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JoAnn C. Carland, Western Carolina University

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JOURNAL OF THE INTERNATIONAL ACADEMY FOR CASE STUDIES

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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.

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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.

JoAnn Carland
Western Carolina University

PHYSICIAN'S DILEMMA: BALANCING SERVICE AND PROFIT

C. Angela Letourneau, Winthrop University
Scott R. Lyman, Winthrop University

CASE DESCRIPTION

The primary subject matter of this case is the application of multiple-product breakeven analysis to a physician's office practice. It allows for the discussion of the different types of medical reimbursements, such as Medicare, Blue Cross/Blue Shield, and Private Insurance. The decision faced by the physician is which patient mix should be seen in order for the practice to be both profitable and still allow him to serve his constituents. The case has a difficulty of level of three (appropriate for junior/senior level courses). The case can be taught in one or two class periods depending on the number of issues considered, and is expected to require two hours of outside preparation by students.

CASE SYNOPSIS

Health care is currently operating in a very turbulent regulatory environment. Changes in physician reimbursement require the physician to pay more attention to the financial side of the practice. Government's nearly continuous change in compensation to physicians produces a varying set of profitable and unprofitable services. This case uses a multiple-product breakeven analysis to examine the difficult situation that a physician finds himself in as he works harder, gets paid less, and faces bankruptcy. He turns to his office manager, our student, seeking help. The case puts students in a position to analyze the financial data, using various accounting techniques including multiple-breakeven analyses to help our physician, Dr. Good Hearted, reach some conclusions about what he should do. By examining the fixed and variable costs of service in a physician's office, students can make different assumptions about the revenues to determine how they influence the physician's revenue and client mix. Developing a solution requires the student to calculate multiple breakeven analyses from various reimbursement sources. The students are then required to recommend to Dr. Good Hearted what course of action he should follow. This case represents a very realistic picture of what physicians are now encountering in delivering health care in a new environment.

SITUATION

Dr. Good Hearted is in local practice in Anywhere, USA. He sat down at the end of a very long day of seeing patients in the office. It was 7:00 pm; he had seen 51 patients today and had made rounds in the hospital. Some of the patients had really been sick and two of them were admitted to the hospital. He knew that he should go to the hospital before heading home. Just then

Sandy, the business manager of the practice, knocked on the door. He looked up and knew that it was not going to be a pleasant conversation. Sandy said that the practice was in very serious financial trouble and she was not sure they could make payroll next week. Dr. Good Hearted looked at Sandy and said, "I am frustrated. I am seeing more and more patients and yet we seem to fall further and further behind financially. How can this be?"

Dr. Good Hearted graduated from medical school as a family practice doctor 15 years ago. He had his own practice in a town of about 70,000 people. His office staff had grown in the last four or five years as he started seeing more patients. He mentioned all this to Sandy and said, "I am angry and puzzled about this. How can I be seeing more patients and working harder and yet have more financial problems?" He had talked to some of his colleagues and they had mentioned the same problem. He shook his head and said to Sandy; "I am a smart person, why can't I figure this out?" He looked over the financial reports that Sandy gave him. Sure enough he was seeing more patients but bringing in less money. The other thing he noticed was that his expenses had gone up. He asks Sandy to come in the office on Saturday so they can spend the morning together going over the books and see if they can figure out what is happening.

Dr. Good Hearted knows that he should go by the hospital and check on the two patients he had admitted that day but he is so tired and frustrated he decides not to. He stops by his favorite restaurant and has dinner and goes home and thinks about what he might learn on Saturday when he and Sandy go over the books.

BACKGROUND

Dramatic changes have taken place in U.S. health care since the introduction of prospective reimbursement i.e. (Diagnosis Related Groups). These changes have affected all health care providers including hospitals, clinics, and physicians. This case focuses on the changes that have taken place in a typical physician's office practice. Much of health care is still delivered by physicians in their office. However, the physicians' office has become much more complex as the essential nature of the health care system has changed. The days of the physician being paid by patients with whatever they had to offer, i.e. farm produce, cash, or some other form of barter are long over. Now physicians receive the bulk of their reimbursement from insurance companies or the government. As government officials attempted to control health care costs, they also introduced new mechanisms to control cost while expecting the physician to maintain the same level of service and quality of care. Physicians are caught in this dilemma--balancing their desire to provide service with the need to make a profit in their practices.

Dr. Good Hearted is a family practice physician who is facing this dilemma and is frustrated by his situation. His situation is typical of many family practice doctors. He is working more and seeing more patients but his financial situation in his practice seems to be worsening. He cannot understand how that this is happening. Dr Good Hearted is in a single physician practice, which he has been in for the last 15 years. He likes his patients and he likes the small town of 70,000 where he lives. He thinks back over the last five years and he realizes that his office staff has grown since he first started. He knows that he needed additional people to deal with all the paper work. The number of insurance companies and service contracts he deals with has climbed from three to well

over 50. He needed the people to file the insurance and process all the paper work that was necessary to get reimbursed. He also realizes that he started seeing more patients over the last five years. During that time the increase in patients was enough to keep the office afloat. But now his office manager says they may not be able to meet payroll. He is very upset by this. Before he goes to set up a meeting with the manager he looks at the reimbursement data from Medicare. He notices that in some cases Medicare is actually going to pay less in 2002 than it did in 2001. He thinks about this and realizes this might be a clue to some of his problems. He knows that Medicare is trying to control cost and one way to control cost is to reduce reimbursement. He goes to find the office manager and sets up a meeting where they will go over the budget for the year.

BUDGETED COSTS

Dr. Good Hearted looks over the budget for the year. The budgeted costs are broken down into fixed cost and variable cost and are displayed in Table 1 below.

Table 1: Cost Classification

Variable Costs:		
	Medical supplies per visit	$ 0.50
	Office supplies per visit	0.50
	Total variable costs per visit	$ 1.00
Fixed Costs:		
	Building rent (5,000sq ft @ $20 per sq ft)	$100,000
	Non physician salaries	110,000
	Physician salary	75,000
	Benefits	42,000
	Utilities	15,000
	Office equipment (computer, etc)	10,000
	Total fixed costs	$352,000

He looked over the fixed costs--he knows they have risen but he cannot see anyway to reduce them. He first looked at the rent he is paying for the building. It is in a good location, it has lots of parking. Although it is not fancy, it is adequate. He has the following four staff members: an office manager, a receptionist/medical records, an insurance person and a nurse. They are well paid but they work very hard and are dedicated to him and the work they do. Currently, Dr. Good Hearted is collecting a salary of $75,000 a year. That is down over last year, and he took a pay cut to help out the practice. But that is part of his frustration, he is working harder and seeing more patients but he is not making as much money. Benefits for himself and his staff are cut to the bone. He is paying for the minimum benefits but these benefit costs keep rising every year. His health care bill goes

up each year, usually more than inflation. His utilities are relatively constant and he has city power, sewage and water, and private garbage for his regulated medical waste. His office equipment was high this year because he bought a couple of new computers and created a LAN in the office. He felt this was necessary because he needed to increase the efficiency of the staff and help with timelier insurance filing. His variable costs were always hard to figure. But he had decided that he had two truly variable cost, medical supplies and office supplies. He felt that these cost did vary directly with the number of visits and that he could assign them a price. He thought that both medical supplies and office supplies were $.50 each for each visit. He sat back in the chair and said to Sandy, " That is about as clear as we can make the cost. We are running a tight operation and we are trying to provide quality service." Now Dr. Good Hearted knew the other side of the equation had to be dealt with and that was the revenue side.

BUDGETED REVENUE

Dr. Good Hearted knew that the revenue side of the equation had always given him the most problems. If he could just get his fee paid he would be happy. The fee that he charged would cover his fixed cost, variable cost, and profit. If he could get his fee he would be in good shape. But he never got paid his fee; in fact, in many situations he got half of his fee. See Table 2 for his average reimbursement per patient visit.

Table 2: Reimbursement Schedule

Medicare Reimbursement:	$18.58 per patient visit
Blue Cross Blue Shield Reimbursement:	$23.96 per patient visit
Private Insurance Reimbursement:	$25.80 per patient visit

With Medicare adopting a prospective reimbursement he got a fee set by the government. Some years that fee was less than the year before. He knew that was because the government was trying to control the rise in health care cost but he did not want that at his expense or his patients. He had to watch as private insurance companies including BCBS had started to pay a percentage of Medicare fees. One private insurance company was paying 125% of the Medicare fee. He had very little control over these fees and he could find no insurance company that would pay his full fee. He shook his head and then plowed ahead with the assumptions that he was making for his revenue side of the equation.

1. He assumed that he would work 50 weeks a year and work in the office for 40 hours per week. He knew that he would work more hours but the additional hours would be in the hospital and he would bill that separately. Now he was concerned with his office practice only. Thus he would have a total of 2,000 physician hours.

2. He assumed that he could have 8 brief encounters with patients per hour of time. He knew that some hours he would have more and some less but that had been his average.

Now Dr. Good Hearted told Sandy, the business manager, "We have a bunch of issues here and I'm not sure what can be done. I can't just refuse to see Medicare patients, but if I see too many it will ruin my practice. Lets look at the questions and see what the issues are and what can be done."

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CASE QUESTIONS

1. How do physicians get paid?

2. Calculate Net Income (ignore taxes) for the year under the following circumstances:
   a. Assume only Medicare patients are seen
   b. Assume only BCBS patients are seen
   c. Assume only private insurance patients are seen.

3. Total profit maximization would occur with no Medicare patients and only private insurance. Two problems present themselves in this situation: 1) a Doctor's ethical responsibility is to provide care to those in need--can he in good conscience exclude Medicare patients? 2) What happens if the physician has unused capacity i.e. more time to see more patients?

4. What are the consequences when you have multiple sources of revenue at different rates?

5. Determine the Net Income (ignore income taxes) if Dr. Good Hearted's patient mix is as follows: Medicare 50%; BCBS 35%; and Private Pay 15%.

6. Determine the number of hours Dr. Good Hearted must work to break-even if the patient mix is as follows: Medicare 50%; BCBS 35%; and Private Pay 15%.

7. Recommend a product mix that maximizes profit while allowing Dr. Good Hearted to serve a balanced patient mix.

8. What else can the physician do other than change product mix?

CUSTOM MADE SADDLE COMPANY

Calvin M. Bacon, Jr., University of Arkansas at Little Rock
Steve W. Edison, University of Arkansas at Little Rock

CASE DESCRIPTION

The primary subject matter of this case concerns the marketing mix of a business. Secondary issues include small business management and budgeting. The case has a difficulty appropriate for junior or senior level. The case is designed to be taught in one or two class hours and is expected to require two to three hours of student preparation time.

CASE SYNOPSIS

Ben and Linda Black started Custom Made Saddle Company after a 3,000-mile trip on horseback in 1982 during which their horses began showing saddle sores. As he rode, Ben Black started thinking of ways to improve the saddle to prevent injury to the horse. When he returned home, he patented a design that allowed the horse to move freely in their natural motion. This eliminated bruises and sores on the horse and increased the ability of the horse to perform. Further, it was more comfortable for horse riders.

The couple started a business based on the new saddle design and soon sold saddles to many types of riders. Custom Made Saddles had an excellent reputation, and the company soon itself as the preferred maker of saddles for endurance racing. Ben and Linda made the strategic decision to apply for patents and trademarks and to use sales revenues to advertise, to create new products, and to develop new processes. For the Blacks, creating the best saddle in the world was an obsession.

THE COMPANY

The owners of Custom Made Saddle Company always considered the company "more than just a manufacturer of high-quality saddles and tack." They felt the business was really about treating horses humanely and enabling people to ride horses in comfort. To achieve this vision, Ben Black and his wife Linda created new saddle designs incorporating high-technology materials.

The designs were so radical for the saddle-making industry that the Blacks applied for and received patents on several of them. The Blacks envisioned using modern technology to advance saddlery while maintaining the "sensuous romance" of riding a horse. The overall concept of the designs was to allow horses to move freely in their natural motion. This led to the elimination of bruises and sores on the horse, to an increase in the ability of the horse to perform, and to more comfort for horse riders.

Custom Made Saddle Company was as revolutionary with its business model as it was with its products. It was the first custom saddlery to produce in large volumes. It was also the first

saddlery in the industry to sell direct to the customer through mail-order catalogs. Ben and Linda Black relished the idea of "breaking all the rules."

There was resistance within the equestrian equipment industry to the company's approach to the saddle business. In particular, dealers did not like the idea of Custom Made selling direct. If other saddle makers adopted the practice, dealers stood to lose a substantial amount of business. Further resistance came from riders who wanted to keep saddles the way they had been for years. They suggested the new technology used in Custom Made saddles was simply a sales gimmick.

To overcome these concerns, the Blacks began major promotions. First, Linda researched horse anatomy and wrote technical articles for equestrian publications on the proper fit of a saddle. The articles explained in detail the theory behind the Custom Made technology and lent credibility to the company's expertise. In addition, the articles referred to the couple's 3,000-mile trip which established them as experienced endurance riders and added a certain mystical quality to the company and its products. Second, the company began offering a 30-day money-back guarantee. This helped overcome the reluctance of buying a $2,000 saddle without seeing it beforehand. Third, the company began attending dealer shows such as the National Western Stock Show and the Hoosier Horse Fair. Attending shows helped the company build a relationship with customers and helped to create an "exclusive" image of the product.

THE EARLY HISTORY

Ben Black's parents owned a car dealership in Nevada, Missouri where he grew up. After he left high school, Ben enlisted in the air force and became an aircraft mechanic. Once his term of duty expired, he returned to his hometown and began a bulldozing company, which ultimately failed, leaving him with almost $180,000 in debt. He then began working in the family business eventually becoming the general manager.

Linda Davis loved horses, the outdoors, and writing. She had fantasized about taking a cross-country horse ride since she was 12 years old. She realized her dream in 1982 when she and Ben went on their now-famous 3,000-mile journey. She and Ben lived in a small one-room apartment on the family farm. While Ben was busy at the dealership, Linda worked at the local radio station as an announcer, an ad sales person, and the news director.

After they returned from their long trip, Ben began tinkering with some saddles in the old barn behind their apartment. He made the first Custom Made type saddle in 1985, the same year Linda published a five-part article on saddle fit in Trail Blazer Magazine. The article was well received and the Blacks began getting inquires into the new saddle design. Ben immediately applied for a patent that he later received.

Sensing a market for the new saddle, the Blacks began placing high-quality, full-page color ads in equestrian magazines. Soon they had revenues from more than 100 saddles, which covered their advertising, materials, and equipment costs. Because money was tight, Ben and Linda took no salaries.

In March of 1987, Ben sold the family business and started working on saddle production full time. Linda joined him and was in charge of sales, accounting, and shipping. It was common

for them to work fourteen hours a day, seven days a week. They called the newly formed company Black's Performance Saddle Company.

The couple convinced some competitive horse riders to use the saddle, and it became well known for its performance. Soon many of the top riders in the Purina Race of Champions were using the company's product. The initial success led the Blacks to expand their product line to include innovative designs for tack (accessories) which further elevated the image of the company.

EXPANDING THE COMPANY

In 1988, the Blacks added a line of English saddles and expanded their line of Western saddles. Western saddles were larger and generally more comfortable than English saddles. Western saddles were used for pleasure riding, and performance riding while English saddles were small, formal saddles mainly used in horse shows. Custom Made English saddles were a major improvement over the traditional English saddles that were known for their stiff, hard ride. In particular, female riders preferred it. To grow their product lines, the Blacks moved into a larger facility and hired employees.

Table 1: Custom Made Sales Growth

Year	Sales	Employees
1985	n/a	2
1986	$240,000 (est.)	8
1987	440,000 (est.)	12
1988	614,079	15
1989	1,046,116	24
1990	1,376,355	40
1991	1,931,025	60
1992	2,471,030	72
1993	2,495,461	75
1994	2,904,782	85
1995	4,270,106	100
1996	4,627,932	110 (est.)
1997	3,215,372	90 (est.)

In 1989, the firm began promoting its saddles to a broader market. It continued the use of articles explaining the issues of saddle fit, but began placing them in various regional publications and focused magazines. To further establish the company as saddle experts, Ben traveled around the country conducting clinics on saddle fit and listening to customers. He used the feedback to develop saddles for roping competitions and hazing competitions.

In 1990, the Blacks continued to spend heavily on advertising and education. Marketing costs climbed to more than 35 percent of sales as the pair tried to overcome resistance to change within the equestrian markets. The company produced the highest quality of catalogs to reinforce the image of exclusive products made to the highest quality standards.

In 1991, John Lyon endorsed the company's products. This was significant because Mr. Lyon was the best-known horse trainer in the industry. In return for the endorsement, the company became one of Mr. Lyon's national sponsors. The marketing efforts began showing positive results as sales increased past breakeven, and the company showed its first profit.

A RUN OF BAD LUCK

Tragedy struck the firm in 1991 when Ben Black had a motorcycle accident that nearly ended his life. He suffered major head injuries causing him to lose his memory as well as his sense of taste and smell. Loyal Custom Made customers were stunned. Many questioned what would happen to the company.

Although the doctors did not give Ben much of a chance to recover, his health improved enough in a month to be released from the hospital. He immediately returned to work and found that in his absence, the operation had lost direction. He took over the struggling firm and led it to continued sales growth. Within a year he was fully recovered and again performing saddle fit clinics across the country. Still, some people claim that he was not the same after the accident.

In 1992 the company switched from selling direct to selling through dealers to gain market penetration. The dealers, used to selling standard products, did not understand how to sell custom saddles. Orders for saddles were difficult to produce, if they could be produced at all. The company decided that orders from dealers were just too costly and the use of dealers was discontinued. Marketing, however, continued to be a major focus of the company. A full color catalog of the company's 35 models of saddles was created. The printing and mailing of 28,000 copies of the catalog cost more than $50,000.

In 1993, Modern Saddletree Company, the firm's only supplier of saddletrees, increased its prices. This was not the first price increase for Modern, and Ben decided the prices were totally unreasonable. He began thinking about making his own saddletrees, but he thought the process should be automated. Because there was no one making machinery for producing saddletrees, Ben designed one himself. He worked with a machinist in Lamar, Missouri to develop a working model that he planned to use for production of his own saddletrees.

As the company continued to expand its capabilities, it began marketing its products overseas. Ben felt the company had a definite advantage in comfort and fit, especially in the English-style saddle popular in Europe. Because shipping costs were high for the heavy saddles, the company decided to partner with an English saddle maker. The firm spent considerable time finding an English producer who could make saddles to the company's standards. Once he located an English producer, Ben found a dealer who could distribute the saddles. The final step was to find a way to introduce Custom Made saddles in a big way. The company established a relationship with the Yorkshire Riding Centre, which helped the company equip competitive riders with Custom Made products.

Unfortunately, when it came time to start distribution, the dealer failed to perform. This sent the entire project into disarray. Without a way to distribute the product, the company was forced to shut down the operation. Black recognized that without the projected European sales, the firm would not meet its sales goals. As a result, he increased the company's domestic marketing efforts by printing and mailing 48,000 catalogs to prospective customers although the failed attempt at entering the European market had sapped a lot of money out of the firm.

CASH SHORTAGES

Early in 1994 the company found itself in a cash crunch. Marketing expenses were high and sales had slowed considerably. Ben Black quickly began looking for a way to keep the business afloat. After discussing his situation with lenders, he was able to reach an agreement with Sack River Valley Bank in Stockton, Missouri. The bank agreed to provide the company with a Small Business Administration loan of $300,000 if it would place a saddletree-making operation in Stockton. The company used $140,000 of the money for working capital in order to produce the saddles in the backlog. The other $160,000 was spent on the development of three new catalogs and two books on saddle fit. Ben planned on increasing sales past the breakeven point and to use the profits to create a saddletree facility.

To further stimulate sales, Ben created a promotion called the "500 Preferred Buyers Club" which entitled members to a $500 discount on saddles and wholesale prices on accessories. The December mailings were used to promote the program. Customer response was enormous. Black estimated that orders from the 500 Preferred Buyers Club would take about a year to produce. Finally the company would be able to plan production requirements ahead of time so it could process orders efficiently.

The company started 1995 with a huge backlog. Employees were busy making saddles, and production was running more smoothly than at any time in the history of the company when the unexpected happened. The facilities of the company's sole supplier of saddletrees burned to the ground. Another supplier who could make saddletrees in the volumes needed by Custom Made simply did not exist. So to keep the factory going, Ben Black was forced to press his automated saddletree equipment into service sooner than expected.

Because the company did not have the money for the saddletree equipment, Black went back to the bank and got another SBA loan for $230,000. This allowed the company to buy the equipment and move saddle making into the Stockton facility. However, all the saddletree patterns were lost in the fire, so Black had to re-create them. Knowing that he would need the patterns in the future, Black improved the old patterns by making them in cast aluminum. This made them much more durable. At the same time, he decided to improve the saddletrees with stronger materials. He developed a fiberglass reinforcement system that dramatically improved the strength and the lifespan of the saddletrees. In fact, the new saddletrees were so much better than the old ones, the company began offering a lifetime guarantee on the Custom Made saddletrees in its saddles. After only a month and $700,000 in expenses, the new Custom Made saddletree plant was in production.

Initially, the saddletree operation had some problems. Quality of the saddletrees varied a great deal, and as a result waste and rework was extensive. This caused production expenses to

skyrocket. However, because the company had much more saddletree-making capacity than it needed, Black decided to leverage the firm's capabilities by offering "conversion" saddles. A conversion saddle was one that a rider already owned that the company would retrofit with the Custom Made Panel System and new saddletrees. This way, customers could get a saddle with the unique features of a Custom Made saddle for a lower price. Custom Made conversions were an instant hit with the customers. The company sold more than $100,000 worth of conversions in the first year. In fact, conversions were so popular, that Dee Pickett, an eight-time world champion roper, agreed to endorse Custom Made saddles in return for $60,000 plus 30 conversion saddles. Soon all the top ropers were using the company's saddles or conversion saddles.

Sales continued to be strong in 1996 so the company decided to discontinue the 500 Preferred Buyers Club program. In addition, the company raised prices ten percent to provide more funds for advertising. Black decided that the firm needed to create an advertisement piece that would be noticable, an ad that would set Custom Made product apart from the others. He bought expensive double-gate-fold ads in Western Horseman, Horse and Rider, and Horse Illustrated. Each advertisement showed the entire catalog of the firm's saddles including the newly redesigned Western Saddle line. The company had calculated that millions of riders would receive the magazines and anticipated stepping up production to meet the new demand. However, most people did not bother opening the pages of the ads, and did not see the impressive layout of saddles. In fact, few customers reported even seeing the ads.

Table 2: Market Segmentation for Custom Made Saddles

Market Segment	Percentage of Sales	Customer Profile
Pleasure Riders	71	Older riders looking for comfort or who might have chronic back problems. Young, inexperienced riders needing a safe mount. About 80% women.
Endurance Competition Riders	10	Riders needing their horses to be free from sores or injuries from long rides.
Roping Competition Riders	10	Riders needing their horses to be free from sores or injuries from long rides.
Dressage Competition Riders	5	Riders needing comfort on the most uncomfortable saddle style.
Gaited Horse Riders	4	Riders needing a large range of horse movement.

At the start of 1997, sales slowed again and the company was forced to lay off employees. It was clear now that catalog mailings were more effective than ads, but now there was no money available for new catalogs. Furthermore, it became apparent to Black that without catalogs, selling directly to the customer would not work. Therefore, the company again decided to sell through dealers. Within a few months, there was a network of more than 100 dealers. Black did not want

a repeat of the first efforts to use dealers, so he brought them all to Kansas City, Missouri for training. By the end of the year, the company began seeing dealer orders for Custom Made saddles.

In early 1998, Custom Made Saddle Company had an extreme cash shortage. The growth of the business and the many changes had required the company to use all the cash reserves and to get additional funding. It had borrowed as much money from the local banks as the bankers were willing to lend. The company now was looking for new sources of cash.

THE FINAL SEARCH FOR CASH

In early 1998, Ben and Linda were seeking a lender to provide working capital. The Blacks expected a lender to assume its current loans and real estate in the process. Metz Banking Company in Metz, Missouri and Sack River Valley Bank in Stockton, Missouri held the company's loans. The banks had lent as much as they could, and all other local banks had refused to lend additional money. Custom Made Saddle Company had more than a half million dollars worth of orders in hand with no working capital with which to fill them.

Because the Blacks were unsuccessful in securing local funding, they began looking for sources outside Missouri. They discovered that other state governments offered financial incentives for companies relocating to their states. The Blacks were willing to move to get the financing; however, the loan from Sack River Valley required them to keep the saddletree production in Stockton. It could be moved only after the loan was repaid.

To satisfy the needs of the company and all the creditors, the Blacks proposed to move the production of saddletrees, Western saddles, silver adornments, and leather carvings to another state. English and Distance saddles would continue to be made in Nevada, Missouri. Furthermore, the Blacks agreed to sell the family farm and to invest the proceeds in the company to reduce debt. Lenders were skeptical that the company could afford to move any of its facilities, but Ben Black assured them that his production methods were highly automated and required little training of workers. He explained how the move would be relatively simple and the startup relatively quick.

Ben called the Arkansas Department of Economic Development which, in turn, contacted Arkansas Capital Corporation. The Arkansas organizations had worked together frequently in efforts to create jobs in areas of the state with high unemployment. After a few discussions with Ben, Arkansas Capital Corporation agreed to assume the SBA loans using the patents and equipment for collateral. In addition, they lent Custom Made $550,000 to buy an 85,000 foot building in Warren, Arkansas for the production of saddles and saddletrees. Then Enterprise Corporation of the Delta made the critical working capital loan to the company. The loan was capped at $625,000 and was collateralized by inventory and accounts receivable.

Custom Made Saddle Company, Inc. Balance Sheets (Ending December 31)				
ASSETS: Current Assets:	1994	1995	1996	1997
Cash	$ 68,903	$ 33,461	$ -	$ 6,669
Accounts Receivable	-	136,115	28,995	79,667
Inventories	916,642	1,185,309	824,709	677,193
Other	4,030	97,109	350	125
Total Current Assets	989,575	1,451,994	854,054	763,654
Long-term Assets:				
Property, plant, and eqmt.	545,472	1,039,512	834,587	847,121
Less accumulated depreciation	181,283	240,627	313,324	387,126
Total Long-term Assets	364,189	798,885	521,263	459,995
Other Assets				
Patterns and molds	-	-	210,516	192,510
Patents	-	-	27,949	39,095
Saddles on loan	-	-	75,250	19,952
Other	7,712	22,551	29,636	36,769
Total Other Assets	7,712	22,551	343,351	288,326
TOTAL ASSETS	1,361,476	2,273,430	1,718,668	1,511,975
LIABILITIES AND EQUITY: Current Liabilities:				
Notes payable	22,339	292,103	217,563	244,055
Current portion of L-T debt	-	101,239	105,000	77,000
Bank overdraft	-	81,072	38,843	-
Accounts payable	192,637	379,044	315,926	235,609
Customer deposits	139,040	605,345	412,391	393,199
Accrued Expenses	22,338	40,278	40,357	45,910
Total Current Liabilities	376,354	1,499,081	1,130,080	995,773
Long-term Liabilities	594,813	621,052	512,471	445,453
Total Liabilities	971,167	2,120,133	1,642,551	1,441,226
Stockholders' Equity:				
Common stock	23,760	23,760	56,000	56,000
Additional paid in capital	46,681	46,681	40,048	40,048
Retained earnings	519,914	282,902	180,115	174,747
	590,355	353,343	276,163	270,795
Less treasury stock	200,046	200,046	200,046	200,046
Total Stockholder's Equity	390,309	153,297	76,117	70,749
TOTAL LIABILITIES AND EQUITY	1,361,476	2,273,430	1,718,668	1,511,975

NEXT STEPS

With the additional cash, Ben Black contemplated the next steps for the company. He really wanted to develop a plan to reinvigorate the business. He wondered: How could he leverage the dealer network to increase sales? Should he increase promotions? Should he standardize products to reduce costs? Ben expected the move to Arkansas to help reduce costs in the long run, but he was not sure how to time the move. He had a gentleman's agreement with the Arkansas Lenders to move the operations, but he was not sure how much time he had to turn the company around.

Custom Made Saddle Company, Inc.
Income Statement (For the Year Ending December 31)

	1994	1995	1996	1997
Net Sales	$2,904,782	$4,270,106	$4,627,932	$3,215,372
Cost of Goods Sold	695,247	2,613,374	2,940,622	2,165,984
Gross Profit	2,209,535	1,656,732	1,687,310	1,049,388
Operating Expenses Selling	154,051	1,064,812	1,031,354	437,206
General and administrative	2,030,114	758,782	610,310	512,947
Research and development	22,823	-	59,727	20,350
Total operating expenses	2,206,988	1,823,594	1,701,391	970,503
Operating Income	2,547	(166,862)	(14,081)	78,885
Other income (expenses)				
Interest income	-	3,799	838	1,234
Interest expense	-	(83,869)	(89,241)	(84,496)
Other	(1,061)	(77)	(303)	(991)
Total other income (expenses)	(1,061)	(80,147)	(88,706)	(84,253)
Net gain (loss) before taxes	1,486	(247,009)	(102,787)	(5,368)
Income taxes Current	-	-	-	-
Deferred	-	(4,054)	-	-
Total Income taxes	-	(4,054)	-	-
Loss before change in accounting principle	-	(242,955)	-	-
Change in accounting principle	-	5,943	-	-
Net profit (loss)	1,486	(237,012)	(102,787)	(5,368)

BENCHMARKING THE ACCOUNTING AND FINANCE FUNCTIONS OF HONG KONG LISTED FIRMS: PERSONNEL AND COST OF OPERATION

Steven P. Landry, Monterey Institute of International Studies
Terrance Jalbert, University of Hawaii at Hilo
Wai Yee Canri Chan, Monterey Institute of International Studies

CASE DESCRIPTION

The primary subject matter of this case concerns benchmarking. Secondary issues examined include data summary and analysis. The case has a difficulty level appropriate for the undergraduate level. The case is designed to be taught in 1.5 class hours and is expected to require one hour of outside preparation by students.

CASE SYNOPSIS

In this case, students are provided raw data related to a survey of 633 listed Hong Kong firms. The survey was sponsored by the Hong Kong Society for Accountants, Financial Management Committee. The survey consisted of 32 questions that addressed seven areas of interest related to the accounting and finance functions within the firms. Sixty-seven firms responded to the survey crossing six different industries and a variety of capitalization levels. Using the data, students are required to develop benchmarks for other firms. The benchmarks can be used by firms to compare their operations to those of other similar firms. Students are also required to comment on the resulting benchmark figures.

INTRODUCTION

Improving and enhancing products, services and operations are critical factors for firm survival in the globally competitive market. Benchmarking represents one method a company can use to assess its performance and competitiveness. Benchmarking is the process of evaluating one firm, called a baseline, to a group of peer firms, particularly with respect to best practices. An attribute of one firm is compared to the same attribute of the peer group. This process allows organizations to identify important areas for improvement, analyze outstanding practices within and across the industry, and implement changes to enhance and improve performance. These changes can enhance competitiveness and ultimately improve profitability.

