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LETTER FROM THE EDITOR

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

The cases contained in this volume have been double blind refereed, and each was required to have a complete teaching note before consideration. The acceptance rate for manuscripts in this issue, 25%, conforms to our editorial policies.

The Academy does not take copyrights on the cases and manuscripts it publishes. Accordingly, 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 author(s) of the case.

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

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

It is with deep regret that we announce the passing of Dr. Larry Watts, the former Editor of the *Journal of the International Academy for Case Studies* and a very dear friend. Larry passed away this past year and he has left us with a deep sadness for his loss but also with many wonderful memories. Larry was extremely valuable to the Allied Academies organization and will be difficult to replace in the organization and impossible to replace in our hearts.

JoAnn Carland
Western Carolina University

NEW EXECUTIVE COMPENSATION AT COOPER TIRE

Javad Kargar, North Carolina Central University
Kofi A. Amoateng, North Carolina Central University

CASE DESCRIPTION

The primary subject matter of this case concerns the controversy about a new compensation plan for executive officers at the Cooper Tire & Rubber Company. The case is intended for use in undergraduate and graduate courses in compensation administration, human resource management, organizational behavior, or strategic management. Specifically, the case could be used in any business courses that address issues of incentive compensation, compensation communication, and employee motivation. Depending on the interests of the instructor, student attention could be focused on the design and implementation of the compensation plan described in the case or on the behavioral problems arising from the use of incentive programs. The broad purpose of the case is to illustrate the difficulties and complexities in the design of incentive pay program. The primary objectives of the case are to illustrate the relationship between executive compensation practices and motivational theories, and to highlight the importance of effective communication in building support for a company's incentive pay plan. 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

The case centers around the board of directors of Cooper Tire & Rubber Company, who have revised and approved a new executive compensation plan. Cooper is a well-established company that produces replacement tire and automotive components. The company employed 400 executive officers at the corporate and business levels. In addition to enhancing the executive earning potential, the board thought the revised executive compensation plan would promote growth of the company business, offer savings by having better control over the flow of funds into purchasing new equipment, and increase stockholders return on investment. Two years after the new plan was adopted, some executives felt that the new system was unfair and unrealistic because they had to work hard to make no bonuses, and that their business units were making more money when they were making less. Mr. Dattilo, the CEO, was concerned that he would lose some executives who were disgruntled with their bonuses. At the end of the case, he was trying to develop a proposal for discussion at an upcoming meeting with the board of directors. He was not sure how the executive compensation problem should be fixed, but he knew something should be done soon.

COMPANY BACKGROUND

Cooper Tire & Rubber Company was a manufacturer of replacement tire and automotive components, headquartered in Findlay, Ohio. The company had been in business for over 80 years and operated out of two separate operating groups: Cooper Tire, and Cooper-Standard Automotive. The groups were each managed separately because they offered different products requiring different marketing and distribution strategies. The Tire Group operated out of three divisions: Cooper North America Tire, Cooper International Tire, and Cooper Commercial Products. Cooper-Standard Automotive had also three divisions: Sealing Systems, Fluid Systems, and NVH Control Systems. It operated more than 60 production facilities in 13 countries and employed more than 21,000 people.

The Tire Group was the seventh largest tire manufacturer in the world. The group's primary product lines included automobile, truck and motorcycle tires, and inner tubes, which were sold nationally and internationally in the replacement tire market to independent dealers, wholesale distributors, mass merchandisers and large retail chains. The company marketed tires under seven proprietary brands: Cooper, Mastercraft, Avon, Starfire, Roadmaster, Dean and Dominator. Cooper tires were sold in more than 110 countries. Sales of the company's tire segment were $1.7 billion in 2001, a decrease of $98 million, or five percent, from $1.8 billion in 2000. And its tire unit sales for 2001 were down eight percent from 2000. Operating profit decreased from $184 million in 2000 to $73 million in 2001. Operating margin was 4.3 percent in 2001, a decrease from 10.2 percent in 2000. An increase in raw material costs of over $30 million, due primarily to increases in the price of petroleum, was the principal reason for the decline in the segment's margins in 2000. Cooper's replacement tire unit sales in North America had increased nearly 95 percent since 1990 while the industry had grown just 15 percent. Including proprietary and private brands, the company had an estimated North American replacement tire market share of 20 percent.

Industry-wide sales of passenger car and light truck tire replacement units in the United States market decreased in 2001 by approximately 4.7 percent from 2000 sales levels. The year 2000 was a record high sales year, due largely to the well-publicized recall of certain Firestone tires. Consumer demand softened in early 2001 due primarily to weakened United States economy. This softening continued throughout the year and was exacerbated by the events of September 11, 2001. In addition, foreign produced, low-priced tires continued to be imported into the United States market at high levels.

The outlook for replacement tire market was expected to be a challenging in year 2002 and beyond. The overcapacity issue that had impacted the replacement tire industry in the past years was expected to reappear. In addition, a decline in consumer confidence as economic conditions became increasingly uncertain could cause reductions in spending on replacement tires. Furthermore, overcapacity among tire producers in South America and Asia, coupled with a continuation of the strength of the U.S. dollar, were likely to result in continued high levels of imports of low-priced, lower-end tires into the U.S. replacement market. A leading trade association forecasted a decline in replacement tire sales in 2002 of one to two percent from 2001 levels, reflecting generally weak economic conditions and a disruption in consumer demand for replacement tires created by the two Firestone recalls.

The Company's automotive segment produced body sealing systems, active and passive vibration control systems, and fluid handling systems primarily for the original equipment manufacturing (OEM) automakers around the world. The year 2001 was one of significantly reduced automobile production in North America. Light vehicle production in North America declined by approximately ten percent to 15.5 million vehicles from 17.1 million vehicles in 2000, which was the highest level ever recorded, and represented an increase of approximately one percent over 1999 levels. Production in Europe was 19.5 million vehicles in 2001, unchanged from the production levels in 2000. South American production totaled 2.0 million vehicles in 2001, which was equal to production levels in 2000. Sales for the company's automotive segment were $1.5 billion in 2001, a decrease of 13 percent from $1.7 billion in 2000. Approximately 74 percent of the segment's sales in 2001 were in North America, 22 percent in Europe, and four percent in Brazil, Australia, and India. Nearly all of the segment's foreign sales were of body sealing components and fluid handling systems. Although the segment did business with all of the world's major automakers, about 76 percent of its global sales were to Ford, Chrysler unit of DaimlerCyrysler, and General Motors in 2001.

Operating profit of the automotive segment was decreased from $69 million in 2000 to $39 million in 2001. Operating margins were 2.6 percent in 2001, versus 4 percent in 2000. The reduction in North American light vehicle production levels in 2001 was primarily responsible for the lower operating profits. Other factors that adversely affected operating profit were the inefficiencies created by erratic scheduling resulting from the short lead times given by the OEMs in advance of the frequent production curtailments that occurred during the year, the pricing reductions granted in 2001, and inefficiencies resulting from the redeployment of the business of the closed Rocky Mount, North Carolina sealing production plant to two other facilities. On the positive side, the segment benefited from North America fluid systems production in Mexico, where the cost structure was significantly lower than in the United States. Prior to the acquisition of Siebe in January 2000, nearly all the company's North American fluid systems production resided in the United States. The performance of the North American sealing business benefited from the greater raw material buying power by combining its purchasing with that of the tire business.

The performance of the automotive segment in the future was estimated to be dependant upon several factors. The overall level of light vehicle production was seen a significant influence on the segment's level of profitability. Performance was also dependent on the extent of price reductions granted to the segment's customers. In addition to reductions that took effect at the beginning of 2002 under long-term agreements, the segment entered into discussion with Ford Motor Company, its largest customer, for additional price reductions. Although the company expected that 2002 would be a difficult year if economic conditions remained weak, emphasis on continuous improvement, lean manufacturing and other cost reduction efforts were required to remain profitable in this environment.

THE NEW EXECUTIVE COMPENSATION PLAN

Cooper had undergone dramatic change over the years 1999-2001. Under the direction of the Board, during that time period, the company had identified a growth strategy, and hired a new chief executive officer charged with implementing that strategy. In 1999, Cooper completed the acquisition of the Standard Products company and announced an agreement to acquire the Siebe Automotive Division of Invensys, which was subsequently completed in January 2000. As a result of the aggressive efforts taken in response to the Board's direction, the company had nearly doubled its revenues, had significantly diversified and broadened its product lines and organizational structure, and had further penetrated its key markets. Given the magnitude of change associated with these transactions, the Compensation Committee of the Board of Directors undertook a review in 1999 of how the company's executive compensation programs should be revised to better support the requirements of the new organization. The Compensation Committee had determined that in order to maximize shareholder value, the company's executive composition program should meet the following objectives:

♦	Attracting and retaining outstanding executive talent
♦	Providing superior financial rewards when the company achieves superior financial performance
♦	Providing incentives through cash bonus payments to meet both the company's short and long-term performance objectives
♦	Aligning the interests of the company's executive officers with those of its shareholders with incentive compensation arrangements that reward executives with cash bonuses when aggressive financial objectives are met or exceeded over annual and longer-term periods
♦	Aligning the interests of the company's executive officers with those of its shareholders with incentive compensation arrangements that reward executives with stock options when shareholders value is created through increases in the company's stock price

As a result of this review, a number of changes were made to the executive compensation program for 2000 and beyond, all of which were within the boundaries of the 1998 Incentive Compensation Plan approved by stockholders in 1998. The changes included:

♦	Targeting the base pay element of the company's executive compensation program at median levels for comparable positions at U.S. industrial companies with a comparable level of revenues
♦	Targeting annual and long-term incentive elements of the program at levels based on survey data for publicly held U.S. industrial companies or their component operations comparable in size to that managed by each executive officer
♦	Replacing return on equity with return on invested capital as the performance measure for corporate officers in the annual bonus plan
♦	Replacing return on equity for corporate officers with a growth element based on generation of operating cash flow as the performance measure in the long-term cash incentive plan
♦	Replacing return on assets managed for division officers with a growth element based on generation of operating cash flow as the performance measure in the long-term cash incentive plan

The Compensation Committee believed that these changes better reflected the requirements of the organization and provided a competitive, performance-based compensation system that would not only attract and return superior management talent, but would motivate and reward those managers to create superior shareholder value. To accomplish these objectives, the company's executive compensation program consisted of four key elements: base salary, incentive compensation based upon meeting designated performance targets over a one-year period; incentive compensation based upon meeting longer-term performance targets over a three-year period; and equity-based compensation, consisting primarily of stock options. The aggregate value of these elements was intended to deliver competitive compensation for each position and was based on survey data for publicly held U.S. industrial companies comparable in size to that managed by each executive officer. The company estimated that as of March 5, 2001, approximately 400 managers were eligible to participate in the Incentive Plan.

Annual Salaries

The Committee determined the base salary of each executive officer of the company. Each base salary was targeted to be at the median for the position at U.S. industrial companies similar in size to the company. The Committee had retained an executive compensation consultant to assist it in determining median compensation levels. The group of industrial companies used as a comparison for determining the base salaries of the company's executive officers, as well as the other elements of their compensation package. Variations from the median in the base pay of certain executive officers were based upon the specific job responsibilities of the position, the job performance of the individual holding the position, and the individual's tenure in the position.

Annual Cash Bonuses

The annual bonus of each executive officer at the corporate and business level was determined by two factors:

Factor 1.	The percentage of base salary that a particular officer will receive if the "performance target" established by the Committee at the beginning of the year for the business unit was exactly met (this was known as the "target bonus percentage").
Factor 2.	The performance of that business unit relative to the performance target established for the unit by the Committee. Beginning in 2000, the performance target for corporate executives was based upon the company's return on invested capital (ROIC), rather than return on equity (ROE). ROIC was calculated by dividing profit after tax to the average of the sum of long-term debt and shareholders' equity.

For executive officers employed in a business unit of the company, the performance target was based upon that business unit's return on assets managed (ROAM). ROAM like ROIC, was a measurement of employees' success in utilizing capital resources but unlike ROIC, focused on specific assets. It was calculated by dividing income before interest and income tax to the average of controlled assets.

The performance target for a given year was determined at the beginning of that year by the Committee, based upon its determination of what would constitute an appropriate level of performance for the company or the business unit. In making that determination, the Committee would take into account the following principal factors:

Factor 1.	The economic environment in which the company expected to operate during the year.
Factor 2.	Expected performance based upon the annual operating plan of the company, which was reviewed and approved by the Board of Directors
Factor 3.	Specific business opportunities identified by management

If the performance target was met, each officer in that business unit would receive his or her target bonus percentage. If the actual performance of the business unit varied from the performance target, the bonus payment would be greater or lesser than the target bonus percentage. If actual performance was 80% of the performance target, a bonus of 50% of the target bonus percentage would be paid. If actual performance was less than 80% of the performance target, no bonus would be paid. The amount paid would increase by 2.5% for each percentage point increase in the actual performance of the unit as a percentage of the performance target. If the performance target was exceeded, an additional 5% of the target bonus percentage would be paid for each percentage point by which actual performance exceeded the performance target. The target bonus percentage was determined for each position based on survey data for publicly held U.S. industrial companies in size to that managed by each executive officer.

Long-term Cash Bonuses

In addition to annual cash bonuses, the company provided its executives with an opportunity to earn additional incentive compensation based upon meeting performance targets established for a three-year period. Beginning with the 2000-2002 performance cycle, the performance target for all corporate and business unit executives were based upon the generation of operating cash flow (net operating profit after tax plus depreciation and amortization) calculated for the company or a business unit, in relation to the operating cash flow targets set by the Committee for the company and each of its business units. The Committee had determined that the company's return on invested capital correlated to changes in shareholder value, and that improvement in operating cash flow was an important element in improving on invested capital. As a result, the Committee had adopted this performance measure for its long-term incentive compensation plan.

Under the program, a "target cash amount" was established for each executive, which would be paid in the year following the end of a three-year performance cycle, if performance targets established by the Committee for the cycle were exactly met. If the actual performance of a business unit varied from the performance target, the actual cash bonus payable would be greater or lesser than the target cash amount. If actual performance was less than 90% of the performance target, no bonus would be paid. If the actual performance was 90% of the performance target, a bonus of 50% of the target cash amount would be paid. That amount would increase by 5% for each percentage point increase in the actual performance of the unit as a percentage of the performance target. If the performance target was exceeded, an additional 10% of the target cash amount would be paid for each percentage point by which the actual performance exceeded the performance target. The "target cash amount" was determined for each position based on survey data for publicly held U.S. industrial companies comparable in size to that managed by each executive officer.

Stock Options

In awarding stock options to the company's key executives, the Committee intended to provide those executives with a direct opportunity to benefit from long-term increases in shareholder value as reflected in the company's stock price. Options under the plan were generally granted for ten-year terms and become exercisable in two equal installments, one and two years after they are granted, respectively. This plan provided for the issuance of up to 5,000,000 shares of Common Stock.

RESULTS OF THE NEW PLAN

Two years after the new executive compensation system was introduced, some operating units executives were disgruntled with it, claiming that they had to work harder but made no annual cash bonuses. The actual corporate performance in 2001 was less than 80% of target performance, resulting in no annual cash bonuses to corporate executives, and also no payouts were made to any business unit executives but one. Fearing that some of his executives might quit, Mr. Dattilo was under pressure to find a way or possibly modify the executive incentive plan to meet its intended objectives.

Grants during 1999 provided for lower target cash amounts and utilized lower performance targets than those utilized with respect to the 2000 and 2001 grants. Payouts made in 2002 for the 1999-2001 cycle equaled 154% of the target cash amount for executives whose performance targets were based on ROE, and 175% to 341% of the target cash amount for executives whose performance targets were based on the ROAM of the various business units.

Exhibit 1 shows the compensation paid by the company to the five most highly compensated executives for the fiscal years ending December 31, 1999, 2000, and 2001.

Exhibit 1: Summary Compensation					
Name and Principal Position	Year	Salary	Bonus	Restricted Stock Awards	Number of shares stock option awards
Thomas A. Dattilo, CEO	2001	$725,000	-	-	100,000
	2000	633,470	336,277	-	100,000
	1999	375,000	550,188	$613,125	150,000
James S. McElya, VP	2001	420,000	-	-	50,000
	2000	334,891	212,921	-	40,000
	1999	-	-	-	-
Roderick F. Millhof, VP	2001	350,000	-	-	40,000
	2000	320,000	120,023	-	35,000
	1999	239,614	246,203	32,625	12,000
Philip G. Weaver, CFO	2001	335,000	-	-	50,000
	2000	300,000	115,833	-	50,000
	1999	185,000	167,784	48,938	9,000
Richard D. Teeple, VP	2001	302,000	-	-	40,000
	2000	287,000	110,814	-	40,000
	1999	214,765	194,780	48,938	9,000

Exhibit 2: Comparison of Five-Year Cumulative Total Return Among Cooper, S&P 500 Index and S&P Auto Parts						
	1996	1997	1998	1999	2000	2001
Cooper Tire & Rubber Company	$100.00	$125.38	$107.10	$ 84.46	$ 59.22	$ 91.71
S & P 500 Index	100.00	133.36	171.48	207.56	188.66	166.24
S & P Auto Parts & Equipment-500 Index	100.00	125.07	120.62	92.73	73.65	88.09

Cooper's stock had lost about 60% of its value over the five-year period ending in 2000. And over the same period, the company's stock had under-performed all six of its peers in the S&P 500, auto parts and equipment. But, with most of the stocks performing poorly in 2001, Cooper's stock price improved in 2001. Exhibit 2 provides data comparing six-year cumulative stockholder returns among Cooper, S&P 500 Index, and S&P Auto Parts & Equipment. This chart assumed three hypothetical $100 investments on December 31, 1995, and shows the cumulative values at the end of each succeeding year resulting from appreciation or depreciation in the stock market price, assuming dividend reinvestment.

THE NEXT MOVE

There was no formal monitoring system by Cooper management to determine the impact of the new executive compensation plan. For Mr. Dattilo, the preliminary results were not quite encouraging. His sales revenue had decreased slightly, and his net income decreased more than half, and some of his executives were not happy. In fact it came as no surprise to Mr. Dattilo when Jack Luthy one of the division executives expressed his frustration about the new executive compensation plan. Although Mr. Dattilo regarded Jack as a competent executive who had the potential to do even better with the division, he was concerned that Jack might need some behavioral changes with regard to the new compensation system.

In reflecting on the complaints from several of his corporate and division officers, Mr. Dattilo had tried to analyze what was happening with the implementation of the new executive compensation plan and how it was affecting them. From his conversations with some executive officers, Mr. Dattilo had made some notes about several issues he wanted to discuss with the Board members at the upcoming meeting. Mr. Dattilo was not sure how the executive compensation problem should be fixed, but he knew something should be done soon. "Well, may be a brilliant idea will come to me over the weekend," he mused as he headed to the airport.

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ST. LOUIS CHEMICAL: THE CASH DILEMMA

David A. Kunz, Southeast Missouri State University

CASE DESCRIPTION

The primary subject matter of this case concerns the difference between cash and accounting profits and the problems a company can encounter if profits and cash are assumed to be the same. Secondary issues examined include the preparation and interpretation of the Statement of Cash Flows, fundamentals of working capital management, and financial statement analysis. The case requires students to have an introductory knowledge of accounting, finance and general business issues thus the case has a difficulty level of three (junior level) or higher. The case is designed to be taught in one class session of approximately 1.25 hours and is expected to require 3-4 hours of preparation time from the students.

The case can be used independently or as follow-up to St. Louis Chemical: The Beginning and St. Louis Chemical: The Start Up

CASE SYNOPSIS

The case tells the story of Don Williams, President and primary owner of St. Louis Chemical, and his current dilemma. By almost all measures the performance of St. Louis Chemical has been outstanding over the last three years. Double-digit sales growth has been achieved, new product lines have been added and profits have more than tripled. But despite this apparent success, cash flow has been a problem. It has been a struggle for Williams to maintain sufficient cash to pay obligations in a timely manner. The company reached its bank-borrowing limit at the end of last year but Williams successfully negotiated an additional $3,000,000 in borrowings using fixed assets as security. The additional capacity was used during the year just ended as well as an extra $2,000,000 working capital loan extended by the bank. The bank has refused to grant additional loans until the debt ratio can be lowered to below 50% and the Times Interest Earned Ratio increased to above four.

BACKGROUND

St. Louis Chemical is a regional chemical distributor, headquartered in St. Louis. Don Williams, the President and primary owner, began St. Louis Chemical five years ago after a successful career in chemical sales and marketing. The company reported small losses during it first two years of operation but performance over the last three years has been outstanding. Sales have grown at double-digit rates, new product lines have been added and profits have more than tripled.

The growth has required the acquisition of additional land, equipment, expansion of storage capacity and more than tripling the size of the work force.

Williams has proven to be an expert marketer and St. Louis Chemical has developed a reputation with its customers of providing quality products and superior service at competitive prices. At the insistence of Williams, the company has promoted "next day delivery" since its inception. Other chemical distributors can seldom provide this service because they don't stock the number of products and the quantity of each carried by St. Louis Chemical. Not surprisingly, "next day delivery" has proven very popular with its customers and has allowed St. Louis Chemical to capture a large market share. The sales force is also a strong supporter of the service but because inventory shortages occasionally cause sales to be missed they are constantly arguing for even greater amounts of inventory to be maintained by the company. Williams has tended to agree with the sales force and has over the years instructed the purchasing department to error on the side of carrying too much rather than too little inventory.

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

CHEMICAL DISTRIBUTION

A chemical distributor is a wholesaler. Operations may vary but a typical distributor purchases chemicals in large quantities (bulk - barge, rail or truckloads) from a number of manufacturers. They store bulk chemicals in "tank farms", a number of tanks located in an area surrounded by dikes. The tanks can receive and ship materials from all modes of transportation. Packaged chemicals are stored in a warehouse. Other distributor activities include blending, repackaging, and shipping in smaller quantities (less than truckload, tote tanks, 55-gallon drums, and other smaller package sizes) to meet the needs of a variety of industrial users. In addition to the tank farm and warehouse, a distributor needs access to specialized delivery equipment (specialized truck transports, and tank rail cars) to meet the handling requirements of different chemicals. A distributor adds value by supplying its customers with the chemicals they need, in the quantities they desire, when they need them. This requires maintaining a sizable inventory and operating efficiently. Distributors usually operate on very thin profit margins. RMA Annual Statement Studies indicates "profit before taxes as a percentage of sales" for Wholesalers - Chemicals and Allied Products, (SIC number 5169) is usually in the 3.0% range. In addition to operating efficiently, a successful distributor will possess 1) a solid customer base and 2) supplier contacts and contracts that ensure a complete product line at competitive prices.

THE SITUATION

Despite the apparent "success" experienced by St. Louis Chemical over the last three years, cash flow has been a problem. It has been a struggle for Williams to maintain sufficient cash to pay obligations in a timely manner. The company reached its bank-borrowing limit at the end of last year (2000) but Williams successfully negotiated an additional $3,000,000 in borrowings using fixed assets as security. The additional capacity was used during the year just ended (2001) as well as an extra $2,000,000 working capital loan extended by the bank. The bank has refused to grant additional loans until the debt ratio can be lowered to below 50% and the Times Interest Earned Ratio increased to above four.

The company has the opportunity to add a product line of high margin water treatment chemicals but an investment of $700,000 is required to finance the special handling and packing equipment necessary. Inventory investment will require another $600,000. Williams has been attempting to acquire this attractive product line since starting the company and if he cannot obtain the necessary capital the line will be offered to its primary competitor. To finance the expected sales growth for 2002 (to $86,000,000), Williams has estimated the firm will need at least $2,000,000 for additional current assets and another $1,200,000 for capital expenditures. Putting it all together the company needs approximately $4,500,000 in new financing to add the water treatment line and provide the necessary resources to achieve the planned sales growth for 2002. Issuing more common stock is not an option since Williams does not want to further dilute his ownership position. The stock is not publicly traded.

Williams has hired Ron Burk, a financial advisor, to provide assistance developing financing options, and in solving the firm's cash problems. At their first meeting Williams provided Charles with income statements for three years (1999, 2000 and 2001) and ending balance sheets dated December 31 for the same three years. (See schedules one and two). A complete analysis at the meeting was not possible but Burk noted the increase in accounts payable and inventory. Williams explained that a large inventory investment was necessary to support the company's "next day delivery" service and how the use of a liberal credit policy has caused accounts receivables to increase. He also stressed the importance of each to the company's continued sales growth. When asked about the firm's daily sales outstanding (DSO) and days invested in inventory Williams stated that ratios are not calculated. Williams said he really doesn't understand all those ratios and besides he doesn't need them to run the business. Since the company's inception, an outside accounting firm has prepared the financial reports based on data supplied by the firm's bookkeepers. To keep overhead expenses low Williams has been reluctant to hire a full-time accountant. The company's accounting firm prepares a quarterly financial statements consisting of an income statement and balance sheet. No cash flow statements are prepared.

THE TASK

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

1. Prepare a Cash Flow Statement for 2000 and 2001. (Complete schedule three). Interpret the information provided by the cash flow statements. How has St. Louis Chemical been using its cash and why is additional cash needed?
2. Calculate the return on equity for the last three years using the extended DuPont equation. Interpret the results. What does the equation reveal regarding the company's profitability, used of assets and sources of financing?
3. Evaluate the company's performance for the last three years using ratio analysis. Calculate the following ratios and evaluate performance. (Complete schedule four).
   a. Current ratio
   b. Accounts receivable turnover
   c. Days sales outstanding (DSO) or Receivables collection period
   d. Inventory turnover - using cost of goods sold
   e. Inventory conversion period - using cost of goods sold
   f. Fixed asset turnover (using net fixed assets)
   g. Total asset turnover
   h. Times interest earned ratio (TIE)
   i. Debt ratio
   j. Basic earning power
   k. Profit margin
   l. Return on assets
   m. Return on equity
4. Calculate the firm's Cash Conversion Cycle for the last three years. Interpret the results. How can the Cash Conversion Cycle be used to evaluate a firm's working capital policy? Evaluate the firm's working capital management.
5. Based on answers to questions 1-4, summarize why the firm is experiencing cash problems? Provide your recommendations to improve the cash situation.

6. What alternatives are available to the firm to acquire the new water treatment product line and finance the required sales growth for 2002?

