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INSTRUCTOR NOTE'S

Editor

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ABSTRACT

This case helps students develop skills in planning, composing and delivering a business-related bad news message and offers options for written and oral deliverables. In addition, this case helps students develop skills in synthesizing and contextualizing secondary research and employing APA citation skills. The case appropriate for junior- or senior-level university courses in business communication. The case is designed to be taught in approximately three class hours; the written and oral assignments are each expected to require two hours of outside preparation by students.

CASE SYNOPSIS

John Carson is the founder and owner of Bug Busters, a prosperous extermination and bee-removal company headquartered in Aksarben, Nebraska, with retail locations in five Midwestern and six Western states. The company was founded in 1976 and employs about 1500 people throughout its many locations.

Carson has always wanted Bug Busters to be a sought-after place to work. To achieve this goal, he has implemented employee-friendly policies and practices, including flexible work hours, bonuses for charity work and mentoring, permission to use company vehicles for commutes, nap rooms at selected locations, and vouchers for child and elder care. As a result, Bug Busters employees, on the whole, enjoy their work and feel pride in their company—and, most importantly, they tend to stay for the long term.

Last month, Carson saw concrete evidence of that employee pride and satisfaction. Scott Lang, who has worked at Bug Busters for six months, showed Carson his newest tattoo: the Bug Busters logo, prominently placed on his bicep. Carson was thrilled that an employee valued his job so much that he would actually make his fidelity permanent on his arm.

Scott's tattoo gave Carson an idea—what if he could persuade other employees to get tattoos of the company logo? The tattoos will be a chance for employees to feel part of the Bug Busters "family"; they would also have potential as marketing and publicity tools. Energized by this "great new idea," Carson emails his Human Resources Director, Courtney Whitmore, to get the ball rolling.

After researching the topic and mulling over the idea for a few days, Courtney decided that the tattoo incentive was a not a good idea. Through her research, she identified a number of drawbacks to the idea of encouraging employees to tattoo themselves with the corporate logo—including health, legal, personnel, and public relations issues.

WRITING ASSIGNMENT RECOMMENDATIONS FOR TEACHING APPROACHES

This case is designed to be used with Peter Cardon's *Business Communication: Developing Leaders for a Networked World* (2^{nd} Edition), especially Chapter 11 (Bad News Messages) and Chapter 3 (Team Communication and Difficult Conversations). Students should have had exposure in class to business research methodology and APA format before beginning work on this case. If desired, this can be done through the presentation of Chapter 12 (Research and Business Proposals and Planning for Business Reports).

This case addresses the principles relevant to the composition and delivery of negative messages in a business environment:

1. Delivering the bad news in a timely manner
2. Choosing the right mix of communication channels
3. Strategies for softening the blow of bad news
4. Providing clear, concise rationale for the bad news
5. Focus on solutions to the original problem and long-term benefits to the audience
6. Maintaining goodwill with the audience.

This case also helps students understand and practice the following general communication principles:

1. Analyzing audience and establishing purpose, determining content, and choosing an appropriate channel
2. Using inductive (indirect) format when writing a negative message.
3. Maintaining a positive and professional tone in the face of potential opposition from recipients.
4. Evaluating the effectiveness of the message from the audience's perspective; addressing audience questions and objections; highlighting reader benefits; employing the practices and principles of good writing (paragraph structure; formatting and layout; style; grammar and mechanics); and maintaining goodwill.
5. Identifying and analyzing reputable, relevant, and convincing secondary sources to add credibility to their message.
6. Using APA format for in-text citations and references.

Discussion Questions for Written Assignment

1. Who is the primary audience for this message? John Carson
2. Who is the secondary audience for this message? Audiences may involve: Bug Busters' insurance carriers, corporate management, and/or HR personnel.
3. Why is inductive strategy appropriate for this message? Inductive strategy is appropriate when a sender anticipates a negative reaction from the recipient, especially if the discussion is in the early stages or if the message is being delivered to a receiver of higher rank or status.
4. Can the students imagine any scenarios in which a deductive message might be more appropriate? Answers to this may vary, but when a writer expects the audience to be more receptive to that message, a deductive approach might be used.
5. What written medium would be the most appropriate for this type of message? Students should discuss the pros and cons of email messages, business letters, or memo/ memo report for this message.
6. Is a written medium preferable to an oral medium for this message? Why or why not? Answers may vary, but in this scenario, the legal, ethical, and other considerations might warrant formal documentation of the response.
7. What kind of information, data, or research should be incorporated into the message to make it more convincing or persuasive to the audience? Examples could be: research on health problems related to tattoos as well as legal and public relations issues.

8. What library resources would be most likely to contain information relative to this case? Databases like the Business Source Complete or Academic Search Complete would be good places for students to start their research.

Writing Assignment Details

Following the class discussion, students should next assume the role of Courtney Whitmore. They should research potential issues (legal, health, cultural, etc.) surrounding tattooing or other body art in the workplace. They should then write a negative message in a medium selected by the instructor to Bug Busters' CEO, John Carson, informing him of their opposition to the proposed tattoo initiative. In composing their messages, students should incorporate the issues in the preliminary questions discussed in class as well as the secondary sources they have identified. Finally, students should follow APA in-text and reference citation format for any external sources used.

ORAL ASSIGNMENT RECOMMENDATIONS FOR TEACHING APPROACHES

The primary subject matter of this case concerns delivering negative messages. The speaking assignment develops this competency by addressing a variety of skills, including synthesizing and contextualizing secondary research, developing and organizing a coherent message, and managing verbal and nonverbal codes.

We assign this case in conjunction with Peter Cardon's *Business Communication: Developing Leaders for a Networked World* (2^{nd} Edition), especially Chapter 11 (Bad News Messages), Chapter 2 (Interpersonal Communication and Emotional Intelligence) and Chapter 3 (Team Communication and Difficult Conversations). The speaking assignment in this case emphasizes the basic elements of delivering negative messages face-to-face:

- Managing verbal and nonverbal codes
- Composing negative messages using indirect or direct messages (depending on audience's receptivity) and organizing content
- Building credibility by effectively incorporating evidence while speaking.

This assignment also enhances students' understanding of the following issues

- Analyzing a receiver's perspective and disposition
- Using positive, forward-thinking reasons to support "bad news" arguments
- Responding appropriately to receiver feedback

For this assignment, students will **role play** the meeting between Whitmore and Carson and will submit their **preparation notes** for the meeting.

Role Play Deliverables

1. Students will have 6 minutes (+/- 1 minute) to deliver an opening statement that details the students' (Whitmore's) view of the issue.
2. Students will demonstrate rapport and provide orientation at the beginning of the meeting.
3. Students' opening statement must provide at least 2 supported reasons against the tattoo incentive.
4. Students will respond to one question/statement from Carson (played by the instructor or another student). The nature of the question/statement will depend on the presenter's opening argument and may be a positive or negative response.
5. Student will express thanks and goodwill at the end of the meeting.

Preparation Notes Deliverables

Students will submit the following:

1. An outline of his or her opening statement.
2. Two possible responses that the student imagines Carson might give. These could be questions or statements.
3. A plan for how to respond to each of Carson's responses. The student's follow-up to Carson's responses should also draw on evidence.

Discussion Questions for Oral Assignment

1. Who is the primary receiver for this message? John Carson
2. How might Carson respond? What are some questions he might have? Carson will likely be disappointed. He will probably have challenging questions. Answers will vary.
3. How will you respond in each scenario? Professional; with positive, forward-looking responses.
4. How might you convince Carson to listen to your recommendation? Incorporate concrete evidence into presentation. Connect potential drawbacks with Carson's professional concerns and goals.
5. How should your voice sound when delivering a negative message to a supervisor? Confident but not arrogant. Respectful.
6. What will you wear to your meeting? Professional attire.
7. What nonverbal or body language cues will you use during your meeting? Attentive, confident body language.
8. What kinds of language should you avoid in the meeting? Phrases like "I think," "it would be a mistake," "this is a terrible idea because…," and other kinds of negative language.
9. How can you demonstrate your authority/ethos? By incorporating concrete evidence to support your recommendation.
10. How will you effectively refer to the research you've done? Contextualize sources while talking about them by referring to authors and the authors' credibility, as well as the timeliness of the evidence/study, if applicable.
11. How will you end your recommendation? End with a positive, forward-looking thought.

Oral Assignment Details

In preparation for this assignment, students will need to find and review secondary research on issues related to the health and safety of tattoos as well as the status of tattoos in the professional workplace. Students should also review principles of interpersonal communication and the principles of negative messages. Finally, students should review strategies for incorporating citation information in their spoken presentations.

Following the class discussion, students should assume the role of the HR director and will role-play the meeting with John Carson. Each role-play should include the opening greeting and orientation as well as the opening statement of the students' recommendation.

Then, the instructor (or another student) should respond to the presenter with a question or statement. The response can be based on the presenter's recommendation, or they may be pre-planned. For example, "Carson's" response might be to counter with evidence supporting his idea. Or, "Carson" may simply respond with a sad reaction or with an antagonistic statement.

The presenting student should respond to "Carson's" response—demonstrating an ability to further support their recommendation and/or effectively manage interpersonal communication. Students should also demonstrate active listening skills throughout their presentation.

Students should also submit their preparation notes for the meeting, such as outlines, notes on how Carson might respond, and how the student would manage the imagined responses, and so on.

REFERENCES

Cardon, P. (2016). Business communication: Developing leaders for a networked world (2nd ed.). New York: McGraw Hill.

INSTRUCTOR NOTE'S: ICHITAN GROUP AND THE PRICE WAR IN THAILAND'S READY-TO-DRINK TEA MARKET

Thunyarat (Bam) Amornpetchkul, National Institute of Development Administration

ABSTRACT

In November 2015, Tan Passakornnatee, the founder and CEO of Ichitan Group, most well-known for its ready-to-drink (RTD) green tea branded "Ichitan," had an extremely critical business decision to make regarding the firm's strategy in view of the long-lasting price war in the RTD tea industry that he had been part of for more than ten years. Two years ago, Ichitan had finally taken the largest market share of the Thai RTD tea market for the first time. Before that, the winner in this market had always been Oishi Group, also founded and led by Tan, who had later left the company, on good terms in midyear 2010, to start another company – later renamed Ichitan Group. As the year 2015 was coming to an end, however, there were a couple of signs that triggered Tan's worries about his recent business performance.

First, based on the third quarter data, Oishi had managed to reclaim its largest market share status, along with a revenue increase that far exceeded Ichitan's. Second, the RTD tea market was projected to suffer a declining trend in 2015, following its first negative growth in ten years that took place last year. In addition, although the total consumption of RTD tea in Thailand increased slightly from the previous year, its value had actually dropped due to various forms of increasingly aggressive, and expensive, price promotions that Ichitan's entry into the market had triggered. While these dynamics had led to rapid growth in RTD consumption among Thai nationals and the exodus of the smaller players, they had also negatively impacted Ichitan's bottom line.

Hence, despite the success of Ichitan's massive price promotions and campaigns during the past few years, Tan was not quite sure whether he was doing the right thing for this company and his customers. While low-income customers praised him for offering them opportunities to win big prizes that could completely turn their lives around, others heavily criticized his marketing campaigns for causing excessive consumption of caffeine and sugar, and for luring Thai people into the habit of gambling. He himself had also started to realize that the sales-boosting effectiveness of these campaigns might be decreasing as the market approached its saturation point. Before his board meeting next week, Tan had to decide on both a short-term strategy to secure the largest market share and improve the firm's bottom line this year, and a long-term strategy to develop more sustainable competitive advantages for Ichitan Group.

TEACHING/LEARNING OBJECTIVES

The learning objectives of the case are as follows:

- Understand causes of a price war and how it can evolve
- Understand the impacts that a price war can have on firms, consumers, and the industry as a whole
- Be able to justify whether a pricing strategy is suitable for a firm
- Be able to recommend appropriate moves for firms involved with a price war
- Be able to develop strategies to help firms achieve sustainable competitive advantages.

After finishing the case discussion, students will be able to:

Understand

- Factors likely to contribute to a price war
- The impacts that a price war can have on firms, consumers, and the industry as a whole

Develop

- Skills to evaluate the success of pricing strategies
- Ideas to create and maintain competitive advantages for a firm

Explain

- How consumers respond to different types of price promotions and marketing campaigns
- How firms should react to a price war

POTENTIAL COURSES

This case is primarily intended to be used in courses on Pricing Strategies. However, depending on the specific issues in the case that the instructor might wish to emphasize, the case can also be fruitfully used in courses on Marketing Strategies, Microeconomics, as well as other courses related to managerial business decision making.

Target Audience

This case is intended for use in the above-mentioned courses at the graduate level. It may also be used effectively in short-term Executive and Leadership Development programs.

Topics Covered in the Case

The following topics are discussed in or raised by the case:

- Thailand’s beverage industry
- Price war
- Price promotions
- Consumer responses to promotions
- Business ethics
- Sustainable competitive advantages

CONCEPTUAL ANALYSIS

Pricing in competition

It is a known fact in Pricing Theory that among the three price setting approaches: cost-based pricing, competition-based pricing, and value-based pricing, the latter is most effective. However, in practice, evaluating consumer valuation of your products or services is not simple. Hence, a pure use of value-based pricing may not be feasible. To achieve the best results, firms should take into account all three factors: cost, competition, and consumer valuation, when making pricing decisions.

The main effect of competition on pricing is the limitation of firms’ freedom in setting the prices that they intend. For example, using a value-based price setting tool, a firm may consider setting its product’s price at $100. However, most of its competitors are offering similar products at $60-$80. If the firm is not completely certain that customers would be willing to pay much more for its product, it might consider offering a price lower than $100 instead.

Reacting to a Competitor’s Price Reduction

A common challenge in pricing caused by competition is how to react to a competitor’s price cut. There are generally four options for reacting when a competitor lowers its price, as summarized in the table below.

		Competitor is strategically	
		Weaker	Neutral or Stronger
Price reaction is	Too costly	**Ignore**	**Accommodate**
	Cost-justified	**Attack**	**Defend**

If a firm is facing a weaker competitor, then it may choose to attack if doing so is not too costly. Otherwise, it may choose to ignore the price cut and maintain its current price, believing that its market share and profitability would not be affected much by the competitor’s lower price. If the competitor is neutral or stronger, the firm is not likely to gain by lowering its price. However, if it sees that the benefit from lowering its price in protecting the market share would be higher than the cost of doing so, then it may choose to offer a price cut as well to defend itself. Otherwise, if a price cut is too costly, the firm should maintain its price level and accommodate the competitor’s price change, even if this means a slight loss in its market share.

To make the safest decision, firms need to carefully evaluate the costs and benefits of each option. Some important factors to consider include, for instance, short-term and long-term costs in matching the competitor’s price, relative market position, competitive adva ntages, market size, consumer price sensitivity, etc.

Price War

Price war refers to a situation where sellers of competing goods sequentially undercut one another's prices, hoping to gain a larger market share or protect their share from the other players who offer lower prices. Contrary to what many people believe, companies generally do not want to initiate or be involved in a price war. This is because the costs of price wars typically far exceed the potential benefits, even for the winner of the war. As the market price is progressively brought down by the price war, all firms in the market suffer from reduced margins. The gain in profits from winning the price war, if at all, is not likely to be sustained. Although the winning firm could slowly increase its price after its competitors have exited the market, soon enough it may face new competitors who may trigger another costly price war.

Nevertheless, price wars do take place in some industries. The following structural drivers have been found to significantly influence the possibility of a price war breakout [2].

Number of competitors

In an industry with a few competitors, monitoring price levels of all the players is quite simple. Hence, if a player lowers its price, the other players could react almost immediately. The effect of this condition on the likelihood of a price war breakout is twofold. If the players choose to intensively compete on price, then the price war can spread very quickly. On the other hand, if the players are well aware of the detrimental impact of the price war, and choose to not compete on price alone, then the market could be kept safe from price wars. In an industry with many competitors, the situation is reverse. Since each player is not likely to be able to monitor all of its competitors' price levels, it may be able to act a little more freely with its pricing while not disturbing the market price. If many players are trying to gain a short-term share by reducing their prices, however, price war would eventually take place.

Competitors' managerial maturity

Whether a price war would break out in an industry or not heavily depends on how each player reacts to one another. If companies' executives decide to compete with their competitors on price reductions, then almost certainly, a price war would start. However, as discussed previously, price wars are not likely to benefit anyone involved, even the winner. Hence, executives with enough experience should know that it would be a wise decision to not try to start a price war.

High fixed costs and low marginal cost

If an industry faces high fixed costs and low marginal cost, then firms would primarily focus on maximizing their sales volume. This automatically results in an intense competition on taking the largest market share among the players. Price cut is often the very first thing that many firms would think of when it comes to increasing market share. Hence, this type of industry faces high risks of a price war breakout.

Industry growth and economic savings

A rapidly growing industry with significant economic savings from large sales volume creates a situation where all firms are trying to win the largest market share. The fastest and most effective tactic that most firms could think of is offering price cuts. Hence, a price war could easily take place in such an industry.

Industry maturity and network externalities

In a new industry, firms have strong incentives to establish and expand their customer base. Additionally, if the nature of the industry is such that the market size could grow exponentially through network externalities, then the needs to secure a large customer base would be even more important to firms' success. In this case, firms may try to offer lower prices to attract customers, leading to a price war. Some examples of such industries include platforms for social media, games, and entertainment.

PRICE PROMOTIONS AND PROFITABILITY

Price promotion refers to a temporary price reduction. There could be many reasons why firms might want to offer price promotions on their products, including stimulating demand, clearing excess inventory, increasing brand awareness, matching competitors' prices, among others. However, the benefits expected from using price promotions do not come at no cost. A price promotion actually affects firms' profitability in both a positive and negative direction. On the positive direction, a price promotion can increase sales volume for normal goods. But by how much the promotion would increase sales volume depends on how much the discount level is and how price sensitive the demand of the product is. A higher discount level would surely be more effective at stimulating sales than a lower discount level. In a market of highly price-sensitive demand, even a small price reduction could greatly increase sales volume. On the contrary, if the market is not very price sensitive, then a price reduction does not have much effect on stimulating sales.

A common tool that can help firms make decision on adjusting product prices is known as "volume hurdle." A volume hurdle for a price cut determines by at least how much the sales volume induced by the price cut needs to increase in order for the price cut to increase the firm's profit. The logic behind volume hurdles is essentially the cost-benefit analysis of a price change. For a price cut, the cost is reduced contribution margin while the benefit is increased sales volume. Hence, if the sales volume is increased enough by offering a price cut, then the benefit would cover the cost and improve the firm's profit overall. It should be noted, however, that volume hurdles cannot guarantee an increase or decrease in firms' profits as a result of a price change. Volume hurdles merely tell firms a condition, in terms of the change in sales volume induced by a price adjustment, for the price adjustment to improve firms' profits. To make an informed decision, firms should have accurate demand forecasting tools to help predict the likelihood of being able to satisfy the condition specified by the volume hurdle. Furthermore, to be able to use the volume hurdle analysis at all, the data on contribution margin needs to be known. This is generally not a problem for a firm interested in using volume hurdle to help make an internal decision. However, since cost is a sensitive, and often confidential, piece of information for most firms, contribution margin is generally not known to the public. This makes it difficult for an outsider to analyze whether a firm's action of changing its prices would improve or hurt the firm's profit.

CUSTOMER RESPONSE TO PRICE PROMOTIONS

Economically, it is well known that customers respond positively to a price reduction of normal goods. However, in practice, the current price level might not be the only factor affecting customer responsiveness to a price promotion.

This teaching note will discuss only three topics of customer responses to price promotions as related to the case. Instructors are welcome to expand the scope of the case discussion in their classrooms to cover other relevant topics in this area.