To develop the baselines, 633 listed companies in Hong Kong were surveyed under the auspices of the Hong Kong Society of Accountants (HKSA) and the Financial Management Committee of the HKSA. The survey contained thirty-two questions related to seven different areas

of interest. The survey instrument is presented in Appendix 1. In this case we are concerned with sections A and B of the survey which relate to the nature of the accounting/finance function as well as its cost. The data are attached in Appendix 2. In this case, students are required to compile the results of the survey for use as a benchmark for other firms.

Surveyed firms were classified into seven groups based on the industry within which the firm operates. The seven classifications are Consolidated Enterprises (CE), Financial (F), Hotels (H), Industrial (I), Property (P), Utility (U) and Miscellaneous (M). Classifications were made based on the collective opinion of the HKSA Financial Management Committee. The survey was mailed and responses were received during the first half of 2000. A total of 67 surveys were returned. That constituted an overall response rate of 10.6 % (67 out of a possible 633). Response rates for the various industries ranged from 0% for the hotel industry to 25% for the utility industry. Note that given the zero response rate, the hotel industry was omitted from this study.

Table 1: Capitalization of Response Firms

Industry	Market Cap in HK$'million										
	50 or less	50-100	100-200	200-300	300-400	400-500	500-1000	1000-2000	2000-5000	Above 5000	Total
CE	0	1	2	2	0	2	4	5	0	4	20
F	1	0	2	1	1	0	1	1	0	4	11
H	0	0	0	0	0	0	0	0	0	0	0
I	0	3	4	3	3	0	5	3	3	0	24
P	0	1	5	1	0	1	1	0	0	0	9
U	0	0	0	0	0	0	0	0	0	2	2
M	0	0	0	0	0	0	1	0	0	0	1
Total	1	5	13	7	4	3	12	9	3	10	67

QUESTIONS

Question A Based on the data spreadsheet provided and using the suggest work sheet format shown below, develop the baseline for each section.

Table 2: Ratio of Finance Staff to Total Staff					
Industry	Responses	Average	Median	Max	Min
CE Total					
F Total					
I Total					
P Total					
U Total					
M Total					
Overall					

Table 3: Ratio of Qualified Finance Staff to Total Finance Staff					
Industry	Responses	Average	Median	Max	Min
CE Total					
F Total					
I Total					
P Total					
U Total					
M Total					
Overall					

Table 4: Average Per Person per Year (Accounting & Finance Staff) Remuneration					
Industry	Responses	Average	Median	Max	Min
CE Total					
F Total					
I Total					
P Total					
U Total					
M Total					
Overall					

Table 5: Ratio Finance Staff Remuneration to Total Staff Remuneration					
Industry	Responses	Average	Median	Max	Min
CE Total					
F Total					
I Total					
P Total					
U Total					
M Total					
Overall					

Table 6: External Cost per Accounting & Finance Person					
Industry	Responses	Average	Median	Max	Min
CE Total					
F Total					
I Total					
P Total					
U Total					
M Total					
Overall					

Question B: Briefly interpret the figures you got from the tables prepared in Question A.

Question C: What benefits might one obtain from such benchmarking data as provided in this case?

Question D For each indicator we calculate in Question A, we calculate both the median and the mean. Which one do you think best represent the reality and is best used as the benchmark figure?

Benchmarking Questionnaire - Finance and Accounting Function

I. What industry does your firm operate in? _____
II. What is the capitalization of your firm? _____

A. Information concerning your accounting and finance staff.

1. How many staff are there in the company? ____
2. How many accounting and finance staff are there in the company? ____
3. How many "qualified" accounting and finance staff are there in the company? ____
   (Qualified means a professional designation such as HKSA, CA, ASCPA, CIMA, ACCA, CMA, AICPA, etc.)
4. Is there a Finance Director on the Board of Directors? Yes: _____ No:__ _
5. Is the Finance Director a qualified accountant? Yes: _____ No:____
6. Is the Finance Director an HKSA member? Yes: _____ No:____

B. Information regarding the cost of operating and training your accounting/finance function during your most recent operating year.

1. What was the total staff remuneration (including benefits) for your company? $_____ M_____
2. What was the total accounting/finance staff remuneration (including benefits)? $_____M____
3. What was the total external cost of training the accounting/finance staff? $_____M____

C. Information with regard to Planning, Forecasting, and Budgeting.

1. How many weeks are required per year to prepare and complete the annual budget? _____weeks
2. How many Man-Days of total company staff are required per year to prepare the annual budget? _____ Man-Days
3. How many Man-Days of the accounting/finance staff are required per year to prepare the annual budget? _____ Man-Days
4. How many weeks, on average, does it take to prepare a financial forecast for year end profits? _____ weeks
5. How often per year does your company update its financial forecasts for year end profits? _____ times per year
6. How many Man-Days of total accounting /finance staff are required per year to update the financial forecasts for year end profits? _____ Man-Days
7. Does your company use a rolling forecast? Yes:_____ No:_____

D. Information with regard to interim management accounts.

1. How often does your company prepare management accounts?
   a. Monthly _____ b. Bi-monthly _____
   c. Quarterly _____ d. Half-yearly _____
   e. Others (please specify) _____
2. How many Man-Days of the accounting/finance staff are required per year to prepare the monthly management accounts? _____ Man-Days
3. Management accounts are available within how many business days after the close of the relevant period? ____ Days
4. Who are the internal recipients of the monthly management accounts? (Please check all that are appropriate)
   a. Chief Executive Officer _____
   b. Chief Financial Officer _____
   c. Board of Directors _____
   d. Divisional/Functional Heads _____
   e. Audit Committee _____
   f. Others (please specify)_____

E. Information regarding preparation of year-end statutory accounts, external audit, and production of the annual report.

1. How many Man-Days of the accounting/finance staff are required to prepare the year-end statutory accounts? _____ Man-Days
2. Statutory accounts are available for audit within how many business days after the close of the year? _____ Days
3. Who are the internal recipients of the year-end statutory accounts? (Please check all that are appropriate)
   a. Chief Executive Officer _____
   b. Chief Financial Officer _____

c. Board of Directors _____
d. Divisional/Functional Heads _____
e. Audit Committee _____
f. Others (please specify) _____

4. How many Man-Days are required to prepare the annual report (excluding your answer to part E2 above)? _____ Man-Days
5. What is the total nonstaff cost of preparing the annual report in terms of design, translation, public relations, printing, etc? $_____ M

F. Information regarding your internal audit department.

1. List the total number of internal audit staff: _____
2. The Internal Audit Department reports to whom?
   a. Top Executive Management _____
   b. Board of Directors _____
   c. Audit Committee _____
   d. Non-executive management _____
   e. Others (please specify) _____
3. Do you outsource any of your internal audit activities? Yes:_____ No:_____
4. If yes, what is the total cost? $_____

G. Information regarding automation of your accounting and finance processes.

1. Which of the following accounting system modules are automated in your company? (Please check all that are appropriate)

a. General Ledger	_____	b. Accounts Payable	_____
c. Accounts Receivable	_____	d. Inventory	_____
e. Payroll	_____	f. Fixed Assets	_____
g. Budgeting	_____	h. Cash Management	_____
i. Costing	_____	j. Asset Management	_____

   k. Others (please specify) _____
2. How many PCs do you have in your accounting/finance department? _____
3. What is the total cost of the most recent year of buying/upgrading/maintaining the accounting/finance system (software and hardware)? $_____ M

BENCHMARKING STUDY - FINANCE AND ACCOUNTING FUNCTION													
Code*	Reply date	A1	A2	A3	A4 (Y)	A4 (N)	A5 (Y)	A5 (N)	A6 (Y)	A6 (N)	B1	B2	B3
											$' million	$' million	$' million
CE2	11/16/99	65	9	3	1		1		1		14.30	2.50	
CE3	11/18/99	28	6	2		1					3.30	2.10	
CE3	12/15/99	23	5	1	1			1		1	7.00	2.70	
CE4	11/18/99	1750	30	8	1		1		1		200.00	5.00	
CE4	11/23/99	45	4	1	1		1		1		15.80	1.40	0.01
CE6	11/17/99	150	8	1	1			1		1	18.00	2.00	
CE6	11/17/99	160	12	1		1					22.80	2.20	
CE7	11/17/99	71	14	5		1					34.00	4.00	
CE7	11/17/99	120	6	2	1		1		1		15.00	1.00	
CE7	11/18/99	200	13	2		1					48.00	2.00	0.01
CE7	-	38	18	7	1			1		1	24.00	10.20	0.10
CE8	12/2/99	70	7	2		1		1		1	33.00	3.80	0.10
CE8	12/3/99	12	3	1		1					14.00	1.00	0.10
CE8	-	45	9	3	1			1		1	9.00	1.60	0.03
CE8	-	53		5	1		1		1		18.00	4.00	0.10
CE8	-	300	9	0	1		1		1		70.00	0.20	
CE10	12/8/99	3029	72	4		1					905.00	20.00	0.03
CE10	12/15/99	104	24	12		1					51.00	9.00	
CE10	12/16/99	70	7	4		1	1		1		60.00	6.00	
CE10	12/17/99	39860			1			1		1	6,522.00		
F1	11/30/99					1							
F3	12/15/99	58	5	2		1					12.00	1.04	0.10
F3	-					1							
F4	-		2	2		1						1.00	0.02
F5	11/18/99	59	5	2		1					30.00	2.00	
F7	-	40	6	2	1		1		1			0.02	
F8	12/1/99	574	22	3		1					216.00	9.00	
F10	11/24/99	3160	90	20		1					841.00	28.00	
F10	11/27/99	1270	29	3	1		1		1		357.00	11.00	
F10	12/17/99	7562	215	48		1	1				1,980.00	69.00	0.04
F10	1/11/00	1500	42	4		1					339.00	7.00	0.20
H													
I2	11/17/99	1625	8	3	1		1		1		35.00	3.00	0.20
I2	11/17/99	590	18	1		1					18.50	2.00	
I2	11/19/99	500	10	1	1		1		1		13.00	1.40	
I3	11/17/99	20	5	2	1			1		1	8.00	1.60	

BENCHMARKING STUDY - FINANCE AND ACCOUNTING FUNCTION (CONTINUED)

Code*	Reply date	A1	A2	A3	A4 (Y)	A4 (N)	A5 (Y)	A5 (N)	A6 (Y)	A6 (N)	B1	B2	B3
I3	11/20/99	130	12	3	1		1				38.00	3.00	
I3	11/23/99	950	10	2		1					10.00	1.50	0.02
I3	12/1/99	180	8	1		1					48.00	2.00	
I4	11/17/99	23	4	2	1		1			1	7.00	1.00	
I4	11/17/99	20	4	1		1					6.00	1.00	0.03
I4	12/10/99	40	8	1	1		1		1		9.00	2.00	
I5	12/16/99	1100	50	7	1			1		1	300.00	10.00	0.05
I5	11/18/99	5000	18	3	1		1		1		60.00	2.00	0.01
I5	-	13000	30	2		1							
I7	11/16/99	12	4	1		1					4.60	1.70	
I7	12/15/99	38	12	4	1		1		1		20.50	5.10	
I7	12/17/99	367	46	6		1					73.00	9.00	0.50
I7	-	1400	40	5	1			1		1			
I7	-	2130	53	16	1		1		1		561.60	17.10	0.10
I8	11/17/99	14	4	2		1					9.00	2.00	
I8	11/17/99	10000	40	7		1					136.00	9.00	
I8	-	2416			1		1		1		309.00		
I9	11/18/99	137	13	6	1		1		1				
I9	11/19/99	4200	42	6	1		1		1		1,326.04	15.53	0.01
I9	11/23/99	2500	60	2		1					4.00	6.00	1.00
P2	12/3/99	410	44	3		1					10.00	2.00	
P3	11/17/99	2000	6	3		1					3.50	0.70	0.10
P3	11/29/99	500	5	2	1		1			1	6.00	2.20	
P3	-	150	13	3		1					29.70	7.40	0.50
P3	-	150	13	3		1					29.70	7.40	0.50
P3	-	200	12	2		1					29.00	4.10	0.01
P4	-	150	13	3		1					29.70	7.40	0.50
P6	11/19/99	1715	38	6		1					426.00	10.00	0.10
P7	12/10/99	500	30	3	1			1		1	30.00	5.00	
U10	12/9/99	4191	139	56		1					2,050.00	106.00	0.40
U10	12/10/99	2068	40	13	1		1		1		790.00	28.00	1.00
M7	11/16/99	400	15			1					3.00	0.25	0.07

This table shows the results of the survey of listed Hong Kong companies.

* Code Consolidated Enterprises (CE), Financial (F), Hotels (H), Industrial (I), Property (P), Utility (U) and Miscellaneous (M).

MAXINE CLARK: FROM SHOES TO BEARS

Wilburn C. Lane, Lambuth University
P. Michael McCullough, University of Tennessee at Martin

CASE DESCRIPTION

The primary subject matter of this case concerns marketing and strategic marketing or strategic management. Secondary issues examined include the social psychology of marketing. The case is appropriate for senior level strategy, marketing, or organizational theory courses, or MBA marketing, organizational theory or strategic management courses. The case is designed to be taught in a 50-75 minute class and is expected to require one-half hour of outside preparation by students.

CASE SYNOPSIS

This case pertains to the creative-marketing enterprise Build-a-Bear Workshops founded by Maxine Clark. This case chronicles the growth, profiles Ms. Clark, elaborates on the concept, and describes the store and the customer's experience in the store. Students analyzing this case will learn of the marketing and ongoing innovation strategies of this company and challenge themselves to think about the implications of what has transpired thus far and what the future might hold for Build-a-Bear Workshops.

Maxine Clark got the idea for the business when she went on a field trip to a toy factory with a friend and her children. She saw how excited they were in learning more about the toys and decided to open her own store where children could actually make their own toys-stuffed teddy bears. The first Build-A-Bear Workshop opened in October of 1997 in the St. Louis Galleria. The store was a huge success, and its sales by the end of 1997 had reached almost $400,000. It was obvious that Ms Clark had developed a winning formula, and she decided to open more stores.

Clark was President of Payless Shoes when the idea for Build-a-Bear Workshops came to her. During her three years as President, Payless Shoe source' market share grew from 16% to over 20% of all shoes sold in America, and she helped expand Payless Kids from 20 stores to over 750 stores and become the largest seller of children's shoes in the world.

The Build-a-Bear company was founded as an interactive entertainment retail experience based on the enduring love and friendship that connects us all to stuffed animals, especially teddy bears. The company reminds us that, "children use teddy bears to keep them warm at night and comfort them while protecting them from the monsters under the bed.

INTRODUCTION

Retailing has faced many challenges in the last two decades. The retailing giant Montgomery Ward, who pioneered mail order retailing, has fallen by the wayside. The largest

retailer in 1990, Kmart, has filed for bankruptcy. Other major retailers like Sears and J. C. Penney have had to redefine themselves. Category killers like Toy R Us have lost market share to super-store discounters like Wal-mart. Internet sales are growing by leaps and bounds. However, there is a new retailer on the scene who has bucked these trends and is growing more rapidly than Wal-mart or Internet sales. The name of this retailer is Build-A-Bear Workshop.

Maxine Clark, who left the May Company in 1996, got the idea for the business when she went on a field trip to a toy factory with a friend and her children. She saw how excited they were in learning more about the toys and decided to open her own store where children could actually make their own toys-stuffed teddy bears. The first Build-A-Bear Workshop opened in October of 1997 in the St. Louis Galleria. The store was a huge success, and its sales by the end of 1997 had reached almost $400,000. It was obvious that Ms Clark had developed a winning formula, and she decided to open more stores. Initially she put $750,000 of her own money in the business and secured another $12 million of capital from other sources. To date she has been able to raise over $40 million dollars in capital, some of which is her own money. This has allowed her to rapidly expand the number of stores. At the end of 2002, she had 109 stores and sales of almost $170 million. Below is a chart that shows the phenomenal grow of this company.

Table 1: Total Sales and Number of Stores (United States and Canada)

Year	Sales	Total Stores	New Stores	Existing Stores
1997	$ .4 million	1	1	0
1998	$ 3.3 million	4	3	1
1999	$ 18.5 million	15	11	4
2000	$ 56.3 million	40	25	15
2001	$107.3 million	72	32	40
2002	$169.7 million	109	37	72

Build-A-Bear Workshop has already sold more than 10 million bears. The average sales volume per store is over $2 million a year. They are projecting to have almost 300 stores in the United States and Canada by the end of 2006, and they eventually plan to have 400-500 stores in North America. Below is a chart that shows their projected growth through 2006.

Table 2: Projected Number of Store by Year (United States and Canada)

Year	Total Stores	New Stores	Existing Stores
2003	153	44	109
2004	198	45	153
2005	246	48	198
2006	294	48	246

They also plan to open stores in Japan and the United Kingdom in 2003. Ultimately, they plan to be in cities throughout Europe, Asia, and South America. Their goal is to go wherever teddy bears are a part of the culture. While the charts above represent some impressive numbers, they are only a part of the entire story. Below is "the rest of the story."

THE OWNER

The driving force behind Build-A-Bear Workshop is Maxine Clark--the Chief Executive Bear. While Ms Clark is only 4'11" tall, she is a retailing giant. In 1995, Discount Store News named her one of the "30 Most Powerful People in Discount Store Retailing". She is a member of The Committee of 200--the premier international organization for female entrepreneurs and top corporate executives. In 1999, she received the Award for Emerging Entrepreneur of the Year from Ernst and Young.

Ms Clark has thirty years of experience in retailing. After graduating from the University of Georgia in the early 1970's with a degree in communications, she passed up a career in journalism to become an executive trainee with The May Department Store Company. She started at the Hecht Company division in Washington, D. C. She rose through the merchandising ranks at Hecht's and was named Manager of Merchandise Development for the May corporate staff. In 1978, Ms Clark was named Director of Merchandise Planning and Research and became an integral player in the 1979 acquisition of The Volume Shoe Company, which was renamed Payless ShoeSource. In 1980, she became Vice President of Marketing for Venture Stores, Inc., May's discount store division. Ms Clark was promoted to Senior Vice President and Executive Vice President of May's Famous Barr Division in 1985. From August 1986 through December 1987, Ms Clark was the Vice President of Merchandising for Lerner, New York, the valued-priced division of The Limited, Inc. She left Lerner to return to May as Executive Vice President of Venture's Softline, until November of 1992 when she became President of Payless ShoeSource. Under her leadership it became a $2.3 billion chain of 4,500 family shoe stores. During her three years as President, Payless' market share grew from 16% to over 20% of all shoes sold in America, and she helped expand Payless Kids from 20 stores to over 750 stores and become the largest seller of children's shoes in the world. These experiences have given her senior management experience in department, discount, and specialty store retailing.

Ms Clark developed a great appreciation for retailing as a small child. She has fond memories of going shopping with her mother in her hometown of Miami. She recalls that on Saturday they would dress up and go shopping. She remembers the shopping experience not as drudgery but as a social occasion. One of her fondest memories was shopping at Burdines. She especially liked the "Little Shop" that had everything really low so children could reach the merchandise. She says there was always something going on at Burdines. One of the things she enjoyed the most was the rooftop circus. Also, she had the opportunity to sit on the Teen-Board for Burdines. These experiences have had a great influence on her life and on what she thinks a retail store should provide.

During her twenty-five years with the May Company, she developed her ability for spotting emerging retail and merchandise trends. She formed partnerships with companies such as Disney,

American Greetings, and Mattel. When she left the May Company in 1996 with the financial security that most of us could only dream about, she immediately began to look for new opportunities. She decided that she wanted to create a business for children that was fun and entertaining, but she had no idea what. She began to research manufacturing businesses she could buy and develop into a retail business. As part of the research process, she decided to live like a kid; and so she set out on a journey that took her to many places-including a factory that made toys while she was on a field trip with a friend and her children. She saw how the children responded to the most basic of activities. Later she went on a bakery tour for business, and again, she saw the same thing-wide-eyed wonder about how things are made. She asked herself how she could recreate this wonder in a retail store? She tried unsuccessfully to buy a toy factory. They just could not see her vision. Not to be thwarted, she decided to reinvent the idea in a mall based setting. Thus, Build-A-Bear Workshop was born. Her love for retailing and her love for kids make Build-A-Bear Workshop what it is today--a great place to spend some quality time with your children.

While most CEO's, excuse me, CEB's do not have time for their customers or their employees, Ms Clark makes time for both. She receives over 4,000 e-mails a month, many from children wanting her to bring a Build-A-Bear Workshop to their community, and she personally responds to every e-mail she receives. As part of the research for this case, Ms Clark and I exchanged a lot of e-mails. One night we began e-mailing about 6:00 p.m. I would send her an e-mail, and she would respond. This went on for hours. Finally, about mid-night I quit sending e-mails because I was tired and wanted to go to bed. I do not know how long she would have kept responding to my e-mails, but when you talk with company employees you get very similar stories about how much time she spends with employees. She is certainly a lady who is generous with her time, not only to make Build-A-Bear Workshop a success but also to make the world a better place to live. She serves on the Board of Directors of the Girl Scout Council of Greater St. Louis, the Board of Barnes-Jewish Hospital, the Board of the Simon Youth Foundation, and the Board of the International Council of Shopping Centers (ICSC). She has also initiated several projects through the company to give back to the community. These will be discussed later in the case.

THE STORE

Most of the stores are about 3,000 square feet and are found in malls. They usually have 25-30 feet of store frontage and are adjacent to appropriate children and family retailers. They do have larger stores (4,000-6,000 square feet) that are found in tourist markets, and they have smaller stores (2,000-2,500 square feet) that are located in smaller markets. The average sales per square foot of a Build-A-Bear Workshop is over $700, which is about twice the national average for stores in its category. The stores are located in 90% of the top 20 U.S. markets, and they are in 88% of the top 50 U.S. markets. Amazingly 60% of the entire U.S. population lives within 30 miles of an existing store. About 75% of the stores are located in destination malls with the remaining 25% located in entertainment/tourist venues. When asked how they decided where to locate new stores, Ms Clark responded, "We are tuned into the market very well and know the best malls and have targeted those. We also have data in our storybook database that lets us understand the demographics of our Guests and we look to prioritize markets that best reflect these demographics."

She also indicated that some of the e-mails she gets from children include suggestions for where to have a new Build-A-Bear Workshop.

THE TARGET MARKET

At first glance most people would probably define Build-A-Bear Workshop's target market as young girls ages 3-13, but actually their clientele includes boys, teenage girls and their boyfriends, parents, grandparents, gift givers, special interest collectors and leisure travelers. In addition there are organizational customers like schools, scout troops, daycare providers, and other child-centric organizations. As you enter a Build-A-Bear Workshop you will see people of all ages actively engaged in the process. Some may be parents who have brought their young children. Some may be grandparents who have bought their grandchildren. Some may be teenage girls who have come with their boyfriends. Some may be young men looking for a bear to hide an engagement ring. Some may be leisure travelers wanting a remembrance of their trip. Some may be part of a Girl Scout troop having a party. No matter who they are, there is one thing they will have in common. They are all having fun and will remember the experience.

THE CONCEPT

Unlike most businesses where the shopping experience is something you have to endure to get your product, Build-A-Bear Workshop actually makes the shopping experience an enjoyable and important part of the product. Build-A-Bear Workshop is based on the premise that if a firm could bundle experiences along with value and affordability into its products, and if customers were allowed to walk in and customize products, shoppers would come to store locations in droves. In an article entitled "Redefining Retailtainment" found in the March 2001 issue of Chain Store Age, Maxine Clark says, "Experiential retailing is where the opportunity lies. You have to give people ways to interact with your brand."

The company was founded as an interactive entertainment retail experience based on the enduring love and friendship that connects us all to stuffed animals, especially teddy bears. The company reminds us that, "children use teddy bears to keep them warm at night and comfort them while protecting them from the monsters under the bed. As they grow, the teddy bear becomes a symbol of romance and love. At all stages of life, teddy bears represent happiness and safety, and they cheer us up when we feel lonely or depressed. They are a constant friend, and we develop a bond with them." It is this natural love for teddy bears combined with the interactive shopping experience that makes the Build-A-Bear Workshop so successful.

THE EXPERIENCE

As part of our research for this case, we visited the Build-A-Bear Workshop in Memphis, Tennessee. The store opened in October 2001, with owner Maxine Clark in attendance. The Memphis area store is in the Wolf Chase Galleria in Cordova, a bustling suburb. When you walk up to the entrance of the store in Cordova, Tennessee, you are greeted by a high school to

college-age girl, or sometimes a boy of that age, which is the same thing that will happen if you approach any of the store locations. Having someone meet the customer at the door is considered a critical part of the Build-A-Bear Workshop experience. Within the store will be a half dozen or more other young ladies or gentlemen, dressed in khakis and brightly colored knit shirts. They will beam smiles and radiate as much warmth as they can, while you are in the store. And, if their smiles are not enough, surely the delight radiating from the children making the bears, will do the trick.

There are two main ways to experience the store. You may simply walk in and come under the capable influence of one of the well-trained associates (called a Master Bear Buildersm), or you may come in as a member of a birthday party at which you are either the one having a birthday or a guest of a friend who is. Either way, the experience begins at the front of the store and takes you in assembly-line fashion through multiple stages until you leave with your own stuffed animal.

The morning we visited, they had a birthday party scheduled in the store for 10 o'clock. After everyone arrived, it got underway at 10:15, with the Master Bear Builder, Jody, leading it. That morning there were five children in the party group, three boys and two girls, with one of the girls, Lauren, being the birthday girl.

Jody tells the children in a kindergarten-teacher voice, that they will each be allowed to spend $25. This becomes significant later, when they pick out their bear, which range in price from $10 to $25; and its clothes and other items, which range from $2 to $12.

After each child has received a nametag, Jody says a few things to gain their confidence and to create an expectant and joyful attitude among them. In this spirit, she asks them if they can hop up and down on both feet at the same time. She demonstrates by hopping herself. The children have no trouble with this request. Next, she asks them to hop with her over to where the animals are.

They hop the fifteen feet or so across the hardwood floor to the right side of the store where there are bears, bunnies, puppies and koalas. The walls are lined with shelves low enough for small children to reach, filled with "empty" animals. Once they have hopped over to the shelves of animals, Jody points out the various prices. The animals are similar in size and come in a variety of bright colors, although some are darker, perhaps to accommodate the tastes of boys or at least the parents of boys. While the other four children, three boys and a girl, are looking for their animals to stuff, Lauren, the birthday girl in this party, holds her bear skin up to her chest and says happy birthday to it as, what appears to be her grandmother, snaps her picture. It only takes about five minutes for all the children to determine which animal will be theirs, and they are off to the next station.

Suspended from the ceiling are signs that lead you through the process of making a bear. In order, the stations to work through are: Choose Me--where you select your animal skin, Hear Me--if you want to implant a sound into your animal, such as a roar, a bark or bell, Stuff Me--where you pump the air pedal with your foot to blow stuffing into your animal, Heart and Stuff--where you put the heart into your bear preceded by a series of rituals, Fluff Me--where you can shower your bear with what appears to be a water sprayer, which actually sprays air, and where you can brush your animal's fur, Dress Me-where you choose your animal's clothes and put them on, name me-where you input your personal information into the computer, including address, phone number and email address and where the computer prints out a birth certificate for your animal, and Take

Me Home-where you get you are given (the Cub Condo) a cardboard box printed to look like a house, into which you insert your animal to make it easy to carry.

All through the process, from selecting to stuffing, to securing their animals, Jody found ways to deepen the experience. She held the bear while each child operated the pump with his or her foot, whoosh, whoosh, whoosh, with every stomp of the foot on the pedal. Some of the children wanted sound in their bear, so they walked to that station and tested the different sound possibilities, from bells to growls, and then a mechanical device was inserted into the bear with the stuffing, which when squeezed, produced the chosen sound.

The children were each given a heart to place in the bear with the stuffing and sound mechanism. Together they went through "birthing rituals" such as holding the heart to their foreheads and thinking of something they did that showed how smart they were. One child said he could use the computer, so Jody encouraged this child to think of that while holding the heart to his head. This would give the bear his intelligence. The heart was transferred to the bicep, where it got strength, and to their heart, where it was given love and warmth. The children were enthusiastic in their response to Jody's every instruction, while the parents and grandparents took pictures, smiled and encouraged their child.

Garments and accessories were chosen, reminding the children that they were on a budget. They had been previously warned that they would only be able to spend a limited amount, and this appeared to work magically. There was no whining to get more than their budget would allow. Perhaps there is a lesson in this for any parent shopping with his or her young child.

Once the animals were stuffed and clothed, together children and family representatives walked to the row of computers to input their personal information. This information serves the dual purpose of data to be printed on the birth certificate, issued by the computer's printer, and as tracking information for Build-A-Bear Workshop. The number on the animal is also printed on the birth certificate. This allows for the bear to be returned to its owner, if ever it were lost.

Payment had already been made prior to the party beginning, so at the end, the children stood together for a group picture of them and their newborn animals. They also sang happy birthday to Lauren and to each of their new creations. The experience took a little over an hour to complete, and this was a small group. If the number of partiers had been much greater, another party leader may have been assigned; and the trip through the store would have taken longer. Individual customers, those not a member of a party, can expect to go through all the stations much more quickly.

MARKETING

Build-A-Bear Workshop uses a variety of promotional techniques. They use traditional advertising, direct marketing, sales promotions, and publicity to communicate with their target market. They have spent over $15 million since it started on building and supporting their brand.

Direct mail is Build-A-Bear Workshop's primary form of advertising. This is an integral part of their marketing program. When the customer fills out the birth certificate for the teddy bear, they are asked to give their name, address, age, gender, and e-mail address. This is very valuable information that is used to market directly to their current customers. They now have over 3 million

households in their database. They do six catalog mailings a year to over 2 million households per issue. They do bi-monthly e-mails to over 3 million Guest each year. They use these direct marketing techniques to make Guests aware of fresh products, new store openings, seasonal promotions, and events.

Their direct marketing effort is closely tied to sales promotions, and a lot of their marketing effort is build around events. Below are just a few of the events they have promoted:

Grand Opening Cele-bear-ations	Furry Fashion Shows
Teddy Bear Tea Parties	Fluffed, Stuffed & Fubulous
Stuffed With Hugs	Bearemy's Bearthday Bash
Kook-y Spook-y Bear Bash	Teddy Roosevelt's Birthday Celebration

They have two mascots that are used to enhance these events. They have Bearemy, who is an adorable ambassador of bear hugs. He is a bear mascot that represents Build-A-Bear Workshop at Grand Opening Cele-bear-ations, mall and charity events, and in the community. They also have Pawlette, the Fashion Advisor to the Furry Famous. This is a rabbit that hosts Furry Fashion shows to keep the furry friends in the latest styles.

They also place a lot of emphasis on birthday parties and other types of parties. They send each Guest a notice about having a birthday party 90 days in advance of their birthday. They have had over a million Guests party with them. Their website www.buildabear.com has over 500,000 guests each day. It has won several awards and is very informative. It provides local store information and highlights upcoming events.