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Schedule One

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

	1999		2000		2001	
	$	%	$	%	$	%
Revenue	43,755	100.00	59,962	100.00	78,953	100.00
Cost of Goods Sold	36,369	83.12	49,828	83.10	65,847	83.40
Gross Profit	7,386	16.88	10,134	16.90	13,106	16.60
Operating Expenses						
Selling	3,894	8.90	4,725	7.88	6,237	7.90
General & Admin.	2,949	6.74	3,958	6.60	4,990	6.32
Total	6,843	15.64	8,683	14.48	11,227	14.22
Operating Profit	543	1.24	1,451	2.42	1,879	2.38
Interest Expense	160	0.37	298	0.50	582	0.74
Earnings Before Taxes	383	0.87	1,153	1.92	1,297	1.64
Income Tax Expense	127	0.28	380	0.63	428	0.54
Earnings After Taxes	256	0.59	773	1.29	869	1.10

Schedule Two
St. Louis Chemical
Balance Sheets (000's/$)

	1999		2000		2001	
	$	%	$	%	$	%
Current Assets						
Cash	25	0.21	39	0.23	14	0.05
Receivables	3,889	32.10	6,829	38.40	10,966	38.96
Inventory	3,839	31.68	6,505	36.58	9,511	33.79
Other current assets	27	0.22	32	0.18	76	0.27
Total current assets	7,780	64.21	13,405	75.39	20,567	73.07
Fixed Assets						
Land	610	5.03	610	3.43	1,710	6.08
Gross fixed assets	4,996	41.23	5,496	30.91	8,096	28.77
(less accum. depreciation)	(1,269)	(10.47)	(1,729)	(9.73)	(2,229)	(7.92)
Net fixed assets	3,727	30.76	3,767	21.18	5,867	20.85
Total fixed assets	4,337	35.79	4,377	24.61	7,577	26.93
Total Assets	12,117	100.00	17,782	100.00	28,144	100.00
Current liabilities						
Account payables	2,223	18.34	4,429	24.90	8,780	31.19
Short-term notes payables	1,300	10.73	2,400	13.50	4,400	15.64
Accrued liabilities	292	2.42	178	1.01	320	1.14
Total current liabilities	3,815	31.49	7,007	39.41	13,500	47.97
Long-term liabilities	1,000	8.25	2,700	15.18	5,700	20.25
Total liabilities	4,815	39.74	9,707	54.59	19,200	68.22
Shareholders' equity						
Common stock	2,000	16.50	2,000	11.25	2,000	7.11
Paid in capital	1,500	12.38	1,500	8.44	1,500	5.33
Retained earnings	3,802	31.38	4,575	25.72	5,444	19.34
Total equity	7,302	60.26	8,075	45.41	8,944	31.78
Total liabilities & equity	12,117	100.00	17,782	100.00	28,144	100.00

Schedule Three St. Louis Chemical Statements of Cash Flow (000's/$)		
	2000	2001
Cash flow from operations		
Net Income	773	869
Plus depreciation expense		500
Change in accounts receivables		
Change in inventory		
Change in other current assets		
Change in account payables		
Change in accrued liabilities		
Total cash flow from operations	(2,286)	
Cash flow from investing activities		
Change in land		
Change in fixed assets	(500)	
Total cash flow from investing activities		
Cash flow from financing activities		
Change in short-term notes payables		
Change in long-term liabilities		
Change in common stock		
Dividends paid		
Total cash flow from financing activities		
Net cash flow	14	(25)
Plus beginning cash	25	
Ending cash	39	

Schedule Four
St. Louis Chemical
Ratios

	1999	2000	2001
Current Ratio			
Accounts receivable turnover		8.78	
Days sales outstanding (DSO) or Receivables collection period (days)	32.00		
Inventory turnover			
Inventory conversion period (days)			
Payables deferral period (days)			48.00
Cash conversion cycle (days)			
Fixed asset turnover			
Total asset turnover			
Times interest earned (TIE)		4.87	
Debt ratio	39.74%		
Basic earning power			
Profit margin			
Total asset turnover		3.37	
Return on assets (ROA)	2.12%		
Equity multiplier			
Return on equity (ROE)			

NEW VISION: FUND-RAISING, TAX CREDITS AND MARKETING STRATEGY

Judy A. Wiles, Southeast Missouri State University

CASE DESCRIPTION

The primary subject matter of this case concerns marketing communications. Secondary issues examined include mental health care marketing, not-for-profit marketing, fund-raising, and professional selling. The case has a difficulty level of four, appropriate for senior level. The case is designed to be taught in one class hour and is expected to require three hours of outside preparation by students.

CASE SYNOPSIS

This case is a classic example of the need for an integrated marketing communications plan for a not-for-profit organization. Interestingly, the organization, a private counseling agency by the name of New Vision Youth & Family Services, Inc. was extremely successful in obtaining clients from referring entities (juvenile courts, schools, and state social service agencies). New Vision was so effective in obtaining clients from the referral market that they did not feel the pressure to develop a marketing communications campaign aimed to the primary market (community residents in need of counseling and potential donors). They did not even have an ad in the Yellow Pages. However, the need for public awareness became evident when they desired to expand and have a capital fund drive.

The capital fund drive was for the purpose of building an adjacent recreation and education center to their headquarters office. New Vision sought and obtained permission to issue tax credits offered by the state of Missouri under the Youth Opportunity Program to donors who qualified. The managing partners of New Vision felt these tax credits would serve as ideal incentives for donors to give money to New Vision's capital fund. The problem became evident when potential donors were approached and they had never heard of New Vision. Because there is a time limit on the offering of the tax credits, the case provides a sense of urgency to act before the tax credits run out.

INTRODUCTION

Tim Gould had a vision of developing a recreation and education center to complement his company's counseling services. As the co-founder of New Vision Youth & Family Services, Inc., Tim knew the needs of youth in his community. He and his partner, Danny Johnson were passionate about expanding their organization's reach into the community. On January 2, 2002, Tim looked out his office window at the land adjoining his property which had the potential for housing this recreation/education center he wanted so much. He reflected on how complicated raising money from the community seemed. He thought the tax credits from the Missouri Youth Opportunity Program (YOP) were ideal incentives for donors to give money to New Vision's capital fund. The YOP tax credits would expire at the end of this year, 2002. Tim was feeling the pressure to resolve his capital fund-raising problem soon.

BACKGROUND

New Vision Youth & Family Services, Inc. was founded in August 1998 by Tim Gould and Danny Johnson in Cape Girardeau, Missouri. New Vision is a private not-for-profit 501 (c) 3 organization. It has experienced phenomenal growth since its inception, providing counseling services and programs to youth and families in seven contiguous counties in Missouri: Bollinger, Cape Girardeau, New Madrid, Mississippi, Perry, Scott, and Stoddard. As of February 2001 New Vision had three Missouri offices located in the communities of Cape Girardeau, Bloomfield and Sikeston. This area is primarily rural with small- to medium-sized towns and the greater Cape Girardeau area (population 50,000) serving as the area's retail/medical/education center.

The founders have extensive experience in the field of counseling. Tim Gould, MA, MS, Ed.D, LPC, and NCC was a juvenile officer for ten years. He served as administrator for the juvenile court system, case manager, therapist and supervisor over the juvenile detention facility and staff. Tim worked for a prison system for 10 years as its director for college programs, counseling inmates on career and academic goals. Also, he has served as a regional director, administrator and therapist for a private agency.

Prior to co-founding New Vision, Danny Johnson, MA, LPC, LCSW and Qualified Family Mediator was a therapist and program coordinator for a private residential agency for three years. He served as treatment coordinator for ten years at a residential treatment center for adolescents. He had experience developing a private counseling practice serving children and families in the southeast Missouri area.

In addition to the founders, the activities of the agency are provided by support staff, licensed therapists, consultant psychologists and consultant psychiatrists. By May 2002 New Vision employed over 65 people in southeast Missouri, including 26 support staff, 22 licensed therapists, three psychologists and two psychiatrists. Most of the employees are "independent contractors" such that they are not salaried positions but receive payment based on services rendered on behalf of the agency. The administrative staff of the organization is lean. The two founding partners share administrative, developmental and operation responsibilities. Tim and Danny were each involved in organizations which were top-heavy and they felt it important that their payment from the agency should also be based on the counseling services they personally provided to the agency's clients.

The philosophy of the firm, which also coincides with changes within the state system of mental health funding, is to provide "wrap-around" services for the families in need. This philosophy respects the family as a system and strives to focus on their strengths to maintain their integrity as a unit. New Vision incorporates the collaborative efforts of the family, target youth, sponsoring agency, school, other stakeholders and other support systems identified by the target youth and family. The processes include individual mentoring; modeling; individual, group and family therapy; and educational programming.

Founder Tim Gould likes to quote Albert Einstein, "You cannot resolve problems with the same level of thinking that created them." He believes that counseling, education and mental health services can help individuals and families to elevate their level of thinking and functioning to be more self-sufficient and successful. Whenever possible, clients should have input into their treatment plans. The philosophy is one of empowerment and helping people make positive attitude and behavior changes.

The New Vision founders believe much of their success is based on the quality of their employees. Their employees are well trained, experienced and share the company's philosophy. Employees are encouraged to develop new programs and seek grant opportunities. The philosophy of empowerment fits with the founders' managerial style. The pay scale for therapists, psychologist and psychiatrists is above that of competing agencies in the area.

New Vision has worked with over 1500 youth and families since its founding. In any one month it has over 400 open cases. They have expedited approximately 100 reunifications of youth from residential and foster placements. They have prevented out-of-home placements with intensive interventions, keeping the family unit in tact. They have counseled approximately 275 youth in their "Stealing Diversion" (anti-shop-lifting) program, having only 4 of the group shop-lift again. They work with 11 alternative schools in the state, having one of the highest graduation rates in the state. The firm serves as a source for practicums and internships for students from two nearby universities. They are one of a select few Continuing Education Unit providers in the area for Licensed Clinical Social Workers and Licensed Professional Counselors because they are sanctioned and certified by the National Board of Certified Counselors.

Their annual budget is over $1 million with an annual payroll of approximately $500,000. They pay approximately $175,000 annually in federal, state and local taxes. Their annual purchases of goods and services from area businesses totals approximately $200,000 per year.

New Vision offers a diversity of counseling services which are customized and rendered in locations suitable to the clients. Services offered include those indicated on the following table.

Approximately 95 percent of their clients are from these referral sources: Missouri Division of Youth Services, Missouri Division of Family Services, juvenile circuit courts in the counties served, and school districts in the counties served. The typical client would be a parent(s) between the ages of 30-50 years old with children between the ages of 10-17 in public or alternative schools. Many are single-parent mothers with low to moderate income levels.

New Vision's charges for counseling services are competitive with those in the region. They charge $75 per hour for therapy. They work with the client to seek payment from eligible sources: health insurance policies; school districts; Medicare; and Medicaid. They also accept Matercard and Visa for payment of services.

Thus far, New Vision's marketing communications have been focused on the referral market. The founders also appointed an Advisory Board, comprised of six people to help promote New Vision to the communities served. Printed literature about the organization consisted of a text-based brochure and booklet.

New Vision Services	
Individual therapy	Family therapy
Group therapy (specific to group of adolescents)	Family assistance
In-school support program	Parent education classes
Supervised visitation	Divorce and family mediation
On-site day treatment	Off-site mentoring
Tutoring	Parent aide
Homemaker services	Resource Coordination
Court appointed special advocate	Stealing diversion program for adolescents
Assault diversion programs	Victim empathy groups
Parent support groups	Life skills groups for adolescents
Assessment for therapy needs	Divorce education for parents
Psychological and Psychiatric services	

THE MENTAL HEALTH FIELD

The outlook for the provision of future services by private agencies in the mental health field appears positive. On April 30, 2002 President George W. Bush generally endorsed a proposal to expand health insurance benefits to include mental health problems (Kornblut 2002). There is a national movement underway that aims to expand school mental health programs (Clauss-Ehlers 2001). A mental health report issued by the U.S. Surgeon General's office in 2000 found that about eleven percent of youth, ages 9 to 17 (which total about 4 million people), have a major mental illness that results in significant impairments at home, school and with peers (CNN 2002).

Table 1 depicts the changes in the types of firms providing mental health care in the U.S. between the years 1970 to 1998. The growth has been in the private sector. (Table 1 is found at the end of the article.)

YOUTH OPPORTUNITY PROGRAM TAX CREDITS

An opportunity for New Vision arose in early 2001 to apply for tax credits from the state of Missouri under the Department of Economic Development's Youth Opportunities Program (YOP). The YOP provides state tax credits to those who give donations to approved agencies which provide services to at-risk youth in Missouri. New Vision applied for these tax credits to be made available to their donors with specific performance targets in the areas of increasing the number of at-risk youth remaining in school and reducing the number of at-risk youth committing crimes and violent acts. Between the period of January 1, 2001 and December 31, 2002, New Vision was granted up to $228,750 worth of tax credits to make available to donors. The tax credits could be used by individuals or businesses in the state of Missouri for franchise tax, bank tax, income tax, property tax and some other Missouri taxes. The YOP tax credits would provide up to 50% tax credit on the donor's Missouri taxes for every dollar donated. Thus, if New Vision maximized the offering of the potential tax credits of $228,750, they would need to have at least $457,500 in donations within this two year period of time. The minimum donation would have to be $100 in order to qualify for the tax credits.

For a donor, the out-of-pocket contribution could be less than 20%. The sample below illustrates an interpretation of the total out-of-pocket cost to a donor in the 28% Federal, 5% Missouri Tax Bracket:

For a $1000 donation….	
Estimated Federal Tax Deduction	$280.00
Estimated Missouri Tax Deduction	$50.00
YOP Tax Savings	$500.00*
Total Out-of-Pocket Cost	$170.00
*In this example, tax savings is realized if the individual owes over $500 in Missouri taxes for the present year. However, credits could be used over a five-year period of time.	

RAISING FUNDS FOR NEW VISION

Tim and Danny saw the YOP tax credits as an opportunity to initiate a capital fund-raising campaign for the facility of their dreams to be located in their headquarters' community, Cape Girardeau (largest population of the communities they serve). They developed three phases to their plans for the new facility. Phase 1 would be the construction of a Family Recreation Center (approximately 5000 square feet) having basketball courts, volleyball courts, fitness/exercise center, small kitchen facilities and meeting area for up to 50 people. Phase 2 was the construction of an Education/Training Center (approximately 4500 square feet) having six conference rooms and an education theater for up to 250 people. Phase 3 would be the construction of offices to house therapists, program coordinators and administrative staff.

After six months into the YOP period, only $5,000 had been raised. A few of the Board members helped Tim and Danny secure donations. A mailing to the Cape Girardeau Chamber of Commerce resulted in a few minor donations. As YOP project coordinator, Tim decided they needed marketing expertise and he called upon a friend who was a marketing consultant in the area, Paul Watson.

Tim Gould presented New Vision's story regarding their capital fund-rising drive and the YOP tax credit program to Paul. Although Paul and Tim had been friends a long time, Paul did not know much about New Vision and he asked Tim and Danny numerous questions. First, he asked whether they were a state agency since their name may imply this with the words "Youth and Family Services" in their name. Also, the term "services" may be vague and not really describe what they do. Paul reviewed the marketing communication efforts previously conducted by New Vision, noting that most had been centered on word-of-mouth within referral agencies, a company brochure, and a brochure explaining the capital fund-raising program. Paul asked if the partners were satisfied with their present level of business that was primarily coming from the referral (secondary) market. Tim and Danny agreed they were not satisfied with having 95% of their business come from the secondary market and wanted to increase their business from the primary market whereby clients would come directly to them, rather than through referring agencies. Paul suggested they really needed to develop a marketing strategy which focused on each of their target markets.

In addition to reconsidering their name, they should also consider the effectiveness of their logo and slogan. The logo was difficult to read. Their attempt at a slogan was long and cumbersome ("Programs and Interventions For Families To Develop A New Vision Of Success and Self-Sufficiency"). Their marketing communication pieces were mostly text-based without graphics or visual images. Their story needed to be told in a more interesting format. Their communication efforts needed to be more targeted, based on who the piece was directed to, rather than having one or two brochures serve all their needs.

Paul used the consumption-concentration theory to help the founders identify where 80% of their business was centered. From the list of services offered in their literature, it was difficult to determine what services were used by most of their clients. An evaluation by New Vision revealed that 80% of their business was in the categories of youth counseling, family counseling and psychiatric services.

Paul asked about New Vision's competitors. Tim considered their major competitor in the area to be the Community Counseling Center which offers a diversity of counseling programs and receives about 90% of its funding from the state of Missouri. Paul noted that the Community Counseling Center is well known in the community with regular fund-raising events. However, Tim replied the Center does not receive the referrals from state agencies, courts and schools to the extent that New Vision does. Further, they do not offer the same range of services that New Vision does. Tim had heard complaints from their potential clients that it may take up to six months to get an appointment with one of their counselors. They do not promise to call back the client within 24 hours to set an appointment as New Vision does. Tim explained that his employees have informed them that the Community Counseling Center does not pay their therapists as much per hour as New Vision does. However, fees charged to clients are comparable between the two agencies.

Other competitors include individual licensed psychologists and psychiatrists in the area and specialized treatment centers such as domestic violence safehouses, group homes for adolescents, and alcohol treatment centers. Paul noted some of the specialized treatment centers have been very effective in obtaining community support when making emotional appeals to the public and to funding agencies such as the United Way.

In order to compensate Paul for his marketing consulting efforts, Tim and Danny offered Paul a financial incentive to obtain donations for their capital fund-raising plan (YOP tax credit program). Paul agreed to work on obtaining a bank as a donor, primarily because they would be interested in financing their construction loan, plus banks have an obligation through the Community Reinvestment Act to invest in economically depressed sections of their community and in not-for-profit charitable causes in their communities. He felt banks might be interested in the tax credits as well as the construction loan which would give the bank income plus meet their CRA goals. In addition to working on obtaining donors, he would develop marketing strategy suggestions for New Vision to implement.

Over the next six months, Paul had appointments with key officials in all banks in the community. In all cases the executives had not heard of New Vision or knew very little about the agency. Thus, Paul had to explain their story. Paul also learned that each of the banks had already met their CRA obligations for that year and beyond. Some of the banks had already made use of Missouri tax credits for the current year and beyond (one could bank the credits for up to five years). Some of the bank executives noted if one was interested in making use of tax credits, they could be obtained at discounted rates, meaning the tax advantages could be even better than what New Vision's YOP tax credits were. The newest banks did not have a Missouri tax liability at this time. All of the financial institutions were positive toward New Vision, some met with the managing partners, Tim and Danny, and would have been happy to have their checking account and offer them a construction loan. However, none were interested in making a donation at this time. Thus, Paul realized that the appeal of the Missouri tax credits to help fund their capital campaign was weak.

Paul met with the managing partners several times and offered marketing strategy suggestions. He made suggestions pertaining to their name, slogan, and logo and emphasized the importance of placing these in all forms of communication. He discussed the importance of understanding the needs and appeals to use on each of their target audiences. When discussing appeals and message strategy techniques, they discussed how counseling, especially involving youth, has unique obstacles. For example, actual testimonials are not feasible due to privacy concerns and potential embarrassment on the client's part. The importance of appealing to the emotions of the "cause" was also discussed. Paul also noted there were many avenues in which to build awareness in the communities in which they served. For example, by obtaining a grant from the United Way, they would be exposing themselves to the United Way Board of Directors, their committee responsible for making grants and to the thousands of donors of United Way.

CONCLUSION

As the YOP tax credit project coordinator for New Vision, Tim Gould realized he only had one year left to obtain donations suitable for the Missouri tax credits. His young company had made tremendous strides since its beginning. However, their level of awareness was low among the general public and most potential donors. His agency was well known among referring entities and of course the clients they served. They only had one more year to offer the tax credits, unless an extension could be granted by the state. He was coming to understand the value of the tax credits was not what he first thought. His hopes for a quick infusion of donations was overly optimistic. Perhaps New Vision's capital funding campaign needed to take a longer view.

Table 1. Number of mental health organizations by type of organization:

United States, selected years, 1970-98

Type of organization	1970	1976	1980	1986	1990	1992	1994	1998
All organizations	3,005	3,480	3,727	4,747	5,284	5,498	5,392	5,722
State and county mental hospitals	310	303	280	285	273	273	256	229
Private psychiatric hospitals	150	182	184	314	462	475	430	348
Non-Federal general hospitals with separate psychiatric services	797	870	923	1,351	1,674	1,616	1,612	1,707
VA medical centers	115	126	136	139	141	162	161	145
Federally funded community mental health centers	196	517	691	-	-	-	-	-
Residential treatment centers for emotionally disturbed children	261	331	368	437	501	497	459	461
All other mental health organizations	1,176	1,151	1,145	2,221	2,233	2,457	2,474	2,832

Source: Published and unpublished inventory data from the Survey and Analysis Branch, Division of State and Community Systems Development, Center for Mental Health Services, located at MentalHealth.org.

Some organizations were reclassified as a result of changes in reporting procedures and definitions. For 1979-80, comparable data were not available for certain organization types and data for either an earlier or a later period were substituted. These factors influence the comparability of 1980, 1986, 1990, 1992, and 1994 data with those of earlier years.

Table 2: The FCB Model (Lavidge & Steiner 1961)

	Thinking	Feeling
High Involvement	Informative (thinking) Model: think-feel-do Creative: demonstration specific details	Affective (feeling) Model: feel-think-do Creative: execution impact
Low Involvement	Habit formation (doing) Model: do-think-feel Creative: reminder	Self-satisfaction (reacting) Model: do-feel-think Creative: attention

ECAMPUS.COM: AUGUST CRISIS

Stephen L. Loy, Eastern Kentucky University
Steve Brown, Eastern Kentucky University

CASE DESCRIPTION

The case illustrates the problems resulting from getting the website created and operating on a time schedule that did not allow sufficient time for thorough testing or for developing a disaster plan and backup systems. The case also illustrates the importance scalability, redundancy, volume testing, telecommunications bandwidth availability and business site selection for e-commerce businesses. The case can be used to highlight e-commerce success factors of creating and maintaining flexibility in technology, getting the technology right, understanding the Internet culture and flexibility in managing e-commerce web sites. The case describes a critical incident that occurred during the first month of operation. This case is suitable for both graduate and undergraduate information systems and e-commerce classes. It has a difficulty level of four. The students should be prepared to spend from six to twelve hours outside class analyzing the case depending on the breadth and depth of the analysis.

CASE SYNOPSIS0

Ecampus.com was created to provide e-commerce services and products in all four quadrants of the e-commerce spectrum, i.e., business-to-business (B2B), business-to-customer (B2C), customer-to-business (C2B) and customer-to-customer (C2C). It is a privately-owned Delaware corporation with headquarters in Lexington, Kentucky. The company was created in January 1999, incorporated in April and went "live" on the Internet on July 2, 1999. Ecampus.com is a "re-intermediation" electronic commerce business that pursues a value-added mission of providing the "easiest, fastest, cheapest way for college and university students to buy textbooks and stuff." Ecampus offers the largest online college textbook inventory on the Internet with more than 2.8 million book titles from more than 30,000 publishers. Approximately 900,000 titles are available for immediate shipment. All textbook orders are shipped free of charge in the U.S. and they ship about 80% within one to two days.

In mid August, when fall semester begins for many U.S. colleges and universities, the Ecampus website was deluged with more traffic than its system could handle. However, after a week of retooling, the crisis was resolved and it soon became one of the twenty busiest web sites in the world. The web site averaged 955,000 unique visitors per month during its first five months of operation. Of these visitors, 14% made a purchase, which is about three to four times greater than the top e-commerce web sites. In the second half of August 1999, the Ecampus.com site attracted nearly 500,000 visitors a week, with as many as 5,600 simultaneous visitors. Within four months, Ecampus had achieved an 80 percent brand awareness among U.S. college students.

Details of the problems that occurred during their first ordering season and the company's response to the crisis. After studying the case, students should be able to (1) better understand the technology used in an e-commerce website, and (2) identify requirements for planning, developing and managing an e-commerce website.

INTRODUCTION

The crisis that began in mid August was now over and Ecampus.com was on it way to becoming a successful e-commerce business. Jack Garvin, V. P. of Information Technology and his staff had worked 16 to 20 hours a day for the past week to upgrade the Ecampus information system to resolve the crisis. It had taken only twenty-three weeks for Ecampus to go from concept to a live business on the Internet. It took only one week to triple the capacity of the information system to handle 6,000 simultaneous visitors to the Ecampus web site. They solved the immediate crisis, but the fixes were only temporary. Jack knew that the current system was operating at capacity and could not handle the increase in business expected in January. He thought about what led to the crisis and what to do to prepare for January.

STRATEGIC ALLIANCE

Ecampus.com was the brainchild of Wallace Wilkinson, who along with nine other investors, invested $51 million create Ecampus.com. Impetus for the venture came from a Request for Proposals (RFP) issued to college textbook store management companies by the University of Maryland (UM) System in the fall of 1998. The UM System has multiple campuses in Maryland and on military installations and ships around the world. Thus, the RFP required a fully transactional Web site to allow students to buy their textbooks from anywhere in the world.

Wilkinson knew that two new companies had begun selling textbooks on the Internet in recent months. However, these companies lacked experience in the textbook industry, their own inventory and distribution operations, and access to used books. Wilkinson felt that being the first to create a fully transactional Web-based textbook company was imperative. Building such a business would be a high risk venture and would require managers with experience in fast action and high risk e-commerce businesses. Nevertheless, Wilkinson had made his fortune by acting quickly and taking big risks.

From its beginning, Ecampus.com was linked in a strategic alliance another company owned by Wilkinson, Wallace's College Textbooks Company (WCTC). WCTC was the third largest seller of college textbooks in the U.S. and supplied books to Wallace's Bookstores, Inc. (WBI). WBI managed campus bookstores for eighty-three colleges and universities. Wilkinson was the CEO of both WCTC and WBI. While WBI was a subsidiary company of WCTC, Ecampus was incorporated as an independent entity.

Wilkinson viewed Ecampus as a way to expand the sales of WCTC even if it cannibalized some sales from WBI's campus bookstores. When asked about Ecampus hurting WBI's sales, Wilkinson replied that it was "better to cannibalize my own campus textbook sales rather than have someone else do it."

The purpose of the alliance was to allow Ecampus to focus on the website storefront operations, marketing and sales, and handling credit card transactions. The WCTC was to handle the warehouse operations, inventory management, purchasing supplies and shipping. The information technology architecture allowed customers to place orders and make payments at the Ecampus website. Then, the order information is transmitted via a secure frame relay T1 line to the WCTC warehouse, located three miles from the Ecampus computer center. Once received, WCTC warehouse management software optimizes the picking, packing and shipping processes for each order, and orders are immediately filled and shipped via United Parcel Service. For books not in stock, a purchase order is electronically transmitted via EDI to the appropriate supplier or publisher who ships the books directly to the customer.

The WCTC's fully automated warehouse system carried approximately 10,000 different book titles or ISBNs in stock. Books in stock are immediately picked and shipped. Books not in stock are ordered either from other book wholesalers or publishing companiies via EDI. WCTC has access to another 25,000 ISBNs that can be shipped to customers in 24 hours, another 60,000 that can be shipped in two days, 900,000 that can be shipped in 2-5 days, and 1.3 million that can be shipped in 10 days.

Ecampus created a network of several hundred "Affinity Partners" to offer college-related merchandise on the Ecampus website. An EDI system is to transmit orders to the Affinity partners, who fill and ship the merchandise directly to the customers. Ecampus collects the payments from the customers through its transactional Web site and makes biweekly payments to the Partners for the shipped orders. This system does not transmit payments for each individual sale. The reason, as explained by Jack, "It's impossible to get all these companies to agree on compatible accounting systems so we can transfer payments when they ship the product. We don't want to send the money until we know the order has been sent to the customer. And, current technology can't handle such a large number of different payment systems."

INITIAL IT ARCHITECTURE

The information technology architecture of the Ecampus Web site consists of the front end, also known as the "store front," and back end systems. The front end components and applications are what visitors see and interact with when visiting the Ecampus.com website. A team of developers from Oracle, Inc. wrote the store front applications using the Java programming language. From the beginning, Ecampus wanted to be the "most high tech of the high tech" e-commerce businesses. To that end, they wanted to create an innovative store front that was "the easiest and fastest place to buy textbooks . . . on the Internet."