Reference price effect

Reference price effect explains customers' responses to a price change of a product based on their experience or memory of the product's previous prices. When making a purchase decision, customers generally compare the product price they are currently observing to the price they have in mind to judge whether the current price is cheap or expensive. The price that customers use as a benchmark is known as "reference price." A customer's reference price for a product is formed from his or her memory of the product price. It can be adjusted up or down based on different observations that the customer has with the product price over time. If the customer observes the product price when it is on sale and is cheaper than the current reference price, then the reference price would be adjusted down. On the other hand, if the customer observes when the product price is increased to be higher than the reference price, then the reference price would be adjusted up. A price lower than the reference price is perceived as cheap and a price higher than the reference price is perceived as expensive by the customer. As a result, during a promotional period, sales volume goes up substantially because many customers see the discounted price as cheaper than their reference prices. However, when the product price is adjusted back to the regular price after the promotional period, sales volume generally drops below the level observed prior to the promotional period even when the price is the same. This is because many customers have adjusted down their reference prices. Such a phenomenon is known as "reference price effect." Understanding reference price effects, firms should be careful not to offer price promotions too frequently; otherwise, customers' reference prices as well as their willingness to pay for the product would be sequentially brought down.

Increased price sensitivity

One side effect of price promotions on the market is that price promotions can gradually increase the price sensitivity of customers. This is because price promotions draw customers' attention to the lowered price of the product, rather than the functionality or quality of the product itself. Especially when price promotions have been used over an extended period of time on a product, customers tend to be mentally trained to primarily focus on the product price when making purchase decisions. Hence, to be able to keep up with sales of the product, the seller is required to keep the price level low, making it difficult for the seller to compete on the other non-price dimensions of the product.

Customer churn

Customer churn, in the context of price promotions, refers to the situation where some customers, who purchase the product or service when it was on sale, switch to another brand after the promotional period has ended. This effect is common among products with low brand loyalty and low switching costs. When a price promotion is offered on a product, the seller typically observes a significant gain in market share as some customers move from another brand to its brand. However, when the product is no longer on sale, the seller may observe a significant loss in market share as some of its customers switch to another brand.

MARKETING ETHICS AND LAWS

To boost sales, firms employ various types of marketing tools, ranging from traditional forms like price discounts and advertising to more exciting activities that encourage customers' direct participation with the brands like posting photos with the products on social media.

Certain types of marketing tactics are subject to skepticism whether they are ethical or even legal to be implemented. The judgment on the ethics and legality of a marketing practice largely depends on the culture and laws inherent in the market where it is present. As can be described by the concept of cultural relativism, a marketing tactic might be culturally and legally acceptable when implemented in one country, but might go against the ethics and laws in other countries. Hence, it is important for firms to understand the culture and laws in each market they deal with in order to make sure that their marketing decisions are effective, ethical, and legal.

As general guidelines, for a marketing practice to be ethical, it should at the very least allow consumers to make purchase decisions voluntarily based on complete and true information about the products or services. It also should not directly or indirectly attack a competitor by giving out misleading information or committing an action intended to create unfair competitive advantages. For a marketing practice to be legal, it should comply with the set of laws and regulations associated with the nature of the products or services and the type of activities involved. While laws vary from country to country, the ultimate goals of business-related laws are rather similar, which are to protect consumer rights and to maintain a fair competition in the market.

DISCUSSION QUESTIONS AND ANALYSIS

Discussion Questions

1. What are the key factors that contributed to the price war in the Thai RTD tea industry? How did they cause the eruption and persistence of the price war?
2. How did Ichitan, Oishi, and the other smaller players in the RTD tea market react to competitors' price reductions? Do you think their reactions were appropriate?
3. To what extent do you think Ichitan's promotions were effective for improving the company's bottom line? How did customers respond to the promotions over time?
4. Do you view Ichitan's and Oishi's lucky draw campaigns as ethical marketing tactics within the Thai RTD tea industry? Would there potentially be a legal or ethical issue if similar marketing tactics were implemented elsewhere?
5. What should have been Ichitan's short-term and long-term strategy in the RTD tea market? Should Ichitan have continued running its large-scale lucky draw campaigns every year, or focused more on conventional price promotions in retail stores, or offered new products and package sizes, or else?

Analysis

Question 1: Causes of price war

There are four major factors that collectively contributed to the price war in the Thai RTD tea industry. Each factor is discussed in details below.

Number of competitors

At the early stage of the Thai RTD tea industry (2001 – 2003), Uni-President (Thailand), under the brand of Unif Green Tea, was clearly the strongest player in the market, facing little competition from several other smaller players. In this case, Unif did not view any particular brand as its major competitor, and hence, had no need to lower its price. The other players were too small to have any significant effect on the market with their prices. Thus, price war did not occur.

In 2004, however, Oishi entered the market and soon proved to be another strong player in the RTD tea industry (Oishi obtained the second largest market share in 2004, not too far behind Unif's). With only two major players: Unif and Oishi, it was clear whom they were competing against, and it was very easy for them to notice each other's moves. When Oishi decided to use price promotions to compete for the largest market share, and Unif responded by lowering its prices too, the price war erupted.

From 2005 to 2010, Oishi had been holding the largest market share but still facing competition from a few major competitors, both existing brands and new entrants with high potentials, from time to time. Due to a small number of major players in the market, whenever a major player offered a price promotion, the other players could quickly follow, causing the price war to remain active.

In 2011, Ichitan's entrance to the RTD tea market brought about a bigger wave of price war. As Ichitan had been increasingly gaining its leading position in the market, many smaller players either quit the market or switched to another product line, leaving only Oishi as a comparable-sized competitor to Ichitan. The RTD tea market became virtually a duopoly, allowing Oishi and Ichitan to watch each other's moves on pricing and promotions carefully, and responded almost immediately.

Executives' decisions

The Thai RTD tea price war would not have occurred if all the players decided to not compete primarily on price promotions. Oishi, under the leadership of Tan Passakornnatee, was essentially the first player to explicitly use various forms of price promotions as a shortcut to quickly gain its share of the market. Unif, Oishi's main competitor then, initially responded by offering similar promotions to protect its share, causing the eruption of the price war. However, Unif's marketing manager revealed that the company had asked all of its distributors and retailers to never set the price too low, showing the company's intention to not be involved in the price war. Indeed, Unif eventually faded away from the RTD tea market and focused on other product lines. Oishi's management decided to continue with its price promotions and marketing campaigns to maintain the largest market share. Several other brands' management who believed they had a chance to take a decent-sized piece of this lucrative market decided to get involved in the price war, though eventually many of them incurred huge losses and had to quit the market.

When Tan came back to the RTD tea market under the brand of Ichitan, he decided to use the same tactics to gain Ichitan's prominence in the market. Oishi, despite being under new management at ThaiBev, continued offering a stream of discounts and lucky draw prizes, as these had already become a crucial part of the brand's image. Oishi Group's Managing Director, Matthew Kichodhan, once made it clear in his statement that his company was willing to fight in this price war. The tension between Ichitan and Oishi was believed to be somewhat personal between the management of the two companies as well as an artifact of Tan's previous work with ThaiBev while still at the Oishi Group.

Later in 2014, however, both Ichitan's and Oishi's executives declared their intention to gradually step away from the price war by reducing the frequency of lucky draw campaigns each year. While price promotions on RTD tea products were still observed from time to time, the overall intensity of price war was reduced.

High fixed costs and low marginal cost

The RTD tea industry requires huge fixed costs to build large-scale factories equipped with high capacity machines and food safety control systems. For example, Ichitan's factory, built on the land of 120,000 square meters with capacity to produce 600 million bottles and 200 million boxes of RTD beverages per year, was valued at 3.5 billion Thai baht. The marginal cost for this industry, on the other hand, is relatively low. While an exact number has never been publicly disclosed by a RTD tea manufacturer, it has been estimated that the marginal cost for a 400-500 ml bottle of RTD tea, typically sold at the price between 15-20 Thai baht, is about 8-9 Thai baht. This means that the contribution margin for a bottle of RTD tea could be as high as around 50%. Hence, to succeed in this industry financially, the RTD tea manufacturers need to acquire large sales volumes. This creates very strong incentives for the manufacturers to employ various marketing tactics to stimulate sales. Since price promotion is anecdotally among the most effective sales-boosting tools, many manufacturers choose to undercut the market price in attempt to gain larger market share. As a result, price war set off and even escalated as the manufacturers continued offering price cuts.

Strong industry growth

Since RTD tea had been introduced to Thai consumers in 2001, the industry had experienced a rapid growth every year for thirteen years straight. Just during the first few years, the market value of RTD tea went from 26 million Thai baht in 2001 to over 3,200 million Thai baht in 2004. Strong growth of the industry was carried through 2013 at around 20-30% each year, and only dropped slightly for the first time in 2014 (from Exhibit 8). Although RTD tea accounted for only less than 10% of the whole non-alcoholic drinks market (from Exhibit 9), it had been one of the fastest growing segments (from Exhibit 4, RTD tea posted the second largest growth in 2010, and the largest growth in 2011).

The industry's massive and consistent growth invited new entrants to the market, leading to more intense competitive environments of the RTD tea industry. Hence, many players employed price promotions as a quick way to secure large market shares before their competitors could, resulting in the RTD tea price war. Major players, like Oishi and Ichitan, might have also used large-scaled price promotions and marketing campaigns over an extended period of time to discourage new players from entering and pressure existing small players to quit the market. This made the price war last for many years.

Question 2: Reacting to competitors' price reductions

The reactions towards one another's price reductions among the three parties: Ichitan, Oishi, and smaller players, are discussed below.

Ichitan vs. Oishi

When Ichitan first entered the RTD tea market in 2011, it was in a weaker position, compared to Oishi. Oishi put its green tea on sale at 16 from 20 Thai baht almost as soon as Ichitan green tea was launched. Soon enough, Ichitan responded by cutting the price of its smaller-sized green tea from 16 to 14 Thai baht. Hence, Ichitan's reaction at this point was to "defend" its market share. Ichitan's reaction actually worked out with the help of its social media and emotional branding strategies. As Ichitan and Oishi took turns offering price promotions and lucky draw campaigns, Oishi seemed to follow almost every promotional activity that Ichitan did. Oishi's reaction was to "attack" Ichitan. Given Oishi's much stronger position at that time and knowing how much of a threat Ichitan could become to the RTD tea market, Oishi's decision to attack was deemed appropriate. Though, what Oishi could have done additionally was to develop more sustainable non-pricing strategies, not just copy Ichitan's marketing campaigns.

Later when Ichitan and Oishi were close in their possession of the market share, the two major players still played the pricing game. A price promotion offered by either party triggered the other to offer a similar promotion. Likewise, the lucky draw campaigns from Ichitan and Oishi were often held during the same time periods, as shown in Exhibit 6. At this stage, Ichitan and Oishi chose to "attack" each other. Oishi generally spent more than Ichitan on promotional campaigns, boasting bigger prizes and hoping to win a larger share of the market. However, Oishi's action might not have been cost-justified as it was revealed that Oishi's beverage business unit experienced as much as 30% negative growth of profit, and had obtained only the second largest share in 2013, losing to Ichitan. Although Ichitan's promotions might have paid off and pushed it to the top of the RTD tea market in 2013-2014, the same benefits did not seem to sustain in 2015. As shown in Exhibit 10, for the third quarter of 2015, Ichitan's revenue dropped by 10% and profit plummeted by 56%, compared to the same period in 2014. This implied that Ichitan's reaction towards Oishi might not have been cost-justified either.

Ichitan vs. smaller players

Ichitan aimed to be in either the first or the second rank in the RTD tea market. Hence, besides Oishi, it did not view any particular smaller player as its major competitor. If only one smaller player cut its product price, Ichitan would choose to "ignore" due to insignificant effects of such a competitive tactic on its market share. On the other hand, when Ichitan offered a discount on its products, some smaller brands discounted their products, too, to "defend" their shares. Other smaller brands who did not believe their discounts could bring additional profits might have chosen to "accommodate" Ichitan's price reductions. These actions were probably appropriate for each party's relative position in the market.

Oishi vs. smaller players

Similar to Ichitan's reaction towards smaller players, Oishi did not respond specifically to any smaller competitors; it chose to "ignore" their price reductions. Smaller players might "defend" or "accommodate" Oishi's price promotions.

Question 3: Effects of promotions on profitability and customer responses

To get a better sense of Ichitan's promotions and financial performance from 2012 through 2015, the data on changes in revenue, selling expenses, and profit from 2012 – 2013, 2013 – 2014, and the third quarter of 2014 to the third quarter of 2015, are summarized in the table below, based on the data given in Exhibit 1 and Exhibit 10 of the case.

Change in	**2012 – 2013**			**14**	**Q3 of 2014 –**	**Q3 of 2015**
	million THB	**%**	**million THB**	**%**	**million THB**	**%**
Revenue	2,048.9	46%	-323.0	-5%	-153.5	-11.2%
elling expenses	399.7	75%	-157.0	-16.86%	23.7	15.9%
Profit	185.9	27.5%	195.1	22%	-146.8	-55%

In 2012 and 2013, the RTD tea price war reached its peak as both Ichitan and Oishi launched a series of price promotions, as well as lucky draw campaigns, trying to win the largest market share. Not surprisingly, as shown in the table above, Ichitan's selling expenses increased by 75%. The resulting revenue also increased quite significantly by 46%, letting Ichitan become the largest market share holder in 2013. Overall, Ichitan's profit was improved by 27.5%, implying the company's promotions might have benefited its bottom line. Note however that in terms of value, the increase in selling expenses far exceeded the increase in profit.

In 2014, both Ichitan and Oishi expressed their intention to tone down the RTD tea price war by offering less frequent promotional campaigns. Evidently, Ichitan's selling expenses declined by 16.86%, but also brought down its sales revenue by 5%. In terms of value, the reduction in selling expenses was much smaller than the reduction in sales revenue. Ultimately, Ichitan's 22% profit increase in 2014 still turned out to be quite an impressive improvement over 2013. Looking more carefully at Exhibit 1, however, it can be observed that in 2014, the company saved a huge amount of money on finance costs, compared to 2013. This was likely to be a more crucial contributor to the gain in profit, rather than Ichitan's promotions.

In the third quarter of 2015, it was clear that Ichitan underperformed financially. Even when the company increased its selling expenses by almost 16%, the resulting revenue was a great disappointment, as it actually dropped by 11%. Consequently, Ichitan's profit plummeted by 55%. Given a negative growth in revenue in 2014, likely to be partially due to its fewer promotional activities, Ichitan decided to boost the market by conducting more of its sales and marketing activities once again. However, the market did not seem to be as responsive to the promotions as before.

Based on these data from 2012 through 2015, it was likely to be the case that the effectiveness of Ichitan's promotions on stimulating demand and improving the company's profitability declined over time. A key reason behind this symptom was the diminishing responsiveness of customers on price promotions when the promotions were offered frequently and consistently. This can be explained using the framework of reference price. As Ichitan offered price discounts throughout the year across different channels, customers cognitively set their reference prices for Ichitan's products lower. That is, since the customers had seen the products offered at cheaper prices for a number of times, they therefore expected to pay less than the regular price for those products. As a result, whenever the products were not on sale, customers were significantly less willing to buy the products at the regular prices.

A series of price promotions offered by Ichitan could also increase the customers' price sensitivity of the products over time. Initially, RTD tea products were marketed as healthy and trendy drinks, attracting customers to the products' utility. However, as price promotions and lucky draw campaigns overtook the market, most customers bought Ichitan's RTD tea products because they were on discounts or because their caps could win prizes from lucky draws; very few customers bought because they really enjoyed the product utility. In such a situation, Ichitan's customers became highly price sensitive. Over time, to achieve the same effect at stimulating demand, increasingly more promotions were needed. When fewer price promotions and lucky draws were offered in 2014, sales dropped significantly. Even when Ichitan increased its selling expenses in 2015, the market did not respond to the same level as before.

Customer churn could also explain, to some extent, Ichitan's loss in sales in 2014. As price promotions and lucky draw campaigns became inseparable from the RTD tea industry, customers typically chose which brand to purchase based primarily on price or attractiveness of the offered lucky draws. In this case, customers had low brand loyalty and low switching costs. Hence, they would pick any brand that offered the best deal. As Ichitan lowered the scale of its promotions and campaigns in 2014, some customers might have switched to another brand that offered cheaper prices or more lucrative lucky draws.

Question 4: Ethics and legality of lucky draw campaigns

Based on the information provided in the case, it was clear that many of Ichitan's and Oishi's customers purchased Ichitan and Oishi RTD tea products because they hoped to win prizes from the lucky draw campaigns – not because they really wanted to consume the products. Hence, the large-scaled lucky draw campaigns ran by Ichitan and Oishi could be viewed as unethical marketing activities in the sense that the campaigns aimed to stimulate compulsive purchase behavior rather than to build the organic need and liking of the products. One could argue otherwise, however, that the lucky draw campaigns were not wrongdoings since the companies did not give out false information about the products or the campaigns. Customers also made their purchase decisions voluntarily, whether and how much to buy the RTD tea products. Furthermore, Ichitan and Oishi did not show any explicit attempt to prevent their competitors from doing similar lucky draw campaigns. In fact, there were other brands in Thailand, both within and outside the RTD tea market, who had tried offering lucky draw prizes for their products but were not as successful as Ichitan and Oishi, often due to limited marketing budgets. Hence, it could not be entirely said that Ichitan's and Oishi's lucky draw campaigns caused an unfair competitive situation in the Thai RTD tea market.

It should be noted, however, that Ichitan's and Oishi's lucky draw campaigns had some risks of violating the Thai laws related to gambling. Some activists had been trying to point out to the Thai government and the society that the nature of the RTD tea lucky draw campaigns was very much like gambling, which was still illegal in Thailand as of June 2016. According to the gambling acts, any activities categorized as gambling were illegal unless they were organized by the government itself (e.g., the government lottery) or granted permission from the government (in which case certain forms of taxes and fees needed to be paid by the organizers to the government). There was not any evidence or a public statement discussing whether Ichitan and Oishi had obtained permission from the government and had been paying taxes and fees for running their lucky draw campaigns. Given the fact that the two companies still continued their lucky draw campaigns over years, it appeared that the campaigns had not been ruled illegal by the Thai government.

In many other countries, where there exist stricter rules and regulations to protect customer rights and control firms' marketing activities, this type of lucky draw campaigns (sometimes referred to as "prize promotions," "lotto marketing," "game of chance," or "sweepstakes") could be viewed both unethical and illegal. In these countries (e.g. Belgium, Australia, and UK), there was a government authority directly in charge of overseeing firms' marketing activities that involved lucky draws. To run a lucky draw campaign legally, firms needed to obtain permission from the government and pay required taxes and fees.

When discussing this question, the instructor could mention the concept of "cultural relativism" to prompt the students to think about potential differences in cultural and legal environments when conducting businesses in different parts of the worlds.

Question 5: Short-term and long-term strategies

Short-term strategies

For short-term strategies, Ichitan should rethink about how to best design its promotions and campaigns. Recent data had shown that the same types of marketing activities might not be able to stimulate demand and improve profitability to the same level as before due to less responsiveness of customers and reduced growth of the RTD tea market. To reduce the reference price effect, increased price sensitivity, and customer churn problems, discussed in Question 3, it is recommended that Ichitan's promotions be more targeted, special, and irregular.

Targeted

Currently, Ichitan's promotions were available to pretty much all customers since the promotions were often offered at 7-11 stores, which could be found virtually in every region in Thailand. This might achieve the company's goal of reaching as many customers as possible. However, when all customers could easily get the same discounts, Ichitan actually lost potential gains from price segmentation. That is, while some of its customers might be willing to pay the regular price for Ichitan's products, they ended up paying the discounted price because it was widely available. This is known as "cannibalization." To increase the profitability of its promotions, Ichitan may selectively offer its promotions in a more limited set of stores, strategically chosen based on customer willingness to pay, market size, etc. This could also help reduce the reference price effect and increase price sensitivity of the market segment with a higher willingness to pay.