Build-A-Bear Workshop has received a lot of publicity. More than 350 stories about Build-A-Bear Workshop have appeared in magazines and newspapers. These stories have created an estimated 175 million audience impressions. Over 130 stories have appeared on television with an estimated audience reach of nearly 22 million.

While all these marketing techniques have certainly raised awareness among members of the target market, their most effective and efficient technique is their customers. Maxine Clark says, "Our guests are often our best spokespeople." Ben McConnell and Jackie Huba in their book, Creating Customer Evangelists, use Build-A-Bear Workshop as an example of how loyal customers become a volunteer sales force. They explain how important loyal customers are to a business, and how Build-A-Bear Workshop has been able to build a 100 + million dollar business in a few short years because of their Guests telling their friends about Build-A-Bear Workshop.

INNOVATIONS

One of the keys to Build-A-Bear Workshop's success is its ability to continually be innovative. This includes everything from the language they use in the store to the products they sell. Below are just some of the product innovations they have developed:

♦	First heart inside bears-Heart Stuff
♦	First carrying case for bears-Cub Condo
♦	First gift-wrap for Cub Condo-Condo Hugger
♦	First clothing case for bears-Bearamoire case
♦	First with ability to return lost bears safely home-Find-A-Bear ID system
♦	First personalized bear birth certificate
♦	First personalized bear storybook
♦	First custom recordable sound for bears-Build-A- Sound
♦	First line of branded clothes for bears-Limited Too
♦	First line of branded shoes for bears-exclusive partnership with SKECHERS
♦	First line of fur-niture for bears-Comfy Stuff Fur-niture
♦	First metal scooter for bears-Scootfur
♦	First line of underwear for bears-UndiBear Collection
♦	First line of collegiate Tiny Teddy Tees for bears

They even have music that has been developed exclusively for their stores by a Nashville songwriter. They are continually coming up with new lines of clothing and accessories. If it has something to do with bears or creative retailing you can count on Build-A-Bear Workshop having it first.

ATTENTION TO DETAILS

In their book, Priceless: Turning Ordinary Products into Extraordinary Experiences, Diana LaSalle and Terry A. Britton make the following comment about Build-A-Bear Workshop, "Every experience the company controls…is carefully planned to be fun and to foster organization." When you walk into a Build-A-Bear Workshop, a host, who is called a Master Bear Builder, greets you. The Master Bear Builder works with the Guest to make sure the Guest has a good experience. The store is laid out in such a way that the Guest flows naturally through the store making decisions and performing activities at each stage of the process. Nothing is left to chance; even the bathrooms are checked regularly to make sure that they are clean. All of the full-time employees are trained at Bear University to make sure that everyone understands the business and their role in the business. In turn, the full-time employees train the part-time employees. Customer satisfaction is stressed at

every store. The store manager's compensation is tied to the customer satisfaction surveys that are continually being done. Ms Clark says the customer satisfaction survey reports are just as important as the weekly sales results. Ms Clark has a Cub Advisory Board made up of 20 children ages 7-16 who review new products and make suggestions about the store. Ms Clark says, "If they don't like it, we don't do it." She also uses their input on new store locations. Her attention to detail and desire to listen to her customers (Guests) has continually kept Build-A-Bear Workshop ahead of its competitors.

OPERATIONS

Build-A-Bear Workshop realizes that their new and fresh products is what brings their Guests back again and again. They focus on the needs of their target guests and are able to respond quickly to fashion trends. You would think that with this philosophy that they would have a very large inventory and would have markdowns to get rid of "old" merchandise, but they do neither. They have less than thirty different animal skins and the clothes are designed in such a way that they only need two different size clothes to fit all the animals. Even with their large selection of accessories, they have less than 600 SKU's. Since the product is made to order and not made to stock, the inventory can be kept low. Therefore the Guest's ability to customize the product actually lowers the business's costs. Also, Build-A-Bear Workshop does not do markdowns. Ms Clark says that if you mark down merchandise that customers will come to expect markdowns and wait until the product is marked down to purchase it. When asked what happens to merchandise that is not selling, she simply replied, "We stop buying it." The company has an information system that is intuitive, easy to operate, and dependable. This allows them to adapt quickly to the changing desires of their customers.

AWARDS

In its short life Build-A-Bear Workshop has received many awards. Below is a list of some of them.

♦	"Best New Concept for 1998" by Change Store Age
♦	"1998 Merchandise Achievement Award" (Best Category Marketing) by Playthings Magazine
♦	"1998 Retail Store of the Year Design Competition" (Special Judges Award for Creative
♦	New Concept and Best Exterior within a Mall) by Chain Store Age.
♦	"1999 Fastest Growing Private Company in St. Louis" by the St. Louis Business Journal
♦	"2000 Winner-Best Other/New Media" for Cub Condo carrying case series by the National Retail Federation
♦	"2000 Eddi Award: Entertainment Development & Design Innovation Award-Entertainment Retailer under 5,000 Square Feet by The Out-of Home Entertainment Business News

♦	"Retail Innovator of the Year for 2001" by the National Retail Federation
♦	"2001 Best Places to Work" by ZD Net-Interactive Week Magazine
♦	"2001 Gold Award" (Postcard Series-Direct Mail) by the National Retail Federation
♦	2001 E-Commerce Awards for www.buildabear.com: "Ease of Navigation" "Most Innovative" "Most Unusual" "Best Use of Graphics" "Best Business to Consumer Site"
♦	"2001 Laclede Award: Best Place to Work" (Corporate Culture) by the St. Louis Business Journal
♦	"2002 Merchandising Achievement Award" (Best Original Promotion-Furry Fashion Shows) by Playthings Magazine

GIVING BACK TO THE COMMUNITY

Build-A-Bear Workshop realizes that it is part of a bigger community and has several projects that give back to the community. They have created a Bengal tiger and a giant panda whose sales proceeds benefit the World Wildlife Fund. They give $1.00 to The Humane Society of the United States for every Black Lab skin they sell. During the first six months of the promotion, the company sold 100,000 Black Labs. The Susan G. Komen Breast Cancer Foundation and the Siteman Cancer Center benefit from the sale of the "Hopeful Wishes Bear." In May of 2001 the company started a "Stuffed with Hugs Day" where children were invited to come to the company's stores to create a teddy bear that is donated to the Teddy Bear Foundation, a nonprofit organization that helps children in crisis. Over 50,000 teddy bears have been made and donated since this program began. On its website the company has two programs that are especially helpful to children. One location is teachme.buildbear.com, which provides educators with fresh, engaging lesson plans and activities that focus on friendship and cultural awareness. This is done in cooperation with Scholastic, Inc. and is for teachers, parents, and students. A second location is Bearemy's Book Club at www.buildabear.com. At this location children of all ages are encouraged to read about bears and other wonderful friends and adventures. Build-A-Bear Workshop is not only a financial successful company but is also a caring company.

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THE TREACHERY OF RATIOS

Sanjay Rajagopal, Montreat College

CASE DESCRIPTION

This case deals primarily with the subject of financial ratio analysis. Secondary issues include efficiency measurement in non-profit organizations and Du Pont analysis. The case has a difficulty level of three, and can be taught in one class hour. It will require approximately one hour of outside preparation by students.

CASE SYNOPSIS

Mr. Mueller represents a foundation that donates to international non-profit organizations. He is searching for a way to rank, by efficiency, potential recipients of his funds. His consultant advises him of the "program ratio" recommended by Philanthropic Research, Inc. (www.guidestar.org). This ratio is defined as the ratio of program services expense to total expense. Mr. Mueller likes the simplicity of this ratio, but the consultant adds that he has devised another, more comprehensive and accurate method of studying efficiency in international non-profit organizations. His approach involves the calculation of a "comprehensive efficiency ratio", which can, in a manner reminiscent of the Du Pont breakdown of the return on equity, be expressed as the product of two other ratios, each of which reflects the efficiency in a different area of management. The consultant insists that his ratio corrects all the "ills" of the "program ratio", and provides a richer framework within which to study efficiency of international non-profits. Mr. Mueller is uncomfortable with the consultant's approach, because he suspects it is flawed. However, he is unable to put his finger on the problem, and students are asked to detect the flaw in the model. The objective of the case is to alert students to the danger of employing ratios for financial analysis without carefully thinking through the meaning of each ratio used.

THE EAGER CONSULTANT

"My secretary will see you out, Peterson. Thank you so much for stopping by! What you say makes sense, and I will give it some serious thought. Imagine all the time and bother these ratios can save me! I might even be able to get out and play golf every afternoon!!" As he walked back to his office from the conference room, though, Mr. Mike Mueller could not help feeling ambivalent about his recently concluded meeting with this young, well-dressed man from Keystone Consultants. Mr. Tom Peterson, the young gentleman in question, had recently been hired by Keystone to assist with the consultancy's advising of clients on non-profit organizations. While Mr. Mueller had been favorably impressed by this fresh graduate who dressed well, seemed enthusiastic, and was very articulate, he could not quite grasp the reasoning behind some of the analytical techniques the consultant had touched upon. In fact, even though he himself did not have a college degree, Mr. Mueller felt that there was some flaw in the young consultant's thinking. But he could not quite put

his finger on the problem. He sank into his chair, picked up a piece of paper, and prepared to sketch out the consultant's ideas.

BACKGROUND

Keystone Consultancy had a few clients like Mr. Mike Mueller, who were charged with the management of large trusts that sought to benefit various causes by providing financial assistance to non-profit organizations. To many of these clients, including Mr. Mueller, there appeared to have been of late a veritable explosion in the number of not-for-profit firms, all hungry for financing. It was clear that a careful examination was needed of both the programs supported by these non-profits, and the efficiency with which the firms managed the funds they received from donors. It was precisely such a concern that had prompted Mr. Mueller to request a meeting with the consultants at Keystone. They had often provided him with sage advice on numerous issues, ranging from personnel matters to the management of the trust's investments. Now, at a time when he felt overawed by the multiplication of potential beneficiaries, Mr. Mueller, a deliberate and diligent man who had risen to his current position as chief executive officer by dint of hard work and consistent use of common sense, knew that it was time he tapped the keen minds at Keystone. Yet, at the end of an expensive visit with the consultant, he was more befuddled than ever. He thought that sketching out the consultant's advice would help him understand it better; all those financial ratios and "decomposition techniques" the young graduate had served up so easily were too much for him to visualize without the help of pencil and paper.

The Wilhelm Foundation, of which Mr. Mueller was the CEO, had a fairly substantial investment income, and sought to use these funds to promote social causes in developing countries. In keeping with its mission, it invited requests for financing from international non-profit organizations that targeted such causes. For several years since its inception, the Foundation had received a manageable number of applications, which Mr. Mueller and his small staff could evaluate diligently. But more recently, the number of applications had risen sharply, and it was becoming increasingly difficult to make a well-informed decision as to which organizations to support with the Foundation's money. Indeed, since many of these non-profits targeted the same causes, weeding out those whose specific programs were not aligned with the objectives of the Foundation still left a large stack of applications to compare and choose from. Mr. Mueller wished there were a quick, rule-based way to rank these applicants in terms of merit. By providing a starting point, such a ranking would greatly reduce the time involved in making an allocation decision. And, more importantly in Mr. Mueller's view, such an approach would lend greater objectivity to a selection process that, on account of the sheer volume of requests, had become somewhat ad hoc.

MR. MUELLER WRESTLES WITH THE MODEL

With his pencil poised over a large blank sheet of paper, Mr. Mueller began to marshal all the advice Mr. Peterson had provided. The latter had begun by informing Mr. Mueller of the "program ratio" (PR) that was recommended by Philanthropic Research, Inc. (www.guidestar.org).

This ratio seeks to measure the efficiency with which a non-profit operates, and is calculated simply by dividing the program services expense (PSE) by the total expense (TE) of the firm: PR = PSE/TE.

The logic of this ratio appealed to Mr. Mueller; a higher value for PR would mean that the non-profit allocated a greater proportion of its budget to programs that assisted target groups, and economized on other cost items such as salaries and miscellaneous expenses. He was quite excited by this new find; it was a simple enough ratio to get the data for and calculate. He might even be able to perform the division in his head! Now, he could weed out all those requests that did not target the causes his Foundation was interested in, and then rank the others in descending order of PR scores. He and his staff could use this information on efficiency rankings to better inform their allocation decision.

Just when Mr. Mueller had thought it could not get any better than this, the consultant had suggested an improvement to the measure, one he named the "comprehensive ratio" or CR. Mr. Peterson had pointed out that while the PR provided useful information, it suffered from at least one inadequacy; it focused on program services expenses and ignored the revenue-generating activity of the non-profit. Mr. Mueller tried to recall the young consultant's explanation of this point.

"Imagine," Mr. Peterson had said, "that there is a non-profit that has a PR of 90%. That may seem like a high efficiency score, but surely you would not think that it could provide a desirable level of service to target groups if all it had was, say, $5,000 in revenue!" Taken by itself, this statement made sense to Mr. Mueller. He knew that a total revenue of $5,000 would not take an international non-profit organization very far at all. "Well," Mr. Peterson continued, more animated than before, "I have devised a new method that explores the revenue generating activity of management in addition to its performance in the area of revenue allocation. It is simple, yet elegant. Remembering that the administrator must both generate revenue efficiently and allocate revenue efficiently, one calculates a separate ratio for each of these two areas of responsibility." At this point, Mr. Mueller struggled to recover control of an eyebrow that had shot up without warning; he had rather liked the simplicity of the PR measure!

"In order to calculate efficiency on the revenue generation side, you take the ratio of total revenue (or TR) to administrative expenses (or ADEX). I call this the revenue generating efficiency (or RGE) ratio." Mr. Peterson was clearly excited as he illustrated his model on a large chalkboard. "And, to measure efficiency on the allocation side, you simply divide the program services expense (or PSE) by the total revenue (or TR). This gives you the revenue allocation efficiency (or RAE) ratio. Now, notice that when I multiply these two ratios, I get a single ratio, PSE/ADEX, which I call the 'comprehensive efficiency' ratio, or CE ratio. A higher CE ratio would obviously indicate a more efficient firm. In my model, I make the reasonable assumption that administrative expenses and program services expenses are the only costs; after all, they are by far the largest costs to the non-profit. My approach is better than the PR measure; it provides one with more information, since it decomposes an overall measure of efficiency into two meaningful components, each addressing an important functional area. With this model, you can not only see whether a firm is more or less efficient than another, but also determine where-revenue generation, or allocation-the weaker firm is lagging behind! Don't you think this is a richer approach, Mr. Mueller?"

Mr. Mueller had nodded pensively. "How about saving? Does your model incorporate that? Would the PSE/ADEX ratio not paint too bleak a picture of efficiency if the firm saved a significant

amount of its revenue?" This had prompted a smile from Mr. Peterson, who had anticipated the question. "Given the nature of an international non-profit organization, it is not unreasonable to assume that, in the long run, saving will be zero. And in the short run, an adjustment can always be made to the numerator of the CE ratio to reflect saving for future projects; after all, that saving is simply a program services expense waiting to happen."

As he sat at his desk, Mr. Mueller tried to make sense of it all. Those efficiency ratios that Mr. Peterson had mentioned, that model that he had presented with such flair, did they really constitute an improvement over the PR approach to measuring efficiency in non-profits? Instinctively, he liked the simplicity of the PR method; but he did not want to forego the opportunity to use the Peterson model, if it indeed was superior. It really bothered him that he could not shake off the nagging doubts he had about the young consultant's model. Finally, he walked back to the conference room to take another look at the chalkboard. And there was Mr. Peterson's model, written in a bold hand:

$$CE = (TR/ADEX)*(PSE/TR) = RGE*RAE = PSE/ADEX$$

Mr. Mueller stared at the equation until the ratios danced before his eyes. Then, turning away, he pulled up the shades and looked out of the window at a beautiful spring afternoon. "There will be no time for golf today," he said to himself sadly.

FARZAM V. GOURMET KITCHENS, INC.

Jan Bell, California State University, Northridge
Rafi Efrat, California State University, Northridge

CASE DESCRIPTION

The primary subject matter of this case sequence is the integration of accounting and business law. Secondary issues examined include budgeting for various decision scenarios, the ethical responsibilities of decision makers, the legal responsibilities for product defects, and the enforceability of contracts restricting claims by injured parties. The case has a difficulty level of three, appropriate for junior level. The case is designed to be taught in three class hours per part (A and B.) That time estimate includes a formal class presentation by a team and a challenge by another student team. It is expected to require ten to fifteen hours of outside preparation by students for the two parts, Case A & Case B.

CASE SYNOPSIS

When design engineers at Gourmet Kitchens discover a way to produce their ovenware making it less expensive to produce (saving about 35 percent of variable production costs) but indistinguishable in looks and functionality from the original product, the product line manager, under pressure to produce a 25% return on sales (ROS), converts operations and books sales for the redesigned product. Unfortunately, during first quarter production, quality engineers discover a product defect that could lead to the product exploding and injury to persons in the immediate vicinity. A management team feels that they have two alternatives available to them: doctor the test results and continue to produce and sell while quietly working to correct the problem or scrap the production, delay shipment, and produce under the old production methods and cost structure while solving the problem. Management decides to take the first alternative, and ultimately several customers are seriously injured from the product.

The A case requires students to calculate a budgeted income statement and compute ROS under each of the available alternatives. Students also discuss the company's ethical responsibility and the stakeholders impacted by their decision. In Case B, students are provided legal opinions from the applicable jurisdiction and asked to evaluate whether a specific injured party is likely to recover compensatory damages for injury and a punitive award. In addition, students must evaluate Commercial Code to determine if a company disclaimer of responsibility for damages is likely to relieve Gourmet Kitchens of their legal liability.

This case requires students to apply materials learned in most Business School's lower division core (LDC). It is used in a course at the beginning of the junior year that has goals to integrate LDC material while developing teamwork and communication skills. Specifically, the case requires knowledge of financial and managerial accounting and a beginning business law course. Student teams prepare the case with tutoring from faculty who provide "just-in-time" specific

knowledge as requested by student teams. A team of students formally presents their case solution, another team acts as a "challenge team" and the whole class participates in an active question and answer session.

INTRODUCTION

Gourmet Kitchens, Inc. produces and sells a line of ovenware (the Chef's Line Ovenware) that goes from oven (conventional or microwave) to the refrigerator without breaking. Its design is functional, yet attractive enough to both cook and serve food. The ovenware items are sold through gourmet shops, such as William Sonoma, and major department stores, such as Macy's or Bloomingdale's.

Due to an economic downturn, sales through gourmet shops and department stores have lagged expectations for the past two years. This has kept the product manager of the Chef's Line Ovenware from meeting his required target of producing a 25% return on sales of product. This return is measured by preparing an income statement containing the sales of this product less any expenses considered attributable to this product line. An attributable expense exists to benefit the product line. It is a cost that would be avoided if the product line were discontinued. Further, when calculating the required 25% return on sales, the product line profitability statement does not deduct any allocations for general and administrative costs. Exhibit 1 provides a product income statement for this line for the past 5 years.

In an effort to increase sales, during 2002 design engineers modified the ovenware product slightly making it less expensive to produce (saving about 35 percent of variable production costs) but indistinguishable in looks and functionality from the original product. Also, the modified product resulted in increased product longevity of about ten percent. The product manager, excited about the modifications and cost savings, lowered the price by 10 percent and presented the item at a national food industry show at the end of 2002. He proudly advertised the product as having exactly the same looks, safety features, and functionality of the original product. He offered the same product warranty, 6 months under normal use conditions, and booked sales of 1,500,000 pieces to existing customers for first quarter delivery. Production commenced immediately to fill the first quarter orders.

During routine quality testing in production, personnel discovered a serious problem with the product. The ovenware, under a small range of extremely high cooking temperatures (450-500 degrees), would explode if set on a cold trivet or placed in the refrigerator. The explosion could potentially cause the person holding the ovenware to suffer serious cuts and substantial, permanent burns. Unfortunately, the seriousness of the problem was not known until after the production of the 1,500,000 pieces was nearly completed. Based on statistical testing, it appeared that the flaw only occurs about .25 percent of the time (one quarter of a percent).

The production, quality, and product managers met on the issue. They felt that they had only two options. First, they could delay shipment, recycle the current production, and produce the original ovenware using old methods. Of course, the product would have to be sold at the 10 percent price reduction while being produced with the old cost structure for six months. Customers would experience about a thirty-day delay in delivery, and some would be so annoyed that they would

cancel their orders. The product manager estimated that about one-third of the year's orders would be lost. In addition, this would likely cause those customers to be permanently lost to competitors. At the conclusion of the six months period, the problem would be solved and the product would achieve the 35% variable cost savings.

Second, they could ship the goods without calling attention to the problem and hope for the best. They would simply act surprised if any problem arose and pay for damages. With only a .25 percent failure rate and only under a small range of temperatures, the risk of the flaw seemed quite small. Further, since the product exploded when set on a cold surface, perhaps no person would actually be hurt and the damages would be limited to broken ovenware replacement.

Under either alternative, production engineers would work on correcting the problem. Engineers felt that they could solve the problem by the end of the second quarter. If the first option was taken, that meant 6 months of old production under new reduced sales prices plus scrapping the existing flawed units. Under the second option, it meant 6 months of producing and selling flawed, new products. Then the problem would be over.

The managers decided that the risk of option two was worth taking, shipped the flawed products (without disclosing the potential hazards), and toned down the quality testing report results such that it appeared that the product might only crack (not explode). Within two months of shipment, things went well. Only 1,575 product claims were made, and none involved personal injury. Replacement items were provided and customers remained satisfied.

In the third month a disaster occurred. During a goodbye party Mrs. Farzam organized for her son before going away to college, Mrs. Farzam prepared her son's favorite chicken and rice dish and cooked it in her oven using the new Gourmet Kitchen ovenware that she bought from her local department store. She cooked it at 475 degrees for about two hours, and when it was ready, she then placed it in the refrigerator. As the ovenware was placed in the refrigerator, it exploded, spraying glass and hot contents on Mrs. Farazam. A glass fragment struck her in the eye. Mrs. Farzam also suffered second and third degree burns on her face, neck, and arms. The accident was reported in newspapers, and the department store began investigating the cause of the accident.

Mangers at Gourmet Kitchens, Inc. acted surprised when contacted by the department store's manager. The product manager of Chef's Line Ovenware answered questions regarding the product. He provided the altered quality report to the department store's manager and continued to sell the product while the engineers worked on a solution to the problem. Meanwhile, several other serious explosions occurred, and other people were seriously hurt. Finally, a quality engineer from Gourmet Kitchens hired an attorney, met with a newspaper reporter, and disclosed that the original test results had been altered. The company was forced to recall all products and halt production.

Case A Questions

Write a report to the upper management of Gourmet Kitchens, Inc. that explains what happened in the Chef's Line Ovenware product line. Explain the decision made and the basis of the decision. To support your conclusions in the report, perform the analysis and answer the questions that follow:

Paragraph No. 1

Prepare a budgeted income statement for Chef's Line Ovenware for 2003 if the engineers' redesign efforts had worked as originally planned. Use the following assumptions:

Paragraph 1a:

First quarter sales of 1,500,000 units will be achieved each quarter in 2003.

Paragraph 1b:

The selling price for 2003 will remain 10% below the price charged from 1998-2002, and there were no sales price increases during the 1998-2002 period.

Paragraph 1c:

Variable cost of goods sold averaged about $5.55 per unit of ovenware from 1998-2002.

Paragraph 1d:

Variable production costs will be reduced by 35% due to the new design.

Paragraph 1e:

The fixed cost of production in 2002 contained one-time, increased costs (about $4,000,000) for the design changes. For 2003, fixed costs are expected to be about 3.5% higher than 2001.

Paragraph 1f:

Marketing costs contain both fixed and variable elements, however, it is budgeted based on spending 7% of expected sales revenue.

Paragraph 1g:

Other fixed costs are expected to increase about 2.5% over 2002.

Would the product manager have met his profit target of 25% return on sales in 2003 for the product line with the redesign?

Paragraph No. 2

Prepare the budgeted 2003 income statement for Chef's Line Ovenware that the production, quality, and product managers considered when they discussed the first option available to them.

Paragraph 2a:

Under that option, shipment would be delayed and about one third of the year's sales of 6,000,000 units would be lost.

Paragraph 2b:

Product would be sold at the 10% price reduction but produced under the old cost structure for six months (variable production costs of $5.55 per unit). After the six months the variable cost savings of 35% would be achieved.

Paragraph 2c:

Assume that recycling the current production would add $500,000 to the fixed production costs originally budged for 2003. In addition, the product line will incur

an additional $2,000,000 in design engineering to solve the problem within a 6-month period (this will involve the use of overtime and consultants).

Paragraph 2d:

Other cost items would stay as originally budgeted for 2003.

What would the product line's profit be under this alternative? What would the return on sales for the product line be?

Paragraph No. 3

The production, quality and product managers considered their second option to be producing and selling flawed units for 6 months while engineers corrected the problem. Under this option, the company would not disclose the problem and hope for the best. Perhaps none of the product claims would involve any injury; only product replacement would be required at a cost of about $12 per unit.

Paragraph 3a:

Adjust the 2003 budget for an assumed defect rate of .25% for 6 months production. (Note this is a defect rate in addition to the normal rate faced in each year, 1998-2002, which is already accounted for in marketing cost.)

Paragraph 3b:

Adjust the fixed production cost for 2003 for an additional $2,000,000 in design engineering to solve the problem within a 6-month period. (This will involve the use of overtime and consultants).

What would the budgeted profit and return on sales be if option two were selected?

Paragraph No. 4

Does this analysis exclude factors that should be considered in this kind of decision? Specifically, did decision makers consider the affected stakeholders or their ethical responsibility? Please discuss affected stakeholders, how they might be affected by the alternatives, and how decision makers might have incorporated ethical considerations when making their decision between alternatives. Before answering this question, please read "Only the Ethical Survive" found at: http://www.scu.edu/ethics/publications/iie/v10n2/ethical-surv.html

Exhibit One					
Gourmet Kitchens, Inc. Chef's Line Ovenware Product Income Statement					
For the years ended December 31, 1998-2002					
	2002	2001	2000	1999	1998
Sales	$ 78,599,808	$ 81,874,800	$ 86,184,000	$ 75,600,000	$ 67,500,000
Sales in units	5,239,987	5,458,320	5,745,600	5,040,000	4,500,000
Cost of Goods Sold					
Variable	29,081,929	31,112,424	31,026,240	27,972,000	24,975,000
Fixed	27,865,240	23,221,033	21,701,900	19,729,000	18,100,000
Gross Profit	$ 21,652,639	$ 27,541,343	$ 33,455,860	$ 27,899,000	$ 24,425,000
Attributable costs					
Marketing	5,894,986	6,140,610	5,774,328	5,140,800	4,758,750
Other (primarily fixed)	2,517,537	2,502,522	2,317,150	2,106,500	1,915,000
Product line profit before G&A allocation	$ 13,240,117	$ 18,898,211	$ 25,364,382	$ 20,651,700	$ 17,751,250
Return on Sales	16.84%	23.08%	29.43%	27.32%	26.30%

Case B Questions

Please refer back to the facts scenario of Case A. Having addressed the financial consequences of Gourmet Kitchens, Inc.'s actions, please analyze the company's potential legal liability. In answering the questions below, please consider reviewing the cases and/or statutory provisions cited to you following the relevant question.

Paragraph No. 1

Assume Mrs. Farzam has filed a suit against Gourmet Kitchens, Inc. for the injuries that she sustained under the theory of strict product liability. Is she likely to recover? Make sure to address all elements of the cause of action. In answering this question, please consider the following court opinion: Robins et al. v. The Kroger Co, et al., 982 S.W.2nd 156 (1998).

Paragraph 2:

Assume that Mrs. Farzam would prevail in a cause of action against Gourmet Kitchens, Inc. under strictly product liability. Is she likely to recover punitive

damages? In answering this question, please consider the following court opinion: Fischer et al., v. Johns-Manville Corporations et al., 472 A.2nd 577 (1984).

Paragraph 3:

Assume Mrs. Farzam has filed a suit against Gourmet Kitchens, Inc. for theinjuries that she sustained under the theory of breach of an implied warranty. Further, assume that the user's manual of the ovenware sold by Gourmet Kitchens, Inc. had the following clause inserted: "GOURMET KITCHENS, INC. DISCLAIMS LIABILITY FOR ANY PHYSICAL OR EMOTIONAL INJURIES SUSTAINED BY THE PURCHASER OR USER OF THIS PRODUCT ARISING OUT OF ANY DEFECT IN THE PRODUCT." Under the Uniform Commercial Code, is this clause likely to relieve Gourmet Kitchens, Inc. of liability for the injuries sustained by Mrs. Farzam? In answering this question, please consider § 2719 of the Uniform Commercial Code.

THE CASE OF BARTON MIRANDO OR CONSERVATION AND DARNITS!

Michael M. Grayson, Jackson State University

CASE DESCRIPTION

The case has a difficulty level such that it is appropriate for college students at any level. It is suitable for use as the first case in a course, particularly so because the case is structured so that students have to figure out an answer, rather than just regurgitate what they learned in the past week. The case is also fun to read, which makes it appealing for use as the first case.

The primary subject matter of this case concerns how value is determined in both closed markets and markets open to trading. While this is traditionally thought of as being either finance or economics, the case also incorporates ethical considerations, international business, and operations management. Secondary issues include international trade, the role information plays in setting value, the role of individual industry (i.e., willingness to work hard) in the well-being of a society, search costs, the roles of intermediaries, logistics, invasion of a society by outsiders, dietary changes, public health, and conservation.

CASE SYNOPSIS

This case tells the story of someone who is shipwrecked, taken in by the natives, and observes changes in the native society when outsiders come.

INTRODUCTION

Barton Mirando was a ship's doctor who was shipwrecked near an island somewhere in the Pacific Ocean. The people who lived there found him clinging to a piece of ship's wreckage and helped him ashore. None of his shipmates was ever seen alive again.

The people who lived on the island were very friendly and hospitable to Barton. As he lived among them for weeks, and then weeks stretching into months, he could not help but notice that it did not take them very long to obtain their needs each day, thanks to the abundance of seafood (especially shellfish such as oysters, clams, and mussels) and coconuts which were available with very little effort. Thus, the additional effort to round out their diet did not take much of the day. Moreover, there was little heart disease, disease of the digestive tract, or tooth decay among the people on the island.

One day a ship appeared and landed at the island. The islanders, true to their hospitable nature, invited the people on the ship to come ashore for a meal--the people on board called it a feast. There were piles of unopened clams, mussels, and oysters, plus other fish which were cooked over fires, coconut milk, coconut meat, and various plant foods which grew on the island.

The islanders never collected small oysters, clams, or mussels, instead letting them grow to a size where they would have already reproduced. Whenever the islanders opened an oyster, usually there was a big, succulent oyster inside waiting to be eaten. However, sometimes the oyster inside was not as big, and had produced a shiny spherical thing which was not edible. In fact, the shiny spherical thing was hard as a rock, so it became known as a "darnit," after the islanders' habit of saying "darn it" when they came across this thing they could not eat. Many of the islanders had small piles of darnits near their dwellings from where they had tossed the darnits over the years. While most darnits were light colored, some were black.