The Ecampus business model was unique to e-tail e-commerce. While everyone else was trying to keep visitors on their site and viewing as many pages as possible, the Ecampus model was to have customers to find their items, pay for them and leave the site as fast as possible. The model was based on their understanding of college students. According to Jack Garvin, "Our key to success is understanding the Internet users' demand for high quality products, excellent customer service, excellent security, and fast loading Web pages that are easy-to-use. We have to understand our customers and the college students' life style. It's all about creating a relationship that meets the customers demands."

The business model was based on the belief that customers already know what books they need, they just want to get them fast and without any hassle. This model meant that the web pages had to load fast, and the search engine and payment/check out process had to be simple and fast. An innovative application to speed things up was the "traveling book bag." The traveling book bag, developed by Oracle for Ecampus, was unlike typical web shopping carts in that the total sales and savings are displayed at the top of every page as the customer moves from page to page. Also, the customer can view the contents of the book bag, without having to wait for another Web page to load. Other proprietary applications developed by Oracle included inventory searches, order processing, calculating shipping costs and delivery times.

The front end systems were supported by a Sun E6500 database server that housed the Oracle 8i database management system, and product, sales and customer databases. The back end systems included the application server that contained the web pages for the storefront and the programs to process orders, validate credit card information, interface with the WCTC warehouse, order confirmation and shipment tracking.

Initially, the website was linked to the Internet via a single T1 service line with a Cisco 3620 router acting as a firewall. A Cisco 2912 switch front ended two redundant RADware WSD Pro server load balancing devices connected to another Cisco switch. Processes (i.e., web page requests) were routed to one of two Compaq Proliant 550 application servers. Each Proliant was configured with two 550 MHz Pentium III processors, 512 Mb of RAM and 512 Kb L2 cache. These servers used Microsoft's Windows NT 4.0 operating system. The Proliants retrieved web pages from the Oracle application server and data from the database server.

The system monitoring and security control function was manned 24/7 in a secured room. The monitoring system can detect unauthorized attempts to alter programs or to access restricted files and data. An instant lockout with backup and recovery capabilities was also provided. A three terabyte RAID systems was used to store product, sales and customer data.

IT MANAGEMENT

Jack Garvin joined Ecampus as the V. P. of Information Technology in May 1999. From February until May, Jack was the project manager from Oracle who worked with the three Ecampus executives to create the front-end and back-end systems for the new web site. Jack had a B.S. degree in computer science, an MBA degree, and fifteen years of experience in systems development and project management with Microsoft and Oracle corporations. Jack had become a millionaire from of the stock options he received while working for Microsoft in the 1980s and Oracle in the 1990s. His compensation package with Ecampus also included a substantial stock option. If Ecampus became successful, it could opt to be a publicly held corporation. With the IPO market for start up "dot com" firms very hot, Jack and the other top managers had a chance to make a lot money.

Jack was a very intelligent manager who clearly understood the opportunities and risks in managing a start up e-commerce business. "The biggest problem in e-commerce is there are no proven models of how best to build an e-commerce business or a Website. People are just trying to make the best decisions they can, make them fast, and see what works and what doesn't."

Jack Garvin had developed an eight-week implementation plan that included three weeks of system testing. However, development was cut to just six weeks when Wilkinson decided that Ecampus.com would go "live" on the Internet on July 2. With much fanfare and local media coverage, they launched Ecampus with the beta 1.0 version of its website. In an article in Network World (June 14, 1999), Brent Tuttle, Director of Operations, recounts the speed at which they built the Web site. "The Oracle consultants put together a mixture of Oracle Application Servers, Oracle database servers, RADware server load balancers and Cisco switches to form the back end of the Ecampus.com site. Since there was no existing network, we were able . . . to unpack the boxes, screw the hardware into the racks and plug them in, and (working) from Friday to Sunday we were up. It was a no brainer. Everything worked right out the box." The management planned to follow the conventional e-commerce model of starting with a relatively small operation and grow as sales increased, and to maintain a high degree of flexibility in both technology and decision making. To this end, Garvin took great care in getting the technology right as to security management, network, telecommunications, hardware and software capabilities.

AUGUST CRISIS

When most colleges and universities in the U.S. began the fall semester in mid August, the deficiencies in the Ecampus.com website became apparent. A ten million dollar advertising campaign that included commercials on the Comedy Channel, Cartoon Network, VH1 and TNT cable television networks immediately generated more than 60,000 visitors a day to the Ecampus.com web site. At the peak, approximately 20,000 people were trying to download a web page from the Ecampus site. The volume of traffic overwhelmed the Ecampus network. System response time degraded to almost a crawl. The main problem was that the web site was designed to handle 2,000 concurrent page requests, or essentially 2,000 concurrent visitors. Ecampus had based its network capacity on the experiences and peak traffic of other web-based businesses, and its prediction of consumer response to its advertising campaign. "We did everything you're supposed to do to predict demand. However, the response generated by the advertising campaign was far beyond anyone's wildest dreams. No one could have predicted it. It was off the wall," explained Doug Alexander, V.P. of Planning and Development.

As the network reached its capacity, the Windows NT operating system became unstable and response times were so slow that customers either terminated their connection or were disconnected. On top of these problems, the electrical power for the Ecampus computer center was knocked out for two hours when the Oracle service technician backed the service vehicle into the electrical power box servicing the building. "We knew we needed a backup power source, but we were too busy just getting the site up and running," Jack admitted. Ecampus estimated it lost 30,000 sales worth about $3,000,000 because of the network and electrical problems.

While the problem with Windows NT was widely known in e-commerce circles, it had not been a serious problem because no e-commerce firm had experienced the sudden traffic volume like Ecampus did. Second, the beta version of the Oracle Application software Ecampus used had a bug that limited it to handling 362 concurrent processes or web page requests. Third, the Proliant computers in the server farm could not be scaled up by adding more processors to the mother boards. Ecampus would be off the Internet for two days while it added more servers and rebooted Windows NT. The fourth problem was the lack of an emergency electrical power source. The fifth problem was the T1 service lines had insufficient bandwidth to handle the volume of traffic. However, greater bandwidths or "fatter pipes" were not currently available in the Lexington area.

According to Garvin, replacing the network hardware was relatively simple. "Fortunately, we leased almost all our equipment, so all we had to do was call the vendors and exchange it for new equipment."

NEW IT ARCHITECTURE

The Web store front is a mission critical system for Ecampus. Creating an IT architecture that is highly reliable, scalable, and security was imperative. To this end, Garvin established a total redundancy policy for firewalls, switches, routers, T1 lines, load balancers and servers. The new IT architecture boosted capacity of the system from 2,000 to 6,000 simultaneous users. (See Exhibit 1 for a detailed description of the architecture components.)

The website capacity and reliability were enhanced by increasing the number of T1 service lines four and adding redundant firewalls with a failover link. The Cisco Catalyst 2912 XL is a switch designed for 100BaseFX fiber connections. It has a packet forwarding capability of 148,800 64-byte packets per second (pps). Redundant load balancers were added to provide a foundation for high service availability and disaster recovery. In case of server or application overload or failure, the load balancers can instantly switch processes over to another server in the farm. A battery backup power supply also was installed to provide emergency power for the data center for up to seventy-two hours. Finally, a total database replication (mirror) system was installed to preserve all data and processes.

To achieve better scalability the four Proliant servers in the farm were replaced with fifteen Sun Solaris Enterprise web servers. The Solaris servers, each equipped with four 450 MHz UltraSPARC-II processors and 4 GB of memory, provide four important advantages. First, they can be scaled up in "slip stream" to as many as sixteen processors without shutting down the website or reinstalling the operating system. Second, they allow for easier integration with "best of breed" third party tools and permit interfacing with leading distributors, content providers and Ecampus' Affinity partners. Third, they run the Unix operating system that is more stable than Windows NT under heavy traffic. Finally, they support distributed processing and integrate easily with the Oracle database server.

WHAT NEXT?

Once the upgraded system was running smoothly, Jack began to think about the future. Obviously, Ecampus was going to grow much faster than planned. Management had prudently anticipated a gradual growth pattern for the company, but the sales volume was already three years ahead of the plan. The web site, as powerful as it was, would not be able to handle the likely growth of the company. Next year, Ecampus expected to have 25 to 30 million visitors to its web site. By mid January, Ecampus needed to have web site front end capable of handling 30,000 concurrent visitors and four million per month.

Jack identified two options. Option one is to expand the server farm to approximately sixty servers and to upgrade the telecommunication link to the Internet to a T3 service. The bandwidth of a T3 is approximately twenty-nine times greater than a T1. The T3 change is about $15,000 per month and the leasing additional web servers would cost $10,000 per month. Also, four more information systems employees would need to be hired at a total cost of $25,000 per month. The life expectancy of this option is about one year. After that, demand would probably exceed the capabilities of the bandwidth available in Kentucky.

Option two is to out source the front-end operation to a web host provider that has a large server farm located the Internet backbone or hub. This would ensure Ecampus access to the greatest bandwidth available and almost unrestricted growth potential. Several large host providers are located on the hub of the Internet in the Washington/Northern Virginia area. Some of the largest Internet companies, such as AOL and Oracle, that have high bandwidth demands have large operation centers there. Web host providers charge one cent ($.01) for every web visitor.

This option would not require moving any employees or hiring additional personnel or installing any additional hardware or software. Several T1 lines or a single T3 service line could electronically link the remote store front to the Lexington center. With this set up, the web pages, copies of the product and customer databases, and the order processing programs would reside on the Vienna system. When a customer places an order, the data would be immediately transmitted via a VPN to the distribution center (WCTC) for processing and shipping. Additionally, this set up allows mirror copies of customer and sales databases to be maintained in Lexington to make it a fully functional backup or "mirror site." The ten Java and XML programmers could remain in Lexington to develop and maintain Web pages and programs. The initial cost to set up the store front on a host provider's system is about $10,000 and the monthly service fees are one cent per visitor. The expected increase in sales should more than offset the additional costs. Currently, 14 percent of Ecampus web site visitors make a purchase averaging $100 per purchase. Sales revenue is expected to double over the next year. The monthly cost of T3 service in Lexington is about $15,000. Currently, Ecampus is paying $2,400 a month for four T1 lines.

Jack began to think about the advantages and disadvantages of these options and what Ecampus should do. It was now mid-September and a decision had to be made soon so they could implement it by December 14. The very survival of the company was at stake. The critical issues are: What is the better option for handling the large volume of traffic that will come to the Ecampus web site in January? Also, what is the better option to support rapid growth in the future? Making the right choice could greatly enhance the value of the company's stock when it is put up for Initial Public Offering (IPO) next May.

EXHIBIT 1

Four T1 service lines, leased from GTE, link Ecampus to the Internet. The firewalls are Netscreen-100 is a high-performance firewall appliance with 100 Mbps throughput capability. They have both DES and Triple DES encryption and use IKE (ISAKMP) Key Management for secure key exchange. They provide network managers with total control to monitor, report and manage Internet access privileges.

The Cisco 2912 switch is an autosensing Fast Ethernet 12-port switch designed for low-cost, high performance 10Base or 100BaseFX fiber connections. The 100BaseFX switch has a packet forwarding capability of 148,800 64-byte packets per second (pps). It has multilevel security on console access to prevent unauthorized users from altering the switch configuration.

The load balancers are Foundry ServerIrons by NetIron and are OSI model Layer 2 through 7 Internet web switches. The ServerIrons are content management hardware switching platforms that provide transparent cache switching, server farm load balancing, application redirection, packet filtering and prioritization, and content-intelligent switching such as cookie redirection, URL and SSL session ID-based redirection and load balancing, and provide a foundation for high service availability and disaster recovery. The ServerIrons provided four important capabilities. First, they provide reliable server load balancing by distributing IP-based services, and transparently balancing web traffic across multiple servers in the server farm while continuously monitoring server, application and content health. In the event of a server or application outage, ServerIron provide sub-second fail-over to another server in the farm. The ServerIrons detect application error conditions such as "404 Object not found" before the client server sees them and transparently redirects the requests to other servers. A built-in web browser-based interface, called the Foundry Command Line Interface, is used to configure and manage the ServerIrons.

Second, the ServerIrons provide remote monitoring and port mirroring, as well as extensive accounting and statistical functions that allow the network manager to collect and display detailed information about network traffic heading to the server farm, and to track the number of active and open sessions per server. Managers can use this information to gauge the amount of traffic between servers and clients, identify applications dominating network traffic, and track traffic loads on servers that support multiple applications.

Third, the ServerIrons include an Active/Standby or Active/Active redundancy capability that protects against session loss. In Active/Standby mode, one unit operates while the other is an idle backup. In Active/Active mode, both units operate together and continuously monitor each other. If one unit fails, the other takes over without losing sessions or connectivity. One of the key features of ServerIron is the SwitchBack or direct server return feature. SwitchBack simply bypasses the load balancing devices for the outgoing traffic in order to avoid overloading the ServerIron with outgoing Web pages.

Finally, the ServerIrons can deliver load-balancing capacity of over 600,000 connections per second, can be scaled to maintain16 million concurrent sessions and 56 gbps of throughput and is highly stable under heavy traffic.

EXHIBIT 1 Continued

The two dual Pentium Compaq Proliant servers that operated as web servers in the initial IT architecture were replaced with fifteen Sun Solaris Enterprise 420R Web servers, each equipped with four 450 MHz UltraSPARC-II processors and 4 GB of memory. The Solaris servers were more expensive to lease and install than the Proliants, but provide four important advantages. First, the 420R servers can be scaled up in "slip stream" to as many as four processors without bring down the website. Second, the 420R servers allow for easier integration of "best of breed" third party tools and permits interfacing with leading distributors, content providers and Ecampus' "Affinity" partners. Third, the 420R servers run the Unix operating system which is more stable than Windows NT under heavy traffic. Finally, the 420R servers support distributed processing, more tightly integrate with the Oracle database servers and support most popular HTTP servers such as Apache, Microsoft and Netscape.

A Sun StorEdge A1000 RAID array was installed to provide Web pages and other content to the server farm via the Cisco Catalyst 2924 switch. The A1000 has a 3.92 TB storage capacity with a 70-MIP processor and 80 MB of cache memory.

The application layer was controlled by a Sun Enterprise 6500 midrange server running the Solaris 2.6 operating system. The 6500 provided the server farm, via Fast Ethernet, with order processing, product catalog, user profiles, the Traveling Book Bag application, check out/payment processing application, and the Oracle 8i DBMS. The 6500E can transmit data at the rate of 2.68 gbps. It can be configured with an I/O board and as many as fifteen memory boards with one or two processors per board and sixteen DIMMs on each board. The 6500 has a memory capacity of 60 GB and compilers for C, C++, Pascal, FORTRAN and the JDK Java workbench. Other features of the 6500 include automatic system recovery, dynamic reconfiguration, alternate pathing, hot-swap disk drives and hardware failure prediction.

An EMC Symmetrix 3830 is a database server with high speed database backup and restore capabilities for the Oracle 8i database management system. It has four 336 MHz UltraSPARC processors and 512 MB of memory. A CNT UltraNet links the EMC Symmetrix via a provided multi-gigabit channel capacity to transmit data from Ecampus to the order fulfillment warehouse owned by Wallace's College Textbook Company (WCTC). A VPN router encrypts the data before sending it, via a frame-rely T1 service line, to the fulfillment center. A second VPN router, located at the warehouse, decrypts the incoming data.

WYETH PHARMACEUTICALS: AN EQUITY VALUATION CASE

James Stotler, North Carolina Central University

CASE DESCRIPTION

The primary subject matter of this case concerns equity valuation of a large corporation using various valuation approaches. Secondary issues include sensitivity analysis, DuPont analysis and evaluation of competitive conditions in the industry using Porter's five force model. The case has a difficulty level of three and is most appropriate for senior level courses. The case is designed to be taught in two classroom hours and is expected to take two or three hours of outside preparation by students.

CASE SYNOPSIS

The student is placed in the role of an equity analyst and asked to prepare a buy or sell recommendation for Wyeth Pharmaceuticals (NYSE: WYE) stock. WYE is primarily a pharmaceutical company with operations in the areas of human ethical pharmaceuticals, consumer health care, animal health care and agricultural products. Recently, the price of WYE stock has been volatile and the company is under pressure from competitive forces within the industry. The student must assess the competitive environment of WYE using the DuPont identity and Porter's five force model of competitive strategy as well as estimate the value of WYE stock. All information in the case is historical and publicly available.

INTRODUCTION

Wyeth Pharmaceuticals (WYE) is a dominant player in the pharmaceutical industry. WYE manufactures health care products such as prescription drugs, medical devices, supplies and instruments, and over-the-counter medications. WYE has several prescription drug subsidiaries including Wyeth-Ayerst Labs, A.H. Robins Company, Sherwood Medical, Corometrics Medical Systems, Fort Dodge Laboratories, and Whitehall Labs. Consumer health care accounts for 17.8 percent of sales, pharmaceuticals account for 70.2 percent of sales and agricultural products account for 17.5 percent of sales.

Products

The company produces research based pharmaceutical products in many different areas including women's health, neuroscience therapies, musculoskeletal therapies, vaccines, specialty products, cardiovascular therapies, anti-infectives, nutritionals, animal health and agricultural products. While WYE makes many popular consumer products like Advil, Robitussin, and Centrum their portfolio is composed of a wide range of products and they are not dependent on any one patent protected product.

In the area of women's health care, WYE produces Premarin and its family of products. Premarin is one of the company's conjugated estrogens manufactured from pregnant mare's urine. This product no longer has patent protection but the Premarin family of products are the most prescribed medications in the United States today. Premarin itself, which has been on the market nearly 60 years, is used to manage the symptoms of menopause and to prevent osteoporosis. Osteoporosis is a condition involving loss of bone mass in post menopausal women.

WYE also develops and markets neuroscience therapies. In this area its two primary products are Sonata and Effexor XR. These products are designed to improve the quality of life for individuals with central nervous system disorders and general anxiety disorder. Sonata was approved in the United States and Europe in 1999 and is the first in a new class of non-benzodiazepine, a sleep inducing compound. This product can be very helpful to people who simply cannot fall asleep because it works within 30 minutes and has no residual physical or cognitive side effects. Also in 1999, Effexor XR became the first drug approved for general anxiety disorder in the United States in more than 10 years.

Enbrel is a leading product in WYE's musculoskeletal franchise. Enbrel is the first FDA approved treatment for rheumatoid arthritis. It was approved in 1998 to treat moderate to severe rheumatoid arthritis in people who had not responded to certain other medications. Immunex, a majority owned subsidiary of WYE, discovered Enbrel and the product is co-marketed in the United States with Wyeth-Ayerst. The product is marketed solely by Wyeth-Ayerst outside the United States.

Other products in WYE's portfolio include the following. Prevnar targets invasive pneumococcal disease which is the leading cause of bacterial blood stream infections and meningitis in infants and children. Rapamune is an immunosuppressive agent designed to prevent organ rejection following transplantation. Myotarg is a product for treating relapsed adult acute myeloid lymphoma which was recently assigned "priority review" status by the FDA which indicates that the FDA intends to act on the application within six months of the date of filing the application.

As an analyst for Carolina Investment Advisors you are assigned the task of estimating the value of Wyeth Pharmaceuticals' stock and issuing a buy or sell recommendation on the stock. Your recommendations are widely watched by clients of Carolina Investment Advisors so you take your assignment very seriously. To get started with the valuation task, you compiled the following information.

Table 1: Key Financial Statement Information (In thousands except per share amounts)				
Wyeth Pharmaceuticals				
ITEM	2001	2000	1999	1998
Net Sales	14,128,516	13,213,671	$13,550,176	$13,462,687
Net Income (Loss)	2,285,294	(901,040)	(1,227,121)	2,474,338
Earnings (Loss) per share	1.72	(.69)	(0.94)	1.85
Dividends per share	.92	.92	0.905	0.87
Total Assets	22,967,922	21,092,466	23,906,277	21,079,068
Stockholders Equity	3,445,333	4,516,420	6,214,747	9,614,796
Source: Wyeth Pharmaceuticals 2001 Annual Report				

THE PHARMACEUTICAL INDUSTRY

In late 1999 and early 2000 the biotechnology sector soared in valuation in anticipation of some very promising research in the area of human genomics which involves attempting to map the human genetic code. Although the biotechnology sector and the pharmaceutical sector are related, much of the human genomics speculation drew investment capital into biotechnology which would have otherwise been invested in the pharmaceutical sector. The second half of 2000 has seen a decline in the biotechnology and human genomics sector and moderate price increases in pharmaceutical stocks.

Overall, major firms in the pharmaceutical industry have recorded many successive years of double digit percentage earnings increases. In general, the drug industry should be able to maintain strong earnings growth in the future, but individual company's can be impacted by such events as patent expirations on key drugs, product recalls, and class action lawsuits involving the company's products.

The industry has recently seen a significant amount of merger activity. For several months a three way battle was underway for control of Warner Lambert. Wyeth Pharmaceuticals submitted a friendly bid to buy the company and an agreement was reached. These negotiations drew the attention of Pfizer, another large pharmaceutical company, and they submitted a hostile bid which was 20 percent higher than the amount which Wyeth Pharmaceuticals had agreed to pay Warner Lambert in the friendly deal. Warner Lambert ultimately went with the Pfizer offer. The original friendly deal between WYE and Warner Lambert included a $2 billion breakup fee which required the party which walked away from the deal to pay $2 billion to the other party. WYE was unable to acquire Warner Lambert but is entitled to receive the breakup fee. Similar types of merger activity are ongoing in the pharmaceutical industry. The driving force behind the merger activity is access to existing and potential patents and proprietary research and development information in the product pipeline.

Table 2: Pharmaceutical Industry Composite Statistics					
ITEM	1997	1998	1999	2000	2001
Sales ($mil)	110,063	121,828	135,230	201,486	208,531
Operating Margin	27.2%	28.3%	29.0%	27.1%	28.7%
Income Tax Rate	28.5%	29.4%	29.5%	28%	25%
Net Profit Margin	16.7%	17.9%	18.4%	16.7%	18.2%
Shareholder Equity	64,537	71,988	80,665	123,136	137,296
Return on Equity	28.5%	30.2%	31.0%	27.4%	27.6%
Source: Value Line Investment Survey, 2002					

Wyeth Pharmaceuticals is in an industry with a moderate number of large competitors and many smaller biotechnology companies. WYE's primary competition comes from large competitors such as Pfizer and Schering Plough. The table below provides a summary of key financial ratios for WYE, its competitors and the industry.

Table 3: Current Key Financial Ratios				
	WYE	Pfizer	Schering Plough	Industry
ROE	0.561	0.456	0.33	0.276
PROFIT MARGIN	0.205	0.259	0.237	0.182
ASSET URNOVER	0.799	1.253	1.02	0.919
EQUITY MULTIPLIER	3.423	1.405	1.365	1.649
Sources: Value Line Investment Survey, 2002 Wyeth Pharmaceuticals 2001 Annual Report				

The return on equity for WYE is above the industry average and that of its competitors. The profit margin of WYE exceeds the industry average but is less than Pfizer and Schering Plough. Asset turnover is quite low for WYE and falls below both competitors and the industry while WYE has an equity multiplier which is much greater than the industry average and that of both competitors.

VALUATION DATA

Your analysis requires some information about the market in general as well as information on how the price of WYE stock behaves under certain market conditions. While compiling the following information, you realize that your estimate of the value of WYE stock is quite sensitive to certain factors. In this regard, you decide to conduct a sensitivity analysis to determine how sensitive the value estimate is to various input variables.

The data collection begins with interest rates. Consulting a reliable online source, you learn that the interest rate on a 90 day United States treasury bill is 4.5 percent while rates on a 6 month treasury bill are 4.9 percent. A 30 year government bond is trading to yield 5.1 percent. Recent rates on certificates of deposit at large banks are around 4.8 percent and large creditworthy corporations have issued commercial paper with a yield of 5 percent. During this same time period, the Standard and Poor's 500 earned an average return of 12 percent.

In addition to the above information on market interest rates, Table 4 contains some information you compiled relating to WYE and the market. The earnings of WYE have grown from $1.28 per share five years ago to $1.72 in 2001. This growth rate is expected to continue in the future.

Table 4: Company Specific and Market Data0	
Beta Coefficient for WYE	0.8
Price/Earnings Ratio for WYE	12.1
Earnings per share estimate	$2.55
Return on S&P 500	12%
Dividend expected next period	$0.92
Recent price for WYE	$31

FROM RUSSIA WITH LOVE: UPDATE.COM AND THE CYBER MAIL-ORDER BRIDE INDUSTRY

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CASE DESCRIPTION

The primary subject matter of this case concerns the cyber matchmaking industry. A secondary issue is one of business ethics in this very personal business. The case has a difficulty level of four. The case is designed to be taught in two class hours and is expected to require two hours of outside preparation by students.

CASE SYNOPSIS

This case explores the business practices of an explosive growth industry, personal introductions over the Internet. The case details the business practices of Udate.com and its subsidiary, Kiss.com and examines the problems and opportunities found in the cyber matchmaking industry.

INTRODUCTION

Olga is a 34 year-old Russian lawyer who is looking for love. She is typical of the many Russian women listed on the Kiss.Com web site. Olga describes herself as tender, loving, caring, romantic, fun loving, and intelligent. She enjoys the theatre, cooking, traveling, reading, and she "wishes to love, and to be loved, and to make my husband happy." Olga is like the thousands of other Russian women who are currently looking for a marriage partner via one of the many Internet marriage brokers.

A 1947 law prohibited Russian citizens from marrying foreigners. The law was in effect until the death of Joseph Stalin in 1953, however, the cold war made marriage, and even contact, with Americans very difficult. In the 1990's Russian women began to sign up with international dating agencies in the hope of finding an American or European husband. Many Russian women consider American men to be more sensitive, polite, and good husbands and fathers. Russian women also feel that American men are more willing to marry a woman with children, something less common with Russian men. Many of the Russian women who are listed with the international agencies are divorced and have dependent children. Since the fall of communism in the former Soviet Union, economic conditions have worsened and made the prospects of marrying a foreigner more attractive.

Since the breakup of the former Soviet Union, Russia has continued to struggle in its move towards a market economy. Russia's GDP has contracted by over 40% since that time and the country suffers from a variety of national ailments. The Russian people have experienced a sudden and extensive devaluation of the ruble, political uncertainty, increased crime and corruption, food panics, declining life expectancy, increased alcoholism and drug abuse, and a declining population. In fact, the current population of Russia stands at 145 million but is expected to drop to 55 million by 2075, if present trends continue. The promise of economic gains through democracy and a market economy have yet to be realized for most Russians. The Soviet era infrastructure is crumbling and the quality of life for many Russians is lower than in the days of communist rule. Russian per capita GDP of $3,983US ranks 84th out of 191 countries and it's ranking in the Human Development Index is 62nd out of 174 countries listed. The increasing social ills plaguing Russia help fuel the demand for international marriage brokers.

Udate.Com is an online personal dating and matchmaking service which operates globally through two Internet sites -Udate.Com and Kiss.Com. Kiss.Com began in 1995 and was acquired by Udate.Com in March, 2001 for $19.1 million payable in shares of Udate.Com and $5 million in notes. Kiss.Com is one of the oldest Internet matchmaking services. Photos and basic information are provided to web surfers free of charge but the companies charge a membership fee for contact information. The two companies maintain a database of thousands of men and women (mostly women) who are seeking life partners. The database includes pictures and information on physical features, age, occupation, interests, and personality. Udate.Com is more advanced technologically and allows members to enter up to 120 pieces of information about themselves which is then stored in the database and used to find a suitable match. Customers can search the database and find matches based on age, height/weight, location, and other factors. Udate.Com also offers members the opportunity to communicate online using instant messages or "whispers" with any of the up to 5,000 members who are online at any given time.