Special

Instead of offering straight-off discounts to all customers, Ichitan could try to make its promotions more special to certain groups of customers who might contribute more to its bottom line, or tie the promotions to other activities that could enhance its brand image. For example, Ichitan could offer special prizes to customers who have purchased its products at certain quantity levels. It could host a contest searching for best ideas on how to recycle Ichitan's plastic bottles and boxes. If customers felt more involved with the brand, then the problem of customer churn could be reduced.

Irregular

Reducing the frequency of price promotions and campaigns and making the periodicity of promotions and campaigns less predictable for the customers could eventually resolve the problem of reference price effect and the increased price sensitivity of the RTD tea market. However, as Ichitan had observed in 2014, the immediate effect following the absence of promotions that customers were already used to could be detrimental to Ichitan's sales volume, especially if its main competitor, Oishi, still maintained the same frequency of its promotions. Nevertheless, since Oishi's management had expressed intention to tone down the price war, it was likely that if Ichitan really changed its competitive direction, then Oishi would follow, and the price war could be alleviated.

Long-term strategies

Since 2014, the Thai RTD tea market had shown some signs of passing its maturity stage and moving on to its declining stage. At this point, price promotions and even lucky draw campaigns would not be effective enough to expand the market further. To be able to sustain and increase the market size in a long run, new and improved products should be added to the market. This is because customers were already highly price-sensitive, rather than utility-sensitive, for Ichitan's existing products; and, this was difficult to change as the price war had been going on for more than ten years. However, if new products were launched and marketed for their benefits, rather than low prices, Ichitan could take this opportunity to enhance its brand image to be more quality-focused than price-focused, and be able to realize larger contribution margins on its products. A product line that would help with Ichitan's brand image, and likely to be an emerging segment in the RTD tea industry, was that of *healthy* RTD tea – in particular, RTD tea with low caffeine and low sugar – since most existing RTD tea products were criticized for containing a large amount of caffeine and sugar, labeled as bad for health.

Another direction for future growth of the company was to expand its market outside of Thailand. While the RTD tea market in Thailand might have passed its highest point, the RTD tea market in its neighboring countries, like Indonesia and Philippines, had not. In fact, in many Southeast Asian countries, the RTD tea market was rapidly growing, similar to the Thai market several years ago. In some non-Asian countries, like those in North and South America, RTD tea products were still not very common, but possibly also because of the cultural differences. Ichitan could consider expanding to these blue-ocean markets in the long run.

EPILOGUE

The Thai RTD tea market in 2015 indeed shrank in its value by 2.5%, from 15,968 million Thai baht in 2014 to 15,574 million Thai baht in 2015. In terms of consumption volume, however, the market grew 0.7% from 2014, to 470.7 million liter. Ichitan held the largest market share of 43.4%, followed by Oishi (35.9%) and Puriku (5.7%), respectively. Compared to 2014, the RTD tea market share had slightly shifted from the top three largest market share holders to smaller players. More precisely, the top three players held 85% market share in 2015, which was a decrease from 90% market share that they held in 2014. (These numbers included sales of herbal drinks, which were sometimes excluded from the RTD tea category by certain data sources.) [3]

Ichitan Group's financial statement for the year ended December 31, 2015 is presented below. [4]

	Financial statements in which the equity method is applied		Separate financial statements	
	Year ended 31 December		Year ended 31 December	
	2015	2014	2015	2014
		(in Baht)		
Income				
Revenue from sale of goods	6,339,576,801	6,179,080,161	6,339,576,801	6,179,080,161
Interest income	1,653,070	9,364,836	1,653,070	9,364,836
Other income	15,535,353	20,420,163	15,535,353	20,420,163
Total income	**6,356,765,224**	**6,208,865,160**	**6,356,765,224**	**6,208,865,160**
Expenses				
Cost of sale of goods	4,214,699,983	4,065,204,432	4,214,699,983	4,065,204,432
Selling expenses	1,019,349,315	774,179,994	1,019,349,315	774,179,994
Administrative expenses	130,910,543	250,418,023	130,910,543	250,418,023
Finance costs	86,501,795	99,415,486	86,501,795	99,415,486
Total expenses	**5,451,461,636**	**5,189,217,935**	**5,451,461,636**	**5,189,217,935**
Share of profit (loss) of investment in joint venture	(48,732,037)	26,653	-	-
Profit before income tax expense	**856,571,551**	**1,019,673,878**	**905,303,588**	**1,019,647,225**
Tax income (expense)	(43,829,559)	59,086,769	(43,829,559)	59,086,769
Profit for the year	**812,741,992**	**1,078,760,647**	**861,474,029**	**1,078,733,994**

From the company's 2015 financial statement, it should be noted that the selling expenses increased from 2014. This reflected Ichitan's marketing strategy in 2015 that went back to relying on the lucky draw campaigns and price promotions in an attempt to recover from its sales decline, despite the company's previous intention to cut back on these promotions in 2014. However, as discussed earlier in the response to Question 3, Ichitan's increased marketing spending in 2015 did not appear to be very effective in boosting sales as evident by the profit drop in 2015.

Tan Passakornnatee revealed his plan for 2016 that the company would continue similar lucky draw campaigns, though the 2016 marketing budget was set to be about 100 million Thai baht lower than that in the previous year. The company also decided to start using celebrities as brand ambassadors in addition to Tan himself. Furthermore, the company would focus on its sizing strategy where many different packaging types and sizes would be introduced to the market to serve various customer segments who might have different consumption preferences. Ichitan's target revenue for the year of 2016 was 7,500 million Thai baht, which was a 17% increase from the previous year. [5]

Helpful Phonetic Pronunciations

Tan Passakornnatee:	Tʌn ˈPɑːssʌgɔːnˈnʌtiː
Ichitan:	ɪˈtʃɪtʌn
Oishi:	əʊɪˈʃɪ
Chonburi:	Tʃəʊnbʊriː
Tom Yum Goong:	ˈTəʊm Yʌm ˈGʊŋ
Kongkiat Wattiranggul:	ˈGɒŋgɪət ˈWʌttɪrɑːŋgʊn
Puriku:	Pjʊəˈrɪkʊ
Kirin:	ˈKɪrɪn
Mirai:	ˈMɪrɑːɪ
Matthew Kichodhan:	ˈMæθjuː Gɪtəʊˈtɑːn
Udom Taepanich:	ʊdəʊm ˈTæpɑːˈnɪt

Teaching Plan

If relevant concepts to the case, as discussed in part IV of this teaching note, have been taught in a previous class, then the case discussion could be done in approximately 90 minutes. However, if the concepts have not been discussed previously, then the instructor is recommended to spend another 90 minutes to go over the concepts in order to prepare the students for insightful case discussion. Below, a 90-minutes teaching plan (case discussion only) is provided.
Suggested flow of discussion & key issues to raise at specific points

INTRODUCTION

The instructor should start the case discussion by asking some students what their favorite RTD products are, why, and how they generally make decision on which drink or which brand to buy. This is to prompt the students to start thinking about the nature of the RTD industry and its customers. Students' responses might be that they base their decision on convenience, price, or the utility they get from the product itself. Then, the instructor should move on to the discussion of the Thai RTD tea market: industry background, market evolution, and key players. After that, the discussion will focus on Ichitan as the main company of consideration in this case. The instructor should lead the discussion about Tan Passakornnatee and his business strategies, key products of Ichitan, and its competitive profile. If the instructor prefers, he or she can also choose to discuss Ichitan first, and then discuss the Thai RTD tea industry, following the same sequence as in the case.
Time Estimate: 10-15 minutes

ISSUES RAISED IN THE CASE

The instructor should plan to end the Introduction part with a review of the outlook for the Thai RTD tea industry, and then lead the discussion to the key issues raised in the case: What was Ichitan's competitive position towards the end of 2015? How did the market respond to price promotions and lucky draw campaigns? What was the direction of the Thai RTD tea industry?

Time Estimate: 5-10 minutes

PRICE WAR

After discussing the issues in the case, the instructor can start with the first case question on price war. Students should be reminded about how price war generally occurs, why price war is detrimental to all parties involved, and what type of market situations could be risky for the eruption of price war. Then, the instructor should discuss how the Thai RTD tea price war occurred and what factors contributed to the persistence of the price war. After that, moving on to the second question, students should be asked to analyze Ichitan's, Oishi's, and other smaller players' reactions towards one another during the price war, and discuss whether they think the reactions were appropriate.

Time Estimate: 25-30 minutes

PRICE PROMOTIONS

At this point, the instructor should prompt the students to think about the effects of Ichitan's price promotions on the company's profitability and the customers' responsiveness, in the third question of the case. If the concept of volume hurdle has been taught in the course at some point, the instructor should point out that the data given in the case are not enough to justify the profitability of Ichitan's price cuts. More specifically, no data on contribution margin or sales quantity were explicitly given. As an additional exercise, the instructor could assume some numbers and ask the students to do a volume hurdle analysis. Based on available case data, the instructor can discuss what pieces of information to look at to try to estimate the effects of Ichitan's price promotions on its profitability. Then, the discussion should be led to the effects of price promotions on the customer side. The challenges of price promotions – such as reference price effect, increased price sensitivity, and customer churn, as well as remedies – should be brought into the discussion.

The instructor should then move onto the discussion of the ethics and legality of the lucky draw promotions, brought up in the fourth case question. To begin, the instructor should discuss whether the lucky draw campaigns ran by Ichitan and Oishi were ethical and legal in the Thai RTD tea context. Students might have different views on this issue, depending on which criteria they based their judgements upon. Then, the instructor should prompt the students to think about a more international context when similar lucky draw campaigns were conducted in another country. Here, the instructor can incorporate the concept of cultural relativism into the discussion.

Time Estimate: 25-30 minutes

THE COMPANY'S STRATEGIES

The last part of the class time should be devoted to the discussion on Ichitan's strategies. The instructor should start with the discussion of Ichitan's short-term strategies, followed by the discussion of the long-term strategies, to let the students start smaller before thinking bigger. For each type of strategies, students should be asked to mention evidence from the case itself, or from their other relevant knowledge, to support why they think the proposed strategies should work. This question is intended to be quite open-ended to provoke robust class discussion.

Time Estimate: 25-30 minutes

Suggested Advanced Reading Assignments

The concepts and theories necessary for the case discussion could be found in the resources listed below. The instructor may assign these readings to the students prior to the case discussion if he or she has not already taught the concepts in the course.

- **Pricing Strategy: Setting Price Levels, Managing Price Discounts, & Establishing Price Structures**, Tim J. Smith, South-Western Cengage Learning, 2012.
  - Chapter 2, 7, 15, 16
- **The Strategy and Tactics of Pricing: A Guide to Growing More Profitably**, Thomas T. Nagle and John E. Hogan, Pearson, 2006.
  - Chapter 7, 11

Research Methodology

The information used in this case was acquired through secondary resources, including news articles, companies' websites, and publicly available data from public and private organizations. The author would like to thank Prof. Dr. Clifford E. Darden for his thoughtful and thorough feedback and comments.

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THE EVOLVING ROLE OF PEER-TO-PEER LENDING: A NEW FINANCING ALTERNATIVE

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CASE DESCRIPTION

The case follows the Online Peer-to-Peer (P2P) Lending from its inception and examines how the online social lending approach affected the success of the finance industry. Online Peer-to-Peer (P2P) lending is used to describe online marketplaces where lenders (also referred to as investors on notes) can lend to individuals or small businesses. In 2005, the first Peer-to- Peer (P2P) lending platform, Zopa, was established in the United Kingdom (U.K.), followed shortly by Prosper, LendingClub, and others in the United States (U.S.). Today, among a dozen P2P U.S. lending companies, LendingClub and Prosper comprise 98% of the market as of 2014. The primary objective of this case is to expose students to the recent developments and information systems implication in the financial industry and to encourage students to conduct research beyond a textbook to stimulate critical thinking. This teaching case can be used in accounting, finance, management information systems or business law graduate courses.

CASE SYNOPSIS

Online Peer-to-Peer (P2P) lending, a new form of connecting supply and demand for funds has experienced considerable growth since 2005. Founded in 2007, LendingClub Corporation is one of these P2P lending platforms that attracts numerous lenders seeking high returns, and borrowers in need of capital but who are challenged to be financed via traditional channels. In December 2014, LendingClub (Ticker: LC, LendingClub thereafter) launched its Initial Public Offering (IPO) at the New York Stock Exchange (NYSE). As a result, there are two categories of investors in LendingClub: the lenders (investors on notes) who participate in the lending activities via lending platforms, and the shareholders (investors on outstanding stocks) who primarily buy and/or sell stocks on stock exchanges. All public companies are subject to the scrutiny of the Securities Exchange Commission (SEC). Thus the corporate filings of LendingClub have become an important source for lenders (shareholders) to make informed lending (investment) decisions. In the context of Lending Club Corporation, this case examines the development and role of Online Peer-to-Peer (P2P) Lending in the financial industry. Further, this case examines the decision making process of online lenders and shareholders of the P2P platforms.

INSTRUCTOR'S NOTE

This paper presents the case of Online Peer-to-Peer (P2P) Lending, the new financing alterative, and the user reactions during the different stages of development. The paper also analyzes the factors that motivate an individual lender (investor in notes) to participate in online P2P lending activities, and an individual shareholder (investor in stocks) to purchase notes, loans, or stocks offered by LendingClub. Students are asked to analyze the risks associated with lending (investing) in LendingClub, thereby identifying the risks that would be unique to LendingClub. Additionally, students should be able to discuss how online P2P lending is regulated and identify any regulatory risks that are not typically associated with investment in traditional financial institutions.

Learning Objectives

After successfully completing this case study, a student should be able to:

1. Describe the current industry background and trends in the online P2P lending marketplace.
2. Explain the technology platform supported on the case.
3. Discuss how the revenue model is designed on the case.
4. Analyze the risk factors related to the online P2P lending business and industry.
5. Examine how the legal, ethical, and tax issues affect the activities on the case.

Pedagogy

The pedagogy of the case, which tells the instructor whom the case is intended for, is described in the following components:

1. Audience of the case: This teaching case can be used in accounting, finance, management information systems or business law graduate courses.
2. Prerequisites: None
3. Degree of difficulty: Medium
4. Allocated class time: This case can be assigned as a one week case study team assignment.
5. Supplemental materials: Students may use the following online resources to answer the discussion questions:
    - The SEC corporate filings by LendingClub Corporation. For instance, Forms 10-K (Annual Reports) can be found at http://www.sec.gov/Archives/edgar/data/1409970/000119312515070385/d851207d10k.htm#tx851207_2
    - The Lending Club corporate website: www.lendingclub.com

DISCUSSION QUESTIONS

1. From the standpoint of an individual lender, discuss how online P2P lending is regulated, and identify any regulatory risks that are not typically associated with investment in traditional financial institutions.

Students should be able to identify the related items from the form 10-K (an example is illustrated in Figure 1). Also, students should also consider other information sources (e.g., news, analyst reports) and provide insightful comments and thoughts to the question.

Figure 1
LENDINGCLUB FORM 10-K ITEM 1: BUSINESS

Regulatory and Compliance Framework

Our marketplace provides a compliance framework that allows investors to participate in consumer and commercial credit as an asset class. We believe that our relationship with issuing banks is a key component of our compliance framework. The banks originate loans to borrowers that apply on our website, and we subsequently purchase a majority of these loans with funds provided by investors through a variety of investment channels, thereby enabling investors to capture the interest rate return on each loan. Our primary issuing bank is WebBank, a Utah-chartered industrial bank that handles a variety of consumer and commercial financing programs. We also executed an agreement with Cross River Bank, a New Jersey chartered bank, to operate as our back-up issuing bank in the event WebBank can no longer be an issuing bank.

We have entered into a loan account program agreement with WebBank that governs the terms and conditions between us and WebBank with respect to loans facilitated through our marketplace and originated by WebBank, including our obligations for servicing the loans during the period of time that the loans are owned by WebBank. Under the terms of the loan account program agreement, we pay WebBank a monthly service fee based on the amount of loans issued by WebBank and purchased by us or our partners in each month, subject to a minimum monthly fee. Effective in October 2014 WebBank also retains ownership of all loans for two business days and earns any interest received on the loans during that time. WebBank pays us a transaction fee for our marketplace's role in processing loan applications on WebBank's behalf. Under a loan sale agreement that we entered into with WebBank, two business days after a loan is closed, WebBank sells the loan to us, including all rights related to the loan, without recourse. The loan sale agreement prohibits us from securitizing the loans without prior written consent of WebBank. The initial terms of the loan account program agreement and the loan sale agreement end in November 2018, with the possibility of two, one-year renewal terms, subject to certain early termination provisions as set forth in the agreements.

2. What are the LendingClub's investment channels offered to investors through its online marketplace?

The following investment channels are offered to the LendingClub's investors. In case of confirmed identity theft, LendingClub agrees to repurchase the loan.

- Notes: The interested investor should first complete the account opening process and meet the financial requirements. The qualified investor can purchase unsecured, borrower payment dependent notes selected by the investor himself. The note channel is supported by LendingClub's investor services group at its online knowledge base website to provide investors with basic customer support. The note investors pay cash flow-based servicing fees.

- Certificates and Investment Funds: The accredited and qualified investors may either directly or indirectly invest in certificates. The investor may directly purchase a certificate or interests in separate limited partnership entities that purchase certificates. Or, the investor may indirectly invest in certificates through LendingClub's advisors or a third-party advisor. The certificates are unsecured and are settled with cash flows from underlying Standard or Custom Program Loans selected by the investor. The certificates investors pay asset-based management fees.

- Whole Loan Purchases: LendingClub sells Standard or Custom Program Loans to institutional investors, such as banks, who hold the loans. The institutional investor owns all right, title and interest in each loan. LendingClub establishes the loan purchase procedures. The institutional investor acts in a co-servicer role and also has access to the borrower's information. However, the institutional investor is prohibited from contacting or marketing to the borrower in any way to comply with privacy laws. LendingClub will continue to be the servicer until the loans are sold and can be removed as servicer only under certain circumstances.

3. What are LendingClub's competitive advantages in the online P2P lending marketplace?

A competitive advantage is a significant and long-term benefit to a company over its competitors and can result in higher-quality products, better customer service, and lower costs. LendingClub's competitive advantages in the online P2P lending marketplace are listed as follows.

- Leading Online Marketplace: LendingClub is currently the world's largest peer-to-peer lending company connecting borrowers and investors in an online platform. As of December 31, 2014, LendingClub serviced over $7.6 billion in loans which included: $2.0 billion invested in through notes, $2.9 billion invested in through certificates and $2.7 billion invested in through whole loan sales (LendingClub, 2014).
- Robust Network Effect: LendingClub's marketplace provides online peer-to-peer borrowing and lending platforms using various credit checking tools. The online network increases potential participation in matching potential borrowers with investors. The increased participation results in a larger investment database which is used to improve the model effectiveness of LendingClub's credit checking and scoring tools. The large investment database also increases LendingClub's trust in the online P2P lending market. The increased trust from the investors demonstrates that investors are willing to accept lower risk premiums that allows LendingClub to offer lower interest rates and attract more borrowers. The robust network effect strengthens LendingClub's leadership position in the P2P lending marketplace.
- High Borrower and Investor Satisfaction: According to LendingClub's survey in January 2013 (LendingClub, 2014), the survey results show that increased borrowers' satisfaction and increased investors' confidence on the LendingClub's marketplace.
- Technology Platform: LendingClub's technology platform supports their online investment to provide borrowers and investors with innovative and flexible investment tools. Additionally, the technology platform also automates LendingClub's operations to save time and cost significantly as compared with traditional financial service companies.
- Sophisticated Risk Assessment: LendingClub adopts proprietary algorithms to leverage behavioral, transactional and employment data to supplement traditional risk assessment tools, such as FICO (Fair Isaac Corporation) scores (LendingClub, 2014). This improved risk assessment approach has built on LendingClub's technology platform to automate the risk assessment process in each borrower's risk profile.