At the meal, the islanders noticed that the people from the ship, when they found some darnits in their oysters, suddenly slipped the darnits into their pockets and started greedily opening more oysters. It seemed as if the people from the ship lost all interest in the rest of the meal, or even in eating the rest of the oysters they opened.

The following day, the ship sailed away. However, left behind was some machinery which could be used to process the coconuts, including canning the coconut milk and bagging the coconut meat. A businessman on the ship had promised to buy all the coconut products which Barton Mirando could supply.

Barton discussed the idea of processing the coconuts with some people in the village. They thought he had gone daft. Why would anyone want to buy coconuts when they were free for the taking? If anyone could not climb a tree to get a fresh coconut, he could always perform some service for a neighbor who would climb the tree. Besides, they already had everything they truly needed, so they did not need to work at processing coconuts. The machinery sat for a long time.

Suddenly, several ships appeared together and landed at the island. There were many rough men on board these ships who were not nice people at all. The islanders referred to the oysters, clams, and mussels as valvos because they essentially operate as valves, a word which they had heard from people on earlier ships. The people on the ships called them mollusks, but so what? These rough men started gathering all the oysters they could find, including the teeny-tiny ones, in hopes of finding all the darnits they could get. Some were so ignorant that they started opening all the clams and mussels they could find in hopes of finding darnits.

As time went on, the islanders found that with their valvo population under attack from the rough men from the ships, they could no longer find oysters, clams, and mussels to eat. Consequently, they found themselves eating the foods brought by the people on board ship. But even though they had freely offered to share their food with the people on board ship, those people wanted to charge the islanders for sharing their food. As a result, the islanders approached Barton about processing coconuts and selling the output to the people on board ship. It seemed that the people on board ship liked alcoholic drinks made with coconut milk and liked some baked goods made with coconut meat, but they were too ignorant or too lazy or too busy doing something else to go climb a tree themselves.

Barton got out the machinery from a cave where he had stored it. He and the islanders built some large huts to use as processing and storage (warehouse) areas, and they started the coconut processing business. However, Barton needed to know the cost of the various products he produced.

Once the villagers were earning the money paid to them by the people on board ship, and from other passing ships, they used the money to buy the foods offered by the ships, since they no

longer could eat all their own traditional foods. After all, it would take a long time for the population of valvos to recover. Barton and the islanders agreed on a maximum portion of the coconuts to be processed, in order that the coconut trees would always be there and always produce coconuts.

After some more time had passed, Barton, being a doctor, noticed that the islanders' health had changed. They now had heart disease, disease of the digestive tract, and tooth decay from eating the foods which had not been part of their traditional diet. He explained the medical reasons why this was so. Some of the islanders blamed it all on the rough men from the ships who were out to get every valvo they could get, almost at the instant of birth, as it seemed to them. Consequently, they formed a Committee On Not Shelling Every Rare Valvo At The Instant Of Nativity to protest what was happening to the valvos. Some bureaucrat back in the home country where the ships had come from gave it an acronym, and started calling it the CONSERVATION movement.

Also, after yet more time had passed, Barton and the islanders felt that they were not getting a fair price for the coconut products, so he reluctantly moved back to his home country of Sweden to represent the islanders' coconut products. To this very day, he claims he drives a Valvo.

TELECOMMUTING AT KENTUCKY AMERICAN WATER COMPANY

Stephen L. Loy, Eastern Kentucky University
Steven Brown, Eastern Kentucky University
E. Sonny Butler, Georgia Southern University

CASE DESCRIPTION

A public utilities company implements a telecommuting pilot project to improve the performance of its customer service department personnel. The case describes the effects telecommuting had on the attitudes and productivity of its customer service agents. This case is fairly simple, avoiding overly technical details, making it appropriate for juniors (level 4) and seniors (level 5). An instructor could make the case more challenging by having students develop a conceptual proposal for expanding the initial telecommuting program beyond the local telephone access area by using some sort of voice over Internet (VOI) and virtual private network (VPN) technology. This case is designed to be taught in a one hour class period and is expect to take three hours of preparation.

CASE SYNOPSIS

Kentucky American Water Company implemented a telecommuting system to improve the service performance of their agents in the customer service department. The case provides a background of the company, the reasons for initiating the pilot program, and the information technology architecture developed to support telecommuting. A brief description of the criteria used to select the agents for telecommuting as well as some of the problems and cost encountered in implementing the project. The statistics show that the productivity of the telecommuters more than doubled and service quality increased significantly. The cost-benefit analysis showed a 571% ROI the first year and a three-year NPV of $170,800 on a $25,000 investment. Comments made by the telecommuting employees and the project managers also indicate the project was successful. At the end of the case, the desire to add agents who live outside the local telephone area (LATA) to telecommuters is raised. The purpose of the extension would be to test the feasibility of using the Internet to avoid long distance phone charges. If this is feasible, it could impact the parent company's plan to develop a national customer service call center.

COMPANY HISTORY

Kentucky American Water Company (KAWC) is located in Lexington, Kentucky and serves approximately 280,000 people in the Lexington-Fayette Urban County area and parts of six surrounding counties. KAWC receives a large number of telephone calls regarding customer concerns and questions. Monday and Tuesday are typically the busiest days of the week and 8-10

a.m. and 3-5 p.m. are the busiest times of the day. The volume of calls during these peak periods often results in lengthy hold times for customers, increased number of customers disconnecting before their call is answered and numerous customer complaints filed with the Kentucky Public Service Commission. KAWC decided to search for a solution that would improve the quality and efficiency of it customer service associates (CSA).

TELECOMMUTING

Telecommuting, a.k.a. teleworking, generally refers to the ability of employees to work at home by using a computer linked to the main information system of their employer. Telecommuting has been used by many large corporations in large cities since the 1970s and 80s. In recent years many smaller businesses have started telecommuting programs. The first telecommuters were usually typists, bookkeepers, programmers and sales personnel. Telecommuting programs are usually developed to: (1) reduce office space and parking lot costs, (2) attract and retain skilled employees, (3) provide job opportunities for people with disabilities or parental responsibilities, (4) create more staffing flexibility, (5) reduce absenteeism and (6) increase office worker productivity. It is common for companies to report dramatic reductions in absenteeism, increases of 20-80 percent increases in productivity, improved customer satisfaction and higher levels of morale for telecommuting employees. Many companies have reported payback periods of six months or less and rates of return in excess of 100%. These factors and the dramatic advances in telecommunication capabilities and decreasing costs are causing more businesses to venture into telecommuting.

PILOT PROJECT

KAWC management had been thinking about setting up a telecommuting program for about five years, but had not initiated one because the cost of the technology seemed to high. However, by 1999 those costs had dropped significantly. The Lexington area was in the midst of a growth boom which caused KAWC to increase the number of its employees. Office space, especially in Billing and Accounting departments, were becoming over crowded, and the employee parking lot was packed as well. If their operations continued to grow, KAWC would need to construct a new office building or lease additional office space nearby. Leasing space for the Customer Service Department would cost about $4000 a year for each CSA. Telecommuting was seen as a less expensive way to relieve some of the crowding. The chief requirements for the telecommuting system were that it had to enable the CSA to connect from home to the same voice and data resources as those in the office, and had to be able to capture the same call performance statistics that were captured for the main office CSA.

KAWC called the telecommuting program the Home Connection and was to last three years because of rumors that the parent company, AWC, was considering a plan to create a national call center to replace customer service area of its subsidiaries, including KAWC. When the Home Connection program began KAWC employed ten (10) full-time and five temporary CSA.

The primary goal of the project was to determine the organizational, technical and economic feasibility of telecommuting for its customer service department. Additionally, KAWC hoped telecommuting would reduce customer complaints, increase customer service performance, reduce overcrowding in the office, improve morale, increase staffing flexibility and reduce costs. An initial budget of $20,000 was approved to set up three telecommuting CSAs.

INFORMATION TECHNOLOGY ARCHITECTURE

Prior to the telecommuting project, KAWC's computer system consisted of an IBM AS-400 midrange computer system and in-house developed COBOL applications. Remote data connections were provided through five ISDN lines. The ISDN lines that gave managers remote access to all network resources, including the IBM AS-400 at the corporate headquarters of its parent company, American Water Company, in New Jersey. Telnet, a protocol that enabled users to log on to other computers on the Internet, was also used to access the customer databases on the IBM AS-400. A Private Branch Exchange (PBX) digital switching device handled communications among the internal voice telephones, computers, and the external telephone network. The telecommuters workstations are Compaq DP6000 microcomputers with a Pentium 266 MHz processor, 64 megabytes of RAM, a 3-gigabyte hard drive, and the Windows NT 4 operating system.

The ACD is an automatic call distributing device that passes incoming service calls to the CSAs. It routes calls based on who is currently available or has the fewest callers on hold. The ACD also collects performance statistics, such as number of calls handled, length and on-hold time of each call, and number of calls disconnected before being answered. The ACD maintains job performance statistics on every CSA also.

An essential requirement for the project was finding a replacement for the existing ACD device. The current ACD could not collect statistics of calls transferred outside the local PBX to an ISDN line. The selection of the ACD, and a compatible ISDN service provider, It took five weeks to determine the specifications for the ACD, ISDN service and to evaluate the available products and vendors. The EXTender 3000 was select as the ACD router for the main office system. Additionally, each remote work station was equipped with an MCK Remote Agent router.

IMPLEMENTATION

The CSAs were given the opportunity to bid on the three telecommuting positions. Following the bidding process specified in the union contract, KAWC used the following criteria in selecting telecommuters: 1) length of continuous service, 2) knowledge, 3) training, 4) ability, 5) skill, 6) efficiency and 7) physical fitness. Due of the nature of the project, four additional criteria were considered: (1) quality of two-way radio communication at telecommuters home; (2) availability and quality of ISDN service to the home; (3) distance from the KAWC office for drop-off of materials and equipment service; and (4) availability of space in the residence for the workstation and office furniture.

The total cost to implement the Home Connection program was $20,132. The costs included $516 for the installation of the BRI-ISDN service in the telecommuters' home, $3870 for the MCK

remote agent equipment and installation, $9,000 for the MCK PBX Gateway, and $6,000 for workstations and printers. Existing office furniture was moved from the main office to the telecommuters home. There is a recurring monthly charge of $ 147 per telecommuter for ISDN service and optional features.

As with any project there were unanticipated problems. In this project, the most significant were the (1) occasional loss of the phone connection caused by faulty wiring in one of the telecommuters's house, and (2) the portable two-way radio given to one telecommuters was unable to reach the field service trucks in all areas of the county. The radio problem was solved by installing a radio system with a more powerful transmitter and receiver at a cost of $800.00.

PRODUCTIVITY IMPACT

The increase in productivity in the first twelve months of telecommuting surprised and delighted everyone. As shown in Table 1, the average percentage of calls answered increased from 87.7 % to 96.4 %, a 9.8 % increase. The industry average is about 90 %. The three telecommuters increased their personal productivity, in terms of average number of calls per month, by a whopping 150%. Together, the home CSA handle about 39 % of all customer calls after they began working at home. Other, performance improvements include a 71% reduction in abandoned calls, and a 73% reduction in customer hold time from 1 minute forty seconds to 27 seconds. Also, only one customer complaint was filed with the state Public Service Commission during this time. Before the telecommuting program there were twenty or more complaints filed each year.

Table 1: Customer Service Agent Productivity Averages

Description	Before	After	Change
Average Calls Received per Month	12,213	12,102	-0.9 %
Average Calls Answered per Month	10,707	11,666	9.0 %
Average Calls Abandoned per Month	1,506	436	-71.0 %
Average Walk in Customers per Month	937	740	-21.0 %
Average Hold in Seconds	100	27	-73.0 %
Average % Calls Answered	87.8 %	96.4 %	9.8 %
Average % Calls Abandoned	12.2 %	3.6 %	-70.5 %
Avg. Percent of Calls Handle by Home Agents	17.1 %	39.3 %	129.8 %
Avg. Percent of Calls Handled by Office Agents	82.9 %	60.7 %	-26.8 %
Avg. Monthly Calls Handled by Per Home Agents	617	1543	150.1 %
Avg. Monthly Calls Handled by Office Per Agent	984	865	-12.1 %
Average Calls per Payroll Hour for Home Agents	3.7	9.4	150.1 %
Average Calls per Payroll Hour for Office Agents	6.0	5.2	-12.1 %

Analysis of the individual performance statistics revealed one telecommuter doubled her all-time record by handling175 calls in one day. A second telecommuter also doubled her all-time record by handling174 calls on one day. The third telecommuter tripled her all-time best by answering 144 calls. The average monthly calls handled of the CSAs who became telecommuters surpassed the office-based CSAs in June 1999 and remained substantially above thereafter.

Table 2: Average Monthly Calls Handled Per Month

Year	Month	Average Calls Per Home Agent	Average Calls Per Office Agent
1998	April	880	780
	May	625	1,146
	June	800	1,054
	July	864	984
	August	1,017	914
	Sept	952	998
	Oct	742	896
	Nov	580	858
	Dec	388	923
1999	Jan	264	1,122
	Feb	203	973
	March	93	1,159
	April	336	967
	May	1,274	711
	June	1,839	914
	July	2,086	853
	August	2,007	1,048
	Sept	1,760	968
	Oct	1,569	940
	Nov	1,433	868
	Dec	1,507	814
2000	Jan	1,668	813
	Feb	1,463	735
	March	1,554	859
	April	1,440	683
	May	1,668	933

BEHAVIORAL IMPACT

After six months of telecommuting, the three CSA remained committed to the success of this project by assisting each other to solve problems and sharing ideas. Their technical skills have improved so they can "trouble-shoot" their PCs most of the time.

Before telecommuting, the three telecommuting CSA focused on dispensing with calls quickly and passing on the "wrap-up" tasks, such correcting a customers bill, to someone else. The setting of call performance standards by management and the feeling of lack of closure in dealing with customers' problems were stressful for them. However, after six months of telecommuting, the three started acting like team by setting their own goals - 15 calls per hour, or 100 calls per day. On exceptionally busy days they pull together to handle 20 - 25 calls per hour.

Management attributes the improvement in productivity of the telecommuters to the absence of the distractions found in the main office, such as chit chat with co-workers. KAWC strives to ensure that the telecommuters are included in every aspect of training, meetings and other activities of the company. Each telecommuters is required to work a few hours at the main office each work or attend a meeting with the main office CSA. Additionally, KAWC communicates daily with the telecommuters via telephone, e-mail, fax, and regular mail. Once each week, a manager from the Customer Service Department personally visits each telecommuters's home to pass along company information, discuss how things are going and to discuss any issues the telecommuters wishes. During these visits the manager also checked to see if the fire alarms are working, that door locks and deadbolts are adequate, and whether disks and paperwork are being properly stored in the locked file cabinet. The telecommuters are not required to have a security system in their home, but KAWC managers like it when they do.

The weekly visits to the telecommuters' home has raised one unexpected issue. One of these managers is a male and all the telecomuters are female. One telecommuter has her computer station set up in her bedroom. The bedroom has no chair for the to sit on, so he sits on the edge of the bed. The male manager has told his supervisor that this arrangement make him feel uneasy.

"We take his concern seriously. I guess our sexual harassment aware training is working," commented Emma Dailey, the Project Manager and Customer Service Supervisor. "We may need to prohibit future telecommuters from putting their work area in a bedroom. In the meantime, we'll either have a female make the visits or to have a female accompany him. If we don't, we could be putting the company in legal jeopardy."

COMMENTS

Pam B: "My thoughts before going into the Home Connection program were that I would be working in a more productive atmosphere. I would be more focused and empowered. It has proven to be just that. It is like having your own little business. I would certainly choose different customers but that's the feeling I get. I have become more creative, more self sufficient, taking on additional responsibilities in order for me to be more efficient and productive. We are stilling dealing with the same customer problems has before, but being in the home atmosphere that I am in, I feel that I can deal with them more efficiently because of not having the distractions and

interruptions. Beverly, Pam and I are committed to making this program work and appreciate the opportunity to do so. This program does and still has a lot to offer both the employee and the company."

Peggy H: "The Home Connection has been the most exhilarating, motivating and difficult project that I have had the privilege to been involved in. This program has allowed me to reach heights within my career that I never dreamed were possible. The foremost highlights are the simple feelings of empowerment and trust. Because KAWC has entrusted me to do my job from my home, I have learned how to be a team member, how to utilize a computer, and I am able to give the customer 100% of my attention. It is truly amazing how much more focused I can be in the quietness of my home. I am proud of the productivity that I have achieved. I have always taken my position seriously. This program has given me a complete control of my energies and goals. I can be in charge of my direction and I can strive to achieve what I know that I am capable of.

I feel fortunate to be a member of the Home Connection and to be a part of the team at KAWC and, most of all, the three ladies that I work with. We have given our "all" to this program and we are proud to say, that because of our hard work and commitment, it is flying high!!"

Beverly H: "When I found out about the Home Connection program I had my doubts; because in order to make this work we would have to work as a team and Customer Service has never worked as a team. After all the meetings and the installation of equipment, I knew in my heart that this was going to be a success. I've had the opportunity to work with two great women who I can ask anything and get a straight answer. I can ask for help and get it. I feel I have reached great heights and I intend to accomplish much more. I am so proud to be a part of the Home Connection team.

The Project Manager and Customer Service Supervisor, Emma Dailey, could not be happier with the performance of the telecommuters. She would like to add two or three more CSA to the Home Connection program. She is planning to expand the responsibilities of the telecommuters by letting them make adjustments to a customer's bill, rather than passing it on to a billing clerk. This change will provide customers with an immediate resolution to billing problems. Dailey attributes the program's success to three factors: (1) the total commitment of the three pilot telecommuters; (2) the availability of the telecommuters during peak call times; and (3) the reduction in interruptions during the telecommuters' work day.

Dailey also happy with the increase in trust, empowerment, morale, and flexibility of its customer service associates. She is also happy to have eliminated all of the temporary CSA positions. According to Emma Dailey, "this has definitely been a "win-win' situation for both KAWC and the telecommuters."

According to Coleman Bush, Vice President of KAWC Operations, "This telecommuting project has been the most successful project I have ever seen in all my years in management. I've never seen anything improve productivity and cut costs as dramatically as this has. Everyone at the AWC headquarters was amazed when I presented the results to them." His analysis, shown in Table 3, shows that the project had a five month payback period, 571 % ROI, and three-year net present value of $170,783! Armed with these results, Bush was convinced that AWC should give serious consideration to telecommuting if they develop the new national call center.

Table 3: Cost-Benefit Analysis			
COSTS	ONE-TIME COSTS	RECURRING COSTS COSTS/MONTH	3-YEAR NET PRESENT VALUES*
Total Development Costs	$20,132	$147	$25,424
BENEFITS	FIRST YEAR	ANNUAL RECURRING	3-YEAR TOTAL
Reduction in PSC Complaints	$ 5,000	$ 5,000	$ 11,416
Salary Savings	36,000	90,000	158,534
Recruiting & Training Savings	7,500	7,500	17,124
Office & Parking Space Savings	4,000	4,000	9,133
Total Benefits	$52,500	$106,500	$196,207
Length of Payback Period	5.4 months		
Net Present Value of the Investment*			$170,783
Rate of Return on Investment	571.7%		
* NPV discounted at 15%			

The national call center would handle all customer service calls from all AWC subsidiary water companies around the country. Customers from thirty-nine states would call an 800-number that will connect them to the Alton call center. The call center would employ 200 CSA and in operation by 2003. At that time, CSA around the country would be given the opportunity to move to Illinois. However, very few are expected choose to move and will either be assigned new positions at their current location or "pink slipped". AWC expects that it will lose its pool of experienced and skilled CSA, and will need to train new ones in Illinois.

"I think some sort of nationwide telecommuting program should be considered for the new call center," Bush argues. "It would allow us to keep our best CSA without having to relocate them to Alton. However, a way would have to be found to avoid or drastically reduce the long distance phone call charges between the call center and the telecommuters homes in thirty-nine states. The costs would be astronomical."

" We have looked into the costs of putting a CSA who lives outside the Lexington LATA on the Home Connection Program. The long distance telephone costs alone run about $1600 per month. If we could use the Internet instead of long distance phone lines, we might reduce the cost dramatically. We have about a year and a half to see if it's technically and economically feasible. I know AWC would gladly support it. I have already contacted WorldCom to see if they can help us out."

DISCLAIMER

This case was prepared by Stephen L. Loy, Steve Brown and Sonny Butler and is intended to be used as a basis for discussion. The views represented here are those of the case authors and do not necessarily reflect the views of the Journal of the International Academy for Case Studies. The authors' views are based on their own professional judgments.

ADJUSTING TO RAPID GROWTH AND NEW TECHNOLOGY: THE EDUSAT PROJECT

Robert Stretcher, Sam Houston State University
Geraldine E. Hynes, Sam Houston State University

CASE DESCRIPTION

This case involves the process of adjustment in a firm experiencing rapid growth in both the market it serves and in the technological sophistication of its product. It is appropriate for use in a variety of business courses to enhance coverage of technology management, entrepreneurial ventures, organizational communication, customer relations management, and the matching of marketing plans with production expectations. It should prove most useful at the undergraduate level, and should require one to two hours of outside preparation by students.

CASE SYNOPSIS

EduSat is a provider of instruction via satellite for elementary, middle, and high school curricula as well as undergraduate and master's level coursework. The system was initiated in 1997 to serve the demand for home study. Typical customers are home schoolers and individuals wanting to pursue both college degrees and topical learning. Cokesbury University provides this service, which has experienced phenomenal growth since the project's inception in 1997. A recent software and hardware upgrade combined with a surge in new customers has overloaded the technical and support staff and resulted in customer complaints about poor service.

THE BEGINNING OF A GREAT DAY

Robert Viner walked into the hallway where preparations were being made for the 9:00 AM quarterly staff meeting. He noticed that people were not in the usual demeanor of coffee and donut consumption while cordially visiting with one another. There seemed to be a tense buzz among the staff, who were intensely conversing in the hallway and in the meeting room. Viner saw his administrative assistant, Mike Lawrence, toting a stack of papers into the meeting room. "Good morning, Mike. What is all this?"

"We'll need these when we discuss the expansion in volume. Michelle in tech support and Donna in customer service are both complaining about the workloads. They say they have been putting in twelve-hour days since mid-July, and that they have been inundated with calls from our customers." Mike thought for a moment. "In fact, I have been getting a lot of emails lately from irate customers complaining about the lack of service."

"We have an hour until the meeting," Robert replied. "Why don't you pull our customer database and run a graph to show growth? And while you're at it, let's get some numbers from the university operator on call volume and response time. They can probably provide that for us within

an hour. If they can't, call the business office. They should have a record until the end of July; I know we got the bill for July already."

"Will do," Mike said.

Robert heads the Division of Satellite Learning (DSL) at Cokesbury University. He came to the university in 1996. He accepted the Director's position with the charge of making Cokesbury a premier provider of satellite education from primary to master's levels. Robert has enjoyed a great deal of support and funding from the university's administration.

A CUSTOMER CALL

Robert walked to the end of the hall, where his office was already open. The division secretary, Shera, was on the phone. "Ma'am, I will certainly give him the message, and he does return his calls...oh, he just walked in. Hold for a second." Shera turned to Robert. "I know you don't like to take direct calls, but this lady is in a panic. She has just set up her system and says she can't get through our help line. Wanna take it?"

"Why not?" Robert replied. "I'm in a productive mood today." Robert closed the door to his office and picked up the phone. "Hello....yes, I'm Robert Viner, and I am the project's director."

"At last!" the voice replied. "I am Joyce Vernon. I ordered your satellite equipment to do home schooling this year. We had a time setting it up, but worked through it with your technical staff. The last time I was able to get through on your help line was a week ago. We always had to wait for lengthy periods for the help, but someone would eventually answer. This past week I have tried to call at least twenty times. I have been put on hold for up to an hour, and half the time they hang up on me after I have waited on hold. That's a pathetic way to end an hour of my time, especially since, while I am on hold, I'm being told every 30 seconds that my call is very important to you and that you very presumptuously appreciate my patience." The voice paused. "I'm about ready to send your equipment back and forget trying to deal with your poor service. Your brochure said that service is your priority."

Robert groaned silently to himself. "I'm terribly sorry you had problems, Ma'am. We have had a tremendous call volume this month, and it should slack off a bit after school starts in September."

"Oh, I feel much better about this week now that you've said that. I still can't get through, and programming for my child's classes supposedly starts tomorrow! Call volume slacking off after September isn't going to help me a bit! Your call center is in dire need of help. Why don't you just admit it and get the help your customers need and the help that I need? Hanging up on me after I've waited on the phone for an hour isn't MY idea of customer service!"

"I'm sorry you feel that way, Ma'am," Robert replied.

"Oh, Puh-lease don't apologize for the way I feel!" her voice sounded loud and irritated now. "I feel the way anyone would feel after being duped by your ads and treated the way I've been treated! I wasn't born yesterday, and I'm not the stupidest person around. I have a master's degree in education, and as far as I know, I haven't claimed to be excellent unless I really delivered! AND I don't tell people they are important to me unless they ARE!!! Your University is associated with

the church, right? Don't you believe that your actions tell the truth, regardless of what your words say?"

Robert winced. He felt the same way when people apologized for the way he felt. "I do apologize. We obviously have a problem, and I will get someone to call you from our tech support department. Please give me your phone number or email address, Ms. Vernon."

"What assurance do I have that they will call me, and will they call before tomorrow?" the voice asked.

"I will give you my personal assurance that someone will call you today, before 4:00. If they don't, you can call me back through a different number." Robert gave her the direct line to his assistant. "I will talk to our support staff within the next hour."

"Thank you. I hope this works," Joyce replied.

"I assure you it will. Goodbye." Robert hoped his assurance that things would work was true. The call was unsettling, especially if others were experiencing the same thing.

THE QUARTERLY STAFF MEETING

Robert had been stopped six times on the way to the front of the meeting room. His staff had shared some nightmarish happenings with him. The phone system had indeed been malfunctioning, and customers had been calling the academic dean's office to complain. Orders for new satellite systems were backlogged by a week, and customers were experiencing problems because of a glitch in the updated software package for the system. Additionally, new customers were experiencing equipment problems with a certain type of receiver, and were clamoring to exchange the equipment. Robert had prepared an agenda for the meeting, but decided to just conduct more of a 'town meeting', since these urgent problems needed to be worked out first.

"OK, folks, the August staff meeting will come to order" Robert began. "I am going to forego the agenda today so that we can concentrate on some pressing problems. My office has received many calls complaining about the poor service we have been providing. With the fall semester starting in two weeks and the home school material starting this week, we need to immediately address some of these issues."

"I'll start!" Michelle Verit stood up. She managed the technical support area, and had three equipment technicians and ten support technicians working for her. "I know you have gotten complaints about us. The new receivers and software have given us a fit. About half the receivers we delivered in the past two months have been defective. They will pick up the signal at our test facility, where we have the LNB's already pointed in the right azimuth and direction, but they won't begin picking up a signal when our customers are trying to aim theirs according to our directions. We've had to replace about 60 so far and we expect more. I can understand the frustration they are experiencing, and our staff is overloaded with the call volume. Our supplier, Igalactic, won't take any responsibility for them other than replacing them. I refuse to work our technicians more than ten hours a day. They work six days a week already, and these sixty hour weeks are getting to all of us. If we didn't have such a large call volume, we could handle things fine."

Donna Brewer raised her hand. She was the customer service manager. "We have received the brunt of the call volume, and we feel that too many systems were sold. We simply can't get to

all of the calls. Customers are irritated at having to stay on hold for so long, and even more irritated that we have to transfer them to tech support and they have to wait even longer. Then, for the past three days, the phone system has been acting up. The university communications department said we're nuts, and that there is nothing wrong. But when I tried to call our service number, I got the same message our customers were getting. It said 'we are unable to answer your call at this time.' When customers can manage to get through, they are asking why we are so 'unable,' and with good reason. This is a terrible time for the phone system to be down."

Michelle Verit stood again. "I'm getting the same story from our customers. They're really angry about it."

Donna spoke up, "they're really angry about tech support, too. They're complaining to us about the attitude of the technicians. As far as I can tell, they're following your instructions, but the systems aren't working."

"That's Igalactic's fault," Michelle replied. "There's nothing we can do about faulty units."

"Our main problem is call volume," Donna said. "If we didn't have all these customers to deal with, we could easily handle customer service requests. Why did we sell so many units, anyway?"

Everyone turned and looked at Randy Hall, the marketing manager. "Now, wait a minute. If you didn't want to gain customers, why did you want marketing done? The problem isn't that I did my job too well. It's that you guys are not doing your job well enough!" Randy had been perturbed for a while because he had been asked to 'help out' in the customer service area, and marketing had been on hold for a month to limit new account growth. He was doing what he considered to be subservient work and not doing what he was hired to do - marketing.

Samantha Turner, the office manager for the service offices, spoke up. "There's no reason why we should get terse with each other. We need to deal with these things and come up with some steps we will implement to get them solved. "If I can help get things done, I am willing to assist."

Robert slouched in his chair, thankful that Samantha had spoken up. "Thanks, Sam," Robert said. "We all need to adopt that attitude. The last thing we need is to get nasty with one another."

From that point, the meeting seemed to drag on. Robert finally sent everyone back to work after an hour, since no progress was being made in the meeting. He walked back to his office. Mike, his assistant, met him at the door.

"I think the sky is falling, Mr.Viner. You have received twenty-six calls during the meeting, all from angry clients, whom I have dealt with as best I can - I'm taking a break now." Mike walked out of the office. The phone rang. The second, third, and fourth lines quickly followed. Mike stuck his head out the door. "Samantha, HELP!" he yelled.

COKESBURY COLLEGE AND THE DSL

Cokesbury College was founded in 1866 as a liberal arts institution associated with an assembly of protestant churches. The mission soon grew to include several divisions, including ministerial studies, business, and sciences. The college remained virtually unchanged until 1956, when an asserted effort to increase the size and breadth of the college began. After a successful fundraising campaign, new buildings were erected and the college became a university with four

schools: liberal arts, business, education, and nursing. In 1992, a division of pharmaceutical studies was added, and in 1995, a division of satellite learning.

The university has maintained a loose affiliation with the church, but now has a much broader financial support base, and therefore answers to a greater variety of stakeholders. The initiation of the Division of Satellite Learning presented an opportunity to build a self-supporting division that would hopefully become a cash-generating venture. The university had spent a small fortune for the infrastructure to support the first few years of operation. By the end of the fourth year of operation, the division had generated cash flow sufficient to pay back one-third of the original investment in 1996. Most of that return had come in the third year, when the number of satellite learners had reached what appeared to be a critical mass, sufficient to continue operations with some additional support from the university.

THE WORD FROM THE DEAN

Later in the day, as Robert was walking back to his office from the faculty/staff cafeteria, he ran into the academic dean, Ed Devinna. "Hello, Robert!" greeted Devinna. "I need to talk to you."