The two companies have similar membership plans which range from $9.95 for a five-day membership to $149.95 for a two-year membership. Members can gain access to the registered members addresses, telephone numbers, and email addresses. At present, Udate.Com has 2 million members and Kiss.Com has over 3 million members. Most revenue for the companies comes from membership fees, however, work is underway to develop additional revenue flows from web advertising and market research data. The two companies have experienced rapid member growth in recent years. In addition to the computer matchmaking service, Kiss.Com has a relationship expert (Pepper Schwartz, Ph.D.) who provides advice to members through online articles and features. Many companies in the industry also organize trips for members to meet the people with whom they have been corresponding and the opportunity to meet other potential life partners in person.

Most of the Internet matchmakers provide testimonials on their web sites from satisfied customers. Most of the testimonials talk about successful marriages, or how easy it was to meet desirable women, or how many beautiful women they had met on one of the romance tours.

> *I just wanted to write and tell you thank you! I met Elana through your service and I could not be any happier. She is truly the woman of my dreams. I never thought I would be able to be happily married after two failed marriages but you made it all possible.*
>
> Frank

> *To date, I have received well over 30 replies! I have chosen 7 very nice ladies from all over Russia. All of the ladies have been most polite, friendly and sincere. As a school teacher, I am planning to take a summer holiday to meet all of them.*
>
> Bill

> *I met more beautiful, intelligent women in one night than most guys meet in a lifetime. These women seemed genuinely interested in meeting me. They aren't just interested in your looks or age or what you can do for them, they are interested in the kind of person you are.*
>
> Tom

According to Kiss.Com, their typical customer is 25-49 years old, divorced, college educated, and professionally employed. The Company strives to provide world class dating, a high quality match, and confidentiality. The Company seeks to provide its customers with a fun, easy, and convenient way of meeting singles from anywhere in the world. While the two firms have listing from many nations, a high percentage of the database is filled with women from Russia and the new republics of the former Soviet Union. In the past many mail order brides came from the Philippines, however, now most come from Russia.

Udate.Com faces many competitors offering personal introduction services. With low barriers to entry it is relatively easy to create an Internet dating service. Some of the competitors Udate faces include A Foreign Affair, Blonde Russian Women, the Russian Connection, TLC Worldwide, GetMarriedNow.Com, Cherry Blossoms, and Loveme.Com. Innovation is an important competitive advantage in this industry and smaller companies can build market share by altering the way they market their service. GetMarriedNow is a much smaller company than Udate, however, the company now allows customers to view a 60-second streaming video of each woman/man registered with the agency. Customers of GetMarriedNow can hear the voice and see a moving image of their potential spouse. This aspect of the service may prove very valuable as the company attempts to establish itself in the Internet dating business. GetMarriedNow is also a niche player in the industry in that it profiles women from only two cities in Russia (Novosibirsk in Siberia and Kherson in the Ukraine) allowing for a customer to select a number of women to meet at one location when taking a romance tour. Another niche player in the industry is Dominican In Love. The company operates a simple web site for the viewing of a limited number of women from the Dominican Republic. While Dominican In Love offers fewer services, it does provide specialization in terms of source location. The Internet matchmaking industry grew rapidly in the 1990's and many companies entered the market. While some consolidation has occurred in the industry, no dominate player has emerged. Udate and all the other cyber-based dating services compete not only with each other, but also with newspaper classifieds, traditional dating services, and Internet portals such as AOL and Yahoo. The industry is still immature and future demand is difficult to predict. A significant component of Udate's success will be its ability to differentiate its service from competitors and to convert its registered members into paying customers. With an estimated online population of over 400 million (global Internet users) and growing rapidly, Udate.Com is confident that membership, revenue, and profits will all increase for the company. While membership has shown impressive growth, profitability has been elusive.

OPERATING RESULTS THREE MONTHS ENDING JUNE 30TH		
	2001	2000
Revenue	$4,217,129	$132,294
Selling & Marketing Expense	1,644,882	604,564
General & Administrative Expense	2,349,155	635,974

After depreciation and the amortization of goodwill due to the acquisition of Kiss.Com, the Company reported a net loss of $1,014,472. Udate.Com has yet to earn a net profit.

Udate is publicly traded on the OTC. The company's stock price has steadily moved down from its IPO price of over $5 to a current price of around $1.50. The chart below shows the firm's stock performance over the last year.

While the cyber mail-order industry is quick to highlight its many successes in finding marriage partners, another side of the story has emerged. Not all mail-order marriages have been successful, especially those involving international partners. Couples have complained about language difficulties and misunderstandings. Some American men complain that their new Russian brides are not very quick to open up about their feelings. Russian brides complain that American men have a "tell all" attitude which they themselves find disturbing. One American who married a Russian woman was quoted as saying "when these marriages are good, they are very, very good, and when they are bad they are horrid." In a number of cases of failed marriages between Russian women and American men the men complained that the Russian women spent money too freely. Russian women counter that their new American husbands were too frugal. One American husband refers to the marriages as "trail by shopping." Some critics of the mail-order bride industry state that the agencies are exploiting women desperate to leave the economic difficulties of their homelands and American and European men seeking a controlling relationship then take advantage of this situation. An immigration attorney speaking about Russian women provides another perspective. "What the men often fail to realize, though, is that underneath the pretty, kittenish exterior are claws of steel and an iron will." Both sides to the debate would probably agree that the marriages face an uphill fight and that the typically brief courting period is not much time to assess the compatibility of each partner. Natalya, a young Russian looking for a foreign husband states, "If I meet someone I like, I would marry him. Of course, a few days is not enough to know someone well, but you can go to America and get to know them better there." Statistics on the success rate of these cyber mail-order marriages is not available, however, supporters provide anecdotal evidence of their success and point to the high failure rate of American domestic marriages.

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COHABITATION AND CONFLICT OF INTEREST IN A PUBLIC AGENCY: JUSTICE SERVED, OR POWER AND POLITICS AT WORK?

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CASE DESCRIPTION

The case concerns an office romance in a government agency. Power and influence are exercised in a fashion that allegedly violates a state conflict of interest statute. Material in the case lends itself to discussion of a number of interesting human resource management and organizational behavior topics. These topics include sexual harassment, ethics, decision-making, power and influence, recruitment, and organizational political behavior. The case has a difficulty level of from three through six. It can be taught in 45 minutes. It is expected that preparation time for the case would also be 45 minutes.

CASE SYNOPSIS

The case explores a long existing situation in a public school district in a high socio-economic area. It involves the hiring of an individual in a human resource office, the subsequent establishment of a romantic relationship with the chief manager of that office, alleged preferential treatment of the subordinate, all amidst protests of an improper conflict of interest based on cohabitation and jointly purchase real estate by the two principals.

The "establishment" comes to the defense of the "embattled" couple in the face of state law that prohibits supervisors from taking actions in matters of personnel from which the supervisor might enjoy material gain. The case is unusual in that it is based to a great extent on public records and documents prepared by officials defending the alleged improper relationship. Decisions made by the School Board, Superintendent of Schools, and District Attorney are documented.

The decisions appear aberrant and imprudent in the current environment in which consensual relationships change quickly into coerced relationships exposing organizations that "knew or should have known" to extensive liability. A plausible explanation for the decision-makers behavior may lie in the power dynamics of the situation. Names of all people and places have been changed. Otherwise the case is entirely factual. All quotes are actual verbatim quotes obtained from available documents. Documentation is available for every attribution to any individual in the case.

INTRODUCTION

As this case was being written, another conflict of interest story broke in Yolo County where Mike Cooper was the District Attorney. The breaking story is quoted extensively from the local newspaper in the Prolog as an illustration of the seriousness of violations of the state conflict of interest statue in this jurisdiction. There are common details in the two situations, but the outcomes are dramatically different. In the public school case public officials, including District Attorney Mike Cooper see no impropriety in a supervisor exercising direct supervision over his cohabitant or in that supervisor making numerous recommendations regarding promotions and/or salary increases. The reader is invited to contemplate why the Deputy Superintendent did not experience problems similar to those experienced by John Wycol.

The case proper begins after the Prolog and consists of descriptions of a series of actions, and reactions related to the Deputy Superintendent of Rock Hill City Schools in Yolo County, Mr. William Padget. The case offers an opportunity to examine the impact of political considerations on public affairs. To assist the reader in organizing a long series of factual events, the case is arranged in chronological order with key events clearly designated by Roman numerals. The reader may find the appendix of significant characters helpful in working through the case.

PROLOG

12/30/99 Evening Herald, Rock Hill, MO. "Yolo County's top engineer overseeing Y2K preparation abruptly resigned his position Tuesday in the wake of criminal allegations he improperly awarded $72,000 in contracts to his live-in girlfriend. John Wycol, director of the Yolo County Information Systems since 1994, is under investigation by Rock Hill police for issuing three consulting contracts to Sharon Lundin in 1995 and 1996. Wycol and Lundin bought a home together in Rock Hill after moving here from Coolville.

"Wycol, who earned $101,244 a year, did not return phone calls. Rock Hill police detectives had obtained a search warrant to get property records from a Rock Hill title company. The property records, along with county contract documents led investigators to conclude Wycol had violated felony conflict of interested codes.

"District Attorney Mike Cooper said his office was informed of the alleged conflict of interest four months ago and turned it over to the Rock Hill police. Cooper said that if convicted of the crime Wycol could face fines and potentially, state prison time as well.

" An anonymous letter was sent to County Administrator Tom Brooks in January 1996 accusing Wycol of improperly issuing contracts to Lundin. In October 1999, Rock Hill police received the same allegations from the district attorney and began their own investigations. Each of the three contracts was for $24,000 and each was approved by Wycol only."(Rock Hill Evening Herald, 12/30/1999).

BUT THAT'S ANOTHER STORY

Our story takes place across town in the city school system and revolves around the School's Deputy Superintendent, Mr. William Padget and people who were associated with him in a variety of capacities in the course of execution of his duties. While Mr. Padget has the lead role in the case, other characters play critical supporting roles that determine the final outcome of events. One important role is played by Ms. Lane Simril, who had the good fortune to be both a subordinate and a cohabitant of Mr. Padget (Rogers, 1997). Other key players will be introduced in due course. The Deputy Superintendent is in point of fact the director of personnel for the School system.

The story is of interest not necessarily because it is unique, though many that are familiar with HR policies may find some events quite unusual. The case is of interest because it may illustrate common practices that can best be understood from a framework of power and politics, rather than from a framework of laws, rules, and codes of behavior.

MR. PADGET MEETS MS. SIMRIL

Among many Mr. Padget had a reputation of being strong willed; some thought to the point of being vindictive. An immediate subordinate upon the occasion of her "forced retirement" wrote about her perspective on the beginning of his office romance.

"Padget did his best to find cause to prepare for my dismissal. Finally, on the verge of a nervous breakdown from so much stress and harassment, I decided to beat him to it - and submitted my retirement letter. He was so enraged he sent me with one day's notice to Briddley Lane (the Siberia of the City School District). He changed the locks at the central office to embarrass me, and my friends had to clean out my desk. That was the end of my nightmare. Let me tell you how it all started.

"When Lane and Padget started to date, Lane would tell me about their dates. I preferred not to hear this, but it opened up the opportunity to use me for her and Padget. I ate lunch every day at the Sundial. I drove and Lane would join me. Padget would come in a little later - surprise, as if he and Lane met there by accident. My husband wished I would get out of the situation because he felt I was being used. I was so naive. Then one day I told Lane I wouldn't be going to lunch with them that day. Lane said, ' You just can't do that, you know you are our cover.' Shortly after that I stopped having lunch at the Sundial. My withdrawal started the vendetta against me. Over several years there were so many hurtful things."(Berty Rhoads, 1998)."

Berty's letter gives a personal view of the Padget/Simril relationship and is suggestive that the relationship would have a dysfunctional impact on the Padget work group.

ILLEGAL CONFLICT OF INTEREST?

As the relationship between Mr. Padget and Ms. Simril continued, eventually a formal charge was made that Mr. Padget's conduct constituted an illegal conflict of interest. Events relevant to the conflict of interest allegations are presented chronologically with limited commentary as they occurred.

I. The relevant state statute is excerpted as follows: "No public official at any level of government shall make, participate in making or in any way attempt to use his official position to influence a governmental decision in which he knows or has reasons to know he as a financial interest." Government Code, Chapter 7, Conflicts of Interest, Article 1. General Prohibition, GC87100, State of Missouri.

II. January 1983. Mr. Padget was promoted from Director of Elementary Education to Assistant Superintendent of Personnel. Mr. Padget was a native of Rock Hill and began his career in the School System some 15 years earlier. Ms. Simril was hired as a secretary in the personnel office in 1981. According to staff in the office their relationship began shortly after Mr. Padget's promotion to the personnel office. Over the next decade and a half, Ms. Simile's career flourished as she received numerous promotions and pay raises during that span. Official organizational charts show Mr. Padget as being Ms. Simile's sole supervisor until late 1996. In late 1996 in the context of a growing public criticism of the relationship between Ms. Simril and Mr. Padget and yet another promotion, the School Board approved a new reporting relationship calling for Ms. Simril to be supervised by three different individuals in what appears to be a matrix structure. Padget continued to exercise independent leadership over her activities and her office continued to be in the Personnel Area of Deputy Superintendent Padget.

III. May 1983. At the recommendation of Mr. Padget, the School Board approved a change for Ms. Simril from Personnel Secretary to Recruitment/ Affirmative Action Technician. No salary reclassification.

IV. Jan. 1986. At the recommendation of Mr. Padget, the School Board approved a change for Ms. Simril from Recruitment/Affirmative Action Technician to Recruitment/Affirmative Action Technician/Title IX Officer. Salary reclassification.

V. July 1987. Mr. Padget approved additional wages for Ms. Simril for a special assignment for the next fiscal year. Toward the end of this assignment in June of 1988, Ms. April Ellis reports that her concerns about "favoritism, and grooming for job opportunities and promotions" lead her to schedule a conference with the District Superintendent to voice her concerns. Ms. Ellis was the Administrative Secretary to Mr. Padget from 1984 until reassignment to the Superintendent's office in 1997. Her reassignment followed her formal complaint of actions taken by the Board of Education relating to recommendations Mr. Padget made in relation to Ms. Simril.

VI. In July 1988 Mr. Padget recommended and the Board approve a staff reorganization which included a promotion of Ms. Simril to a position with added responsibilities and a larger salary. During this period Ms. Ellis claims to have taken her concerns of favoritism to members of the School Board.

VII. February 16, 1990. Mr. Padget and Ms. Simril become partners in a real estate transaction and on this day a Grant Deed was recorded in the County of York to: "Bill Padget, and unmarried Man . . . and Lane Simril, An Unmarried Woman . . . as Tenants in Common"(Grant Deed, 1990).

VIII. July 7 1992. Mr. Padget recommended and the Board approved a Personnel Department reorganization. This reorganization included a promotion for Ms. Simril to the position of Personnel Operations Supervisor, with a salary reclassification.

On the occasion of this recommendation by Mr. Padget a group of 33 employees of the School District signed a letter of concern/protest stating: "Our concern is with the recent 'reorganization' of the Personnel Department and the fact that , with the renaming of four positions, three Personnel employees were given substantial raises. . . . The salary and benefit cost in this case is a convoluted maze which nets out to an overall cost of almost $5,000 for the person who has been promoted from range 1 to range 9 . . . But the cost cannot be measured in financial terms alone. The loss of trust and confidence that other employees have in the administration and Board will continue to undermine our ability to work as a team . . . the reorganization was unduly costly at a time of severe budget cuts and cost cutting elsewhere in the system"(Employee Correspondence, 1992). There is no record of a response to the concerned employees.

This letter gives evidence that the relationship between Mr. Padget and Ms. Simril had been become a concern of a group not confined to the Deputy Superintendent's office. The letter also suggests that the behavior of the Deputy may have been causing wide spread morale problems among district employees.

IX. September 20, 1996. Mr. Padget became involved in a controversy relating to salary matters on his own behalf. According to the Rock Hill Evening Herald: (September 20, 1996).

"The Rock Hill School Board, which met behind closed doors four times this summer to consider contract extensions for three top administrators before a Board majority is elected in November, has dropped the talks . . . The board met in closed sessions during July, August, and September and considered extending the contracts for three positions directly under Superintendent Lew Clarke even thought the three-year contracts don't expire until June of 1998. All make more than $80,000 a year. One of the three administrators, Deputy Superintendent of Personnel Bill Padget, had asked that the topic be put on the agenda in July because his contract and the two assistant superintendents contracts 'needed some technical changes to make it accurate,' Board of Education President Fred Prew said. George Funk, one of the 10 candidates for three seats on the School board, publicly call the board to task and argued that any decision on contracts should be made after the November elections."

Funk was quoted as saying "the current board does not act independently and merely rubber stamps the policies of Clarke and his staff." (Rock Hill Evening Herald, Sept. 20,1996). The incident suggests that Padget had a great deal of influence with the Board since it was his request that resulted in the issue being place on the agenda.

X. September 24, 1996. The School Board at its regular meeting considered yet another Padget reorganization rationalized by growing work demands. A major change was the addition of a personnel director in his office justified as follows: "During this time period, to assist in the workload, I have utilized a confidential employee in the capacity of Personnel Operations Supervisor. The POS has provided district-wide leadership and support, is highly respected by management, certificated, and classified staff, both in the knowledge of personnel functions, and problem solving in related areas . . ." (Padget, 1996a).

The revered Personnel Operations Supervisor was Ms. Simril, "longtime cohabitant and member of a committed relationship" with Mr. Padget (Rogers, 1997). The Board tabled the recommendation and requested that the proposal be brought back for Board consideration in written form as an advertised position (Board of Education, 1996a).

XI. September 26, 1996. Letter from Mr. Padget to Ms. Ellis: "Yesterday morning, I telephoned you from my office directing you to give me a list of any telephone calls you received relating to my Board of Education agenda item (September 24, 1996), requesting a Directorship/reclassification and additional personnel help. Since I have not received any response from you as of this time, it would be with the understanding no one contacted you about the agenda item. If I am not right, your response is to be given to me today." (Padget, 1996b)

XII. October 1996. Mr. Padget complied with the Board's request and provided them with a written job description for their October meeting. The job description made the new Director jointly responsible to Mr. Padget, the Superintendent, and another assistant superintendent. The recommended salary range was from $45,000 to $53,000. Mr. Padget recommended the following time line for the recruitment: Advertised both in and out of the district from 10/23 to 11/1. Interviews during the week of 11/4 and Board approval of the selected candidate on 11/12 (Padget, 1996c). The Board approved Mr. Padget's proposal on 10/22/96 (Board of Education, 1996b).

XIII. October 24 1996. Mr. Padget and Ms. Simril deeded title to their earlier obtained property back to the original owner "for valuable consideration" (Grant Deed, 1996).

XIV. November 11, 1996. A written complaint was filed with the School Board by Ms. Ellis, who had worked in the District since 1972 and in the personnel department since 1983. Ellis was protesting the proposal by Mr. Padget to promote his direct subordinate into the position of personnel director. Ellis's complaint begins with words of praise for the School district and then moves to her area of concern. In her own words:

"There is, however, an area of concern which most seriously needs to be addressed: the matter of an unjust internal operation within the Personnel Department for the last ten years, of which you are aware. The main focus is the situation of: (1) conflict of interest, (2) preferential treatment, (3) favoritism, (4) unethical, unprofessional behavior, (5) nepotism.

"This has been an ongoing process since the mid- 1980s, which has been brought to your attention, addressed both in writing and in meetings, without any response from you to this concern. I refer you to the organizational structure charts and a letter of concern from July 1992, signed by thirty-three (33) district employees." (Ellis, 1996).

XV. November 12, 1996. The Board of Education approved the recommendation that Ms. Lane Simril be named to the newly created post Director of Internal Personnel Operations (Board of Education, 1996c). A supervisor would be Mr. Padget "cohabitant and partner in committed relationship" (Rogers, 1997). April Ellis did not apply for the position, though she believed herself to be qualified. Her explanation was that the decision was preordained and her application would be only a source of humiliation to her.

THE INVESTIGATION

Prior to the formal complaint of Ms. Ellis the School Board could ignore whatever complaints were informally expressed in relation to controversial reorganizations and personnel decisions. The several references to a "rubber stamp" board of education in the context of the upcoming election could be ignored, the letter of concern by the 33 employees in 1992 could be ignored, April Ellis's oral complaints to the Superintendent and members of the Board of Education could be ignored. However, Ms. Ellis's complaint would change all that and require the attention of public officials to the situation, because a Board policy guaranteed a response to all formal complaints.

XVI. November 13, 1996. Superintendent Lewis Clarke responded to Ms. Ellis complaint in a formal letter by inviting her to arrange a meeting with him. He advised Ms. Ellis to notify him if she would bring legal counsel so that he might also have a lawyer to represent the interests of the District (Clarke 1996).

XVII. December 28, 1996. Ms. Ellis sent yet another letter to the Superintendent and the School Board describing incidents of retaliation directed toward her by Mr. Padget beginning in Sept. of that year, and requesting a response from the Board regarding these charges and her complaint of November 11. (Ellis, 1996b). Dr. Clarke asked Mr. Padget to respond to the charges. Mr. Padget's response was not available.

A series of meetings involving Ms. Ellis, her attorney, Dr. Clarke and the Board of Education Attorney Mr. Robert Paully took place. Mr. Paully's firm, "School and College Legal Services" had a contract with the Office of Education and served as General Counsel of the District. According to Paully's letterhead the firm serves clients in six piedmont counties. Presumably, Mr. Paully and Mr. Padget would be frequent professional associates given the degree to which personnel is regulated by law. In any case the meetings were not successful in resolving the complaints brought by Ms. Ellis. Mr. Paully argued that the State fair employment law, which permits spouses working in the same department, legitimized the Padget/Simril employment arrangement. Ms. Ellis did not agree and insisted that the issue in the School District was a relationship in which one party supervised the second party, thus constituting an illegal conflict of interest under state law.

Mr. Paully recommended that the District retain independent counsel, a colleague from a state association of school districts to conduct an impartial investigation. Neither Ms. Ellis nor her attorney Mr. James Grayson knew Mr. Paully's contact, one John Rogers. Surprisingly Mr. Grayson raised no objection to allowing the lawyer for the School District to pick the "independent investigator". (Mr. Grayson was a candidate for Judge of the Superior Court of Rock Hill in spring of 2000). Shortly thereafter, Ms. Ellis was transferred laterally from Mr. Padget's office to the office of the Superintendent. Her letter of notification indicated that she would take a pay cut as a result of the transfer, which the School District represented as requested by her. The rationale for the pay cut was that during the last reorganization, duties of Ms. Ellis as payroll supervisor had been shifted to the newly created Internal Director of Personnel and therefore executed by Ms. Simril. Mr. Robert Paully responded to protests by counsel Grayson of the pay cut stating: "the District was unaware of your client's expectation that beyond this School year she should be paid for work she is no longer performing." Mr. Paully's response did not address counsel Grayson's concerns that Mr. Padget's taking duties (and salary) away from critic Ms. Ellis and giving them to cohabitant Simril constituted retaliation, as well as violation of conflict of interest law (Clarke, 1997).

XVIII. June 23, 1997. Dr. Clarke sent Ms. Ellis a copy of the report from independent consultant Rogers. Mr. Rogers found no conflict of interest nor any violation of any law regarding nepotism. Dr. Clarke also personally reviewed her concerns about harassment, retaliation, and favoritism in the Personnel Department and found no factual basis for her concerns. He declared the issue closed.

XIX. Mr. Roger's report was addressed to School Board President Jane Roberts and apparently repeats Ms. Roberts' charge to Mr. Rogers in executing his investigation. Rogers' report states: (1) "For purposes of this analysis, I am to assume that there is no (emphasis in original) sharing of any financial investments (Rogers, 1997)." Given that the complaint is a conflict of interest involving Padget and Simril, this is indeed a peculiar starting point for the investigation. It also appears to be an assumption known to be false since the Board had already been apprised of the real estate partnership between Padget and Simril. It also seems reasonable that cohabitation is prima facie evidence of "sharing of financial" interests.

Mr. Rogers continues: "As set forth in your letter of Jan. 24, 1997, there exists a relationship of long-standing between a Deputy Superintendent, and a subordinate in his office. These employees live together in a committed relationship but are not married."

Rogers repeated the two questions which the Board charged him to answer: "Does the relationship as described constitute nepotism as defined by Missouri law?" And, "Does the relationship constitute a financial conflict of interest on the part of the Deputy?"

To answer the question of nepotism Rogers examines that area of employment law dealing with discrimination, namely the Fair Employment and Housing Act of Missouri and the US Civil Rights Act of 1964. Rogers' answer to the question based on his research: "I conclude, therefore, that the relationship described above which I will describe as cohabitation does not meet the definition of nepotism."

For the sake of better understanding, the literature Rogers reviewed and cited in his report supports two conclusions: (1) Employers have a legitimate interest in making rules (nepotism rules) that regulate the working relationship of people who have familial or social relationships outside work. And (2) employers should take care in making such rules that they do not inadvertently adversely impact people of a particular gender. As noted above Rogers found the "relationship does not meet the definition of nepotism."

As regards the question "Does the relationship constitute an economic conflict of interest?' Rogers' answer: "Not in and of itself." See item V above for the language of the Code. His full explanation is offered for the readers' consideration:

"Discussion: Economic conflicts of interest are defined in several sources of law: the common law, statutory law (including Government Code Sections 1090 et seq., 1125-1129, 81000-91015), and regulations of the Fair Political Practices Commission. In general, the conflict occurs when there is a clash of the public interest and the private pecuniary interest of the public official. I assume that a Deputy Superintendent is a public official for these purposes. If the position has a reporting obligation, then there is a clear indication that the position is.

"Three specific areas of conflict exist which are highly regulated: (1) prohibition of a financial interest in a contract (Govt. Code 1090 et seq.); (2) prohibition of a financial interest in a District decision (Govt. Code 87100 et seq.), and (3) prohibition of a direct or indirect interest in the outcome of a decision (common law). In all instances, a financial benefit flowing to the spouse of a public official is prohibited unless specifically excepted.

"There is no reason to automatically impute the prohibition regarding spouses to cohabiters. Nevertheless, there could be instances where the actions of a public official inures to the financial benefit of the public official as well. Those instances, however should be properly analyzed based upon the specific facts. For purposes of this memorandum, you have asked me to assume that the parties do not share any financial investments.

"There is no inherent economic conflict of interest in the relationship. A specific potential conflict should be analyzed based upon the specific facts" (Rogers, 1977).

It may be difficult to evaluate the meaning of Mr. Rogers' statement in that his report contains no mention of the actions of Mr. Padget and is based on the assumption that there ". . . is no sharing of financial investments." And, though Mr. Rogers sites Missouri conflict of interest laws, his investigation makes no analysis of whether the recommendations of Mr. Padget regarding his cohabitant Ms. Simril breaches those laws.