- Efficient and Attractive Financial Model: LendingClub's revenue model is to gain revenues from various revenue sources. The revenue sources include transaction fees from loan originations, servicing fees from investors and management fees from investment funds. According to LendingClub's policy, they do not use their own capital to invest in loans offered on their marketplace except for very limited cases.

4. **Prosper is one of the primary competitors of LendingClub. Prosper, based in San Francisco, is the first online P2P lending marketplace in the United States. Prosper has funded over $5 billion loans. In April 2015, Prosper raised $165 million in its IPO, and was valued at around $1.7 billion. Please compare the profitability and solvency of LendingClub and Prosper and discuss which company would be a better investment choice, and why.**

   A. This question is used to assess the student's understanding of the form 10-K filed with the SEC and the ability to analyze financial statements to quantitatively evaluate a company's performance. The students should be able to identify the proper sources of the data for analysis, that is , Item 8 (Figure 2) of the Form 10-K as shown in Figures 3-4, where pictures of the Balance Sheet and Statements of Operations of LendingClub in fiscal year 2014 were presented. Students should be able to find similar information from the Prosper's Forms 10-K.

Figure 2
LENDINGCLUB FORM 10-K (2014) ITEM 8 FINANCIAL DATA AND SUPPLEMENTARY DATA

Item 8. Financial Statements and Supplementary Data

Consolidated Financial Statements of LendingClub Corporation

Figure 3
LENDINGCLUB CONSOLIDATED BALANCE SHEETS AS OF DECEMBER 31, 2014

LendingClub Corporation
Consolidated Balance Sheets
(in thousands, except share and per share data)

December 31,	2014	2013
Assets		
Cash and cash equivalents	$ 869,780	$ 49,299
Restricted cash	46,763	12,208
Loans at fair value (includes $1,772,407 and $1,158,302 from consolidated Trust, respectively)	2,798,505	1,829,042
Accrued interest receivable (includes $15,209 and $10,061 from consolidated Trust, respectively)	24,262	15,975
Property, equipment and software, net	27,051	12,595
Intangible assets, net	36,302	—
Goodwill	72,592	—
Other assets	14,332	23,921
Due from related parties	467	355
Total assets	$3,890,054	$1,943,395
Liabilities		
Accounts payable	$ 5,892	$ 4,524
Accrued interest payable (includes $16,989 and $11,176 from consolidated Trust, respectively)	26,964	17,741
Accrued expenses and other liabilities	31,620	9,128
Payable to investors	38,741	3,918
Notes and certificates, at fair value (includes $1,772,407 and $1,158,302 from consolidated Trust, respectively)	2,813,618	1,839,990
Total liabilities	2,916,835	1,875,301
Commitments and contingencies (see *Note 14 – Commitments and Contingencies*)		
Stockholders' Equity		
Preferred stock	$ —	$ 103,244
Common stock, $0.01 par value; 900,000,000 and 360,000,000 shares authorized at December 31, 2014 and December 31, 2013, respectively; 371,443,916 and 54,986,640 shares issued and outstanding at December 31, 2014 and December 31, 2013, respectively	3,714	138
Additional paid-in capital	1,052,728	15,041
Accumulated deficit	(83,223)	(50,329)
Total stockholders' equity	973,219	68,094
Total liabilities and stockholders' equity	$3,890,054	$1,943,395

Figure 4
LENDINGCLUB STATEMENTS OF OPERATIONS YEAR 2014

LendingClub Corporation
Consolidated Statements of Operations
(in thousands, except share and per share data)

	Year Ended December 31, 2014	Year Ended December 31, 2013	9 Months Ended December 31, 2012
Operating revenue			
Transaction fees	$ 197,124	$ 85,830	$ 26,013
Servicing fees	11,534	3,951	1,474
Management fees	5,957	3,083	720
Other revenue (expense)	(1,203)	5,111	720
Total operating revenue	213,412	97,975	28,927
Net interest income (expense):			
Total interest income	354,453	187,507	56,861
Total interest expense	(356,615)	(187,447)	(56,642)
Net interest income (expense)	(2,162)	60	219
Benefit for losses on loans at amortized cost	—	—	42
Fair value adjustments, loans	(124,602)	(57,629)	(18,775)
Fair value adjustments, notes and certificates	124,480	57,596	18,180
Net interest income (expense) after loss provision and fair value adjustments	(2,284)	27	(334)
Total net revenue	211,128	98,002	28,593
Operating expenses:			
Sales and marketing	87,278	39,037	14,723
Origination and servicing	38,286	17,217	6,134
General and administrative	117,068	34,440	11,974
Total operating expenses	242,632	90,694	32,831
Income (loss) before income taxes	(31,504)	7,308	(4,238)
Income tax expense	1,390	—	—
Net income (loss)	$ (32,894)	$ 7,308	$ (4,238)
Basic net loss per share attributable to common stockholders	$ (0.44)	$ 0.00	$ (0.10)
Diluted net loss per share attributable to common stockholders	$ (0.44)	$ 0.00	$ (0.10)
Weighted-average common shares - Basic	75,573,742	51,557,136	41,359,676
Weighted-average common shares - Diluted	75,573,742	81,426,976	41,359,676

B. Table 1 showed the financial data for LendingClub, and Prosper, respectively. Students are encouraged to use horizontal analysis. As defined in ‘Financial Accounting” authored by Spiceland et al (Spiceland, Thomas, & Herrmann, 2013), horizontal analysis is a method to examine the trends in one single company’s financial data. Based on the data, Table 2 computed the profitability and solvency ratios for further examination. Students may consider using cross sectional analysis, that is, student may want to compare the financial ratio of similar companies (here LendingClub and Prosper). There are no standardized answers to the analysis. Students should exercise their own professional judgment and cite appropriate evidence to support their statements.

Table 1
LENDINGCLUB VS. PROSPER MARKETPLACE:
FINANCIAL DATA FROM FORMS 10-K

	LendingClub Corporation			Prosper Marketplace, Inc.		
	Nine Months Ended 12/31/2012	Year Ended 12/31/2013	Year Ended 12/31/2014	Year Ended 12/31/2012	Year Ended 12/31/2013	Year Ended 12/31/2014
	US$ (In thousands)			US$ (In thousands)		
Income Statement						
Total operating revenue	28,927	97,975	213,412	4,149	16,526	77,836
Total net revenue	28,593	98,002	211,128	6,701	18,381	81,317
Total operating expenses	32,831	90,694	242,632	22,811	45,388	83,986
Interest expense	56,642	187,447	356,615	21,889	33,321	37,734
Net Income	(4,238)	7,308	(32,894)	(16,110)	(27,007)	(2,669)
Balance Sheet						
Total assets	850,830	1,943,395	3,890,054	178,322	310,259	440,158
Total liabilities	798,620	1,875,301	2,916,835	172,285	285,929	364,387
Total equity	52,210	68,094	973,219	6,037	24,330	75,771

Table 2
LENDINGCLUB VS. PROSPER MARKETPLACE: A RATIO ANALYSIS

	LendingClub Corporation			Prosper Marketplace, Inc.		
	Nine Months Ended 12/31/2012	Year Ended 12/31/2013	Year Ended 12/31/2014	Year Ended 12/31/2012	Year Ended 12/31/2013	Year Ended 12/31/2014
	US$ (In thousands)			US$ (In thousands)		
Profitability Analysis:						
Operating margin	-13.496%	7.431%	-13.692%	-449.795%	-174.646%	-7.901%
Net profit margin	-14.651%	7.459%	-15.413%	-388.286%	-163.421%	-3.429%
Return on assets		0.523%	-1.128%		-11.055%	-0.711
Return on equity		12.149%	-6.318%		-177.871%	-5.333%
Solvency Analysis:						
Debt-to-assets ratio	93.864%	96.496%	74.982%	96.615%	92.158%	82.785%
Debt-to-equity ratio	1529.630%	2753.989%	299.710%	2853.818%	1175.212%	480.906%
Times interest earned ratio	0.511	0.523	0.598	0.190	0.496	2.010

Note: Operating margin = ((Operating revenue-Operating expenses)/Operating revenue)
Net profit margin = (Net income/Operating revenue)
Return on assets = (Net income/Average total assets)
Return on equity = (Net income/Average total equity)
Debt-to-assets ratio = (Total liabilities/Total assets)
Debt-to-equity ratio = (Total liabilities/Total equity)
Times interest earned ratio = (Operating revenue/Interest expense)

C. Students may be aware that the terminologies used in the financial statements and the related disclosures of LendingClub and Prosper are different from those of companies in other industries. Students are encouraged to examine the sources of the differences (e.g., different revenue generation drives) and also discuss how these differences may impact the valuation of the two companies in the innovative P2P lending business.

5. What are the key technology elements utilized on LendingClub's platform?

LendingClub's key technology elements include:

- Highly automated. The loan acquisition process, registration, credit decision making and scoring, servicing and online payment systems for the borrowers and investors are automated and built from LendingClub's internal software. The Automated Clearing House (ACH) technology is also used to pay and receive payments from borrowers and investors.
- Scalable Platform. LendingClub's infrastructure design is scalable, including such technologies as virtualization, load-balancing and high-availability platforms. The application and database servers are designed in horizontal tiers.
- Proprietary Fraud Detection. LendingClub combines the analytical tools from a third-party data and current and historical data obtained during the application process to determine the fraud risks. If an application is confirmed as a fraud, the application will be canceled. Besides, the system will be able to identify and flag the characteristics of the fraud to further help the fraud detection in the system.
- Data Integrity and Security. LendingClub's database maintains effective data integrity and security standards, such as ISO2700x and NIST 800 series to protect the confidentiality, integrity and availability of borrower and investor information.
- Application Programming Interface. LendingClub uses the API (application programming interface) technology to create user friendly and easy access interface to allow borrowers, investors and partners using the online tools and analyzing the investment data.

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WAS COOPER TIRE & RUBBER RIPE FOR SALE?

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CASE DESCRIPTION

The primary subject matter of this case concerns the competitive strategy of a very successful small tire manufacturer – Cooper Tire & Rubber Company (Cooper). It can be used to teach a number of strategic management lessons, particularly implementation and choice of strategic direction. The time frame of the case is from the firm's inception to the middle of year 2013. The case has a difficulty level of four-five, appropriate for senior level undergraduate or second year MBA students. The case is designed to be taught in two seventy-five minute classes and will require approximately three to four hours of outside preparation by the students.

CASE SYNOPSIS

Cooper is a U.S. based independent tire manufacturer with a history of consistent high growth and strong returns for more than a decade. What is interesting about this case is that Cooper has been able to find a niche in a mature industry. Although Cooper is the fourth-largest U.S. tire maker, it does not cater to car manufacturers, a market with strong competition and lean margins. Cooper does not invest much in research and development, preferring to wait two or three years to gauge acceptance of the latest tire designs, then copying the winners and competing on price in the marketplace. Cooper realizes that in a competitive environment like the global tire industry, differentiation is an important component; hence it emphasizes quality in their products to get a differentiation advantage. There is also a focus on a low-cost approach so the customers can get a low-price high-quality product. Moreover, Cooper maintains good relations with its distribution channels in order to achieve competitive advantage. Cooper also realizes that the key factors for survival and growth in the tire industry lie in managing production costs and global expansion. But the future of the company was expected to be periods of continuing and new challenges, with increased threats of competition in the replacement tire market. The company also believed that significant numbers of Chinese tires will be imported immediately following the expiration of the special U.S. tariff on such tires.

On June 12, 2013, Apollo Tyres Ltd. (Apollo), a second largest Indian tire maker offered to acquire Cooper. It was obvious for some analysts that Apollo would jump into the North American market someday, but it had to absorb some of its expansions into other regions of the world first, such as Africa and Europe. So was Cooper ripe that Apollo couldn't wait?

INSTRUCTORS' NOTES

Learning Objectives

This case is designed to reinforce learning of the following strategic management analysis and decision tools:

Porter's five forces of model
Industry driving forces
Industry key success factors
Financial ratio analysis
SWOT analysis
Generic strategies (Porter)
Implementation of strategy
Company Valuation

It is assumed that all of the above topics will have been covered with textbook readings or classroom discussion prior to asking the students to analyze the case. If these topics have not been covered in detail, they provide a real opportunity for the "black board panel" approach recommended by Harvard University.

TEACHING THE CASE

The starting point for this case is the classroom discussion of Porter's Five Forces of Model, SWOT analysis and Generic Strategies. Any good strategic management text should cover all of these three concepts in some detail because they are so common to the strategy literature. Financial ratio analysis, is of course, a topic from the prerequisite accounting or, perhaps, first course in finance. Surprisingly, no accounting or finance majors frequently need to go back and review, so it probably makes sense to talk about the common ratios and their interpretation as a classroom review item.

When assigning this case, we have found it helpful to require students – particularly undergraduates – to jot down their answers to the case questions and to bring those responses to class. All too often, it seems, some undergraduates "breeze" through the case and are woefully unprepared for a rigorous class discussion.

When discussing the case, we feel that the "black board panel" approach to case organization works well.

ASSIGNMENTS QUESTIONS

1. Conduct a Five Force Analysis of the global tire industry (in both OEM market and replacement tire market). How do you assess the threat of New Entrants?
2. What driving forces do you see at work in the global tire industry? Are they likely to impact the industry's competitive structure favorably or (unfavorably)?
3. What are the key Success factors in the tire manufacturing industry?
4. Which of Porter's generic strategies does Cooper seem to be following? In what ways might their generic strategy be somewhat different than what Porter suggests?
5. What are the specific policies and operating practices Cooper has employed to implement and execute its chosen strategy?
6. Perform a SWOT analysis on Cooper. What are the most important SO strategies suggested by the SWOT analysis? Are there any WT strategies?
7. What is your assessment of Cooper's financial performance over the past several years? How strong is the company's financial condition?
8. Should Cooper continue with the present strategy or make some major changes? What new moves would you recommend?
9. Is Cooper a prime candidate for takeover?

10. If there is any truth to the rumor of Cooper acquisition attempt, in order for Cooper to entertain a serious bid (or for existing shareholders to entertain their shares), how much the acquisition would have to be valued?

DISCUSSION QUESTIONS

1. Conduct a Force Analysis of the global tire industry (in both OEM market and replacement tire market). How do you assess the threat of New Entrants?

It is worth spending 15-20 minutes of class time establishing just why competitive conditions in the tire industry are currently very tough. A five forces model for the tire industry is depicted below.

OEM TIRE MARKET

Porter's 5 forces	OEM Tire Market
Bargaining Power of Customers	Buyers are: Auto manufacturers Strong competitive force: Auto manufacturers buy all of their tires directly from tire manufacturers. The buyers have the power to switch orders between tire manufacturers at low cost. Also, there are few buyers overall, thus the tire manufacturers have to compete for the buyers, Auto manufacturers have more power and do not hesitate to use the leverage
Bargaining power of Suppliers	A Low competitive force: The raw material used in manufacturing is considered a commodity.
Threat of Substitute product	No competitive force: There are no real substitutes for a new car tire in the world yet.
The Threat of Entry	Low competitive force: Brand loyalty Economies of scale are enjoyed by some large players, this in turn hinders the entry of new competition into this market. There is also intense capital and equipment required in order to enter this market.
Rivalry among established tire producers	A fierce competitive force: The low switch costs of buyers Limited number of buyers Buyers order size is big Market conditions significantly influence choice of buyers.

Replacement Tire Market

Porter's 5 forces	Replacement Tire Market
Bargaining Power of Customers	Buyers are: Independent dealers, retailers (at all levels), wholesalers. Buyers' Power: Medium to strong competitive force: Quantity and quality of information improved and readily available to buyers. The big dealers and distributors have substantial bargaining power. This is particularly true in the case of choosing whom to give their contracts fo private-label tire production. Independent vehicle owners, in shopping for replacement tires have som leverage over tire retailers—they can go somewhere else to get their tires. B independent dealers have influence on end user's tire purchase. Big retailers, such as Sears, can have power over suppliers. The suppliers can also have power over buyers as they can be picky abo choosing distribution channels.

Bargaining power of Suppliers	Medium to low competitive force: Most of the industry's raw materials are commodities widely available from variety of suppliers on world markets. There's no evidence that the tire manufacturers who integrated backward into rubber plantations, synthetic rubber, or fabric cord have gained a meaningful cost advantage or have better ability to differentiate their products on the basis of quality.
Threat of Substitute product	Low competitive force **now** but in the future it could be a strong competitive force: The only substitute for new tires in the replacement tire segment is recapp tires. Their ability to serve a substitute is limited (always new tires must produced in order to provide a continuing supply of recappable tires). Car buyers are buying fewer recaps as replacements. Technology to produce better retread tires is improving continuously. The production of retread tires is also increasing, and the top producers of retread tires are preparing for the increased production.
The Threat of Entry	Medium to low competitive force: There is no evidence in the case that indicates room for new firms. While it is quite unlikely that new start-up firms will enter the tire industry, it clear from the information in the case that existing tire producers anxious operate their plant at or very near full capacity will seek out customers geographic markets where they do not currently have a presence. Foreign manufacturers with a low-cost advantage may penetrate the market. It is also clear that "new entry" is occurring when companies like Coop acquire less successful tire producers and try to turn their operations into stro contenders in the marketplace. The domestic major existing manufacturers are looking to enter geograph markets where they do not have a presence. There is a strong threat that some of the major existing tire manufacturers w seek to boost their market share in the replacement tire market. High capital requirement Costly state-of-art equipment required Removal of tariffs imposed on importing Chinese tires. Buyer demand in general has been low due to economic issues.
Rivalry among established tire producer	A fierce competitive force: Rivalry revolves heavily around price competition because tires are becoming commodities. Producing tire of satisfactory quality is somethi most producers have mastered. In a commodity market, buyers shop heavily for the lowest/best price. Competitors are moving to low-cost regions to improve business performance. Buyer demand is growing slowly due to economic recession. The buyer's switching costs are low, Thus the competition among the firms is higher. Other competitive weapons include: Strong distribution channels, Reputati for quality, Mileage guarantees for warranties, Breadth of product line, a Brand name recognition.

2. **What driving forces do you see at work in the global tire industry? Are they likely to impact the industry's competitive structure favorably or (unfavorably)?**
   Three factors qualify as driving forces here:
   - Technological innovation in tire industry. This driving force is acting to greatly increase the competitive pressures.
   - Tire-making capacity worldwide exceeds the demand for tire, such that companies anxious to operate their plants at full capacity.
   - Industry consolidation to a smaller number of larger and more competitively successful tire producers. Aggressive companies in reasonably good financial

condition (like Cooper) may be able to acquire efficient plants at bargain prices, thus enhancing their long-term competitive market position.

The important point for students to grasp at this point is that while industry conditions are tough for high-cost tire producers, the industry outlook and competitive structure is much brighter for a low-cost, high quality producer like Cooper that is in good financial shape and that can benefit from the weak competitiveness of high-cost tire producers.

In other words, tough industry conditions do not hit all competitors equally hard. As one of the industry's low-cost producers, Cooper is in good position to gain sales and market share at the expense of the high-cost producers and the financially troubled firms that may be forced to exit the marketplace. Thus while an industry's market environment may be unattractive to some rivals, it does not follow that the environment is unattractive to all rivals—tough conditions for some may mean opportunities for others. Students need to recognize this.