Usually when Devinna said he needed to talk, it was either really good news or really bad news. He was good at leaving routine concerns for regular meetings. Devinna and Robert stepped over to a convenient bench. "I've been receiving phone calls about some problems people are having with your system, and with getting through to your staff," he began. "In fact, we've been getting these calls fairly frequently for the past few days. What's going on?"

"We have had some problems with the phone lines, and have had a tremendous call volume for the past two weeks. The problem with the phones started about a week ago, as far as I can tell. I've asked the communications director to handle it."

Devinna looked away for a moment. "We can't have this continue, Robert. I don't want poor service to be associated with Cokesbury. I consider this project to be equally important as our traditional programs."

"We're very aware of the problems that all of these new satellite students have created, and we're moving to correct them. We had a staff meeting this morning about it," Robert replied.

"New students are not the problem, Robert. New students are our survival," Devinna asserted. "Let me know your plans for dealing with this by tomorrow about this time." With that, Devinna said goodbye and headed off to his own office.

Robert walked back to his office. Mike had left the call volume report and a growth chart on his desk (exhibits 1 and 2). Robert pondered the information. The growth looked about as he had expected, perhaps greater than expected for the current month. The call volume report reflected the customer concerns that had been expressed to him, the customer service personnel, and unfortunately, to the academic dean's office. Average wait time had hit a high during the past week. It was almost one hour. Robert noticed another figure of interest at the end of the report. An item labeled 'timeouts' had been at a low level until the past few weeks. He picked up the phone and entered the communication department's extension. "Hello, Carol. How are you?" Carol was the communications director's assistant. "What does the timeout item mean on this report you sent me?"

"Oh, that's the number of times a held call timed out," Carol replied.

"What do you mean by 'timed out'?" asked Robert.

"Well, if the system indicates a hold, at the end of one hour, it times out and the connection is terminated. That is there because we have a limited number of lines, and sometimes a caller will disconnect, but it won't be detected. After an hour goes by, that line will reset."

Robert sighed. "What if someone really HAS been on hold for an hour? Would the system disconnect them, even if they're still on the line?"

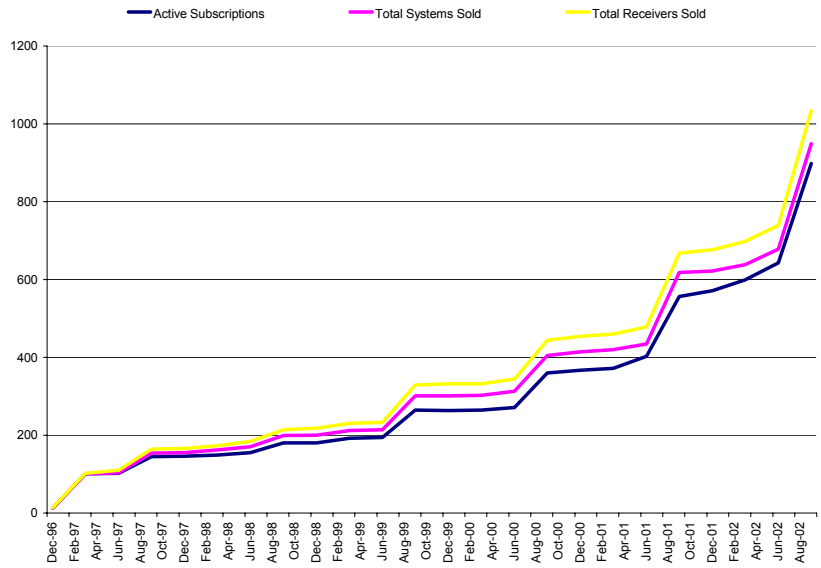
"Yes." Carol replied. "But who would leave someone on hold for an hour? That would do wonders for Cokesbury's reputation, wouldn't it?"

"It would. Thanks for the info, Carol. Bye." Robert flushed with embarrassment. "WE would leave them on hold for an hour and hang up on them, that's who," he thought to himself.

Exhibit 1: WEEKLY CALL VOLUME REPORT: June-August 2002

Week	Total Calls	Avg Wait	Timeouts
June 3-7	4,328	0:12:02	0
June 10-14	5,843	0:10:53	0
June 17-21	5,736	0:10:12	0
June 24-28	6,940	0:16:08	0
July 1-5	8,902	0:21:21	0
July 8-12	10,641	0:21:23	1
July 15-19	9,459	0:15:02	1
July 22-26	9,996	0:18:38	0
July 29-Aug 2	12,399	0:29:23	4
Aug 5-9	14,623	0:38:01	1
Aug 12-16	24,930	0:45:00	24
Aug 19-23	31,043	0:58:00	184

Exhibit 2: ACCOUNT AND UNIT SALES GROWTH



COUNTING THE RETURNS: WHAT CONSTITUTES FAIR DISCLOSURE?

David Coffee, Western Carolina University
Roger Lirely,Western Carolina University

CASE DESCRIPTION

The primary subject matter of the case is accounting for returned merchandise. The student is confronted with ethical issues about the responsibility of independent auditors to insure full disclosure, when such disclosure might not be specifically required under generally accepted accounting principles (GAAP). The case has a difficulty level of four/five and is appropriate for intermediate or graduate level students. It is designed to be taught in one hour and requires two hours outside preparation by students.

CASE SYNOPSIS

Hair Force One is a closely held manufacturer of aftermarket motorcycle parts. The company has done well in recent years, and there is speculation that larger companies may be targeting the company for buyout at a handsome profit to the shareholders. Recent quality control problems have led to a significant increase in sales returns and allowances. Nancy Clark, the firms' independent auditor is concerned that following the industry practice of reporting net sales may not fully disclose relevant information about the company related to the large number of returns and the quality control problems. Yamato Zhu, the major stockholder of Hair Force One, opposes any disclosure about sales returns and allowance, arguing that such information is proprietary. Students are required to research GAAP pronouncements and accounting literature to determine the generally accepted accounting for sales returns and make a series of professional judgments about professional responsibilities of independent auditors. Students must address issues about what is and is not proprietary information and what constitutes full disclosure.

A GROWING COMPANY AND PROBLEMS WITH QUALITY CONTROL

Hair Force One is a company incorporated in 1994 and is closely held. The major stockholder is Yamato Zhu, a noted motorcycle enthusiast who is known in the motorcycle industry as an innovative and imaginative source of aftermarket bike parts. In the late seventies, Yamato patented what became a very popular touring fairing, and later developed and produced aftermarket seats with unique designs and features. Hair Force One produces and sells Yamato's latest creation, which are hard saddlebags made from a new material called fiberfoam. The saddlebags are retailed directly to customers as well as wholesaled to dealers. They fit many of the popular cruisers, standard bikes, and sport touring bikes. Because of their unique styling, light weight and relatively moderate price, the sales of the bags have surged over the past three years. The small group of Hair

Force stockholders now find themselves in a very nice situation. Speculation about possible interests in a buy out by larger companies has intensified and shareholders stand to make handsome profits. There also have been discussions about the possibility of going public and expanding the business into a comprehensive line of aftermarket parts.

Hair Force had their first independent audit for the year ended December 31, 2001 and is currently involved in the audit of their statements for the year ended December 31, 2002. These statements are presented in Exhibits 1-5 in the appendix.

To Tell Or Not To Tell

Nancy Clark, a newly promoted partner with the independent auditors, White and Newberry, is having lunch with Yamato. The lunch was at Nancy's request. She wants to discuss Hair Force's sales returns and how they should be reported on the income statement.

"Look Nancy, I'll be candid with you." Yamoto spoke slowly, not taking his eyes off his glass of red wine, as if reflecting on something profound. "We have made some quality control decisions which we wish we had not made. Unfortunately, these decisions are not easily undone because they relate to initial investments in manufacturing infrastructure which would, at this point, be very costly to correct."

"Yamoto, I regard quality control issues as management issues and I am not trying to manage Hair Force. From everything I hear, the company is in good hands and I think management understands the quality control problem and its importance." Nancy spoke with as much reassurance as she could muster, because she knew she was about to raise a very difficult issue. She watched Yamoto intently for his reaction as she went on. "My concern is how to report sales returns on the income statement. Last year we simply netted sales returns against sales and reported only the net sales figures. I can't help but question if this is adequate disclosure. One could argue that both gross sales and sales returns should be shown on the income statement, or at least disclosed in the footnotes, in order to meet the requirements of a full and fair disclosure."

Yamoto narrowly avoided loosing the sip of wine just nurtured from his glass. Short of this, he made no effort to conceal his disagreement. To the contrary, a notably loud sigh and weary smile simultaneously emerged and Yamoto, the ball now in his court, made the return, decisive and without hesitation. "Nancy, this issue is not new and I have been over this ground before. Rick Collingsworth, was in charge of this for you guys last year and he researched the accounting treatment of sales returns and concluded that reporting sales net of returns is not only allowable, but the norm."

Yamoto's response took Nancy by surprise, but she succeeded in concealing this and replied, with a calm and reassuring presence, that she would look at the professional pronouncements and a recent edition of Accounting Trends and Techniques in search of guidelines.

Yamoto seemed satisfied with Nancy's response, concluding, perhaps prematurely, that his cause was won. "Look Nancy, we are not Enron or World Comm. Hair Force is an honest company with honest hard working management and ownership. We know and appreciate the importance of honest and reliable financial reporting. Anyone who knows me knows this, and you have been with White and Newberry long enough to know me. But you need to understand that some kinds of

information are just plain proprietary and not the business of those outside the company. This is one of those things. This is management stuff, not stuff for outsiders. Our responsibility to outside users of our financial statements is to fairly measure and report income and we are doing this by reporting net sales. Gross sales and sales returns are management information, which we use to manage the company. See my point?"

"Yamoto, we will give this issue full consideration, and together, Hair Force and White and Newberry will do the right thing. I'm not suggesting this is an Enron or World Com thing. You are aware, I presume, that your returns increased from 15% of sales in 01 to 20% of sales in 02?

"Yes. I'm management and it's a management issue."

QUESTIONS TO CONSIDER

1. Research the professional accounting pronouncements to determine if there are guidelines on reporting sales returns and report your findings.

2. If you were Nancy, would you require Hair Force to report both gross sales and sales returns? Why or why not.

3. Discuss Yamoto's assertion: "…you need to understand that some kinds of information are just plain proprietary and not the business of those outside the company…our responsibility to outside users…is to fairly measure and report net income and we are doing this by reporting net sales. Gross sales and sales returns are management information which we use to manage the company."

4. Are there other areas of Hair Force's financial statements that might be subject to increased audit risk because of the sales returns?

Table 1: Hair Force One Income Statement Years Ended 12-31-01/02		
Sales Presented Gross For Internal Viewing Only		
	Year Ended 12-31-01	Year Ended 12-31-02
Sales	$1,400,000	$2,100,000
Less Sales Returns	210,000	420,000
Net Sales	$1,190,000	$1,680,000
Cost of Goods Sold	680,000	960,000
Gross Margin	$510,000	$720,000
Selling and Administrative Expenses	400,000	$500,000
Income Before Taxes	$110,000	$220,000
Income Taxes	38,500	77,000
Net Income	$71,500	$143,000
Earnings Per Share	$7.15	$14.30

Table 2: Hair Force One Income Statement Years Ended 12-31-01/02		
Sales Presented Net For External Viewing		
	Year Ended 12-31-01	Year Ended 12-31-02
Net Sales	$1,190,000	$1,680,000
Cost of Goods Sold	680,000	960,000
Gross Margin	$510,000	$720,000
Selling and Administrative Expenses	400,000	500,000
Income Before Taxes	$110,000	$220,000
Income Taxes	$38,500	$77,000
Net Income	$71,500	$143,000
Earnings Per Share	$7.15	$14.30

Table 3: Hair Force One
Statement of Changes in Retained Earnings
For the Years Ended 12-31-01/02

	Year Ended 12-31-01	Year Ended 12-31-02
Beginning Retained Earnings	$5,500	$72,000
Plus Net Income	71,500	143,000
Less Dividends	5,000	5,000
Ending Retained Earnings	$72,000	$210,000

Table 4: Hair Force One Balance Sheet 12-31-01/02		
	12-31-01	12-31-02
Assets		
Current Assets:		
Cash	$18,500	$82,200
Accounts Receivable	120,000	$250,000
Less Allowance for Doubtful Accounts	10,000	12,000
Raw Materials Inventory	40,000	70,000
Work in Process Inventory	2,000	4,000
Finished Goods Inventory	4,000	16,000
Supplies	1,000	1,500
Prepaid Expenses	500	300
Total Current Assets	$176,000	$412,000
Property Plant and Equipment	$500,000	$600,000
Less Accumulated Depreciation	100,000	150,000
Total Property Plant and Equipment	400,000	450,000
Total Assets	$576,000	$862,000
Liabilities and Stockholders Equity		
Current Liabilities:		
Accounts Payable	$34,000	$65,000
Refunds Due Customers	8,000	16,000
Taxes Payable	5,000	10,000
Interest Payable	8,000	12,000
Total Current Liabilities	$55,000	$103,000
Long Term Liabilities:		
Bank Note	$149,000	$249,000
Total Long Term Liabilities	$149,000	$249,000
Stockholders Equity:		
Contributed Capital		
Common Stock	$10,000	$10,000
Paid in Capital in Excess of Par Value	290,000	290,000
Total Contributed Capital	$300,000	$300,000
Retained Earnings	$72,000	$210,000
Total Stockholders Equity	$372,000	$510,000
Total Liabilities and Stockholders Equity	$576,000	$862,000

Table 5: Hair Force One
Cash Flow Statement
For the Years Ended 12-31-01/02

	Year Ended 12-31-01	Year Ended 12-31-02
Cash Flows From Operating Activities		
Net Income	$71,500	$143,000
Increase in Receivables	(40,000)	(128,000)
Increase in Inventories	(20,000)	(44,000)
Increase in Supplies	(100)	(500)
Decrease in Prepaid Expenses	300	200
Increase in Accounts Payable	10,000	31,000
Increase in Refunds Due Customers	4,000	8,000
Increase in Taxes Payable	2,000	5,000
Increase in Interest payable		4,000
Depreciation Expense	50,000	50,000
Net Cash Provided From Operating Activities	$77,700	$68,700
Cash Flows From Investing Activities		
Acquisition of Plant and Equipment	($104,200)	($100,000)
Net Cash Used by Investing Activities	($104,200)	($100,000)
Cash Flows From Financing Activities		
Bank Loan	$49,000	$100,000
Dividends Paid	(5,000)	(5,000)
Net Cash Provided From Financing Activities	$44,000	$95,000
Net Change in Cash	$17,500	$63,700
Beginning Cash Balance	$1,000	18,500
Ending Cash Balance	$18,500	$82,200

LABOR RELATIONS AT SMEAD MANUFACTURING COMPANY'S CEDAR CITY PLANT

Roy B. Johnson, Southern Utah University
Gerald E. Calvasina, Southern Utah University

CASE DESCRIPTION

The primary subject matter of this case concerns labor/management relations. Secondary issues examined include company strategies in Labor Relations, Collective Bargaining, and Legal issues associated with Labor/Management Relations. The case has a difficulty level of four to five and should be appropriate in both undergraduate and graduate courses in labor/management relations, human resource management, or strategic management. The case is designed to be taught in either one or two class hours depending on instructor preference, with one to two hours of outside preparation by students depending on the use of the bargaining role-play exercise. Employee names have been disguised to protect their privacy.

CASE SYNOPSIS

This case examines the relationship between a company and labor union nearing the end of their first contract. The key issue to address is management's overall labor relations strategy to date and what is and is not working. This assessment will then become the basis for management preparation to begin bargaining of a new agreement. There are a number of secondary issues that can also be explored through the case including the company's decision to re-locate the plant from the Los Angeles, California area to a remote rural area in Southern Utah. An assessment of management's approach to bargaining over the first agreement and its outcome should also be explored. Depending on the amount of time the instructor chooses to devote to the topic, the case also presents a collective bargaining role-play opportunity.

INTRODUCTION

Bob Smith sat at his desk contemplating his responsibilities over the coming months. In the year 2000, he had been transferred to the Smead Company production facility in Cedar City, Utah as the plant Human Resource (H.R.) Director. The preceding H R Director had left the company after unsuccessfully resisting an employee unionization effort. This effort had been contentious as the employees battled for higher pay and the company resisted. Even after the employees had voted to support the union by a two-to-one margin, the company was slow to cooperate. It had taken almost a full year after the union was voted in for the contract to be negotiated and the company gave little in the way of concessions. Now that contract was set to expire it would be largely his responsibility to negotiate a new one and, on a more basic level, to help set an overall labor relations

strategy. Given everything that had already happened, what were his options and what decision would be the best for his company?

SMEAD MANUFACTURING COMPANY

> Smead continues to set the standards for effective state-of-the-art records management.
> Smead Website (www.smead.com)

> I went to Smead and it's a nice place, but it's not going to take care of my family
> Rusty Galetka, Smead Employee

Smead manufacturing company produces thousands of modern filing products in order to make records management more efficient and economical. It is a family owned American company that began in 1906. Smead's basic business principle is to provide quality filing products that best serve the needs of their customers.

Smead's journey began with the bandless file, which the founder Charles Smead invented. Since then, Smead has focused on new advancements in records management. The company has received several trademarks for its innovations. These range from the first bandless file to comprehensive packaging of new systems using electronic tracking, imaging and bar code techniques.

Shortly after founding the company, Charles Smead died. P.A. Hoffman, an employee purchased the company and with the help of his son Harold, led Smead for the next thirty years. Mrs. E.C. Hoffman assumed leadership of the company after the death of her husband Harold in 1955. She was well known for taking over a faltering company and building it into a $236 million enterprise. In 1995, her 40th year as president, Smead was ranked 31st on Working Women magazine's list of 50 largest women-owned businesses.

In July 1998, Mrs. Hoffman transferred the leadership of Smead on to her daughter, Sharon Lee Avent, herself a 35-year employee with Smead. Sharon assumed the Office of President / CEO and Mrs. Hoffman remained Chairman of the Board of Directors until her death in February 1999. Smead has received much recognition because of the leadership that women have played in the company's development. Most recently, Smead was ranked number two in the 1998-1999 Top 25 Women-owned Businesses in Minnesota. This came at a time when the company's yearly sales growth was 37.5 percent and employee growth 16.0 percent.

As the company grew, it opened several production and distribution facilities across the United States, eventually extending into the European market. This growth allowed the company to branch out into different industries, providing a full range of records management products. Smead's major competition comes from industry rivals American Tissue and Esselte.

As of 1996, Smead had 6 plants in: Locust Grove, Georgia; Logan, Ohio; McAllen, Texas; McGregor, Texas; River Falls, Wisconsin; and Pico Rivera, California (Exhibit 2). Each of these plants had on average between 250-500 employees working fulltime. This is in addition to the

headquarters plant in Hastings Minnesota, which has between 500-1000 employees. The McGregor, Pico Rivera, and Hastings, plants were each unionized.

With Smead's rapid growth rates, some of its plants began reaching capacity. The plant in Pico Rivera, California had grown from one building to three. Because of the limited space and structure, these buildings were not designed in such a way that efficiencies could be captured. Costs were increasing and new space was needed. Smead began to look for the best place to build a new plant.

Smead needed a good location for shipping and a better production setup (one building with capacity to grow) where economies of scale could be realized. A key consideration in choosing a new site was a need to reduce costs. Smead paid attention to differences in labor costs, taxes and utilities. The company also looked at relocation incentives offered by municipalities giving breaks in taxes, utilities and rent in exchange for jobs. After examining several possible locations, Smead decided to build a new plant in Cedar City, Utah and to close the Pico Rivera plant.

CEDAR CITY

> Cedar City has been as successful (for its size) as any community in the state in attracting new jobs.
>
> Mark Bacon, author

> Companies are moving here to exploit lower wages.
>
> Russ Taylor, PACE union negotiator

Contrary to its name, Cedar City is a small town of about 22,000 in rural southwest Utah. It is located in Iron County, which had a total population of about 30,00 in 1996. Cedar City is home to Southern Utah University a comprehensive regional university with about 6,000 students and 1,000 employees. This contributes to a low median population age of 23 to 24 years old. It also provides a reservoir of cheap, if somewhat unsteady labor. The presence of student labor helped attract such firms as Convergys, a telemarketing firm and Iron County's largest private employer.

The presence of student labor also helped dampen pressure on wages in the county. The average wages in Cedar City are at 64 percent of the national average while the cost of living is 93 percent. According to Iron County - Cedar City Economic Development Director, Clark Krause, this wage rate is an improvement. Several years ago, he said, the wage level in Cedar City was at 56 percent of the national average.

Since then, the city had aggressively recruited businesses with relocation incentives. Most of these were small manufacturing firms, though two of the largest new employers were telemarketing firms

While increasing the number of jobs, the new companies paid only slightly higher wages. A local industry association called the Southern Utah Manufacturers Association (SUMA) was

formed to further the companies' joint interests. This association came under attack for allegedly colluding to fix prices. SUMA president Ray Smith denied any collusion and claimed that low wages were simply the result of supply and demand. "It is my belief that the wages are established by the market and there are people here with skills who want to live here and are willing to perform jobs at a lower wage here than they would be in Orange County, or Chicago," he said. "And I'm one of those." Support for Smith's claim can be seen in an annual population growth rate of over four percent in 1990's. In spite of low wages, over a thousand new residents were settling in Iron County every year.

Cedar City had other advantages for businesses as well. While in a rural setting, Cedar City is centrally located in the western states; less than 600 miles from Denver, Los Angeles, Phoenix, and San Francisco. The town is less than two hours from Las Vegas and three hours from Salt Lake City. It lies on Interstate15 the main route between Salt Lake City and Los Angeles. It also had rail access provided by Union Pacific and Utah's second largest municipal airport. Cedar City was also investing in internet infrastructure so that by 1998 Yahoo! Internet Life magazine (February 1998) noted that "Utah is surprisingly well wired…, But the title of most impressive online community belongs to the tourism-driven Cedar City." Worker compensation and tax rates are lower in Utah than most other states as are utilities and land costs. According to an article in Fortune magazine (Feb. 14, 1993) "Utah has the lowest cost of doing business of any state in the nation."

All of these factors played a part in Smead's choice of Cedar City for its new plant, but the kicker was a $334,000 tax incentive agreement between the city and Smead. The contract stipulated that Smead had to invest $10 million in Iron County over a two-year period, have 200 or more employees hired on a full-time basis and pay an hourly wage and benefit rate at least 20 percent higher than the prevailing rates in the county.

Smead began actual production work in August of 1996. Although their plant was not finished until January of 1997, they were able to use excess capacity at the local Gore manufacturing plant to begin production. By 1999, Smead had over 200 employees working at the Cedar City plant and it had become the third largest private employer in the county.

LABOR PROBLEMS

> Smead's loyalty to its employees is reciprocated by the very personal dedication to Smead's customers among its personnel. You can rely on the stability, consistency and personal service that naturally accompanies long-term employee commitment.
>
> Smead Website

> We're treated like cattle. In some instances, I think cattle are treated better.
>
> Sheila Colclasure, Worker at Smead's Cedar City plant

It didn't take long for difficulties to develop. Within two years of the move, workers at Smead's Cedar City plant began to grumble. They had discovered that they were paid on average

about $2.00 less per hour than employees at Smead's two other plants in Hastings, Minnesota and McGregor, Texas. In 1999, workers at Hastings, for example, started at $10.58 per hour, while Cedar City packers began at $7.06 per hour. The average employee at Smead made about $9.50 an hour. According to the 1999 annual Out of Reach report issued by the National Low Income Housing Coalition, residents had to earn at least $11.69 an hour to afford a standard two-bedroom apartment.

While there were differences in wages among Smead's different plants, the wages at Smead were not out of line with those of most other local employers. This was one of the features that attracted Smead to Utah in the first place.

Employees also complained that management just "didn't care about people." They felt that management micromanaged their every move. Employees were restricted in their ability to socialize, there was no room for error in attendance, and even their restroom time was monitored closely. With such demanding conditions, management still expected the employees to have a positive and cooperative attitude.

Another issue concerned production quotas. Smead, like most production companies used standards (or quotas) to gauge performance. It is also common to assume a learning curve with a particular environment and thus adjust the standards to better performance. Production operators claimed that management didn't seem to ever stop raising the requirements. According to the workers, if an employee's machine broke-down, the down time counted against "run-time," preventing him or her from meeting the necessary quotas. Because some of these machines were so unique in design it could take anywhere from a half hour to two weeks to fix. The employees said that several of the operators lost their jobs due to down time or quotas they found impossible to meet.

In a letter to a union representative, the plant General Manager, Gordon Goodall addressed these accusations. He noted that, "there are no production quotas per se." However he added, "The use of machine standards and production recording is a method of scheduling, costing, and tracking machine efficiency. Our goal is to continue to improve production output through continuous improvement activities. This would include equipment design and manufacturing processes." Goodall denied that anyone had been, "disciplined for failure to make 'production quotas.'"

Because this industry had seasonal highs and lows, employee's work schedules could vary greatly. Employees were asked to work around the clock, with no overtime at times of high demand. They complained about mandatory, 48-hour workweeks. According to one employee, workers were expected to work three Saturdays a month and a mandatory Sunday. In times of slow demand, on the other hand, workers would not be given enough work, they complained of being relieved for days at a time. This type of schedule affected the employees' personal lives, physical health, and overall morale. Rather than use inventory to smooth out these production cycles, management, in the interest of efficiency, kept inventory levels very low.

Employees tried to change policies at Smead but to little avail. By 1999 they had noticed one major difference between their plant in Utah and the other, higher paying plants: those plants were unionized while the Cedar City plant was not. While Southern Utah is extremely conservative with strong anti-union attitudes, employees began to consider the option. If Smead organized, it would be the first unionized plant in the area and the employees were noticeably reluctant to take

this step. "This is not about greed on our end, it's about surviving," Rusty Galetka, a worker at Smead said. "It's the wages," said a case manager at the local shelter, "These people aren't lazy. But, on these wages, it's hard to support kids, a house, a car." Sheila Colclasure, another Smead worker called unionization, "a necessary step forward for us." She said, "We need job, benefit and wage security to better raise our families and contribute to our community as well." According to a union representative, Smead brought the union vote on itself. "Quite frankly the company has done nothing for three years," he said. "It's not like the people haven't told them. The company has completely ignored the workforce."

UNIONIZATION DRIVE

> Obviously as a whole, employees feel that management has not concerned themselves with addressing real employee hardships or issues. If they had, perhaps there would be no union desires.
>
> Scott Buckley, Smead Employee

> There's no question that the right to organize is a basic fundamental right - it's about coming together to freely associate and change workplace conditions. But it's also a human right aimed at preserving the basic human condition - dignity, respect, and a voice on the job.
>
> Boyd Young, International President, PACE Union

> If the Union wins, nothing automatically changes.
>
> Gordon Goodall, Smead Cedar City Plant Manager

Seventy percent of the employees signed authorization cards authorizing the Paper, Allied Industrial, Chemical, & Energy Workers International Union (PACE) to represent Smead production and maintenance workers for the purpose of collective bargaining. Initially, PACE sought voluntary recognition by Smead management but was rebuffed. With the federally mandated thirty percent showing of interest in hand, PACE petitioned the National Labor Relations Board to conduct a representation election to certify the union as the exclusive representative of the employees.

The campaigns of both Smead management and PACE were fairly close to the norm for these situations. Smead management chose not to wage their campaign in the media, preferring to focus on the employees on site and in their homes. When questioned by reporters, Smead officials said, "the vote on whether to unionize is a matter between them and their employees" and declined further comment. Smead showed its workers mandatory "anti-union" films twice a week. Letters home (See exhibit 1) from the Cedar City Plant Manager were also utilized to communicate directly with the employees.

Smead's strategy included pulling out all stops in attempting to remain union free. While the company had no public response, internally, the company's position was clear. (See Exhibit 2).

Jack Cavanaugh, PACE union representative directed most of his efforts at making personal contact with Smead employees. As the campaign wore on, Cavanaugh was confident that Smead employees were strongly in favor of union representation. He spent most of his time in what he called "inoculating them against what they're going to hear" from Smead management and to answer the company's "blatant" propaganda. (See Exhibit 3)

Cavanaugh wanted to keep the employees focused on the real issues, which he identified clearly as the sub-standard wages paid at the Cedar City plant compared to what Smead paid at it's two unionized plants in McGregor, Texas and Hastings, Minnesota even though the cost of living is nearly as high

On December 2, 1999, by a 2 to 1 majority, the hourly workers at Smead voted to authorize PACE to represent them. The final vote was 182 to 90 out of 277 eligible voters. With the vote, Smead became the first large Cedar City factory to have its employees represented by a labor union.

CONTRACT NEGOTIATIONS

> Through your Union Contract, PACE insures that you receive fair wages, benefits, safe working conditions and just cause for discipline.
>
> Boyd Young, International President, PACE Union

> Nobody got rich and we knew we weren't
>
> Russ Taylor, PACE union negotiator

> No comment.
>
> Smead Manufacturing Company

While the workers celebrated the victory, the fruits of unionization remained to be seen. Goodall had threatened that, "If the Union won the election, and if bargaining took place, I can promise you that we would bargain legally, but we would bargain hard, over our own bargaining goals." By winning the election, PACE became the employee's agent in collective bargaining. In January negotiations on a new contract began. While employers are required to bargain with unions in good faith, much latitude in negotiations remains.

While the company and union negotiators tried to resolve differences, PACE continued its public relations campaign. This campaign focused on the issue of wages.

Spurred by the unions, local newspapers printed several articles during this time with titles like: Union Committee Seeks Higher Wages; Workers Talk about Low Wages at Union-Sponsored Meeting; and Union Accuses Cedar City Companies of Colluding to Maintain Low Wages. PACE also took out a full-page newspaper advertisement to call attention to the issue. Smead, in contrast, continued to have, "no comment."

When there was still no progress on the negotiations by October 2000, PACE organized a rally in Cedar City with the slogan, "Not in Our Town." Nearly 80 people attended the meeting, including about 45 PACE members from Salt Lake City. At the meeting, employees told personal tales of hardships caused by the low wages and how they were trying to make ends meet. Few people attended, however, who were not union members.

Finally, on December 16, 2000, after almost a year of negotiations, union members unanimously approved a new contract. It contained modest raises, which, according to union negotiator Julie Hauzer, are "reflective of Smead's refusal to pay wages higher than other Cedar City manufacturers." Hauzer said, "I don't know why people in Cedar City aren't outraged," by the refusal of manufacturers to raise wages. According to the contract, Smead workers, including those not in the union, would receive two raises. The first raise ranging from 3 to 4.2 percent would be retroactive to January. The second raise of 3.25 percent would occur on April fools day 2001. This contract is effective until June 2003. Workers' wages at the Cedar City plant remain $2.00 to $3.00 less than at Smead's other plants.

In spite of this, the union put a positive spin on the contract. According to Russ Taylor, another PACE negotiator, "…It gives us a bigger say. A lot of good came out of it." Hauzer noted that the contract increases the worker's ability to question decisions made by Smead. "There's no more employment at will at Smead," she said. There were also some changes in rights of seniority and the granting of vacation time for overtime assignments. Smead had no comment on the contract. In the time since the election, union membership is down to 103 employees, less than half of the company's 200-plus workforce. Union membership and finances at the Cedar City plant are so low that, according to a Cedar City Union representative, the union can't even afford to process a grievance, let alone work for more sweeping reforms.