XX. November 14 1997. Attorney Kenneth Reese representing Ms. Ellis filed a complaint with the Yolo County District Attorney Mike Cooper which stated in part: "Starting in the mid-1980s, Deputy Superintendent, Bill Padget and Ms. Lane Simril began cohabiting. During the period of this relationship, Ms. Simril received no less than four (4) promotions. None of these was advertised or subject to competitive testing or interviewing as required by law. During this time the above named parties commingled funds, purchased real property together and acted in such a manner that any economic benefit to one also benefited the other. . . . I know this is a political "hot potato", but in the years I have known you and your work, you have always done what justice required." (Reese, 1997a)

XXI. December 3, 1997. Cooper to Reese: "After receiving your information concerning the allegations of conflict of interest I contacted Mr. Robert Paully General Counsel, Office of Education to discern if he had any additional materials. He provided me with copies of the advertisement for the internal personnel operations, memo to the Board of Education from Mr. Padget dated October 22, 1996 concerning the recruitment, a recruitment checklist, and an additional copy of the letter from Mr. Rogers. I also have a copy of a letter from Dr. Clarke to your client and a copy of a letter from Mr. Padget to Dr. Clarke. In addition, I requested and received from my investigator a copy of a grant deed, which I enclose, evidencing the transfer of the property which was owned by Mr. Padget and Ms. Simril on October 24, 1996. It is my conclusion that there was no conflict of interest upon which my office should pursue any civil or criminal matter" (Cooper, 1997).

XXII. December 24, 1997. Reese to Cooper: "I am in complete disagreement with your finding in this matter. . . is it the position of the District Attorney's office that, in public employment, favoritism on the part of a supervisor toward an employee founded upon a sexual and personal relationship is not a violation of law?

"As to the most recent promotion of Ms. Simril, the documents shown to you by Mr. Paully tell only part of the story. On September 24, 1996 Mr. Padget proposed to the Board of Education that the previously eliminated position of Personnel Director be reinstated and that Ms. Simril be given that position. Once more Mr. Padget attempted to promote Ms. Simril without any advertising of the position or competitive interviewing or testing. The Board tabled the proposal and requested more information and recommended it follow the advertisement/ recruitment process. With other directorships, the advertising period had been 30 days. This particular position was advertised to the public for five days. At the time the interviewing took place, the majority of the interview panel knew of the intimate relationship between Mr. Padget and Ms. Simril, knew that Mr. Padget had proposed Ms. Simril for the position without any competitive process being used, and knew that whoever received the position would have to interact with Mr. Padget on a day to day basis.

"The fact that Mr. Padget and Ms. Simril owned and then sold real property is of great importance. Whether or not Mr. Padget and Ms. Simril own the property now or not is irrelevant, what is important is that this transaction evidences the fact that they have commingled funds and that in so doing created a situation where an economic benefit to one is an economic benefit to the other. . . At this point, I think we should cut to the chase and brush aside all the smoke and mirrors. What we have here is a case where, for more than a decade, the School District has allowed the deputy superintendent to promote his girlfriend outside the required Personnel process. It doesn't matter if you call them reorganizations, staff reclassifications or anything else. At each step, she received more pay, more responsibility and more authority. It is my hope that you will reconsider this matter. . . .I do not believe any of the persons involved think that the court of public opinion will find the School District is anything but guilty of allowing this Conflict of Interest to continue and then engaged in a cover-up of its wrong doing"(Reese, 1997b).

XXIII. January 6 1998. Cooper to Reese: "Dear Mr. Reese: I have considered your argument, but I must decline to initiate any further investigation into the matter. I do not believe there is a reasonable cause to believe criminal statutes were violated.

XXIV. Superintendent of Rock Hill City Schools resigned under pressure from the Board of Education. His interim replacement was Mr. Bill Padget. It was not immediately announced who would be responsible for the duties previously performed by the new Superintendent, nor who would now supervise Ms. Simril in order to avoid the appearances of an improper conflict of interest.

POST SCRIPTS

Meanwhile the Rock Hill Evening Herald carried two other stories of alleged violations of state conflict of interest laws. One was in Yolo County and the second was in the adjoining county. Newspaper reports are reproduced to establish a frame of reference for the City Schools incident.
XXV. Evening Herald March 15, 1998: "Yolo Technical College President Doreen Flowers will not be jailed after pleading no contest to a charge of using her position to secure a $700 consulting contract for her husband. However, it is not clear whether she will keep her job. Flowers was charged with using her official position to 'influence a government decision that would have a material financial effect on her or her family. . . The misdemeanor charge carries a maximum penalty of six months in jail and a $10,000 fine."

XXVI. Evening Herald September 24, 1997. "Former Monte Vista School Superintendent Stephen Bertran will not be prosecuted for conflict of interest in allowing his wife and a partner to operate a for-profit child care center at the School. Yolo County District Attorney Mike Cooper said a review of the case by his office found that both Bertran and the district's School board had committed an error of omission in allowing the business relationship. Bertran, under fire from the community and from his own School board resigned. . ."

APPENDIX CAST OF CHARACTERS	
Mike Cooper.	District Attorney of Yolo County. In his capacity he determines who will be charge with criminal offenses in Yolo County. Paraphrasing a cliché from baseball, "It ain't a crime until Mike calls it's a crime."
John Wycol.	John's a newcomer in town. He was hired several years ago as the Director of the Yolo County Information Systems. It is alleged that when he needed help at work, he would give his live-in girlfriend a contract in violation of state laws.
Sharon Lundin.	Sharon is John's "live-in" girlfriend. They moved to town together in 1994 and purchased jointly owned real estate.
William Padget.	Bill is the Deputy Superintendent in charge of Human Resources at Rock Hill City Schools, and has been an employee of the School District for over thirty years. According to a consultant hired by the Board of Education, Mr. Padget is involved in a long-term committed relationship with Ms. Lane Simril.
Lane Simril.	Lane was hired as a secretary in the Office of the Deputy Superintendent. It has been reported that she has been involved with Mr. Padget since shortly after her arrival in the School District. Lane has been blessed with a number of reclassifications to higher classifications and promotions while working with Mr. Padget.
Berty Rhoads.	Berty was a clerical assistant in Padget's office for many years. It appears she may have been an early victim of the Padet/Simril relationship.
John L. Rogers.	Rogers is a lawyer and an associate of Robert Paully, legal counsel to the School District. Rogers and Paully are both associated with the state associations of school district personnel. At the suggestion of Paully, Rogers was contracted as a consultant by the Rock Hill Board of Education to investigate the charges of April Ellis. His report to the Board described the Simril/Padget relationship as "cohabitant(s) and partner(s) in committed relationship".
April Ellis.	April was the Administrative Secretary to Mr. Padget. She felt herself to be the victim of Padget's relationship with Simril, and repeatedly complained that Padget's behavior violated state law regarding conflict of interest. She became tenacious in her pursuit to put to an end to what she believed to be Padget's abuse of position and power. April was the source of many materials in the case which were sent to her by officials in response to her continuing complaints.
Board of Education.	The Board has the responsibility for establishing policies for the School District. They must approve all formal personnel actions including hiring, promotions, reclassifications, and salary increases.
Superintendent Lewis Clarke.	The Superintendent is the chief operating officer of the School District. It is his responsibility to operate the District on a day-to-day basis and to recommend to, and implement policies of the Board of Education. He had had his own problems with the Board of Education and was not considered a strong Superintendent.

Fred Prew.	Fred was a long time member of the Board of Education and its President in 1996. He was alleged by insiders to be a part of the old-boy network which included Bill Padget. He has served on the Board of Education for many years.
George Funk.	George was a candidate in the early portions of the case, and later elected to the Board of Education. George was critical of the Board prior to his election. He accused the Board of rubber stamping recommendations from the Superintendent and his staff which included Bill Padget.
Robert Paully.	Mr. Paully is an independent contractor hired by the Board of Education to has serve as the District's lawyer. He has served in this capacity for many years. His role is to give advice and defend the Board in legal matters. As an "employee" of the Board, he would be expected to propose legal theories which would legitimize actions of the Board.
James Grayson.	Mr. Grayson was retained by April Ellis to pursue her complaints of favoritism, and conflict of interest for a short time before removing himself from the conflict. Grayson is a local lawyer who has represented the City's teachers in negotiations with the school district. In that capacity Mr. Grayson would negotiate with Mr. Padget the terms of teachers' contracts. The relationship between the Padget and Grayson was cordial. Some union members felt Mr. Grayson gave Mr. Padget an "easy ride" in contract negotiations. Mr. Grayson successfully ran for Superior Court judge in 2002
Jane Roberts.	Jane was the Board of Education President. In that capacity she wrote the letter to John Roberts which established the framework for his investigation. The extent to which Board lawyer Paully participated in the framing of the letter to Mr. Rogers is a matter of conjecture.
Kenneth Reese.	When Mr. Grayson declined to pursue April Ellis' concerns, Mr. Reese was retained by her. Reese is an in-your-face sort of fellow. Judged by some acquaintances as being abrasive to the extreme. It is clear that Mr. Reese was willing to speak frankly and directly to the point of an issue.

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RISK-BASED PRICING AT PORTNEUF COLLEGE CREDIT UNION: A CASE STUDY

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CASE DESCRIPTION

The primary subject matter of this case involves cost and pricing issues arising from a risk-based pricing policy decision faced by a credit union. Secondary issues include activity analysis, design of data analysis, and ethics considerations involving potentially prejudicial lending practices. The case has a difficulty level appropriate for junior level students and is best taught in a 75-minute class period. Out of class preparation time is estimated to be 2 1/2 hours. This case primarily has been used in an Advanced Management Accounting course as an assignment in the cost allocation and activity based-costing module. It has also appropriate for a Money and Banking course.

CASE SYNOPSIS

Mark Murphy, Portneuf College Credit Union manager, championed the adoption of a risk-based lending policy for the institution two years ago. The institution's board of directors is now reviewing the effects of the policy and deciding whether to maintain the practice as is, alter the policy, or abandon it altogether.

Through risk-based lending, borrowers are charged rates based on their creditworthiness or default risk. The theory is simple enough - higher risk (cost) borrowers are charged higher rates. At issue, however, is whether the policy is contrary to the general credit union philosophy of one member, one vote, where all members are treated equally. Mrs. Cooper, a board member, supports the practice in concept but requests an analysis to determine whether the rate differentials established at the time the policy was implemented reflect the true differential costs of the related default risk categories. Mr. Kelly, another board member, vigorously opposes the practice and suggests that it masks price discrimination along ethnic or racial lines.

The board, agreeing that these are relevant and compelling issues, charges Mr. Murphy with preparing an analysis that addresses these concerns and asks him to report his findings back to the board.

PONTNEUF COLLEGE CREDIT UNION

Portneuf College Credit Union (PCCU) is a member-owned cooperative depository institution serving more than 8,000 students, alumni, and employees of Portneuf College, a small college located in the Western United States. PCCU has grown steadily over the past decade. Lending, its biggest use of funds, encompasses auto, home equity, credit card, real estate, unsecured advances, and other loans. Its main source of funds is member deposits, including checking accounts, savings accounts, IRA's, money market accounts, and certificates of deposits.

Mark Murphy, PCCU manager, and the board members were introduced to the concept of risk-based lending a few years ago at a credit union conference. Subsequently, PCCU was one of the first credit unions in the state to adopt the practice. Since that time the manager and the board have monitored its success and made adjustments to credit policies and rates to fine-tune this practice.

RISK-BASED LENDING

Risk-based lending is a controversial issue in the credit union movement. Through risk-based lending, borrowers are charged rates based on their creditworthiness or default risk. Low-risk borrowers with excellent credit ratings are charged the lowest rate, while higher-risk borrowers are charged higher rates for the same loan to compensate the depository institution for the additional default risk. Proponents believe that more members, both low and high risk, end up getting better deals at their credit union than they would from other institutions. Opponents feel that risk-based lending constitutes a form of discrimination that has no place in the credit union movement.

They believe that all members should be treated equally and that any member qualifying for a loan should receive the same rate as all other borrowers. PCCU's mission statement is shown in Exhibit 1.

With risk-based lending, the member (customer) is rated by a credit bureau on several aspects of their credit history and a score is calculated. PCCU uses a "Fair, Issac Score (See Exhibit 2). The Credit Union then uses the score to establish a rating such as A, B, C, or D to the member's loan application. Loans with "A" ratings are charged the lowest rate for their loan, while loans with "D" ratings are charged several percentage points higher.

The Case For Risk-Based Lending

Risk-based lending can be likened to "peak-load pricing," a practice in which different rates are charged for the same service depending on the time of demand. Time of demand is associated with different costs, since periods of peak demand require a larger capacity. For example, different rates are charged by telephone companies based on time of day or day of week, utilities charge higher rates at times of high demand, and public transportation sometimes levy a surcharge during rush-hour. Likewise, with risk-based lending, different rates are charged based on different costs (or the default risk) that the depository institution takes in making the loan. Lending to high-risk members requires a larger loan loss reserve and also results in higher collection costs.

Without risk-based lending, one interest rate is charged to all borrowers for a certain type of loan. This rate is generally an "average" rate that would be charged for all borrowers. Thus, low-risk borrowers would pay somewhat higher rates than they might otherwise and high-risk borrowers would pay somewhat lower rates. Low-risk borrowers tend to be astute shoppers and have several options available when borrowing funds. If they cannot receive a good rate from their credit union, they may borrow from competitors if the competitor offers a better rate.

On the other hand, without risk-based lending, a credit union is more likely to turn down loans requested by less creditworthy members, because those loans are not profitable at the rate charged to "average" members. As a result, the less creditworthy borrowers might be forced to borrow from finance companies which charge significantly higher rates than their credit union, or from "payday" check-cashing companies which charge as much as 500% for short-term loans.

The Case Against Risk-Based Lending

Opponents of risk-based lending believe that such practices run counter to the basic credit union philosophy of one member, one vote, where all members are treated equally and democratically. They feel that it is a form of price discrimination, and that it can be difficult to disclose actual rates to members if not all members will be charged the same rate for a given loan. The credit union movement motto is, "not for profit, not for charity, but for service." Opponents of risk-based lending feel that all members should be served equally, not according to personal characteristics such as ability to repay.

RISK-BASED LENDING AT PCCU

When Mark Murphy initially proposed a risk-based lending policy to the Board of Directors, the board voted in favor of adopting the practice for all lending except VISA and real estate loans. VISA (credit card) loans were not included in the risk-based lending pool because credit card loans are really a steady stream of small loans and it was not clear how often a VISA account would have to be re-evaluated to determine if it is in its appropriate risk category. For example, should credit card accounts be evaluated every six months or every year? With about 3,000 VISA accounts, this would be a costly process, both in terms of obtaining a Fair Isaac score for the borrower and in terms of the labor cost to perform an account analysis. Also, the VISA processor was not flexible enough to handle the multiple interest rates required by risk-based lending. Lastly, no other depository institutions were applying the risk-based practice to VISA loans. Thus, was no existing model to serve as an example for PCCU.

Real estate loans were excluded for a number of reasons. First, real estate lending is heavily regulated with laws prohibiting redlining and discrimination. While risk-based lending charges higher rates associated with higher default risk, it was not clear whether the rate differences would be interpreted as discrimination under these laws. Second, it seemed risk-based lending was unnecessary for real estate loans, since the real estate itself represents stable collateral for the loans.

Moreover, at the time the policy was adopted, PCCU was just establishing its real estate department and management felt that risk-based lending would be one unnecessary complication at the time.

Establishment Of A Risk-Based Lending Policy

At the time that PCCU instituted risk-based lending, very few credit unions had adopted such a policy. Hence, it was difficult to set the parameters of the policy. For example, what ranges in the credit score should be used to set rate breaks? And how large should the interest rate differential be between the various risk categories?

PCCU obtained a credit score for each loan applicant from Equifax, a credit bureau that calculated a "Fair Isaac" score for borrowers. The Fair Isaac score was calculated for each borrower based on their credit histories and other available tradeline information deemed relevant to ability to repay the loan. The PCCU management then used the Fair Isaac score to categorize borrowers from A to D, with A being the lowest and D being the highest risk category. Management also had to set the interest rate spread between these four categories. These four risk categories and the respective interest rate spreads were based on observation and an informal analysis.

The rating (A, B, C, or D) and the member's loan-to-value ratio then determined the size of the risk premium. Table 1 shows the initial matrix of Fair Isaac scores for rates offered to borrowers. For example, a borrower with a Fair Isaac score of 690 and 70% loan to value would receive a .5% discount from a base rate on his or her loan rate. A borrower with a Fair Isaac score of 590 and 100% loan to value would pay an additional 2.5% on his or her loan rate. Mr. Murphy and the Board agreed to review the policy in two years, to decide if they wanted to continue the policy and determine whether the rate differentials were appropriate.

Two Years Later

Two years later, the Board revisited the issue of risk-based lending. Mr. Murphy told the board that he felt that the practice had a positive impact on the Credit Union and its members, and he reported that he received few complaints about the policy. He recommended the practice be continued as it was currently implemented. One board member, Ms. Cooper, suggested that his recommendation be supported by a relevant data analysis since the credit union had two years of risk-based lending under its belt. Specifically, she was interested in 1) knowing whether the credit score categories (A - D) adequately reflected the delinquency risk of the loans in each category and, 2) whether the interest rate difference for each category reflected the differential cost of administering the loans. The credit union was currently charging 2.5, 1.5, and .5 percent more for D, C, and B loans than for A loans. The two major differential costs associated with the various risk categories are collection costs and default (bad debt) costs.

Another board member, Mr. Kelly, was still vigorously opposed to the practice of risk-based lending. He suspected that it was masking price discrimination along ethnic or racial lines. He wanted some assurance that that was not the case if he were to support such a practice.

The rest of the board agreed that these were relevant and compelling issues and asked Mr. Murphy to prepare an analysis using PCCU data.

REQUIRED:

1. Construct an activity flow diagram for a lending process at an institution like PCCU and highlight those activities that are uniquely attributable to high-risk loans. Think about all of the steps that must occur from the time a loan application is submitted until the time the loan is paid off or a foreclosure process is completed. How would you cost these activities? Given what you have diagramed, are you satisfied with Mr. Murphy's cost allocation techniques? Why or why not?

2. Perform a data analysis with relevant charts and graphs that addresses Ms. Cooper's concerns. Include a Pareto diagram for delinquent loans by category. Explain the results of your analysis.

3. Do you agree with Mr. Murphy's recommendation to continue with risk-based lending? Why or why not? Would you change the risk categories or the interest rate premiums for any category? Why or why not?

4. What type of statistical analysis could you perform to address Mr. Kelly's concern? Identify the specific statistical test(s) and list the variables you would need to perform the test. Do you suppose these data are available in PCCU's information system? What difficulties would you encounter collecting the data?

5. Do you support risk-based lending at PCCU? Why or why not?

DATA AVAILABLE FROM THE PCCU INFORMATION SYSTEMS

Table 1 shows the Fair Isaac Scores and Risk Premiums as of July 2000. Column 1 shows the Fair Isaac Score and the associated risk category (A - D). Column 2 indicates the rate premium charged for each category. Columns 3 through 5 show the reduced premium assessed for a loan to value ratio of 90, 80, or 70 percent.

Table 2 shows the active credit scored loans as of April 2000. Available information includes the number and dollar value of loans in each risk category, and the number and dollar value of delinquent loans in each risk category.

Table 3 shows the collection costs for the year 2000. To make the analysis more manageable, Mr. Murphy requested combined collection costs for A/B loans and C/D loans rather than for each category individually since some of the information was collected manually. Mr. Murphy suspected that the largest operating cost differential would come in the area of collection costs. Higher risk loans would likely use more of the credit unions resources to monitor and handle the associated delinquencies. Other costs, such as building and other fixed assets and cost of funds were equally spread over the risk categories.

Wages represents the wages and benefits of the four employees involved in collection. This involves tracking the delinquent loans, calling and writing letters about the loans, time spent trying to find where the delinquent members work and/or live, counseling on matters such as debt consolidation and refinancing, and bankruptcy court document preparation and appearances, and repossessing collateral on defaulted loans. The *loan-loss allowance* represents the anticipated loan write-offs (bad debts). Training represents the costs of training new employees on loan collection procedures including account collection, tracking member whereabouts, using the court system and understanding the relevant regulations and laws. It also includes continuing education regarding collection methods and changes in regulations and laws. *Loan servicing* includes generating credit reports, handling special requests, fielding inquiries on existing loans, judgement filing costs, attorney fees, stationary, supplies and postage, and long distance telephone calls used to track members, the repossession costs of pick up, storage, evaluation and repair, and advertising and selling of repossessed collateral. First time loans require a credit report. For subsequent loans, depending on the time since the last loan, it is more likely that only C/D loans will require credit reports. *Late payment fees*, mostly attributable to the C/D loans, are subtracted from the collection costs.

Mr. Murphy and the head consumer loan collection officer noted that most of the 30-day delinquent A/B loans self-corrected after a reminder (letter or telephone call). Consequently, they made a subjective estimate that of the resources consumed in collection activities for the scored loans, about 10 percent were for A/B loans and 90 percent were for C/D loans. Hence, in Table 3, for wages, loan loss allowance, training and loan servicing, the A/B loans were assigned 10 percent of the total score loan collection cost. The late payment fees were allocated by their respective historical amounts. And, for the total collection costs for wages and training and loan servicing, they estimate that 27 percent went to VISA loans and 73 percent went to the scored loans (A/B and C/D). VISA loans, due to their higher delinquency rates, had a relatively higher percent (49) of the total loan loss allowance.

Table 4 presents PCCU's estimated the total cost of operations, less its cost of funds. Total expenses are projected to be $1,104,685 for 2000. Subtracting collection costs and non-interest income (less the late payment fees already taken out of the collection costs) from total expenses yields the total cost less collection costs and non-interest income.

Table 5 shows the dollar value of the risk-scored loans by category and their percent of the total.

Table 6 shows the total year-end 2000 costs (less collection costs and non-interest income) projected for the risk-based scored loans are projected to be $449,110. Mr. Murphy noted that this amount is 64 percent of the total costs from Table 4 (first subtracting out $5,000, the cost to run the PCCU investments, which include corporate credit union deposits and U.S. government securities). He noted that of the current $14,260,424 in risked-based scored loans, that 82 percent or $11,693,548 were A/B while 18 percent or $2,566,876 were C/D.

Additionally, PCCU records showed that the average cost of funds (from deposit interest payments) was 3.8 percent, and the board required a one percent contribution to reserves.

Table 1: Fair Isaac Scores and Risk Premiums, July 2000

Fair Isaac Score	Loan to Value			
	100%	90%	80%	70%
685+ (A)	+0.00%	+0.00%	-0.25%	-0.50%
650-685 (B)	+0.50%	+0.25%	+0.00%	+0.00%
600-649 (C)	+1.50%	+1.25%	+1.00%	+0.75%
Below 600 (D)	+2.50%	+2.25%	+2.00%	+1.75%

Table 2: Active Credit Scored Loan Accounts, April 2000

Credit Score	Number of Loans	Number Delinquent*	Dollar Value of Loans	Dollar Value Delinquent*	Percent Delinquent*
A	923	13	$8,967,374	$ 44,836	.5%
B	297	16	2,799,547	72,788	2.6%
C	239	30	1,568,318	127,034	8.1%
D	180	38	925,185	173,009	18.7%
Total	1,639	97	$14,260,424	$417,667	2.9%

*Accounts 30 or more days past due were considered delinquent.

Table 3: Collection Costs Excluding Mortgage Loans, 2000**

	Total	Visa	A/B Scored Loans	C/D Scored Loans
Wages*	$110,000	$30,000	$8,000	$72,000
Loan Loss Allowance	45,000	22,000	2,300	20,700
Training	2,000	540	146	1,314
Loan Servicing	10,800	2,916	788	7,096
Late Payment Fees	(17,000)	0	(3,000)	(14,000)
Total	$ 150,800	$55,456	$8,234	$87,110

*Wages and benefits, 4 employees

**Mortgage loan collections are handled separately by a different staff.

Table 4: Total Cost Net of Collection Costs and Non-interest Income, 2000	
Total Expenses, Net of Mortgage Loan Collection Costs	$1,159,685
Consumer Loan (VISA and A/B, C/D scored loans) Collection Costs	(150,800)
Non-interest Income (minus late payment fees)	(302,150)
Total Cost less Collection Costs and Non-interest Income	$ 706,735

Table 5: Loans by Category, 2000		
Visa	9%	$ 2,005,372
Real Estate Loans	27%	6,016,116
Risk-based Scored Loans	64%	14,260,424
Total	100%	$22,281,912

Table 6: Total Costs of Risk-based Scored Loans, 2000	
Total Costs minus Cost of Funds and Non-interest Income*	$452,310
Costs to Run Investments**	3,200
Total Costs for Risk-based Scored Loans	$449,110
*64% of Total Costs from Table 4.	
**64% of $5,000 cost to manage credit union investments	

EXHIBIT 1: PCCU MISSION STATEMENT

PCCU Federal Credit UnionMISSION STATEMENTTo provide our OWNERS (members) desired financial services while offering both dividend rates and loan rates that are generally more favorably than those normally found at other consumer lending institutions. As the Credit Union grows and more services are added, friendly, courteous service will continue to be our top priority. The volunteers and staff of Idaho State University Federal Credit Union strongly support our founding motto: "NOT FOR PROFIT, NOT FOR CHARITY, BUT FOR SERVICE."

For more information on federal credit unions see the National Association of Federal Credit Union's website at http://www.nafcunet.org

EXHIBIT 2: FAIR ISAAC RISK MODEL	
Fair Isaac Risk Scores are derived from a model built on roughly one million consumer credit histories. The model:	
♦	Analyzes the credit histories over a 24-month period.
♦	Includes the experience of credit grantors, collection agencies, public records information, and inquiries found on a consumer's credit file.
♦	Uses those variables most closely correlated with credit performance as a basis for a risk score.
♦	Develops a score ranging from the 300s to the 800s with a higher score representing a better credit risk.
Variables examined include:	
♦	Presence of derogatory information,
♦	Amount of tradeline information (number and types of transactions reported), and
♦	Length of time on file
For more information see www.experian.com	

ENDNOTES

1 Even though high-risk borrowers pay higher rates than the low-risk borrowers, the rates they are charged at their credit union are generally significantly lower than what they would find at a finance company or pay-day lender.

2 Several credit bureaus dominate the credit bureau industry and use different, but similar scoring scales.

3 Mortgage loan collections are handled separately, by a different department.

I'M MAKING YOU AN OFFER YOU CAN'T REFUSE!

Herbert Sherman, Southampton College - Long Island University

CASE DESCRIPTION

This case describes a typical situation in a small business franchise environment; a former employee and a current employee of a retail franchise vacuum cleaner store have been asked (strongly persuaded) by the store's owner to become partners in a new store. The problem for the characters in question is whether or not they each (individually or as a team) enter into this venture and how they should then proceed given their decision. Several factors complicate this business startup decision, including: the need to make the decision quickly in order for the new venture to take advantage of Oreck's new store inventory special (discounted inventory) and a low rent store location (which may be leased within a few days), the negative relationship between two of the potential partners, the rather complicated legal and organizational structure of the new organization (including the fact that this is a franchise operation), and the fact that one of the partners will not be contributing any substantial capital towards the new venture. The case has a difficulty level appropriate for sophomore level or above. The case is designed to be taught in one class period (may vary from fifty to eighty minutes depending upon instructional approach employed, see instructor's note) and is expected to require between two to fours hours of outside preparation by students (again, depending upon instructor's choice of class preparation method).

