 2011 and fiscal 2010, respectively, when compared to the previous fiscal year. Net sales in fiscal 2011 were a result of Wal-Mart's continued expansion activities. In fiscal 2011, it added 3.4% of additional retail square feet (Chiles & Dau, 2005). In addition, foreign currency exchange rates played a favorable role in fiscal 2011 sales growth. It added an approximately $4.5 billion (Chiles & Dau, 2005). In fiscal 2011, Wal-Mart had a 0.6% decline in total U.S. comparable store and club sales (Chiles & Dau, 2005).

In fiscal 2010, the net sales increases resulted from increased customer traffic, continued global expansion activities, and the acquisition of the Chilean subsidiary-Distribucióny Servicio S.A. de C.V. ("D&S") in January 2009. Said net sales were offset primarily by a $9.8 billion unfavorable currency exchange rate that affected Wal-Mart's International segment and adversely affected by price deflation in certain merchandise categories in its U.S. segment (Chiles & Dau, 2005).

As growth of its US division has slowed, Wal-Mart's sales were expanded abroad. Wal-Mart International segment continued to be a growth segment in 2011. It contributed to 26% of the overall total sales, generated a 12% net sales increase, and added approximately 8% net more selling space with the addition of 458 new units (Chiles & Dau, 2005). On the other hand, Sam's Club contributed a little more than $49 billion that is 12% of the total company's net sales with a 3.5% increase over its 2010 net sales. As Wal-Mart sales increases, its net income is also increasing year after year resulting in a net profit margin's increase to 4% in 2010 and 2011 from 3% for the years 2007-2009.

It is important to mention that while comparable store (per store) sales increased from 2007 to 2009 for Wal-Mart U.S. and Sam's Club, it decreased by 0.7% and 1.4% in 2010 respectively for both entities. However, comparable stores sales for Sam's Club recovered in 2011 when it went up to 3.9%. Wal-Mart U.S. continued its decline by 1.5% in 2011. Please refer to Table 3.

Table 3
Wal-Mart's Calendar Comparable Store and Club Sales for Fiscal Years Ended January 31

	2011	2010	2009	2008	2007
Wal-Mart U.S. *	**-1.5%**	-0.7%	3.2%	1.0%	1.9%
Sam's Club**	**3.9%**	-1.4%	4.9%	4.9%	2.5%
Total U.S.	**-0.6%**	-0.8%	3.5%	1.6%	2.0%

* Comparable store sales are a measure, which indicates the performance of Wal-Mart existing stores by measuring the growth in sales for such stores for a particular period over the corresponding period in the prior year.
**Sam's Club comparable club sales include fuel.
(Wal-Mart, 2011b)

Wal-Mart explained the reason as due to deflation in certain merchandise categories and lower fuel prices. Additionally, new stores may take sales away from existing units. Wal-Mart estimated the negative impact on comparable store sales because of opening new stores as approximately 0.8% in fiscal 2011, 0.6% in fiscal 2010, and 1.1% in fiscal 2009 (Wal-Mart Stores, 2011b).

In addition to that, students might want to analyze key financial ratios as shown in Table 4. Note that sales (quarter versus year ago quarter, year to date versus year to date net income, and quarter versus year ago quarter net income might help asking what are the implications, these ratios are not good indicators of the health of the company.

Table 4:
Wal-Mart Key Financial Ratios*

Growth Rates %	Wal-Mart	Industry	S&P 500
Sales (Qtr. vs. year ago qtr.)	8.10	8.60	14.30
Net Income (YTD vs. YTD)	NA	NA	NA
Net Income (Qtr. vs. year ago qtr.)	-2.70	0.50	44.80
Sales (5-Year Annual Avg.)	6.21	6.60	8.22
Net Income (5-Year Annual Avg.)	6.12	7.43	8.46
Dividends (5-Year Annual Avg.)	15.06	13.71	5.94

***Financial data in U.S. dollars (Money Central MSN.com, 2011, n. p.)**

On the other hand, the five years' sales, net income average, and dividends are stronger indicators. Accordingly, while Wal-Mart 5 year's sales and net income average are increasing, they are still below industry and S&P 500 average. Net income growth average for the past 5 years is 6.12%. While this average is below industry (i.e. 7.43%) and below S&P (8.46%), it could be explained that Wal-Mart is the low cost leader and would like to keep so meaning it is not a surprise for a Wal-Mart to be below average. A strong indicator of financial health is that Wal-Mart's dividends are ahead of its industry and S&P 500 for at least the past 5 years.

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INSTRUCTOR'S NOTES: ANDREW MASON & GROUPON, INC.

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CASE SYNOPSIS

This case takes place in late 2012 and examines Andrew Mason, the co-founder of Groupon, Inc. and his journey to build his company. Mason was just reelected by the Board of Directors to remain as CEO of the company despite the stock price being down approximately 80% from its IPO in 2011. Mason was in a situation where he had to figure out how to turn the company around.

RECOMMENDATIONS FOR TEACHING APPROACHES

Students will find the case very interesting because most of them will have heard of Groupon. Students will combine the facts presented in the case with their own perceptions and experiences of Groupon. The case examines Andrew Mason and Groupon and takes students through the process of starting and growing an online enterprise. Students are asked about the challenges that Groupon faces in late 2012 and the recommendations they would make to Andrew Mason. The following questions are recommended for discussion.

QUESTIONS

1) Discuss the childhood, background, education, and personality of Andrew Mason.

2) Discuss the history of Groupon from startup until today. What strategies did Mason and Groupon employ to grow their business?

3) In what industry(ies) does Groupon compete? What companies does Groupon compete against? Perform a SWOT Analysis of Groupon. What is Groupon's competitive advantage?

4) What were the major problems facing Groupon, Inc. in 2012?

5) What recommendations would you make to Andrew Mason? Why?

DISCUSSION QUESTIONS WITH SUGGESTED ANSWERS

1) Discuss the childhood, background, education, and personality of Andrew Mason.

At just 31 years of age, Andrew Mason was the CEO of Groupon. Mason had a somewhat unique background and interesting personality. He had a casual style and was a very humble person. Mason has a great deal of creative energy, was stubborn, and looked at problems in different ways. His sense of humor was also noteworthy as each Groupon deal included a quirky description that was sure to bring a smile to any reader's face.

Mason was an entrepreneur since his youth in Mount Lebanon, a suburb in Pittsburgh, PA. His first entrepreneurial activity was a company called Bagel Express that delivered bagels on Saturday mornings. Mason also differentiated himself by using cranberries from his yard to sell muffins to his neighbors. He also had a passion for music. Mason actually earn a music degree from Northwestern University in 2003.

After college he worked with several entrepreneurial ventures in Chicago focusing on web design. He assisted in the start-up and promotion of a number of online businesses in the late 90's and early 2000's. One of the companies that he worked for was, Starbelly, which was sold to a company for $240 million right before the dot-com bust in January 2000.

In 2006, Mason earned a scholarship to return to school to work on a degree from the University of Chicago's Harris School of Public Policy. He started experiencing problems with his cell phone provider and began brainstorming an idea for a website that was devoted to change based on a large group of people desiring the same thing. Eric Lefkofsky, a venture capitalist, offered Mason $1 million to create a company. Mason dropped out of the University of Chicago and created a company called ThePoint. ThePoint was a web platform that allowed anyone to write a campaign exhorting others either to do something (stage a demonstration) or give money to a cause (make Election Day a national holiday).

Unfortunately, the company was not sustainable due to a lack of profitability. Mason created a sub business within the Point called Groupon. He noticed that his company's most popular campaigns had involved group buying. This was the beginning of Groupon. Groupon's first offer was a two-for-one pizza deal on October 22, 2008. Twenty-four Chicago residents bought the deal, and Groupon was off and running. After six months of operating solely in Chicago, it expanded to Boston, New York City, Toronto and Washington, D.C.

2) Discuss the history of Groupon from startup until today. What strategies did Mason and Groupon employ to grow their business?

Groupon provided its members a site that allowed them collective buying power or "power in numbers". Groupon was a service that offered consumers select discounts to local businesses, categorized by city. In a 2010 interview with Charlie Rose, Mason stated that each Groupon offered on his site would give the purchaser a 50% discount or more. There were a number of different types of businesses including: restaurants , spas, art studios, health providers, movie theaters, etc. In order for a consumer to get a coupon, Groupon required a minimum number of people to purchase the coupons. Therefore, collective buying power also benefited local businesses as well. By establishing a minimum performance level, these businesses could guarantee that enough customers would purchase their coupons in order for their side of the deal to be worth their time, money, and effort. Mason stated that Groupon was able to create performance based marketing for the first time. They only paid when these Groupon customers walked in the door.

After only 14 months, Groupon had 1.8 million subscribers. By 2010, Groupon expanded into several new cities each month in addition to international expansion. The company rejected multi-billion dollar offers from both Google and Yahoo! in 2010 and closed the year with 50.5 million subscribers.

By June 2011, the company had more than doubled its subscriber count to 115.7 million subscribers. From January, 2009 to June, 2011, over 23 million customers purchased one Groupon and over 50% purchased more than one. In 2012, the company reported that it had 11,471 employees with sales of $1.6 Billion.

Groupon employed a multi-country, multi-regional strategy that focused on getting people to buy into currently popular or potentially popular products/services from vendors in their urban area and online merchants. Groupon formed strategic alliances with businesses to gain access to deals for its members. This led to an increase of revenue up to 50% of the deal purchase price. These businesses were known as Groupon partners. They were key to the success of Groupon's business model. Groupon also had its vendors/partners sign a year-long contract that locked them into getting placement with Groupon and no one else during that time. Groupon had a very active and highly efficient sales force that focused on beating Groupon's competitors by working hard to get quality deals for Groupon members.

Other Groupon strategies included: broad market penetration; clever, interesting, e-mails that promoted each Groupon; simple, core technology that focused on delivering e-mails that contained Groupon pitches and processed transactions quickly for deals that reached the tipping point; encouraged word-of-mouth and paid referrals (in Groupon dollars) while simultaneously engaged in mass marketing/advertising to bring in new members (especially for newer markets overseas); maintained affordability of all deals offered by Groupon (price sensitivity), and possessed a large, growing group of talented staff who acted as salespeople, writers, and brokers for Groupon.

In 2011, Groupon diversified its product line by launching Groupon Goods. The subsidiary was a forum that sold discounted products. Groupon Goods sold $2 million worth of goods in its first week and surpassed $200 million during the second quarter of 2012. It is expected to sell between $600 million and $800 million worth of goods in 2012. This would place Groupon Goods among the largest North American online retailers such as Saks Direct at No. 38 and Abercrombie & Fitch at No. 45 with online sales of $552.6 million.

3) In what industry(ies) does Groupon compete? What companies does Groupon compete against? What is Groupon's competitive advantage?

Andrew Mason developed a new industry. Even though the company held a first mover advantage, many copycats arose. LivingSocial was probably the biggest competitor. Other replica companies have been forced to find new ways to compete through diversification or market segmenting; rather than appealing to general masses with diverse products and services, these companies will market and sell to select groups of consumers.

The classification of the industry that Groupon competed in can be called the discount group buying service industry, or the "social group buying" industry. This industry was characterized by "daily deals." This was an emerging industry that Groupon single-handedly brought back into the limelight after it had all but died online by early 2001. Groupon had some group buying coupon competitors/Groupon clones that generated excellent traffic at times but not necessarily revenue or profit like Groupon did. Amazon.com had invested in their biggest competitor. As of 2011, LivingSocial had a market value of $3 billion. Other competitors included YouSwoop, Scoop St., BuyWithMe, Tippr, Gilt Groupe and DailyCandy, all of which offer daily local deals. Google has been building and beta-testing a Groupon clone called Google Offers, something they began after Groupon rejected their offer to purchase the company.

Initially Groupon's competitive advantage was the uniqueness of the product. Unfortunately, many competitors arose, diminishing the company's value. Also, many of their strategic partners began to realize that their relationship with Groupon was not good for business. However, Mason's confident leadership with a strong vision and new ways of doing business online put Groupon in a position as an industry leader.

4) What were the major problems facing Groupon, Inc. in 2012?

A critical problem for Groupon was the merchants that were doing business with were failing to get any brand loyalty. That's why they went with Groupon. Instead, coupon users were drawn to the company for the one time and once they used their coupon they looked for a deal somewhere else. Customers realized that they would never have to pay full price again, which was a total disappointment to the retailers. On the other hand, merchants were told that these coupon deals would lead to new customers that would stick around and pay full price.

The co-founder of Bloomspot, Jasper Malcolmson, compared deal offers with merchants to that of the marketing of subprime loans during the housing boom. According to Malcolmson, "They were giving these mortgages to every consumer regardless of whether he could handle it. But sooner or later you find that you can't make great offers to people if they're not making you money". This led Bloomspot to change its primary focus to profitability.

Another critical problem was the ease of replication in regards to Groupon's business model. Groupon had to ensure that it remained attractive and profitable for all of its partner businesses that it worked with to bring deals to the consumer. Many foreign markets where Groupon had limited or no experience, rivals could gain the upper hand prior to Groupon ever even arriving (as has happened in Australia, India, Japan, and elsewhere) and thus pressure Groupon into either expending more resources to gain a foothold in those markets or perhaps pay top dollar to acquire the first-mover. Groupon's biggest future competitor will be Google Offers. Google did not establish themselves in any meaningful markets.

In addition to the problem of brand loyalty, coupon fatigue seems to be setting in. With the revenue generating model that Groupon created, countless other companies have entered the market in hopes of creating some of their own revenue. Copycat sites by the name of DoubleTakeDeals, YourBestDeals, DealFind, DoodleDeals, DealOn, DealSwarm, and GoDailyDeals exist among hundreds of others. There were 40 active coupon sites in New York City. The strange thing is 80% of subscribers to the website's daily e-mails have never actually bought a deal. Realizing this as a huge problem, Groupon has made attempts to increase purchases by offering $10 off the first coupon bought. This number has since increased to $15.

Another problem for them was the increase in the number of subscribers, but the actual percentage of those subscribers that were actually making a purchase was low. In many ways it meant that the huge sums of money spent on marketing Groupon have paid off, but the company was failing when it came to getting the customer active with their service. The spending by subscribers was also low which presented an opportunity for Groupon. The dollars spent by customers need to increase if Groupon expects to make a profit.

Groupon also has financial problems. The company lost about $3 million in the third quarter of 2012. In the beginning of 2011, Groupon's gross billings of $668 million were growing by over *1,400* percent year over year; but in the third quarter of 2012, the $1.2 billion in billings represented a mere 5% annual increase. In that same time period, the number of customers who had purchased a Groupon in the previous year rose from 15.4 million to just under 40 million. But the gross billing per customer had fallen by just under 12%, from $169 to $149. The year-on-year growth rate of the company's quarterly revenues slumped from 1,358 percent in early to 2011 to 33 percent in the third quarter. Groupon's marketing expenses were also going up. As a result of this, Groupon laid off 954 workers in the third quarter of 2012.

Dr. David Reibstein, a professor at the University of Pennsylvania, stated that Groupon would eventually suffer because merchants would realize that the coupons were not a good deal. He argued that Groupon's customers were "price-sensitive," which meant that they searched for the best deal they could find. This meant that they were not likely to be repeat customers.

As a result, some merchants offered deals, sometimes at a loss, but then got little future business. Moreover, companies could alienate current customers by offering coupons. For example, take a woman who has paid full price for a massage. Then she sees someone get it at half price. She would feel insulted, or ripped off. Reibstein stated, "Nothing irritates people more than finding that they are paying a premium over what other people are paying. Even those customers who were perfectly willing to pay the full price for a spa treatment could get a Groupon instead, making the spa take a loss on a customer who was willing to pay full freight. The last group you want to offer coupons to are your existing customers".

5) What recommendations would you make to Andrew Mason? Why?

We recommend that Groupon do an employee audit. They have already laid off a number employees. Further layoffs may be needed. Furthermore, key people may need to be reallocated to different areas.

The company has diversified into selling products through their "Groupon Goods" retail division. This has already accounted for approximately 25% of the sales within the company since 2011. A strategic focus on expanding this area is recommended. National and international geographical expansion is recommended especially into the fast growth emerging economies. Along with this will come the need to hire the best from other companies to manage and grow these operations. As Groupon Goods continues to grow, the company will need to hire people with expertise in consumer goods at the retail level.

Historically, Groupon has been about making strategic alliances with small to medium sized businesses. However, Groupon needs to think "outside of the box" about diversifying into other areas besides mere Groupons. There are ample opportunities to grow Groupon through larger companies and venues. For example, they could team up with athletic teams throughout the world. Or they could form strategic alliances with other larger organizations. New Groupon offerings including Goods, concept stores, an **Apple-**specific point-of-sale solution, and merchant payment services, are all new revenue opportunities. Groupon must continue to think way outside of the box to generate revenue. They must reinvent themselves as technology changes. They must think not one step ahead but 10 steps ahead than the competition.

EPILOGUE

Groupon's story is one of the American Dream. The company went from 400 subscribers in 2008 to over 200 million today. Unfortunately, Groupon's success has not been shared by investors. Company shares have fallen over 80% over the past year and left investors panicked.

Groupon has teamed-up with MLB Advanced Media, the interactive media and Internet company of Major League Baseball, to offer deals that will take baseball fans out to ball games and provide discounts on peanuts and crackerjacks, among other related experiences and merchandise. The company will become MLB.com's official daily deals site through the 2014 season. Under the agreement, Groupon will host deals from MLB clubs through its GrouponLive events platform, which launched in May 2011 as a joint venture between Groupon and Live Nation Entertainment to offer deals on live entertainment (Lacy, 2012).

Mike DeLuca was appointed Vice President of Sales for Breadcrumb, which is Groupon's iPad-based point-of-sale system for restaurants, bars, and cafes. Furthermore, DeLuca should continue to cover his current role as VP of Sales and Operations for Savored, which is a Groupon-owned restaurant reservation and yield management platform for high-end establishments (Powell, 2012).

Groupon's stock price was last seen at $3.89 on December 5, 2012.

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THERE *IS* ROOM AT THE INN! : INSTRUCTOR'S NOTES

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DISCUSSION QUESTION

Make a recommendation to Mr. Shah regarding his next course of action. Should he stick to his current strategy of being a franchisee motel? Should he turn the place into an Assisted Living? Should he convert it into a student housing facility?

SOLUTION

Any of the options can be turned into a success story if some thought is put into it. This can be a group project for the class with each group examining a different option as a solution.
Let us look at the first solution first.

SOLUTION 1: TURNING PART OF THE MOTEL INTO AN ASSISTED LIVING PLACE

There is evidence that a market for assisted living exists in the town. Looking at the demographics (Table 1), we see there are over 17,000 people in the 62 and above age group. Assisted living as it exists today emerged in the 1990s as an eldercare alternative on the continuum of care for people, for whom independent living is not appropriate but who do not need the 24-hour medical care provided by a nursing home and are too young to live in a retirement home. (http://elderpoint.com/content.php?page=costofcare) Kwality Motel could fill the gap for active seniors that do not have any major health issues but would like a break from managing a home and yard and other day-to-day activities. Ideally, they would also benefit from the companionship of other similarly aged seniors.

Going with this option would mean students need to identify and list requirements for assisted living facilities. While this varies by the state, since the case mentions the location as Texas, the agency to refer to would be The Texas Department of Aging and Disability Services (DADS). It licenses and regulates providers of these services, and administers the state's Guardianship program.

People who live in newer assisted living facilities usually have their own private apartment or individual living spaces resembling a dormitory or hotel room consisting of a private or semi-private sleeping area and a shared bathroom. There are usually common areas for socializing, as well as a central kitchen and dining room for preparing and eating meals.

There is usually no special medical monitoring equipment that one would find in a nursing home, and their nursing staff may not be available at all hours. However, trained staff is usually on-site around the clock to provide other needed services. Household chores are performed: sheets are changed, laundry is done, and food is cooked and served as part of the base rent and included services. Depending on their disclosure of services, assisted living services may include medication management, bathing assistance, dressing, escorts to meals and activities, toileting, transferring, and insulin injections by an RN. Some homes even have a beauty parlor on site. Grocery service is often available too. The accommodations generally are self-contained; i.e., they have their own bedroom and bathroom, and may have a separate sitting area or small kitchen. Registered nurses and license practical nurses are available by phone or e-mail 24 hours a day.

To make a gradual transition to being an assisted living facility, Kwality Motel will need to make some modifications. Students need to identify some or all of these listed below:

1. Making the rooms more senior friendly. Some steps such as putting bars in showers, or having some rooms with walk-in showers will help.
2. Making sure the lighting in the room is bright enough.
3. Installing a communication system that can help guests call for help in case of an emergency. The motel can arrange for every guest to have a wearable alerting bracelet or necklace.
4. Having wheel chair ramps in every part of the building.
5. Investing in a security system that covers the outside of the premises. Since the case mentions that the place is in a bad part of town, family members need to feel assured of the safety of their loved ones. Install an electronic gating system that keeps unsavory elements out.
6. Introduce some community events such as Bingo night or gardening that would promote companionship among the residents.
7. Include transportation to the church, mall, park once or twice a week

Students also need to put some thought into additional employees that may need to be hired and the cost needs to be included so as to come up with a Break-even point.
For example:

1. State Licensed Facility Administrator (annual salary approximately $70,000)
2. Registered Nurse (annual salary approximately $60,000)
3. Nurse Assistants and Care givers (annual salary approximately $30,000)
4. Kitchen Staff (annual salary approximately $30,000)

SOLUTION 2: TURNING PART OF THE MOTEL INTO A STUDENT RESIDENCE

This solution is also open to a lot of creativity on part of the students. Students can imagine what they would like to see in a place where they would live for almost 4 years and include those features while trying to come up with a cost-benefit analysis for each.

One benefit of a student residence over an Assisted living place would be the elimination of many requirements of licensing, modifications to the rooms etc. On the other hand, the lack of transportation could be the biggest stumbling block. Getting around that would require the owner to start a shuttle which would then introduce expenses such as driver, vehicle insurance and increased liability insurance for the place as a whole. That may still not be enough since most students do not like to wait for a shuttle to get back to their rooms in between their classes.

The student housing facility could also be run as a cooperative which would include some students in the operations of the facility. This could bring multiple benefits. Firstly, Mr. Shah would not need to hire many more people to manage the place. Secondly many places prefer not to lease their places to students because of fears that they will trash the place and cause expensive repairs. Having student managers can act as a deterrent through peer pressure of the positive kind!

Some other advantages of having students as the residents are that Mr. Shah can introduce multiple options regarding the meals. For example:

1. Flat rate for rent including utilities and access to the large shared kitchen (student provides own groceries)
2. Flat rate for rent including utilities and hot breakfast
3. Flat rate for rent including utilities and all meals
4. Flat rate for rent including utilities and pay as you go for meals

Since the town has 1 large University, it becomes easier to promote the student residence. Some cost-effective ways to spread the word can be:

1. Advertising the place to student bodies, fraternities, sororities etc
2. Using social media like Facebook to target young students in the town and its neighboring areas
3. Having a couple of Open House events with free pizza, hot dogs etc. to generate interest
4. Printing and distributing flyers comparing the dormitories with the much cheaper Kwality Motel

Eventually, the franchise agreement can be completely dropped in case either of the solutions works out well. This case study is designed to be open-ended with students having ample opportunity to be creative and come up with out-of-the-box solutions.