SUMMARY

> There's nothing wrong with making a profit, but there's something really wrong with economic development that exploits a community.
>
> Robert Wages, PACE Executive Vice President

It was now getting close to the time when the contract would have to be renegotiated. This was a good time to review the company's labor relations and human resource management strategies. While Smead was the only unionized company in Southern Utah, things could have gone much worse. Mr. Smith sipped his coffee as he pondered whether there was anything that needed to be changed.

Exhibit 1

Date: October 25, 1999

Dear Fellow Associates:

By now, everyone knows that the PACE Union tired to force the Smead Manufacturing Company to recognize it without giving associates an opportunity to cast a secret ballot. We refused to do so.

We had reasons to refuse to recognize the Union: First, we think the fair thing to do is to allow each associate the opportunity to vote in a secret ballot election. Second, several associates have told various members of the leadership team that they felt they were subject to undue pressure from the Union and its supporters to sign a card.

Associates also said they felt uncomfortable about expressing their opinion in the plant. That also is why I wanted to write you at home, where you can review this letter without someone looking over your shoulder. This may be one of the most important questions we ever face while working here.

We need to start thinking about what this election is really about. If the Union wins, nothing automatically changes. All this election is about is an opportunity for this Union to sit down at the bargaining table with our negotiators and talk. That's it. And during bargaining, nothing changes until the Smead Manufacturing Company agrees to it.

It is important that you all know that there are no guarantees during bargaining and that both sides have the opportunity to make proposals. If the Union won the election, and if bargaining took place, I can promise you that we would bargain legally, but we would bargain hard, over our own bargaining goals.

I was disappointed when I was told not only of the pressure the Union put on people to sign a card, but of the tactics in excluding associates from Union meetings because they didn't share the same views. I can't help thinking that if that kind of pressure is being put on associates now, the pressure during the election campaign, or if it when that far, during long, drawn out negotiations, would be unbelievable. What I see is associates being turned against fellow associates, and associates being turned against facilitators and management. That can only hurt all of us who work here.

It is very important that you get information from both sides of the Union issue before you make a decision. You need to learn more about what Unions are and what they aren't. This election campaign will affect your future, my future, and the future of this entire facility. Please, please ask any questions you might have about Unions. I can't guarantee that I will have all the answers immediately, but I can promise you that if I don't, I will get the answers, and I will get back to you.

Please get the FACTS.

Gregory Gladiator, Plant Manager

Exhibit 2

From: Winnere, Rose

Sent: Thursday, September 14, 2000 9:00 AM

To: Mike Schmidt, Bernie Parent, Bobby Clarke, Larry Bowa, Kate Smith, Steve Carlton, Maurice Chicks.

CC: Gregory Gladiator: Plant Manager

Subject: RE: ABC (Temporary Staffing Firm)

Do you agree with the decision to hire all of these permanently? Have you noticed any particular Union alliance with these ABC associates? Let's not shoot ourselves in the foot by bringing on permanent people who are known Union supporters. If any of these ABC people have been wearing the stickers, I would question if we want them as Smead employees. Please let me know immediately if anyone should not be hired. Thanks.

Exhibit 3

WOULD YOU VOTE YOURSELF A WAGE CUT?
WOULD YOU VOTE FOR A CECREASE IN BENEFITS?

The company is trying to scare you into believing that you would do just that. The fact of the matter is that once a tentative agreement is reached between your bargaining committee and the company, the membership has the final say as to whether or not to accept the agreement, not the company. If you don't like it you have the right to vote it down.

The National Labor Relations Act Section 8(a)(5) makes it illegal for an employer to refuse to bargain in good faith about wages, hours, and other conditions of employment with the representative selected by the a majority of the employees in a unit appropriate for collective bargaining….The duty to bargain covers all matters concerning rates of pay, wages, hours of employment, or other conditions of employment.

According to The Labor Guide to Labor Law, Vol. 3, "An employer who meets with the union, but goes through only the motions of bargaining with no intention of reaching an agreement is using the tactic called surface bargaining". It goes on, "There are certain bargaining tactics that the Board has traditionally regarded as surface bargaining". One of these tactics is "Proposing wages and benefits that are no better than before the union was certified". This is an illegal tactic. Is the company telling you that they intend to break Federal Law?

Think. Right now the company has the right to discipline you, fire you, change policies and procedures at their whim. Can you do anything about it? No. The company would like to keep it that way. Isn't it amazing just how much of an interest the company is currently taking concerning your welfare? If the company really felt that they could bargain a wage and benefit decrease, and blame it on the union, they would have probably invited the union in a long time ago. Fact of the matter is that they know if you are successful, the free ride on your backs will be over. In several of the meetings Dean has admitted that the companies here have set the wages. Have the companies formed a union of their own? How can you fight back?

STAND TALL FOR YOUR FAMILIES AND YOUR COMMUNITY
ORGANIZE!!!

REBOUND SPORTS TECHNOLOGY

Carl Obermiller, Seattle University
Chauncey Burke, Seattle University

CASE DESCRIPTION

This case was developed for and used in an MBA marketing elective, Marketing for New Ventures. It has also been used in an undergraduate marketing management course. The focus of the case is on the entrepreneurial questions, Can the firm be profitable? and, What form should the firm have? The essential problem is that it is not clear that RST can be profitable given its current strategy; if not, students must determine a better strategic direction. Then, the question is how the best strategy can be executed. Specific challenges include sales management, channel relationships (getting distribution), product line management, and some advertising and segmentation issues, which may provide sufficient material for use in marketing courses. The case is moderately difficult, appropriate for juniors and seniors or graduate students. It is designed to be taught in one class session and typically requires three or four hours of student preparation work.

CASE SYNOPSIS

Rebound Sports Technology (RST) is an example a classic entrepreneur's challenge- building a sustainable business from a personal aspiration. This case is a chronological, first person account of a baseball enthusiast's passion and sacrifice to bring the joy of hitting a baseball to children. The entrepreneur, Larry Cripe, has developed a unique product to help new baseball players enjoy the experience of a well-hit baseball and also help established baseball players maintain their baseball hitting skills. The product has received strong endorsements from users and opinion leaders, but it simply hasn't made much money. Now, investors are out of patience; Cripe must design a business and marketing plan that will make RST profitable and meet his own personal objectives, if possible.

Students follow the venture to the point where Cripe must make critical decisions for long term success. The decisions require a clear understanding of the financial, marketing and managerial challenges facing RST. There is sufficient documentation in the case and exhibits to come to this understanding. The more difficult and exciting component of this case study is to derive an integrative market strategy that will achieve a sustainable competitive advantage for Rebound Sports Technology. To do so, students must think critically about the business opportunity, the basic objectives, and the competitive strengths and weaknesses of RST. Students should be able to apply whatever they have learned about business strategy.

It is useful to review RST's web site and competitor web sites to learn the benefits of the products and alternative technologies used in batting instruction. An internet search on such key words as "baseball equipment" or "batting equipment" will lead to many sources. The instructor may also suggest specific readings related to business strategy. Students will find sufficient data

in the case for most of their analyses; but, suggestions for new, creative strategies may require additional research.

REBOUND SPORTS TECHNOLOGY

Spring Training

In 1996 Larry Cripe was in a discussion with Rob Johnson, the marketing vice president of Precor USA. The two were huddled over coffee at the Super Show, in Atlanta, the biggest sporting goods tradeshow. They were discussing a deal for Precor to buy the rights to a product Cripe had invented, the SwingAway, a baseball swing training device. Cripe had been explaining his business plan, which would result in unit costs of about $150 and a price of $399. Cripe wanted to know if he could do better by selling the rights to an established manufacturer.

Cripe: So, Rob, you've seen my estimates. I know all about the risks of going on my own. Tell me about your offer.

Johnson: Well, Larry, as I said earlier, we really like your product and we think we could sell plenty. We can buy you out for $200,000. Or, you can take our licensing offer, which, our estimates indicate would return $20,000 to you the first year, with up to $100,000 in later years, if it really takes off, with a maximum total pay-out of $500,000.

Part of our success would result from changing the materials and workmanship somewhat. We believe that $200 is the crucial price for retail sales. And, our guidelines are a cgs margin of 20%; so, we'd get that cost down to about $40.

Cripe: I'd love to sell at the lower price, but I cannot believe you can produce a quality product for $40.

Johnson: Volume is a big part of it. Precor would sell a lot more units than you could. But, we also view this as more toy and less "training device." Kids would be using this for fun, and they wouldn't need the strength or durability that you have designed into this product. Some of the features could probably be designed out, too. Like the multiple anchors on home plate. Why not have just one?

Cripe: Kids need to learn how to hit balls on the inside of the plate. And the outside. And, early and late.

Johnson: If they want to work on outside pitches, they can stand further away.

Cripe: It's not the same thing. Hitters almost always stand in the same place with respect to the plate; and, they see the ball relative to the plate. A ball on the inside of the plate is not just closer to the hitter's body.

Johnson: Well, maybe so; but, we think you're worried too much about the subtleties of the product. Kids want to practice swinging and have fun whacking the ball. They're not worried about the position of the ball relative to the plate.

Cripe: I'm worried about it. Sure, I want kids to have fun with the product; but, that's not my primary concern. I want them to become good hitters. Hitting is a difficult skill. Most of the kids that start baseball end up quitting because they can't hit. If a kid can master hitting, he'll develop his confidence in the game. And, that confidence will apply to other aspects of his life.

Becoming a good hitter can help a kid become a better student and a better man. That's what I want-more kids playing baseball and playing it well. I'd like to be able to help every kid in the country become the best hitter he can be.

Cripe didn't make the deal with Precor. His company, Rebound Sports Technology (RST), was founded in 1996, although he didn't begin mass production until the end of 1997. Unhappy with both the financial aspects and the apparent lack of enthusiasm for what he viewed as crucial qualities of the product, Cripe rejected the licensing deal with Precor and set out to manufacture the SwingAway on his own. Four years later, he passed on a similar offer from Huffy Sports. Now, he wondered if he had made a mistake.

The Minors

Cripe was a commercial airline pilot. He had had experience and modest success running a small business on the side, Northwest Evergreens, Inc., a distributor of holiday wreaths. Cripe was an avid fan of baseball and former collegiate and minor league pitcher and first baseman. The origin of RST was his invention of a baseball swing training device to help his son. The device consisted of framed netting supported by elastic cords and a baseball suspended by bungee cords. (Cripe had applied for a system design patent.) The height of the ball could be adjusted. When the batter hit the ball, the bungee cords returned it to the original position. The netting served as insurance against a broken bungee cord and could be used separately for pitching and fielding practice. (See www.swingaway.com for picture and details.) The aim of the SwingAway was to help a player learn to "groove" his swing for a variety of pitch positions, to improve stance, reduce casting, increase bat speed and improve follow-through.

The original prototype, built in 1994, was a big hit with Cripe's sons and their teammates and coaches. Casual use of the device led to several requests for them. Over the course of several years, Cripe built half a dozen products for friends and local baseball people. A collection of serendipitous coincidences moved him from casual backyard inventor to manufacturing entrepreneur. The first was a chance encounter with the video director of the Seattle Mariners, in which the conversation naturally gravitated to baseball and Cripe mentioned his training device. Several days later, he received a telephone call and was told that M's star Jay Buhner was interested in seeing one. The device was set up in Jay's driveway, and after three swings Buhner pronounced, "I love this thing."

The second bit of good fortune was the Major League Baseball strike of 1995. With little else to do, M's manager Lou Piniella and hitting coach Lee Elia, who had heard Buhner's praise, contacted Cripe and asked him to demonstrate it at Spring training. They were impressed enough to commission two trainers for use by the Mariners. With the validation from professional players and coaches, Cripe decided to go into business.

Although Cripe continued to build the trainers, now called the SwingAway Swing Trainer, in his garage, through 1996, his original intent was to license the product to an existing manufacturer. The experience with Precor and no success with other options motivated Cripe to do the job himself.

Even had the Precor decision been different, Cripe had a changed feeling when he faced the prospect of losing control of the SwingAway. As he put it, "They just didn't have the passion for

it that I did." Cripe evinced a passion, not just for success, but for the benefits of the product. He loved baseball and wanted to help kids become good hitters. He also believed sincerely that success in the game transferred confidence and self esteem to the rest of a player's life. He saw confidence and self esteem as the ultimate benefits delivered by the SwingAway.

After Cripe committed to launching RST, he set out to raise capital. He put together $350,000 in small private investments from friends and family and set up shop as an LLC. (Included in the first investors were two who came on board out of the blue. Cripe took a unit to the offices of some investment bankers and set it up in the parking lot. A group of shirt-sleeved workers were soon crowding around, listening to the story and taking some cuts. Two of them were officers from Washington Mutual, principal tenant of the building. They liked what they saw and heard and invested $15,000 each. Since the inception of the company RST has raised $3 million in capital. (See Exhibit 1.)

RST moved out of Cripe's garage into a small building in Seattle. Construction was done by hand, using mostly part-time labor. Hinges and joints were manufactured by suppliers. The first model, later called the SwingAway Pro, sold for $595. The target market was organized teams, from professionals down to little leagues. From the beginning, once people spent some time with the device, they were likely purchasers. The marketing challenges were to get people the experience or, lacking that, to develop a powerful selling message.

In 1998, RST moved to a location in Kent, Washington, which was large enough to house office space, a show room, a manufacturing site where as many as 300 units per day could be produced, and ample extra floor space.

The RST management team was developed as the company grew. (See Exhibit 2.). Cripe felt fortunate to have good contacts who agreed to serve on his advisory board. He was very confident in his manufacturing man and his hitting instructors. His biggest personnel problem was, unfortunately, the most important. Cripe did not want to run the day-to-day operations himself. He enjoyed being a pilot. He believed in the mission of the firm and hoped it would be very profitable, but he was careful to keep much of his life separate from RST. Once growth began, in 1997, Cripe hired a CEO, who lasted only eighteen months before Cripe took over again. In 1999, he hired a former professional basketball player, who lasted a little over a year. Cripe took over again in late 2000. He identified a potential candidate who had a strong baseball background, but, after six months, Cripe decided against the hire and began looking again.

The Hitting Trainer Equipment League

According to the National Sporting Goods Association's most recent survey, over 15 million Americans reported playing baseball in the past year. Another 14 million reported playing softball. (The overlap between these two was not reported.) Expenditures for baseball and softball equipment in 2001 were estimated at $332 million. No breakdown on equipment is available; thus, there were no estimates on the size of the more specific, hitting trainer equipment market.

The customers fell into fairly clear segments by sport-baseball and softball-age, organizational affiliation, and commitment. Most kids played baseball to some extent. By the time they were in their teens, the serious players are usually affiliated with some organized team. Teams

were organized both through schools and through a variety of non-school organizations-Little League, etc. After high school, the best players continued to play at community colleges or universities. For the remaining adult players, there were some organized leagues for adult baseball players and many for adult softball players. Finally, there were the professional leagues. Equipment purchases were made both by the individual players and by the teams or schools that sponsor the teams.

There were dozens of suppliers of baseball training equipment. Such equipment ranged from the low end-tees and bat weights-to the high end-computer guided pitching machines and batting cages. No market share data were available, but the market appeared to be highly fragmented with many products available from direct market providers who placed ads in baseball magazines and have websites. None of these players had sufficient marketing muscle to establish much of a brand name or develop retail distribution. JUGS was the best known, because of the frequent mention of their name in connection with their radar guns. The large sporting goods manufacturers-Wilson, Rawlings, etc.-were always potentially competitors.

With SwingAway, RST offered a hitting training device that doubles as a pitch-back device for use in pitching and fielding practice. The market was filled with training devices for nearly every aspect of hitting, pitching, and fielding. Included were many forms of hitting gloves, wrist braces, shoes and stride guides-even an electronic device that monitors head movement. RST might compete with all these products in a general sense for the pool of dollars spent on training equipment, but they did not appear to compete directly with many of them. To determine the set of direct competitors, one might consider first only those products that are used principally to aid hitting the ball. Then, those products might be evaluated in terms of the benefits that the SwingAway was designed to deliver. These benefits included the following:

- dynamism-a ball that moves or can be adjusted
- feedback-the realistic feel of hitting a pitched ball and senses of distance and direction hit
- convenience-little downtime between swings, a small space requirement, one-person operation, no need to pick up balls, easy storage and transportation
- multiple uses-pitching and fielding practice, potential use for other sports

Competing products can be categorized as follows:

- ball holders-batting tees and balls suspended from poles
- swing guides-batting tees with the addition of poles to guide the stroke
- rotators-balls that are "pitched" by rotation on a rope or arm
- ball/screen/tossers-combinations of a mechanism to toss the ball up for hitting and a screen to stop the ball's flight
- ball/screen/tethers-combinations of tether to suspend and hold the ball and a screen to stop its flight

♦	pitching machines/batting cages-devices to throw balls, simulating pitching, with or without the framed netting of a batting cage
♦	"partner"-another person to pitch or toss balls repeatedly

The prices of these options ranged from about $10 for the low-end batting tees to several thousand dollars for a combination pitching machine and batting cage. Clearly, the price range reduced direct competition with both the low and high ends. The swing guides were priced from $150 to $200; rotators from $150 to $575; the ball/screen/toss and ball/screen/tethers from $166 to $475; and the low end pitching machines started at $180.

The SwingAway was a ball/screen/tether device, and its most direct competitor was likely the Solo Hitter, another ball/screen/tether product. The SwingAway was made from heavier framing material; its screen acts had a bungee cord mounting that allowed it to act as a pitch-back device; and, its ball was mounted with bungee cords rather than mere rope, which provided for faster ball return and more realistic resistance from a pitched ball. SoloHitter, on the other hand, was priced at $210 versus the $399 of the most popular SwingAway.

Other close competitors were combination ball toss and screen products from JUGS ($475) and Batter Up ($600) and the Reps motorized rotator ($525). The main advantages of the SwingAway over the ball toss and screen products were the ability to specify position of the ball with precision, the realistic feel provided by the bungee cords, no need to pick up (or buy) balls, and the pitch-back function of the screen. Relative to the Reps motorized rotor, SwingAway provided faster repetition, more feedback on direction of hit, and, also, the pitch-back function. These competitive products, however, provided a more dynamic experience, since the ball was actually moving. With the Reps product, the ball presentation simulated a pitched ball. (Exhibit 3 provides a competitor assessment.)

Initial Game Plan

Larry Cripe believed in the quality of the SwingAway product. His belief was affirmed by the reactions of professionals, and he believed others would, likewise, be persuaded by experts. He thought of this as his "pyramid strategy," with major league players at the top, other professionals and collegiate players below them, then, high school and good organized teams, then, at the bottom, the thousands of little league teams and individual players. With that in mind, he sought out testimonials from players and coaches. He decided to make it a policy not to pay spokespeople; the standard deal was a free SwingAway in return for 30 minutes of video-tape of the player using and commenting on the product. (He also rejected the standard MLB endorsement, which was 11% of gross revenues.) Among the first early spokespeople were Buhner, Jason Giambi, Rafael Palmiero, and Harold Baines.

From the beginning, RST was a direct marketer. Print ads in targeted magazines attracted likely buyers to an 800 number (See Exhibit 4.). The earliest leads were mailed a black and white brochure. The current full-color videotape was produced in January, 1998. Cripe compared results across magazines, eventually focusing on Baseball Weekly, Junior Baseball, and Baseball America.

Baseball Weekly was consistently his best vehicle, with a conversion rate of about 15% (sales per contacts) on between 300 and 400 inquiries per month. Demand was highest in the "off-season," October-March, giving rise, in 2000 to the tagline, "Now, there is no off-season!"

Early on, Cripe attempted to get retail distribution. Athletic Supply, Inc. agreed to carry the product on consignment, but only a scant dozen units were sold by the time the two parties agreed to end the arrangement-after three months. When he visited the stores, Cripe discovered that little care was being taken to merchandise the product properly. One unit had the home plate removed and the ball cord wrapped and taped around its support pole. Store managers indicated that customers were interacting unsafely with the units-swinging bats endangered other shoppers. Few customers were willing to take a chance on an innovative product that had been improperly displayed, that they had not been able to experience, and that the store's salespeople knew little about.

In January of 1999, RST launched its web site, www.swingaway.com. Cripe was proud of the site, which was designed by his son. Traffic climbed steadily, reaching an average of 200 "hits" per day in the summer of 2000. Sales completed via the web reached an average of 45 per month.

For the first year, RST had only one product, the SwingAway Pro, which sold for $595. In 1997, they added the SwingAway Collegiate ($399), and the SwingAway Trainer ($299). The Pro model was the original design; in general, it was sturdier, with cast fittings. The design of the new products was driven by distribution. Cripe worked long hours to design the models such that they would meet the UPS upper limit of 130 total linear inches. The Trainer came unassembled and, once assembled, was fixed. The Collegiate was collapsible and came fully assembled. Sales of the three models were fairly steady at 10% Pro, 20% Trainer, and 70% Collegiate.

RST continually experimented with promotion in its attempt to (a) get leads for sending a videotape to people with some degree of interest, and (b) give people experience or a vivid demonstration of the product. Limited use of television ads was tried, primarily on ESPN Sportscenter and Fox Sports. The cost of leads generated from the television ads, measured by the cost of the ads divided by the number of leads that could be sourced to them, was high $7.50, and the conversion rate from those leads, low-5%, versus an estimated 8.5% breakeven conversion rate.

ESPN was also an indirect partner in "SwingAway the Easy Way," a promotion aimed at school and league teams. Through a magazine subscription service, any group that totaled 20 ESPN the Magazine subscriptions, including renewals, received a free SwingAway (paid for by ESPN). The offer was promoted through coaches' clinics and direct mail to coaches. Results were poor-only eleven sales in six months.

Much of the thrust of RST's promotion was in grass roots sales efforts. Based on Cripe's belief that personal experience with the product was the best selling tool, RST tried to get the product to where kids play ball, sold by the people associated with baseball and softball. A two-pronged direct selling effort was developed. On one side, RST tried to have a demonstration unit on site wherever baseball players might be-tournaments, festivals, fairs, baseball stadiums, etc. For example, RST held several SwingAway promotions at Wrigley Field, with a dozen units set up on the field for fans to try out before a Cubs game. On the other side, RST assembled a large group of sales representatives among coaches, baseball instructors, and anyone else close to the baseball scene. The demonstrations effort was not successful. What Cripe envisioned was a fleet of colorful

trucks and trailers, with one coach/instructor and one salesperson. The unit would be set up amid fanfare; and, while one employee gave instruction to eager kids, the other would busily close orders. In fact, the effort was largely ad hoc, limited by almost no available budget-no trucks, no trailers, no employees.

The group of sales representatives, on the other hand, grew steadily, to 120 by summer of 2000, with the addition of 2 or 3 per week. Any inquiry who was identified as a coach or other with contact with kids was flagged as a potential representative and contacted by RST's head of sales. Potential reps were sent a package of materials that outlined the offer. Reps received a 10, 15, or 20 per cent of gross sales as commission but no salary. The commission rate depended on sales-more sales led to higher commissions. Reps were required to have purchased a SwingAway unit and received no sales training. They were not assigned territories and worked, essentially, without management.

Minor League Prospects

By 2001, RST had considered a number of new tactics. They continued to pursue retail distribution, but space, salesperson training, and the risk of injury remained challenges. One consideration was to introduce the product with a high profile demonstration that would simultaneously attract interested customers and serve as an opportunity to train the store's employees. The product would then be left with a demonstration model or, at least (and, as well as), a repeating video loop.

Cripe had long considered an infomercial but worried about the cost. He believed that sales of the SwingAway might take off once a threshold level of sales was achieved. Word of mouth would be a strong force. But the risk was high. An infomercial would cost about $500,000-about $300,000 for production, testing, and refinement, the remainder to be available to ramp up to meet possible demand. In fact, some infomercials were so successful, Cripe felt he should have access to perhaps another half million dollars for immediate production increase, should the effects of the infomercial be maximally positive. On the downside, many infomercials did nothing for their products-industry studies showed a breakeven rate of only about twenty per-cent.

In 1999, RST was contacted by a venture capitalist who liked the product and believed an infomercial was the way to go. The VC proposed to take the risk in return for a major share of future profits. He proposed that if sales did not jump, his committed $300,000 (at minimum) would be lost. If sales did jump, he would get the lion's share of profits, up to $1 million, and, RST would forego those profits. If Cripe was right about sales' multiplying through word of mouth, long run returns would more than justify the investment. On the other hand, Cripe believed that even a moderately positive effect of the infomercial might do nothing more than repay the VC; and, the consequent lack of retained earnings might spell the end of the ballgame for RST.

RST was considering several new products, some of which might provide an easier entry to retailing, but all of which would extend the brand name. Among these were a pitch-back unit (the netting and frame portion of the current SwingAway). A pitch-back unit was a familiar product to most consumers; so, it would not require demonstration. The RST version would be designed such that the hitting component could be added on later. A second new product was a SwingAway T-ball

unit. The usual T-ball product was a hard rubber plate with a rubber cylinder mounted on its center. The ball was placed atop the cylinder, and the batter would hit it. The SwingAway unit would use the home plate from the SwingAway Trainer, and the ball support could be positioned the same way-front/back and in/out. The cylinder support was also more easily adjustable up and down. Thus, like the SwingAway, the T-ball unit would facilitate practicing on balls at all pitch positions. The T-ball unit had a projected retail price of $49.95. A third product was sheets of netting, similar to those used in the SwingAway product. These large rectangular sheets could be used to catch balls for practicing golf, baseball, tennis, soccer, etc.. A fourth product was one or more versions of pitching machines-one that pitched plastic wiffle balls (priced at about $800); a second one that pitched baseballs or softballs with all-dimensional spin options for curves and sliders (priced at about $2500). Modifications of the SwingAway were also being considered for other sports. Tennis, golf, and soccer applications were being planned. The pitch-back, T-ball, and netting products were being sold over the web by 2001 but not promoted. The pitching machines and adaptations for other sports were merely ideas. At the time, with expenses severely cut, there were no funds for development.

For future consideration was some more dramatic modification of the SwingAway, ranging from a completely electronic model that would provide measures of distance and location of the hit to a "virtual baseball game" in which the player would hit at a SwingAway unit, then see the virtual response on a large attached screen. In 1997 Cripe and RST received a Washington Technology grant through the University of Washington, which allowed them to develop the necessary software and electronics. In addition, RST had made a connection with Video Motion, a developer of sports video games, which used the SwingAway in creating their video baseball hitters. In a trade for a free Pro Model, Video Motion included SwingAway advertising on the outfield fences in their game stadium.

In the spring of 2000, Cripe received a proposal from a firm in Taiwan to produce the SwingAway there. Unit costs were currently about $150 and could go as low as $90 at near maximum production. The offer from Taiwan was $65 per unit at a rate of 4000 per year. Shipping would cost about $7 per unit. (Baseball-related products were exempt from duties.)

Finally, also in development was a package of technology for use in hitting instruction. Cripe had his own ideas about how to hit, and he had the expertise of the people on his staff. To communicate this knowledge to the purchasers of the SwingAway, RST developed a video, which was included along with each unit. Cripe envisioned much more, however, for the near future-a combination of electronic measuring instruments (in the SwingAway and the bat) and a digital camera with playback software. Feedback would be provided on bat speed, swing arc, strike force, ball flight direction, and ball flight distance. A display would show a sequence of stop-action photographs and would allow analysis and comparison with past swings or the swings of other players, ideally major league players to be used as models. Some of this technology was completed as part of the Washington Technology grant; some was under development elsewhere but could be licensed. Cripe hoped the entire package would be available by 2002.

A Rising Star?

A significant recent development was the SwingAway Academy. The SwingAway Academy was a training facility and service. Four thousand square feet of space at the RST site was dedicated to the first Academy. In Autumn 2000, promotions began to recruit the first Academy class. The training consisted of five weekly 1-hour sessions on site with training on SwingAways from professional instructors plus the use of a SwingAway unit for the five weeks. The fee was $275, of which $75 was for rental of the unit and could be used as credit toward its purchase. The rental fee was waived for those who already owned a unit. Academy classes were limited to eight students with two instructors. Instructors were collegiate and professional coaches and former players.

The SwingAway Academy was expected to serve several functions. Originally, it was intended simply as another way to get kids the SwingAway experience. Cripe estimated that as many as 25% of Academy students would buy a unit. (Figures from the first session showed that 50% of those who rented, bought-admittedly, a small sample.) Further sales were expected to come from word of mouth. Since RST had been tracking, about 30% of purchasers indicated they first learned of the SwingAway from a friend who owned one. To encourage word of mouth, RST had a referral program. Each purchaser received several RST cards with space for his name. These cards were to be passed along to potential customers. Whenever a sale resulted, the card could be turned in and the card issuer would receive a check for $15.

But, as a separate component, Cripe hoped that the Academy might prove to be a significant, perhaps major, revenue generator on its own. RST estimated enrollment in the initial Academy for the first year as 600-700. Cripe thought he could place as many as six Academy sites in the Puget Sound area, with the potential for expansion nationally. The expansion could take the form of franchising, depending on the availability of further funding. Limited research indicated the baseball training market was entirely localized, with no major franchises. Most operations were large (and consequently, costly), 15,000-20,000 square feet, to accommodate hitting and fielding. The Academy model required a 4,000-5,000 square feet space. Cripe estimated start-up costs for a facility at about $25,000, with a full-time manager/instructor at $50,000 and another instructor at $25,000. Facilities of the necessary size could be rented and maintained for about $25,000 per year. The crucial requirement would be to find owner/operators who would be dedicated to the business, loyal to the RST vision, and well-networked in their local baseball/softball scenes.

RST box score

It took RST six years finally to show a profit. (See Exhibits 1 and 5.) In the year 2001, RST had just over a million dollars in sales. About 2300 SwingAways were sold. Limited data were available for the SwingAway Academy. For the first two months of 2001, the Academy accounted for 23% of total revenue. If treated as a distinct and separate unit, charged its share of overhead, the Academy returned a 37.5% net profit. (These projections were uncertain because of unknown seasonality both in product sales and Academy enrollment.)

Cripe knew that much of the problem historically was a lack of direction. He believed strongly in the product, and he was frustrated that he could not come up with a way to get it out to

potential customers. In December of 2000, his board of directors gave him a strong indication that they expected the firm to show a profit and recommended that he sell the company or license the product (the offer from Huffy Sports). In rejecting that option, Cripe decided to cut all discretionary expenses. So, marketing was virtually eliminated for 2001. Cripe was heartened both by finally reaching profitability and the fact that, with no promotional support, sales had increased by the same percentage as the year before. Nonetheless, he did not believe the company could continue to grow without effective marketing, and marketing would require investment, which he was uncertain he could obtain, not without a solid plan. On the other hand, he believed he could generate enthusiasm among potential investors for the Academy idea. But, would that mean abandoning the product? By the end of 2001 he knew he had to make some fundamental decisions about the future direction of his company.