CASE SYNOPSIS

Derived from observation and field interviews, the case describes how the owner of a series of Oreck retail stores, Marc Paulson, offers a former employee (Stephen Hodgetts) and a current employee (Gerald Mahoney) the opportunity to invest in a new store with Mr. Paulson as a silent partner. Stephen Hodgetts is intrigued by the offer but Gerald Mahoney is silent throughout the meeting . Stephen and Gerald go to visit the store location site in question, and on the way back from the trip Gerald makes it clear to Stephen that Marc Paulson is not to be trusted and that he would be a very difficult person to work with. When Stephen and Gerald get back to the store March Paulson hands them projected revenue and cost data that indicates that the store would yield $4000/month in positive cash flow. The case ends with Mr. Paulson asking for a decision and reminds Stephen and Gerald that they need to act quickly in order to take advantage of Oreck's inventory discounts and to lock in the desired store location.

I'M MAKING YOU AN OFFER YOU CAN'T REFUSE![1]

"Come in, come in -- great to see you! The gang just hasn't been the same since we closed the Mahopac store and we had to let you go. I know that it was just a part-time job and that you were simply doing me a favor working on the weekends, but I have always felt guilty about having to dismiss you".

Marc Paulson, the owner of The Paulson Group, Inc., a chain of Oreck Vacuum Cleaner franchises in Dutchess and Putnam counties in the mid-Hudson valley in New York State, was greeting his former employee, Stephen Hodgetts. Stephen had received a call from his former store manager, Mr. Gerald Mahoney, who said that Mr. Paulson wanted to speak with him about a matter of grave importance. Many would have thought that a fired employee would never go back to talk with his former employer, but Mr. Hodgetts left on good terms with both the manager and the owner and was certainly not resentful about being fired from the Mahopac store. Working at Oreck was his second job and he was planning on quitting in a month or two just prior to being let go. He therefore let his curiosity get the best of him when Mr. Mahoney called and Mr. Hodgetts wondered what Mr. Paulson had in mind. Mr. Hodgetts thought to himself, "what harm could one meeting do anyway?"

"It is just like old times, isn't it!" replied Mr. Hodgetts. "Gerry's out on the floor selling like a madman and you're in the back repairing vacs. I can see by a quick look around the store that you have a few new models including a couple of canister-style vacuums -- is Oreck going after the Electrolux market?" "For a guy not in the business" answered Mr. Paulson "you sure keep a sharp eye on things. I thought that you had vacuums in your blood and that your interest in the industry would continue even when your employment did not, and I obviously was right about you. Sit down and make yourself comfortable, I'm about to make you an offer you can't refuse."

The Offer

Mr. Hodgetts and Mr. Paulson exchanged a few more pleasantries and then Mr. Paulson got down to business. Mr. Mahoney was called in to join the conversation and it was apparent that Mr. Paulson had something important on his mind. "I have worked with both of you for the past several years and I know how you work, I know how you handle customers, and I really like what I see. Gerry deserves a real shot at running his own store as a partner (the store he managed in Mahopac was solely owned by the Paulson Group) but I know that he can not swing the capital in order to make it happen. This is where you come in Stephen -- I know that you're now in pretty good financial shape and that you could help Gerry swing this deal. I'm therefore offering both of you partial ownership in a new store."

Stephen shot Gerry a penetrating stare and Gerry immediately returned the same gaze of disbelief that greeted him. "I know that this is sudden" continued Mr. Paulson "but we have to act quickly in order to make this deal go through with Oreck. Let me lay out the particulars for you and why we have to move fast.

One, Oreck is offering any franchiser that opens a new store within 90 days $ 10,000 worth of inventory. It usually costs between $20,000-$25,000 to outfit a store and we'd be saving a good chunk of up front capital. My experience tells me that even if we signed a lease today for a store, that it would take at least 60 days to get both the store in shape as well as file the paperwork necessary to start a new corporation and set up the books.

Two, I have found a great location for a store in Newburgh, New York. It is about 20 miles from our Fishkill store but more importantly it is on the other side of the Hudson River, just over the Newburgh-Beacon Bridge. The store is in a strip mall on Route 300, just North off Interstate 84, and opposite a Shopping Mall which includes a movie theatre, and about 40 chain stores. The rent is only $1600/month for a 1200 square foot space, and is quite inexpensive compared to the Mall which would charge us $ 3000/ month for the same size store. There are other stores in similar strip malls along the Route 300 corridor but they would run anywhere between $2200-$2500/month. The real problem is that the owner of the strip mall has given us three days in which to sign a lease, otherwise he has a taker for the store.

Three, in order to make this deal work for all of us, here is what I'm offering:

◆	That each of you would own 25% of the store while I, through The Paulson Group, would own 50%. Oreck requires that franchisers own at least 50% of each store that they open.
◆	I would be responsible for setting up the corporation, the store, and the books and making sure that we have enough inventory to open. I would also manage all of the advertising, in conjunction with my other stores.
3.	Gerry would work the store six days per week and earn $750/week plus benefits while Stephen would work weekends earning $125/day.
4.	Each of you would contribute $17,500 in order to start the store. I figure it would take $10-$15,000 to fix-up the store, again about $10-$15,000 for inventory, and we'd have $5-$10,000 for our rent deposit and to handle short-term cash flow.

That's the whole story. I'm approaching you guys first with this deal because I know that the two of you can make the store work and I trust both of you to do a wonderful job. I told you that this was a excellent deal -- what do you say fellows, are we partners?"

Stephen nearly fell out of his chair while Gerry looked as if he had been kicked in the stomach. "Wait a minute, hold on there. Marc, you really must be kidding me, aren't you? I worked for you part-time for six months because my friend Gerry needed help on the weekends in the Mahopac store. It was fun getting paid to hang out with Gerry and I admit that I liked making a few extra bucks. And you're right, I really did enjoy working with the customers and got a kick out of trying to repair vacuums. I've talked with you on occasion, maybe worked with you once the entire six months, and I think we might once have had lunch in the back office together. But to go into the vacuum cleaner business and become your partner? We really don't know each other that well and I must admit that it never even crossed my mind. Let me mull it over for awhile."

"Stephen, I know that you're right and that under normal conditions I would be very appreciative of your need to take your time on a decision like this. However, we really don't have the freedom to waste time thinking about this deal. We need action and we need to strike while the iron is hot! I understand that this is real sudden and perhaps I should have told Gerry to give you some warning over the phone. I'm sorry if I caught you so off guard. However, I wanted to talk to you face-to-face, man-to-man so to speak, to show you my sincerity in putting this offer on the table and making you my business partner. You're a bright guy, a good salesman, and I know that you can pick up the repair end of the business. You've known Gerry for years so I know that you can work with him. Plus Gerry is the best darned salesperson I have besides myself. Why wouldn't I want to make both of you my business partners?"

Gerry was noticeably silent throughout this exchange and Stephen knew that something had to be up with Gerry, but what, he just didn't know. There had to be a way that he could get Gerry alone and get to the bottom of this without insulting Marc. Stephen was also aware of the fact that if he and Gerry did not play this just right that Marc might get so mad at Gerry that he would fire him. Gerry could not afford to lose his job nor offend his boss and Stephen did not want to be responsible for Gerry paying the consequences for a badly handled negative decision that might infuriate Marc.

Marc continued the discussion. "Gerry, Stephen. You're both in your forties and you've been working for other people all of your lives. You both make a decent wage but let's be honest, you don't earn the big bucks that you can make from owning your own business. You know that I have a million dollar home on the riverfront, that I also own a forty-five foot sailboat which I moor right at my own dock, and I always drive the hottest Beemer (BMW). Don't you guys think that you deserve an opportunity to live the same good life I do? Stephen, you're a family man, aren't you worried about how you're going to pay for your two kids to go to college or worried about how you're going to live after you retire? Well let me tell you that going into your own business is a great long term investment."

"Secondly" continued Marc "don't you guys want to be your own bosses? How many times have I heard you, Gerry, tell me that if you had it your way you would run the store differently than I do? I'm giving you a chance, Gerry, to prove yourself right and prove me wrong. Let's see if you can make your ideas work on how to run the store and make it more profitable than mine! Heck, I don't mind making a few extra bucks and perhaps even learning something!"

Stephen had to admit to himself that he was intrigued by the notion of owning a piece of the store, and the American dream. All he had to do was to work part-time and he could share in the "full-time" profits from the store's operation. Heh, if the store was that successful he could even quit his regular job, which he wasn't crazy about, and work with Gerry. That would be a real gas now, wouldn't it? Even better, if the store really did take off he could use the profits from this store to buy into another one -- build an empire of stores just like Marc had done. Dollar signs were dancing in Stephen's head as his imagination soared at the prospect of big bucks and the good life.

Reality smacked Stephen square in the face as he remembered that his friend Gerry had not said more than two words during this entire discussion. "You would think that if Gerry had any interest in doing this deal that he would have chimed in about the proposal ", thought Stephen, "or at least leant some voice to Marc's comments. Something must be going on that Gerry isn't saying in front of Marc and I need to talk with Gerry ASAP." All of a sudden, a light came on and Stephen had an idea.

"Listen Marc. You always told me that location was the most important factor for any retail operation. I also learned from my father a long time ago that what's sounds good in theory may not work very well without looking at the numbers. Let me propose the following:

1.	That Gerry and I take a drive to the store we'd rent and check it out. See what's around the store, traffic patterns, etc. This way both Gerry and I could get a feel for the location.
2.	That while we're gone, you work up some preliminary numbers that would show both Gerry and I what would be the projected monthly revenues and expenses based upon your operation of the other stores. I'd like to know how long it would take Gerry and I to recoup our initial investment and the possible profit the store might throw off once we've paid ourselves back..

Marc thought about Stephen's request for awhile and reluctantly agreed to let Gerry "take a few hours off from work" in order to check out the new store's location. Stephen wasn't sure if Marc suspected that Stephen was worried about Gerry but assumed that Marc figured that Stephen and Gerry would discuss the deal in the car. The meeting then broke up and Marc went to jot some figures down on paper while Gerry and Stephen got in the car to drive to Newburgh.

The Road Trip

Since Stephen knew generally where the store was, he drove to Rte. 300. Gerry was silent for the first fifteen minutes of the ride but after some friendly chiding from Stephen finally opened up. "Look Stephen", he muttered, "you really do not know what you're getting yourself into if you're serious about going into business with Marc. I've spoken to both of his partners at the other stores and neither Jack nor John can deal with Marc. He's pushy, arrogant, a know it all, and he's a thief besides. I've worked with Marc since he closed the Mahopac store and let me tell you, it has been like living hell. Why would I want to be this guy's partner if I don't trust him, can't work with him and outright can't stand him?"

Stephen thought that something was wrong, but he never imagined that the situation was this bad. "Hold on a minute, if you felt this way since you left Mahopac, why are you still working for him?" There was a long moment of silence and then Gerry blurted it out "because it's easier to work for Marc, a tyrant I do know, than to get another job and take a chance of getting a worse boss than Marc. I can deal with Marc, although I hate working for him."

Stephen thought about Gerry's comments and suspected that there might be more to it than just hating the boss. "Now let me get this straight" responded Stephen. "Marc's a S.O.B. and a crook but you'd rather work along side him every day rather than work in your own store and not have to deal with him -- am I missing something here? This is a real opportunity for both of us and I'd hate to pass it up just because you don't like or trust Marc. Isn't that what capitalism is all about? Everyone out for themselves, that sort of thing? We can protect ourselves through contracts, and remember, we will own half the company so that we can block him if we don't like what he might propose to do. Furthermore, I'm sure that we can get a management agreement out of Marc that would give the operating manager of the store final say if the stockholders reach a stalemate -- if not, we simply won't do the deal."

"You're dreaming Stephen, just dreaming" Gerry continued. "If you think that Marc is going to allow us to make the final decisions in terms of the store's operation then you don't know Marc very well. Management agreement or not, he'll badger me to death, just like he does his other partners, and he'll finally get his way. The guy is relentless. When he wants something, he usually gets it and he will drive you crazy in the process. If Marc were not part of this deal than I would certainly consider the offer -- but that's just not possible. Working with him is one thing, getting into bed with him, well that's another matter entirely!"

Stephen realized that he had hit a brick wall and decided to drop the issue when they arrived at the proposed store location. Gerry was all business when it came to sizing up the location. Gerry noticed that there was a heavy amount of traffic on Route 300. The major shopping mall opposite the strip mall that the store was in was quite modern and well kept and seemed to be doing a very brisk business (a full parking lot). The strip mall, on the other hand, looked rather rundown and seemed to attract a minimal amount of traffic (a near empty parking lot). A couple of store fronts were vacant (a bagel shop had a going out of business sign hung in the window), yet the unfilled stores' interiors looked in good shape and seemed to provide ample room for an Oreck store.

Stephen and Gerry went into a few of the stores that were open to confirm their observations and talked a little bit with each of the owners to see how their businesses were doing. All of the owners said that they were doing fairly well but that the owner of the strip mall was not intending to improve the mall's appearance in the foreseeable future.

THE MALL OR NOT THE MALL, THAT IS THE QUESTION

On the drive back to the Poughkeepsie store, Gerry and Stephen discussed the pros and cons of the proposed store's location and the strip mall. Gerry, who seemed enlivened by the conversation, started the discussion. "The density of traffic we observed for a midweek day, early afternoon was quite good and the major shopping mall seems to act as a magnet for the area. Of course, a store in the mall would be the best of all worlds in terms of trying to capitalize on the traffic flow. The strip mall seems to get some traffic although good advertising should be able to increase this. The strip mall is certainly not a bad location given the rental fee. However, the condition of the strip mall would detract from the Oreck quality image. We would have to get concessions from the owner of the mall that he would invest in the mall's appearance."

"It's a shame" continued Stephen "that the strip mall is so run down -- otherwise the location and price would be perfect. Perhaps we should investigate any other strip malls along Route 300 to see if they have space to accommodate a store? The conversation drifted away from location issues and the offer as they headed back to Poughkeepsie.

Closing the Deal

When Stephen and Gerry got back to the store, Marc was ready for them. After discussing the location for a while, and some of the issues related to the management of the store, Marc handed each of them a piece of paper with the following information:

Figure 1: Projected Cash Flow - Newburgh Store		
Projected Revenues		
$ 24000/month		
Estimated Costs		
Salaries	$ 5600/month (includes FICA and other benefits)	
Rent	1600/month	
Utilities	900/month (electric/phone)	
Advertising	1000/month (in conjunction with the Paulson Group)	
Cost of Goods Sold	9000/month	
Insurance	1000/month	
Incidentals	500/month	
Total	$ 19600/month	
Profit Before Taxes	Estimated Taxes	Profit After Taxes
$ 4400/month	$ 400/month	$ 4000/month

Marc seemed very reasonable about the request concerning a management agreement and agreed that Gerry should be able to independently manage the store after he was coached for the first few months. It was Marc's expectation that Gerry would make all of the day-to-day decisions, including short-term inventory orders, and only asked that advertising and inventory be left to his discretion (since he bundled these items for all of his stores and received substantial discounts).

Stephen and Gerry quickly looked at the sheet while Marc made the following comments: "All of the data on the sheet is from my experience with the other stores. We usually throw off about $ 4,000/month which we divide amongst the owners, unless we decide to reinvest the funds back into the business. I would assume that for the first 2-3 months that we would retain any profits from the business so that we would have something to fall back on just in case we had a tough month or two. Assuming a worst case scenario, we might even retain the first 6 months of profit in order to purchase inventory in bulk and take advantage of any manufacturer's sales. If that's the case, after 6 months we would divide the profits as per our ownership percentage. That would mean that it would take each of you a little over 17 months after we decide to give out dividends to recoup your investment. All told, you'll break-even in slightly under two year's time. After that, the money you make is the money you keep. Sounds good, doesn't it! So, do we have a deal or what?"

ENDNOTES

1 The location of the stores and the names of the parties involved in this case have been changed at the request of the store owner.

Appendix A: The Paulson Group, Inc.
The Paulson Group, Inc., a limited liability corporation, is the major shareholder of three retail stores that are in Dutchess county, New York, in the towns of Poughkeepsie, Red Hook and Fishkill. Each of the stores are separately incorporated, with two of the stores, Fishkill and Red Hook, having minority ownership by the store managers (Poughkeepsie is solely owned by The Paulson Group, Inc.). Mr. Hodgetts had worked in a fourth store in Mahopac before it was closed due to poor sales. Each store is about 30-45 miles away from each other. Mr. Paulson, the sole shareholder of The Paulson Group and the owner of the franchise agreement with Oreck, visits each store daily in the morning. However, he spends most of his time in the Poughkeepsie store which is the busiest and most profitable. Each store has one sales manager and one sales associate.
Sales and Service
There are two distinct revenue streams: sales, which accounts for 90% of the revenues (predominately of vacuum cleaners) and repair work, the other 10%. In terms of sales, by far the best moving item is the Oreck XL, followed by vacuum bags (which is carried for all makes and models) and cleaning accessories. The markup on vacuums and other cleaning equipment is 100% while the markup on cleaning products and ancillary items is 200%. The Oreck products (unlike the non-Oreck vacuum bags and accessories) can be purchased by the store in bulk from Oreck thereby reducing the per item.

Table 1: Price Chart for Oreck XL Uprights

Model No.	Price	Description (All models come with separate Hand Held Vacuum)
XL 2200	$ 299.99	Basic Upright
XL 2400	$ 349.99	Basic Upright with Hypoallergetic Outerbag
XL 2500	$ 399.00	One Speed Upright with Headlights and Custom Handle
XL 2600	$ 449.99	One Speed with Hypoallergetic Outerbag/Upgraded Hand Vacuum
XL 2800	$ 499.99	Two speeds with Hypoallergetic Outerbag/Upgraded Hand Vacuum with Wheels

Repair work, on the other hand, varies dramatically and can run the gamut from a simple unclogging of a vacuum hose to the replacement of a motor. Repair work, like vacuum bags, includes all makes and models, although the most serviced vacuums seem to be Hoovers and Orecks. Servicing of Orecks, in some cases, is under warranty and therefore the cost is absorbed by the store owner with the owner only being obliged to service those machines sold by his store. Warrantied vacuums that had manufacturer's defects were replaced by the store owner who received replacement credit from Oreck. Most vacuums, especially Orecks, are repaired in the store by the sales managers and associates who receive on-the-job training from Mr. Paulson. Sales associates are trained to perform the simpler repair jobs including unclogging machines, installing new outer bags, upgrading older Oreck models, and installing new electrical cords. Markup on repair work varies given the store's flat fee pricing system (i.e. tune-up is $29.95 regardless of make or model). Parts are priced out at 200% over cost and there is no direct hourly labor repair charge. Very minor repair work (that can be done in under fifteen minutes and while the customer waits) is done at minimal or no cost to the customer as a way of building and rewarding customer loyalty.

Each store averages about $6000 a week in gross sales, with a total operating cost of about $10,000 per month, excluding cost of goods sold. Store managers who are owners receive a flat $750/week including benefits, plus their share of the store's profits. Full time employees receive a straight salary of $300/week plus benefits (medical and dental coverage, 2 weeks paid vacation) and earn a commission of 2.5% of gross sales over $7000/week. Part-time employees receive $6/hour plus a commission of 2.5% of gross sales over $2000 for weekends and the one weekday they work.

KNIVES FOR TRADE: BEAR CUTLERY

Patricia C. Borstorff, Jacksonville State University
W. Mark Hearn, Jacksonville State University

CASE DESCRIPTION

The primary subject matter of this case concerns international issues. Secondary issues include environmental scanning, market analysis, and an analysis of economic factors involved in an international decision. The difficulty level is three, appropriate for upper level courses. The case is designed to be taught in a one and one-half hour class session. Internet access will help students collect information for their responses. The case lends itself to being introduced at the first of an international business class (first two chapters of text should be assigned) as it encourages students to begin to think globally. This case could be used with an international chapter in Principles of Management, an international trade and foreign investment chapter in International Business, an export chapter in International Management, or a international marketing in a Marketing class.

CASE SYNOPSIS

This case centers upon the decision to engage in international business. The company must decide whether to pursue foreign markets. If the decision is to become international, then the company must decide whether to export or manufacture in another country. The vice president of marketing has suggested that Bear's future success lies in exporting their products. However, the company is small and located in a small southern town. The owners and members of the board of directors are reluctant to enter such an uncertain environment. None of them have any international experience and, quite frankly, they do not know where to start.

THE CHALLENGE

The students must assess the situation and then determine if they would suggest exporting and/or manufacturing overseas. If the decision is to engage in international business, they must identify both opportunities and threats that could arise from this decision. The students can perform a SWOT (strength, weaknesses, opportunities, and threats) analysis.

BACKGROUND

Once a company enters the international business environment, management functions are both more difficult and riskier. The international business environment has features that are not found domestically. For example, a company must be concerned about per capita income (income resulting from the nation's production of goods and services divided by the total population) in the country where it wishes to export or manufacture. Other areas of interest are the target country's infrastructure, markets, exchange rates, inflation, interest rates, and economic growth. The legal and political environment must be evaluated also. This would include the political system in operation, political risk, political instability, and laws and regulations. Another environment to consider is the socio-cultural, which includes shared beliefs and values, religion, language, attitudes, social organization, and education.

Bear Cutlery is located in a small southern town and manufactures popular traditional knife designs as well as high-tech blade shapes and handle materials. Bear uses the highest quality materials and has many years' experience in producing knives. The three owners have a combined 80 years of knife knowledge and skill. They have the newest cutlery factory in the U.S. and are equipped with the newest, most modern machinery in the world. Their work force is both skilled and experienced, resulting in high quality knives. Many extra hand operations go into the making of the product. The factory is fully self-contained, which means that all the various parts are manufactured in-house. The knives offered range from traditional pocket and hunting knives to commemoratives, limited editions and special production runs. Additionally, they offer etching and/or computerized engraving. Bear knives are designed, finished, and priced to sell to the hunter, sportsman, handyman and knife enthusiast.

Some features of the knives include: popular blade styles, high-carbon 440 rust-resistant steel blades, hollow ground blades, parts ground to exact tolerances, contoured handles for a comfortable grip, and all contact points hand polished for smooth operation. The rust-resistant steel used holds a superb edge, easily sharpens, and has the added advantage of resisting rust and corrosion. State-of-the-art heat-treating is used to bring out the very best qualities in the special formulated steel that Bear uses. Blades are Rockwell-tested at 57-59C.

Bear's mission statement is: Our commitment is to make the best knives possible, make them affordable, and make them in America. Bear has received awards from the National Knife Collectors Association for "Best Hunting Knife," and "Club Knives, Folding and Hunting." Blade Magazine chose them for "Best Buy in America," and "Best Collector Value."

Recently, the owners of Bear have been discussing the possibility of exporting or even manufacturing their knives internationally. Some of the governing board at Bear is concerned about these possible foreign affairs. Also, they are on record stating that they will only make their knives in America. However, Bear wants to increase profits and be competitive with others, which are core reasons why firms go abroad.

The products they offer are unique because of their technology, design, and cost. They have lean operations, which saves money and speeds decision-making. They realize that potential markets overseas can grow faster than those at home. Also, the volatility of some foreign situations (which could escalate to war) could increase the need of military associated items.

Jim Jenkins, the vice president of marketing, has often mentioned to the president, Bob Foster, that their knives would be successful in international markets. In fact, just today, Jim brought up the topic once again at their strategic planning meeting.

Bob asks, "Jim who's going to help us do this and where are we going to sell our knives? The worlds a big place."

Jim promises to put some numbers together for Bob to look over. As Jim leaves the meeting, he realizes that the task ahead is a big one. Bear faces a borderless world. If they do not think globally, someone else will. He feels that they risk being left behind if they do not pursue opportunities that are before them. Additionally, Jim believes that thinking globally can provide a competitive edge. He determines that if they choose the "export only" option, Bear would need a marketing director for a 3-6 month international tour. If they decide to manufacture, the need could be for expatriates who could be abroad possibly for three years or more.

Back at the plant, Jim mentions to Ken Elkins, the distribution manager, the possibilities of going international. Ken informs Jim that they have their toes in the market already. Some of their sales personnel have exported a few knives on their own. Ken says that exporting can start accidentally. Jim is interested in what Ken has to say.

Ken mentioned that the U.S. is behind most other developed countries in exporting and that small businesses in the U.S. lag those in other countries. Ken related that some ways to begin exporting include sales personnel indirectly exporting by selling to others engaged in international trade.

When companies have excess capacity, a natural way to turn is internationally where the excess product might be turned into profit. At some conferences or meetings, one might bump into salespeople supplying foreign markets. Ken continues that Bear's exporting experiences have been sporadic. He warned that indirect exporting involved no learning and no control.

"Listen, instead of this hap hazarded approach, maybe we should try to develop some more stable relationships with foreign markets. But, where? If Bear wants to sell products outside the U.S., the big question is where", Jim says.

"Great, how do we answer that question", Ken replies.

Market screening. Jim explains that they need to go through the process of market screening to give them some direction. Market screening is a modified version of environmental screening in which the firm identifies markets by using environmental forces to eliminate the less desirable markets. Jim believes that market screening is perfect for a company like Bear.

First they need to conduct an initial screening. One way to do this is by looking at whether or not a particular produce is even being sold in a market. From earlier reports by salespeople, the fixed and folding knives at Bear manufactures seem to sell well across cultural lines without needing much in the way of adjustments. But, more information is needed. One quick way to get a feel for the U.S. export market for knives (or most any product) is by checking with the International Trade Administration (www.ita.doc.gov). By doing so, Bear can find out if knives are being exported from the U.S. and if so, where they are going. This information can be checked by using the Export Harmonized System Code.

HS Codes

The Harmonized Tariff System Classification is an international standardized numerical method of classifying traded products. The identifying number assigned to each product is used by

Customs officials around the world to determine the duties, taxes, and regulations that apply to a product.

The HS code is a complete, multipurpose international goods classification system, organized in a ten-digit numbering system. The HS code has replaced the Tariff Schedule of the United States Annotated and Schedule B U.S. export code. The HS code number must appear on the Shipper's Export Declaration and other documents in order for exports to leave a country. The HS system was developed through the active participation of 60 countries, 23 public and private international organizations, and two national trade facilitation organizations. Most U.S. trading partners were partner to the creation of this system to provide added exporting ease to businesses throughout the world.

The HS system is organized into 99 chapters arranged in 22 sections. Each section generally covers an industry and the chapters cover the various products and materials of the industry. The first two digits of the code identify the product category (e.g., Chapter 82 covers: Tools, Implements, Cutlery, Spoons AND Forks, of Base Metal; Parts Thereof of Base Metal). The third and forth digits narrow the category (e.g. for bear the appropriate digits look like "11", covering different types of knife related products). The fifth and sixth digits focus on types of knives ("92" for fixed blade knives and "93" for folding knives).

The complete codes for fixed and folding knives are HS 821192 and HS 821193 respectively. See http://www.ita.doc.gov/td/industry/otea/Trade-Detail/Latest-December/Exports/82/index.html (You can also find the figures if you do a Google search (www.google.com) by the codes: HS 821192 and HS 821193).

"I'm impressed. These HS code figures show some interesting stuff. What's next?" Ken remarks.