Figure 1: Occupancy Rates

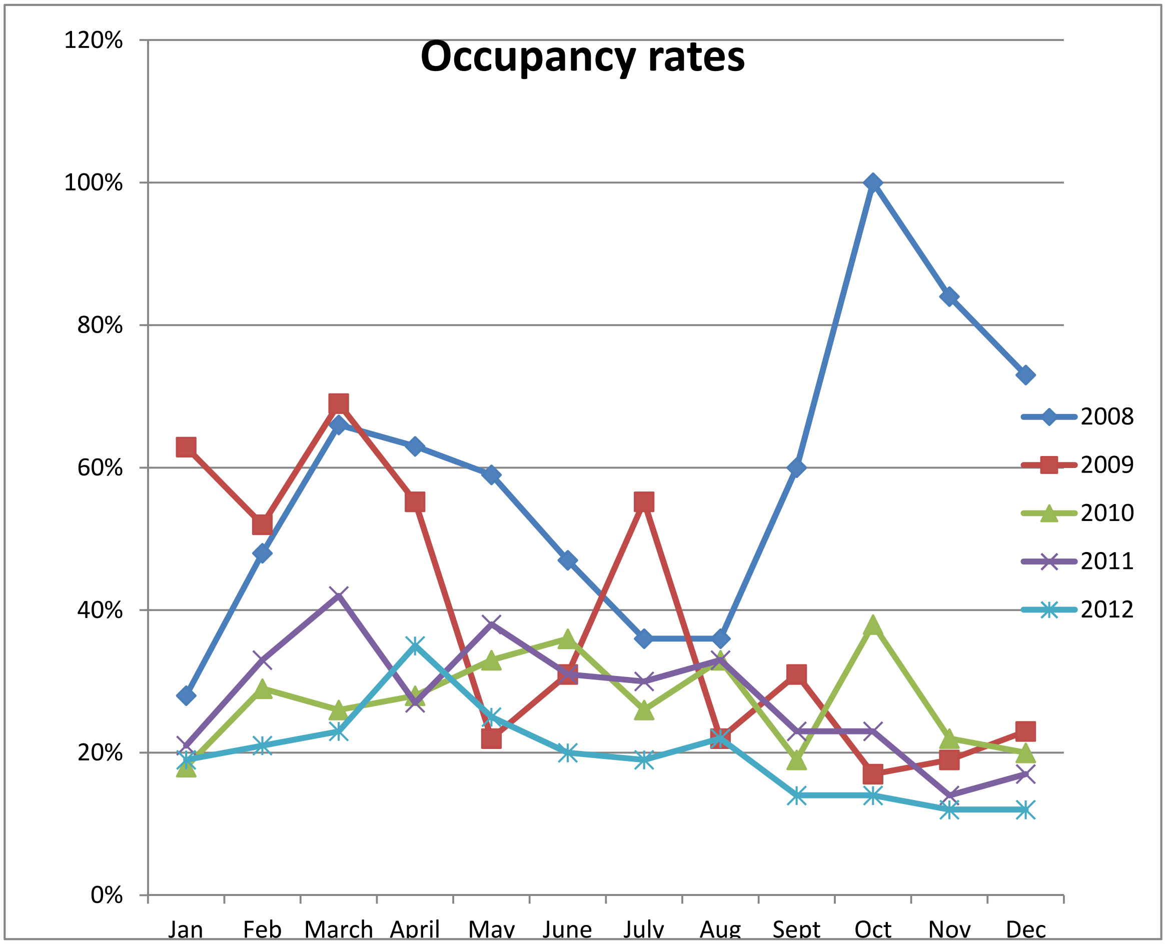

Table 1: Census Data (2010) Age		
Subject by Age	**Number**	**Percent**
Total Population	118,296	100.0
Under 5 Years	8,582	7.3
5 to 9 years	7,900	6.7
10 to 14 years	7,738	6.5
15 to 19 years	9,265	7.8
20 to 24 years	9,999	8.5
25 to 29 years	8,924	7.5
30 to 34 years	7,637	6.5
35 to 39 years	7,129	6.0
40 to 44 years	6,872	5.8
45 to 49 years	8,063	6.8
50 to 54 years	8,446	7.1
55 to 59 years	7,490	6.3
60 to 64 years	5,859	5.0
65 to 69 years	4,084	3.5
70 to 74 years	3,148	2.7
75 to 79 years	2,757	2.3
80 to 84 years	2,289	1.9
85 years and over	2,114	1.8
Median Age (years)	34.4	(X)
16 years and over	92,433	78.1
18 years and over	89,027	75.3
21 years and over	82,670	69.9
62 years and over	17,673	14.9
65 years and over	14,392	12.2

Table 2: Profit and Loss Statement January through December 2011	
Ordinary Income/Expense	
Income	
Room rental Income	397,379.14
No Show Charge Income	220.92
Miscellaneous Income	16,189.12
Total income	**413,789.18**
Expense	
Happy hour Guests	36.88
Accounting Fees	3,103.41
Advertising	13,335.48
Automobile Expenses	3,916.09
Bank Service Charges	40.15

Table 2: Profit and Loss Statement January through December 2011	
Commissions	1,235.81
Computer Service	340.92
Continental Breakfast	5,386.71
Contract Labor	4,155.14
Contributions	10.00
Credit Cards charges	6,417.46
Dues and Subscriptions	482.80
Cable-Equipment Rentals	20,610.41
Franchise Fees-Rodeway Inn	40,184.07
House Keeping Expenses	7,840.25
Insurance Expenses	63,943.71
Interest Expense	96,607.66
Laundry & Linen Expenses	3,054.82
Maintenance & Repairs	12,348.69
Office Expenses/Supplies	269.68
Payroll Services	259.80
Postage & Delivery	217.56
Salaries-Officers	24,000
Salaries-Regular	70,324.41
Small Equipment	550.07
Supplies Expense	8,261.91
Taxes Expense	42,070.82
Telephone	928.78
Travel	149.40
Utilities	52,121.98
Waste Management	2,426.51
Total expense	**484631.38**
Net Ordinary Income	**-70,842.20**
Other Income/Expense	
Other Income	250
Net Income	**-70,592.20**

ECONOMICS OF APPLE IPHONE: PRICE DISCRIMINATION OR PRICING ERROR?

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INSTRUCTORS' NOTES

CASE DESCRIPTION

The present case examines Apple's iPhone pricing decisions and provides an opportunity to review the underlying principles of several pricing strategies. The case is designed to cover a number of learning outcomes in a Managerial Economics course at the M.B.A. or upper undergraduate level and has been tested in M.B.A. Managerial Economics classes at two business schools over several semesters. The case is designed to be taught in one class hour and is expected to require two hours of outside preparation by students.

CASE SYNOPSIS

Apple has achieved a leadership position in the consumer electronics market however its launch of the original iPhone was far from smooth. The iPhone was a highly expected product that tapped into a large new market for the firm. Just over two months after the launch of the device, Apple cut its price for the 8 GB model significantly and discontinued the 4 GB model altogether. This decision was unexpected and led to dissatisfaction among early buyers and a loss in stock value. Apple had to react to the customer backlash and CEO Steve Jobs reached out to customers with a rare public apology.

The key question in this case is whether these events resulted from a pricing error by Apple or were a part of a long-term pricing strategy. The case provides an opportunity to review the conditions for successful price discrimination and evaluate the reasons for Apple's pricing decisions and consequences thereof.

CASE QUESTIONS

1. Do you think the aforementioned events resulted from a pricing error by Apple, or were a part of a long-term pricing strategy? Provide arguments supporting your position.
2. What can we learn from this case? If you think this was an error, how can a firm minimize the occurrence of such errors? If you see this as a carefully planned strategic move, what are the underlying principles of that strategy?

3. If you are facing an unknown market demand and have to experiment with prices in search of your optimal price, is it better to make a mistake by pricing too high or by pricing too low? Please discuss both short-term and long-term implications.
4. What is your opinion of the way in which Apple handled customer dissatisfaction resulting from the price drop? What other solutions could you recommend?

RECOMMENDATIONS FOR TEACHING APPROACHES

This case study is designed to cover some of the learning outcomes typical of a Managerial Economics course at the upper undergraduate or M.B.A. level and may be integrated with a typical Managerial Economics textbook such as Baye (2010). While other cases on Apple's iPhone exist (e.g. Farris and Spekman, 2009; Mallin and Finkle, 2011), the focus on the unusual pricing revision by Apple is unique to the best of our knowledge.

In completing this assignment, the students need to apply economic theory along with critical thinking and take the product and market characteristics into account to develop their conclusions. The following pedagogical objectives are achieved by this assignment. Students will: (1) Critically evaluate pricing decisions made by a firm; (2) Recognize the conditions for successful price discrimination; (3) Apply theoretical foundations to forecast the expected outcomes of various pricing strategies.

The case is based on actual events and includes sufficient detail to provide depth to the students' analysis. While it most naturally belongs to the discussion of pricing strategies, it also provides the instructor with an opportunity to discuss various other topics that are typically part of a Managerial Economics course. In order to ensure meaningful discussion and exchange of ideas, students should be familiar with economic welfare analysis and the concepts of pricing power and price elasticity.

Based on our experience from testing this case, student opinions on questions 1 and 2 are about evenly divided between viewing these events as a pricing error and asserting this was the result of a preconceived strategy. Such variety of opinion invariably results in an interesting and animated discussion.

The strategic pricing argument builds on the price discrimination idea, specifically that of intertemporal price discrimination (ITPD). When the pool of potential buyers is heterogeneous in terms of their subjective valuation for the product, the firm can increase profits by charging different prices to different groups. In the present case, the variance in the consumer patience factor between early adopters and other customers gave Apple the opportunity to discriminate its customers across time. First, the highest-valuation buyers were served at high prices and then, once that market was addressed, the company moved on to the lower-valuation tiers. This interpretation seems to be supported by Steve Jobs himself who acknowledged in his letter that the primary purpose of the price cut was to broaden the market for the product, or as he put it, "get new customers in the iPhone tent" (Jobs, 2007). That is best achieved by a price cut, after the least patient adopters have already been served.

Case discussion provides an opportunity to revisit the necessary conditions for price discrimination in a broader context, namely: the presence of pricing power, recognizing demand heterogeneity, being able to distinguish between groups of customers based on their demand elasticity, and eliminating or reducing the possibility of product resale between groups.

Those students who believe this is an example of a pricing mistake typically make the following arguments: (1) The price cut came much sooner and was much deeper than any other price change for the iPhone line, as seen in Table 1; (2) CEO Jobs repeatedly refers to the price cut as "the right decision" but never says the same about the original price; (3) No official sales figures were provided other than the one for the first 30 hours, perhaps indicating less-than-projected sales the company did not want to disclose; (4) A price cut is more understandable when a new and better product is introduced, or when a competition in comparable products get stronger with time. In both cases, the demand for the original product would drop and so would the price optimally charged by the producer. No such event took place here, suggesting that the demand was initially overestimated.

Regarding the last point, one possibility is that Apple based their initial price estimates on the prior success of the iPod. However, the iPod had no close substitutes within its product category whereas in the cell phone market Apple faced "an onslaught of cell phones from other handset makers featuring steadily improving iPod-like entertainment functions -- often at a cheaper price per unit" (Wingfield, 2007a).

Another interesting observation based on Figure 1 is that the announcement of new handsets and mobile applications by Nokia on Aug 27, 2007 did not affect the upbeat outlook on Apple. In other words, such an announcement was already factored into market expectations. The drop in the AAPL stock price occurred only after Apple followed up with the iPhone price cut. Perhaps this move by Apple was at least temporarily seen as an indicator of either lackluster sales figures or Apple's concerns about the increasing competitive pressure.

Sales volume is especially important in this case because of the presence of network externalities affecting the company's ability to benefit from the network of adopters of its product line down the road. Greater iPhone sales enhanced the potential to profit on complementary products such as phone apps and online music downloads.

In summary, the consensus following the discussion of questions 1 and 2 is typically that the ITPD reasoning applies to this case but the magnitude of the price cut affected the public perception of Apple and forced it to make an effort to accommodate the early buyers.

In opening the discussion of question 3, the instructor may point out that in an uncertain market for a new product some experimentation is inevitable. For example, it is virtually impossible for a company to determine the profit-maximizing price correctly without first taking the product to market. Therefore there will always be pricing errors and price adjustments will always follow.

During the discussion, two important points need to be made, both of these suggesting that opting to charge a higher initial price is preferable to lower. First, prices that turn out to be higher than the desired revenue- or profit-maximizing point can be relatively easily corrected downward. A firm can lower the price in order to eventually sell surplus items. Such a price adjustment would be unrelated and in addition to the ITPD. When, on the other hand, the price is initially set too low, the products are bound to be sold and the lost revenue cannot be recovered. Second, a gradual reduction in price is generally seen more favorably by consumers than a gradual increase. Consumers tend to see the prior price as a reference point, which may affect their perception of the product's value. In other words, declining prices give them the feeling they are "getting a good deal", which further positively reflects on sales. One exception to that principle is the low introductory pricing practice but that practice is successful primarily for entry into well-established markets for repeatedly purchased goods; therefore it is not applicable to the present case.

Continuing with the market experimentation topic, one additional observation can be made about Apple's strategy. The company entered an unexplored new market with not one but two products, a 4 GB phone and a 8 GB phone. Doing so allowed Apple to learn more about the specifics of the demand it was facing and gave it a better idea of what features consumers valued and how much they were prepared to pay for specific features.

Question 4 is only tangentially related to pricing strategy topics, but it provides an important instructional opportunity. The way in which Apple handled consumer backlash was brilliant. The store credit issued by Apple achieved two objectives. First, it was a good public relations move in the sense that it managed to mend the company's relationship with its customers. One aspect of this positive effect may be seen in the performance of Apple's stock price following Steve Jobs' letter and the announcement of accommodation to previous iPhone customers, indicating that peace between Apple and its loyal customers has been re-established.

Second, according to a number of Apple customers, issuing the refund in the form of store credit was a "shrewd effort to encourage more business at Apple's online and physical stores" as the $100 store credits was only valid at these stores. Industry analyst Toni Sacconaghi estimated the financial impact of the credits on Apple's cash flow to be "very modest" given Apple's overall revenue and the number of affected iPhone users (Wingfield, 2007b).

Time permitting, it may be instructional to complement the in-class analysis of the student answers to the four case questions with a more general discussion of potential reasons for price declines. The most common themes that emerge during that discussion are summarized in Table 2 in the Appendix. It is important to note and point out to students that these themes are entirely independent of each other. For example, the ITPD theme discussed above may in some cases coincide with product obsolescence (that would be the case of Apple's practice of releasing newer, better products) but it doesn't have to as these two themes are completely independent of each other. Therefore it is very important that students be open-minded in their future analyses of declining price patterns since every such case is likely to have a different explanation or combination thereof.

This case has been tested in M.B.A. Managerial Economics classes at two business schools over several semesters. Class sizes ranged from fifteen to thirty-six students. The topic is typically of interest to students as they have experience with and opinions on Apple's products. Students appear well informed about Apple products as well as events in the technology market in general. Many students in fact go beyond the information provided in the case and contribute the results of their own research. Thus, the use of the case helps not only achieve course learning outcomes, but also improve student engagement in the Managerial Economics classroom.

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REENGINEERING A PUBLIC UTILITY AS AN ENTREPRENEURIAL ENTERPRISE: IMPLEMENTATION OF AN EXECUTIVE COMPENSATION PLAN

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INSTRUCTORS' NOTE

CASE DESCRIPTION

The primary subject matter of this case concerns implementing an executive compensation plan. The focus is the Board of Directors of the Electric Power Board of Chattanooga, Tennessee, when its role as a nonprofit public utility expanded to include an entrepreneurial enterprise, EPB Telecom. With this expansion, the need for, and the role of, an executive compensation plan became critical. The case has a difficulty level of three to four and is appropriate for junior-and senior-level undergraduates. The case is designed to be taught in 1.25 class hours and is expected to require two to three hours of outside student preparation.

CASE SYNOPSIS

Executive leadership and company culture are keys to success for growth and innovation. Rewarding executive leadership and encouraging best performance through an effective compensation plan can determine the eventual success and growth of any company. This case involves the student in measuring executive performance, determining the reward system for a changing enterprise, and determining executive compensation. Can a public utility under public scrutiny adopt a private industry culture and executive compensation plan? Students will use Key Performance Indicators (KPI's) to evaluate executive performance and determine compensation levels in major performance areas.

RECOMMENDATIONS FOR TEACHING APPROACHES

This case is appropriate for an undergraduate, senior-level class in human resources management. The case can be used in a number of ways: as a take home exam using end-of-case assignment questions; as homework for executive compensation analysis and subsequent class discussion; as a team assignment for role playing the views of the board of directors and recommending executive compensation, or used for in-class discussion

The case highlights executive compensation policies and issues associated with implementation. The inclusion of tables and appendices of actual documentation of the executive compensation plan allows students to experience the process by actually evaluating executive performance and determining compensation levels in major performance areas.

The Epilogue at the end of the Teaching Note can be used as a follow up for discussion and to update students on the current status of the case. It also demonstrates how effective a compensation plan can be in adapting to changing conditions – whether a public or private entity.

LEARNING OBJECTIVES

1. To explore the establishment and application of an executive compensation agreement.
2. To review the steps in implementation of a new compensation change, emphasizing the importance of culture in organization management.
3. To discuss the role of executive compensation in reengineering a public utility and using the compensation plan to encourage the organization to become more entrepreneurial and innovative.

ASSIGNMENT QUESTIONS FOR HOMEWORK

1. Assess Mr. DePriest as a Manager? Score the KPI in Table 9.

Students must match the KPI's with the performance report using Table 9 as a guide. The solution as shown in Table 10 and Table 11 (with the value of the KPI results) should show specifically his effectiveness as a manager for each area. Not all KPI's generate actual dollar savings. An executive compensation bonus is paid only if the funds generated by the KPI's are sufficient to pay bonuses for that fiscal year. For the first year the performance was rated as 110% by the Board. The results of the assessment of Mr. DePriest's performance were a bonus expressed as a percentage of his salary:

1. Short-term objectives – 30% of salary
2. Long-term – 10% of salary
3. Supplemental Retirement Plan – 5% of salary

1. Why establish an executive compensation plan? Why pay an executive additional fund for doing his or her job?

In this case, the board did not want to permanently raise the salaries of its executives but wanted to offer incentives for creating the entrepreneurial role of the company.

Table 10
EPB EXECUTIVE COMPENSATION PLAN*
Key Performance Indicators (KPI's) Rating Form
Short-Term Objectives and Board Ratings

	Board Rating of KPI's Value	**Measure-ment Value**	**Percent Complete**	**Score**
Financial Objectives (50%)				
Corporate				
1. Increase valuation of EPB Company	A	300	110	330
2. Successfully mentor	B	200	100	200
3. Successfully develop research	B	200	110	220
Power				
1. Write and maintain an accurate financial forecast	A	300	110	330
2. Cost reduction via employee head	B	200	100	200
3. Reduce annual electrical bad debt write-off	C	100	110	110
Telecom				
1. Grow telecommunications	A	300	90	270
SubTotal		**1,600**		**1,660**
Individual Objectives (50%)				
Corporate				
1. Design and implement an effective diversity program	A	300	110	330
2. Install equitable new compensation pay system	C	0	0	0
3. Mentor executive group to actively participate in Chattanooga area civic leadership	C	100	100	100
4. Maintain good employee relations	C	100	100	100
5. Write a succession plan	C	100	100	100
6. Improve management skills of company leadership	C	100	100	100
Power				
1. Customer satisfaction	A	300	110	330
2. Continue to improve service continuity/productivity	B	200	110	220
Telecommunications				
1. Revise marketing plan	B	200	110	220
Sub Total		**1400**		**1500**
Corporate				
1. Design and implement an effective diversity program	A	300	110	330
Power				
1. Operate an efficient power business	B	200	110	220
Telecom				
1. Redefine and manage transitional EPB management profile	B	200	110	220
Sub Total		**700**		**770**

*By Permission of EPB Chattanooga

Table 11 VALUE OF KPI RESULTS IN ACTUAL DOLLAR SAVINGS*		
KPI	**Results**	**Incremental Gain**
Increase valuation of EPB by $6.5 Million Net Plant Value	Plant value increased by $ $ 7,471,811.30	$ 971,811
Cost reduction via employee Head count maintain annual EPB employee average at 410 below or reduce overall and external labor cost	Total EPB employment began at 414 and ended at 408. Contract forces were reduced early in the year, and remain at low levels. Average EPB pay package is @ $40k. Six full-time reductions x 40K = savings)	$ 240,000
Reduce the annual electrical bad debt write-off from $760,000 to $400,000	Electrical bad debt for $204,415. ($760,000 - $ 204,415 = $ 555,585)	$ 555,585
Maintain good employee Relations as measured by Turnover at 12% or below and Unauthorized absenteeism at 0.01% or below.	Turnover was 8.3%. Unexcused absenteeism for the year was 0.002%.Net turnover difference from goal equal to 15 full-time positions (15 x 13,200** equals replacement cost savings) ** 33% annual salary (estimated USDL turnover replacement cost)	$ 198,000
	TOTAL	**$ 1,965,396**
Actual award to EPB executive for this period	Short-Term Bonus Long-Term Bonus Supplemental	**$ 45,000** **22,500** **15,000**
	TOTAL	**$ 82,500**
**By Permission of EPB Chattanooga*		

2. Why not just raise the executive salary instead of using the executive compensation plan?

The purpose of establishing an executive compensation structure is three-fold: First it serves as an incentive for achieving goals in a given time period – results oriented and the results should be measurable, secondly, key incentive indicators can be both financial and nonfinancial and tied to the planned activities of the business both strategic and operational, and finally, it motivates executives to perform at superior levels –talent management – allows the organization to hire and retain the best people to accomplish strategic goals. It is perfectly logical to pay for performance when the duties of the executive exceed existing job descriptions.

3. Should the board of directors of a company control the executive compensation process?

It is rarely wise to allow the executives who are being reviewed to become part of the control process. There must be autonomy in the assessment which can be maintained only if the board can maintain control of this process. This is especially true since the consultant frequently assists the executive in assessing their performance and for presentation to the board.

4. Should an executive compensation plan be continued indefinitely?

Circumstances should determine the use of an executive compensation plan, as situations change, as the economy and goals and objectives change, the executive compensation plan should be continuously reviewed. Ideally, the plan will be the linchpin in changes in the organization that may make a different compensation plan appropriate. Changing the structure of an organization causes an evolution in the strategy of a company. As the strategy changes, it may in turn affect the structure of the organization which will result in additional strategic changes. The process is a difficult balancing act.

5. Was the idea of EPB Telecom a good idea? Why? How should the EPB respond to criticism from private companies (Comcast, Charter, etc.) that they were using public funds to compete unfairly?

Yes. The decision was actually the perfect transition to changing the culture of EPB and making it become more entrepreneurial. As external regulation is changed, private companies were able to compete in utility activities without restrictions that are ordinarily association with a public utility. By taking the first step that utilized its existing resources and knowledge, EPB positions itself to become a truly entrepreneurial entity able to compete with the private sector and therefore assist in the economic development of the city and cost-control for its citizens. Economic growth and continuous development of a community depends on entrepreneurship. The only way any public utility can compete in the marketplace is by following the same ground rules. EPB did not use any of the power company's resources or generate any additional funds from EPB to pay salaries. They systematically and deliberately separated the public and private companies so they had intrapreneurship and entrepreneurship in the same company.

ADDITIONAL QUESTIONS FOR IN-CLASS DISCUSSION

1. Given the list of objectives that EPB Telecom should accomplish, do you agree that rewarding performance and hiring experienced people should be first? Why or why not? Suggest possible challenges or benefits if a different order in the five objectives were chosen.

Rewarding performance of people hired with the experience needed in the fields that reflect the strategy of the organization must be first. A plan or strategy can only be implemented is if the objectives are reflected from the top of the organization. Without this leadership and guidance the other objectives could not be met.

2. Discuss the formation of the Compensation Committee. Was it effective?

When reviewing the information to determine Mr. DePriest's annual raise, the board was surprised to see that compensation was not based on merit but by tradition. The committee was formed specifically by the board to address this issue and to initiate a policy of rewarding performance versus a traditional cost-of-living raise. The committee was effective because the members strongly believed in making these changes to the compensation and that compensation of all employees should be merit-based.

3. How can KPI's be used in organizations?

KPI's must be based on the strategic plan of the organization. If they are closely linked then there will be progress in the organization. Individuals will be compensated on their accomplishments toward fulfilling the strategy of the company. All goals in the KPI are thus mission driven and support the strategy of the organization and reflect merit. They also provide direction for the organization and provide an objective assessment of the employees and also provide a guide for needed future changes in the employee's performance. Used annually at a minimum, it serves as a check and balance for the organization to determine whether supporting executives are fulfilling their roles. It can prevent leadership and employees from engaging in activities that support their own self-interests.

4. Define organizational culture. How does it limit and/or support strategic change?

Organizational culture is derived from top management. An organization's culture depends upon the leadership of the CEO. It is difficult to change, but not impossible; however, if strategic change is to occur, the culture must fit the goals and objectives of the new strategy.

5. Why was the consultant needed? Describe an organization's characteristics that could implement such a venture without an outside consultant.

The board of directors wisely recognized that an executive compensation plan was beyond their expertise. They did not feel comfortable to develop a plan. The new entity set up by EPB (fiber to the home; smart grids; research consulting activities, etc.) was characterized by different objectives (innovation, speed, customer service, reasonable cost, commitment to community growth). These characteristics were inherent in the consultants. If these characteristics are present in the organization, the consultants are not needed. As the culture changes over time, management may be capable of making changes without a consultant.

6. Can one board successfully manage both EPB and EPB Telecom companies?

Yes, but only if the CEO understands the goals and objectives and works closely with the board. The board at EPB was re-defined by the city leadership and the plan executed by the current mayor who was determined that board members be industry leaders and understood the mission of the city. New members were added to the board reflecting the city's vision and a deliberate decision was made to join a CEO with vision and entrepreneurial ideas with a governing entity that would support those ideas.

7. How did the presence of "The Big Five" challenge EPB Telecom?

It hampered their ability to respond to the need for change in the perception of how a public utility should be run and whether it should engage in entrepreneurial activities beyond its original charter. While there was no interference by the big five there was a perception issue required handling by the CEO of EPB.

8. Is there a potential market for EPB Telecom? Why? What can the venture mean for a city like Chattanooga, TN.?

Yes. Whenever there is control of a market under a semi-monopolistic structure and competition from outside, demand should be more responsive to price competition. Being the leader in providing an alternative service should result in lower costs for businesses. Other industries relying on telecommunications and high speed access will be attracted to the city thus fostering economic development. From a macro-perspective it can lead to more jobs, better supporting infrastructure, more innovation, and cultural improvement for the city.

9. What mistakes were made that could have been avoided?

The board recognized several initial mistakes and have subsequently discussed whether they should have patterned the area of expansion after a similar public utility. They felt they had fallen into a "trap" of perpetuating the same mentality in the telecom venture. If the Board had been more aggressive in hiring outside individuals (not associated with the public utility) the initial years of lower than expected productivity could have been avoided. When the board began to recognize the low performance, they began to rely on sources outside the industry to get a more directed focus on the venture.

EPILOGUE

EPB achieved even greater goals than originally anticipated. Students should read the epilogue following discussion of the questions in the TN and brainstorm how the process can be applied to other companies, industries, cultures, and companies.