3. What are the key Success factors in tire manufacturing industry?

- **High Quality Products**: Quality is an important factor contributing to the business success. Since tires are an integral part of any moving vehicle, it is important to get the auto manufacturers' orders.
- **Low-Cost Production**: In the replacement tire market, the low cost production can ensure the tire manufacturer could take a better position to survive in the high competitive market as the consumer can switch between buyers easily. This is why manufacturers are choosing to invest in low-cost regions. In addition, utilizing economies of scale can result in low production costs as well. However, it is critical not to sacrifice quality in the whole process.
- **Advancement of Technology**: Innovation in manufacturing processes and distribution are essential to supplement the low-cost production and healthy dealer relationship network so that competitive advantage can be gained. Thus, the manufacturers invest in R&D, and state-of-art equipment to gain a competitive advantage.
- **Good Dealer Relationships**: Consumers are heavily influenced by the independent tire dealers. Thus, dealers may influence consumer purchase decisions. Hence it is vital to establish good relationships with current and future dealers.
- **Employee Relationships**: Employees at all levels should be engaged in the process, as they are highly valued resources of a company. Labor unions should also be engaged with strong contractual agreements, as any conflict may affect production capacity. The employees can improve productivity, quality and provide efficient customer service.

4. Which of Porter's generic strategies does Cooper seem to be following? In what ways might their generic strategy be somewhat different than what Porter suggests?

Cooper concentrates on the replacement tire market, which is large and has a larger gross profit margin as well.

Very clearly, Cooper is pursuing a best-cost strategy. Such a competitive approach often is the best strategy in an industry becoming a commodity product. It has achieved this through highly efficient manufacturing processes, relatively low expenditure on R&D compared to the major tire manufacturers, and choosing low-cost regions for production.

Just as clearly, Cooper has been successful in achieving relatively low production costs. Cooper builds plants inexpensively and operates them efficiently. Cooper's record of profitability—even during hard times in the domestic tire market—is strong evidence that Cooper has low costs relative to other domestic tire producers and probably is quite cost competitive with many foreign tire producers selling tires in the U.S.

Furthermore, Cooper's cost competitiveness is longstanding, not something that it achieved just recently or temporarily. No domestic competitors appear to have costs as low as Cooper—and this has been the case for many years. As a consequence, it is fair to say that Cooper has a sustainable low-cost advantage over domestic tire producers and it seems able to hold its own in competing against low-cost foreign tire producers that are selling tires to customers in the U.S. Differentiation is achieved through producing high quality, best models and its quality control procedures and the perception of low cost high quality tires gives it the competitive advantage.

Efficient customer management and good dealer relationships have also given Cooper a lead in the replacement tire market.

5. What are the key policies, operating practices and approaches that Cooper has employed to implement and execute its chosen strategy?

Students will undoubtedly see Cooper's best-cost strategy clearly enough but they may not be as clear about all the things that Cooper has done to achieve its low-cost status. Some of the key operating practices, policies, and approaches that Cooper has employed in pursuit of low-cost leadership status include:

- Cost-saving technological improvements at its plants.
- Cooper's incentive compensation system for both plant employees and managers—the compensation scheme is highly effective in generating, continuous gains in labor productivity and motivating employees to seek out cost-saving operation.
- The company's low-cost culture and cost-conscious operating practices.
- Corporate structure: Cooper has a thin and lean organizational structure with an efficient and effective leadership. The employees are able to understand the management's vision and strategy and work towards achieving the goals. Cooper also emphasized on decentralized decision-making in the plants and has a very lean corporate staff.
- Human resource management and employee motivation: The employees have the least union representation which shows that there is a good HRM policy in place which keeps the employees satisfied and motivated. They are participative in the company's management procedures and have been given shareholder status also so that they will work more efficiently towards achieving the goals. Furthermore, the company invests in talent programs, which are in place to recognize strong employees that will become future leaders. The program aims at educating and training these employees to better prepare them.
- Good relation with dealers and channel members: An outstanding customer service and dealership relationships has helped Cooper in striving ahead in the replacement tire market. Cooper is also building relationships with other channel members to grow its business.

- Low-cost efficient manufacturing process: The efficient use of technological advancements and innovations to provide a low-cost efficient manufacturing process has supported Cooper in achieving low costs.
- Low-cost labor locations: Cooper has been able to utilize low-cost regions in Asia and South America, and is continuing to do so in order to take advantage of the low-cost labor, which contributes to lower overall costs.
- Quality control procedures adopted: The quality control procedures adopted by the company promote its view of outstanding quality at the lowest price.
- Cooper has a simple organizational structure to allow employees to innovate and make quick decisions.
- All the plants operate at maximum capacity.

6. **Perform a SWOT analysis on Cooper. What are the most important SO strategies suggested by the SWOT analysis? Are there any WT strategies?**

A scan of the internal and external environment of Cooper:

Strengths

- Lean organizational structure that allows efficient communication throughout
- Financial soundness and long term investment
- Market position-concentrating on replacement tire market
- Economies of location
- The company has been paying dividend every quarter for 40 years. Dividends play an important role in any organization's credibility. Cooper, by distributing year-on-year dividends, has proved that it is a financially sound company.
- Cooper has maintained a good liquidity position, posting an increase in its cash and cash equivalents.
- Cooper's EPS has shown an increase trend over the years.
- Strong financials.
- Favorable relationship with independent tire dealers and various distribution channels
- Efficient inventory control and productive low-cost manufacturing processes
- Low cost production, high quality product
- Clear goals and objectives
- Operating at full capacity

Weaknesses

- Relatively small market share, especially on a global level, compared to other giant tire manufacturers
- Does not own any retail outlets for its brand
- Percentage spent on R&D is relatively low compared to other giant tire manufacturers
- Labor union issues (Findlay, Ohio plant)

Opportunities

- Use of new technologies such as IT to boost growth potential

- Removal of international trade barriers allows it to fuel its global expansion plans
- Acquisitions and alliances are on the cards as there is a dramatic change in market scenario
- If the economy continues to improve, the demand for tires will grow, thus the tire manufacturing industry may improve as well.
- Increase in per-capita income
- Decrease in crude oil prices
- Decrease in raw material prices

Threats

- Unwanted changes in tariffs or other international policies which may hinder the company growth or give competitors an advantage
- Disagreements with Unions which may affect production capacity
- Cheaper imports from foreign manufacturers
- Slow economy or decrease in per capita income may deter consumers from buying tires
- Industry has overcapacity production
- Rise in raw material costs
- Technology advances for substitute products may make the substitute product more attractive

SO strategies are fairly numerous and obvious. WT strategies might include expansion or acquisition of another tire firm to grow rapidly and enter additional markets.

7. What is your assessment of Cooper's financial performance over the past several years? How strong is the company's financial condition?

You should press the class to critically review the numbers in case Exhibits 2 and 3 as a basis for evaluating Cooper's performance and financial condition. Case Exhibit 2 clearly indicates that Cooper has been able to grow its business very consistently over the years. Eager beaver students may run the numbers and come up with the following compound annual growth rates (CAGR):

CAGR in net sales 1983-2012: 7.94%
CAGR in earnings before taxes 1983-2012: 8.25%
CAGR in earnings 1983-2012: 8.37%

The data in Case Exhibit 2 indicates that Cooper is in good financial shape and that its financial performance has been particularly strong over the past two years (2011-2012). Using the financial ratio information along with calculations of CAGRs, students can determine the following:

- Cooper's net sales grew from $1,742,218,000 in 2002 to $2,932,515,000 in 2007, a very healthy CAGR of 10.98%.
- Cooper's net earnings grew from $55,032,000 in 2002 to $91,435,000 in 2007, equal to a robust CAGR of 10.69%.
- Cooper's diluted net earnings per share of common stock jumped from $0.74 in 2002 to $1.46 in 2007, a strong CAGR of 14.56%.

COOPER, SELECTED FINANCIAL RATIOS, 2008-2012

Year	2008	2009	2010	2011	2012
Annual Sales Growth	NA	(3.57)%	20.29%	16.91%	7.50%
Gross Profit Margin (GPM)	2.64%	15.08%	12.04%	8.83%	15.57%
Net Profit Margin (NPM)	-7.61%	3.00%	3.48%	6.49%	5.25%
Return On Equity (ROE)	(57.59)%	17.97%	22.23%	36.32%	24.26%
Return on Assets (ROA)	-10.74%	3.97%	5.04%	10.10%	7.87%
Return on Sales (ROS)	(7.52)%	5.62%	5.64%	4.18%	9.45%
Current Ratio (times)	1.42	1.78	1.93	1.94	2.21
Debt-to-Assets	0.81	0.78	0.77	0.73	0.68
Debt-to-Equity	4.36	3.53	3.41	2.60	2.08
Long Term Debt-to-Equity	85%	71%	61%	47%	37%
Fixed Asset Turnover	3.25	3.31	4.05	4.35	4.38
Total Asset Turnover	1.41	1.32	1.45	1.56	1.50

Calculated from Case Exhibit 3

ANALYSIS OF RATIOS

Revenues

Company's revenue growth turned negative in 2009, hitting $2,778.9 million in 2009, a 3.57% decline from 2008. Then the revenues increased every year, peaked in 2012 at $4,200.8 million.

Margins

Gross margins for the company had declined from 15.08% in 2009 to 8.83% in 2011. It was uncertain from the case itself whether this decline could be attributed to weaker pricing, rising input costs, or a more difficult competitive operating environment. The company's gross margin peaked to 15.57% in 2012.

Profitability

Net income had improved from a loss of $219.4 million in 2008 to a profit of $220.4 million in 2012. This turnaround in profitability had improved all of the company's return ratios as well. ROS improving from -7.52% in 2008 to 9.45% in 2012. The company's ROA ratios had also improved.

Liquidity

There were no signs of liquidity distress on the company's balance sheets. Cooper's working capital (shown in the case exhibit 3) has increased from $296.7 million in 2008 to $794.6 million in 2012, giving it more money to conduct business operations and more financial flexibility. The company's current ratio (shown in the case exhibit 3) has climbed steadily during 2008-2012 period.

Leverage

Even though Cooper's long-term debt climbed from $325.7 million in 2008 to $336.6 million in 2012, Cooper's long-term debt as a % of stockholders' equity dropped from 85% to 37%; the company clearly has the ability to handle the higher level of debt such as new acquisitions.

Activity

Both fixed assets turnover and total asset turnover ratios are important in determining whether a company's management is doing a good job of generating revenues from its resources. Both ratios are improved from year 2008 to 2012. In 2008, the company generated $3.25 for dollar invested in fixed assets. But, in 2012, the company generated $4.38 worth of sales for dollar invested in fixed assets. It implies that it was more productive in 2012, since every dollar invested in plant assets produced an extra $1.13 in sales.

Total assets turnover takes into account both net fixed assets and current assets. The company produced $1.50 worth of sales for every dollar invested in total assets versus $1.41 worth of sales in 2008. So the company was more productive in 2012 than previous years.

COOPER, COST ANALYSIS, 2008-2012

	2012	2011	2010	2009	2008
Net Sales	4,200.8	3,907.8	3,342.7	2,778.9	2,881.8
% growth	7.5%	16.9%	20.3%	-3.6%	
Cost of Products Sold	3,546.6	3,562.8	2,940.3	2,359.9	2,805.6
% growth	-0.5%	21.2%	24.6%	-15.9%	
Selling, General & Administrative	257.3	181.7	193.4	207.0	185.1
Cost of products sold as a% of sales	84.43%	91.17%	87.95%	84.92%	97.36%
Selling, G&A as a % of sales	6.13%	4.65%	5.79%	7.45%	6.42%

Note: The rise in Cooper's cost of goods sold percentages in years 2008 and 2011 is more reflective of cost running out of control than depressed sales prices for tire products. During 2011, Cooper actually cut selling, G&A below 2010 level.

SUMMARY

Cooper experienced financial difficulties during 2008 due to the economic recession. The operating profit margin and net profit margin were in the negatives, indicating loss of profit. However, Cooper's current ratio had remained above 1.0, indicating that Cooper had the ability to current liabilities using assets which could be converted into cash. The following year, Cooper managed to increase its profits and improved in most areas. Overall, Cooper is doing well with its profitability ratios, showing an upward trend, and it is also performing well according to its liquidity, leverage, and activity ratios. All things considered, Cooper is in very good financial shape as of 2012 and its financial performance during 2008-2012 has been quite strong. The data in case Exhibit 3 indicates that Cooper has considerable competitive ability to gain sales and market share.

8. Should Cooper continue with the present strategy or make some major changes? What new moves would you recommend?

The preceding analysis indicates that Cooper has a strong strategy. There is no need for radical surgery. But there are some definite opportunities, which Cooper is in position to take advantage of.

- Cooper's best chances for continued growth and profitability lie in doing more of what it does best—producing high quality tires at a relatively lower costs for the replacement tire market.
- Continue to acquire more plants; upgrade their technologies and equipment, and use Cooper's marketing muscle to boost sales. Financially, Cooper is in an excellent position to support expansion. Some possibilities are more acquisitions or joint ventures.
- By increasing the production capacity, Cooper's efforts should be focused on expanding foreign markets for its products (product development).
- Increase marketing effort towards individual users—pull strategy. Cooper needs to expand into television advertising in order to improve its product image (market penetration).
- Increase more tire product lines to keep its product offerings fresh and in tune with market demand (product development).

9. Is Cooper a prime candidate for takeover?

It is possible to determine whether a company is a potential takeover candidate before a public announcement has been made. There are some characteristics that well-financed suitors look for in their target companies. Once we know what they are looking for, we'll be able to determine whether or not Cooper was a prime candidate for takeover.

Most often companies determine the best way to achieve a strategic objective is through acquisition. This decision will come after a thorough evaluation of the make vs. buy options. Acquiring companies buy a company at a reasonable price that has a unique niche in a particular industry. Smart suitors will wait until the smaller company has done the risky footwork and advertising before buying it. In terms of both money and time, it is often cheaper for larger companies to acquire a company than to build it out from scratch. This allows them to avoid much of the risk associated with a startup procedure. Once it is determined that an acquisition is part of the solution to achieve a company's objectives, they evaluate potential candidates. This evaluation step is paramount to the success of the acquisition. Some of the main factors they may consider are discussed below (Curtis, 2009).

Expandable Margins

Acquirers want to buy companies that have the potential to develop the economies of scale and increase operating margins. As a company grows its revenue base, it develops economies of scale. By that we mean that the company's revenues grow but its overhead such as warehouse expenses, rent, interest payments and perhaps even its labor costs stay the same, or increase at a much lower rate than revenue. In 2012, Cooper's revenue increased by 7.5% over year 2011, but it's operating profit increased more than 142%.

Solid Distribution Network

If the company is a manufacturer, it must have a solid distribution network. Any company that is believed could be a potential takeover target has not only the ability to develop a product, but also the ability to deliver them to its customers on a timely basis. Cooper has established loyal distributors for its tire products.

- **Clean Capital Structure.** Suitors want to make sure a perspective takeover target has a clean capital structure. They look for companies with just one class of common stock and a minimal amount of debt that can be converted into common shares. This is very true with cooper.
- **Clean Operating History.** Usually a takeover target has a clean operating history. It has consistent revenue streams and steady businesses. Cooper definitely meets this requirement.
- **History of Enhancing Shareholder Value.** Acquiring company would like to see that the target company is able to enhance shareholder value. Therefore they want to see that the target company has been proactive in telling its story to the investment community and has the ability to work as a standalone, which applies to the investor relations and public relations function.
- **Possibility of Debt Refinancing.** When considering the possibility of a takeover, acquiring companies look for companies that could be much more profitable if their debt loads were refinanced at a more favorable rate.
- **Cost Savings.** When a company acquires another company, management usually tries to save money by eliminating redundant overhead. For example, why maintain two warehouses if one can do the job and is accessible by both companies?
- **Experienced Management.** Acquiring companies often look for target companies that have been run well. In some cases, when one company acquires another, the management team at the acquired company is sacked. But, in other instances, management is kept on board because they know the company better than anyone else.
- **Minimal Litigation Risk/Threats.** Almost every company at some point in time will be engaged in some kind of litigation. Usually companies seeking acquisition candidates will steer clear of firms that are saddled down with lawsuits.

SUMMARY

With the investment community focused on increasing profitability, companies will always be looking for acquisitions that can add to earnings fast! Therefore, companies that are well run, have good financial structure, excellent products and have best distribution networks are logical targets for a possible takeover. Based on the above criteria, obviously, Cooper is a good target for any Asian tire company that does not have a strong presence in the U.S. tire market and they know that it would be very difficult to do it on their own. We believe that a merger with Cooper will give Apollo Tyres a jump-start for growth in U.S. market with a valuable partner.

10. If there is any truth to the rumor of Cooper acquisition attempt, in order for Cooper to entertain a serious bid (or for existing shareholders to entertain their shares), how much the acquisition would have to be valued?

To answer this question, we are using an article that was published on *Forbes* magazine on October 11, 2012. This article was written by Taesik Yoon under the title, "*A Deal for Cooper Tire in the Works?"* in response to the report written in *The Economic Times*.

Usually when one firm acquires another firm, it is for all of the shares outstanding. According to Mr. Yoon, the source of the article specifically mentions what it would cost to acquire a “controlling stake” is more consistent with a hostile bid than a friendly takeover offer. Most majority stakes require owning more than 50% of total outstanding voting shares. This is sometimes difficult to do if a significant portion of a company’s common stock is owned by insiders. However, that’s not the case here with Cooper insiders owning less than one percent of total shares outstanding. In fact, with more than 90% of Cooper’s common shares floated, acquiring these shares would not be difficult to do provided you have the capital. It would merely require an open tender offer to existing shareholders at a price attractive enough to get majority ownership of all voting shares.

The article in *The Economic Times* mentioned that at the low-end, it would take $600 million (less than $20 per share) to acquire a controlling interest of the company. Mr. Yoon found it hard to believe that anyone in their right mind would tender their shares at a price of less than $20 per share.

In his view, for the company to even entertain a serious bid (or for existing shareholders to be tempted to tender their shares), the acquisition would have to be valued much closer to the high-end of $800 million that the article noted. This would place the total value of the firm at more than $1.6 billion, or roughly $25.50 per share. This would represent almost a 40% premium over one day before the article’s date closing price.

Still, Mr. Yoon was not sure this price would be enough to convince Cooper’s management and Board to pull the trigger. It was possible that Apollo initially approached the company with an offer that was rejected.

While the high-end price ($25.50) represents a substantial premium over where shares were trading most recently, it was only 11% above the year-to-date high of $23.40 the stock reached less than a month that the article was published. A $25.50 per share offer price would value shares at just 10 times for year 2012 expected earnings and 8.7 times expectations for year 2013. It would also price Cooper’s enterprise value at $1.95 billion, valuing the deal at an enterprise value-to-earnings before interest, taxes, depreciation and amortization (EV/EBITDA) multiple of just 5.2. For comparison, Cooper’s common share average price-to-expected earnings multiple over the past five years was 12.4, while its average EV/EBITDA multiple was 8.5.

Mr. Yoon concluded by stating that it would be difficult for him to believe that Cooper would be willing to sell the firm at these low multiples, especially at a time when the company’s operations were performing at their strongest levels in two years.

On the other hand, one may argue that investors don’t care much for multiples these days and don’t seem to have much interest in holding stocks at any length. Therefore, the tender offer might work in the current investing environment. He concluded by saying that if there’s any truth to this rumor, the chances are good that a deal will get done some day.

EPILOGUE

Mr. Taesik Yoon was right about the valuation of the company. On June 12, 2013, it was announced that Apollo has signed an agreement to acquire Cooper under a wholly-owned subsidiary of Apollo via an all-cash transaction valued at approximately U.S. $2.5 billion ($35 per share). Before the news was out, Cooper’s stock price was $24.56 a share; at the end of the day, it was $34.66. Cooper posted net income of $92 million on net sales of $1,746 million for the six months ended June 30, 2013. That compared to income of $74 million on net sales of $2,043 million for the same period in 2012. Its operating profit rose 16%, from $143 million to a six months record of $166 million.