Exhibit 1: RST Balance Sheet year 2000*

Current Assets		Current Liabilities	
cash	5,440	accounts payable	26,000
accounts receivable	4,000	other	132,000
inventory	98,000	notes payable	309,440
Fixed assets			
plant and equipment	2,750,000		
less depreciation	<399,000>		
furniture	217,000	Equity	
less depreciation	<100,000>	contributed capital	3,188,000
startup and org. costs	85,000	retained earning/loss	<995,000>
Total Assets	2,660,440	Total Liabilities	2,660,440

* these figures are approximates and do not reflect the actual financial statements of RST

Exhibit 2: The RST Lineup
Management Team
Larry Cripe, founder and president.
John Messer, VP of marketing. Messer, formerly VP of Marketing at Toys R Us joined RST in Spring 2000 and brought expertise in marketing consumer packaged goods and dealing with retailers. Messer was committed to RST for only two years.
Phil Rognier, product development and instruction. Rognier had extensive business and baseball experience. Among other things, he had developed several youth baseball organizations in the Puget Sound area and had headed his own product development and consulting company.
Mike Arnold, manufacturing. Mike had worked at Precor and been in charge of production at the Baby Jogger Company.
Ryan Cripe, webmaster. Ryan, Cripe's son, was a marketing major a year out of Washington State University.
Brad Peterson, hitting instructor. Formerly manager of The Ball Yard, an instruction and batting cage facility, a former collegiate player and coach.
Mark Enderton, hitting instructor. Green River Community College softball coach.
Board of Directors
John Bauer, Executive VP of Nintendo America.
Robert Ginn, former CEO of Brown Jordan, furniture manufacturer.
Peter Lamb, retired partner with Accenture.
Tom Sweet, captain for Alaska Airlines, lengthy involvement with RST.
Advisory Board
Bob Lemon, Accenture-new venture management.
Mark Britton, Expedia Inc.
John Baughn, Accenture-organizational change programs in high technology.
Brad Cummings-technology consultant.
Leonard Pritchard, Avagadro Partners-venture investments.
Bruce Merrel, founder of Laptop Lane Ltd.
Jon Rands, Accenture.
Steve Reed, Chief Scientific Officer, Corix Inc..
Lee Elia, former Hitting Coach for the Mariners-hitting instruction consultant.
Carl Hamilton, instructor with the Mariners-video technology expert.

Exhibit 4: Sample Print Ad

(no electronic format-see www.swingaway.com for comparable pictures and claims)

Exhibit 5: Chronology of RST's Financial Performance
Dollar figures in thousands

		Sales	CGS	Exps. (gen)	Exps (selling)	Profit (Loss)
1996	founded as a limited liability company	124	97	155	67	(195)
1997	development of initial production facilities; initial capitalization of $350,000 through founders and private equity offerings; focus on direct response sales	262	131	136	91	(96)
1998	shift to Kent facility with capacity of 200/day; exploration of new products and new marketing approaches	563	275	356	144	(212)
1999	continued efforts to develop a successful marketing strategy	732	333	440	226	(267)
2000	the first SwingAway Academy	892	383	408	326	(225)
2001	eliminate virtually all discretionary spending	1086	448	395	217	26

NEGOTIATING WITH THE CHINESE: CHINESE TIGER BARRELS IN THE CALIFORNIA WINE INDUSTRY

Erica Louise Harrop, Sonoma State University
Sarah Louise Dove, Sonoma State University
Duane Dove, Sonoma State University
Wingham Liddell, Sonoma State University

CASE DESCRIPTION

The primary subject matter of this case concerns cultural differences in cross-cultural business negotiation between Chinese and American negotiators. Secondary issues examined include Chinese business practices and the importance of planning and preparation for the American businessperson doing business in an unfamiliar culture. The case has a difficulty level of three (appropriate for junior level) and four (appropriate for senior level). The case is designed to be taught in two-three class hours and is expected to require one-two hours of outside preparation by students.

CASE SYNOPSIS

This case study investigates the actions of a small California wine barrel company as it attempts to secures an agreement with a Chinese government forestry bureau to sell wine barrels into the California wine industry. The company operated a small but successful import distributorship selling French oak barrels and other wood products from around the world for winemaking. The marketing plan was to offer a product line covering all tiers of oak aging needs from the most expensive barrel to the least expensive oak chips. Lacking a middl- priced product, the owner sought to negotiate with the Chinese Forestry Bureau for the exclusive rights to sell "Chinese Tiger Barrels". Eventually the owner traveled to the manufacturing site in China to finalize the negotiation. He faced negotiating in a country and in a manner for which he was unprepared because of lack of prior relevant experience and planning. After a grueling five-day visit filled with elaborate formal luncheons and dinners, a five-year contract was signed by the two parties. As events unfolded the owner greatly regretted the terms of the contract and felt he had fallen victim to clever negotiating tactics that resulted in a contract that was not compatible with his best interests.

IN A NAPA VALLEY, CALIFORNIA RESTAURANT

It was May 18, 2001, and Erik Lynn, owner and salesperson of American Consolidated Barrels, an importer of wine barrels and wood products, was sitting at a Napa Valley restaurant. He

had just struggled through a negotiation with his Chinese supplier, Director Wang Chan of the Forestry Division of the Kweilin Forestry Bureau, about problems with the wine barrels Lynn had received from them five months prior. Yu Wen, the Oregon-based, independent wood broker who had introduced Lynn to the Chinese almost two years before, had also been present. For the past year and a half Lynn had dealt with the Kweilin Forestry Bureau, a division of the Chinese Government, to secure a business deal to sell Chinese Tiger Barrels in the California winery market. Lynn had come to the meeting angry because he felt he had been cornered into a purchase that had stuck him with prepaid inventory of 40 faulty barrels shipped from China in December, 2000. Every new Tiger Barrel leaked from the sides and corners as it made its debut into the California market.

Less than two years ago at the first negotiation, Lynne had been on Chinese turf and had let the Chinese control the whole visit. Feeling pressured by all the attention the Chinese bestowed upon him, Lynn had signed an agreement that he later regretted. This time, Lynn turned the tables by setting the agenda and booking a table at a modest local restaurant.

The meeting with Wang and Yu had been surprisingly cordial and conciliatory. Yu, acting as interpreter, had successfully conveyed the congenial atmosphere that Wang wished to establish. Over lunch Wang had discussed the sales contract both parties had signed in China. He reminded Lynn of the second-year quantity of 300 barrels that Lynn had committed to order for shipment before the September 2001 harvest. Lynn had complained that he had not yet been able to deliver to his customers any of the forty barrels that he purchased in the first year of the contract due to their unacceptable quality. All forty barrels had major repairs to undergo, and the barrel repairman Lynn hired had not been able to fix them yet. A distressed Lynn explained with that he was stuck with paid inventory, a future repair bill and advertising expenses, yet no sales revenue.

Wang had replied, "Our two parties have committed a lot of energy and time to this project; we must both remain committed to making it work." Wang emphasized that they trusted Lynn's technical expertise and that it was unfortunate that the first attempt was not a success but that Lynn could trust them to correct the situation. Wang reminded Lynn that both parties had committed to establishing and maintaining a long-term relationship when they signed the business deal. Due to this commitment, Lynn could expect that the barrels would soon improve in quality.

Lynn had argued that American Consolidated Barrels was not a large enough company to support these setbacks. He had invested $6,000 in advertising, which included ads placed in four major wine journals. The forty barrels paid in advance had cost him $16,400 and the ongoing repairs to the shipped barrels would be about $4,000,

During the meeting Wang had repeated his conviction that once winemakers tried the Tiger Barrels there would be many return customers no matter what the price. Yet Lynn insisted that price was indeed a factor if they wanted to move any amount of barrels in the future. He couldn't justify trying any longer to sell the barrels at $450, a price too close to the current pricing of French barrels, the best quality barrels used in the U.S. which also benefited from favorable exchange rates. Lynn was covering all of his costs with gross profits of only $20 per barrel; he normally grossed between $60 and $110 per barrel.

Prior to the meeting, Lynn had concluded the chances of the project succeeding were dwindling and had almost decided not to commit more time and money to it. But before making a final decision, Lynn had wanted to see how his Chinese business associates would address both the

faulty barrel quality and the mounting repair bills. In the meeting, Wang had graciously offered to pay for the barrel repairs. He was so convinced of the future success of his barrels in the U.S. market and obligated to his long-term relationship to Lynn that he had also promised to be flexible about the upcoming year's contracted order quanity so that Lynn would continue the venture.

At the end of the meeting, Lynn had delayed making commitments to buy more product until he received reimbursement for barrel repairs. Even if these problems were resolved to his satisfaction, he would still initiate more negotiation regarding more favorable terms for shipments, pricing, and payments.

After the Chinese had left the luncheon, Lynn sat back down by himself to think about his business. What had motivated him to attempt this novel project, and what had he done right to make it work? What had he done wrong? Could he trust the Chinese to correct the quality problems? Could he trust the contract that Yu had convinced him to sign? Could he trust the Chinese about anything? If the quality of the barrels were improved, was the deal financially viable for him to pursue? Would the Chinese truly work with him to create a deal that worked for Lynn as Yu had indicated?

THE WINE BARREL INDUSTRY IN CALIFORNIA

The California wine industry was first established in the 1700's when Spanish missionaries traveled north from Mexico. The industry continued to develop as many European explorers and gold diggers turned to winemaking. Most of the historical wineries still standing today were founded by Germans, French, and Italians. These strong European roots combine the ancient practices of winemaking with modern science. Since 1990 the U.S. has become the fourth largest producer of wine in the world, with California contributing 95% of the nation's production.

Oak barrels became a very important part of the California wine industry beginning in the 1980's. The fascination of California winemakers with new barrels was based on their desire to emulate the European top growths, or top wine houses, by making wines in the old European way. In Bordeaux, where the most prestigious Cabernet Sauvignon wines come from, and in Burgundy, where arguably the best Chardonnay wines originate, the top wineries use new oak barrels. Wine not only attributes its flavor characteristics to the grape source but also to the environment in which it is stored, traditionally a 55 gallon oak barrel. Barrels offer complex flavor compounds, comparable to spices used in very complex recipes, that are extracted into the wine over time. The cost to attain these aromas and flavors, however, is only allotted to wines that can justify them, wines priced at $20 and more per bottle. This high-priced segment of the California wine market had been growing between 10% and 20% since the mid 1990's; therefore, there was a growing need for barrels.

In 1999, the wine barrel industry sold about 200,000 French barrels; 200,000 American barrels; and about 20,000 Eastern European barrels to California vintners. Total barrel sales revenue that year was about $135 million to the California wine industry, whose wine wholesale revenue was valued at $3 billion. Barrels represented a large part of a winery's budget so finding less expensive sources was important. Low pricing of American oak kept many American oak barrels in place at wineries that continued to believe that any 55 gallon oak barrel was better than none. Hungarian and

Eastern European barrels offered flavors similar to French barrels, and these were sold as an upgrade to American oak. The price of the Eastern European barrels was strategically placed between the American and French barrels because the market could bear the higher cost for them, although the raw product and labor costs were largely reduced compared to French and American barrels.

In 2000, the Eastern European and American barrel prices were pushed as high as the market could bear in order to compete with French barrels. Barrels fetched as much as $600 for a French barrel, $420 for an Eastern European, and $200-300 for an American oak barrel. As the barrel price declined, the wine aged in them developed flavors considered less favorable, more one-dimensional, than wines aged in French barrels.

Interestingly, barrel production costs show a similar breakdown regardless of origin. This breakdown is approximately the following: one third raw wood, one third construction of the barrel, and one third sales costs including marketing and transportation. French forests, managed by the French government, are considerably more expensive to harvest than American private forests where clear-cutting is permitted. The labor in France is unionized, so barrel construction costs are high. Transport to California is expensive as well. Profit margins on French barrels are very high in the US compared to the other wine markets of the world because of high demand; thus they are proportionately more expensive than American barrels.

Barrels have always been hand-made at a barrel manufacturing plant, called a cooperage, by assembling pre-cut staves into a ring shape, adding the hoops or metal rings around the outside, bending the staves over a fire, and then placing the headboards into the two ends. French and Eastern European wood is split with a maul; American oak is sawn. Only two French barrels are made from one cubic yard of wood, whereas five American barrels are produced with the same amount of wood.

French oak barrels are accepted as the highest standard for winemaking in California. This confidence in French barrel quality persists even as economic considerations has led many producers of less expensive wines to shift toward less costly American oak barrels. With a strong attraction to create the most elegant wines in the world comes the desire to experiment with old and new techniques. Each winemaker normally tests independently the idea of a new method or material that could make a more interesting or complex flavored product.

Barrels are sold through a variety of distribution channels in the California wine industry. The largest US and French cooperages have established their own production facilities almost exclusively in Napa and Sonoma Counties, for example, to produce, market, and repair their barrels. They hire their own salespeople who are paid a salary and commission on what is sold. This is the least risky compensation arrangement for the salesperson but also the most financially limiting.

Smaller producers hire local sales people as agents who are paid on commission. Sometimes expenses and a small salary are included since barrel sales are very competitive and market development is time consuming. The salesperson is independent but carries minimal risk, and their financial cap is set by the manufacturer.

Some individuals act as "brokers" (distributors); they take title to the product and handle all the activity from the production facility to the final destinations. Handling the importation and storage is a risk, but it can double or triple the $50,000 to $80,000 yearly income that a successful agent can expect to make.

Barrels from overseas are imported in closed containers. They can be 20 or 40 foot containers, the most economical being a 40 foot container which holds around 150 barrels. A 20 foot container holds about 70 barrels. Transport costs for a 40 foot container are about $3,000 to bring in from France, compared to about $2,500 for a 20 foot container. Once product cost, shipping and insurance are accounted for, the total outlay for a 40 foot container of barrels averages about $60,000.

The fact that barrels contribute to and alter wine flavors makes liability issues a serious risk. If a barrel damages 55 gallons of wine worth $20 per gallon, and if this wine is blended into other wines, the damage claim can be astronomical. No small American-based distributor would want to be the target of a financial claim, so extensive insurance is required. To compensate for these risks, however, distributors enjoy considerably higher financial rewards than agents who work only on commission.

American Consolidated Barrels, owned by Erik Lynn, sold about 1,500 barrels in 2000. This represented about 0.3% of the total California market.

American Consolidated Barrels, LLC

Erik Lynn, born into a diplomatic family, grew up around the world. His father served as ambassador to several African countries during Lynn's childhood. Living abroad for many years, Lynn felt comfortable interacting with many cultures. He graduated from Harvard University in 1981 and then received an International Business Degree from The Fletcher School of Law and Diplomacy in Boston in 1985 where he became a skillful negotiator and communicator. Lynn applied his skills to the corporate world after graduation but dropped out in 1992, unsatisfied with the limited opportunities that large organizations offered for exercising creativity.

Lynn moved to Sonoma and Napa Counties where he began working for wineries and their suppliers. In 1996, he joined Parrelle Barrels, a small importer of barrels from a French cooperage. This was late in the game when the marketplace was nearly saturated with barrel salespeople; Parrelle was the 25th French cooperage to enter the California wine market was rather disconcerting. Only a few wineries had ever bought Parrelle barrels in the past, so making inroads was very challenging. A record grape crop in 1997 gave Lynn his break; a shortage of barrels allowed him the opportunity to make some important sales. Due to Parrelle's poor barrel craftsmanship, however, 30% of Lynn's existing customers failed to reorder in subsequent years. Too many barrels leaked, and the winemakers would not tolerate a second bad experience even if the barrels sold to them were quickly repaired. Fighting to be added as a barrel supplier to a winery was a very tough task, especially when it was difficult to present a consistent list of satisfied references.

Lynn purchased Parrelle Barrels in 1998 for only $12,000. He renamed it American Consolidated Barrels and created an LLC because of the flexibility it offered if the company grew. The real cost to Lynn was the outlay of capital amounting to about $700,000, required each barrel delivery season, which lasts from August to December. Lynn's annual sales from 1998 to 2000 were ten to twelve containers, each valued at $60,000 and each containing about 150 barrels. Lynn was required to secure a bank line of credit for $150,000 against his personal assets, his home and property. He negotiated with the cooperage to have 90-day terms ex-works for payment. Lynn was

responsible for the transport as well. He paid upfront all the transport fees, and the liability for shipment was his responsibility. Early in the grape harvest season Lynn had no problems paying the cooperage. Later, however, the wineries were busy with the grape harvest and would pay Lynn late, making it difficult for him to pay the cooperage after the third or fourth container. Lynn was one of a few American entrepreneurial salespeople who established distributorship agreements with cooperages, but this is rare as buying and reselling barrels requires a great deal of investment. Lynn could be extended $300,000 at any one time if the harvest were late.

Currency issues were a major factor for the Parrelle products during the barrel selling season, March through November as customer prices were based not only on margins but also on the currency rate. The barrels were paid for in French francs and Lynn bought forwards in order to minimize his risk. This allowed him a floating average in his currency exchange so he could move prices up or down during the selling season. During the first years he found the tendency was for the dollar to get stronger during the delivery season so delaying his full coverage seemed to benefit him. Lynn also had seen the prices drop 15% between 1999 and 2000 as the US dollar gained against the French Franc.

Following his marketing strategy to offer "the one-stop shop for all your oak aging needs", Lynn began looking for a lower-end product to sell to the larger wineries who did not use high grade French oak. He diversified his product line in 1999 by becoming sole U.S. agent for Duxon Timbers, an Australian manufacturer of oak inserts and chips. The fact that there was little competition in oak inserts made this product a valuable addition to his line. Inserts are planks put into old oak barrels or stainless tanks that impart flavors to the wines similar to what new barrels might extract. Not every winery could afford expensive oak barrels to enhance the flavors of their wine and this was a relatively new method to add wood flavors to wine. Duxon oak inserts could be sold to wineries whose wines were going to retail at $10 and less a bottle, a segment estimated at more than 80 percent of the world consumer wine market in 1999. The added cost of the oak inserts to the wine was about one fifth the cost of a real oak barrel.

Duxon inserts were an immediate success in the market. Strictly commission-based, they limited Lynn's risk, but he would not be able to base his future income on these sales because they were inexpensive products with low margins. The products were sold to customers in US dollars, and customer pricing was more elastic due to the favorable currency exchange.

Lynn continued to sell Parrelle barrels, his original product, because even though sales were static between 1997 and 2000, he could still make a very good living off this product. Duxon Timbers contributed only a small part of American Consolidated Barrells' net revenue due to the small rate of commissions Lynn could make from this product, but the sale of the products was going exceedingly well. To round out his product line Lynn began looking for a middle range product to complement his high priced French barrel and the lower priced Australian product.

THE TIGER BARREL PROJECT

One day in the fall of 1999 Lynn received a letter from a wood broker, Yu Wen of FineWood Imports, a large Oregon-based producer of high quality carved furniture and other wood products which were exported around the world. Yu, the liaison between China and American-based

distributors, inquired about Lynn's possible interest in selling a new line of oak barrels into the California market. She explained that the Chinese oak grown by the Chinese was the same genus as the white oak sold for American and French barrels. Lynn had once seen some Chinese oak but only a very few barrels were ever released into the American market due to their very inferior craftsmanship. No one, it seemed, knew about the flavors the wood might offer. Lynn's interest was piqued because this unique and enticing product would complete his product line.

Lynn accepted Yu's invitation and began working with the Kweilin Forestry Bureau, the source of FineWood's products, with the goal of becoming the sole US broker for the new Chinese wood product, the Tiger Barrel. He initiated a preliminary analysis of the quality of the Chinese wood by sending pieces of the wood to be scientifically studied at one of the French Cognac Houses. The results showed that the wood was of high grade with many aroma qualities, much like Eastern European oak which is considered almost as good as French. In fact, the laboratory mistook the Chinese wood for Eastern European oak due to the similarity of its physical structure to French oak. With this in mind, Lynn informed Yu that the Chinese company would need to follow French, not American, wood stave-making procedures by splitting, not sawing the wood. He told Yu that if the Chinese were serious about selling their product, they would put aside split oak immediately so that it could air dry in time for the upcoming year's barrel production. Pleased with his interest in the Tiger Barrel, Yu sent a letter of intent to work with Lynn on an exclusive basis.

At Yu's request, Lynn called his contacts in France and for a few months worked on sourcing barrel-making machinery to use in the Chinese barrel-splitting mill. Lynn devoted much time to research and the writing of numerous proposals only to be informed later by Yu that the Chinese had already reverse-engineered and manufactured all the wood splitting equipment they would need. In the following summer of 2000, Director Wang Chan, the second most senior person at the Kweilin Forestry Bureau, asked Lynn to come to China to assist in the making of the barrels. Wang assumed Lynn would pay his own way since he was to be the distributor but Lynn thought the opposite as he was providing value to the Chinese by helping them with the barrel making. Lynn replied that he would come only if they paid to bring both him and a cooper, a professional in the barrel-making field. They haggled for three months with the Chinese winning in the end: Lynn would pay for the trip to China on his own. This quarrel postponed the planned trip three months at which time the French barrel master Lynn had lined up to work with him in China would now not be available.

Upon Lynn's arrival in Beijing, a young student translator, a relative of a manager in Kweilin, and a chauffeur helped him around Beijing the first day. He was booked into a Chinese hotel, located a block off the main avenue, not in one of the major western-style hotels situated conveniently in the center of town. The next day he traveled by plane to the farthest part of Eastern China, a four-hour flight; then he was driven seven hours by a plain-clothed, non-English speaking driver to the headquarters of the Kweilin Forestry Bureau. Upon Lynn's departure from the factory to the airport five days later the same driver showed up in his People's Republic of China (PRC) party military outfit.

Lynn had been notified by the Chinese that he would find a "surprising abundance of food" in China which was a way of introducing him to the lush agricultural region in which the Forestry

Bureau was located. Wang and Yu, who continued to act as a liaison, greeted Lynn upon his arrival to headquarters and escorted him for the five days Lynn had budgeted to spend in China.

Lynn offered as a gift to Wang his American Consolidated Barrels baseball cap which Wang wore with pride many times during the visit. He was interviewed on local television and given tours of the town, which included a hospital, schools and stores run by the Forestry Bureau. Wang arranged for a professional video to be made of the five-day visit which he gifted with pride to Lynn upon his departure.

The busy days began at 7 in the morning and were highlighted by lavish banquets each day at both noon and in the early evening which lasted for hours each. Large amounts of spirits and rich foods were consumed. During the highly ceremonious meals, the Chinese officials toasted often, underlining the importance of the new union of friendship and trust between the two companies and the prosperity that would soon follow. The atmosphere was very friendly but very businesslike at all times.

Numerous meetings were held with many managers and officials of the state to discuss points of the business deal. Lynn did not know who the endless stream of managers and officials were were but was told that one director was in charge of the Foreign Relations Department. Later Yu explained that this person was the government PRC party representative. Upon being questioned, Lynn discovered that the man knew little of foreign affairs. Many meetings seemed only to be formalities as topics and principles were discussed in a very general nature.

At the barrel-making factory during work hours, Lynn noted that although the laborers worked hard to assemble a barrel, the equipment was subpar and often quite dangerous. He was amazed by the number of people, at least 10 at any time, who worked on a single barrel, each holding one part of the whole barrel as it was assembled. Normally one person made a barrel in France. The major flaw he was not prepared for was that although the wood had been split as requested, a large amount would not meet the quality standard he needed. Accompanied by a translator, he toured the wood park with the barrel workers, explaining to them why barrels leaked and how leaks could be predicted from poor choice of wood. He helped the workers to sort the wood by proper grain structure. Notes for future use were taken copiously by Wang's personal secretary although her English was very rudimentary. In the end, Lynn was impressed by the crude but effective way barrels were being made. He was convinced the Chinese could match the workmanship of the French coopers.

Wang asked Lynn to assist in translating the notes taken by Wang's secretary into production guidelines which would later be used as a training tool for the employees once Lynn departed. Lynn saw no harm in doing this as he was confident his training was sufficient enough to be able to provide guidelines, and because the Chinese knew he was not a professional cooper.

Lynn, suffering jet lag the whole five days, struggled to keep up with the demanding schedule of entertainment, sightseeing, and dining. Not able to speak Chinese, he felt awkward most of the time and counted the days to his departure. Much friendliness was exhibited during banquets and sightseeing, but a very forceful, aggressive stance was displayed during discussions in Wang's office with the ever present hordes of staff members and managers.

At one evening banquet soon before Lynn's departure, Wang, Zhang Xiancheng, the head director of the Forestry Bureau, and another Director, somehow more important than Wang, were

present. Lynn was reminded that this was the first time all three Directors were at the same meeting and that he should feel highly honored.

On the last day of his visit, Lynn came to Wang's office and found six other plant managers seated around the room on couches. Wang suddenly began discussing very specific issues, like future sales amounts and pricing. Shifting dramatically from his cordial style of the first four days, he ranted and waved his arms, attempting to convince Lynn that his cost structure required that the barrels be sold at his suggested price. From Lynn's point of view, however, the high price Wang proposed put him at a real disadvantage. Wang presented his position as though it were a concession to Lynn: he would be willing to sell the barrels to Harrop for $410 delivered to Napa, California. He explained that his wood costs were high and that there was more waste splitting the wood than he had originally thought.

A contract was drawn up after Wang and Lynn reviewed what Lynn could sell at the various price levels. Wang argued heavily that he could not accept lower prices and that his labor costs were not much different than those in America and France. Lynn decided to accept the price even though he knew labor costs were much lower in China. There was no discussion of possible currency fluctuations that could push prices up or down as was already the case with Lynn's Duxon and Parrelle products.

Wang agreed to pay for part of the costs to exhibit the barrel at the January Sacramento Unified Symposium, a wine industry trade show. However, Wang insisted that for Lynn to be reimbursed expenses incurred, he had to take it from future sales because the laws in China did not allow money to leave the country. This seemed preposterous to Lynn but Wang would not budge. Feeling obliged after all the lavish attention the Chinese had bestowed upon him, and in an effort to build trust, Lynn conceded this point even though he did not agree to it.

The contract was written in Chinese and then translated to English by Wang's assistant for Lynn to sign. Yu informed Lynn that the contract would not hold him accountable to buying the barrel quantity stated but that it was simply a formality needed by Wang to show his superiors that the project had true potential. Contracts in China, Yu explained, are a reference point to continue further discussion and are not intended to be binding the way Americans understand them. an and to later show them their mistakes in planning. Based on the relationship he felt he had established with Wang and other Chinese officials and wanting to cement exclusivity as a dealer, Lynn figured he was fairly safe. He agreed to sign the contract, feeling there were enough exclusions to allow him a way out if necessary. Besides, if the contract truly was only a formality, details he was not pleased about could be worked out later. In addition, he needed to wrap things up; the barrels needed to be ready to market in California for the upcoming harvest.

Yu told Lynn repeatedly that he need not worry; he could return the barrels at any time for any reason, but an order needed to be placed now. The investment of $16,400 he risked, Lynn reasoned, could be recovered in sales. He ordered his first 40 barrels feeling really excited about his new product.

Returning to Napa in September 2000, excited by the Tiger Barrel in spite of the dubious outcome to the negotiation in China, Lynn set out to sell his first 40 barrels for $430 a piece, even though he intuitively felt this was too high a price for the market. He hoped to deliver them upon their arrival to California in December, only 3 months after his visit to China. Knowing that he

would take a loss on the first shipment of these few barrels, he justified this as a long-term investment in the project. Lynn reasoned that he could convince Wang to come down in price after testing the market.

Lynn's goal had been to offer the Chinese barrel at a point lower than the price of an Eastern European barrel price since those barrels were gaining respect with winemakers due to the flavors they contributed to the wine. The first forty Chinese barrels, however, he felt he could sell by their uniqueness alone. He placed a full-page advertisement in two of the major wine journals in January 2001 and took a sample barrel to the Unified Symposium where he immediately was exposed to an audience of 5,000 industry contacts. Lynn also secured a lead story about the Tiger Barrel project in a September issue of a weekly Web-based journal, the Wine Business Weekly, which drew a lot of calls from interested winemakers. The successful advertising and article brought in one of the largest wine companies in California as well as many other new customers for Lynn.

The first four of forty barrels were delivered in December 2000, but by January Lynn discovered they had significant quality problems. He stopped delivering and quickly withdrew the first four barrels from the market due to their unacceptable quality so as not to ruin his reputation. Lynn was not surprised when the local cooper who repaired the barrels confirmed that the barrels themselves were made acceptably but the wood selection was poor. The Chinese barrel makers simply required more training; Lynn still believed there should be an experienced technical expert hired to teach them properly.

In February, Lynn wrote two letters to Yu, the first in which Lynn outlined several problems and their solutions, and the 2nd of which outlined a better way of setting pricing to correct what he saw as a major hurdle for future sales. In both letters he attempted to appeal to the Chinese business style he had recently read about by explaining that he needed to correct problems in order to save face. Lynn had counted on the testimonials of customers who had used the barrels to obtain new orders for August 2001 sales, but since the barrels had been faulty, he's not been able to cultivate these product recommendations and therefore lost the selling season. He would have at least his 40 repaired barrels to work with in 2001.

MAY, 2001, NAPA RESTAURANT REVISITED

Lynn thought to himself after the lunch meeting that there were still significant gaps in his business plan with the Chinese. He had had been totally convinced in the Chinese workers' abilities to build a wine barrel. He had invested a lot of development time and advertising money in this venture which had paid off with impressive press articles so that he would have something unique to make winemakers take notice. Instead, the project had turned into an expensive disaster.

He was now more concerned if he would be reimbursed for the faulty barrels than in seeing his commitment to the Chinese through for the following year. However, if the barrels he had already sold brought in good results, he was still positioned to proceed with the deal. Unfortunately, his momentum was long gone. He wondered what went wrong: How could he have averted some of the problems he now faced? What could he now do to try and save the deal? Based on the pressures he felt during the visit in China, he wondered were the Chinese really sincere about making the barrels the right way in order to produce consistent quality down the road?

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HELP ME! AN ETHICAL DILEMMA

Carol Bruton, California State University San Marcos
Gary Schneider, University of San Diego

CASE DESCRIPTION

This case concerns an ethical decision that needs to be made by Scott Peterson. Scott takes a job at a company that he later discovers is, in all probability, fraudulently billing the federal government. Scott is financially strapped and desperately needs the pay from this job and must decide whether to quit the job, and if he is to quit the job, how to quit to the job. He also needs to decide whether to turn in his boss or not, and if so, who to contact. Scott has assisted with the fraudulent billing so he could go to jail. The case is appropriate for freshman through graduate students.

The case requires approximately 20 minutes for the students to read and analyze. Subsequent discussion may be as short as ten minutes, or 30 to 40 minutes, or longer. The instructor can require the students to read the case during the class period or outside of class. The students do not need to obtain additional materials outside of class to be able to analyze the case. The case can be taught in any discipline (marketing, management, finance, etc.), however, the case is particular suited to an accounting course because Scott is an accounting major performing billing responsibilities.