THE PLAN

EPB's Executive Compensation Plan (ECP) is an ongoing element. Among the changes from the original ECP are:

1. The inclusion of several levels of management who are eligible to participate in the plan. They were incrementally added to the ECP approximately three years after the plan was adopted.
2. New KPI's were developed to reflect the culture and the expansion of the entrepreneurial ventures of EPB. The KPI's still include strategic objectives, but have been expanded to include such strategies as preparing for the future, providing enhanced values to the community and developing a leadership position in the community. All strategies must directly relate to EPB's mission statement.

The Board of Director's directives concerning the parameters of the Plan are still rigorously followed: a self-funded plan, based on the accomplishment of KPI's that are derived from EPB's Strategic Plan, and results that are determined exclusively by "hard" measurable factors. Each executive is personally responsible for the development of his/her KPI's. Approval is the sole responsibility of the CEO but subject to review by the Board.

The evidence of the positive impact of EPB's Executive Compensation Plan is impressive. The annual incremental gains, as measured by the strategic objectives of the KPI's, have been positive for each year since 2002. This has allowed EPB to lower costs and expand services.

THE CITY

EPB has continued to play a major role in the development of Chattanooga. The combination of entrepreneurial Mayors, City Council and the CEO of a major utility resulted in significant accomplishments for Chattanooga. The City continues to attract new businesses—local, national and global—because of the competitive Smart Grid instituted by EPB. The role of the Executive Compensation Plan is undeniable. It allowed EPB to attract superior employees, instill a culture of innovation and efficiency, and create an atmosphere of exceptional customer service.

The list of achievements is impressive. EPB Telecom (launched in 2000) expanded its operations (2003) to include an all-fiber high speed business internet service which is 300 times faster than traditional connections. This was followed by a "Fiber to the Home" initiative (2007), the implementation of which was to begin in 2008. In 2009, EPB was awarded a $111 million grant from the U. S. Department of Energy to share the cost of the installation of new "smart meters." The latter allows continual monitoring of energy usage and its cost. It also helps reduce an estimated 40 percent of outages. The system was completed in 2012. By 2012, all EPB customers had access to the company's fiber based television (i.e., cable), internet and telephone service.

To further enhance Chattanooga as a destination for new businesses and potential new residents, EPB upgraded its fiber network (in 2010) to add a one gigabit-per-second internet service. At the time, demand in Chattanooga for the gig was not extensive. EPB was confident that the mere availability of the gig would be effective as a marketing mechanism for the City's business development. It would attract businesses needing a gigabit of broadband to achieve greater profitability

In fact, Chattanooga was the first city in the Western Hemisphere to offer one-gigabit-per-second internet services. The announcement of this accomplishment generated global interest. Chattanooga has been recognized both nationally and internationally for having created an economic advantage that has given the City a major competitive edge in economic development. To say the least, the first few years that EPB used the ECP were rocky, but all agree the changes were worth the effort.

THE TRILATERAL MBA: AN APPROACH TO INTERNATIONAL EXCHANGE OF STUDENTS

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INSTRUCTOR NOTES

CASE DESCRIPTION

The primary subject matter of this case is the development and implementation of a joint graduate program involving schools from multiple countries. Secondary issues examined include funding, business models, and evaluation of joint international programs. An innovative MBA program involving students and universities from three North American countries is presented. Other issues include the adapting of curriculum and using funding sources for these types of programs. Students reading the case are faced with a critical decision at the end of the case including whether the joint international program can continue and in what format.

The case has a difficulty level of five, appropriate for first year graduate level or above. The case is designed to be taught in one hour following appropriate introduction of the key issues involved. The case is expected to involve one hour of student preparation.

CASE SYNOPSIS

The face of internationalization of universities is changing. Students are opting for more programs where they earn a degree at an international institution. Universities are adopting new and innovative programs to retain high achieving students who have the ambition and drive to study outside of the U.S. While universities understand the importance of increasing the internationalization of their students, they also understand the importance of doing so at a cost neutral or relatively low cost method. This case examines the experiences of a U.S. institution, a Canadian institution, and a Mexican institution as they design and implement a joint program using the "twinning" approach. It examines some of the internal and external challenges that arise in internationalization efforts today.

While this case centers on the experiences involving an MBA program, the issues involved are easily adapted to other international and/or joint programs. This case can be centered on many different facets – curricular design, financing, development and balance of exchange programs, benefits and costs to students and a university of exporting and importing *students, the role of grants in internationalization efforts, student recruiting, and selecting the appropriate exchange model.*

RECOMMENDATIONS FOR TEACHING APPROACHES

You may approach this case in several ways, depending upon the particular course in question. This case is helpful to any class in which internationalization is discussed, where students are discussing study abroad opportunities, where program assessments and learning objectives are important issues, and strategy units where program decisions rely upon both external and internal variables. Business, education, language, and other departments often examine these issues.

The primary question to ask is "what should the institution(s) do?" Students should be reminded of the multiple goals of this program and other global studies programs – to increase the internationalization of students (through study abroad or exposure to students from other countries), to gain an understanding of differing cultures and how they affect business and other relationships, to develop a curriculum that includes global learning objectives, and to do so in a cost effective manner. For purposes of discussion, three alternatives could be offered for student discussion:

1. The TMBA should continue as it is.
2. The TMBA should be discontinued
3. The TMBA should change the business model and continue
4. You should consider changing the partner school(s) to include destinations your students have a greater interest in visiting. If this option is selected, you should suggest the countries and types of schools. How do you present this to the school(s) that you no longer wish to have involved?

Refer to the alternatives presented in the case:

1. Direct enrollment – students pay tuition at the institution where they are taking classes. This option works well if the cost of tuition is comparable at the participating institutions. Students should discuss the differentials in tuition paid at public vs. private institutions in Mexico, tuition for institutions in Canada, and tuition at their home institution. How would this impact the mix of students in the program? We believe this would limit the incoming students, in particular those coming from Mexico, to those from a much higher socio-economic status. Does this impact the tangible and intangible benefits to the US institution?
2. Continuing Education/Outreach – a more recent model for entrepreneurial programs at some institutions is where programs are operated by an arm of the university with more flexibility at funding and tuition. Under this process, differing tuition may be allowed, providing a mechanism for balancing exchanges without suffering significant financial loss. Students should discuss the impact this has on curricular design and restrictions it may place on the ability of the US institution to incorporate the visiting students with a wider range of domestic students.

3. Twining programs – an exchange, where students pay tuition to their home institution while studying at a host school. Therefore, each student from one country is "twinned," for accounting purposes, with a student from the second country. Under this approach, unless there is significant US demand, we introduce significant volatility into the program. The three institutions must be willing to operate with significant uncertainty from year to year regarding the number of students who will participate in the program. It also requires that the institution with high demand turn away students based solely on the demand at the partner schools. Balance may be kept by seeing outside sources to provide scholarships and grants to support participation by students from the US institution, thus increasing the demand.

4. Balanced twining program – a special case of twinning which requires a balance between incoming and outgoing students, either on a yearly basis or on a rolling basis. This option has many of the same limitations as the first alternatives in that if there are significant differences in the tuition paid at the participant schools, it might lead to a change in the mix of the students involved. This approach might also be used if the institution values the intrinsic benefits received as a result of the program and is willing to underwrite the deficit.

5. Hybrid – a mixture of these approaches may be employed. This could be approached by finding grants, endowments, or sponsorships to support the difference in the tuition dollars received by domestic students and the tuition dollars needed for the incoming students.

There is no clear-cut answer to these questions. However, it could open the discussion to the benefits of internationalization and how to achieve the goals of a particular university and/or program.

Regardless of the option selected, students should understand the loss incurred under the current arrangement. The first US intuition was down the cost of eleven semesters worth of tuition. The second US institution was down seven semesters of tuition.

If you wish to concentrate on the financing of study abroad/internationalization programs, you could assign teams to determine the financial burden to the department (or university) of this particular program (twinning) and compare that under different funding models (balanced twinning, continuing education/outreach, direct enrollment). Discuss the pros and cons of each. What is the best method to approach this and why? What impact does the tuition paid at your partner schools have on your answer? Would this affect your selection of partner schools? What are the intrinsic costs involved with limiting your partner schools to those with similar fee structures should you select a method where all students pay tuition at the host institution, either directly or through an annual settlement?

"Best" is somewhat subjective. Students should consider the benefits that accrue to the university as well as those which are seen by the individual participants. How much should the university be willing to underwrite? Why? You could engage students in a discussion of how limiting the participants – excluding lower income countries or limiting participation to only private institutions in lower income countries – would affect the experience of your students when they become mobile.

Regardless of the approach, you might want to include the assignment of finding the travel policies (e.g. response to travel warnings) for your particular school and a review of the U.S. Department of State Travel Warnings in general (http://travel.state.gov). How would a travel warning affect YOUR students? How should a university respond to travel warnings? Would a viable option be to find a partner in a country where there are not travel warnings? If so, what do you do should unrest occur? In addition to Mexico, consider the recent volatile situation in the Middle East and how you might want to consider potential problems (e.g. South Korea).

The answers to this question are somewhat subjective and should provide for a lively discussion. You might wish to engage the students in a discussion on legal liability to the university and how to go about minimizing exposure.

A second question is “How do universities and students best assess the value of study abroad programs like the TMBA program?” What are the benefits to your students? What are the benefits to your university? What are the benefits to your faculty? This question is related to the first question since if there is little value in the program there is much less motivation to continue it.

A good answer might use one of the analytic structures found in the case.

Near the end of the case there are a set of variables upon which such programs are assessed in terms of value:

1) Cross-cultural competency – The case does not provide any measures or examples of specific behaviors concerned with such a competency. Students can have a good discussion on how a program might measure this competency. What would be the subcategories of cross-cultural competency?

2) Language acquisition – TMBA students studied a foreign language along with their MBA studies although the professors all taught in English regardless of where the courses were taught. While the case did not discuss this explicitly, students should understand that a good deal of learning, including language, took place since students all lived in two foreign countries. Remember that the Canadian university was in a French-speaking university.

3) Value added to the student learning experience for participating students (employability, increased earnings potential, etc.) - Students can discuss their perception of the value of the TMBA or other such programs might be in the eyes of employers and the impact it might have on future earnings. The case points out that TMBA graduates received a certificate signed jointly by the three schools in addition to their home school MBA diploma.

4) Value added to regular MBA students not part of the TMBA cohort but who interact with TMBA students – The case discusses that students sitting in class but not part of the TMBA cohort reported “positive experience through interaction with students from different cultures.” Students can discuss the value of the added diversity added by international students studying abroad in the student’s country.

5) Expansion and enrichment of the institution's curriculum – The case discusses the fact that the U.S. college had to add an entire new course to its curriculum, "International Accounting." This course is now regularly offered to domestic students. As the case points out, the Mexican university required an internship and a thesis for its students. The Canadian school required additional courses also. The discussion between the program leaders from each of the three schools led to good discussions about the value of internships, a thesis, International Accounting, and other aspects. It might be interesting to ask student what should change in their institution's curriculum.

6) Increased collaborative options for faculty and staff – While this is not discussed directly in the case, program leaders from each university meet at least twice per year. There have also been visits from some members of the faculty of each university to one or both of the partner universities of the TMBA alliance. This has involved faculty primarily. Students might discuss what kinds of collaborative efforts might be expected from such an exchange of students. Students will likely discuss how teaching and learning might be improved but the discussion leader might suggest that research and writing might be enhanced by a more informed international view as well.

A question might be, "Why has the number of U.S. students studying abroad leveled off for the first time in 30 years?" Here are some suggested answers that might be assigned.

1. The economy - The case suggests that the weak economy might be to blame. The economy can actually explain a couple of reasons the increase in U.S. study abroad leveled off to about a 1% increase. Students can certainly having less "spare" money during tough economic times but might not realize that most universities also have needed to cut their budgets. Public universities in particular have had to cut back in a number of areas and sometimes student travel and global educational investments are still often considered expendable.

2. Program design and opportunity – The case quotes Goodman, president of the IEE as saying we should not blame the plateauing of study abroad participation *entirely* on economic reasons. He said "We have the wrong paradigm". Student's can be asked "what is a better paradigm different from the one that exists for study abroad at your own school?"

One of Goodman's ideas is to introduce opportunities well before the junior year in college. What are others?

What role does length of program, in terms of weeks, play in the desirability of study abroad opportunities to U.S. students? Why do U.S. students typically enroll in the shorter programs? Many observers would contrast the short trip preference for U,S, students with the long trip preference of students from other nations. It is common for students from the EU to spend at least a semester in another country studying (some programs require such study).

3. The perceived danger of international travel – The case indicates that the countries with the largest drop in U.S. study abroad students were Mexico (-42%) and Japan (-33%). These are dramatic decreases. Students should discuss whether the press reports of drug-related murders and other violence in Mexico were the real reasons TMBA applications stopped coming

in from the U.S. and Canadian students. Students could discuss when the effect of this violence on travel would become sufficiently old that it would no longer inhibit student applications. The drop of students going to Japan, ostensibly due to the tsunami and the resulting devastation, is another good topic to discuss. Again, how long will that event affect traffic of study abroad students to Japan?

Is the of the top U.S. study-abroad destinations provided in the case - the UK, Italy, Spain, France, and China – selected on the basis of safety? Students can be asked about what variables do lead these countries to be those to which the most U.S. students travel?

A fourth discussion question might be, "What role could technology play in satisfying some of the traditional goals of study abroad programs?"

On the technology side, students can engage in a discussion of developing technology and its role in making the world smaller. Technologies like online learning, social media, and "Telepresence" or High Definition videoconferencing, are now integrated into modern society and business.

One the learning goals side, students can refer to one of the sets of goals provided in the case: one from the perspective of the student and another from the perspective of the university.

Marion's set of student focused variables are

1) greater awareness of cultural relativity,
2) increased open-mindedness,
3) broadening of horizons, and
4) new insights into one's own self.

Institutional type variables are

1) interest in international security,
2) maintenance of economic competitiveness, and
3) fostering of human understanding across nations.

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SOUTH CAROLINA DEPARTMENT OF REVENUE: MOTHER OF GOVERNMENT DYSFUNCTION

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CASE DESCRIPTION

This case describes a successful spear phishing attack, the factors that precipitated it and the response to the crisis by top management. The primary issues concern the mismanagement of information systems security by top management, the conflict in goals between executive management and the information security professionals, and crisis response.

This case can be used to highlight several different perspectives. One perspective involves the management of information systems and information systems security, a second involves information silos, and a third concerns crisis management. This case is suitable for graduate and advanced undergraduate management information systems classes. The case has a difficulty level of five. Students should spend from ten to fifteen hours outside of class analyzing the case, depending on the breadth and depth of the analysis the instructor desires.

CASE SYNOPSIS

In 2012, the South Carolina Department of Revenue (DoR) was a victim of a spear phishing attack that led to the biggest data security breach on record for a U.S. state government. This case describes how the spear phishing attack began, what the attacker did, and the conditions that made the DoR vulnerable to the attack. The attack, which resulted in the theft of confidential data on 3.8 million individual taxpayers and 699,900 businesses, was enabled by an executive decision not to spend a relatively small amount of funds for a needed information system security system. The initial response when news of the attack became public is a classic example of poorly handled crisis management.

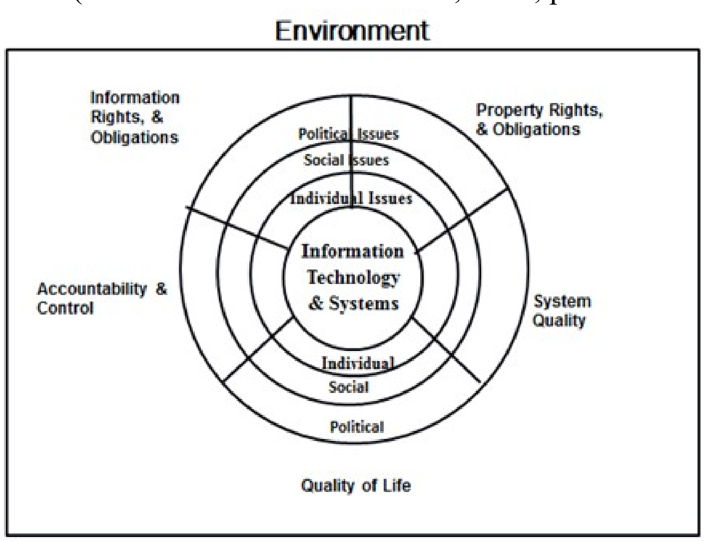
The DoR is responsible for collecting and processing $8.5 billion of tax payments. Decisions to reduce expenses for proper safeguards to protect its computer network, databases, and taxpayer data, made the information system vulnerable to the attack. Mismanagement of the information system is a chronic problem for state governments due to their hierarchical structure and insufficient funding. The case title characterizes the incident and how it was handled as the "mother of management dysfunction." While this portrayal may be extreme, it is not made lightly. Rather, it reflects the seriousness of the incident and issues related to it.

INSTRUCTORS' NOTES

Two main issues can be identified in the case: (1) the conflict in between the goals of executive management and the goals of the information security professionals; and (2) information silos operating in a highly departmentalized and hierarchical structure of the state government. The instructor might have students identify various symptoms and link them the problem that caused the symptom. A partial list of symptoms includes: the DoR directors rejecting the advice of the chief information security officer to spend funds for the dual password software, leaving the department CIO position vacant and not increasing the CIO salary to a market competitive level, increasing employee resignations, information systems policies and security decisions are not integrated with other departments; and there is no overarching CIO to establish and enforce information systems policies across all departments of the state government.

The central message of the case is that executive managers must take information security seriously, even when budgets are reduced. Managers must protect the computer and information resources that they and their organization use. This requires adopting a risk management perspective in which money spent on security is viewed as insurance to protect a valuable asset, information, against known risks. In today's online world, government systems, business systems, and personal computing devices are under constant attack. The attackers are not stereotypical young nerds challenging their skill at breaking into systems. Instead, they are highly knowledgeable professional criminals, organized crime syndicates, and government spying units that break into systems to steal money, personal data, or confidential documents.

Figure 1: Ethical, Social, and Political Relationships in an Information Society
(Source: Laudon and Laudon, 2012, p. 129



Other topics that could be addressed include: (1) the importance of security awareness training for executive managers; (2) the need to consolidate IT security policies and management for all state agencies under a single chief information officer; (3) crisis management; (4) critical success factors for information security and security management; and, (5) the relationship between environmental factors and information systems from a systems view approach is shown in Figure 1.

LEARNING OBJECTIVES

Students will learn what spear phishing is, how it starts, and what a spear phishing attacker can do. Students will learn that information security is an investment that should not be compromised, even during periods of budget cuts. Students will learn the need for executives to be knowledgeable users of information systems who follow good security practices. Students will learn the importance of crisis management.

While learn what happened and how it happened are important, students can gain a richer learning experience by engaging critical thinking skills to analyze bigger questions, such as: Why did the director know about the danger of opening an attachment to an email message from an unknown sender? Why did the DoR director make the decisions he made? What might have been his underlying motivation or mindset? Why was the DoR an information system silo? Why isn't there a CIO in the South Carolina Executive Cabinet? These questions are not included in the following discussion. It left to the instructor to decide whether to ask these questions.

TEACHING METHODS

The instructor should act as the moderator for the case discussion. The case questions may be assigned to individuals or groups. Alternatively, groups could be assigned one or more questions to answer, then the class be brought together to present and discuss their answers.

DISCUSSION QUESTIONS AND NOTES

The following questions can be used by the instructor to stimulate class discussion.

QUESTION 1

Why was the spear phishing attack on the DoR successful?

The attack was successful, not because the DoR had "1970 equipment." The security breach began when the director opened a malicious file attached to an email message sent by someone he did not know. Why the director was seemingly was unaware of the dangers of opening such email attachments is not known. Students might say it might be due to lack of security training, or information systems user experience related to age.

The state government does post cyber security policy and use guidelines on the Division of State Information Technology (DSIT) Website. These Guides are written for non-technical users. DSIT recommends distribution of these guides to all executives, managers, information technical managers, as well as staff. The DSIT conducts numerous security training programs to provide education and awareness about cyber security to all state agency managers and employees. Apparently, Etter did not know about, or follow, the cyber security guidelines. It is likely that he had not attended user training workshops during his tenure as the head of the DoR.

It is not known whether the DoR used an email proxy server with spam and phish filters capable of detecting and deleting suspicious attachments. Such proxy servers are a common safeguard used in organizations today.

The director's rejection of the department's chief security manager's advice to purchase a license for the dual password software turned out to be worse than "penny wise and pound foolish." It was $25,000 wise and $14 million dollars foolish, and Etter got fired as well.

Apparently, the DoR did not perform frequent checks of its server logs for unusual activity. Checking the logs is how the Mandiant forensics team was able to detect when the intrusions occurred, what the attacker did, and how the attacker did it. Organizations, typically, use proprietary software, such as Log Analyzer, to run regular security scans of server logs to detect unusual accesses and activities by employees and intruders. Intrusion detectors, like GFI EventsManager, can "automatically analyze and archive logs from a variety of servers, devices, and systems, such as Windows servers and workstations, firewalls, routers, SQL Server and Oracle databases, IIS, SharePoint and Exchange servers and many more." (GFI.com, 2013) Either the DoR did not have intrusion detection software, or did not use it.

QUESTION 2

What organization factors made the security failure possible?

The short answer: The conflicting goals between the focus on cutting expenses and the responsibility for protecting the department's information systems. The longer answer: Leaving the CIO position vacant for a year left a missing link in the chain of command between Etter and the IT personnel. Without a CIO, no one was overseeing and coordinating the information system resources or had the status to press the security issues with the department director. Without a CIO, information systems decisions and management responsibilities became the director's responsibilities, which created conflicting objectives for him.

Director Etter's focus on cutting expenses conflicted with the need to hire a CIO and the acquisition of needed security software. The lack of priority for security is evident in the DoR 2011-2012 Accountability Report in which security is mentioned only once (S.C., 2012, p. 37).

> *4.5. An independent security audit was completed on our computer systems to help maintain data integrity, accuracy, and security ensuring the reliability of data used for decision making.*

> *Business Objects ... is a primary tool for giving reliable, accurate, and timely feedback on performance, allowing better opportunities to improve during the process versus at the end of the period (S.C., 2012, p. 37).*

QUESTION 3

What are the information system responsibilities of executive management? What are the critical success factors for information security management systems?

To be effective, the ISMS must: (ENISA, 2006, p. 18)

> Have the continuous, unshakable, and visible support and commitment of the organization's top management;
> Be managed centrally, based on a common strategy and policy across the entire organization;
> Be an integral part of the overall management of the organization related to and reflecting the organization's approach to risk management, the control objectives and controls, and the degree of assurance required;
> Have security objectives and activities based on business objectives and requirements;
> Undertake only necessary tasks and avoiding over-control and waste of valuable resources;
> Fully comply with the organization philosophy and mindset by providing a system that instead of preventing people from doing what they are employed to do, enable them to demonstrate their abilities;
> Be based on continuous training and awareness of staff and avoid the use of disciplinary measures and "police" or "military" practices;
> Be a never ending process.

QUESTION 4

In what ways did the executive managers fail to perform the responsibilities listed in Question 3?

The director did not show a visible support and commitment to information systems area. Hiring someone to fill the top CIO position, which had been vacant for one year, indicates lack of support and commitment. Also, offering a salary that is well below the CIO market salary indicates a lack of support and commitment.

The director overruled the advice of the professional IT security manager, rather than allowing him to do his job of protecting the department's information and to demonstrate his abilities. Rejecting the advice to purchase a $25,000 license for the dual password and monitoring system, did not understand the security risks, security objectives and requirements of the IS function. Apparently, the director did not understand the risk of spear phishing to the department's network and database (Adcox, 2013).

Top administrators were focused on cutting expenses, which may have made employees feel their jobs were at risk, managed the department in a top-down style. The politically appointed director had many years of experience in building and running his own businesses, any may have felt no need to involve employees in making decisions. This management style may have conflicted with the department's existing culture.

QUESTION 5

What are information silos? What problems do silos create?

An information silo exists when a system is managed separately and is unconnected to systems in other functional areas or departments. The DoR system is independently managed from the other state government information systems, in that there is no overarching management function to oversee and enforce information systems operations and policies. Information silos generally result in "silo thinking," "silo vision," or "silo mentality." In other words, department decisions tend to be myopic in that they fail to consider the policies, practices, and needs of the greater organization. Silos also limit productivity, provide greater opportunity for security lapses and privacy breaches, and frustrate stakeholders who increasingly expect information to be secure.

Figure 4 of the case shows the organization chart of the state government. The Statewide Chief of Information Security Officer (listed as Statewide Security) reports to the director of the DSIT, who reports to the Governor's Chief of Staff, who reports to Budget and Control Board. The members of the B&CB are the: Governor, State Treasurer, Comptroller General, Chairman of the Senate Finance Committee, and Chairman of the House Ways & Means Committee. This position in the hierarchy limits the authority of the statewide security function to the DSIT. Those functions will not to be need greater power in the state government. To achieve that, South Carolina will need to create a centralized IT division, headed by a Cabinet-level CIO, that is empowered to set and enforce standards across state all departments and agencies. Information security must be a high-level priority across the entire state government.

QUESTION 6

Why do information silos exist in organizations?

Historically, state governments have hierarchical structures with multiple departments with multiple levels within each department. Over time, the chains of command increase as state government takes on more programs and provides more services.

Information silos exist because management does not perceive any benefit from sharing information with people in other departments (Krytalkeen, 2012). Also, given that information is power, especially for those who have control over critical information, silos are a way to exert power and to protect it. The DoR is a very powerful department in state government because it is responsible for collecting the revenue, and it is a powerful player in determining the state budget. One characteristic of silos is the information system and data belong to the department, rather than the organization. In a silo, there are usually substantial barriers preventing users from departments accessing the system and its data. Outside users often are required to attain special authorization or training before being assigned access privileges.