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INSTRUCTORS' NOTES: ELECTRICAL AND ELECTRONIC EQUIPMENT CLUSTER IN THAILAND: CAN COMPETITIVENESS BE REGAINED?

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ABSTRACT

In April 2015, General Prayut Chan-o-cha, the 29th Prime Minister of Thailand who took over the government to end the political crisis in May 2014, announced upon assuming control of the country that Thailand needed a dramatic reformation before the next democratic election. Now that the country was going through an economic recession, he was pressured to urgently address how to reform the country's economy. In particular, the National Reform Council raised a key issue that the Electrical and Electronic Equipment (EEE) cluster, which had long been the most valuable exported product category providing large employment opportunities, was experiencing a diminishing growth rate. The council demanded directions from the country's leader as to how to resolve the challenges in the EEE cluster and regain the country's competitiveness in the world economy.

Prime Minister Chan-o-cha observed a few warning signs that the Thai EEE industry was experiencing major challenges. A number of foreign firms had relocated their production to neighboring countries with lower labor costs in response to Thailand's recent announcement of the new higher minimum daily wage. Also, the amount of FDI in the EEE sector had been decreasing during the past few years. The share of export revenues of EEE products, although still large, had shown a downward trend over recent years. Several important issues had also been reported, including a shortage of high-skilled workers and scientists, a lack of local suppliers for high-tech parts, insufficient and unsophisticated local demand, unaligned incentives and goals between the public and private sectors, and the lack of enforcement of agreed-upon technology transfers from foreign firms.

A formal meeting with the National Reform Council had been scheduled exactly one week from now and Prime Minister Chan-o-cha needed not only to investigate the problems related to Thailand's EEE cluster but to examine the current development status of the EEE cluster in Vietnam and China, the prime competitors of Thailand in this cluster. Prime Minister Chan-o-cha pondered how he should respond to these challenges facing the key cluster of the country, and in which direction should Thailand be geared towards in order to regain and sustain its competitiveness. Clearly, he had to come up with an economic reformation plan that would secure a promising future for the nation.

I. Teaching/Learning Objectives

The learning objectives of the case are as follows:

- Understand the EEE industry in Thailand
- Understand the interplay between the cluster and the competitiveness of Thailand
- Investigate important issues and challenges facing Thailand's EEE cluster
- Develop ideas on how to make a cluster sustainable and how to leverage the cluster's strengths to enhance a nation's competitiveness

After finishing the case discussion, students will be able to:

- **Understand**
    - The process of the EEE cluster development
    - The issues and challenges related to the EEE cluster
    - The importance of the EEE cluster to the competitiveness of Thailand
- **Develop**
    - Problem solving and decision making skills regarding the cluster policies
    - Decisions about issues related to the EEE cluster
- **Explain**
    - The value of the EEE cluster for Thailand's competitiveness
    - The relationship between cluster and competitiveness
    - How the EEE cluster can be utilized by the nation to gain competitive advantages

II. Potential Courses

This case is intended to be used primarily in courses on Microeconomics of Competitiveness. However, depending on the specific case issues that an instructor might wish to emphasize, the case may also be fruitfully used in courses in Economics, Policy Development, Management, Strategy as well as other related courses focusing on cluster development and competitiveness.

Target Audience

This case is intended for use in the above-mentioned courses at the graduate level. It may also be used effectively in short-term Executive and Leadership Development programs.

Topics Covered in the Case

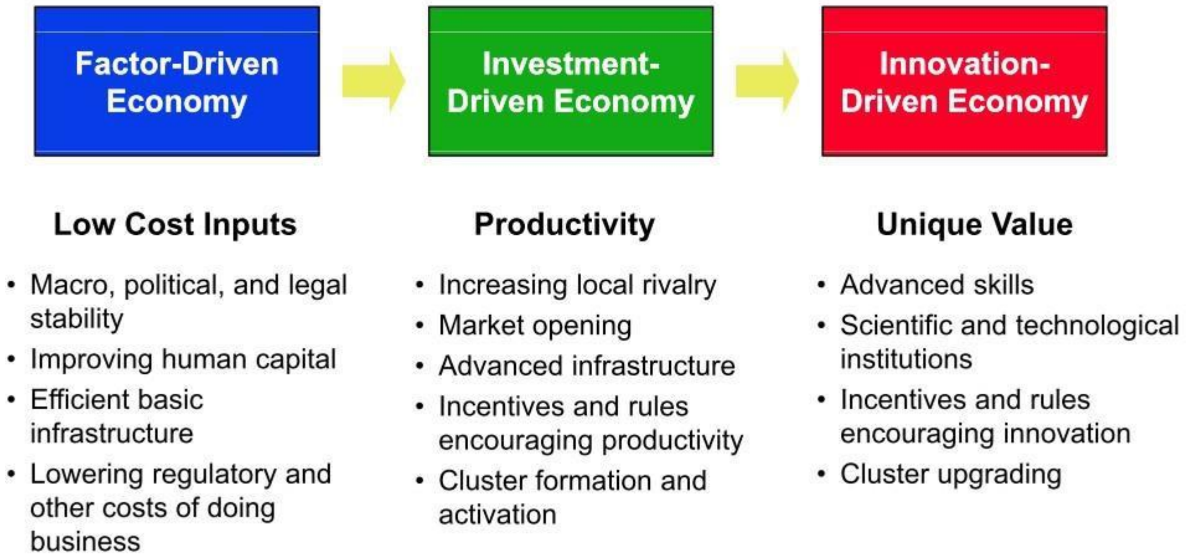
The following topics are discussed in or raised by the case:

- EEE industry
- Cluster and competitiveness
- Macroeconomic, Microeconomic, and cluster policies
- Issues and challenges facing the Thai EEE cluster
- Resolution to the challenges and guidelines to enhance the nation's competitiveness

III. Conceptual Analysis

1. Competitiveness

Professor Michael E. Porter of the Harvard Business School defined competitiveness as *the productivity with which a nation utilizes its human, capital, and natural resources.* Productivity allows a nation to set standards of living (including wages, return on capital, and returns on natural resources) [1]. Porter states that competitiveness does not depend on the particular industries in which a nation competes but on how it competes in those industries. Porter also posits that productivity in a nation is derived from the combination of domestic and foreign firms. A nation competes to provide "the most productive environment for business."



Stages of National Competitive Development

According to Porter, there are three stages of competitive development for a nation, with different nations having different conditions for competitiveness.

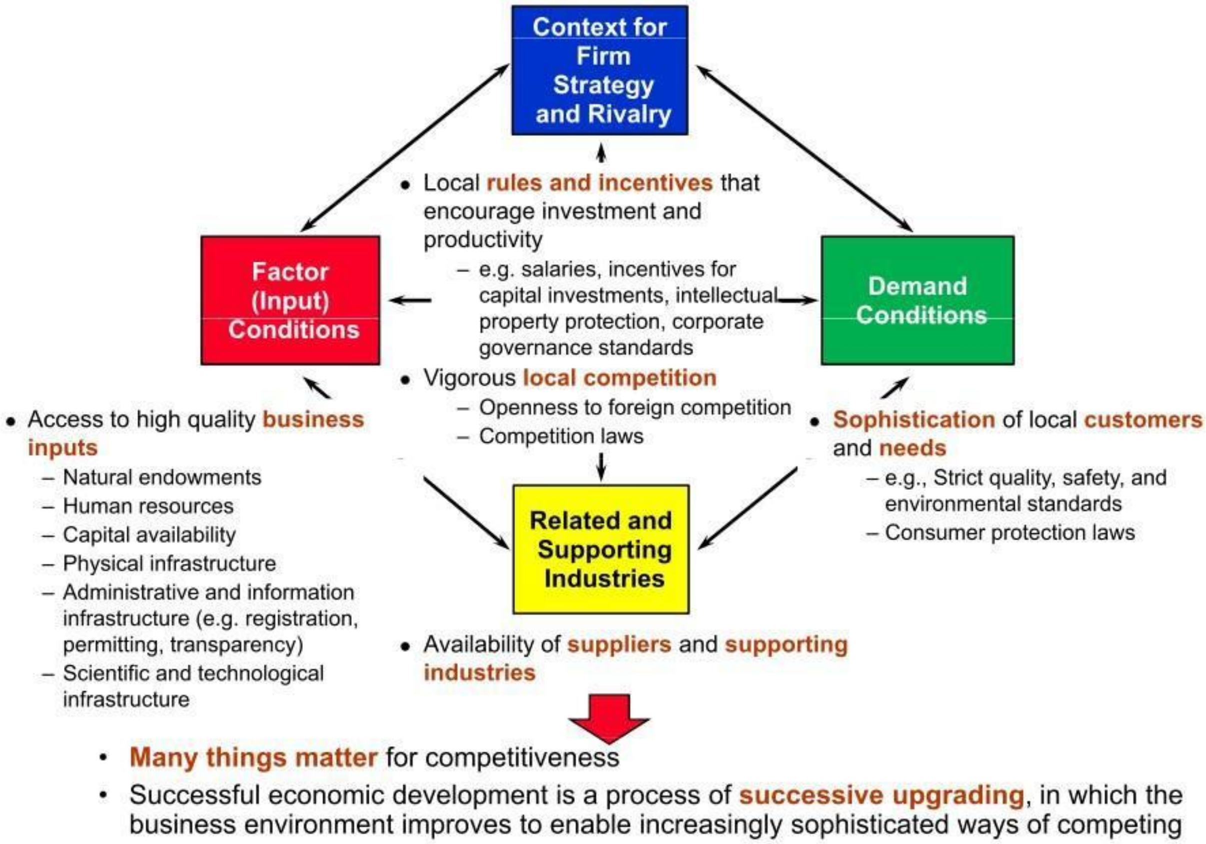
A. *Factor-Driven Economy* — Countries in this category compete based on low-cost inputs. The main objectives to enhance competitiveness are to create political and legal stability, improve human capital, create efficient basic infrastructure, and lower regulatory and other costs of doing business. The countries in this category are under-developed countries.

B. *Investment-Driven Economy* — Countries in this category compete based on creating a good business environment for investment. The main objectives to enhance competitiveness are increasing local rivalry, opening the market, creating advanced infrastructure, and creating cluster formation and activation. The countries in this category are developing countries. Thailand would fall into this category.

C. *Innovation-Driven Economy* — Countries in this category compete based on innovation. The main objectives to enhance competitiveness are creating advanced skills, creating scientific and technological institutions, and upgrading the cluster. The countries in this category are developed countries. These countries normally have world-class companies. Porter notes that a lot of countries in an investment-driven economy cannot upgrade their economies to an innovation driven economy because they cannot develop innovations of their own.

2. Understanding the "Diamond Model"

The Diamond Model is a model developed by Michael Porter in his book, the Competitive Advantage of Nations, in which he published the theory explaining why particular nations and industries become competitive in particular locations [2].



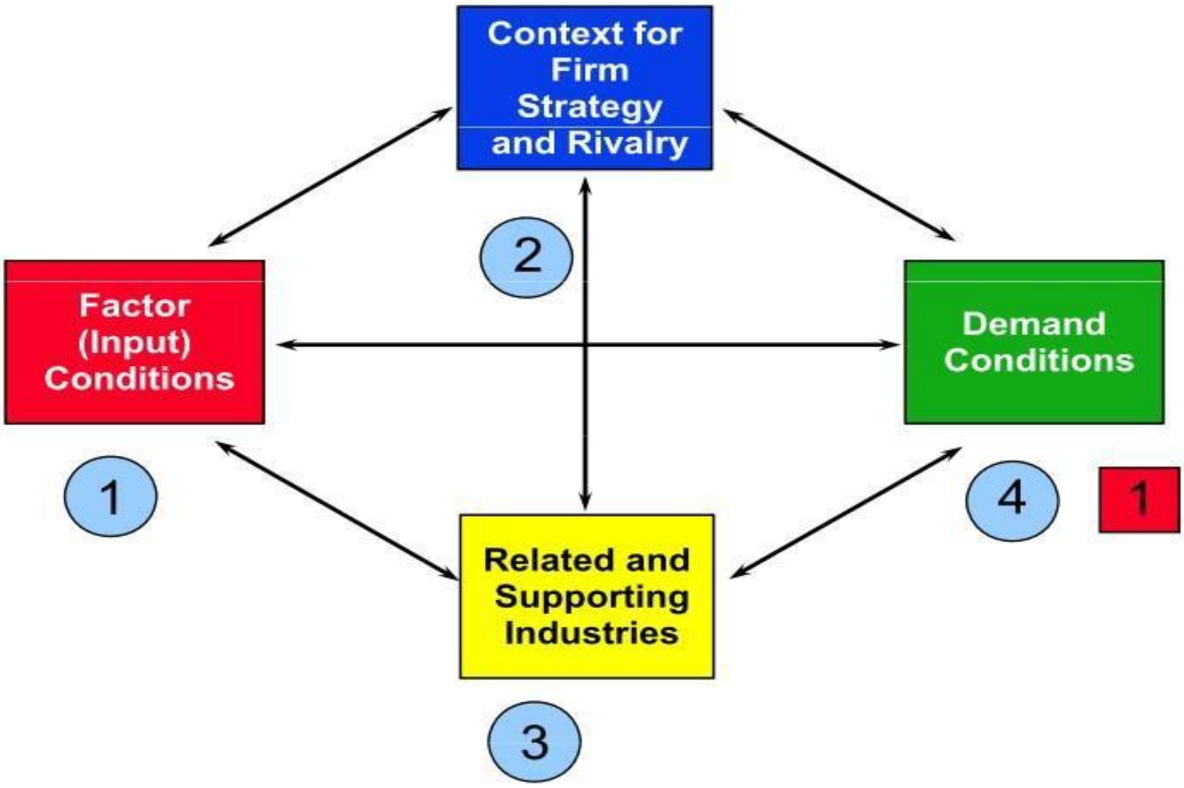
The Diamond Model is used to examine the four factors held to comprise the business environment: (i) Factor Conditions, (ii) Context for Firm Strategy and Rivalry, (iii) Related and Supporting Industries, and (iv) Demand Conditions. The Model is not used to analyze a single firm; rather, it is used to analyze the industry, the cluster, or the nation. Four factors need to be investigated to identify how competitive the industry or nation is.

A. *Factor Conditions* are specialized resources specific for an industry or a nation that are important for its competitiveness. Factor Conditions normally include human resources, capital resources, physical infrastructure, information technology infrastructure, scientific and technological infrastructure, and national resources. Sometimes, a nation does not inherit, but instead creates, the factor conditions such human skills, science, technology, and innovations. When nations and firms face a disadvantage, such as high land costs, labor shortage, or lack of natural resources, they *must* innovate and upgrade in order to be competitive.

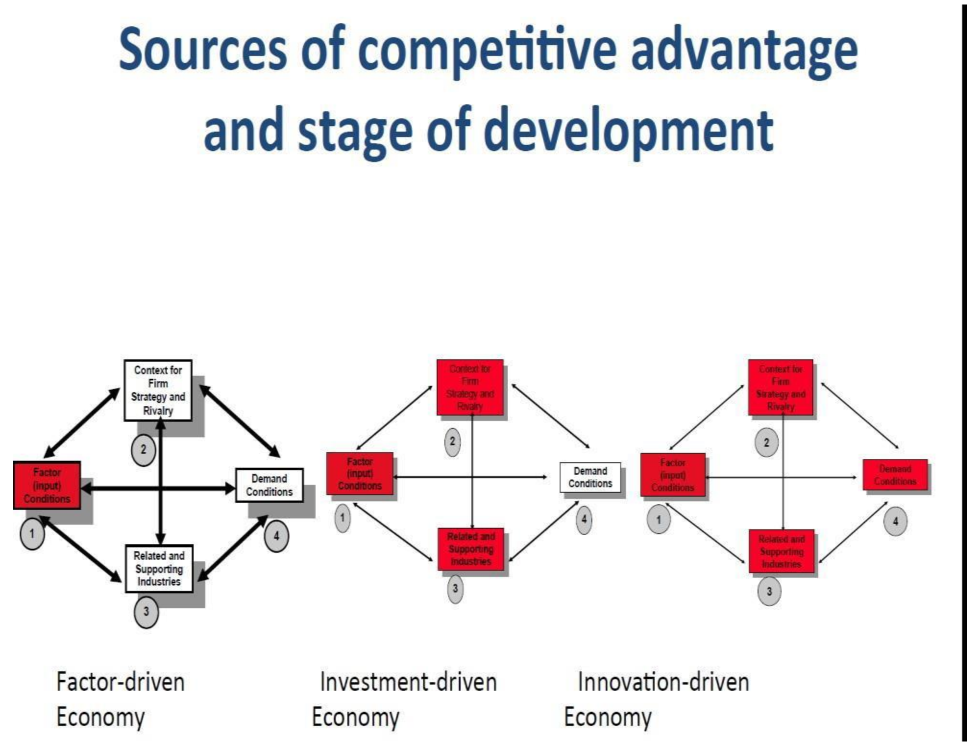
B. *Context for Firm Strategy and Rivalry* includes the business environment in the location. A good context for firm strategy and rivalry includes strong competition among locally-based competitors, openness to trade and investment, free trade agreements, and local context and rules that encourage investment and sustained upgrading (intellectual property protection and anti- corruption laws).

C. *Related and Supporting Industries* provide the access to capable, locally- based suppliers, firms, and institutions in related fields such as energy providers, communication providers, transport services providers, universities, R&D institutions, specialized institutions, institutes for collaboration, etc. The collaboration of these institutions and firms forms a "cluster." A cluster is a group of related companies, public sector entities, and other related institutions with the objective of improving the competitiveness of a group in a specific geographic region.

D. *Demand Conditions* concern the demand for products and services that firms produce in the home market. A strong demand can create pressure to meet high standards, pressure to improve and to innovate, and pressure to respond to tough challenges. In other words firms, industries, and nations can gain a competitive advantage where home demand can provide clear feedback or an earlier picture of customer needs.



For the process of competitiveness development, Porter posits that not all factors are equal, depending on the business environment. In general, if the country, industry, or clusters starts from nothing, he suggests that the first step is to develop Factor Conditions, followed by the Context for Firm Strategy and Rivalry, Related and Supporting Industries, and Demand Conditions.



The Diamond Model can be applied to the competitiveness development. For the factor driven economy, factor (input) conditions must be emphasized. For example, the countries need to develop good infrastructures and education systems. For the investment driven economy, the countries need to create a good context for strategy and rivalry. For example, the countries need to have a strong FDI policy. The laws and regulation, such as patent protection and anti-trust laws, need to be enforced. Also, the clusters normally emerge in the investment driven economy. For the innovation driven economy, the demand condition must be cultivated.