"Now, we need to look at Financial and Economic forces for countries that look good after our initial screening. Political and legal issues follow that. Then, we'll need Sociocultural information. We need to look at the competition. Finally, we probably need to personally visit markets that look good after the previous screenings", Jim says.

"Where do we get all this info?" Ken comments.

"Well, one way is back to the web. Do another Goggle search by "country information" and see what comes up. There's some good stuff at the CIA World Fact Book (www.cia.gov/cia/publications/factbook), the IMF Country Page (www.imf.org/external/country), and Country Reports (www.countryreports.org)," Jim comments.

Jim adds that the next issue after the screening is once we identify a few potential markets, how are we going to enter them.

Ken responds, "What do you mean?"

"Well, we're doing a little indirect exporting now. Maybe we should do some direct exporting: no middleperson. Or, we could set up a foreign sales company in a potential market to support are sales and marketing efforts for a country.

We could go another way entirely: foreign manufacturing. If we did that there would be even more alternatives: a wholly owned subsidiary, joint venture, licensing agreement, franchising, or contract manufacturing", Jim says.

"Well, the boss is pretty set on keeping the manufacturing in the U.S. Keeping manufacturing in the U.S. is written into our mission statement", Ken remarks.

"Good point, but if we find that the case for foreign manufacturing is strong enough, we should at least pass the information of to the boss", Jim says.

Ken suggests that they divide up some of the countries that look good after the examination of the "HS" codes and see what they can find.

YOUR ASSIGNMENT

Bear Cutlery is at a turning point. The owners must decide whether to engage in international business and, if so, in what capacity. You are to study their products and the strengths and weaknesses of Bear Cutlery. Do a SWOT (strengths, weaknesses, opportunities, and threats) analysis in reaching your decision for international business. You are to prepare a brief (2-3 pages) proposal to the owners which should include: 1) your decision, i.e., do you engage in international trade; if so, do you export or manufacture abroad; 2) a SWOT analysis; 3) time table to carry out your decision, if it is affirmative. Answer the questions: What is happening at home and abroad that would impact the decision both negatively and positively. Consider political, legal, financial, cultural, labor, and cost implications.

BEACH FOODS, INC.

P. Michael McLain, Hampton University
Jitendra K. Sharma, University of Lucknow
Robert Stretcher, Sam Houston State University

CASE DESCRIPTION

The case is designed for undergraduate and graduate courses in business. Both qualitative and quantitative tools can be used to assess business decision-making. Specific courses for which this case is intended include Business Policy, Financial Management and Accounting for Decision Making. The topics to be covered are Ratio Analysis, Credit Analysis, Working Capital Management, Risk Assessment and Bankruptcy Prediction.

CASE SYNOPSIS

This case is a decision case, which requires the students to analyze the financial statements of a company. The analysis is based upon whether to extend trade credit to a company with marginal financial statements. The case reviews some financial ratios developed by Altman and Beaver to make the determination to extend trade credit.

An analysis is discussed in the case concerning the Altman Z-score for non-public companies. While the most popular Altman is discussed in the case, the case examines how to adjust the model in the event a determination for trade credit is required for a non-public company.

INTRODUCTION

Mike, as the controller for Apex Manufacturing, was examining the financial statements of Beach Foods, Inc. Beach Foods, Inc. wanted to establish trade credit. Beach Foods, Inc. is a distribution company, which distributes a variety of different food products primarily to restaurants. Normal trade credit terms in the food industry was 2/10n30. This allowed a quick turnaround in the account receivable for Mike's company.

Beach Foods, Inc. did not have a good credit history. Beach Foods, Inc. normally paid its bills after 40 days according to the credit report. Beach Foods, Inc. was privately held. Its stock was held by two brothers and their father.

Beach Foods, Inc. is looking at purchasing about $10,000 worth of product a month. Beach Foods, Inc. probably would not purchase any product from Apex Manufacturing, unless it was granted trade credit. Similar products could be purchased from Apex Manufacturing competitors.

Mike asked the salesman why, Beach Foods, Inc. was deciding to purchase from Apex Manufacturing since it had been purchasing from Apex's competitor. The salesman stated that Beach Foods, Inc. was purchasing from Apex because it had the lowest price. Mike is not sure that Apex is always the lowest price on its manufactured product.

It would have been an easy decision to turn the company down for trade credit, but Mike's new boss had come from the Sales Department and the company was now totally sales driven. Mike knew that has soon as he turned down giving trade credit to Beach Foods, Inc., the sales department would telephone Mike's boss and the decision Mike made would be overturned. Mike had to develop some method which he could get approved, to make the credit decision into a quantifiable method.

Mike's bonus at Apex Manufacturing is based upon Apex's return on investment along with the day's sales outstanding of the account receivable. The bonus plan is an all or nothing type of plan. You either hit your assigned financial ratios and earn your bonus or you miss the numbers and receive no bonus. Any increase in the day's sales outstanding could eliminate Mike's bonus. This bonus amounted to $15,000 last year and is slated to remain the same this year.

Mike had read about the bankruptcy prediction models developed by Beaver and Altman. If he could use one of these models to predict the credit worthiness of his customers, his accounts receivable problems might be solved. Mike's boss, would then have to argue "against the numbers", and that would be more difficult. Besides, if the Board of Directors questioned the rise in day's sales in account receivable; he would have plenty of documentation concerning the credit decisions made.

Mike had obtained a copy of Beach Foods, Inc. income statement and balance sheet. A local CPA had reviewed these financial statements.

Because Beach Foods, Inc. was privately owned, the normal Altman Z-score model does not work. Altman provided two other Z-score models in his book for privately owned firms.

Beaver's univariate model is cash flow/total debt. This model had a prediction accuracy of 95% in the year before bankruptcy. Other predictive ratios used by Beaver included net income/total assets, total debt/total assets, and current ratio. He found that cash flow/total debt had some predictive ability five years prior to bankruptcy.

Beaver defined cash flow as net income plus depreciation, depletion, and amortization.

Altman used several variables in combination to predict the ability of a firm to continue. The classic Altman model is $Z = .012X1 + .014X2 + .033X3 + .006X4 + .999X5$. X1 is defined as Working Capital/Total Assets, X2 Retained Earnings/Total Assets, X3 Earnings Before Interest and Taxes/Total Assets, X4 Market Value of Equity/Book Value of Total Debt, and X5 Sales/Total Assets. A score of less than 1.81 is an indication of bankruptcy, between 1.81 to 2.99 a gray area, and above 2.99 an indication bankruptcy is not likely.

The problem with this model is that it will not help Mike with Beach Foods, Inc. Beach Foods, Inc. is not a public company and X4 could not be calculated. Substituting book value for market value is a poor substitution. Since book value is based upon historical costs under accounting rules, while market value is based upon fair market value.

Altman provides for revised weighting based upon book value substitution. This will be referred to as the five variable model. $Z = .717X1 + .847X2 + 3.10X3 + .420X4 + .998X5$. X4 is defined as net worth (book value)/total liabilities. All the other X items remained as defined above.

The scoring area changes to less than 1.23 an indication of bankruptcy, between 1.23 to 1.81 an indication of possible failure, and above 1.81, an indication of going concern.

Altman also provided a four variable model as Z = 6.56X1 + 3.26X2 + 6.72X3 + 1.05X4. X1 is defined as working capital/total assets, X2 retained earnings/total assets, X3 EBIT/total assets, X4 Net worth (book value)/total liabilities. Below 1.10 is an indication of bankruptcy, between 1.10 to 2.60 an indication of possible bankruptcy, and above 2.60 an indication of a going concern. In the model X1 to X4 are expressed as percentages while X5 is expressed as an absolute value. EBIT is defined as earnings before interest and taxes.

Mike could also calculate the dollar of cash flow generated per sales dollar. This ratio is calculated by the total cash flow divided by the total sales. In order to compute this ratio the Statement of Cash Flows must be calculated, since it was not provided to Mike.

Another method of determining the payment ability of a firm is to analyze the operating cycle. The operating cycle of the company is how long it takes to convert cash into inventory, then accounts receivable and back into cash. The operating cycle can be calculated by calculating the days in inventory and adding it with the days in accounts receivable. You can compare this with the days in accounts payable. Any deficit must be made up from other sources of funds.

Mike can make two incorrect decisions. He can grant credit and then have Beach Foods go bankrupt or he can deny credit and Beach Foods could prosper. (Type I and Type II errors). Either error can be considered to be the incorrect decision.

Credit decisions are often made in business. They are based upon the five "C's" of credit. They are capacity, capital, collateral, conditions, and character. Capacity means the ability to repay the money borrowed. Capital means you have the financial ability to repay with available assets. Collateral is the security that exists in the event of nonpayment. Conditions mean what the money is going to be used for or also is the current economic climate. Character means the people running the company. Many credit professionals will look at not only the character of the firm, but also the character of the management. Running credit reports on the payment history of the company and credit reports on the firm's management.

Generally in trade credit collateral is not given. Collateral would be provided for such loans as bank loans or other borrowings.

With the five "C's" of credit, some of the determining factors are subjective. In addition, they are not provided equal weights. Some of them are considered more important than others.

QUESTIONS

1. What is the meaning of Reviewed Financial Statements? Why are they different from audited financial statements?
2. What is the prediction ratio for the Altman four variable model?
3. What is the prediction ratio for the Altman five variable model?
4. What is the prediction ratio for the Beaver model?
5. What other financial ratios do you think could be used? Are multivariate or univariate models better? Why?

6. Do you think financial ratio analysis is better at predicting short or long-term financial position? Explain why?
7. Would you grant trade credit to Beach Foods, Inc?
8. What credit limit would you assign?
9. Calcultate the operating cycle of the business.

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REVIVING A FLOUNDERING BUSINESS: A CASE STUDY OF A FAMILY BUSINESS WITH MUTIPLE PLANTS

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CASE DESCRIPTION

The case focuses on how to diagnose the symptoms of a failing business and devise strategies to restore it to solvency. The case is appropriate for an undergraduate senior level or graduate level managerial economics, finance, business policy and small business management courses. The case has a difficulty level of four and is designed to be taught in three class hours and is expected to take four hours of preparation outside of class.

CASE SYNOPSIS

Students are provided with a scenario of small business that is on the verge of failure. The case requires students to conduct SWOT, and internal and external factor analysis; compute critical financial ratios from the balance sheet and income statements; evaluate the costs and benefits of a plant closing; analyze the market environment by using RMA (Robert Morris & Associates) analysis and the Porter's five forces model of competition; project sales and cost estimates, and develop breakeven charts. To enable students to perform tasks described above, the following data is provided: financial statements for three years; sales data by each plant for 10 years; price comparisons between Sim's, Inc. and four other major competitors; and pertinent data for industry and RMA analysis.

INTRODUCTION

Sandy, Sim's wife, knew that something is wrong. Lately, Sim has been distant, withdrawn and melancholy. Whenever Sim is at home, he is in a pensive mood. This is unlike Sim. He is a born optimist and manages to keep his chin up no matter how vexing the problem and how grave the circumstances. Gosh, Sim was even able to beat the cancer when all odds were stacked against him. Upon constant nagging by Sandy, Sim broke down and told her that he is distraught and depressed because his business, which he nurtured over so many years, is floundering. Each audit report seems to reflect the fact that his company is steadily but surely heading toward insolvency. It was Sim's dream to leave a profitable business for his son. But Sim's dream is shattered and he is heart broken.

Sim's, Inc. is a family owned business, which has been in existence for over four decades. It employs fourteen employees to produce a variety of high quality products such as quilted bedspreads, comforters, pillows, table covers and table's ruffles. The company has well-trained, experienced core of employees and a network of in-house sales representatives who concentrate on the interior design and fabric trade. The company is headquartered in Jefferson city, but it has a satellite plant located in the Glover city - approximately 200 miles away from it's headquartered. The company markets its products by selling directly to interior decorators and retail fabric stores close to its headquarters. To access markets outside the region, it employs the services of the sales representatives located in other regions of the United States. The company has a customer base of 1,600. Over the years, the company has assiduously acquired an outstanding reputation for quality, attention to details and friendly service. The financial position of the company was sound until the sales began to slump.

The company has no mission statement and strategic plan. The management is so engrossed in day-to-day operations that it has no time to develop a vision and set quantifiable goals against which it can measure its performance. For the last several years, the company had not developed any new products, and merely responded to the manufacturing needs of its customers. There has been no marketing innovation and its customer's base has barely expanded. The product catalog has not been updated and it contains photographs that were taken in 1980's. Sales representative rarely visit with customers and consequently a few customers had learnt about the company's products directly from the sales representatives. This stems partly from the fact that the geographical area covered by the sales representative is too large for effective market penetration; four sales representatives cover fourteen states and other states are covered through the independent sales representatives. The independent sales representative, however, has little incentive to push Sim's products because its sales constitute less than 10 percent of their total business. Also, the independent sales representatives bundle Sim's products with other products sold to designers and thereby exclude its products' sale to retailers.

The company insists that payment be made in cash, and does not accept credit cards. It is not that the company is strapped for cash; in fact, it has a large cash reserve, which is invested in the mutual funds and also used as self-insurance fund to cover fire, flood, and other damages.

The Company has an antiquated telephone system that impedes efficient communication within the company and with clients. Several clients have requested a toll free number, but management has refused to provide this convenience. The management rarely communicates with the sales force and the sales force is not provided access to customer database.

Issues described above have plagued the company for several years. No wonder, its sales have been declining both at the Jefferson and its Glover plants. Most of its solvency ratios, equity ratios, and profitability ratios also have been slumping in tandem. Net income has also been declining because the sales have been declining faster than the costs. Because of declining sales, both plants have been working below their capacity (Jefferson plant, 80 percent and Glover plant, 60 percent). Accordingly, both the plants have been unable to adequately cover the overhead costs. The problem is further exacerbated by a steady increase in cost of employee benefit packages, based on the length of service. The Glover plant is particularly hard hit because the average term of service of its employees is over 25 years.

THE INDUSTRY

The custom quilting and fabrication industry has grown by 25 percent over the past ten years, despite cyclical peaks and valleys. There are 53 workrooms of similar size to Sim's of 25-100 employees scattered throughout the country. At the same time, there are numerous small workrooms capable of duplicating Sim's products and offering services to decorators. Smaller firms, however, do not have the capability to compete with larger enterprises in terms of scope. Consequently, they tend to fabricate simple jobs and in the process they whittle away at the market available to larger ones. There is little possibility for economies of scale in this industry, since most of the fabrications are individualized and are made to order by interior designers. Brand loyalty is very little, and designers normally look for the best deals with very little switching cost. The substitute products for custom quilted bedding are the "ready made" upscale designer labels, such as, Ralph Lauren and Laura Ashley. These products are available in department stores, boutiques, and catalogues. Although, the ready-made products do not provide custom fabric and quilting, they compete in price and image. The barriers to entry are relatively low, which has led to a fragmented market in terms of geography, price, and quality. The raw materials; including, lining and polyester filling are readily available at very reasonable prices, due to the generic nature of the materials and competition among the suppliers.

In the southeastern region there are four major competitors, other than Sim's, for custom quilting and fabrication: 3-W Quilting & Laminating Co; Scroll Fabrics; Virginia Quilters; and Artistic Quilting. While each of these firms has the same core quilting business, each also produces its own specialties, such as, laminating, down products, hotel contracts for spreads and headboards. There are also many medium and small workrooms, which are jockeying for a position in the same market.

INSTRUCTIONS TO STUDENTS

You are expected to conduct SWOT analysis; compute critical financial ratios, examine the productivity and profitability of the company and develop breakeven charts; analyze the market environment by using RMA analysis and the Porter's five forces model of competition; project sales and cost estimates, and review the case study carefully and using the following data to complete the tasks listed above:

♦	Balance sheet for three years. (Appendix A)
♦	Income statement for three years. (Appendix B)
♦	RMA ratio calculation guide. (Appendix C)
♦	Price Comparison between Sim's, Inc. and major competitors (Appendix D)

Table 1: Sim's, Inc. Consolidated Balance Sheet						
Sim's, Inc.	Dec. 31		Dec. 31		Dec. 31	
Statement in Thousands $	Year 1		Year 2		Year 3	
ASSETS Common Sized	$	%	$	%	$	%
Cash On Hand	231	0.0	252	0.0	683	0.1
Cash Accounts	(4,404)	(0.8)	9,455	1.8	22,222	4.3
Savings	78,825	14.8	103,400	19.2	121,900	23.7
Trade Accounts Recv- Jefferson	35,795	6.7	29,956	5.6	8,952	1.7
Trade Accounts Recv- Glover	54,818	10.3	41,375	7.7	40,730	7.9
Other Accounts Receivable	805	0.2	(893)	(0.2)	(943)	(0.2)
Other Accounts Receivable	0	0.0	0	0.0	10	0.0
Net Accounts Receivable	91,418	17.2	70,438	13.1	48,749	9.5
Trade Notes Receivable	6,972	1.3	6,972	1.3	6,972	1.4
Inventory- Jefferson	43,402	8.2	40,408	7.5	40,444	7.9
Inventory- Glover	32,904	6.2	35,629	6.6	28,036	5.4
Total Inventory	76,306	14.4	76,037	14.2	68,480	13.3
Mortgage- 560 Eastern Ave	5,858	1.1	2,368	0.4	0	0.0
Mortgage- 320 N. Sally	35,901	6.8	32,734	6.1	29,344	5.7
EDJ Investments	146,086	27.5	146,086	27.2	146,086	28.4
Total Current Assets	**437,193**	**82.2**	**447,742**	**83.4**	**444,436**	**86.4**
Land	8,478	1.6	8,478	1.6	8,478	1.6
Buildings	54,789	10.3	54,789	10.2	54,789	10.7
Machinery & Equipment	173,931	32.7	173,931	32.4	173,931	33.8
Other Equipment	23,489	4.4	23,489	4.4	16,697	3.2
Furniture & Fixtures	84,394	15.9	87,281	16.2	88,759	17.3
Leasehold Improvements	89,382	16.8	89,382	16.6	89,382	17.4
Other Fixed Assets	1,992	0.4	1,992	0.4	1,992	0.4
Gross Fixed Assets	436,455	82.1	439,342	81.8	434,028	84.4
Accumulated Depreciation (-)	(341,941)	(64.3)	(349,912)	(65.1)	(364,041)	(70.8)
Net Fixed Assets	94,514	17.8	89,430	16.6	69,987	13.6
TOTAL ASSETS	**531,707**	**100.0**	**537,172**	**100.0**	**514,423**	**100.0**

Table 1: Sim's, Inc. Consolidated Balance Sheet						
Sim's, Inc.	Dec. 31		Dec. 31		Dec. 31	
LIABILITIES Common Sized						
Trade A/C Payable- Jefferson	10,859	2.0	12,049	2.2	10,322	2.0
Trade A/C Payable- Glover	4,690	0.9	4,512	0.8	1,377	0.3
Accrued Payroll Tax- Jefferson	0	0.0	2,633	0.5	222	0.0
Accrued Payroll Tax- Glover	0	0.0	42	0.0	260	0.1
Withheld Mo. Income Tax	804	0.2	838	0.2	475	0.1
Withheld Employee Savings	(502)	(0.1)	0	0.0	85	0.0
Withheld Employee Savings	(98)	0.0	0	0.0	260	0.1
Employee Fund	104	0.0	492	0.1	317	0.1
Total Current Liabilities	**15,857**	**3.0**	**20,566**	**3.8**	**13,318**	**2.6**
Total Liabilities	**15,857**	**3.0**	**20,566**	**3.8**	**13,318**	**2.6**
Reserves	97,860	18.4	97,860	18.2	97,860	19.0
Capital Stock- Jefferson	1,292	0.2	1,292	0.2	1,292	0.3
Capital Stock- Glover	11,815	2.2	11,815	2.2	11,815	2.3
Paid-in Surplus	9,374	1.8	9,374	1.7	9,374	1.8
Other Equity- Jefferson	7,656	1.4	7,656	1.4	10,996	2.1
Other Equity- Glover	0	0.0	3,340	0.6	(7,136)	(1.4)
Retained Earning- Jefferson	209,485	39.4	206,901	38.5	198,536	38.6
Retained Earning- Glover	178,368	33.5	178,368	33.2	178,368	34.7
Total Net Worth	515,850	97.0	516,606	96.2	501,105	97.4
TOTAL LIABILITIES & NET WORTH	**531,707**	**100.00**	**537,172**	**100.00**	**514,423**	**100.0**

Table 2: Sim's, Inc. Consolidated Income Statement

INCOME STATEMENT Common Sized	Year 1		Year 2		Year 3	
	$	%	$	%	$	%
Sales- Jefferson	523,286	49.3	576,241	51.9	546,177	51.3
Sales Plant- Glover	522,452	49.2	514,184	46.3	498,347	46.8
Other Income- Jefferson	16,222	1.5	16,791	1.5	17,499	1.6
Other Income- Glover	129	0.0	2,938	0.3	3,111	0.3
Total Sales	**1,062,089**	**100.0**	**1,110,154**	**100.0**	**1,065,134**	**100.0**
Cost of Goods Sold- Jefferson	410,522	38.7	419,541	37.8	420,432	39.5
Cost of Goods Sold- Glover	396,119	37.3	392,295	35.3	349,449	32.8
Gross Profit	**255,448**	**24.1**	**298,318**	**26.9**	**295,253**	**27.7**
General & Admin- Jefferson	160,513	15.1	152,525	13.7	161,398	15.2
General & Admin- Glover	146,276	13.8	144,709	13.0	159,101	14.9
Bad Debt Expense- Jefferson	1,513	0.1	1,834	0.2	628	0.1
Bad Debt Expense- Glover	4,338	0.4	1,906	0.2	654	0.1
Operating Expenses	**312,640**	**29.4**	**300,974**	**27.1**	**321,781**	**30.2**
Operating Profit	**(57,192)**	**(5.4)**	**(2,656)**	**(0.2)**	**(26,528)**	**(2.5)**
Sale of Assets- Jefferson	(4,462)	(0.4)	(638)	(0.1)	(21,250)	(2.0)
Sale of Assets- Glover	(255)	0.0	0	0.0	0	0.0
Other Expense- charity	1,090	0.1	446	0.0	2,977	0.3
Other Expense	513	0.0	120	0.0	110	0.0
Total Other Expenses	(3,114)	(0.3)	(72)	0.0	(18,163)	(1.7)
Profit Before Tax	(54,078)	(5.1)	(2,584)	(0.2)	(8,365)	(0.8)
Profit Before Extraord. Items	(54,078)	(5.1)	(2,584)	(0.2)	(8,365)	(0.8)
NET INCOME	**(54,078)**	**(5.1)**	**(2,584)**	**(0.2)**	**(8,365)**	**(0.8)**
RECON. OF NET WORTH	Common Sized					
Beginning Net Worth	569,928	110.5	515,850	99.9	516,606	103.1
Changes in Retained Earnings:						
Net Income (Loss)	(54,078)	(10.5)	(2,584)	(0.5)	(8,365)	(1.7)
Changes in Other NW						
Unreconciled Difference	0	0.0	3,340	0.6	(7,136)	(1.4)
Ending Total Net Worth	**515,850**	**100.0**	**516,606**	**100.0**	**501,105**	**100.0**

Table 3 RMA Ratio Calculation Guide	
Ratios	
Operating Ratios:	
Sales Growth	Total sales - Total Sales(Next Year) / Total Sales(Next Year)
Pre-Tax Profit Margin	Profit Before Tax/ Total Sales
Profit Margin	Net Income/ Total Sales
Return on Assets (ROA)	Net Income/ Total Assets
Return on Equity (ROE)	Net Income/ Total Net Worth
Asset Turnover	Total Sales/ Total Assets
Current Position:	
Current Ratio	Total Current Assets/Total Current Liabilities
Quick Ratio	(Cash +Accounts Receivables) /Total Current Liabilities
Working Capital	Total Current Assets - Total Current Liabilities
Working Capital/Assets	Total Current Assets - Total Current Liabilities / Total Assets
Working Capital Turnover	Total Sales / (Total Current Assets - Total Current Liabilities)
Receivable Turnover	Total Sales / Trade Accounts Receivables
Age of Receivables	Trade Accounts Receivables / (Total Sales / 365)
Inventory Turnover	Total Cost Of Goods Sold / Total Inventory
Days Supply in Inventory	Total Inventory/ (Total Cost Of Goods Sold*365)
Payable Turnover	Total Cost Of Goods Sold/ Trade Accounts Payable
Age of Payables	Trade Accounts Payable / (Total Cost Of Goods Sold*365)
Equity Position:	
Owner Equity/Assets	Total Net Worth/ Total Assets
Creditor Equity/Assets	Total Liabilities / Total Assets
Debt/Tangible Net Worth	Total Liabilities / (Total Net Worth - Intangibles)
Fixed Assets/Long Term Debt	Net Fixed Assets / (Total Liabilities - Current Liabilities)
Fixed Assets/Tangible Net Worth	Net fixed Assets / (Total Net Worth - Intangibles)
Plant Turnover	Total Sales / Net Fixed Assets

Appendix D Price Comparison between Sim's, Inc. and major competitors					
PRICE COMPARISON (WHOLESALE PRICES)					
	Sim's, Inc.	3W	Atkinson Fabrics	Scroll	Virginia Quilting
Quilted Bedspread	$168	$215	$195.50	$200	$155
Queen Comforter	$143	$195	$148.50	$140	$142.10
Dust Ruffle Gathered	$59	$95	$47.50	$73	$50
Quilted Pillow	$87.10	$120	$77	$100	$76
Table Covers	$73.75	$85	$75.50	$82	N/A
Square Pillows	$40.00	$37.50	$45	$38	$34.50

ENDNOTES

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FLORIDA FOODS

Joseph M. Sulock, University of North Carolina-Asheville

CASE DESCRIPTION

The primary objective of Florida Foods is the evaluation of a proposed expansion of one of the company's stores, and is best used in any course where the students have a background in capital budgeting. This suggests that it is probably most appropriate in the upper-level undergraduate (where we use it) or first-year graduate course in corporate finance, or a strategic management class. An important secondary objective is to address some financial performance measures that are often used to evaluate a company. Other objectives include the opportunity to explore real versus nominal discount rates and sensitivity/scenario analysis.

The required amounts of class time and student preparation depend on 1) the topics the instructor chooses to cover and 2) whether students have access to the template that accompanies the case. Certainly one class is ample for instructors who focus only on the capital budgeting issues, and student preparation should require a maximum of five hours. Allow an additional class to adequately cover the evaluation aspects. Student preparation to cover all issues should run eight to ten hours without the template.

CASE SYNOPSIS

This case is based on a situation involving a friend of the author's, and could be used for role-playing, writing assignments, and student presentations. The setting involves an energetic and ambitious store manager who has decided to submit to home office an evaluation of a possible expansion of the store. An unexpected development is that the regional manager has informed him that he is being considered for one of the positions at the home office that will become open in the next few years. It is clear that the home office is not just interested in whether an addition to the property makes sense. Top management is also interested--and perhaps more so-- in whether he has the "right stuff" for a higher-level executive position and, hence, the evaluation will be viewed by top management as a test.