QUESTION 7

Using Figure 1, in what ways might political issues have affected the security of the DoR information system?

From a systems perspective, the DoR is an open system affected by the individual, social forces, and political forces (Laudon and Laudon, 2012). Information systems and managers are not immune to these environmental forces. Managers of governmental information systems are especially constrained in their management policies and practices by political issues.

Given that the DoR Director is political appointee and elected state officials are focused on reducing government spending, one might reasonably speculate that spending funds on something not included in the current budget would be discouraged. While the director's motivations are unknown, it might be a useful in critical thinking exercise to have students identify how political issues might have influenced director's decisions. Some possible answers follow.

At the time of the attack, the DoR was developing new online applications and a data warehouse, which required a great deal of resources. These projects may have been straining the department budget. Also, executives tend to like to build new and visible systems that impress people, rather enhance security which is invisible. Even the best IT professionals can't protect a system when management fails to provide adequate funding for security.

The position of department director is a political appointment, who, in essence, an outsider who will leave in a relatively short time. In the private sector, departmental executives typically come up through the ranks and have a great deal of exposure to the people, processes, and systems in the department. Alternatively, administrators who are merit or classified employees are permanent employees who retain the job when the executive administration changes due to elections. Thus, political issues exert less influence on merit employee decisions.

Decisions involving risk have political ramifications. The Risk Aversion Principle, as observed by the medical profession, provides a useful guide for managers in business and government. In short, the principle states that one should take the action that produces the least harm or the least potential cost. Following this principle requires paying great attention to the high-failure-cost potential of moderate to high probability. The risk of a security breach of the DoR information system is high, due to its connection to the Internet and the high black-market value of the information it contains. The potential individual, social, and political costs resulting from a security breach are very high, also.

QUESTION 8

What mistakes were made in handling the crisis? What should have done instead?

The answers can be framed using the five stages of crisis management model (Welch, 2008).

Stage 1: Denial
This stage usually begins by claiming the problem isn't very bad, or claiming that it isn't their problem. The mark of good leadership is the ability to dispense with denial quickly and face reality. It becomes the leader's job to help people confront reality, create a new direction, and inspire people to positive action.

Stage 2: Containment
In this stage for people to try to keep the problem quiet. From there, it is not uncommon to find that leaders, even those who are extraordinarily gifted, try to make the problem disappear by giving it to someone else to solve.

Stage 3: Shame-Mongering
This stage is exemplified by finger pointing fingers, blame shifting, and donning the mantle of victimhood. Various stakeholders fight to get their side of the story told and portray themselves as a victim.

Stage 4: Blood on the Floor
In just about every crisis, there is at least one high profile person who becomes the "fall guy" and gets fired. The DoR crisis is no different. James Etter was forced to resign. What is not evident is Etter trying to take other people down with him. He went quietly.

Stage 5: The Problem Gets Fixed
The last stage is when a plan is developed, accepted, and implemented. Eventually, the crisis is resolved and the organization is usually improved. It is too early to tell when or how this stage will begin in this case. The legislature may appropriate emergencies funding for DoR to address the immediate problems. The longer-run solution will require legislative action to authorize reorganizing state government and for creating a State Chief Information Security Director position vested with the power to create and enforce information security policies for all state computer systems. This stage, most likely, will take a long time to complete.

When the public was initially informed of the attack on October 26, it was said that the attack was so sophisticated that nothing could have prevented it and that no one was to blame. This is both a Stage 1 response--deny culpability, and a Stage 3 response—"we're innocent victims."

Another Stage 3 response was invalid claim that "…that we had 1970 equipment. This is a new era in time where you can't work with 1970 equipment, and you can't go with compliance standards of the federal government." (Have students visit the DoR Web site at http://www.sctax.org.) As described in the case, the DoR information system is actually fairly sophisticated and up to date, except for security.

The attempt to scapegoat the Internal Revenue Service (IRS) for the security breach that exposed taxpayer Social Security numbers (SSNs). The claim that South Carolina is compliant with IRS rules and that the IRS does not require SSNs to be encrypted, and that other states do not encrypt personal data was an embarrassing gaff. This is certainly a Stage 3 response. One might argue it fits Stage 2, in that the SSN encryption problem isn't a state problem to solve. The initial confusion over important facts could be part of a Stage 2 attempt to conceal administration mistakes.

When the press asked for a copy of the DOR data security policy, they were told that disclosing the policy might further compromise security. Stonewalling the media is usually a bad idea. This is a Stage 2 containment response.

When we asked how someone could have used the Internet to gain access to the DoR system, the press was told the Internet wasn't used. However, the Internet was used to send the spear phishing email message, as well as for entering the DoR network, and for transmitting files into and out of the DoR network. This simple confusion could be a Stage 1 denial response.

Initially, the attack was portrayed as a man-in-the-middle (MITM) attack by someone intercepting network transmissions or "conversations" within the DOR's statewide wide area network (WAN). This could be classified as a Stage 1 or Stage 2 response.

A MITM attack can occur if one victim is using an unencrypted Wi-Fi wireless access point, which enables an attacker to intercept messages. The man-in-the middle attacker intercepts the messages transmitted between two users and uses the message encryption keys of the users to fool them into thinking so they talking to each other instead of the attacker. An MITM attack can succeed only if the attacker has the message encryption keys of authorized users.

MITM attacks are not common because network operating systems have embedded cryptographic protocols that provide endpoint authentication. SSL (Secure Socket Layer) is a highly secure and common encryption protocol used by businesses and government bodies worldwide.

At the November 20 press conference to release the Public Incident Response Report, it was acknowledged that state officials did not do enough to prevent the attack. The resignation of the Director of the DoR is a Stage 3 action.

The action of former DoR security chief, Scott Shealy, testified before a House panel that both Etter and the former department CIO would not listen to his advice about implementing the dual password system. Shealy said the security breach actually wasn't very clever or hard to detect (Adcox, 2013). This could be a Stage 4 behavior where a former employee piles on the scapegoat and tries to implicate others.

In summary, the administration should have better understood and admitted the seriousness of the problem (Stage 1), and not try to blame others (Stage 3). The initial actions were short-term, stopgap measures. The top government officials should have accepted responsibility, taken firm steps to find out what happened, and promised to find long-term solutions to protect citizens' confidential data. Immediate authorization to hire an experienced CIO for the DoR, at a competitive market salary, should have been made. Additionally, a proposal to re-organize the structure of the state government with a cabinet-level CIO with authority over all state government computer systems should be initiated. However, these measures carry significant political risks because they run counter to the dominant political trend of downsizing government and cutting budgets.

QUESTION 9

Should the State of South Carolina consolidate IT policies and oversight for all state information systems under a single State Chief Information Security Director (SCISD), as some states have done? If so, what would be the advantages? Should the SCISD be a politically appointed Cabinet officer? Or, should the SCISD be a nonpartisan, career merit position? Explain.

South Carolina could break down its departmentalized information systems silos by consolidating IT management into a single department, such as Alabama, North Carolina and others have done or are doing. North Carolina is consolidating the IT priorities of its Office of State Budget and Management with those of the State CIO in order to target IT infrastructure issues that pose significant risk to agency operations or data, or that provide opportunities for immediate cost savings. For South Carolina, this would be akin to turning the Budget & Control Board's IT management, which oversees all departments, over to the State CIO in the DSIT.

The mission of the North Carolina IT Consolidation Program is to "Optimize information technology investments by focusing on the consolidation of local area network, voice, data center (servers), security, desktop, and service desk operations and services." (North Carolina IT Consolidation Program, 2013)

Consolidation of IT management across all state agencies must be provided appropriate funding by the legislature and must have an organizational model to support and sustain the consolidation effort. The SCISD could be vested with enforcement authority to ensure the statewide security policies are uniform, implemented, and followed. To successfully accomplish consolidation would require the executive branch and legislature to work together to enact the necessary enabling legislation.

Below is a job description for a California State Chief Security Officer.

> Responsible for determining enterprise information security standards. Develops and implements information security standards and procedures. Ensures that all information systems are functional and secure. Requires a bachelor's degree with at least 12 years of experience in the field. Familiar with a variety of the field's concepts, practices, and procedures. Relies on extensive experience and judgment to plan and accomplish goals. Performs a variety of tasks. Leads and directs the work of others. A wide degree of creativity and latitude is expected. Typically reports to top management.

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TIEN SON: GROWING A STUDENT BUSINESS AFTER GRADUATION

Joseph Trendowski, University of Evansville

CASE DESCRIPTION

The primary subject matter of this case concerns the transformation of a student-run business after graduation. The secondary issues examined include geographic market expansion and balancing technology and personal service. The case has a difficulty level of three; junior level. This case is designed to be to be taught in one to one and a half hours and is expected to require one hour of outside preparation by students.

CASE SYNOPSIS

Lan Do is a member of an eight generation family business. She came to the United States for an American business education to help her family business grow back home in Viet Nam. During the fall semester of her junior year, she co-founded ViCo Fashion with friend Andrea Cadavid as part of an entrepreneurship course with Lan focusing on Men's suits. The following semester, Cody Land joined the team and helped transform Tien Son from a student business into a legitimate custom suiting option for the greater Evansville, Indiana metropolitan area. As graduation approaches, Lan must decide whether to accept a position at Vectren Corporation and continue the business part time, or devote full-time hours to Tien Son.

Discussion Questions:

1. Should Lan take the job at Vectren Corporation with the guaranteed salary or devote full-time hours to Tien Son?
2. How have Lan Do and Cody Land's backgrounds helped them with their student business venture?
3. What challenges face Tien Son as they expand beyond Evansville?
4. How does Tien Son's business approach differ from a department store?
5. How does the current economic situation affect Tien Son's startup going forward?
6. Is an online presence appropriate for the custom tailored suit industry?

RECOMMENDATION FOR TEACHING APPROACH

For initial discussion, I like to ask the students how many of them are interested in having a custom made suit. This is often met with a wide array of responses. Many of the students will be at the internship and/or first job stage which makes this question very timely. Males and females will have to consider the tradeoff of an off the rack suit versus a custom made suit. In most instances, students will be in the market for a decent quality suit at an affordable price as, typically, their funds will be limited. Some of the students will be strongly in favor of a custom made suit for reasons such as a) trouble finding a suit that fits; b) higher quality than many off the rack suits at a similar price point; and c) the opportunity to customize the suit with fabric, style, pockets, buttons, and monograms. I find this question evolves a quality initial discussion.

A secondary question to follow could be: what characteristics does it take to be a success entrepreneur? Most college students have limited time in their schedule. Lan exemplifies extreme time management, dedication, passion, and expertise. Though the work can be taxing, she absolutely loves what she does. During her client meetings, she spends time to get to know the client and his needs. This model has helped her to achieve initial success through relationship building. This leads to the next main characteristic, personal skills. Though English is not her native language she listens intently to provide the customer with what he is looking for. Customer satisfaction is applicable to all entrepreneurs. As far as dedication, she is running this business while being an exemplary student. Customers don't feel like they are a secondary priority. She is available to meet anyone in the local area anytime from 9am to 9pm, provided she isn't in class. The final main attribute she possesses is expertise. Having grown up in the industry, clients can see that she knows what she is talking about. From giving measurements herself to styling questions, Lan knows the business from top to bottom.

Specifically to the case, there are some additional questions that may be useful for class discussion:

<u>Suggested Assignment Questions:</u>

1. *Should Lan take the job at Vectren Corporation with the guaranteed salary or devote full-time hours to Tien Son?*

This question can be answered in two distinct ways. First, some students will feel that the company will need her full attention and that she should pass on the job offer. As the case points out, once Cody devoted more time and attention to the company, sales doubled ($3,000-$5,000 to $5,000-$10,000 per month). Since she is the founder and the expert tailor she needs to be as dedicated to the business as Cody in order for it to succeed. She has to be present for all appointments where customers are being measured. If she has a full-time job outside of Tien Son, scheduling these meetings may become more difficult. Students might also comment that more time spent with the business may grow it even further. Currently Tien Son is generating up to $10,000 in sales per month. If Cody and Lan are both full time, this number may increase. A student may also point out that Lan earns $200 per suit. Therefore she would only have to sell 170 suits (170 X $200) to make up for the lost income. If sales increase because of the extra commitment, this shouldn't be a difficult task.

A second perspective is that she should take the position with Vectren Corporation because it provides a steady income during down cycles. If both Cody and Lan have no outside employment, their livelihood is 100% reliant on this business. That can often scare entrepreneurs in the early stages of the startup. The $34,000 salary will be a safety net to help pay living expenses and/or business expenses if needed. From the operations side, Cody manages most of the day-to-day tasks since Lan is a full-time student. If she were to take this position at Vectren Corporation, it would be no different than her using those hours for classes and coursework. In essence, the schedule is basically what she already has.

2. *How have Lan Do and Cody Land's backgrounds helped them with their student business venture?*

Lan's lineage as an eighth generation tailor is the most significant attribute that led the team to start their own custom tailor company. She has been learning the business and craft of custom tailored clothing since she was a little girl. She has gone through training to be able to understand how to measure as well as what clothes look best on different body types. In addition, have her close family members in the industry also provides benefits to the business. Her father, Son Do, has been making European styled men's clothing for over 25 years. With her dad, she has access to a superb mentor whenever she has questions about running the business or industry trends. Being part of a long line of family entrepreneurs, she understands what it takes to be successful. She knew what she was getting into when she started this business as part of a student project.

Cody Land, in contrast, isn't part of a long line of family entrepreneurs. He was born and raised in Evansville, Indiana. After he graduated high school, he joined the United States Air Force. Being an Evansville native, Cody had a much larger network of potential clients. Through people that he knew, he had greater access to the business community in Evansville. Additionally, having a US Veteran owned business opens other channels to the company. He also has previous entrepreneurial experience through starting his own business, Everything Auto.

3. *What challenges face Tien Son as they expand beyond Evansville?*

The greatest challenge for Tien Son expansion is making personal connections. With Lan and Cody both attending the University of Evansville and Cody being an Evansville native, the founders have strong ties to the local community. Early business was conducted through positive word of mouth advertising through the campus community and the greater Evansville community as a whole. Local events held at the University of Evansville as well as the local mall provided a central location for a large number of potential customers to view the products.

When Tien Son expands to a new market, they do not have as strong of a network to get business started. When they operate in Evansville, people have heard of them via radio, print, or word of mouth. In a market that is outside of the Evansville metropolitan area, they do not possess these same advantages.

One significant factor of the men's clothing industry is the establishment of a strong brand name. Without strong brand recognition outside Evansville, Tien Son may face tough competition from larger retailers. The industry has medium concentration, with the top four companies owning 66.8% (Ibisworld) of the revenue. In 2010, Phillips-Van Heusen purchased Tommy Hilfiger increasing their market share by over 10 percentage points. Over the past five years, this industry has become increasingly more concentrated. As such, Tien Son needs to promote their brand based on quality and continue to get new customers via word of mouth referrals. However, competing against strong brand names continues to be a daunting task.

4. *How does Tien Son's business approach differ from a department store?*

Tien Son's business approach differs from large department stores by focusing on the uniqueness of an individual. Lan strongly believes that suits should be just as unique as the owners themselves. People are not mass produced and therefore neither should their clothing. Unlike providing the customer with generic sizes of small, medium, and large, each Tien Son suit is made to the exact measurements of the client. Rather than have a suit that is size 42, 44, or 46R, you receive a suit that is "your" size.

Additionally, their personalized service goes beyond the custom fit. The co-owners Lan Do and Cody Land personally help each client through the order process. After Lan meets each client for the initial sizing, she and Cody discuss the various options with the customer. The customer can then determine the right look and feel for his personality. After the suit or clothing choice is made, the order is hand-made by an expert tailor. The tailors undergo a seven year training process before they are capable of making a custom suit. Unlike the mass produced department stores, each suit is drawn, cut, and pieced together by one expert tailor. Tien Son truly offers a unique one-of-a kind product. To make the customer service go above and beyond department stores, Lan personally delivers each item to the customer to ensure profit fit and satisfaction. Large retail stores are unable to duplicate this level of service.

5. *How does the current economic situation affect Tien Son's startup going forward?*

In general, the men's clothing industry is very sensitive to the current economic recession. As the case indicates, the industry has been declining by of nearly 3% per year since 2009. The industry is very sensitive to external factors such as employment and disposable income. Fashion is considered by many as luxury goods. When the overall economic situation is poor, the public is less willing to spend money on items such as custom made suits. The situation can be analyzed even further when discussing the need of a suit for work versus the luxury of a custom made suit.

As future unemployment decreases, more men and women will need to purchase office attire such as suits, sport coats, shirts, ties, etc. Given that Tien Son produces each of these products, they should be able to take advantage of the market trend. Since unemployment is expected to decrease in 2013, the increased potential customers should coincide well with Tien Son's expansion. Further economic improvements will increase consumers discretionary spending on apparel. Consumer with the ability and desire to purchase higher quality items opposed to low-cost purchases will be the segment that Tien Son will be able to develop.

6. Is an online presence appropriate for the custom tailored suit industry?

Tien Son has built their business one client at a time through exceptional customer service and client referrals. As with any market, Evansville may eventually become saturated. Most clients only own a handful of suit and are unlikely to make annual purchases. As time goes on, Tien Son will ultimately have to determine how to expand while keeping their brand image. Tien Son has a website, http://tscustomsuits.com/, where customers can browse the product line, learn about the company and see people wearing Tien Son clothing. Students can often get a better feel for the company and its products by visiting this website.

To answer this question, the students may take one of two approaches.

First, an online presence is appropriate. These students feel that Evansville alone will be too small for continued expansion. Since Lan and Cody are hands on owners, they need to be located in the city where they are selling. An online presence will allow them to get the product to more areas while still remaining in Evansville and running the business as they have from the start. Any market expansion will be done with them rather than hiring outside help in a different city. Customers would either measure themselves or have another tailor provide the measurements. These measurements could be entered online, followed by the customer placing his order.

The second viewpoint is that Tien Son should avoid selling their product online. They have evolved as a leader in exceptional customer service. Clients repeat business with them mainly because of the quality of their products and their level of individualized attention. By selling their product online, they may diminish that second part of the brand. The next part of this viewpoint will likely discuss whether or not Tien Son should enter into another market. If they decide that Tien Son should expand into another market, they can discuss what it may take to be successful. Some approaches to success in another market may include, but not limited to: a) network with former classmates to find new customers; b) hold events in multiple cities to see where the most potential is; c) incorporate other successful tailors who have a presence elsewhere.

EPILOGUE

Lan has decided to accept the position at Vectren Corporation. Tien Son has continued to grow earning up to $12,000 in month sales. The company expects the growth to continue with their upcoming fall collection.

APPENDIX:

EXHIBIT 1: RIBBON CUTTING CEREMONY WITH THE SW INDIANA CHAMBER OF COMMERCE

Pictured: Center (with scissors) Cody Land and Lan Do

EXHIBIT 2: LAN DO AND CODY LAND MEETING CALVIN KLEIN

Lan and Cody had the opportunity to meet famous designer Calvin Klein during his trip to Evansville, IN as the guest speaker for The Institute for Global Enterprise in Indiana. Here they are pictured presenting Calvin Klein with a Tien Son tie.
Pictured (L to R): Lan Do, Cody Land, Calvin Klein.

INFOTEK COMPUTER SERVICES & CONSULTING, LLC

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NOTE TO INSTRUCTORS
CASE DESCRIPTION

This case focuses primarily on marketing-related challenges faced by the owners of InfoTek. These marketing challenges are common to small business owners, particularly those who lack training and/or experience in marketing or whose personalities and personal values make the implementation of marketing fundamentals difficult. InfoTek Computer Services and Consulting, LLC is an information technology firm that helps small businesses select, install and maintain computer hardware, software, networks, peripherals and telecommunications equipment. Given the case's appropriateness for undergraduate business courses, such as Principles of Marketing or Introduction to Entrepreneurship/Small Business Management, its difficulty level is set at three. The issues and concerns of this case can be adequately addressed within a 50-minute class period. It is expected that students will require at least two hours of preparation time.

CASE SYNOPSIS

Garrett Roberts dreamed of becoming an engineer but a mission trip experience the summer before college altered his plans. Instead, he earned degrees in biblical studies and worked as a Youth Pastor until his position was eliminated. His search for employment led to opportunities related to his hobby tinkering with computers. Several years later, he and Jack Pinella started InfoTek Computer Services and Consulting, LLC. Although reliance on word-of-mouth has provided a solid base of satisfied customers, in recent years billable hours have gradually fallen to fewer than forty hours per week. Clients have been postponing hardware and software upgrades as cost containment efforts in order to survive the Great Recession. Garrett and Jack now encounter a crossroad of their personal values juxtaposed with a need for growth in sales and income in order to sustain InfoTek.

KEY ISSUES AND DISCUSSION POINTS

Garrett Roberts and Jack Pinella have relied exclusively on word-of-mouth to promote their business, InfoTek Computer Services and Consulting, LLC, since its inception in 2003. Although this marketing strategy has allowed their business to survive, recent macroeconomic challenges have encouraged them to contemplate other promotional strategies. Nonetheless, a change in approach might conflict with their personal values that are rooted in their religious beliefs.

Several interesting themes that lend themselves to rich classroom discussion permeate this teaching case. These themes and discussion points include:

1. Identifying profitable market segments for a small business, and developing an appropriate portfolio of services to offer each market segment.
2. Effective pricing strategies for small businesses.
3. Effective marketing promotional strategies for small businesses.
4. Determining how distribution plans are developed for small businesses in the service sector.
5. Using Porter's Five Forces Analysis to develop small business marketing plans.
6. How small businesses develop effective marketing plans using limited budgets.
7. The influence of entrepreneur's values, specifically the entrepreneur's ethics, spirituality and religious beliefs, in the marketing and management of his/her small business

LEARNING OBJECTIVES

1. To help students to integrate theory and practice, particularly related to marketing fundamentals, by comparing and contrasting the real-life issues presented in this case with content from textbooks and other required readings.
2. To help students to develop and refine their critical thinking skills by (a) identifying the central issues of the case, (b) and proposing solutions that address the critical issues while recognizing connections between central and peripheral issues.
3. To provide an opportunity for students to gain insights from the perspectives and experiences of their classmates through class dialogue of the case content and discussion questions.

TARGET AUDIENCES AND COURSES

This teaching case was developed for use in undergraduate business courses, including Principles of Marketing and Introduction to Entrepreneurship/Small business management. In these courses, this case can be used to introduce students to marketing in the small business sector. This case explores how small businesses develop marketing strategies using each of the four Ps of marketing: product, price, promotion and place. It also exposes students to the challenges small businesses experience when they must develop effective and extensive marketing plans, but have limited budgets to do so.

SUGGESTED TEACHING APPROACHES

For a Principles of Marketing course, this case can be assigned after students have read chapters on and discussed the merits and challenges of any of the following topics, with guidance and input from the instructor. Chapter topics should cover the marketing of services; developing pricing strategies; selecting consumer and trade promotions; distribution planning in the service sector; and Porter's Five Forces analysis. Within the class period dedicated to discussion of this case, students should first be encouraged to iterate the critical issues of the case. The instructor can then use the suggested discussion questions to guide students through the process of analyzing the critical issues and proposing appropriate solutions in the form of an action plan.

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DISCUSSION QUESTIONS AND SUGGESTED ANSWERS

1. What is the product/service the InfoTek is selling? What kind of business is InfoTek and in which industry does the company compete?

   InfoTek is a service; it does not manufacture or sell any products. InfoTek offers computer selection, installation and maintenance services and is competing in the Computer Information Technology Services industry.

2. Who is InfoTek's primary audience? Secondary audience?

   InfoTek's primary customers are small businesses in the city of Philadelphia, the Delaware Valley region and nearby cities in New Jersey and Delaware. The company's secondary target audience is residential customers in the same geographic areas.
   The core customer is the business owner, and he is likely to be a Caucasian male, between the ages of 30 and 55, and who is married with school-aged and/or teen-aged children. He probably resides in the suburbs and is a homeowner. He most likely worked for another company at one time where he gained his skills then left to begin his own business. He might also have inherited his business from his family.

3. What service benefits does the primary customer target audience want and need? Why do they buy InfoTek's services?

   InfoTek's small business customers are looking, in general, for IT support because they (1) do not have in-house IT personnel, (2) need to supplement their existing, but limited, IT departments or staff, (3) have more IT work than their existing staff can manage or (4) their IT staff lack the advanced skills required to provide IT support at the level needed to maintain smooth operations.

   The customers buy InfoTek's services because of the company's reliability, integrity and personal attention to each customer's needs. They also buy InfoTek's services because Garrett and Jack are competent and able to solve their IT problems.

4. What is InfoTek's competitive advantage? Is it sustainable? Why or why not?

   InfoTek's competitive advantage can be viewed in terms of its core benefit and the services or features supporting that benefit. The benefit is that InfoTek makes each small business feel as if it has acquired its own personal, outsourced IT department. The competence of Garrett and Jack to solve computer and IT problems is the service feature that supports this benefit. A second feature is that InfoTek is able to be a one stop shop, offering a wide range of critical services to each client, namely acquisition, installation and maintenance of computer systems.