CASE SYNOPSIS

This case is based on an actual situation. The issue is an ethical decision that needs to be made by Scott Peterson. Scott takes a job at Bennett Contracting and he later discovers, in all probability, that Bennett Contracting is fraudulently billing the federal government. Scott is preparing the invoices and worries about his legal involvement. Can, and will he go to jail for this? Scott is financially strapped and must decide whether to quit the job, and if he is to quit the job, how to quit to the job, and whether to turn in his boss, knowing he could be prosecuted also. The case is an excellent ethical case because the situation evolves slowly and subtlely, similar to how an actual ethical situation usually occurs, and there is not a perfect solution.

INTRODUCTION

Scott Peterson graduated from high school and went to work at his father's service station. A year later he married his high school sweetheart. Things were going well at the service station and he planned to take it over in ten years from his retiring father. Five years into his marriage his

wife had a beautiful baby boy and eight years into his marriage his wife had a beautiful baby girl. Life was great.

Service stations have strict environmental laws for the below ground tanks that hold the gasoline to prevent the gas from leaking into the ground water. In two years, the old outdated tanks would have to be removed and replaced with new tanks. Scott and his father went to the local bank that they had always relied upon to obtain a loan. They needed money to remove the old tanks and to purchase and install the new tanks. After reviewing the station's revenue for the past few years, the bank concluded that the station would not be able to generate the profit to repay the loan. Scott and his father were turned down. They went to three additional banks and received the same answer. Without the new tanks the station would have to close within two years when the new environmental law took effect.

Scott was 27 years old, with a wife and two children, and would be losing his income, and all he had hoped for in the future. He was devastated. Scott was living in a small town with limited employment opportunities. He agonized over what he should do. He needed to support his family - but he could not think of any option. Finally, Scott decided it was best to try to obtain a college degree in a field that would support his family. This would entail moving four hours away to a bigger city that had a university. Scott feared how he would support his family, while also attending classes and trying to finish the degree as soon as possible. He knew he could not take a full load while working 40 hours a week, but he would try to take as many classes as he could and work as many hours as he could, hoping to finish the degree in six years.

The first two years it was very tight. The family of four lived in a small 20-foot camping trailer in a mobile home park. It was all Scott could afford with his wages of $6.75 per hour and the tuition and books for school. He had purchased the trailer for $500 and paid a monthly space fee of $150. The trailer was one room with Scott and his wife sleeping on the sleeper sofa and the children sleeping on the floor. The kitchen was a stove and sink and about one-foot of counter space. It was tight, but they could afford it. Scott and his wife discussed the possibility of her going to work, but when they put the numbers on paper, they would lose money after paying the children's daycare.

After Scott completed his introductory accounting course he decided that accounting would be a good major. His instructor told him that there were many jobs that paid well. An additional attraction was the part time jobs that are available to accounting majors while they are completing their degree. Some of these jobs even led to a full-time offer upon completion of the degree. That is what he hoped for, the security for his family.

Scott visited the university career services office often looking at the job postings. He was looking for an accounting position that would have flexible hours so he could continue his school work, be relatively close to school to minimize his commute time and cost, and pay at least $11.00 per hour. This particular day a job caught his eye, it was for a small company that provided food to military bases. The job was to complete the invoices for the federal government. The job paid $13.00 per hour. The location was right, the job was right near the university. This was it. This was the job Scott was hoping to get. He faxed his resume. Three days later he received a call to come in for an interview. He was extremely nervous because the job would be so perfect. Money was very tight and Scott so desperately needed the increase in pay from his $6.75.

Scott went to the interview and discovered that he would be the only employee for the company. This made the job even more attractive. Scott was from a small town and he was most comfortable working in a small family type environment, where everyone knew each other well. His boss was very flexible about his hours, as long as he got the billing completed he could come in whenever he wanted. He was free to work in the evenings or on the weekends. The job kept looking better and better. He finished the interview and was very anxious because he wanted, and needed, the job so badly.

The company, Bennett Contracting, is a federal contractor that purchases food for navy bases from various suppliers. The suppliers ship the food directly to the bases, but invoice Bennett Contracting. Bennett Contracting sends one monthly invoice to the navy. This way the navy receives one invoice and deals with one supplier, greatly simplifying the purchasing process for the navy. They do not have to deal directly with a multitude of suppliers, such as a meet supplier, dairy supplier, etc. The federal government does not see the original invoices from the suppliers, only the "marked up" invoice from Bennett contracting. Bennett Contracting is owned by a women, Gloria Bennett, and qualifies as a minority owned business for federal contracting.

Two days later Scott received a call from Gloria saying he had got the job. He was thrilled! What he really wanted more than anything was to move out of the camping trailer and into a small apartment. The family needed more room. The children were three and five and were getting too big to live in that small of space. It was especially difficult during the winter when the children could not be outside.

Scott started the job. Scott would handle the invoicing to the federal government. Gloria gave him the numbers and he put those numbers in the correct format on the invoice and mailed the invoice to the federal government. Things were going well. After four months Gloria was so happy with Scott and his work ethic she gave him a raise to $15.00 per hour. With Scott's new income he could finally afford to move to a small apartment where there would be more room for the family.

Gloria admired that Scott was getting an accounting degree while supporting his wife and two children. Scott was a hard worker. Gloria knew how important every penny was to Scott, and after nine months gave him another raise to $17.00 per hour. After all, Bennett Contracting had the resources to pay $17.00, and Gloria believed that was the least she could do to help Scott. Scott and his family were beginning to become Gloria's family also. Gloria had never married and her parent's were no longer around. Gloria even began to baby sit the children off and on for no charge. Things were great and were really turning around.

At $17.00 per hour Scott could definitely afford a one or two bedroom apartment. He and his wife were able to find a very nice place near school and work and signed a one-year lease. They sold their camping trailer for $500, just what they had paid for. It was a relief to see it gone. Scott and his wife had only one car that was costing over $1,500 per year in repairs. Scott was always nervous when he left with their one car. There would be no car for his wife if the children needed to be rushed to the doctor. Also, Scott would have to miss class when the car was broken down. They purchased two newer used cars so each could have reliable transportation. Both cars were four years old with around 60,000 miles. Much better than their ten year old Chevrolet with 160,000 miles. Scott was somewhat surprised that it was no problem getting the bank loans for the cars after his negative experience with banks trying to fund the service station's tank removal and installation.

Scott's rent was $1,200 per month and the two car payments totaled $400, they had paid about $4,000 for each car. That would leave them with $800 for food, clothes, tuition, and books. It was tight but they could make it. Scott was working about 40 hours per week.

Soon Gloria started giving Scott more responsibility. Scott started doing some of the food ordering. Gloria started giving Scott a few of the invoices from the suppliers and allowing Scott to calculate the mark up for the amount to bill the federal government. And, the really great news, was that Gloria had offered Scott a full-time permanent position upon graduation for $45,000, five thousand dollars more than most of the offers he had heard about! Just what Scott needed. He wanted a good paying job. He was older and had children and was financially on his own. Exactly what Scott was hoping for.

Gloria was now letting Scott take most of the invoices from the suppliers and calculate the markup himself. He would then invoice the federal government based on his calculations. He noticed that some of the markups that Gloria gave him seemed kind of high, for example, milk was marked up 2.9 times. Scott thought it might be because of the perishabillty of the product and didn't think a lot about it. Then Scott noticed that potatoes were marked up 2.4 times. Maybe it was just because potatoes were inexpensive, so more mark up was allowed. He had also heard how wasteful the federal government was and maybe this was just another example of their wastefulness. This was just in line with what he had heard about how lucrative a federal contract was.

As Scott took on more of the work, Gloria was in the office less and less. He was getting free reign of most activities. One day while Gloria was out to lunch, he noticed a bound volume on Gloria's desk that he had never seen before. It looked like a manual from the federal government. Scott was curious and wanted to learn as much about this job as possible since he would be making a career out of it, so he glanced through the manual. On one page he noticed some allowable markups on various products and nothing he saw was higher than 1.8 times. This was puzzling since Gloria was having him mark up items higher than that. He put the manual back down, not knowing if Gloria would approve of him reading it or not, and he did not want to do anything to jeopardize the full-time $45,000 position he was offered. Scott thought that if he had read the markups for the products that he was familiar with, the markups probably would have been the same in the manual that he had used to invoice the federal government. Scott never saw the manual on Gloria's desk again. Gloria had worked with the federal government so long she knew all the rules and did not need to refer to it. Gloria must have kept it in the file drawer to her desk. Scott did not go through Gloria's drawers. He did not need the manual for any reason. Gloria told him the markups. He did not want to go through her desk drawers. That would not be right.

In addition to his other duties, Gloria had Scott start opening and sorting the mail. On occasion he would see updates for the manual. Scott would take a look at them. Again, he did not see any mark ups above 1.8 times. But he never saw the exact same products listed that he was billing, only similar products. After about one month had passed, Scott began thinking more about it and started becoming a little concerned. Should he ask Gloria about it? Or, should he just observe for awhile, after all, she had been in this business for ten years and he had only worked there about one and one half years.

Scott noticed the nice life style that Gloria led. She had a very nice house with nice furnishings and drove a nice car. Part of the reason she kept expanding Scott's responsibilities was

so she could travel and be away for extended periods and he would be able to run the office. She had some very nice trips planned. Soon she was going to Australia for three weeks. Gloria's life style made Scott even more excited about the full-time permanent position because the company appeared to have a promising future.

Still, Scott felt uneasy about the markups. After another month, he became fairly certain she was doing it incorrectly. Should he point it out to her, or, maybe she was intentionally doing it incorrectly - defrauding the federal government.

In the next two weeks, a manual update came in the mail. Scott read it and became fairly certain that Gloria was marking up items too high. Was this a fraud? And, if it was, was he assisting the fraud since he calculated the mark ups and then invoiced the federal government? Although, he had only seen a fraction of the entire manual and the manual was very complicated. He had seen nothing that directly related to the exact products he was invoicing. However, of all the food products he saw - none were allowed a markup greater than 1.8 times. Maybe there were different mark ups for minority contractors?

Scott was worried. He had two car payments and a one-year lease on his apartment that had five months left. Should he look for a new job? If he looked for a new job while working there, would Gloria find out? Would a potential employer call her for a reference? Would she notice the time he would need away from work to look for a job and interview? What would she say? What would he say? He could not be without a job for even one week. He cannot quit without a new job. What would she say when he quit? Should he turn Gloria in? If so, who should he call? Will Gloria blame the fraud on him - that he alone did it? Would he go to jail? Is Scott just expecting the worse and Gloria really hasn't done anything wrong? Is this just a false alarm?

Scott's life was in shambles again - just like when the service station closed. And, just when things were working out so well. If only his or his wife's family could afford to loan them money to get him through this.

QUESTIONS

1. What are the clues that Gloria was possibly defrauding the government?
2. Should it have been obvious to Scott from the start that Gloria was defrauding the federal government?
3. What choices does Scott have now?
4. What is the theoretical "perfect" choice for Scott if he did not have any budget or time constraints?
5. Why might Scott not make the above theoretical perfect choice?
6. What choice do you think Scott will make and why?
7. What choice would you recommend and why?
8. Why would Scott fear looking for a new job while employed by Gloria?

9. Is timeliness important with Scott's actions? Should he wait and observe Gloria and her operations longer?

10. Should Scott turn Gloria in? Give reasons why and reasons why not.

11. If he is going to turn Gloria in, whom should he call?

12. If Scott is charged in the case what will be the likely outcome?

13. How might this situation, coupled with the service station closing, affect Scott's outlook on life?

A CASE STUDY OF FOREIGN EXCHANGE EXPOSURE MANAGEMENT: XMETAL LTD

Ernest Mudogo, Zayed University, Dubai, UAE
Rae Weston, Macquarie Graduate School of Management, Australia

CASE DESCRIPTION

The primary subject matter of this case concerns the design and implementation of foreign exchange exposure management policies in a Singapore company. Secondary issues examined include the organizational context in which decision-making for foreign exchange exposure management is set, the identification of problems posed by the organizational context, an examination of actual and potential hedging tools, and the provision of adequate foreign exchange protection when there are capital controls .This case is used in international financial management courses in an MBA program taught in 3 countries.

CASE SYNOPSIS

Xmetal Ltd is a joint venture company with Singaporean and Japanese partners The company has been successful and has grown fast .This is now exposing problems for management with respect to its organisational structure and its foreign exchange exposure management policy .The company is exposed to risk in the US$, Japanese yen and Malaysian ringgit.

This case allows students to consider how foreign exchange exposure management ought to be established within a company and how its decision-making should be operationalized. The case content includes extracts from interviews with company management and staff .The company's existing organisation makes it a potential Baring's and comparisons may readily be drawn .In the first stage the organizational problems are identified and their impact on foreign exchange exposure management analysed. The second stage is an identification of the range of tasks that need to be undertaken to structure an efficient foreign exchange exposure management policy, including formulating the role and composition of a foreign exchange exposure management review committee.

A key element in the case is the range of currencies on which hedging may be required which includes a capital control currency. Natural hedging and the use of derivatives need to be discussed in order to suggest appropriate solutions

FOREIGN EXCHANGE EXPOSURE MANAGEMENT (FEEM) PRACTICES IN XMETAL LTD.

Organisational Context

Xmetal Ltd. is a joint venture company, which was formed between a local Singaporean company, Strong Metal Enterprises Ltd., and a Japanese company. Mr. W. Tan and his two brothers, Wu and Chong, founded Strong Metal Enterprises Ltd in 1965, as a machine shop. The three brothers owned 75 percent of Strong Metal Enterprises Ltd, and the other 25 per cent of the ordinary share capital was held by four other relatives.

By the early nineteen seventies Strong Metal Enterprises Ltd's sales had grown at an average of 25 percent per year since the company was formed. According to Mr. Tan, this success was the source of motivation for expansion of business. He said:

> *We became interested in getting into manufacturing and were looking for a joint venture relationship with a foreign company, which had experience and technology in the manufacturing of metal products. After a period of search and negotiations we found a Japanese company which was interested in being a joint venture partner with us.*

The joint venture was formed in the mid-seventies to manufacture speciality metal components used in diverse activities such as bridge and building constructions, vehicle manufacture, and domestic appliances. Today, XMetal Ltd. is considered to be one of the leading manufacturers of metal products in the country. It has achieved a sustained growth by taking advantage of the favourable Singapore economic climate.

The top management of XMetal Ltd. consisted of three Japanese, in the key positions of managing director, sales director, and production manager. One of the local partners, Mr. W. Tan, held the position of general manager. The other senior officers were Singaporeans and included heads of transport, procurement, and finance and administration, departments.

According to Mr. Tan, the company had grown from a small machine shop in which distinctly separate functions could be performed by one individual to a multi-product joint venture enterprise, whose scale of operations required a formal organizational structure to provide for the smooth running of internal functions, ranging from policy formulation to task implementation. To this end, departments had been created in order to facilitate specialization. He noted that in the early years of the joint venture (1975-1977), for instance, the organizational structure was informal. He said:

> *There was no feeling of a boss-subordinate relationship. A person's duties might have changed from one function to another, perhaps with no conscious effort. With increased scale of operation a more formal structure has been established in order to serve our customers efficiently.*

Xmetal Ltd's business has been profitable and at the time of this research, it was considered that there was potential for growth because the construction industry was expected to benefit from the economic growth in Southeast Asian economies. It was known, for instance, that the Malaysian Sixth National Plan emphasized public housing and the Malaysian Government supported the provision of housing loans. This was likely to lead to higher demand for better quality construction materials. The company's directors were enthusiastic about the business growth potential. And following the joint venture formation, it had become possible to have access to the Japanese market as well. The Japanese joint venture partner had a long history in the industry, dating to the 1950s and had therefore a backing of experience and expertise, which became available to the joint venture.

However, Mr. Tan pointed out that the company was facing some problems, which needed to be addressed in order to remain profitable and to meet business challenges. First, there was a need for some stability at the top. The three Japanese managers (the managing director, the sales director, and the production manager) worked on rotation. Each of them served in Singapore for only five years before being recalled to their different regional offices in Japan. Mr. Tan noted that a change in three senior managers every five years was not good for the company. He felt that a stable top management was essential in order to establish long term goals arid objectives, and to see to it that procedures for implementing these were in place.

The second problem related to control and coordination particularly between the technical and the sales departments. The sales department sought to promote as much sales volume as possible so as to show good sales performance and to maintain good relationships with customers. In the words of the sales director:

> *Our objective is to sell as much as possible, to ensure delivery of products and to collect payments from customers.*

While sales staff sought to portray a good image to customers, the works managers in charge of production in the factories wanted to ensure maximum machine utilisation. The production of metal components was tailor-made to specific job orders. This did not facilitate big batch production runs. Different production orders entailed different machine settings, which took time. The production department perceived the sales department as motivating customers to place orders for small component lots of different sizes, and therefore unsympathetic to the situation in production. The works managers were answerable to the production manager. The sales director was influential with the top executive and was dismissive of the concerns in the production department.. The production manager said:

> *Sometimes, in order to accommodate urgent requests from customers, we have to interrupt our planned production sequence further exacerbating the production backlog.*

The communication problems between the sales and the production departments made it difficult for sales staff to consider production lead-time when dealing with the company's customers.

The other departments were aware of the tension between the sales and production departments, but did not feel it had anything to do with them, even though some of the problems in the two departments impacted on their performances.

The organization was hierarchical and bureaucratic at the top. This did not help in resolving interdepartmental conflicts. The formal information channels both vertically and laterally were inadequate. This made it difficult not only for the top managers to have a clear understanding of what was happening at the implementation level, but also made it hard for different departments to have the essential information they needed in time. In an effort to improve information flow, the company executives authorised the acquisition of a computer. They recruited a systems administrator to implement computerization. However, at the time of the interview, most employees did not seem to know what to expect from the computerized system. Although the system had been established to provide quality information in activities such as invoicing, it was pointed out that there were many errors which led to more complaints from customers than was the case when such information was being produced manually. The Systems administrator was new to the company and had not studied in any detail the needs of the various departments before embarking on the computerization exercise. One of the managers said that the decision to acquire a computer and to recruit a systems administrator had not been properly thought through. In his opinion, what was required was a study of the operations to examine what information was needed. This study would identify the information which was not available, and find a solution to an identified problem. He thought that a systems administrator was not the right professional needed under the circumstances. But he said he was not surprised by the decision: the people at the top who had taken the decision were not conversant with information technology. He said:

> *They always think that computers offer solutions to all problems of control and coordination.*

The problem of control and coordination had yet to be carefully addressed. The company employees comprised local Chinese, Malays, and Indians; and Malaysian Chinese. There was a need to formulate policies and to communicate them in order to forge a common organizational identity. The need for policies arid implementation procedures seemed to be even greater for new employees who wanted to know more about the company and what was expected of them.

ORGANISATION FOR FOREIGN EXCHANGE EXPOSURE MANAGEMENT (FEEM) IN X LTD

Foreign exchange exposure (FEE) in X Ltd. arises largely due to the importation of manufacturing inputs, foreign currency denominated sales to overseas customers, and currency remittances between the joint venture partners.

The most important currencies for foreign currency payables were the United States dollar and the Malaysian ringgit. The estimate of foreign currency denominated payables as a percentage of total sales was 33 per cent: 20 per cent in the United States dollar, and 13 per cent in Malaysian

ringgit. All foreign sales on credit were denominated in the United States dollar, except sales to Japan which were denominated in Japanese yen. The estimated ratio of foreign sales as a percentage of total sales was 45 per cent: 30 per cent in United States dollar, 10 per cent in Japanese yen, and the remaining 5 per cent was denominated in Singapore dollars. FEEM was significant because the company had foreign currency denominated payables (33 percent of total sales). Similarly, about 40 percent of the company's revenue derived from overseas sales, which were invoiced in foreign currencies. It was felt that insisting on invoicing sales in the domestic currency (Singapore dollar) could have led to loss of foreign business as the company's customers were known to prefer suppliers who invoiced in customers' currencies.

The company had employed a treasury manager, Mr. Tim Chan, whose main duties included FEEM. The awareness of FEE as a significant corporate problem was underscored by the fact that the Managing Director had taken the step of introducing Mr. Chan to some experienced FEEM managers in Japan so that he could consult them if the need arose.

Foreign exchange exposure management was centralized in the treasury unit. The treasury unit was in the finance section of the department of finance and administration. The department of finance and administration comprised treasury, accounting, and personnel functions. The responsibilities for the finance function included corporate financing, and FEEM. The treasury manager, Mr. Chan, had a degree in accounting. He was in his mid-thirties and had considerable accounting experience having been an employee for six years in one of the major accounting firms in Singapore. In the FEEM function Mr. Chan had one assistant whose day-to-day functions included compilation of foreign exchange data from banks and other financial publications. Mr. Chan's assistant had identified the foreign exchange information sources and acquired the information on a regular basis.

Mr. Chan attempted to minimize and control exposure wherever possible. He managed FEE almost single-handedly. In practice he hedged 60% of the United States dollar receivables and payables, and 50% of its Japanese yen receivables. The Malaysian ringgit was not hedged. The hedging techniques included use of forward market contracts, use of the money market, and matching receivables and payables where information was available. The review of the hedging policy was ad hoc, and was done at the treasurer's initiative.

The availability of the internal exposure management information was the weakest link in the exposure management task. There was little opportunity for matching or netting foreign currency denominated receivables against foreign currency denominated payables due to lack of accurate and timely information about exposed business. In particular, the preparation of net exposed cash flow in each of the foreign currencies in which receivables and payables are denominated was not done. Part of the problem for this omission was due to the fact that there was no guideline as to who should prepare this information. The financial information produced was according to traditional financial statements such as internal quarterly management accounting reports and the other external financial reports. The task of preparing additional exposure management reports as an integral part of coping with the task of exposure management in the present environment of currency fluctuations had yet to be internalized or made part of financial management practice.

Most of the senior managers lacked awareness of foreign exchange exposure ramifications. There was no formal company-wide foreign exchange exposure management policy. This made

exposure management something of concern to the treasury unit only. As noted in the discussion on organizational context, there was inadequate information for control and coordination of corporate activities, In terms of organisation for FEEM, there were both structural issues as to who should be involved in, as well as inadequate information for, exposure management. The procurement department and the sales department generated exposures. However, these departments were unaware that they had any role to play in minimising or reducing FEE. The treasurer said that he wrote to request details of business that was done in foreign currency, but he said that such information from these departments to the treasury unit usually arrived late, if it ever came. The organizational design encouraged optimization at the departmental level without regard to the overall interests of the company as a whole. Following familiarization with the organizational context and other company information, it was arranged to have interviews with key members of the company in order to investigate FEEM practices. The results of the interviews and dialogues are presented below.

In the area of FEEM the question of centralisation/decentralisation usually arises from the consideration that the tasks of exposure identification, exposure assessment and exposure management inevitably have a bearing on the organisational structure to be adopted. As a company assumes more FEE there is some expectation that the exposure management function becomes more specialised, thus contributing to the case for centralised exposure management. However, there are also good arguments against centralisation because of the possible lack of communication or mis-communication between the exposure manager and departments such as marketing and procurement which interface with international trade operations. If there is no efficient reporting mechanism of information on buying, purchasing and price fluctuations to keep up with the dynamic nature of foreign exchange environment, centralising FEEM in one unit of the company may not be a good strategy. The question of centralisation versus decentralisation was variously viewed within the company. One manager said

> *The question as to whether centralisation or decentralisation for exposure management seems inappropriate. Does centralisation mean delegation of authority from the Managing Director or the Board to the treasury unit, or does it mean centralisation of the exposure function to one of the joint venture companies? If it means the former, how about the need for information from other departments in the company to enable the treasury unit to manage exposure and how about the contribution of other key departments whose officers are concerned with activities which give rise to exposures? If one recommends the latter approach, the need for liaison with members of the other joint venture company remains. So, what does one mean when one recommends a centralised or a decentralised organizational structure of FEEM? There is a need for both.*

However, his counterpart followed up and stated:

> *But centralisation has the advantage of encouraging specialisation with the difficult foreign exchange exposure management task; a task in which only a few people can*

claim some competence. Although other departments need to be consulted, it is important to have a specialist unit.

While the importance of a specialist treasury unit was considered necessary, members of the company thought that the presence of the treasury unit alone was not sufficient for coping with the wider and pervasive FEE ramifications. One of the members suggested that allowing too much personal discretion in currency risk management was dangerous. He said:

Foreign currency changes are very tricky ... Nobody can win all the time, so there must be controls to prevent excessive individual discretion.

He went on to emphasize his point by saying that in view of the recent problems at Barings Bank, nobody should be allowed to handle foreign exchange hedging and dealing alone. He suggested that unless top management had a policy on this matter, there were dangers. He read a recent newspaper extract to make an analogy between what was reported to have happened at Barings and what can happen to an institution which doesn't have proper internal controls and accountability in foreign exchange exposure management:

[The blue bloods] were too aristocratic to be involved, ... For that they would pay the ultimate price. In Singapore, the apparent lack of supervision had set the stage for disaster. London allowed Leeson to take control of both the trading desk and the backroom settlement operation in Singapore. It is a mix that can be - and in this case was - toxic ... For a trader to keep his own books is like a schoolboy getting to grade his own tests; ... You should never have had the same person making and settling the trades, ... You should have had someone running Leeson in Singapore. Who guards the guards? (Powell, 1995:53).

The member suggested that market disasters such as the one that afflicted Barings can be avoided or minimized if the company understands the nature of the problem and institutes an organizational mechanism to control it. He pointed out that in today's turbulent economic climate ignorance about the environment and lack of adequate organizational strategies can lead to business failure. He suggested that at Barings there were management problems. He quoted the newspaper extract which said:

It is about a deeply divided firm that allowed itself to get blindsided in a business it didn't understand - even though it got warnings just a few months ago as to precisely how that might happen. (Powell, 1995: 52).

There was a general agreement among the members of the company that since exposure can affect corporate value, it was important for the board of directors of the company to appreciate the significance of FEE. It was felt that if the top executives did not appreciate the FEE problem then it would become difficult to adopt a company-wide approach to its management. One of the members commented later in a private conversation as follows:

The Chief Executives must go back to classroom so that they can learn about new problems which can affect the company, such as FEE. The Chief Executives are the ones who make decisions on how corporate resources are to be used. At least all senior mangers must have familiarisation seminars about FEE.

The dialogue continued. An emerging view was that centralisation did not mean lack of consultation or coordination. It was pointed out that there was a need to promote specialisation, coordination, and accountability. Overall, most members were of the view that centralisation should be subject to coordination and control.

The next subject was to consider the importance of an FEEM policy. Mr. Chan, the treasurer, pointed out that he evaluated each individual transaction on an ad hoc basis. He said:

I take a flexible approach to hedging and much depends on my perceived view as to how the market in a particular currency will move. We don't have a hedging policy. I make my judgement on how to hedge based on foreign exchange forecasts compiled by my staff and also based on information on exchange rate movements from my counterpart in Japan.

Further dialogue with the other members of the company supported the treasurer's view that any policy on exposure management has to be flexible. It was felt that any predetermined hedging policy might be essential in order to create exposure awareness to all employees, but that such a policy should be broad to allow exposure managers the incentive to make judgements. Some members of the company were of the opinion that a predetermined hedging policy would stifle creativity and destroy managerial flair of judgement, while others felt that relying completely on an informal, intuitive approach could be just as dangerous, especially given the rapidity of exchange rate changes and the need to be alert in order to control exposure risk. On balance members of the company thought that exposure policy should be flexible to allow for unique circumstances to be dealt with depending on the situation. One of the members stated:

If we improve accountability for exposure management, produce accurate and timely exposure information, and make use of the experience of our counterparts in Japan, that should fix most of the issues we are discussing here.

But the means to improve accountability and generate the essential exposure management information seemed difficult to achieve under current arrangements where treasury management was perceived as a staff function. It was agreed that there was a need for senior management to spell out general FEEM procedures to be followed in order to make the corporate treasurer's exposure management task more effective. At this stage the dialogue proceeded to consider the treasurer's hedging decision criteria.

The dialogue about the treasurer's hedging decision criteria was concerned with the extent to which the treasurer should cover a given exposure As one member asked:

Does it mean that the company should accept the treasurer's attitude to risk as representative of the whole company's view of risk?

In reality, it was clear that the treasurer's risk aversion affected his hedging decisions. Some members conceded that having a representative risk aversion was a difficult problem as it was impossible to aggregate interpersonal attitudes to risk. One of the members suggested:

Perhaps a managerial consensus is likely to be safer for the company than relying on the idiosyncrasy of one manager. In this way, at least the risk attitude of more than one manager can be taken into account.

After some lengthy discussion, members of the company endorsed the above position and it was suggested that once coordination and control were in place, then a committee should be established to assist the treasurer in deciding on the extent of hedging. It was argued that instead of relying on a rigid policy, the treasurer in regular consultation with the committee should assess the situation and hedge or manage exposure accordingly. One of the senior members stated:

We should start brain-storming exercises to establish who should sit on the FEEM committee. We need this kind of dialogue to direct our energies to a problem of common concern.

Due to the importance of foreign exchange forecasts as an input in FEEM, another issue was the influence of the quality of the forecasts in hedging criteria. Although there was no in- house foreign exchange forecasting in X Ltd, the treasurer had an assistant who had compiled exchange rate forecasts for all the important currencies the company dealt with consistently for the past five years. The main sources of information for the exchange rate forecasts were banks, financial publications, and advice from the Japan offices. Furthermore, an attempt was always made to analyze macro-economic and other factors that can influence exchange rate changes The treasury manager said that so far, the exchange rate forecasts he used were satisfactory, but that an improvement was required in the production and communication of accurate exposure information on time. In his opinion:

Obtaining accurate exposure information on time is the weakest link in the exposure management programme.

When asked the extent to which the degree of hedging was influenced by the reliability attached to previous foreign exchange forecasts, the treasurer stated:

Foreign exchange rate changes follow a random walk, so even if previous accuracy in our forecasts was encouraging I have tended to be pro-active rather than reactive to previous satisfaction with foreign exchange forecasts.

The treasurer's assistant had earlier said that he believed that monitoring exchange rate changes included getting to grips with most factors which can impact on currencies in which the company's businesses were conducted, and that such factors were never static. The other members of the company did not have much to say about foreign exchange forecasts because, unlike the treasurer and his assistant, they had no familiarity with them.

X Ltd engaged in foreign currency transactions at least once a week. The average credit period for accounts payable was 60 days, and for accounts receivable the average credit period was 90 days. Members of the company felt that because the company was involved in export and import business frequently this called for more vigilance in exposure management. According to the treasurer:

> *Greater intensity of involvement in foreign currency transactions means that the company has to be careful about FEEM responsibilities.*

REFERENCE

Powell, B. (1995). Busted, *Newsweek,* March 14

QUESTIONS

1. What are the key problems identified from the case description
2. What are the key tasks that you think should be identified as part of structuring an efficient foreign exchange exposure management policy for X Ltd.
3. Discuss the issues of conflict revealed in the discussion above and explain how you would resolve them.
4. How do the company's current hedging tools work?
5. What other hedging tools should be considered?
6. Outline the tasks for the FEEM committee?
7. What hedging policy should the company adopt?