3. Cluster

Porter describes *"clusters"* as "geographical concentrations of interconnected companies, specialized suppliers, service providers, firms in related industries, and associated institutions (universities, standard agencies, trade associations, etc.) in particular fields that compete but also cooperate." A cluster can create productivity and increase efficiency because organizations and companies in the cluster can share resources and collaborate in the creation of innovations. According to Porter, the cluster enables the following:

- Business Attraction
- Export Promotion
- Market Information and Disclosure
- Education and Workforce Training
- Science and Technology Investments
- Standard Settings

IV. Discussion Questions and Analysis

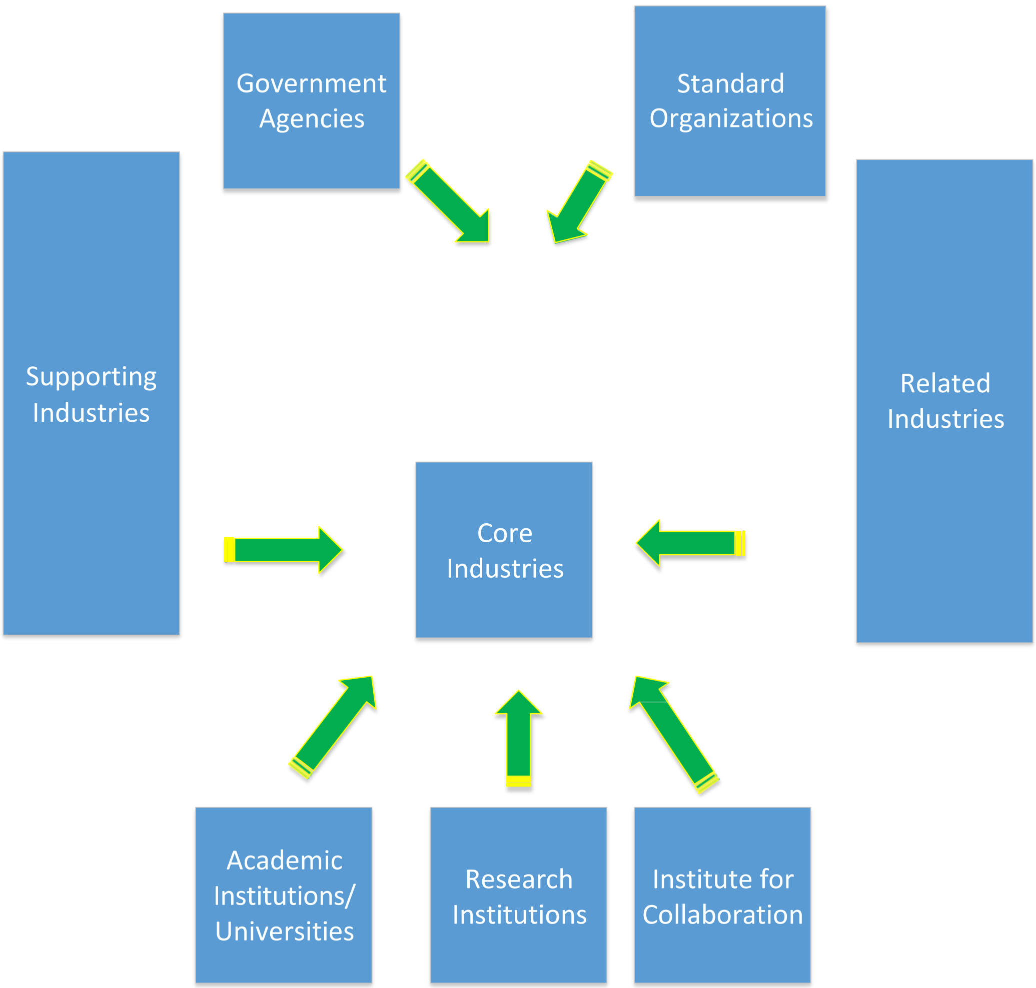
A. Discussion Questions

1. Please construct a cluster mapping of the Thai EEE industry. Identify the components and their interrelated functions.
2. How did the Thai EEE cluster perform? Please assess the success and challenge factors of the cluster.
3. How should Thailand have positioned its EEE cluster relative to competitor countries like Vietnam and China?
4. What should the Thai government have done to enhance the competitiveness of the country? For example, should the government have continued promoting the EEE industry, or should it have stepped back to look at a more traditional industry where it previously had competitiveness, like value-added agriculture?

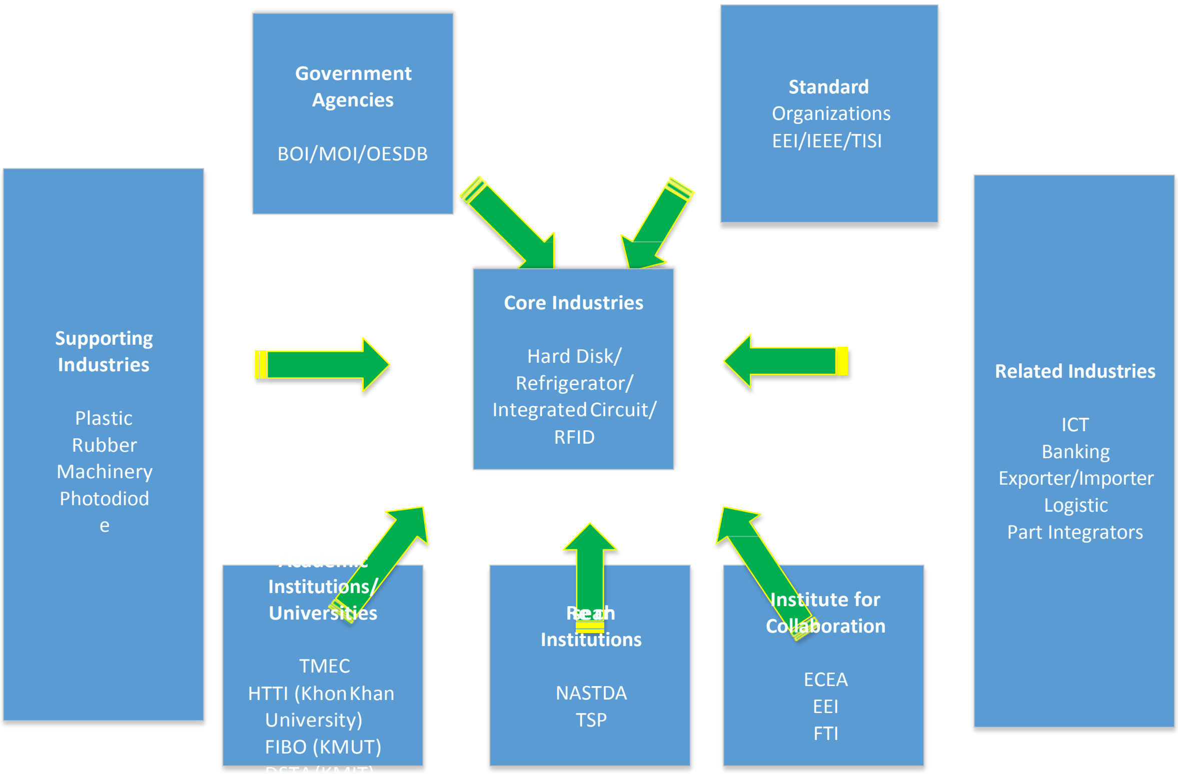
B. Analysis

Question 1: Cluster Mapping

Cluster mapping involves the process of identifying components in the cluster and how they are related to one another. This is the first step for cluster analysis. The cluster mapping can be described by the following figure:



There are eight components in the cluster: 1. Core Industries, 2. Supporting Industries, 3. Related Industries, 4. Academic/Training Institutions, 5. Standard Organizations, 6. Government Agencies, 7. Research Institutions, and 8. Institute for Collaboration. The figure below summarizes the cluster mapping for the Thai EEE cluster.



Core industries, which include the manufacturing of key EEE products, are supported, promoted, and influenced by many different factors, which could be categorized into one of the other seven components of the cluster mapping.

Question 2: Cluster Analysis (Diamond Model)

From Appendix 1 and Appendix 7, the EEE cluster in Thailand had been performing well in terms of FDI and export value. However, it started to perform poorly in recent years in terms of FDI and export share growth.

For a cluster to truly perform well, it should possess all four components in the Diamond Model. To evaluate the performance of the Thai EEE cluster, we will investigate whether the cluster has: i) all inputs – both labor and capital – necessary for the production of EEE products, ii) competitive environments, rules, and incentives that encourage investment and productivity of the EEE industry, iii) suppliers and supporting industries of the EEE industry located in the nearby location to the EEE manufacturers, and iv)sophisticated and sufficient local demand for EEE products. Below is provided a summary of the success and challenge factors of each component of the Thai EEE cluster.

i) Factor Conditions

Success Factors	Challenge Factors
• Abundant natural resources • Warm climate • Port facilities • International airports • Motorways • Basic infrastructure • Low-cost labor	• No advanced infrastructure and well-planned logistics system • Lack of high-skilled labor • Insufficient scientists and workers with professional/technical training • English deficiency • Insufficient R&D activities and collaboration with universities

ii) Firm Strategy, Structure, and Rivalry

Success Factors	Challenge Factors
• Pro-investment policies from BOI (tax and non-tax incentives) • Special packages for specific zones and activities (science, technology, and research) • Local competitions • Supporting organizations:	• No technology transfer enforcement • Insufficient incentives for R&D investments • Unstable political situation

iii) Related and Supporting Industries

Success Factors	Challenge Factors
• Investments from world-class EEE companies from many nations • Presence of local suppliers of low- to medium-tech parts	• Lack of local suppliers of high-tech parts • Small number of local R&D facilities • Less developed beginning-to-end supply chain • Lack of linkages within clusters

iv) Demand Conditions

Success Factors	Challenge Factors
• Large population among ASEAN countries • Large number of social media users	• Unsophisticated demand • Small domestic market

As can be seen from the cluster analysis above, the Thai EEE industry still lacked some components required for a successful cluster development. Most challenges facing the cluster originated from the low quality of education.

Question 3: Competitive Positioning

The identification of skill-based and innovative clusters is affected by the unique characteristics and properties. Products that require a high level of in-depth know-how were more likely be of interest and can be contributed to the global value chain. In this case study, there were opportunities for cluster development in both Vietnam and Yunnan for EEE industries. As presented in Table below, there were several aspects of the emergence of EEE clusters in Vietnam and Yunnan.

Vietnam (Strength)	Vietnam (Weakness)
- Strategic location - Excellent infrastructure in the industrial zone - Tax benefits - Low labor costs	- Lack of the collaboration among business - Low level of research and development activities - Lack of local integration due to the very high level of import activities such as raw materials, parts, and components - Lack of local integration due to the very high level of export activities of finished products - Lack of highly skilled labor - Lower trust due to the language and culture difference - Lack of regional integration - Lower cross-border activities - Lack of industrial zone management
Yunnan (Strength)	**Yunnan (Weakness)**
- Strategic location - Low labor costs - Science Park - Large domestic markets - Excellent infrastructure in the industrial zone - Large domestic industrial networks	- Lack of the collaboration among business - Low level of research and development activities - Lack of incentives to move toward international markets due to the very low level of export activities. - Lack of highly skilled labor

- Large domestic input supplies - Better industrial zone management	- Lower trust due to the language and culture difference - Lack of regional integration - Lower cross-border activities

In order to compete with other countries like Vietnam and Yunnan, it was important to capture all factors that drove the competitiveness of EEE industries. ***The first focus*** would be on how to promote the domestic production of EEE and to increase the export value added. The Prime Minister could set the priority on the quality of institutions that could support the EEE industries, increase the involvement of governments in infrastructure development and the quality of the workforce, and embark on investment and microeconomic policies to attract more EEE investors to increase the degree of competition.

Science Park was another critical supporting factor to the development of an innovative cluster. Many studies reported the success of Science Park in attracting clusters of innovative firms and promoting technological capability (Jongwanich, Kohpaiboon, & Yang, 2014). Science park was typically found in a cluster with high-tech industries and was often located near research institutes and universities (Jongwanich, et al., 2014). Science Park in the PRC acted as a catalyst to facilitate localized knowledge flow through the collaboration between the research institute and university. As a result, 80 percent of high-tech industry output in the PRC was produced by firms located in Science Park (Jongwanich, et al., 2014). Their study indicated the direct impact of Science Park on innovations. More precisely, the empirical results suggested that firms located in a science park produced the majority of patents (Jongwanich, et al., 2014). Thus, ***the second focus*** for the Prime minister should be to continue to provide support technically and financially for Science Parks in Thailand in order to increase the collaboration between high-tech companies, research institutes, and universities in the region.

Furthermore, the Prime Minister should promote regional economic integration among local and foreign firms to support both the local and global value chains and reduce the language and cultural barriers. More investment should also be made in the R&D activities, and communications and collaborations within and outside industrial zones among firms and institutions should be encouraged. Aside from government policies, a better quality of public services such as road, transportation, utilities, and information technology should also be provided.

Question 4: Enhancing Competitiveness

To enhance the competitiveness of the country, the Thai government should aim to improve the quality of education and promote the development of science and R&D activities in order to push the country from being investment-driven to becoming innovation-driven. Here are some policies to help direct and prepare the country to become more innovative.

- Allocate more resources to science and R&D facilities
- Impose stricter regulations on technology transfers
- Revive the education system to focus more on fundamental sciences, professional/technical degrees, and English

- Set clear and transparent key performance indices for evaluation of the effectiveness and benefits of collaboration between the private and public sector

As a practical matter, the government may select the EEE industry or value-added agriculture as its key competitiveness driver. Each option has pros and cons as summarized in the table below.

EEE CLUSTER

Pros	Cons
- EEE products are much more valuable, compared to agricultural products; hence, likely to generate more revenues, bring in more FDI, and bring more prosperity to Thai workforce. - Thailand had long been one of the world's largest production bases/exporters of several items such as HDD, refrigerators, and air-conditioners. It was well-known to the global market. - The global demand for EEE products was becoming more sophisticated, driving the manufacturers to strive to be more innovative. Hence, Thailand would be motivated to generate more innovations.	- Given the lacking status of Thai education, it might be difficult for Thailand to catch up other developed or developing countries in terms of labor skills in time. - The development of necessary labor skills and R&D facilities takes large private investments and/or government budgets. - Thai domestic market may not be large enough to attract suppliers and manufacturers of high-tech parts.

Value-added Agriculture

Pros	Cons
- Thailand was endowed with warm climate and abundant natural resources, giving it advantages to efficiently produce agricultural products. - Thailand had a long experience of having an agricultural-based economy. A large proportion of the Thai workforce had traditional and unique know-how that could be adapted to increase value. - The neighboring countries with the closest proximity to Thailand, e.g. Lao PDR, Myanmar, and Cambodia, also had strength in agriculture. These countries could work together to form a strong agricultural-based cluster.	- The value-added agriculture sector was more labor-intensive than the EEE sector, and the products were valued less. - Although value-added agriculture had started to employ technology, the innovation development in this sector was much slower than that in the EEE sector. If sticking with agriculture sector, it would be hard for Thailand to become innovative-driven. - The value-added agriculture sector was still largely dependent on climate and was prone to being significantly affected by natural disasters.

TEACHING PLAN

The instructor needs between two and three hours for class discussion. The time allocation can be separated into two sections: theory building and case discussion. If the students have a background in competitiveness concepts and theories such as cluster mapping and diamond model, the instructor can start with the case discussion. If the students do not have background about competitiveness concepts, the instructors may start with an introduction to theories and concepts related to competitiveness.

Expected Flow of Discussion & Key Issues to Raise at Specific Points

The class can start with the theories, then take up the case, or with the case followed by the theory. Our preference is to start with the case discussion, then conclude with how theories and concepts are linked with the information provided in the case. The instructor might use this approach if the students have enough background in the key concepts of clusters and competitiveness. If the students do have such backgrounds, the instructor might want to start with the introduction to industry competitiveness, cluster mapping, and the DiamondModel.

First, the instructor starts discussing the background of Thailand and the traditional sources of competitiveness of Thailand. Next, the instructor might pinpoint the problems of the floods, political situations, and rising cost of doing business that affected Thailand's competitiveness. To help students understand the business environment necessary for cluster development, the instructor might use the Diamond Model to analyze the business environment inThailand.

Time Estimate: 15-20 minutes

Then, the instructor leads the discussion of the EEE industry in Thailand. The instructor can start with the background of the Thai EEE industry. The instructor might ask students about what the past sources of the competitiveness of the EEE industry were and what problems or issues were affecting the competitiveness of the Thai EEE cluster during 2011-2015. The instructor might ask students to create or draw the Thai EEE's cluster map. The students need to identify components of the EEE cluster and the linkages among them.

Time Estimate: 40-50 minutes

Additionally, the instructor should compare the Thai EEE cluster with the EEE clusters of competing countries: Vietnam and China. The instructor might ask students to identify the differences and similarities between Thailand's EEE industry and EEE industries of neighboring and competing nations.

Time Estimate: 30-40 minutes

Next, the instructor can ask students to come up with a strategy and action plan to regain competitiveness in EEE cluster. The instructor might ask students to act out a role play representing the views from the businesses and government agencies.

Time Estimate: 20-30 minutes

Finally, the instructor can conclude the case discussion with the lessons learned from the EEE cluster development in Thailand. The instructor might explain the consequences of each option mentioned at the end of the case.

Time Estimate: 20-30 minutes

SUGGESTED ADVANCE READING ASSIGNMENTS

To make sure students have required knowledge related to competitiveness prior to the class discussion, the following reading list should be assigned along with the assignment of the case.

1. Porter, M.E., On competition, Updated and Expanded Edition The Harvard business review book series. **2008**, Boston, MA: Harvard Businesss School Publishing. vi, **576** p.
2. Porter, M.E., The competitive advantage of nations: with a new introduction. **1998**, New York: Free Press. xxxii, **855** p.
3. Jongwanich, J., Kohpaiboon, A., & Yang, C.-H. (**2014).** Science park, triple helix, and regional innovative capacity: province-level evidence from China. Journal of the Asia Pacific Economy, **19(2)**, **333-352.**

RESEARCH METHODOLOGY

The information used in this case was acquired through both primary and secondary resources, including in-depth interviews, surveys, news articles, and publicly available data from public and private organizations. The authors would like to thank Prof. Dr. Clifford E. Darden for his thoughtful and thorough feedback and comments.

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1. Porter, M.E., *On competition, Updated and Expanded Edition* The Harvard business review book series. 2008, Boston, MA: Harvard Businesss School Publishing. vi, 576 p.
2. Porter, M.E., *The competitive advantage of nations : with a new introduction*. 1998, New York: Free Press. xxxii, 855 p.
3. Jongwanich, J., Kohpaiboon, A., & Yang, C.-H. (2014). Science park, triple helix, and regional innovative capacity: province-level evidence from China. Journal of the Asia Pacific Economy, 19(2), 333-352.
4. Michael E. Porter’s 2012 MOC Session 1 presentation

ETHICAL ISSUES RELATED TO EARNINGS MANAGEMENT: AN INSTRUCTIONAL CASE

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Gary Taylor Culverhouse School of Accountancy University of Alabama

CASE DESCRIPTION

This instructional case explores the comparative ethical implications of accrual versus real earnings management. Primary issues include management's concern about how to meet analysts' annual earnings forecasts and its effects on future performance. Secondary issues include use of the COVER ethical decision-making model to help students address the difference between the two types of earnings management. In addition to gaining experience in ethical decision-making, students are introduced to implications of various stakeholders' concerns about short run versus long run performance. The case has a difficulty level of four and five to include senior level business courses as well as first year graduate students. The case is designed to be taught in three class hours and is expected to require six hours of outside preparation by students.

CASE SYNOPSIS

Apostolou et al (2015) identify a profile for instructional cases where "an actual or hypothetical set of information followed by a set of questions or activities" encourage students to understand complexities of a topic or topics (p. 70). We introduce students to an ethics toolkit providing them with a strategy they may apply when faced with an ethical dilemma. We begin by asking the students to research the similarities, differences, and ramifications of/between real and accrual earnings management. Then the students are asked to utilize the ethics toolkit to analyze an ethical dilemma involving real and accrual earnings management. It is important to note that while the toolkit is introduced and explained with respect to the earnings management dilemma, the skills reflected in the toolkit may be used in any number of ethical dilemmas.

INSTRUCTOR NOTES

Introduction

The purpose of this case is help students relate ethical decision making in general, and earnings management in particular, with accompanying validation analysis. The case begins by requiring the students to differentiate between accrual and real earnings management. We provide an annotated bibliography that will help point the students in the right direction. We then ask the students to identify the implications of accrual and real earnings management. Specifically, we are asking the student to understand that, while real earnings management may allow the firm to disclose favorable results of current period operations, real earnings management may have actual negative implications for future operations. We developed this case because we believe that in order to understand how earnings management is unethical, students must thoroughly understand what is meant by earnings management.