   This competitive advantage is the reason why small businesses choose InfoTek over other IT service providers. Since there are many competitors able to provide competent computer support services, just the competency of InfoTek's staff by itself is not enough of a competitive advantage, nor is it a sustainable advantage due to the many competent competitors available to customers in the market. However, what makes InfoTek's competitive advantage sustainable is that customers like InfoTek. Although InfoTek believes its clients choose them because of their lower prices and moral standards, the customers choose InfoTek because the company provides reliable, personal service. InfoTek is able to sustain its competitive advantage because the company has built loyalty by creating committed relationships with its clients. The client-company relationships are strong.

   InfoTek has many strengths. It knows its core customers are small businesses so it maintains a focus on them without being distracted by large businesses that may have greater needs than InfoTek might be able to provide.

5. What are InfoTek's greatest threats, using Porter's Five Forces as a basis for analysis?

   InfoTek's greatest threat is competition. There are very low barriers to entry into the industry because the only cost to entry is knowledge of how to deliver IT service and support, which many can acquire.

Since there are many other companies able to provide the same services at comparable prices, the threat of rivalry exists. This threat is moderate to high if competitors are competent and reliable.

As for substitutes, because there are few, this threat is weak. Substitutes would consist of do-it-yourself fixes by workers or friends.

The buyers are the customers who hire InfoTek for IT support. The power of these buyers is high because the supply of IT service providers is greater than the demand. This means that InfoTek can be replaced easily, which limits InfoTek's power in its relationships with its clients. If InfoTek lost its strong relationships with its customers, a competitor could easily steal InfoTek's customers by providing competent service while building strong, trusting relationships with them.

Supplier threats are low because InfoTek is supplying a service that is not dependent upon outside suppliers. Short supply of competent staff, however, might become a threat if InfoTek plans to grow. The faster and larger InfoTek's client base grows, the greater the need would be for competent staff. If demand for InfoTek's services increased and InfoTek could not find enough competent staff able to provide service in a manner consistent with the company's values, then InfoTek would be unable to maintain its reliable, personal service for each customer.

6. What is InfoTek's greatest weakness and vulnerability?

   InfoTek's exclusive reliance on word-of-mouth to promote its business appears to be its greatest weakness. In Garrett's own words, he states that "We are going to need more customers and word of mouth is wonderful, but it's a little too slow." Garrett and Jack must consider incorporating additional means of marketing promotions such as those iterated in the response to question #11. Furthermore, Garrett and Jack might benefit from reconsidering their present perception of customer relationship management. Rather than characterizing periodic contact with clients in-between service calls as "bothering" their clients, they could see them as ways of strengthening relationships and maximizing customer service.

7. What makes the industry's target customers loyal? Are customers loyal in this industry? How vulnerable is InfoTek and what can the company do to keep its customers loyal?

   The industry's target customers are small businesses, large businesses and residential customers; each with different reasons for their loyalty to their IT service provider. InfoTek's customers are small business owners who appear to be very loyal because of the close relationships they have with InfoTek. InfoTek can keep its customers loyal by maintaining excellent service and strong relationships with its clients.

8. How should InfoTek create a pipeline of innovative new services? Should InfoTek adopt a new service development or product development strategy through which they begin to present regular new products and services to their customers? In the technology industry how risky is it for InfoTek not to constantly launch new products and services?

   Garrett and Jack should maintain their credentials and technological skills so that they do not become obsolete or irrelevant. The IT industry changes rapidly so all services should be upgraded and training should occur continuously.

9. Describe some new services or products the company could launch?

   This list can vary. Students should provide strong arguments supporting each recommendation.

10. What are your thoughts about InfoTek's pricing strategy ("$80 per hour deadens the pain")? What changes, if any, would you recommend?

    Three questions a company should consider when developing a pricing strategy are: a) What price will help the company to generate the greatest profits? b) What prices are customers willing to pay given how much or how little they value the services provided? and c) What level of competitive service is offered vs. that offered by competitors?

    A company should price low if the service offered is below average, at parity if the service is competitive and higher than average if the service is better than average. Companies can also charge higher prices if their services have few substitutes that cannot be imitated easily and if they have truly sustainable, competitive advantages that are highly valued by their customers.

    InfoTek is using a low pricing strategy by pricing its services below competitive rates. This strategy is best to use if costs are also low and if the service is below average. However, a low pricing strategy does not always yield high profit margins. This strategy can yield high profits if a company sells a high volume of services. If a company's growth potential is limited, the company will be unable to generate enough business to build the volume needed to generate the most profit.

    InfoTek must analyze its profit margins per service and per client to determine whether or not it is generating a profit each time services are provided. Once the indirect fixed and overhead costs are factored into the equation, InfoTek may in fact be losing money on every sale. InfoTek's primary costs are for salaries and overhead for maintaining its back office, covering transportation and keeping string communication with clients. If expenses are low and InfoTek has low fixed costs, then the company has a chance of making a profit. But if these expenses are at the same level as those of competitors then InfoTek will have lower profit margins versus those competitors are earning. Lower than average profit margins will eventually lead to failure and, en route to it, drained resources requiring constant loans and cash infusions from owners' equity.

InfoTek must lower its costs substantially to make a low pricing strategy work. If the company cannot lower its costs, then prices must be raised to competitive levels. InfoTek fears that a parity pricing strategy will weaken business, however, as long as InfoTek can differentiate itself from competitors it does not need to fear a loss of business.

11. What other options, besides "schmoozing", might Garrett and Jack pursue to promote their business?

    Many possible promotion strategies could be used in the areas of advertising, public relations and consumer promotions. As for advertising, InfoTek could use low priced vehicles such as social media or other small business trade publications. Because paid advertising requires such a substantial investment to reach a target audience effectively, InfoTek should use less expensive, more efficient promotion strategies. Effective ad reach means that an ad was viewed enough times in a given time period by customers, that they recall having seen it.

    Use of public relations would be a more efficient choice because through it, InfoTek could reach many target customers at a lower cost than that of advertising. These public relations options could include (1) developing a referral program in which existing customers would refer potential clients, (2) developing a web presence via twitter or Facebook, (3) enhancing InfoTek's website so that it includes customer reviews with the intent of attracting future customers or (4) identifying low-cost ways to increase InfoTek's visibility on Google searches.

    As for consumer promotions, each one suggested should offer some type of pricing discount tied to a specific behavior the company wants to encourage customers to adopt. These promotions should include trial incentives for new customers, and loyalty-building incentives to encourage and reward long term relationships. Promotions just to offer deals would erode profits and should not be offered unless they will eventually lead to higher revenue.

12. Weigh the pros and cons of using a PR versus an Advertising strategy.

	Public Relations	**Advertising**
Cost	Low cost or free	Expensive
Speed	No lead time	Varying lead time needed
Efficiency	Low cost per thousand customers reached	High cost per thousand customers reached
Message complexity	Can be complex	Must be short and simple
Effectiveness	Allows for personal selling	No personal selling
Targeting	No guaranteed target	Highly targeted

13. How do services develop strong distribution strategies? What kind of distribution strategy should InfoTek use, push or pull and why? How does InfoTek obtain new clients? Would a sales force make sense? What about a partnership with a secondary sales location to sell services for the company? With whom should the company partner?

    Services can develop distribution strategies by partnering with companies that can sell and/or create access to their services by connecting the companies with their target customers. InfoTek currently has no distribution partners assisting them with selling to their customers or creating access for customers to InfoTek's services. InfoTek obtains its customers virtually exclusively through word-of-mouth advertising. A sales force would be cost-prohibitive and only needed if InfoTek wanted to expand its customer base substantially. A partnership with a secondary sales location might be a wise strategy for InfoTek to pursue. If so, InfoTek should target partners who do substantial business with InfoTek's primary customers.

14. How large could InfoTek grow and how fast? What can InfoTek do to drive growth? What is the right size for a company like InfoTek to become?

    InfoTek probably should avoid attempting to grow very quickly because its competitive advantage is its personal service. It can be very difficult to maintain this level of personal service as a larger company. Growing the business too quickly would mean that the company would not be able to maintain relationships with clients very well, which could cause the company to lose its competitive advantage of building strong relationships with its clients.

NOTES

The author collected most of the information presented in this case via multiple interviews of Garrett Roberts. Industry-related information on computer services and information technology consulting were gathered from the Hoover's database and Manta.com. Community-level census and other demographic data were obtained from USA.com. Although the individuals and events described in this case are real, all personal and business names were changed for reasons of privacy.

THE INTERN: AN INSTRUCTIONAL CASE FOCUSING ON ETHICS FOR TAX SERVICES

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INSTRUCTOR'S NOTES
CASE DESCRIPTION

The primary subject matter of this case concerns ethics for tax services. Tax services include tax preparation, consulting, and planning. Secondary issues examined include guidance available to professionals from the AICPA code of ethics, the AICPA standards for tax services, and the Internal Revenue Service Circular 230. The case has a difficulty level of four, appropriate for senior level. The case is designed to be taught in three class hours and is expected to require another six hours of outside preparation by students.

CASE SYNOPSIS

A tax practice, like any other business, strives to improve efficiency and profitability. One major difference between a tax practice and any other business is that accountants have a responsibility to service the public interest. Accountants are entrusted to be competent and to act with objectivity and integrity. These expectations sometimes are clouded by greed and self-interest. Tax practices face increasing pressure from clients to minimize tax liability and are encouraged to adopt aggressive tax positions. These demands place tax practices at risk of violating professional standards especially when ethical values are not an integral part of the company's culture. The purpose of this case is to introduce students to the applicability of the AICPA Statements on Standards for Tax Services (SSTSs), the AICPA code of conduct, and the Internal Revenue Service Circular No. 230. The main learning objective is to develop students' analytical, ethical and research skills to better prepare them for a professional career in accounting.

RECOMMENDATIONS FOR TEACHING APPROACHES

DISCUSSION QUESTIONS

1. Identify the ethical issue(s) of this case.
2. In reference to the AICPA code of conduct, what principles of professional conduct are applicable to this case and why?

3. Who are the stakeholders who can influence or be affected if Diane uncovers the truth? What are their interests?
4. To whom does Diane owe her loyalty to: the client, the government, the financial institution or A&A? .
5. Help Diane come up with alternative solutions to this conflict (list at least three alternatives). What is the impact of each alternative on the stakeholders?
6. How does each alternative listed in #5 above satisfy the current professional rules, regulations and laws? Refer to the AICPA Statements on Standards on Tax Services (SSTS) and IRS Circular 230 to answer this question.
7. Write a recommendation to Diane identifying the best alternative solution from the previous question.
8. What is your opinion on the usefulness of the existing guidance available (AICPA Code of Conduct, the AICPA SSTS and IRS Circular 230) to assist tax accountants to solve these ethical issues?

LEARNING OBJECTIVES

A. Understand the obligation to comply with professional standards, and to be competent when providing professional services.
B. Use the ethical decision-making model to analyze tax ethical matters to determine an adequate course of action.
C. Describe and understand the applicability of the AICPA Code of Conduct, the AICPA Statements on Standards for Tax Services and the Internal Revenue Service Circular No. 230.
D. Use critical thinking and problem solving skills for decision-making.
E. Communication clearly and concisely findings and recommendations.

SUGGESTED ANSWERS FOR THE DISCUSSION QUESTIONS

1. Identify the ethical issue(s) of this case.

There are many facts described in this case, and this question forces the student to define the main issue. Students may focus on financial statement manipulation and underreporting the client's tax liability. The instructor can build on this point to discuss A&A's corporate culture and lack of quality controls.

2. In reference to the AICPA code of conduct, what principles of professional conduct are applicable to this case and why?

Accounting professionals are held at a higher standard. The AICPA Principles of Professional Conduct applicable are: Section 52 – Article I: Responsibilities, Section 53 – Article II: The Public Interest, Section 54 – Article III: Integrity, Section 55 – Article IV: Objectivity and Independence, and Section 56 – Article V: Due Care. These provide broad ethical standards and guidance to professionals, including accounting firms.

3. Who are the stakeholders who can influence or be affected if Diane uncovers the truth? What are their interests?

This question is intended to bring the students' attention to internal and external parties that are directly or indirectly affected by Diane's decision. By doing this exercise, the student will gain an understanding of the motivation behind the stakeholders' actions. Students also will learn during the decision making process that stakeholders' interests are important to consider, but that it will be difficult to satisfy all of them when making a decision. Nonetheless, the decision considered should result in more benefits than costs. Students can see that sometimes a person's self-interest conflicts with his or her professional duty and responsibilities.

Table 1
STAKEHOLDERS

Stakeholders	Interest
Diane	**To build a successful career and become a partner at A&A.**
Joseph	**To meet profit goals, and become managing partner or director of A&A.**
Larson	**To pay a minimum amount of taxes while maximizing profits at all cost.**
A&A	**To grow the practice and maximize profits; to become the largest small to midsize company tax provider nationwide.**
A&A's clients	**To receive quality service at a reasonable price from honest and trustworthy professionals.**
Lenders, investors, third party users, etc.	**To rely fully on A&A's generated financial audit reports and tax returns to meet their objectives.**

4. To whom does Diane owe her loyalty to: the client, the government, the financial institution or A&A?

As described in AICPA code of conduct ET Section 52, a member has a responsibility to all those that use their professional services while upholding public confidence and the traditions of the profession. Thus, all stakeholders are the beneficiaries of these professional services. The public is represented by A&A's clients, employees, creditors, the firm and its reputation. Students have already identified the stakeholders, so it should be clear by now that any decision will have an impact on each one of these. Students tend to focus on internal stakeholders without considering external stakeholders as well. When making educated decisions, all factors must be considered and carefully evaluated. For a public accounting firm, having a good reputation is vital for its survival and the profession as proven by the fall of Arthur Andersen.

5. Help Diane come up with alternative solutions to this conflict (list at least three alternatives). What is the impact of each alternative on the stakeholders?

The ethical decision model is a tool that can be used to analyze and determine the best possible solution and outcome to an ethical dilemma.

6. How does each alternative listed in #5 above satisfy the current professional rules, regulations and laws? Refer to the AICPA Statements on Standards on Tax Services (SSTS) and IRS Circular 230 to answer this question.

The students have an opportunity to navigate through the SSTSs and Circular 230, analyze and extract the relevant sections and statements that are pertinent to this case.

The steps are as follows:

Table 2
ETHICAL DECISION MAKING MODEL

Step 1	**Recognize the ethical issue**	**Refer to question no. 1**
Step 2	**Gather the critical facts**	**These could be identified and outlined during classroom discussions.**
Step 3	**Indentify the stakeholders**	**Refer to question no. 3**
Step 4	**Consider your alternatives**	**a) Diane could ignore her findings and proceed as instructed.** **b) Discuss the matter with Joseph.** **c) Confront the client.** **d) Become a whistleblower and disclose the misdeed to the financial institution.** **e) Inform A&A's managing partner.** **e) Quit the firm.**
Step 5	**Consider the effect on stakeholders**	**a) If Diane ignores her findings, she would be in violation of the standards and if discovered she would be sanctioned accordingly. Moreover, her inaction would imply acceptance of these actions. It would be much harder for her to report anything subsequently because she willingly and knowingly misrepresented facts. The firm's reputation would also suffer.** **b) She should discuss the matter with Joseph giving him a chance to explain his actions. Once they come to an agreement, Joseph should inform the client of the misstatement and recommend that the tax return is amended to reflect the correct amount of tax due.** **c) Confronting the client directly may add to the confusion and disappointment. The client may wonder why Diane, an intern, is discussing this sensitive matter with him rather than Joseph or Abbott. Larson may fire A&A and take his business to a competitor. He could take legal action against the firm for negligence and for involving him in an illegal act.** **d) Diane could circumvent anyone involved at the firm and disclose the wrongdoings to the financial institution. More than likely, the firm will face legal action from the bank and any third party affected by this lending transaction: vendors, employees, etc. The firm's reputation will suffer and any bad publicity will have a negative impact on profits.** **e) If she informs A&A's management without consulting with Joseph first, she is jeopardizing Joseph's position with the firm. She also may be jeopardizing hers if A&A management agrees with Joseph's position. They may admire her for being ethical or they may think she is an insubordinate for by passing Joseph's authority.** **f) If she quits the firm, she will not have a chance to remediate the issue. .**

Circular 230:

a. **§10.21 – Knowledge of client's omission: as soon as the practitioner discovers that an error or omission has been made in a client tax return or any other document that was subsequently submitted to the IRS, he or she must inform and advise the client of the consequences of such error or omission.**
b. **§10.22(a) – Diligence as to accuracy: under section (a), a practitioner must exercise due diligence when preparing or approving a tax return.**
c. **§10.34 – Standards with respect to tax returns and documents, affidavits, and other papers: a practitioner may not recklessly and willingly sign a return that purposely understates the tax liability. A practitioner must inform the client if there are any penalties associated with understatement of liability. Practitioners can rely on client provided information without verification. Nonetheless, practitioners have to inquire if the information provided appears incorrect or inconsistent.**
d. **§10.50 through §10.52 – Sanctions for violation of regulations: outlines the Secretary of Treasury authority to suspend or disbar practitioners who violate these regulations.**

AICPA SSTSs:

a. **SSTS No. 1 – Tax Return Positions: the profession's self-assessment system is only effective when practitioners follow these standards or the taxing authority's standards if higher. A practitioner not only has a duty to their client, but also to the tax system. A practitioner's duty to their client is to minimize their tax liability within the tax law. A practitioner's duty to the tax authority is to take a tax return position that can be supported by a good faith argument.**
b. **SSTS No. 3 – Certain Procedural Aspects of Preparing Returns: a practitioner can rely in good faith on the information provided by their client without verification by third parties. However, reasonable inquiries must be made if the information provided appears inaccurate, inconsistent or incomplete.**
c. **SSTS No. 6 – Knowledge of Error: Return Preparation and Administrative Proceedings: after an error is discovered, the practitioner must inform their client of the error and any potential consequences such as penalties, and recommend that the taxpayer corrects the error. However, the taxpayer not the practitioner is responsible for deciding whether to correct the error or not. If the taxpayer chooses not to correct the error, the practitioner must consider whether to remain the taxpayer's tax practitioner or cut any ties.**

The instructor can discuss in more detail the sanctions and penalties imposed to tax practitioners that violate these standards. Most students are surprised to learn that there are monetary penalties imposed on practitioners. Practitioners also risk having their license to practice revoked and in some instances professionals may face imprisonment.

7. Write a recommendation to Diane identifying the best alternative solution from the previous question.

Students are asked to write a report addressed to Diane as her advisors recommending the best solution based on the professional code of ethics, the SSTS and Circular 230. The recommendation should be written clearly and concisely and should include interpretations and applicability of the ethical framework justifying the conclusion.

8. What is your opinion on the usefulness of the existing guidance available (AICPA Code of Conduct, the AICPA SSTS and IRS Circular 230) to assist tax accountants to solve these ethical issues?

The AICPA code of conduct, the AICPA SSTSs and IRS Circular 230 provide a framework to assist practitioners in solving complex and difficult ethical problems. However, this framework is not meant to be exhaustive but rather focuses on broad principles that apply to each specific issue. It is impossible for any code of conduct to cover all possible scenarios, thus, it's important to also consult with colleagues and other experts (legal advisor) as deemed necessary.

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INSTRUCTOR'S MANUAL GROWING TOO FAST? AN ENTREPRENEURIAL DREAM…OR NIGHTMARE

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CASE SYNOPSIS:

Hank Patterson and Larry Kennedy were two successful medical sales representatives in the Memphis, Tennessee area. The friends often used local caterers to feed their clients during sales pitch lunches and breakfasts. The two became frustrated with the lack of food and service quality of the local caterers. This frustration led the pair to open up their own catering business.

The first two years of operations were a rousing success, which left the partners with several difficult decisions. The central decision revolved around how the partners would respond to the rapid success of the firm.

**This case was developed based on interviews of actual owners and staff employed at the firm in question. Disguises have been used to mask the names and locations involved.*

CASE DESCRIPTION

The primary subject matter of this case concerns Small Business and Entrepreneurship. Secondary issues examined include Strategy Development and Implementation, Exit Strategy, Marketing Strategy, and Decision Making. The case has a difficulty level of four which means that it is appropriate for senior level courses. The case is designed to be taught in two class hours and is expected to require four to six hours of outside preparation by students.

CASE USE:

This case is designed for use in undergraduate level Entrepreneurship or Small Business classes.

CASE OBJECTIVES:

1. To examine the challenges associated with starting a small business / entrepreneurial endeavor.
2. To explore how various startup decisions (e.g. business form taken, owning or leasing your place of business) impact the short term and long term success of the firm.
3. To examine the critical role of strategy development (this case addresses marketing strategy as well as exit strategy).
4. To examine the essential aspect of strategic decision-making and the difficulty associated with the decision-making process.

TEACHING PLAN:

This case should be discussed as companion to chapter(s) / lecture(s) on business startup decisions, marketing strategy, employee management, and strategic decision making. The case can be used multiple times within a given semester to address startup, marketing strategy issues, employee management and motivation issues, and strategic growth / exit decisions. Re-using the case will allow the instructor to assess student retention of earlier topics and build towards an integrative decision point at the conclusion of the case.

DISCUSSION QUESTIONS:

1. **Discuss the pros and cons of the various business forms that Hank and Larry mention (LLC, LLP, S-Corp). Is there another form that they may need to consider?**

LLC/LLP	
Pros	**Cons**
Easy to set up and maintain.	Requires an operating agreement before creation
Defined parameters regarding partnership agreement (Articles of Agreement).	Legal and accounting fees
Legal protection regarding personal assets.	Governmental regulations
Capital can be raised by the LLC as an entity separate from the owner(s).	
Potential for single taxation.	

S-Corp	
Pros	**Cons**
Shareholders are only responsible for debts up to their investment amount	More complex establishment rules
Can issue stocks and bonds to raise capital.	Continuity subject to qualifications under the Federal Tax Code and the IRS
The corporation may borrow money based on its credit.	Overseen by a board of directors set by shareholders (complex for a small business)

Another potential business form is a general partnership, though this should be avoided in the case of WCC due to the unlimited personal liability of either Hank or Larry.

2. What issues are important as Hank and Larry decide on leasing or owning their business space?

- Positives to leasing (negatives to owning)
    - Limits amount of debt
    - Offers flexibility for growth or change of location
    - Offers 3rd party management of building maintenance thus expense reduction
    - May add to value of business when business is sold
- Negatives to leasing (positives to owning)
    - Not building equity
    - Offers stability in that business owner does not have to worry if lease will not be renewed forcing them to relocate and potentially lose customer base
    - Gives option of fixed cost
    - Would not allow for large structural changes

3. Discuss the positive of Hank and Larry staying small and happy (curtailing their growth) and keeping their sales jobs. Discuss the negatives of the above strategy.

- Positives
    - No additional responsibility
    - Will not have to extend staff and salaries
    - Stay in touch with customers better
    - Will not have to borrow money and acquire debt
    - Will not have to adhere to additional regulations should company expand

- Negatives
    - May lose customers if cannot provide service to current customers due to workforce being spread thin
    - Turning down opportunity
    - May be edged out by competition

4. What is the distinctive competence – or value proposition – of World Class Catering in its market?

WCC's distinctive competence is its ability to understand the needs of catering clients. With years of experience utilizing caterers and noting their weaknesses, Hank and Larry created WCC with the intention of making the weaknesses of others' their strengths, namely tasty, fresh food delivered on time.

5. What marketing strategy is World Class Catering utilizing? What additional marketing strategies might they consider?

WCC is relying primarily on word of mouth marketing. They had not intentionally attempted to move beyond the medical sales community, but had grown organically. At the present time, additional marketing ventures should not be undertaken due to WCC's service limit without expansion.

Should WCC expand to have excess capacity, the following are possible avenues for marketing strategies.

1. Market segmentation – While the company currently focuses on a segmented market of medical sales professionals, many businesses that utilize caterers run into the same problem Larry and Hark were having. By promotion their on-time service record, WCC could be attractive to many other niches.
2. Targeted promotions efforts – something beyond the current word-of-mouth method currently used. This could include brochures directly distributed to medical and pharmaceutical sales reps, email promotions, and direct mailings
3. Consumer Relationship Management – Hank noted in an interview that the job CRM would be a full time job for someone.
4. Digital and Social Media Promotion – Many medical offices use social media to alert patients to changes in office hours, etc., and they could be marketed to that way.

6. Do you see any ethical issues with Hank and Larry purchasing meals from their own catering company in their separate roles as medical sales representatives?

1. Yes, they didn't disclose their business venture to their other employers.
2. They can unethically misrepresent their catering competition to fellow salesmen who don't know they own WCC.
3. They could charge their medical companies too much for catering.
4. Runs counter to the spirit of the medical sales regulation – they are profiting from these meetings whereas they are supposedly only informational meetings.
5. Spy on the competition – know who they're meeting with, how successful they are.

7. Should Hank and Larry pursue World Class Catering as full time occupations? What should influence this decision?

1. They both appear to like their sales jobs better than they like the food business
2. If they quit their jobs then they may lose the business that they have been giving themselves (business technically from their employer)
3. If one goes full-time it becomes very risky, they suddenly have something to lose
4. Decision should be influenced by financial needs and long-term goals (both career and personal)

8. Should Hank and Larry begin to explore options to sell the firm? Why or why not and what should they consider when making this decision?

1. Yes, this was never their dream
2. They're having difficulty communicating with their employees, and if they stay part-time they'll never improve that
3. They can't manage the workload or sustain the growth by staying part-time
4. By selling, they can avoid the ethical dilemma
5. If they expand, they'll probably have to go into debt. This will be a way to make a profit and not worry about debt.
6. They do not have time to grow it any more without being full time and they don't want to be full time

9. What factors should Hank and Larry consider when assessing the value of their firm / establishing an asking price for World Class Catering?