Another angle is his concern over the impact of the expansion on a number of financial measures used to evaluate a store's performance. These include the return on investment, return on equity and economic value added, all measured at book values. Thus projections of these statistics will be made with and without the expansion. Of interest is that these statistics do not necessarily "improve" with the implementation of this highly positive NPV project

The case has two Excel templates that contain pages relating to the computational questions listed in the Instructors' Notes, and are useful for performing sensitivity/scenario analysis so characteristic of real-world forecasts. The case can be done without them but are included to *expand its versatility. One template is complete in that all the appropriate formulas have been entered. The other lacks a number of key formulas that the students must enter in order to use the template effectively. The Instructors' Notes offers suggestions on how the case and templates might be used in both lower and upper level courses.*

INTRODUCTION

It's been over thirty years, but Bill McCauley can still remember the eavesdropping that motivated him to open his first grocery store. It was 1971, McCauley was twenty-eight, and he was helping his dad operate a number of family-owned convenience stores in central Florida. He was eager to take the business to another level, but he was unsure what it should be. Then, while dining in a local restaurant, he overhead a conversation about the area's largest supermarket, a nationally known chain. "I really don't like shopping there," a lady remarked. "It's dark, it's dirty and the people aren't very friendly. But where else can I go? I sure wish there was a cleaner, friendlier alternative."

This chance remark inspired McCauley to conduct some informal market research. He visited not just the store in question, but all the larger supermarkets in the region. Nearly all the stores were unkept, the atmosphere was generally dull if not gloomy, and the service C-grade at best. Do customers want a more pleasant shopping experience? It was easy for McCauley to believe the answer was "yes". Few of the customers seemed especially happy with the surroundings, and some looked downright miserable. "Grocery shopping should be an event, not a chore," McCauley thought. The next step was to choose a location. No, he didn't want to go head to head with any of the major food chains. Thus McCauley needed a location the name chains had overlooked that was large enough to support a major supermarket. He decided that Tilton County would do nicely. The area was growing and the nearest major grocery store was about ten miles away.

McCauley then approached his father for help in locating investors, and shortly thereafter Florida Foods, Inc was created. The first store was about 20,000 square feet, quite small by modern standards but rather large for the time. The facility was clean, well lit, and the employees well trained and courteous. Product selection was diverse and prices competitive. In short, McCauley felt confident that he had developed a store that would indeed make grocery shopping an event and not a chore.

Sales far exceeded expectations; McCauley expanded into surrounding areas, and over time has opened at least one new facility each year. At the present time (2002) FF operates 130 stores in five different states, and annual sales exceed $1 billion. Though McCauley admits that he has been fortunate, there is little doubt that he has a keen business sense. For example, he has always believed in surrounding himself with the best managerial talent and is willing to pay generously to attract top executives. And McCauley was right on the money when he decided to add a bakery and delicatessen to each store, as well as offer 24-hour shopping in over half the stores.

Always cost conscious, McCauley has paid special attention to distribution expenses. Florida Foods operates a modern 650,000 square foot warehouse and distribution center that supplies groceries, meat, produce and dairy products to all its stores. Plus the facility is large enough to handle the additional expansion of stores into the foreseeable future.

GEORGE CHANDLER

Florida Foods continues to follow McCauley's initial strategy of avoiding direct competition with major supermarket chains. Thus, it will only locate in regions that management thinks is under served by existing stores. But this isn't enough to convince FF to enter a market. Management believes that owning rather than leasing property makes the most sense. The thinking is that real-estate ownership lowers occupancy costs and provides long-term flexibility for the expansion of a store. Consequently Florida Foods will not enter even an under-served market unless it is able to purchase suitable property.

The store that Florida Foods opened five years ago in Riverton, Florida meets the company's expansion criteria nicely. Riverton seemed to be a growing area that the major chains had overlooked. FF purchased land in a prime location and built a 25,000 square foot unit, relatively modest compared to both the company's average store size of 38,000 square feet and the 55,000 square foot "superstores" that it operates in a number of areas. The property is much larger than necessary to accommodate the present facility but was acquired in order to allow for the possibility of future expansion. And George Chandler, the store manager, thinks that "expanding the store is well worth considering."

Chandler, promoted only eighteen months ago, was and is struck by the growth in the surrounding area. The local Chamber of Commerce has promoted Riverton as an attractive area to both retirees and businesses, and continues to do so. Of interest is that much of the region's growth has occurred on the north side, the location of the store. Traffic count on the highway in front of the store has increased 30% in the last two years and over 50% since the facility was constructed. Plus two large housing developments and an apartment complex are under construction within a few miles of the store. Further, he believes that sales have been hurt by the inability to carry a wider variety of products, and the relatively long check-out lines at peak times. At times Chandler has even wondered if the store "was undersized right from the start," a concern also shared by Roberta Lewis, one of FF's regional managers.

There is also the issue of competition. A rival company, Pathway, purchased an old department store about one-half mile from Chandler's facility, and apparently in haste converted it two years ago to a supermarket with roughly 20,000 square feet. Despite its rather dingy and unappealing atmosphere, the store seems to be doing quite well. Chandler thinks that either Pathway or another competitor will develop a superstore in the area if FF does not. "If the demand is there---and I think it is--and we don't expand to accommodate that demand, then surely someone else will," he remarked to Lewis. "And that could force us to close." Lewis agrees with this and added "It does seem to me that someone is going to locate a state-of-the-art facility in the region. If so, I'd like it to be us."

SOME FINANCIALS

Chandler thinks--and Lewis agrees-- that he should develop and submit a proposal to take the facility to "superstore status," which involves an addition to 55,000 square feet. Most store managers would not be comfortable compiling the financials for such a project, but Chandler was a business major in college and since graduation has completed additional courses in finance, accounting and economics. Ambitious and energetic, Chandler took these classes partly out of personal interest but mainly to further his long-term professional objective of becoming a major player at the home office. And he knows that top management attributes its success in part to the financial expertise of its upper-level executives.

Chandler's first decision is whether to perform the analysis in real (inflation adjusted) or nominal terms. Lewis told him that "the home office will have no preference" so Chandler decided to do the analysis in real terms because he feels he thinks better about the numbers if they are adjusted for inflation.

Note: Unless specified otherwise, all numbers that follow are in real terms, i.e. in 2002 dollars.

Chandler is aware that top management uses a ten-year time period and a thirty percent tax rate when making a forecast on a store, and that the company's cost of capital (required return) is 15 percent. This return is a nominal value, however, and incorporates a four percent expected annual inflation rate. All this implies a real return of 10.6%, but on the advice of Lewis ("The home office prefers whole numbers!") he decides to use an 11% as the real rate.

Exhibit 2 shows information that he compiled based on internal reports distributed to store managers. Sales per square foot tends to increase with store size because selling space as a percentage of total space will increase, and because of the greater variety of products. Gross margin is independent of store size primarily because FF's purchasing agents negotiate contracts for the entire company and, thus, all stores benefit from the company's buying power.

General and administrative expenses include items such as compensation of the store managers, local advertising and local property taxes. These costs, as a percentage of sales, tend to decrease with a store's size because of economies of scale. For example, management compensation will increase by a smaller proportion than the increase in space. The percentages listed in Exhibit 2, however, do not include any allocation for the store's share of the cost of running either the home office or the company's distribution and warehouse center (mentioned earlier). The accountants will assess a store for these costs at 1% of sales and is shown on the income statement in Exhibit 1 as "support costs." It is the opinion of Lewis, though, that the impact of the expansion on these costs will be minimal. She is quick to emphasize that "The store's annual income statement will most definitely show a charge for these items. Our accountants absolutely insist on it."

Perhaps the most crucial estimate is forecasted sales. Without expansion, Chandler thinks that sales will not increase in real terms and, thus, will remain at $5,250,000 per year or $210 per square foot. If the expansion is undertaken, he believes that sales will take a hit in the first year because construction requires about a year to complete which means that shoppers will be unavoidably inconvenienced. He will assume sales in year one of $4,200,000, a 20% decrease, and then a rebound to $7,875,000 in year 2, numbers that are consistent with other major renovations that FF has done. Chandler predicts a further increase to $11,825,000 in year three because it generally takes another year for residents to "fully appreciate" the additional product lines and convenience that the larger store offers. He forecasts no real growth in sales after year 3. When he showed these estimates to Lewis, she remarked "These numbers seem reasonable to me and may even be somewhat conservative given the lack of real competition and the growth potential of the area."

Chandler knows that the appearance and design of the company's stores are important to top management because they want to create a first-class environment for shoppers. Construction and equipment costs for a quality expansion are estimated to run $2,100,000 up front with an additional $300,000 in year 1. These amounts include not just the extra space and equipment, but also a redesign of the existing space in order to blend with the more modern addition. Top management also requires that a forecast incorporates "normal equipment and machine replacement" that equals one percent of annual sales.

For the purpose of analysis--and when the evaluation is done in real terms-- top management assumes that annual real depreciation equals the amounts spent on construction and equipment spread on a straight line basis over the remaining life of the project. In essence, this simplification assumes that the nominal increase in depreciation each year from "normal equipment and machine replacement" spending offsets the inflationary reduction in nominal depreciation from construction and equipment spending. All this means in real terms that Chandler will use depreciation of $210,000 in year 1 (=$2,100,000/10) and $243,330 in years 2-10 (=$210,000+$300,000/9).

Stores often receive a "facelift" about every seven years which typically involves some painting plus the repair of floor and wall imperfections. The existing facility is scheduled for a $400,000 facelift in two years, which will be unnecessary if the expansion is implemented. However the new larger store would likely require about a $500,000 renovation in seven years. All such costs are deducted in the year they are incurred.

The store's current adjusted working capital situation is considered "pretty typical,"and Chandler will use the information in Exhibit 1 to forecast the impact of an expansion on the store's working capital. What about a terminal value? Lewis recommends that Chandler use an after-tax terminal value of five times projected year-ten EBDIT (earnings before depreciation interest and taxes). "This number", according to Lewis, "is quite consistent with similar projects we've evaluated. It's also the figure that we use in an acquisition."

EVALUATION CONCERNS

The Riverton store is Chandler's first stint as a store manager. And, quite frankly, he is somewhat anxious about this proposal and how it will affect his career. This concern is understandable given that he was only recently promoted, plus it is unusual for a store five years old to be expanded since most of FF's additions and remodels have been done to facilities at least ten years old. In fact, for a brief time he wondered if it was even a good idea to develop an expansion proposal. After all, here he would be--a new manager--submitting what top management would consider a "major project". Would they view this as initiative or uppityness? And what if the proposal was thought "unsound"? "Or, worse yet, what if he convinced the home office to approve it and the store flopped? For all these reasons, Chandler at one point told himself "Better to do nothing. Just do your best managing the store as it presently exists."

These fears were only transitory, however. "I honestly believe," he told his wife Barbara, "that it's a good idea to carefully investigate an expansion, and Lewis agrees. Anyway, the home office has always treated me fairly and generously. There's no reason to think that will change. Besides, at some point I'd sure like to move beyond store manager. It seems to me that if I'm going to do that I can't be afraid to take at least some personal risk."

Chandler admits, though, that he is "more than mildly curious" about how the expansion will affect his annual performance review. Each year the home office evaluates every FF store. The process includes an on-site visit involving items like the appearance of the building, product selection and displays, and even employee morale. Chandler is not concerned with any impacts on these nonfinancial issues. In fact, if anything he envisions "higher marks in these areas" in part because he has ideas about how to make shopping more enjoyable, but lack of space has prevented him from implementing them.

His concerns center on the evaluation of the store's financials. Key statistics that will be examined include the return on investment (ROI), the return on equity (ROE) and the economic value added (EVA); and Exhibit 3 explains how FF computes these numbers. What does the home office look for? Lewis has told Chandler "Home office realizes that these measures are based on accounting information. It doesn't take them literally. However, it is clear that a single-digit ROI., a negative EVA using a ten percent rate, or an ROE under fifteen percent will get their attention."

As Chandler prepared to make some sense out of all the information he has gathered, there was an unexpected development. He received a somewhat lengthy e-mail from Lewis who had discussed the Riverton store with another top manager. In a nutshell, home office "eagerly awaits" Chandler's report. Lewis emphasized, though, that Chandler has been requested to evaluate, not necessarily advocate, an expansion. Her e-mail also mentioned that a number of upper management positions will probably become open in the next few years, and the home office likes to promote internally if possible. She also recommended that Chandler should be prepared to address the numerous what-if questions that top management is so fond of asking.

Though Lewis did not mention it, Chandler knows quite well that this is a significant request and opportunity. It is clear that the home office is not just interested in whether an addition to the Riverton property makes sense. Top management is also interested--and perhaps more so-- in whether Chandler has the "right stuff" for a higher-level executive position. He smiles as he reflects on all this since, after all, it wasn't long ago that Chandler wondered if it was good idea to even develop a proposal. "At least now," he muses, "I can be sure someone at the home office will read what I send....and maybe closer than I would like."

Exhibit 1

Current (2002) Income Statement and Balance Sheet
Riverton Store ($000s)

Income Statement	
Sales	$5,250.0
CGS	3,937.5
Gross margin	1,312.5
G&A	761.3
Support costs	52.5
EBDIT	498.8
Depreciation	92.1
EBIT	406.6
Interest	43.1
EBT	363.6
Taxes (30%)	109.1
Net income	$254.5

Note: "G&A" refers to "General and Administrative. Items included in this category plus the "support costs" are explained in the case.

Consolidated Balance Sheet

Adj W.C.	$ 157.5	Debt	$ 615.6
Net Fixed	1,381.6	Equity	923.4
Total	$1,539.1	Total	$1,539.1

Exhibit 2			
Selected Financial Information by Store Size			
Store Size (Sq ft)	Sales per Sq Ft	Gross Margin	(G&A)/Sales
<30,000	$175-215	.25	.145
30,000-40,000	186-230	.25	.140
40,000-50,000	195-240	.25	.135
>50,000	200-250	.25	.130

Notes: Chandler compiled the information in this table based on internal company reports. Nearly all stores operate within the sales ranges given above. For example, there are 30 stores with less than 30,000 square feet and 29 have sales between $175 and $215 per square foot.

Exhibit 3	
The Calculation of ROI, ROE and EVA by Florida Foods	
ROI.	Refers to "return on investment." Equal to (EBIT-taxes)/Invested Capital where "taxes" are 30% of EBIT, "invested capital" equals adjusted working capital plus net fixed assets, all at book values. "Adjusted working capital" equals receivables plus inventory less accounts payable less accruals. The ROI for the Riverton store is currently 18.5% based on the information in Exhibit 1.
ROE	Refers to "return on equity." Equal to (EBIT-interest-taxes)/equity. "Taxes" are computed on EBIT less interest. "Invested capital" in the ROI formula is assumed to be raised by 40% debt and 60% equity. The debt is assumed to be raised at 7% percent, the current market rate. The ROE for the Riverton store is currently 27.6% based on the information in Exhibit 1 and assuming a 30% tax rate.
EVA	Refers to "economic value added." Equal to (ROI - cost of capital) times "invested capital." Florida Foods" uses a 15 percent cost of capital (required return). The EVA for the Riverton store is presently $48.2(000) based on the information in Exhibit 1.

THE MAGIC OF MEVATEC

Linda B. Shonesy, Athens State University
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CASE DESCRIPTION

This case is intended for use in undergraduate entrepreneurship or management courses. The primary subject matter of this case concerns the growth of a small business based upon entrepreneurial leadership and vision of the owner and founder. This case allows the student to carefully evaluate an organization's corporate culture and corporate strategies; and to determine the relationship of culture to financial and strategic success. It also enables the student to identify the challenges that many organizations are facing today, with the downsizing that is occurring in both the government and in the private sector. This case is designed for one to two hours of class time, and is expected to require two to four hours of outside preparation.

CASE SYNOPSIS

This case concerns an entrepreneur who used a nurturing leadership style, an entrepreneurial vision, empowerment of employees, and a competitive company culture to guide company growth This culture is referred to as "Mevatec Magic" and places an emphasis on individual development. Mevatec is a unique organization that uses scientists, engineers, and business professionals, who apply creative insight along with advanced technologies to assist government and industry to solve daily problems (www.mevatec.com/compinfo/intro). Nancy Archuleta bought Mevatec, a manufacturer of commercial electronic components, in Las Cruces, New Mexico in 1985. However, in 1987 this new business was in trouble, and she had to lay off 75% of her employees when she lost a major contract. Ms. Archuleta made a decision in 1988 to transition to the government high-tech services sector, because she learned that she must not depend upon one contract for survival. The company reduced their dependence on defense work from nearly 100% of revenue to an estimated 60% by 1996 (Mevatec Corporation, 1999).

In 1989, the company moved to Huntsville, Alabama, where revenues have soared from $50,000 in 1988 to over $100 million in 2002 (About Mevatec, 2003). They have diversified into aerospace engineering, management services, and information technology. Mevatec's customer base is well diversified, but the United States Army is the largest customer. The fastest growing business base is in the area of assisting commercial and government entities in driving down costs and improving customer service (Mevatec Corporation, 1999).

THE MAKING OF AN ENTREPRENEUR

Nancy Archuleta, Chief Executive Officer of Mevatec Corporation, was raised on a farm in Las Cruces, Mexico. She learned early that to get ahead in life, she must work hard and often make personal sacrifices. She lived with her family in a one-room house that was accented by three beds and a “pot-belly” stove. Since her father was disabled, her mother was forced to iron clothes for others to help earn a living (James, 1993).

Mrs. Archuleta described her mother as a person who tried to make the best of things. She even tried to be creative by placing four different colors of tile on the floor of their house, designating each color as a room for her girls (Interview, 1999). Her mother always emphasized that no matter what a person had in this world, that they must leave things better than they found them. For example, if you cut down a tree, two trees should be planted in its place (www.mevatec.com/about/ceomessage). Mrs. Archuleta embraced that philosophy.

Mrs. Archuleta was a dreamer and spent her time reading and dreaming about far-away places. She was a determined, hard worker in her world of leftover lunches, hand-me-down clothes, and after school jobs, such as picking cotton. However, her dreams seemed to be pushed farther and farther away, after she dropped out of high school to marry and work. She was very bright and aware of the importance of education, and she kept her dream of making an important contribution to society in the back of her mind (Interview, 1999).

When Mrs. Archuleta’s first marriage was in trouble, she made up her mind that she must turn her life around. She began working several jobs, attended night school to obtain her diploma, and then, began taking college courses, while supporting her four children (James, 1993). Mrs. Archuleta began working for a life insurance company, and was able to have her own agency within several months (Interview, 1999).

Because of Mrs. Archuleta’s success in the insurance business, she became more visible in her community, and was asked to serve on the board of a company called Mevatec Corporation. Mevatec was located in Las Cruces, New Mexico. They were a very small company with less than 50 employees and manufactured printed circuit boards for contracted commercial customers. Mrs. Archuleta observed that the company had several management problems, and as she believed that she could improve its overall performance, she bought out the other investors in 1985 (Interview, 1999).

TURNAROUND MAGIC

Nancy Archuleta had no idea of the seriousness of the situation that she would be facing with her purchase of Mevatec. By 1987, she lost a major contract, and had to lay off seventy-five percent of her employees. The economy during that time period was on a roller coaster. There was no magic wand to solve her problems. She quickly diversified into both commercial and government jobs (Poole, 1994). Then, she transitioned the company into a technical service company by 1989. Mevatec specialized in research and analysis; software engineering; systems design, development, and integration; and technical support services. The fastest growing part of the company, however, was in cost analysis and estimating, and business process re-engineering, using Activity Based

Costing/Activity Based Management (ABS/ABM). As she began to concentrate more and more on government defense work, she moved the company from Las Cruces to Huntsville, Alabama. Huntsville was a thriving community that seemed immune to defense cutbacks, and thus, work for her fledgling company was readily available. It was a haven for entrepreneurs like Nancy Archuleta (Brinkley, 1996).

Revenues began to improve after the relocation to Huntsville. Mrs. Archuleta put her own family members to work, and set out to grow her business. She started with only eight employees. A former marketing professor once gave her some advice, as she set out to conquer the lucrative defense industry. He said, "Build a business plan, as if peace were declared in the world tomorrow." (Mackowski, 1992, p.96) She did just that and more. Her plan was based upon the premise that she would never let the economy move ahead of her and dictate a decision for her. She would be ready for peace tomorrow. She decided that a solid business plan was her magic wand.

A MAGICAL CORPORATE CULTURE

"Mevatec Magic" was a term used by Ms. Archuleta to describe the environment that she wanted to create inside her company. This environment was to reflect her values and included an emphasis on the individual development of her employees. She insisted that her employees give back to the community, which had been so good to her company. She encouraged her employees to participate in various community service projects, providing time off for each employee to participate in volunteer community projects of their own choosing (James, 1993).

In the Huntsville, community, Mevatec was regarded as a leader in community service. It was especially interested in those organizations that sought to improve the quality of life for others. As a part of their management philosophy, employee contribution, as mentioned above, was given in various fund-raising, walks, and golf tournaments, where participation was appropriate. Agencies supported by Mevatec included the American Cancer Society, Hope Place, United Cerebral Palsy, Alzheimer's Association, Junior Achievement, Make A Wish Foundation, United Way and Children's Miracle Network, among others (www.mevatec.com/about/community).

The style of management that was seen in Ms. Archuleta's early years changed drastically, as she grew with her company. She made decisions in a more decentralized style by empowering her employees to be involved in all aspects of her business. She instilled a strong sense of loyalty and drive into each employee, by setting a good example for them to follow (www.mevatec.com/prod/serv). Mevatec's corporate culture could best be described as a family environment.

Ms. Archuleta described her management philosophy, "Once you delegate a task, get out of people's way and let them do it; never ask anyone to do anything that you would not be willing to do yourself; and have a great capacity for hugging." (James, 1993, p. G6) This environment promoted individual initiative and creativity with a strong sense of teamwork. She always sent out an email when she returned from a trip that said, "Come get your hugs!" (James, 1993, p. G6).

Ms. Archuleta did not place a lot of credence in organizational charts. She felt that charts tended to restrict the flow of information and make the team concept too formal. She did not make a "big deal" of executive positions. Instead, the company operated in what is termed an "information society" populated by "knowledge workers." She indicated that since this world is constantly changing, workers must be constantly learning and replacing their knowledge. She viewed leadership positions as enablers and worked to create a positive learning environment that promoted equality, rather than separation of employees and management (www.mevatec.com/careers/management).

In recognition that employees were their greatest "asset," the board at Mevatec granted employees ownership in the company. They have adopted the Mevatec Corporation Stock Ownership Plan. In doing this, Mevatec recognized that success rested in teamwork, positive attitudes, and job responsibility of all employees. It also recognized employee contributions (www.mevatec.com/careers/ownership). In addition, the philosophy for employee growth and development is summed in the term "Sheet of Music" management. In other words, employees should reach a decision about their work goals and personal goals with their managers, so that all are "singing off the same sheet." That enabled everyone to have a simple guide for all activities to maximize contribution (www.mevatec.com/careers/).

Ms. Archuleta sat on various boards in the community and served as a volunteer for several organizations. She was always willing to take personal time to mentor and coach other small minority and women business owners, as she believed in strengthening relationships by giving back to the community that had been good to her (Mackowski, 1992). The awards for Mevatec have been numerous. Ms. Archuleta and her company were recognized by President George Bush Sr. as one of the top 500 Hispanic-owned businesses in the country (She Knows Where, 1994), and President Bill Clinton as an outstanding entrepreneur and small business-owner (Strategic Defense Contractor, 1993). In 1997, she received a leadership award from the National Executive Women in Business. In 1998, Mevatec was rated number nine in the top 200 Hispanic owned and controlled businesses in Hispanic Business Magazine, and in the top 500 in Working Women's Magazine (Mevatec Corporation, 1999). In 2000, Ms. Archuleta received recognition as a Who's Who Business Executive, and the company received the White Sands Environmental Award (www.mevatec.com/about/award).

MEVATEC'S GROWTH

Since relocating to Huntsville, revenues soared from $50,000 per year to over $78 million per year in 2001 (www.mevatec.com/news/press). The other good news was that the company reduced its dependence on defense work from nearly 100% of revenue to approximately 60%. Ms. Archuleta looked for ways to use her defense technologies in the private sector. One solution was to apply computer graphics to animation. She invested money in research on computer animation and software development for commercial purposes. She saw her company's future in Hollywood, as well as in Washington (Brinkley, 1996).

Mevatec was successful in competing against the "Big Six" accounting firms, as well as long-established "cost-estimating houses." They assisted both commercial and government entities in cutting down costs and improving customer service. They also provided information technology, such as web-based applications development for both the government and commercial sectors. Mevatec was also recognized as a leader in the area of missile defense engineering (www.mevatec.com/pubrel/awards/awards). In the spring of 1997, Mevatec won the largest small business contract ever awarded by the United States Army with a contract ceiling of $844 million (www.mevatec.com/prodserv).

Mevatec expanded rapidly to include several locations by the late 1990s. Besides the headquarters in Huntsville, AL, other offices included Boston, MA, Eglin AFB, FL, Vicksburg, MS, Dallas, TX, FT. Huachuca, AZ, Alexandria, VA, New Bonnefield, WA, El Segundo, CA, Warner Robbins AFB, GA, and White Sands, NM (www.mevatec.com/locations). With these support centers and the headquarters in Huntsville, AL, Mevatec employed 475 people by 2002 (www.mevatec.com/news/press).

CONCLUSIONS

Mevatec is considered an energetic technical services company, whose main strategy was focusing on engineering services, supporting both commercial and governmental sectors of the economy. It has experienced significant growth from eight employees in the mid-eighties to approximately 475 employees today. While still a small business, this company clearly gets the job done with the explosive talent that it has been able to attract. This is due to its unique company culture that begins with a truly innovative entrepreneur and other leaders, who call themselves team players, rather than executives. The company focuses on quality and places its employees on the same level of importance as their customers. “Everyone a coach, everyone a player” is the continuing education hope for each employee from Mevatec. This results in a culture that is enthusiastic and dedicated to customer satisfaction, because the company is a real team (www.mevatec.com/about).

As an indicator of the promising future of Mevatec, the company logo is the Zia, which comes from the Zuni Indians in New Mexico. It is used as a reminder to the company that it is based in tradition and the name Mevatec, which is imposed over it in a forward slant, indicates forward movement toward the future (www.mevatec.com/about/logo).

Mevatec has several mission statements for different divisions of the company. The general one states, “At Mevatec, we value our customers, our employees, and our community. We take pride in our solutions, insist on integrity, and accept individual responsibility for our actions. We seek balance and harmony in our life” (www.mevatec.com/career/careers). From the marketing standpoint, the mission reads, “Responding to our customer’s needs and continually reviewing our processes to be faster, better, less expensive” (www.mevatec.com/perspectives/sales). These mission statements summarize Mevatec best.

Mevatec is well positioned for future success with an array of technical capabilities, excellent management, energetic and loyal employees, a strong financial base, and Nancy Archuleta. Mevatec and Nancy Archuleta simply provide professional consulting services that show other companies how to improve their competitive position. This is accomplished by offering e-learning courses and classroom training for interested businesses. She teaches others what she does best--how to manage. Her magic wand seems to be working overtime. You can almost see the pixie dust!

QUESTIONS

1. Analyze Mevatec's internal strengths and weaknesses and external opportunities and threats.
2. What generic and grand strategies does Mevatec use, and how does Nancy Archuleta's management philosophy support the use of these strategies?
3. Describe this company's corporate culture and discuss how it supports the employee.
4. How has Nancy Archuleta's background contributed to her success? What specific entrepreneurial traits does she possess?
5. What future issues or problems might Mevatec face? Why has this small business been able to weather the downturn in our economy simply by being a consulting service firm?

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