1. Their initial investment
2. Existing cash flow

3. No debt
4. Future cash flows
5. Stellar reputation amongst customers (good will)
6. High potential for growth
7. Asset valuation – building, equipment, vehicles, etc.
8. Employees – whether they get to stay with the new company
9. Any required involvement on their part after closing the deal

KOCH RANCHES: "WHERE'S THE BEEF?!"

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INSTRUCTORS' NOTES

CASE DESCRIPTION

A wave of concern is sweeping small businesses, such as Koch Ranches (K-R), as their current customers' age and new markets, such as the Millennials (See Appendix A), grow into their next life cycles of careers and families.

The owners of K-R, Gloria Koch Lynch, the matriarch, and her husband, Kenny Lynch, have recently learned that their children have decided to take their rightful places back at the ranch after they graduate with their degrees in Management and Veterinary Medicine.

The main product from the ranch that spreads across Frio and Medina Counties in South Texas is Angus beef. The ranch has flourished through seven generations of the Koch family and has become known for its natural, grass-fed, tender, and tasty beef.

Within the last decade, the family decided to open a country store that initially featured the fruits and vegetables grown on the ranch, but has recently started including local produce from surrounding producers.

Students will enjoy working through this case on at least two levels: (1) they enjoy tailgating and cooking outside and are truly interested in natural and organic foods, and (2) they can see themselves in the roles of the college students, Henry and John Lynch, and their parents, making decisions about what they want to do after graduation.

The case presented here has roots in an actual ranch and country store, the people presented in the case are fictitious, yet they reflect real people making decisions that may include growing the business so that it can comfortably support additional young families as children return to their roots.

The difficulty level of the case is at least 3, as the script reflects what goes on backstage, at the ranch, that will affect the lives of many people as one particular owner of the ranch brainstorms with herself through many scenarios that can grow the business large enough to provide comfortable lifestyles for two more families as their children move back home with their degrees.

As students read through the case, they can put themselves in the roles of Henry and John, planning to return home after college to contribute to the business and make it work for them. They will also get introduced to the very large United States beef industry (Appendices B *and C), become aware of demands for beef in general and for natural, grass-fed beef specifically, and increase their awareness of charges for advertising fees and services (See Appendix D). They will be made aware of the wholesome local foods that can be purchased in farmers markets and country stores and learn the inside scoop on some of the decision-making that keeps this ranch on track to develop new products and break into new markets.*

International marketing and management can be discussed in the case as the readers discover that the ranch maintains an international identity as well as a domestic identity.

Brand equity for K-R is challenged to make itself known to new customers, the Millennials (see Appendix A). K-R must also investigate opportunities to grow the business through technological, genetic advancements in beef development, and an overall sound marketing plan that can embrace new types of media, messages, and markets.

CASE SYNOPSIS

The US consumer's love affair with good beef and the desire to pursue pure and natural products creates strong possibilities for niche marketing strategies for producers of grass-fed beef. The case that follows sets the potential for technology to drive marketing strategies for a small business embracing the cutting edge of a traditional industry. Right in the middle of a dynamic distribution channel is Koch Ranches where, for over seven generations, choice beef has been produced from their 4,400 acres watered by the Edwards Aquifer in Frio and Medina Counties in South Texas. The fact that natural grasses and an aquifer are key parts to the case will raise students' awareness of the roles these elements play in developing an old product, grass-fed beef that is new again addressing demands of some of the purest consumers, Millennials. As students see the main character, Gloria Koch Lynch, grasp for solutions to grow a business to be productive enough to support her own family and the families of her sons, they will be able to better understand relevance of decision making in all aspects of small business.

Gloria, now the family matriarch, has two children in college, a husband that helps with the ranch, and a diminishing market for her family's products. Koch Ranches, K-R, are known for their quality, natural, grass-fed beef. Their market has been strong, but many of their current customers have either moved away to live near their children, or have passed away. The current market knows what K-R stands for in quality and natural goodness but as this market diminishes the brand equity for K-R may also diminish.

Her children plan on moving back to the ranch once they graduate from college and start their careers in veterinary medicine and management. She and her husband, Kenny Lynch, are happy about the boys' decision, but are also concerned about how to grow their markets so that the ranch can support comfortable lifestyles for three families.

Decision points involve varying the size of the herd, changing the process that makes income from the cattle, utilizing a marketing firm that has just come on board, entering at least *two new markets, changing the distribution channel and maintaining the quality and quantity of their products.*

PREPARATION

Require that students read the case prior to actually addressing the decision points in class. Many marketing and management concepts are applicable to the case, i.e., management processes, marketing plans, industry influences on production and prices, advertising and social media prices, and young consumers, Millennials, coming of age as potential markets for natural, healthier products.

Teams from two to four students can enhance discussion and presentation of the decision points. When students are thinking of their own ideas and interpreting material, many times they need encouragement from another student or two to verbalize their solutions to a case.

Decision point discussions in class will require at least 1.25 hours. Students should be encouraged to use the four appendices as they evaluate solutions that Gloria thought about in her home office, and they should be encouraged to put themselves into the roles of Gloria and Kenny as they plan for, each in their own way, their children, college educated, coming home to make a comfortable living and building their families on the ranch.

Several variables play key roles in brainstorming solutions for growing the markets productivity of K-R and Country Store, for example, current distribution of beef products through Country Store, lack of web pages for the ranch or country store, influences of pending legislation that influences labeling and international distribution of beef, and perceptions of Millennials of quality, natural products.

Present the case to the students without specific mention of any of the appendices. This will allow students to sift through the appendices to discover any keys to justifying Gloria's ideas and their own ideas.

The material presented throughout the case builds a solid foundation for updating discussions regarding the case and decision points. Natural, grass-fed beef is a topic for discussion in many news and food programs throughout the world. The cattle industry is so aware of consumers' demands for natural, grass-fed beef that many feed lots are allocating half their space to natural, grass-fed beef (see Appendix D).

DECISION POINTS

1. **Current picture via S. W. O. T. Analysis for K-R**

   Emphasize the unique roles of strengths and weaknesses, opportunities and threats. Remind the students of the internal characteristics of strengths and weaknesses and the external characteristics of opportunities and threats. The following represent just a few examples of each variable, and can initiate thinking about several other items in each category.

Challenge students to make lists of items in each category and to be able to present their reasons for classifying variables and facts relevant to K-R as they did.

2. **Fancy Food show—go or not go, how would she keep up with market trends if she doesn't. Marketing firm may help, but will be more costly than food show.**

   Refer to Appendix D and Gloria's animosity toward the Fancy Food Show in New York. The total budget for the show, $20,000 for the week provides cause for determining an informal cost/benefit analysis for Gloria's return on investment. Of course, the total includes travel, hotel, registration, and supplies for K-R Trade Booth for five days. In her comments and thoughts, Gloria sees the trade show as a necessity, not a vacation, and not fun.

3. **To hire the marketing firm? No, yes???**

   How can Gloria possibly evaluate the marketing firm? She is expecting the firm to build the web pages for K-R and Country Store in a short amount of time. Some discussion could develop into educating Gloria about what is necessary for web pages to be successful. Then, students will give more thought about crucial planning stages for effective web pages.

   Make note that there is an app in Appendix D. Why does Gloria think she will need an app? Or, does she? Is this an item that an over-zealous marketing firm thinks that they can encourage their client to pay for, without reviewing its potential benefits. Have the students discuss the benefits of Pinterest, Twitter, and LinkedIn for K-R and Country Store.

   This decision point provides opportunities to discuss the product adoption process, market development, and niche marketing that exist in the case. By including all the Appendices, A – D, students can extrapolate some of potential profits and costs necessary to develop new markets and deepen niche markets.

4. **Do we want to hire a ranch manager or does Gloria want to retain those responsibilities until one of the kids comes back?**

   Here is where the students can step into roles of Gloria, Kenny, Henry and John. Encourage the students to develop a script for Henry and John as they talk with both Gloria and Kenny about their ideas for making the ranch more successful than it is. Stay on point about the management role that a ranch manager fills. Encourage students to consider another internship possibility for ranch manager development. Whoever accepts the job title as ranch manager will need an assistant—can an intern fill that position?

5. **The child who is becoming a veterinarian can set up his practice for the ranch, save money, or spend money.**

   This provides transition from the scripts that the students prepared to answer Decision Point 4. Yes, if the main characters decide to pursue the genetic multiplication of the herd from a nucleus of registered animals, then having the ranch's veterinarian as an owner is a good thing.

   The balance of the current registered herd could be sold in a dispersal sale, generating funds for the new genetics idea. These cattle have been proving themselves and their genetics for seven generations of Koch owners; they will generate solid market prices in a dispersal *sale. If they decide to sell 50% of the herd, 400 cattle, they will probably average approximately $2,500 per head, or close to $1 million.*

The child earning the degree in management will have his work cut out for him as he reviews and evaluates all the processes involved in growing income for K-R and the Country Store.

6. **Country store—keep it going for all producers in the area? Hours, personnel, strategy.**

   What should they do about the Country Store? Currently, it is a key part of the distribution channel for the natural, grass-fed beef and the fruits, vegetables, and jellies and preserves produced by K-R and other local producers.

   They realize that people who work from 9 – 5 need store hours that extend beyond 5 PM. They have been keeping the store open throughout the week, not just on weekends, and they have seen an increase in store traffic and sales. However, as the store grows, more people may need to be hired to keep the store open.

   And, the Country Store provides one more opportunity for an intern from an area college. This intern can be focused on learning about and describing the current and new customers of the Country Store.

7. **Should we market toward the natural product—no feed lot, no hormones, no antibiotics, all pasture, etc?**

   This decision point will require thinking about society's increasing interest in products that have not been exposed to chemicals and hormones. Many grocery stores have recognized this concern by customers and have separate sections for organic and natural produce and meats. These products demand higher prices that other products, yet the demand for them increases. The students will need to learn more about Millennials to provide answers to this decision point. All the appendices will be helpful in developing bases for solutions to the decision point.

8. **How to maintain a presence everywhere for the ranch?**

   To answer this question, the students need to refer to both Appendices B and C. International demand for beef is growing. With cattle herds diminishing in numbers over the last two years, and demand growing exponentially, ranchers will need to employ effective strategies to keep their ranches in the minds of consumers throughout the world.

   Students also need to remember that Gloria wants to get K-R beef into some of the more exclusive restaurants in the San Antonio area. They should be encouraged to discuss various ways she can get some of the chefs in those restaurants to include K-R grass-fed beef in their dishes and menus.

9. **Should we consider changing the distribution channel, get appropriate licensing and meet standards required for outside distribution and compete with Omaha Steaks? They will need an actual web site that allows for ordering, shipping, and payment on line.**

This decision point could catapult K-R into another business, distribution of natural, grass-fed beef via social media. The market for K-R natural grass-fed beef is within the San Antonio area. Remind the students that all the advertising monies are currently being spent in local newspapers and magazine. The focus for the store and beef that they process is the San Antonio area. Students should note how much Gloria is spending on traditional media such as catalogs, Holiday catalog, newspapers, coupons, and magazines.

10. **Include all media, why didn't Gloria check e-mail first? Facebook? She went through the mail, and then stopped. Students should remember that Gloria never checked her e-mail when she poured that tall glass of tea and started brainstorming in her office. Then, the students should note how much Gloria may get to spend on social media if the marketing firm is allowed to follow its current suggested budget for K-R. Why does K-R need an app?**

    If Gloria agrees to go along with what is proposed in Appendix D, then either she or the marketing firm will need to find human resources to monitor the progress, changes, orders, etc. from the social media. This is a full-time job.

    Here, students can think about suggesting that K-R develop internships for the ranch operations, country store marketing, and social media. They can identify colleges within a 50-mile radius of the ranch and suggest that Gloria contact internship directors at the colleges to post the internships for the ranch.

THE RISE AND FALL OF NETFLIX: WHAT HAPPENED AND WHERE WILL IT GO FROM HERE?

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INSTRUCTORS' NOTES
CASE DESCRIPTION

The primary subject matter of this case concerns company analysis. Secondary issues include financial statement analysis, corporate strategy and international expansion. The case has a difficulty level of three and should be appropriate for undergraduate and graduate courses in investments and financial and strategic management. The case is designed to be taught in one to two class hours, with three hours of outside preparation by students.

CASE SYNOPSIS

Netflix is an innovative company that has changed the way we rent movies and watch TV shows. Its business model is based on a subscription service that provides home-delivery of DVD rentals and streaming of movies and TV shows. The company took advantage of the rapid growth in the DVD rental market, the internet and e-commerce by providing a service that the traditional brick-and-mortar retailers, such as Blockbuster, could not compete with. In 2011, however, a price hike, poor management decisions, changes in technology, and increased competition threatened Netflix, leading to a sharp decline in its share price. In this case, students analyze the fundamentals of Netflix including its financials and management decisions to help determine if Netflix's poor stock performance in 2011 was predictable as well as what the future might hold for this company.

RECOMMENDATIONS FOR TEACHING APPROACHES

Instructors may want to leave the case open-ended and see what the students come up with. Alternatively, they could give some guidance by providing some or all of the following exercises.

1. Do a ratio analysis covering liquidity, long-term solvency, asset utilization, profitability, cash flow and market valuation.
2. Graph the stock price over the past 10 years and comment on what events affected it through that time period.

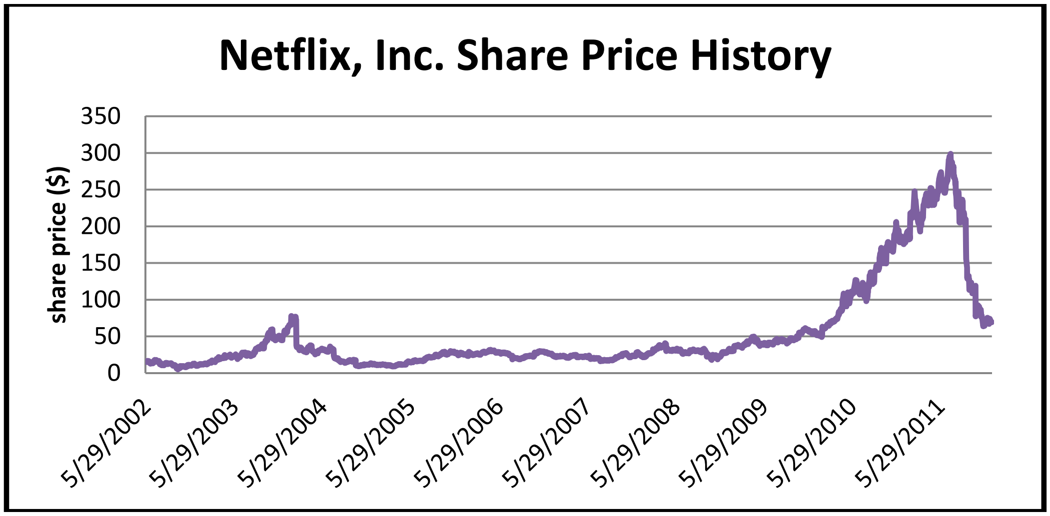
3. Develop a SWOT Analysis.
4. What are the obstacles to penetrating international markets?
5. What does Netflix's international expansion say about the direction it is taking?
6. Summarize your prognosis for Netflix.
1. Look at the financial statements and analyze Netflix's financial position from 2007 to 2011 to determine if there were any apparent weaknesses. Make sure to comment on, liquidity, long-term solvency, asset utilization, profitability, cash flow and market valuation.

	2007	**2008**	**2009**	**2010**	**2011**
current ratio	1.96	1.67	1.82	1.65	1.49
debt to equity	0.50	0.78	2.42	2.39	3.77
total asset turnover	1.86	2.21	2.46	2.20	1.04
gross profit margin	34.77%	33.26%	35.39%	37.22%	36.35%
net profit margin	5.56%	6.08%	6.95%	7.44%	7.05%
return on assets	10.36%	13.43%	17.06%	16.40%	7.36%
return on equity	15.55%	23.92%	58.29%	55.52%	35.15%
Free cash flow	247 mill	76 mill	279 mill	118mill	183mill
Stock price	$26.62	$29.89	$55.09	$175.70	$69.29
Price/earnings	27.4	22.6	27.8	59.3	16.7

Source: Morningstar Investment Research Center (nd).

As can be seen in the table above, Netflix was in a much stronger financial position in 2007 than it was in 2010 and 2011. The liquidity (current ratio) and the long-term solvency (debt to equity) were stronger in 2007 than any other year afterwards. The asset utilization (total asset turnover) had improved over the four years after 2007 but by the end of 2011 it had dropped substantially. This was most likely due to the decrease in memberships (revenues) in the second half of 2011. The gross and net profits seemed to hold fairly constant and did not indicate any problems. The return on assets actually improved over the years after 2007 until a slight drop in 2010 and then a drastic drop in 2011. The increase in return on equity was mostly driven by leveraging. The large drop in 2011 was due to the large drop in return on assets. The decrease of free cash flow (amount of cash left over after the firm has paid its expenses and made necessary expenditures) by approximately 40% in 2010 was an indication that the firm had less cash available to grow. Another disturbing financial in 2010 was the P/E ratio. It had doubled since 2009 indicating a potentially over sold stock. Prior to 2011, the financials that were most concerning was the large increase in debt, the decrease in free cash flow and the high P/E; however even these numbers would not have indicated that the stock was about to go through a freefall by mid-2011.

2. Track the history of Netflix's stock price and discuss events that may have had an effect on the price at given times. Using a graph of the stock price would be a good way to present this information.



Source: Yahoo (nd).

Netflix made its Initial Public Offering on March 22, 2002 at $15.00 per share. Since then, Netflix has consistently grown its subscriber base each year. Netflix introduced streaming in 2007. Each year, Netflix has increased the amount of consumer products that are available for streaming, greatly increasing the number of subscribers that have access to the service (2008-Xbox 360, Blu-ray players, TV sets-boxes, & Mac computers; 2009-PS3, internet connected TV's). Between March 2009 and July 2011 Netflix rose from $35 to a peak of $304.79 (+770%). Netflix expanded to Canada in 2010 and continued to increase the products that were available to stream-Apple products, Nintendo Wii and internet connected devices. Subscribers reached 20 million by the end of 2010, a 63% jump in subscriber base from 2009. In 2011, Netflix launched in Latin America and in the Caribbean (for a total of 43 countries). In July of 2011, a 60% increase in the price of its internet-plus-DVDs-in-the-mail plan for new subscribers was announced with existing subscribers affected as of Sept. 2011. On September 17th, Netflix announced its plan to break the DVD and streaming services apart. This plan was aborted shortly after being announced, but the damage was done. These unpopular decisions caused a loss of goodwill and were one of the factors that caused the stock to plummet. Netflix's rapid international expansion may have also caused fear for investors as Netflix announced it would lose between $60 million and $70 million in foreign markets in the third quarter. From July to December of 2011 Netflix's stock plummeted from over $300 per share to low of $67. On May 21, 2012, Netflix's shares were trading at $68.50.

3. Develop a SWOT analysis on Netflix to determine the internal strengths and weaknesses and external opportunities and threats that the company faces.

Strengths	**Weaknesses**
First mover with a well-established brand name. Growing subscriber base. Experienced management team. Successful marketing strategy: e.g. movie recommendation services.	Cost structure of the streaming segment: High fixed costs for content acquisitions and variable revenues based on number of subscribers. Loss of reputation due to a hike in the subscription price and an attempt to split the company into two: Quickster for DVD's and Netflix for streaming. Streaming library content: e.g. lost Starz and therefore Sony and Disney movies will be removed from library. High bandwidth required for streaming that somewhat restricts the potential subscriber base, particularly in foreign countries. Potential lack of capital to increase library content due to the cost of the international expansion.
Opportunities	**Threats**
New markets with international expansion: first-mover advantage. Adding video games to keep the DVD component going for a few more years. Increasing demand for streaming.	Increased competition in industry including Hulu, Amazon, and cable companies. Increased prices for licensing media. United States Postal service plans to eliminate next day delivery of 1st class mail, which is how Netflix delivers its movies so quickly. The time delay of 2-3 days would make DVD's by mail less convenient. Regulatory changes – particular in the international markets.

4. What obstacles did Netflix face in international markets?
   There were several challenges that Netflix had to contend with in international markets. First, there were differences in the infrastructure: namely a potential lack of bandwidth required by Netflix to be able to stream its content. Second, Netflix needed costly separate licensing agreements for each country. Thirdly, Netflix needed to add foreign language content to each of its foreign libraries. Fourthly, Netflix needed ensure that it understood the differences in viewing habits in different cultures. Also, the company faced the risk of more stringent and/or costly government regulations. Netflix would need to be mindful of these factors as it expanded into foreign markets.

5. What does Netflix's extensive international expansion say about the company's direction?
   Netflix was looking for an international subscriber base for its streaming service. The rising cost of content licensing and possibly its desire to "set up shop" before the competition, has had the company being very aggressive in its efforts to expand. The company was moving towards the new technology even in the U.S. where its idea of splitting DVD and streaming services caused a huge backlash and a massive loss of subscribers (800,000 in the third quarter of 2011). However, Netflix believed that streaming was the future of the company, consistent with the fact that at the end of 2011 there were over 21 million subscribers to streaming, while there were only about 11 million subscribers to the domestic DVD segment.

6. What is your prognosis for Netflix's future?
   It is clear that Netflix is facing serious challenges to maintain its position as the market leader. If Netflix can build a stellar library for both the domestic and international markets it will have a chance to reclaim and grow memberships. While the competition is heating up for Netflix, the company has maintained the position of the market leader and should be able to maintain that position for some time if the company could avoid making such poor moves as in 2011 in the future. However, it would also be likely that the profit margins for Netflix will shrink as content costs are increasing and subscribers have proven to be very price sensitive.

Appendix 1: Netflix, Inc. Balance Sheets (in millions of $)

End of December	2007	2008	2009	2010	2011
Assets					
Current assets					
Cash and cash equivalents	177	140	134	194	508
Short-term investments	208	157	186	156	290
Total cash	385	297	320	350	798
Inventories			37	181	920
Deferred income taxes	2	6			
Prepaid expenses	13	27	30	62	56
Other current assets	16	32	24	47	57
Total current assets	417	361	411	641	1831
Non-current assets					
Property, plant and equipment					
Fixtures and equipment	85	124	175	171	220
Other properties	59	100	91	94	86
Property and equipment, at cost	144	224	266	265	306
Accumulated Depreciation	-66	-99	-134	-137	-170
Property, plant and equipment, net	77	125	132	129	136
Intangible assets	132		109	183	1047
Deferred income taxes	16	22	16	17	
Other long-term assets	4	109	12	13	55
Total non-current assets	230	256	269	341	1238
Total assets	647	618	680	982	3069

source: Morningstar Investment Research Center (nd).

Appendix 1: Netflix, Inc. Balance Sheets (in millions of $)

End of December	2007	2008	2009	2010	2011
Liabilities and stockholders' equity					
Liabilities					
Current liabilities					
Short-term debt		1			
Capital leases			1	2	2
Accounts payable	104	100	91	223	1013
Accrued liabilities	36	31	33	36	54
Deferred revenues	72	83	100	127	149
Other current liabilities					7
Total current liabilities	213	216	226	389	1225
Non-current liabilities					
Long-term debt			200	200	400
Capital leases		38	37	34	
Accrued liabilities				48	
Other long-term liabilities	4	17	18	21	801
Total non-current liabilities	4	55	254	303	1201
Total liabilities	216	271	481	692	2426
Stockholders' equity					
Common stock	0	0	0	0	0
Additional paid-in capital	403	339		52	219
Retained earnings	26	108	199	238	423
Treasury stock		-100			
Accumulated other comprehensive income	2	0	0	1	1
Total stockholders' equity	431	347	199	290	643
Total liabilities and stockholders' equity	647	618	680	982	3069

Appendix 2: Netflix, Inc. Income Statements (in millions of $)

End of December	2007	2008	2009	2010	2011
Revenue	1205	1365	1670	2163	3205
Cost of revenue	786	910	1079	1357	2040
Gross profit	419	454	591	805	1165
Operating expenses					
Sales, General and administrative	271	249	289	364	530
Other operating expenses	57	84	110	157	259
Total operating expenses	328	333	399	522	789
Operating income	91	122	192	284	376
Interest Expense		2	6	20	20
Other income (expense)	20	12	7	4	3
Income before income taxes	112	132	192	268	360
Provision for income taxes	45	48	76	107	133
Net income from continuing operations	67	83	116	161	226
Net income	67	83	116	161	226
Net income available to common shareholders	67	83	116	161	226
Earnings per share					
Basic	1	1.36	2.05	3.06	4.28
Diluted	0.97	1.32	1.98	2.96	4.16
Weighted average shares outstanding					
Basic	67	61	57	53	53
Diluted	69	63	58	54	54

sources: Morningstar Investment Research Center (nd) and Yahoo (nd).

Appendix 3: Netflix, Inc. Cash Flow Statements (in millions of $)

End of December	2007	2008	2009	2010	2011
Cash Flows From Operating Activities					
Net income	67	83	116	161	226
Depreciation & amortization	225	243	258	339	840
Amortization of debt discount/premium and issuance costs			2	1	
Investments losses (gains)			-3	-1	
Deferred income taxes	-1	-8	6	-1	-19
Stock based compensation			13	28	62
Prepaid expenses	-4	-4	-11	-35	6
Accounts payable			-2	140	24
Accrued liabilities			13	67	69
Other working capital	34	-20	-46	56	20
Other non-cash items	-29	-9	-20	-478	-910
Net cash provided by operating activities	292	284	325	276	318
Cash Flows From Investing Activities					
Investments in property, plant, and equipment	-45	-208	-46	-34	-50
Property, plant, and equipment reductions	22				
Acquisitions, net	-223		11		
Purchases of investments	-405	-257	-228	-107	-224
Sales/Maturities of investments	201	307	210	137	89
Purchases of intangibles			0	-124	-85
Sales of intangibles				13	
Other investing charges	0	12	-193	0	4
Net cash used for investing activities	-451	-145	-246	-116	-266
Cash Flows From Financing Activities					
Short-term borrowing			-20		
Long-term debt issued			213		198
Long-term debt repayment			-1	-2	-2
Excess tax benefit from stock based compensation			13	62	46
Common stock issued	10	19	35	50	220
Repurchases of treasury stock	-100	-200	-324	-210	-200
Other financing activities	26	4			
Net cash provided by (used for) financing activities	-64	-177	-85	-100	262
Net change in cash	-223	-38	-6	60	314
Cash at beginning of period	400	177	140	134	194
Cash at end of period	177	140	134	194	508
Free Cash Flow					

Appendix 3: Netflix, Inc. Cash Flow Statements (in millions of $)

End of December	2007	2008	2009	2010	2011
Operating cash flow	292	284	325	276	318
Capital expenditure	-45	-208	-46	-158	-135
Free cash flow	247	76	279	118	183
Supplemental schedule of cash flow data					
Cash paid for income taxes			59	56	79
Cash paid for interest				20	19

source: Morningstar Investment Research Center (nd).

MOBILE DETAILERS, INC.

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INSTRUCTORS' NOTES

CASE DESCRIPTION

The primary objective of the case is to reinforce the accounting cycle process by illustrating the true purpose of accounting which is to identify business transactions, record the transactions in the proper period, and communicate the results by preparing financial statements. The secondary objectives of the case are to encourage critical thinking, and strengthen student's understanding of accrual accounting principles. The case allows students to become familiar with the language of business, addressing terminology typically used in accounting such as 'issued', 'on account' and 'incurred'. The case is presented in two parts. The first part covers daily journal entries while the second part continues with the adjusting entries, financial statement presentation and closing entries. The case has a difficulty level of 2. It is suitable for either an Introductory Accounting course or an Intermediate Accounting course. If used in an Introductory Accounting course, students can complete Part A and B in approximately two hours each. If Instructors use the case as an in-class assignment or lab, four 50 minute class periods should be sufficient. If used as a review for an Intermediate Accounting course, students can completes Part A and B in approximately two and a half hours.

CASE SYNOPSIS

John Eco and Manning Stewart have just graduated from college. They have raised financing from family to start their new venture which is based upon a business plan created in college. Mobile Detailers, Inc. is a car detailing service. During their first month John and Manning tackle issues common in many new businesses. Will Mobile Detailers win the race or crash and burn?

RECOMMENDATIONS FOR TEACHING APPROACHES

The benefits of using cases for learning have been extensively researched (Cullen et al., 2004; Healy & McCutcheon, 2010; Robertson, 2007; Weil & Rainsbury, 2004; Wynn-Williams et al., 2008). The case method can provide students with real life situations that enhance the learning experience. Cases challenge the student to "move beyond their customary learning strategy" (Healy & McCutcheon, 2010, p557). Technical skills learned in the typical lecture need to be applied so students can gain a deeper understanding. The realism of cases provides a framework for developing a well-structured knowledge base (Boyce et al., 2001).

Principles of Accounting textbooks typically present information separately, leaving the student to consolidate the information into a meaningful process. For example, Cornerstones of Financial Accounting (Rich et al., 2012) discuss the financial statements in Chapter one, analyzing, journalizing and posting transaction in Chapter 2, and adjusting and closing entries and preparing the financial statement in Chapter three. While the same company is typically used to illustrate the transactions and financial statements in Chapter two and three, students have difficulty seeing the overall process. This case gives students the opportunity to see the accounting cycle in its entirety.

INTRODUCTORY ACCOUNTING

There are several options for using the case in an Introductory Accounting course. Part A covers the basic journal entries found during the day to day operations of a business (Activities for March, found at the end of the case). Part B provides a narrative of adjusting entries that need to be recorded, the preparation of the financial statements and the closing entries..

Option One: Instructors can use Parts A and B in class as they teach the first few chapters. This allows students to practice the journal entries and obtain immediate feedback. To make Part B more engaging, Instructors can assign the narrative as an interactive exercise. Students can play the roles of the characters in the narrative. The narrative facilitates the critical thinking process by providing the instructor with an opportunity to query student understanding.

Option Two: Instructors can assign either Part A or Part B as an out of class assignment. Instructors can review Part A in-class before the students begin Part B to ensure that the students have the correct journal entries to move forward and to discuss any problems they may have encountered. Alternatively, Instructors can assign Part A as an out of class assignment and Part B as an in-class assignment. Instructors can walk the students though the narrative in Part B to show how to record the adjusting entries, prepare the financial statements and close the accounts.

Option Three: Both Part A and Part B can be assigned as an out-of class assignment. If this option is selected, Part A should be collected and reviewed first. This allows all students to make necessary corrections before they begin Part B.

INTERMEDIATE ACCOUNTING

Instructors for Intermediate Accounting courses can assign both parts as an out of class assignment to provide students with a refresher of the accounting cycle at the beginning of the semester. An option is provided to use a worksheet to assist students in preparing the end-of-period steps in the accounting cycle. Excel templates are included in the Instructors' Notes. These can assist students in organizing their work.

PART A QUESTIONS

A. Record the daily transactions that occurred during the month of March in the General Journal. Use Journal Page 1 (J1) and Journal Page 2 (J2) for the daily transactions.
B. Post the journal entries to the General Ledger.
C. Prepare a Trial Balance

Part B Questions

D. Using J3, record the adjusting journal entries in the General Journal.
E. Post adjusting journal entries to the General Ledger.
F. Prepare an Adjusted Trail Balance.
G. Using your Adjusted Trial Balance, prepare the Income Statement, Balance Sheet, and Statement of Retained Earnings (HINT: Start with the Income Statement).
H. Record the closing journal entries in the General Journal (Use J4)
I. Post the closing journal entries to the General Ledger.
J. Prepare the Post-Closing Trail Balance.
K. Optional: Use the worksheet to prepare the adjusting journal entries, the adjusted trial balance, and the financial statements.

STUDENT FEEDBACK

This case was administered in review workshop for Intermediate Accounting students. Students completed Part A during the workshop and Part B at home. Students were asked to evaluate the case using a 1 - 5 likert scale, with 1 = Strongly Agree and 5 = Strongly Disagree. Of the 15 students who attended the workshop, 12 submitted evaluations. Overall, students enjoyed the case and found it beneficial as a review tool. The means ranged from 1.17 for "The case required me to use critical thinking skills" to 1.67 for "The case increased my understanding of journal entries". The comments included positive statements such as, "Very helpful workshop; started semester off right", "The workshop was very complete and helped me remember many things I had forgotten from ACCT 211", and "I believe it was a much needed session and that it served as an amazing benefit to individuals like myself that consider accounting difficult".

SURVEY	MEAN
I enjoyed the case	1.25
The case required me to use critical thinking skills	1.17
The case increased my understanding of journal entries	1.67
The case increased my understanding of adjusting journal entries	1.58
The case increased my understanding of posting journal entries to the ledger	1.50
The case increased my understanding of preparing financial statements	1.25
The case increased my understanding of the accounting cycle	1.25

SUGGESTED SOLUTION

A. Record the daily transactions that occurred during the month of March in the General Journal. Use Journal Page 1 (J1) and Journal Page 2 (J2) for the daily transactions.

		General Journal			J1
Date		Account Title	Ref.	Debit	Credit
Mar	1	Cash	100	50,000	
		Common Stock	310		50,000
		(Issued stock for cash)			
	1	Equipment	150	31,000	
		Cash	100		31,000
		(Paid $15,500 each for two vans)			
	1	Rent Expense	740	500	
		Cash	100		500
	2	Equipment	150	5,000	
		Note Payable	200		5,000
		(Cleaning Equipment, 3 mo., 12% bank note)			
	4	Prepaid insurance	135	2,400	
		Cash	100		2,400
		(Purchased 1 year insurance policy)			
	4	Supplies	130	900	
		Cash	100		450
		Accounts Payable	210		450
		(Purchased supplies half cash half on account)			
	4	Cash	100	36,000	
		Unearned Revenue	220		36,000
		(6 mo. Contract with Dreyer Auto Leasing)			

		General Journal			J2
Date		Account Titles	Ref.	Debit	Credit
Mar	7	Cash	100	960	
		Service Revenue	400		960
		(Detailed 8 cars for cash)			
	9	No Transaction			
	12	Accounts Receivable	120	1,800	
		Service Revenue	400		1,800
		(Detailed 8 Trucks: Sammy's Firewood on account)			
	20	Cash	100	1,500	
		Accounts Receivable	120	1,500	
		Service Revenue	400		3,000
		(12 Vans: Sandhills Catering cash and on account)			
	27	Cash	100	1,800	
		Accounts Receivable	120		1,800
		(Sammy's Firewood paid on account)			
	29	Dividend	332	500	
		Cash	100		500
		(Declared and paid dividend)			
	30	Salary Expense	730	7,600	
		Cash	100		7,600
		(Staff Salary thru 24th,2 Owners for entire March)			

D. Using J3, record the adjusting journal entries in the General Journal.

		General Journal			J3
Date		Account Titles	Ref	Debit	Credit
		Adjusting Entries			
Mar	31	Gas & Oil Expense	640	585	
		Accounts Payable	210		585
		(To record gas and oil used)			
	31	Unearned Revenue	220	6,000	
		Service Revenue	400		6,000
		(To record revenue for services provided)			
	31	Insurance Expense	720	200	
		Prepaid Insurance	135		200
		(To record Insurance expense)			
	31	Salaries Expense	730	800	
		Salaries Payable	230		800
		(To record salary expense)			
	31	Interest Expense	910	50	
		Interest Payable	235		50
		(To record monthly interest expense)			
	31	Supplies Expense	630	750	
		Supplies	130		750
		(To record supplies used)			
	31	Depreciation Expense	710	600	
		Accumulated Depreciation	155		600
		(1 mo. of straight line depreciation expense)			

H. Record the closing journal entries in the General Journal (Use J4)

		General Journal			J4
Date		Account Titles	Ref.	Debit	Credit
		Closing Entries			
Mar	31	Service Revenue	400	11,760	
		Retained Earnings	320		11,760
		(To close revenue to retained earnings)			
	31	Retained Earnings	320	11,085	
		Supplies Expense	630		750
		Gas & Oil Expense	640		585
		Depreciation Expense	710		600
		Insurance Expense	720		200
		Salaries Expense	730		8,400
		Rent Expense	740		500
		Interest Expense	910		50
		(To close expense accounts to retained earnings)			
	31	Retained Earnings	320	500	
		Dividends	332		500
		(To close dividends to retained earnings)			

B., E., & I. Post the journal entries to the General Ledger.

100 - CASH

Date		Item	Ref.	Debit	Credit	Balance
Mar	1		J1	50,000		50,000
	1		J1		31,000	19,000
	1		J1		500	18,500
	4		J1		2,400	16,100
	4		J1		450	15,650
	4		J1	36,000		51,650
	7		J1	960		52,610
	20		J2	1,500		54,110
	27		J2	1,800		55,910
	29		J2		500	55,410
	30		J2		7,600	47,810

120 - ACCOUNTS RECEIVABLE

Date		Item	Ref.	Debit	Credit	Balance
Mar	12		J2	1,800		1,800
	20		J2	1,500		3,300
	27		J2		1,800	1,500

130 - SUPPLIES

Date		Item	Ref.	Debit	Credit	Balance
Mar	4		J1	900		900
	31	Adj. entry	J3		750	150

135 - PREPAID INSURANCE

Date		Item	Ref.	Debit	Credit	Balance
Mar	4		J1	2,400		2,400
	31	Adj. entry	J3		200	2,200

150 - EQUIPMENT

Date		Item	Ref.	Debit	Credit	Balance
Mar	1		J1	31,000		31,000
	2		J1	5,000		3,600

155 - ACCUMULATED DEPRECIATION

Date		Item	Ref.	Debit	Credit	Balance
Mar	31	Adj. entry	J3		600	600

200 - NOTES PAYABLE

Date		Item	Ref.	Debit	Credit	Balance
Mar	2		J1		5,000	5,000

210 - ACCOUNTS PAYABLE

Date		Item	Ref.	Debit	Credit	Balance
Mar	4		J1		450	450
	31	Adj. entry	J3		585	1,035

220 - UNEARNED REVENUE

Date		Item	Ref.	Debit	Credit	Balance
Mar	4		J1		36,000	36,000
	31	Adj. entry	J3	6,000		30,000

230 - SALARIES PAYABLE

Date		Item	Ref.	Debit	Credit	Balance
Mar	31	Adj. entry	J3		800	800

235 - INTEREST PAYABLE

Date		Item	Ref.	Debit	Credit	Balance
Mar	31	Adj. entry	J3		50	50

310 - COMMON STOCK

Date		Item	Ref.	Debit	Credit	Balance
Mar	1		J1		50,000	50,000

320 - RETAINED EARNINGS

Date		Item	Ref.	Debit	Credit	Balance
Mar	31	Closing entry	J4	500		500
	31	Closing entry	J4		11,760	11,260
	31	Closing entry	J4	11,085		175

332 - DIVIDENDS

Date		Item	Ref.	Debit	Credit	Balance
Mar	29		J2	500		500
	31	Closing entry	J4		500	0

400 - SERVICE REVENUE

Date		Item	Ref.	Debit	Credit	Balance
Mar	7		J1		960	960
	12		J2		1,800	2,760
	20		J2		3,000	5,766
	31	Adj. entry	J3		6,000	11,760
	31	Closing entry	J4	11,760		0

630 - SUPPLIES EXPENSE

Date		Item	Ref.	Debit	Credit	Balance
Mar	31	Adj. entry	J3	750		750
	31	Closing entry	J4		750	0

640 - GAS & OIL EXPENSE

Date		Item	Ref.	Debit	Credit	Balance
Mar	31	Adj. entry	J3	585		585

	31	Closing entry	J4		585	0

710 - DEPRECIATION EXPENSE

Date		Item	Ref.	Debit	Credit	Balance
Mar	31	Adj. entry	J3	600		600
	31	Closing entry	J4		600	0

720 - INSURANCE EXPENSE

Date		Item	Ref.	Debit	Credit	Balance
Mar	31	Adj. entry	J3	200		200
	31	Closing entry	J4		200	0

730 - SALARIES EXPENSE

Date		Item	Ref.	Debit	Credit	Balance
Mar	30		J2	7,600		7,600
	31	Adj. entry	J3	800		8,400
	31	Closing entry	J4		8,400	0

740 - RENT EXPENSE

Date		Item	Ref.	Debit	Credit	Balance
Mar	1		J1	500		500
	31	Closing entry	J4		500	0

910 - INTEREST EXPENSE

Date		Item	Ref.	Debit	Credit	Balance
Mar	31	Adj. entry	J3	50		50
	31	Closing entry	J4		50	0

C., F., & J. Prepare a Trial Balance

Mobile Detailers, Inc.
Trial Balances
March 31, 2013

	Before Adjustments		After Adjustments		Post-Closing	
	DR	CR	DR	CR	DR	CR
Cash	$47,810		$47,810		$47,810	
Accounts Receivable	1,500		1,500		1,500	
Supplies	900		150		150	
Prepaid Insurance	2,400		2,200		2,200	
Equipment	36,000		36,000		36,000	
Accumulated Depreciation		$ 0		$ 600		$ 600
Notes Payable		5,000		5,000		5,000
Accounts Payable		450		1,035		1,035
Unearned Revenue		36,000		30,000		30,000
Salaries Payable		0		800		800
Interest Payable		0		50		50
Common Stock		50,000		50,000		50,000
Retained Earnings		0		0		175
Dividends	500		500		0	
Service Revenue		5,760		11,760		
Supplies Expense	0		750		0	
Gas & Oil Expense	0		585		0	
Depreciation Expense	0		600		0	
Insurance Expense	0		200		0	
Salaries Expense	7,600		8,400		0	
Rent Expense	500		500		0	
Interest Expense	0		50		0	
	$ 97,210	$97,210	$99,245	$99,245	$87,660	$87,660

G. Using your Adjusted Trial Balance, prepare the Income Statement, Balance Sheet, and Statement of Retained Earnings (HINT: Start with the Income Statement).

Mobile Detailers, Inc.
Income Statement
For the Month Ended March 31, 2013

REVENUE		
Service Revenue		$ 11,760
EXPENSES		
Supplies Expense	$ 750	
Gas & Oil Expense	585	
Depreciation Expense	600	
Insurance Expense	200	
Salaries Expense	8,400	
Rent Expense	500	
Interest Expense	50	
TOTAL EXPENSES		11,085
NET INCOME		$ 675

Mobile Detailers, Inc.
Balance Sheet
March 31, 2013

Assets		
Cash		$ 810
Accounts Receivable		500
Supplies		150
Prepaid Insurance		200
Equipment	$ 36,000	
Less: Accumulated Depreciation	600	30,000
Total Assets		$ 87,060
Liabilities		
Notes Payable		$ 5,000
Accounts Payable		1,035
Unearned Revenue		30,000
Salaries Payable		800
Interest Payable		50
Total Liabilities		36,885
Shareholders' Equity		
Common Stock	$ 50,000	
Retained Earnings	175	
Total Shareholders' Equity		50,175
Total Liabilities And Shareholders' Equity		$ 87,060

Mobile Detailers, Inc.
Retained Earnings Statement
For the Month Ended March 31, 2013

Beginning Retained Earnings	$ 0
Add: Net Income	675
Less: Dividends	500
Ending Retained Earnings	$ 175

K. Optional: Use a worksheet to help prepare the adjusting journal entries, the adjusted trial balance, and the financial statements.

Mobile Detailers, Inc.
Worksheet
For Month Ended March 31, 2013

	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Balance Sheet	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Cash	$47,810				$47,810				$47,810	
Accounts Receivable	1,500				1,500				1,500	
Supplies	900			f 750	150				150	
Prepaid Insurance	2,400			c 200	2,200				2,200	
Equipment	36,000				36,000				36,000	
Accum. Deprec.				g 600		$ 600				$600
Notes Payable		$ 5,000				5,000				5,000
Accounts				a						1,035

Payable		450		585		1,035				
Unearned Revenue		36,000	b 6,000			30,000				30,000
Salaries Payable				d 800		800				800
Interest Payable				e 50		50				50
Common Stock		50,000				50,000				50,000
Retained Earnings										
Dividends	500				500				500	
Service Revenue		5,760		b 6,000		11,760		11,760		
Supplies Expense			f 750		750		$ 750			
Gas & Oil Expense			a 585		585		585			
Depreciation Expense			g 600		600		600			
Insurance Expense			c 200		200		200			
Salaries Expense	7,600		d 800		8,400		8,400			
Rent Expense	500				500		500			
Interest Expense			e 50		50		50			
Totals	$97,210	$97,210	$ 8,985	$ 8,985	$99,245	$99,245	11,085	11,085	88,160	87,485
Net Income							675			675
Totals							$11.760	$11,760	$88,160	$88,160

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CREATIVITY AND CULTURE AT PIXAR AND DISNEY: A COMPARISON

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INSTRUCTOR'S NOTES

CASE DESCRIPTION

This case studies the leadership and organizational dynamics of the Disney and Pixar companies and the events leading up to Disney CEO Robert Iger's offer to purchase Pixar. After analyzing the comparative histories and cultures of the two companies, students are asked to consider the advantages and disadvantages of accepting Iger's offer. If Pixar were to become a permanent part of Disney, would it lose its entrepreneurial spirit and become part of a corporate machine? If Pixar were to break ties with Disney, who would manage their marketing and distribution and how would the company have to change to handle the additional responsibilities?

CASE SYNOPSIS

In 2005, Pixar had a big decision to make. After struggling for years as a department of Lucasfilm and as an independent advertising agency and software company, Pixar had burst onto the scene in 1994 with the release of Toy Story, the first computer generated feature film. Following the film's release, the company became a publicly-traded corporation and grew into a studio large enough to produce more than one computer-generated feature at a time. The company's lucrative partnership with the Walt Disney Company gave it access to the larger firm's marketing and distribution capabilities and led to the appearance of Pixar characters at Disney's theme parks. As Pixar's characters grew in popularity, Disney saw a decline in the popularity of its own animated features, and Pixar's leaders became less satisfied with the Pixar-Disney partnership. When Disney experienced a change in leadership, Bob Iger, the newly-elected CEO, set out to not only restore Disney's relationship to Disney, but to use Pixar's creative chemistry to revitalize Disney's own animation division. He met with Pixar's leaders and offered not only to purchase Pixar but to place co-founders John Lasseter and Ed Catmull over Disney Animation and give Lasseter a role in theme park attraction development. It sounded like a "Cinderella" deal, but Catmull and Lasseter had much to consider. Many Pixar employees, they knew, would not be in favor of a Disney purchase. They were at a critical turning point in the life of their company, and the decision they made would have to be a good one.

ANALYSIS

This case is a study of leadership, core competencies, and corporate culture. At the conclusion of the case, the students will be asked to evaluate the company's options in light of these.

OBJECTIVES:

1. Students will describe the leadership styles of the various individuals mentioned in the case. (These may be related to leadership concepts like charismatic leadership, Theory X/Y, and participative leadership and to the Myers-Briggs and Keirsey temperament types.)
2. Students will list and analyze Pixar's core competencies.
3. Students will analyze and describe the complementary gifts of the members of the leadership teams described in the case.
4. Students will describe Pixar's corporate culture, pulling examples from the case to support broader summarizing statements. (Terminology from chapters on corporate culture may be incorporated into the discussion.)
5. Students will summarize the stages Pixar went through to become a financially viable movie studio.
6. Students will note the individuals and experiences that they believe were instrumental in shaping Pixar's corporate culture, supporting their conclusions with examples from the case.
7. Students will list and discuss the advantages and disadvantages of Iger's offer to purchase Pixar for Disney, offering and defending their own suggestions for the direction the company should take.

COURSES AND LEVELS: This case is appropriate for business students in organization theory and behavior and entrepreneurship classes. It might also be used in strategic management classes though it lacks the financial data present in many strategic management cases.

DISCUSSION QUESTIONS:

1. Discuss the leadership styles of Walt and Roy Disney: a. What did each of them bring to the team? b. Which of the two do your own leadership strengths mostly closely match? c. What were the features of Walt's leadership style and what can young leaders learn by studying them?

2. John Lasseter's Development as a Leader: a. List some of the experiences John Lasseter encountered that shaped his leadership style. What role did family, education, and employment at various companies each play in his development as a leader? What common threads do you note? b. Based on the information in the case, what kind of leadership style did Lasseter himself develop? c. Compare and contrast Lasseter's style to that of Walt Disney. Were they the same basic type of leader or did you note differences?

3. The Pixar Leadership Team: a. Compare and contrast the leadership styles of Ed Catmull, John Lasseter, and Steve Jobs. b. What strengths did each leader bring to Pixar? c. Which leader would you have most wanted to work for?

4. Pixar's Core Competencies: a. What were the core competencies of the Pixar team? b. What factors made these competencies possible? c. Do you believe the company had any distinctive competencies (i.e. strengths that put it ahead of other companies in the industry)? d. Do you think being the first firm to release a computer-generated feature film gave Pixar a first mover advantage?

5. Pixar's Corporate Culture: a. Based on the material presented in the case, what are some of the hallmark features of Pixar's corporate culture? What did the company seem to assign the most value to? b. Which of

the following leadership styles best describes the style used at Pixar: Autocratic, Participative, and Laissez Faire? Do you feel that this style is a good match for Pixar's strategy and goals? c. What challenges did Pixar's leaders and employees face? Give examples and tell what role those challenges had in shaping the company's culture?

6. Group Creative Processes: a. Using examples from the case, describe the process Pixar used in creating its films. Was the process leader-driven, team-driven, or a combination? b. How did the technological and artistic aspects of Pixar's creative processes interact? c. Describe Pixar's creative process using the following terms: groupthink, escalation of commitment, empowerment, participative leadership, tacit knowledge. (Note to teachers: If you are not familiar with these terms, I have included brief descriptions in the Instructor's Notes.)

7. Stages of Development: Look back over the case and summarize the steps Pixar went through, starting with its beginning as a department of LucasArts. How did the company support itself financially at each of the following stages of development:
    a. As a department of Pixar.
    b. As an independent company before the Toy Story Deal with Disney.
    c. As an independent company during the production of Toy Story.
    d. As a corporate entity following the release of Toy Story.
    e. As a part of the Disney corporate umbrella.

8. The Disney Purchase: a. What factors did Pixar's leaders consider in evaluating Robert Iger's offer to merge with Disney? Are there any others they should have considered? Place the factors in two columns, one for the positive aspects and the other for the negative. b. Do you think they should accept Iger's offer? Why or why not? c. What factors led Bob Iger to try to purchase Pixar for Disney?

ANSWERS:

1. The leadership styles of Walt and Roy Disney:

Before discussing leadership styles, it is helpful for students to have a vocabulary. More information on the following theories and concepts may be drawn from your textbook or located with a quick internet search:

McGregor's Theory X and Theory Y Leadership: Theory X leaders assume people are lazy and do not like to work, but Theory Y leaders assume people want to do a good job and make a contribution and are motivated when their jobs allow them to. Theory Y leaders pay more attention to developing the workers themselves rather than just nitpicking the details of their work. (McGregor, 1957) Many of the leaders described here worked to develop their people rather than micromanaging them.

The Myers-Briggs Type Indicator (MBTI) is used in many organizations to assess personality. (Myers and Myers, 1980) A similar (but slightly less well-known) device for discussing leadership strengths is based on the temperament studies of David Keirsey (1998). Students can locate information about Keirsey's theories at www.keirsey.com.

David Keirsey, in *Please Understand Me II* (1998), and Stephen Montgomery (2008), in *People Patterns*, describe four temperaments and four types of leadership intelligence in relation to temperament type. The four temperaments are Guardians, Artisans, Idealists, and Rationals. Each is briefly described below:

Guardians, are practical, concrete thinkers who respect tradition and do what is sensible. Their effectiveness comes from their attention to detail.

Artisans are spontaneous, sensory-oriented individuals who scan the environment for opportunities and do what works. They are effective in situations that require a quick response, but bored with routine.

Idealists are visionary, growth-oriented individuals who deeply value people and build consensus through trust.

Rationals are visionary, growth-oriented individuals who constantly seek new knowledge and better ways to do things. They are creative like idealists, but are more tough-minded and critical and have little patience with incompetence. They are also effective strategists who see patterns in complex situations.

The four types of leadership intelligence are logistical intelligence, tactical intelligence, diplomatic intelligence, and strategic intelligence.

Logistical Intelligence is the careful management of schedules and resources. Guardians are typically strongest in this type of intelligence.

Tactical Intelligence is the ability to respond quickly to unanticipated crises, to "think on ones feet," and develop innovative solutions to problems that arise. Artisans are typically strongest in this type of intelligence.

Diplomatic Intelligence is the ability to understand the emotions and motivations of people, to build trust, and to bring them together to work toward a common goal. Idealists are typically strongest in this type of intelligence.

Strategic Intelligence is the ability to develop "big picture" plans to solve complex problems. Rationals are typically strongest in this type of intelligence.

(Students can take an online test at www.keirsey.com to determine their own types.)

Walt Disney and Steve Jobs showed many of the characteristics of the Rational temperament. They were constantly pushing toward new frontiers and were able to pull people and resources together to reach them. Roy Disney, a classic Guardian, kept Walt's creative efforts focused and tried to keep the company from getting too far into the red. Lasseter and Catmull, both visionary and kindhearted and personal in their treatment of people, showed many Idealist characteristics though Lasseter may be a warm-hearted Composer or Performer Artisan (Montgomery, 2002).

a. What did each of them bring to the team?

Walt's strengths were in his artistic creativity and his boundless vision. He was constantly pushing for improvement, quickly adopting any new technology that could enhance the animation process. He reinvented the animated cartoon and the amusement park. He also had a knack for attracting and developing talented people.

Roy faced the challenge of taking his brother's dreams and wrestling with the financial and logistical challenges of making them viable in the marketplace. As the case points out, Roy is sometimes viewed as a naysayer, but he arranged many of the licensing deals that made their company successful.

(In the language of the Keirsey temperament sorter, Walt was a Rational and Roy was a Guardian. Walt constantly pushed the frontiers of knowledge and Roy found practical ways to make Walt's visions work.)

b. Which of the two do your own leadership strengths mostly closely match?

Many business students will probably identify more closely with Roy, though some will identify with Walt.

c. What were the features of Walt's leadership style and what can young leaders learn by studying them?

Walt surrounded himself with talented people, invested in their development, and tried to assign them to tasks that matched their strengths. He sent his animators to art classes and finally invested in the California Art Institute. He brought in guest speakers to inspire his artists. The case tells about an artist named Emil who "didn't draw ducks" but preferred the more exotic characters like the devil figure in Fantasia.

A discussion of Theory X and Theory Y leadership would be instructive at this point. Though Walt showed some of the hard-driving tendencies of a Theory X leader, his approach was really more Theory Y because of his investment in his people and his attempts to place his employees in their areas of strength where intrinsic motivation would be stronger.

Optional:

Other theories you might consider using include the Ohio Studies (Likert, 1961) Tannenbaum and Schmidt's leadership continuum (1973), Fielder's (1976) LPC Theory, Robert House's work on Charismatic Leadership Theory (House, 1977).

In popular writings, Michael Maccoby's *The Productive Narcissis*t (2003) and *Narcissistic Leaders: Who Succeeds and Who Fails* (2007) and Jim Collin's (2001) *Good to Great: Why Some Companies Make the Leap and Some Don't* paint two wildly contrasting pictures of leadership.

Walt Disney and Steve Jobs are classic examples of Maccoby's "productive narcissist" personality. The "Level 5" leaders Collins uncovered in his research on companies whose leaders had transformed good companies to great ones were completely different. Rather than being "out front" visionaries (What Collins describes as "Level 4" leaders), they were behind-the-scenes leaders who led through others rather than forcing them into line with their own vision. Lasseter and Catmull blended the two types. They were vision-driven leaders, but they were catalysts and mentors as well. Neither of them fits the "narcissist" mold.

2. John Lasseter's Development as a Leader:

a. List some of the experiences John Lasseter encountered that shaped his leadership style.

Both Ed Catmull and Dennis Muren (the special effects supervisor on the Young Sherlock Holmes project) were participative leaders who involved their subordinates in the creative process. Lasseter's negative experience with a former boss at Disney Animation was also influential in driving Lasseter toward a more participative style. The case also mentioned that his summer job at Disneyland helped him to get over his initial shyness.

b. Based on the information in the case, what kind of leadership style did Lasseter himself develop?

Lasseter was a participative leader who welcomed input from the Pixar team throughout the process. He helped shape other animators to serve in leadership roles as well. When the studio began developing more than one movie at the same time, he placed other animators in charge of those projects rather than trying to control everything himself. He later brought Brad Bird into the company to shake things up.

c. Compare and contrast Lasseter's style to that of Walt Disney. Were they the same basic type of leader or did you note differences?

Both Lasseter and Disney believed in investing in their employees and trying to place them on projects that matched their gifts. Both believed in taking on continually more challenging projects and both kept up with technology and tried to use it to their advantage. In Disney's case, "technology" meant sound, color, and stereophonic sound systems in theaters. In Lasseter's case, the technology was more specifically tied to computer graphics.

One notable difference was Lasseter's early willingness to share credit. Walt Disney did not, originally, even list the names of the animators in the credits of his films. Lasseter shared both credit and authority.

3. The Pixar Leadership Team:

a. Compare and contrast the leadership styles of Ed Catmull, John Lasseter, and Steve Jobs.

Catmull and Lasseter were both participative leaders who assembled teams of talented people and harnessed the synergy of their ability to work together.

Steve Jobs was outspoken, opinionated, and sometimes volatile, but also very charismatic. He was said to have had a "reality distortion field" that made listeners buy into *whatever vision he was promoting. All three leaders were visionaries who wanted to "change the world."*

b. What strengths did each leader bring to Pixar?

All three were experts, and all were "connected" in their realms of expertise:
Catmull was a leader in computer graphics technology. He had pioneered three major developments himself and had assembled a team of the world's top computer graphics researchers.

Lasseter was a Disney-style animator who combined his love of story with a vision for what computer technology could do. Without someone like him, Catmull's team would have created beautiful graphics, but would not have had stories that resonated with their audiences. Lasseter not only had an animator's abilities, but he also had connections in the animation industry because of his education at CalArts and the time he had spent working for Disney.

Jobs was an entrepreneur who had founded two computer companies. One practical benefit he brought was, simply put, his money. He purchased the company for $5 million and invested, according to some estimates, about ten times that much into the company in the decade that followed. Jobs handled the financing of the company in other ways as well. He negotiated the agreement with Disney that led to Disney's paying for and assisting in the production of Toy Story, and renegotiated the new agreement that followed. He pushed for the company's incorporation, and handled the arrangements for it. He made the arrangements for Disney's purchase of Pixar with Bob Iger.

c. Which leader would you have most wanted to work for?

Opinions will vary. Some students would probably prefer to avoid Jobs' stormy temper, while others will express admiration for his gifts as an entrepreneur and a negotiator.

4. Pixar's Core Competencies:

a. What were the core competencies of the Pixar team?

Note to Instructors: Birchall and Tovstiga (1999) discuss the value of a company's capabilities in "The Strategic Potential of a Firm's Knowledge Portfolio in *Journal of General Management*, 25(1), August, 1-16. (Cited in Gamble and Thompson, (2011) *Essentials of Strategic Management*.)

One of the most notable competencies was the firm's expertise in technology. Ed Catmull had assembled a group of leading innovators in the field of computer graphics. While other companies would have had to rely on "out of the box" software, Catmull's team could develop its own software from scratch and configure computer networks to create the images.

The animation team's gift for creating characters that resonated with audiences represented a kind of tacit knowledge. (Tacit knowledge is knowledge that is difficult to describe or reduce to formulas. It is the combined result of craft, intuition, talent, and experience.) One might say Pixar had developed its own brand of "Disney magic." Pixar's films had all, up to the time of its purchase, been financially successful. Most had been critically successful. Ironically it was Cars*, the least favorite of critics, that had generated the most merchandise sales.*

A third core competency was Pixar's ability to combine state-of-the-art graphics with quality storytelling. Steve Jobs once commented that Hollywood and Silicon Valley are two completely different cultures, but that Pixar had found a way to successfully combine the two.

b. What factors made these competencies possible?

One crucial factor was the talented people the company had managed to pull together. The company's leaders and their connections to others who shared their creative visions had laid the foundation for those core competencies. Catmull had trained at a leading computer graphics technology school and Lasseter had trained at a leading animation school and both had brought classmates with them. The Walt Disney Company and Lucasfilm, in addition, had served as "lightning rods" for creative talent that helped bring together the core of the company together. After their initial successes, Pixar itself became a "lightning rod" for talent n its own right.

Pixar's continual investment in its people was another factor in the company's continued success. The company had founded Pixar University (The name was chosen partly because the initials spelled "P.U.") to provide training for its people.

c. Do you believe the company had any distinctive competencies (i.e. strengths that put it ahead of other companies in the industry)?

Catmull's team of programmers may have been unique, though other companies had assembled their own teams of computer graphics professionals. The smooth interaction between Catmull's programmers and Lasseter's animators had been honed over the years, but the distinctiveness of that chemistry is difficult to quantify.

d. Do you think being the first firm to release a computer-generated feature film gave Pixar a first mover advantage?

This is, of course, open for discussion. In the fifteen years since Toy Story*'s release, the number of companies producing computer-generated features has proliferated.* Shrek*, produced by Dreamworks, has been immensely popular.*

Veggietales, a direct-to-video series originally released in Christian bookstores and now available at general merchandise retailers, is one of the most popular direct-to-video properties ever to be released.

One class exercise instructors might try is to mix a list of Pixar's animated features (e.g. A Bug's Life, Finding Nemo, Brave, Cars, The Incredibles*) with a list of animated features by other companies (e.g.* Shrek, Antz, Epic, Madagascar, Rise of the Guardians) *and see if students know which were produced by Pixar and which were produced by other studios.* Antz *and* A Bug's Life *are particularly easy to confuse.*

Pixar's reputation and its connection to Disney have placed it at the head of the game even though Pixar is no longer the only company that produces computer-generated features. In discussing the value of name and reputation, instructors might want to ask students if Starbucks has any advantages over other coffee shops. After all, coffee is coffee,…or is it?

5. Pixar's Corporate Culture:

a. Based on the material presented in the case, what are some of the hallmark features of Pixar's corporate culture? What did the company seem to place the most value on?

The company placed a strong emphasis on creating a quality product even if it meant changing directions in the middle of a project. Pixar also believed it was important to involve as many of its employees as possible throughout the creative process. All employees attended meetings where they viewed "dailies" and critiqued the work of their peers, always looking for ways to improve. This meant that everyone involved had to be willing to accept constructive criticism "for the good of the project." An underlying foundation of trust and mutual respect was necessary to keep egos from getting in the way.

Note to Instructors: The Competing Values Network (See: Cameron and Quinn, 2011) characterizes corporate cultures as bureaucracy, clan, market, and adhocracy. The adhocracy (the term is also used by Henry Mintzberg, [1979]. The Structuring of Organizations) is a company with a flexible structure that is typical of technology firms in dynamic markets. Teachers might want to have students briefly research the CVN online and use it as a framework for discussing the company's culture.

b. Which of the following leadership styles best describes the style used at Pixar: Autocratic, Participative, and Laissez Faire? Do you feel that this style is a good match for Pixar's strategy and goals?

Pixar's style was primarily participative, though each project ultimately had a director who had the final say in the direction a project was to take. Constructive criticism and suggestions for improvement were welcomed throughout the process. Based on the quality and the financial success of Pixar's films, the style seems to have been a perfect match for the *company's strategy and goals. In any process that involves integrating the work of experts in a variety of fields to create a single finished product, "refereed" participative management is essential.*

c. What challenges did Pixar's leaders and employees face? Give examples and tell what role those challenges had in shaping the company's culture?

The challenges involved in producing the original *Toy Story* film helped to forge the company's culture. When Disney threatened to shut down the project in midstream, Pixar's animators made the decision to trust their own instincts and produce a product that, first and foremost, pleased them rather than working so hard to please Disney's executives. That decision turned out to be the correct one.

As the first movie was nearing completion, Steve Jobs began to think about ways to transform Pixar from a single-product operation to a studio that was capable of producing at least one feature film a year. One change this brought about was that Pixar would have to have multiple projects in the works at the same time. To manage that process, Lasseter decided to share his director's role with other animators rather than matching all projects to his own creative vision.

The production of *Toy Story 2* was another crucial turning point. When the company decided against producing a low quality, direct-to-video sequel, they had to revamp the entire project, and pack work that would have taken them two years into nine months. The challenge led to refinements in the company's creative process. When the pace of the project proved damaging to the physical and emotional wellbeing of the animators, Pixar instituted programs that were designed to safeguard the health of the employees.

6. Group Creative Processes:

a. Using examples from the case, describe the process Pixar used in creating its films. Was the process leader-driven, team-driven, or a combination? How did the technological and artistic aspects of Pixar's creative processes interact?

As Lasseter described it, "the art challenges the technology and the technology challenges the art." In the early days of computer animation, the animators were more constrained by the limitations of the hardware. Toys and insects, for example, were chosen for Pixar's first films because their bodies did not require realistic skin or hair. Insects did not even have to wear clothes. Each film was, in some way, more challenging than the previous one. While Toy Story *was primarily indoors,* A Bug's Life *was in an outdoor world of dirt and plants. The* Incredibles *was the first film to feature mostly human (or superhuman?) characters.*

b. Describe Pixar's creative process using the following terms: groupthink, escalation of commitment, empowerment, participative leadership, tacit knowledge. (If you cannot find these terms in your textbook, do a quick internet search for them.)

Groupthink is the process in which the members of a group are so convinced of their own superiority or so afraid to disagree with prevailing opinions that they lose their ability to be objective. Escalation of commitment (Brockner, 1992), similarly, is a situation in which a group "talks itself into" going in what is clearly the wrong direction because the decision has already been made and too much energy has always been expended.

An interesting picture of Groupthink is provided by Irving Janis' (1971) application the concept of Groupthink to the Bay of Pigs disaster during Kennedy's administration.

Pixar safeguarded against these processes in a number of ways. One was by welcoming dissent from group members. All members of the company participated in meetings where they were kept up to date on the company's various projects. Everyone was encouraged to challenge the process and continually seek ways to make a film better. Bringing in outsiders like Brad Bird, who wrote and directed *The Incredibles*, also kept the company from getting "into a rut."

As the story behind Toy Story 2 demonstrates, the company showed itself willing to "stop the train" any time it became evident that a project had drifted off course and was going in a direction that did not work.

Empowerment, the sharing of leadership authority, was practiced in a number of ways. After *Toy Story*, when the company incorporated and began producing more than one film at a time, John Lasseter shared directing responsibilities with other directors. He also used short films like *Jeri's Game* and *Boundin'* to allow animators to develop their directing skills.

Tacit knowledge is that kind of knowledge that is difficult to communicate directly or pass on verbally. (See: Lubit, 2001, and Castillo, 2002) It is the result of talent, experience, and intuition. This knowledge may be held by individuals who have, over time, refined their abilities to perform certain types of tasks, or by the members of groups who have developed efficient and innovative ways of working together. The ability to create animated characters that resonate with an audience or to integrate technology with animated storytelling are applications of tacit knowledge. John Lasseter says he developed a sense of comedic timing while working as a guide on Disney's Jungle Cruise. That sense of timing is a type of tacit knowledge. One fear that Ed Catmull expressed when executives at LucasArts threatened to sell off the computer graphics department was the breakup of the team itself. His team of experts and the way they worked together, he believed, was more valuable than any of the products or equipment they had produced.

Tschang and Goldstein (2010) have written an interesting article about the challenges of outsourcing animation work to the Philippines.

7. Stages of Development: Look back over the case and summarize the steps Pixar went through, starting with its beginning as a department of LucasArts. How did the company support itself financially at each stage of development?

a. As a department of Pixar.

Pixar began its life as the computer graphics department of LucasArts. It was not bringing in much income of its own, so it relied on the income generated by the other departments of LucasArts. That was a source of contention with the other departments.

b. As an independent company before the Toy Story Deal with Disney.

In its second stage, Pixar existed as an independent company supported by Steve Jobs. The company brought in a little bit of revenue by producing television commercials and from the sale of hardware and software, but it was not enough to make a profit.

c. As an independent company during the production of Toy Story.

Steve Jobs negotiated a deal with Disney to finance the production of *Toy Story* and to provide creative and marketing assistance for the film. Disney would retain most of the profits from the first film, however.

d. As a corporate entity following the release of *Toy Story*.

Steve Jobs took Pixar public just as *Toy Story* was release. Raising $150 million, the IPO was the most successful of the year. This allowed Jobs to negotiate the 50/50 partnership with Disney in which Disney and Pixar would share in the costs and profits of Pixar's next five feature films, and Disney would put the force of its massive marketing machine behind them. (Paik, 2007, p. 110)

e. As a part of the Disney corporate umbrella.

Following the Disney, Pixar was once again under the corporate umbrella of a larger corporation.

8. The Disney Purchase:

a. What factors did Pixar's leaders consider in evaluating Robert Iger's offer to merge with Disney? Are there any others they should have considered? Place the factors in two columns, one for the positive aspects and the other for the negative.

One important consideration was the history the companies had shared: Pixar's partnership arrangement with Disney had been great for the company when it was still new. Disney had financed the production of Toy Story *and had lent its expertise to the project. They had also marketed and distributed the film. In exchange, Pixar had given Disney ownership of the characters and most of the profits. After* Toy Story *turned out to be a hit and Disney went public, Steve Jobs negotiated a 50/50 partnership in which Pixar and Disney would each cover half of the production costs of the films and would share equally in the profits. Disney would own* *all of the rights to the characters. They could make sequels with or without Pixar's approval, but Pixar would have the right of first refusal. This arrangement, early on, was pleasing to Pixar, but as the company developed its own production capabilities and earned enough to finance its own films, Pixar's leaders began to look forward to the end of the agreement. One bone of contention was Disney's treatment of* Toy Story 2*. The agreement was supposed to cover five films, but Disney did not include* Toy Story 2 *in that agreement because it was a sequel.*

Their single greatest concern was protecting Pixar's culture: John Lasseter's negative experiences as an employee at Disney Animation in the early 1980s had shown him the type of company he did not want to work for, and his experiences with the Eisner-era Disney had led him to distrust the corporation. Steve Jobs' personal dislike of Michael Eisner had soured him on dealing with Disney until the corporation underwent a change of leadership. These factors had initially driven away from Disney.

When Bob Iger took over leadership of Disney, Jobs, Lasseter, and Catmull were all impressed with him. Iger not only wanted to purchase Pixar. He wanted to put Catmull and Lasseter over Disney Animation in the hopes of revitalizing it.

If Pixar did not accept Iger's offer, they would have to either find another corporate partner to handle the marketing and distribution of their films or develop those capabilities in-house. Leaders with expertise in marketing and distribution would have to be brought in and two or three hundred new employees would have to be hired and trained to operate Pixar's business division. They would also be responsible for covering their own losses rather than having a corporate partner to bail them out in the case of delays or downturns.

b. Do you think they should accept Iger's offer? Why or why not?

Naturally, some students will argue for the purchase and some will argue against it. If Pixar was going to have a corporate partner, Disney was "the known devil," and they owned Pixar's characters. Robert Iger was going out of his way to give Lasseter and Catmull creative control, so the deal worked very well for them. Some may suggest a compromise in which Disney and Pixar would continue to operate as partners. Some students might express the concern that Iger might be replaced at Disney by a less Pixar-friendly CEO, and that is a concern worth noting.

c. What factors led Bob Iger to consider purchasing Pixar for Disney?

Iger noticed that all of the popular characters Disney had produced in the past decade had come from Pixar's movies rather than from the films produced by Disney's own internal animation department. He also had to consider that forty-five percent of Disney's movie revenues came from Pixar's films. It was in Disney's best financial interests to keep Pixar in its corporate fold.

EPILOGUE

Ultimately Jobs, Lasseter, and Catmull decided to accept Iger's offer. Their employees at Pixar were stunned by the decision, but Catmull and Lasseter alleviated tensions by meeting with groups of employees and explaining the thought process behind the choice. By the time they had finished, according to Catmull, "everybody understood the decision, and we didn't lose a single person in the process." (Paik, 2007, p. 292)

When Catmull and Lasseter flew to Burbank and met with five hundred of Disney's animators, they were greeted with bursts of applause. With Lasseter at the helm, the animators hoped for an end to the layoffs they had been experiencing for the past few years. Catmull and Lasseter soon began to make their mark on the studio, rehiring some of the outstanding animators that had been laid off. These included Joe Musker, one of Lasseter's former classmates, who had co-directed *The Little Mermaid*, *Aladdin*, and *Hercules*. (Price, 2008, p. 253-254)

One year after the merger, according to Ed Catmull, the whole process was working out beautifully. Catmull, Lasseter, and Jobs had all assumed different roles. Catmull and Lasseter had moved into their roles of overseeing both Pixar and Disney Animation. Jobs was part of the six-person Pixar and Disney Animation oversight committee and a member of the Disney board. (Paik, 2007, p. 297)

By the end of the decade, Pixar was still producing hit films and Disney Animation was showing signs of returning to its former glory. *Up*, released in May, 2009, grossed $731,304,609 worldwide, giving it a ranking of eight in worldwide box office receipts at the end of the decade. *The Princess and the Frog*, also released in 2009, was the first feature to use traditional cel animation since *Brother Bear* was released in 2003. *The Princess and the Frog* combined computer technology with traditional cel animation to give the film the look of a traditional Disney film only with greater depth and fluidity of movement. The movie continued two Disney traditions. Like *The Little Mermaid*, *The Beauty and the Beast*, and *Mulan*, the heroine of the story was a bright young woman going against the forces of society to pursue a dream. The choice of New Orleans as a setting the story reflected Walt Disney's own fondness for the famous city, a fondness reflected in the New Orleans Square section of the Anaheim Disneyland. The feature was well received by critics, but, unfortunately, did not achieve the same level of box office success as Pixar's computer generated features nor of traditionally animated features like *The Lion King, Aladdin,* and *Tarzan* had in the 1990s. (2010, www.the-numbers.com/movies/ series/Buena Vista.php) The feature was also plagued with criticism from a variety of special interest groups. Though Tiana, the film's heroine, was Disney's first African-American princess, the film still received criticism from some African Americans who thought the prince should have been completely black, and that setting the story in New Orleans was insensitive to Katrina victims. Some religious groups felt that the use of demonic black magic by the villain was inappropriate, and advocacy groups for religious tolerance felt that the film presented voodoo in a negative and stereotypical light. (The Week, 2009)

Toy Story 3, released in the summer of 2010, broke the record set by *Pirate's of the Caribbean: Dead Man's Chest* had set to became Disney's all-time highest-grossing feature film. (It held that record until Marvel's *The Avengers* passed it up in May, 2012.) *Tangled*, a Disney animation feature based on the story of Rapunzel, was released in November, 2010. Ranked by its opening weekend receipts of $48,767,052 the movie ranked eighth in opening weekend sales compared to all Disney animated features and sixteenth compared to all Disney films at that time. (*Cars 2* bumped it to the ninth slot in summer 2011.) That places it below *Toy Story 3*, *The Incredibles*, *Finding Nemo*, *Up, WALL-E*, *Monsters, Inc*., and *Cars* opening weekend sales, but above every other feature animation produced by Disney and Pixar. The film was still in theaters at the end of the 2000-2010 decade. (2010, www.the-numbers.com/movies/series/BuenaVista.php) Pixar's *Cars 2* and Disney Animation's *Mars Needs Moms* were both released in summer of 2011. *Cars 2* surpassed its predecessor in first weekend sales and worldwide gross. *Mars Needs Moms* was less successful. *Brave* was released in July, 2012. It had earned $237,282,182 by August of 2013. *Monsters University*, released in June of 2013, had earned $261,134,998 within two months of its release. *Planes*, released in August of 2013, earned $48,356,207 in its first two weeks. *Frozen*, another Disney animated feature, was scheduled for release in November, 2013. (http://www.the-numbers.com/movies/distributor/Buena-Vista)

At the end of the decade, John Lasseter had settled into his role in leading both Pixar and Disney Animation, and was busily involved in the development of theme park attractions. A section of Disney's California Adventure based on the movie *Cars* opened in 2012.(Vaugn, 2012)

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