Our approach is consistent with the growing body of literature (McWilliams and Nahavandi, 2006) that promotes case analysis as a method for teaching ethics to business students (Sheehan and Schmidt 2015; Thorne et al., 1999; Winston, 2000). Case analysis has been found to engage students in a discussion of both simple and complex issues and real world dilemmas such that students draw upon a wide variety of cognitive skills and personal insights. (Maclagan, 2003).

We note several previous studies of instructional cases related to earnings management in the archival literature. For example, Neely and Tinkleman (2013) consider accounting treatment for a non-profit organization. Similarly, Ebrahim and colleagues (2010) describe opportunities for earnings management in a family-owned business. The case described by Stallworth and Braun (2007) is especially interesting since it draws upon the student's ability to understand the potential effect of the Sarbanes-Oxley Act of 2002. We contend that our case provides a new opportunity for student learning, as it incorporates both an accounting earnings management situation and a model for ethical decision making to assist students. We are unaware of any other published instructional cases that use this approach.

This case is most appropriate for an undergraduate senior-level or master's-level financial accounting theory course or an MBA user-oriented introductory financial accounting course**.**

Using the case with Master of Accountancy students rather than MBA students would allow the instructor to provide additional discussion of the procedural and technical components of the earnings management process, as well as a discussion of the practice implications of the academic archival research literature on earnings management.

The Case Description, Case Synopsis, and Instructor Notes should be removed before assigning this case to any student or a student group. We also provide in the Epilogue section detailed validation of the case.

Student Learning Objectives

The fundamental learning objective of this case is to provide students with an ethical decision making framework for addressing the issues of accrual and real earnings management. This fundamental learning objective may be decomposed into the following sub-objectives:

1. To provide the student with an understanding of the definition and examples of accrual earnings management. The students learn this material through their reading the material provided in the annotated bibliography and by providing responses to the relevant case questions.
2. To provide the student with an understanding of the definition and examples of real earnings management. The students learn this material through their reading the material provided in the annotated bibliography and by providing responses to the relevant case questions.
3. To provide the student with an understanding of ethical decision making related to earnings management. The students learn this material through their reading and understanding the COVER model described in the case materials provided to them and applying the COVER model to the scenario presented in the case in responding to the relevant case questions and through participation in class discussion of the case.

THE CASE

Over view

Bernie Madoff, in describing how a client's secretary became involved in an embezzlement scheme, said "Well, you know what happens is, it starts out with taking a little bit, maybe a few hundred, a few thousand. You get comfortable with that, and before you know it, it snowballs into something big." (Gino, Ordonez, and Welsh 2014). C. S. Lewis may have said it best with "Indeed the safest road to Hell is the gradual one – the gentle slope, soft underfoot, without sudden turning, without milestones, without signposts" (Thinkexist.com). Welsh, Ordonez, Snyder, and Christian (2015) find that unethical behavior tends to grow over time in conjunction with the increase in magnitude of the unethical act. For accountants, earnings management may represent the slipperiest slope of accounting ethics.

There are numerous instances where accountants are forced to make reporting decisions where there is no bright line right or wrong decision. Both Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) require accountants and auditors to use their judgment in making the appropriate financial reporting decision. Many accounting professionals would contend that a significant amount of earnings management, while not fraud, is unethical. While the reported financial results may fall into the category of acceptable principles and standards under both GAAP and IFRS, they result in a misleading picture of the firm's financial status. These actions may be taken to increase management compensation or mislead the firm's stakeholders. Consider the idea that accountants and auditors should hold themselves to a higher standard than "it is acceptable within GAAP (IFRS)" and ask whether the reported financial disclosures fairly portray the financial activities and status of the firm.

This is a fictional case that focuses on management's concerns about meeting analysts' annual earnings forecasts. Rich Dailey is the President and Chief Executive Officer

(CEO), and Joe Jones is the Chief Financial Officer (CFO) of Devon, Inc. This case begins by asking you to investigate and understand the differences between accrual and real earnings management. Throughout the discussion, you are asked to consider the ethical issues involved in accrual and real earnings management using tools designed to help you recognize and prevent ethical lapses in organizational decision-making.

At the end of the case, you are asked to answer nine questions about the case from both an accounting and business ethics perspective. Note that several articles are recommended in the accompanying reference list, and reading and including them in your answers is part of the assignment. Note, while we provide the COVER (Mitchell and Yordy, 2010) ethical decision making model, this model is only one of many similar frameworks for this purpose. While we provide guidance to work through this specific decision, other approaches are available that help guide you through a variety of ethical dilemmas.

The Case Scenario

"Joe, I need to talk to you right now about our earnings projections for this quarter," said Rich Dailey, President and CEO of Devon, Inc., a publicly-held pharmaceutical company whose shares are traded on the New York Stock Exchange at $50.30 per share at the current time. Analysts' forecasts of earnings per share are $3.00, $3.35, $3.75, and $4.20 for each of the next four years. Analysts note that a significant portion of the growth is attributable to Devon, Inc.'s reinvestment of its earnings into the firm's advertising, and research and development departments. Devon, Inc. has a proud history of turning research and development projects into marketable and profitable products.

Rich was speaking to Joe Jones, the CFO of the firm. "What do you have in mind, Rich?" asked Joe.

"I have just reviewed our internal projections for next year's earnings per share. Based on our analysis, it appears that we will fall a penny short in next year's earnings per share. Our current projections are that next year's earnings per share will be $2.99. I am very concerned that this year's earnings will fall short of the analysts' forecast, and you know what happens to our stock price when we miss the forecast even by just a penny—it takes a nose dive. As a result, I am proposing an approach to assuring we meet the forecast without our independent auditors calling us to task."

"Rich, you know that you are asking me to engage in earnings manipulation, and you know that it goes against my moral fiber to be associated with such inappropriate behavior!"

"Joe, listen, I am not asking you to engage in earnings manipulation. All those firms that got in trouble with the SEC were manipulating their accruals, and I agree that such behavior is wrong. However, there is a substantive difference between earnings manipulation and earnings management. What I am proposing is that we cut back on discretionary expenditures like R&D and advertising for the rest of the year since those items are a direct reduction of the bottom line. I am not taking this action lightly. In order to determine whether or not this would be considered fraud, I spent the weekend reviewing the International Standards for the Professional Practice of Internal Auditing (ISPPIA). The ISPPIA specifically defines fraud as, and I quote, as "Any illegal act characterized by deceit, concealment, or violation of trust." Here is the website for you to check yourselfhere:https://na.theiia.org/standards-guidance/mandatoryguidance/Pages/Standards.aspx. Based on the ISPPIA, I think fraud relates to theft of assets, performing illegal acts such as paying bribes or engaging in insider trading, or intentionally misrepresenting the financial data. I do not believe that this falls into any of those categories. In fact, we are being very honest and transparent with what we are doing. We will factually report the reduction of R&D and advertising expense on the income statement."

"But Rich," exclaimed Joe, "cutting back on R&D and advertising will hurt the bottom line in future years—don't you realize that?"

"Joe, my concern is this quarter, not future years. I don't want a precipitous decline in our stock price, and remember that my annual bonus is tied directly to the annual earnings number, and I have hungry mouths at home to feed! Determine how much R&D and advertising must be reduced in order for us to meet analysts' forecasts of $3.00 a share."

"But Rich, what you are proposing will reduce the firm's future cash flows. Our investors are trusting us to do what is in the long term best interests of the company. I cannot in good conscience do something that will affect the long term prospects of this company."

"Joe, I beg to differ. I think our investors only care about the immediate effect on the stock price. We both know that the stock will get hammered if we do not at least meet the earnings forecasts. I believe our shareholders would prefer that we avoid the immediate negative stock price reaction from missing analysts' forecasts even though we may be reducing future investment opportunities and growth prospects. Joe, in other words we are exchanging a short term negative market reaction with a reduction in long term market performance."

"But Rich, what are the ethical ramifications for maximizing the short term market price by reducing the future growth prospects of the company!"

The Case Assignment Continued

Part 3: Preparing Your Written Assignment

You are asked to contemplate and analyze this case by writing detailed and insightful answers to the following questions.

1. Refer to the attached reference list and define earnings management.
2. Refer to the attached reference list and define accruals earnings management and accrual management.
3. Refer to the attached reference list and define real earnings management.
4. What is the difference between accruals management and real earnings management? Is either ethical or unethical? What is the difference between earnings management and earnings manipulation? How might real earnings management affect the future profitability of the firm? Why?

5. What are the facts, issues, alternatives and stakeholders related to the ethical dilemma in this scenario? Is real earnings management unethical if it is potentially detrimental to the firm's longer-term profitability?
6. Given the relationship between meeting analysts' forecasts and stock price, identify potential misalignment of incentives between management and shareholders.
7. Does your answer to question 5 change if upper management is not expected to retire for another twenty years versus a scenario where upper management is expected to retire within the next twelve months?
8. In a publicly traded company, management works for the firm's shareholders. However, shareholders have both long and short-term investment horizons. Should management actively manage operations and/or earnings to the detriment of one group (e.g. short term) but to the benefit of the other group (e.g. long term)?
9. Your investment portfolio contains only Devon Inc. stock. Under what scenarios might you prefer Devon's management to reduce advertising and research and development expenses versus maintaining or increasing their investments in advertising and research and development?
10. A debate exists about how much of management's bonuses should be tied to accounting earnings versus the equity value of the firm. Based on your insights from this case, identify the pros and cons of accounting and equity based bonus plans.

PART 4: GRADING

Evaluation of your assignment will be based on guidelines discussed in class. Participation in this assignment is part of your class participation grade as well as a graded written assignment. Be sure to provide detailed answers to the questions above. Also be sure to use the American Psychological Association reference style manual when including citations.

EPILOGUE

Case Administration Overview

Consistent with the guidance of Apostolou and colleagues (2015) concerning empirical evidence of case effectiveness, we tested the case during the fall 2015 semester to 57 Master of Accountancy students and 55 Master of Business Administration students at a major state university. The case and questions were distributed to the students a week in advance. Students were not required to turn in written responses to the case questions, though such an approach could be taken if the instructor so desired. For our purposes, the students were required to participate in the in-class discussion of the case, which affected their participation grade, which was a substantive component of their final course grade. The class discussion was very lively, and a substantial number of the students volunteered to participate at least once in the discussion. After the discussion, each student was asked to complete the validation survey appearing below.

The Validation Results

Our validation survey as shown in Table 1 below provided an opportunity for students to describe their learning experience.

Table 1
THE VALIDATION SURVEY

Upon completion of the case please complete the following anonymous survey.

Please check one column for each question	1	2	3	4
PRIOR TO COMPLETING THIS CASE:				
1.How knowledgeable were you about real earnings management?				
2.How knowledgeable were you about accruals earnings management?				
3.How knowledgeable were you about financial statement analysis?				
4.How knowledgeable were you about the use of ethical models in decision making?				

Let:

1 = Extremely knowledgeable or strongly agree.
2 = Knowledgeable or agree.
3 = Somewhat knowledgeable or somewhat agree.
4 = Neither agree nor disagree.

Table 2
MEANS RESPONSE FOR THE EIGHT VALIDATION SURVEY QUESTIONS

Please check one column for each question	1	2	3	4	5	6	7
UPON COMPLETION OF THE CASE:							
1. I learned additional information about real earnings management by completing this case.							
2. I learned additional information about accrual earnings management by completing this case.							
3. I learned additional information about financial statement analysis by completing this case.							
4. I learned additional information about ethical decision making by completing this course.							

Let:

1 = Strongly agree.
2 = Agree.
3 = Somewhat agree.
4 = Neither agree nor disagree.
5 = Somewhat disagree.
6 = Disagree.
7 = Strongly disagree.

We provided this case to 57 Master of Accountancy Students (MACC) and 55 Master of Business Administration (MBA) students at a large state university. We analyzed the data using Excel software and compared the means of the MACC and MBA students with a two-tailed t-test with unequal variances. The lower the score, the better the student rated his/her learning from the case. Questions one through four had a four-point scale, while questions five through eight had a seven-point scale.

Table 3
RESULTS OF ONE SAMPLE T-TEST OF MEANS ON POST CASE VALIDATION SURVEY QUESTIONS

The mean score for each question are contained in the MACC and MBA columns while the t statistic (p-value) associated with a two- tailed t-test with unequal variances is contained in the TEST column.	**MACC**	**MBA**	**TEST**
PRIOR TO COMPLETING THIS CASE:	N=57	N=55	
1. How knowledgeable were you about real earnings management?	3.11	2.75	2.36 (0.02)
2. How knowledgeable were you about accruals earnings management?	2.95	2.55	2.56 (0.01)
3. How knowledgeable were you about financial statement analysis?	2.37	2.11	2.11 (0.04)
4. How knowledgeable were you about the use of ethical models in decision making?	2.37	2.2	1.08 (0.28)
UPON COMPLETION OF THE CASE:			
5. I learned additional information about real earnings management by completing this case.	1.94	1.90	0.22 (0.83)
6. I learned additional information about accrual earnings management by completing this case.	2.09	1.96	0.48 (0.63)
7. I learned additional information about financial statement analysis by completing this case.	2.56	2.54	0.14 (0.89)
8. I learned additional information about ethical decision making by completing this course.	2.40	2.07	1.33 (0.19)

Prior to beginning the case, the MBA students perceived that they were more knowledgeable about real and accrual earnings management, as well as financial statement analysis than the MACC students. There is not a statistically significant difference in the mean response with respect to their knowledge about ethical models in decision making prior to completing this case. Interestingly, upon completion of the case, both MACC and MBA students felt equally knowledgeable about real and accruals earnings management, financial statement analysis, and the use of ethical models in decision-making. In other words, the case appeared to provide sufficient learning objective attainments that, post-case, the MACC students felt as comfortable with these accounting topics as the MBA students.

We used a seven- point scale to measure the degree of learning associated with the completion of this case. If there had been no learning, the responses should not be a statistically significant difference from “4” (the median). We evaluated whether learning had been associated with this case with a one-sample t-test with unequal variances with an expected mean of four.

Post Case Validation Questions Questions 5-8	**MACC**	**t-test (p-value)**	**MBA**	**t-test (p-value)**
I learned additional information about real earnings management by completing this case.	1.94	9.51 (<0.001)	1.90	14.68 (<0.001)
I learned additional information about accrual earnings management by completing this case.	2.09	8.99 (<0.001)	1.96	14.34 (<0.001)
I learned additional information about financial statement analysis by completing this case.	2.56	7.66 (<0.001)	2.54	9.37 (<0.001)
I learned additional information about ethical decision making by completing this course.	2.40	7.42 (<0.001)	2.07	15.54 (<0.001)

The one-sample t-test scores indicate that the students believe that the case provided an improvement in their understanding of real and accruals earnings management, financial statement analysis, and the use of ethical models in decision-making. “Four” represents “Neither agreeing nor disagreeing with the statement,” and the means of all four post-case questions for both MACC and MBA students are significantly different from “4” (p-values < 0.001). These results provide substantive empirical support that the students believe that the case provided a contribution to their learning and understanding of these accounting and ethical issues.

Recommended Answers to the Case Questions

Student responses to the nine case discussion questions will vary, but we offer the following as guidance for instructors in terms of grading:

1. Earnings management refers to the legal and illegal use of accounting methods and techniques to achieve financial goals. These goals may include smoothing earnings increases or, as used in this case, meeting earnings benchmarks. Generally accepted accounted principles (GAAP) provide management with a wide menu of accounting choices to utilize when preparing financial statements. In addition, management is normally provided the opportunity to be an early adopter of new accounting principles. All of these are provided so that management may provide firm related information to the company’s stakeholders. Earnings management becomes fraud when management prepares financial statements that are not representative of the company’s economic activities.

2. Accrual management is the use of accounting accruals and estimates to present the economic activities of the company. Accruals are used to record earnings that have been earned and expenses that have been incurred for which the cash has not been received or paid. The use of accruals and deferrals are necessary to present accrual based financial statements.

   Accruals earnings management is the manipulation of accounting accruals in order to increase earnings in order to reach an earnings benchmark or to decrease in earnings in the current period in order to have higher earnings in the future (cookie cutter reserves). Accruals earnings management does not directly affect cash flows.

   An example of accounting accruals manipulation is the arbitrary decrease (increase) in the allowance for doubtful accounts in order to decrease (increase) the current period's bad debt expense that increases (decreases) current period net income. Arbitrarily increasing the allowance for bad debts creates an accrual reserve that the firm can lower in future periods in order to increase earnings in the future.

3. Real earnings management refers to management's operating choices that may increase or decrease current period earnings. Examples of operating decisions that may affect net income are (1) whether to hire additional employees to meet increased demand, (2) whether to invest in repair and maintenance, and (3) whether to increase research and development expense. Real earnings management has a direct effect on cash flows. It is very difficult to identify real earnings management, as it is problematic to determine whether the operating decisions were consistent with the operating goals of the company or performed to manage current period earnings.

4. Accruals earnings management refers to the manipulation of earnings via choices available within Generally Accepted Accounting Procedures (GAAP). This approach can range from manipulating accruals to the strategic implementation of new accounting standards. Accruals earnings management does not affect the operations of the company. Real earnings management refers to decisions that affect both net income and the operations of the firm. Real earnings management differs from accrual earnings management in that real earnings management has true economic consequences for the firm. For example, decreasing current period research and development expenses increases current period net income, but may decrease product innovations that decrease future period sales (net income).

   Student explanations will vary concerning whether accrual earnings management or real earnings management are ethical or unethical. With the COVER model, accruals earnings management uses choices available in GAAP, and thus it is not strictly a ***C***ode violation. Real earnings management may also meet accounting standards, but that it is intended to affect the operations of the firm should raise additional red flags concerning the outcomes of the decision, as well as the slippery slope it can create for future financial reporting. In both approaches, the overall consequence could be erosion of trust between shareholders and companies, and thus by definition they are unethical acts. Finding an accrual approach that meets GAAP does not change the intent to manipulate financial reporting.

Students may choose to identify two different sets of factors when discussing ethical decision making in this case. External factors include efforts to meet expectations of financial analysts with the rationalization that analysts tend to punish companies that miss earnings projections, even by a small amount. Internal factors refer to managerial incentives, including the bonus that is a concern of Rich the CEO. While external and internal factors can be used to rationalize earnings management decisions, it is expected that students will reach the conclusion that intentionally exploiting flexibility in financial reporting standards is an unethical act (Elias 2002).

5. Student answers will vary, but the instructor should expect that they will identify aspects of this situation that lend it to an ethical dilemma (highly competitive situation, unsupervised situation, lack of a formal policy on this action, that the executives could be rewarded for unethical behavior).

6. Management generally has a short-term investing horizon. Two reasons exist for this short- term time horizon. First, management's bonus is often a function of the increases in the firm stock price. Second, management is often granted stock options that become more valuable as the firm's stock price increases. The proportion of long term versus short-term investors that hold the firm's outstanding shares determines whether management has the same time horizon as other investors. Short-term investors are more likely to be interested in short term gains (incentives aligned with management). Long term investors are not interested in short term gains or losses, but rather prefer management to implement operating decisions that increase the long-term growth prospects of the firm.

   This scenario is the essence of an ethical dilemma in business, where managers must make judgments about what is right or wrong for the long term benefit of the firm. That does not preclude serving the interests of short-term investors. What is missing here, that students should be able to identity, is the lack of a corporate code of ethics or guidelines for this company that restrict opportunities for self-interest on the part of managers or other stakeholders. Companies with the highest ethical standards have codes that help managers work through the many complex conflicts concerning use of organizational resources and other financial decisions (Welker and Berardino 2013). If nothing else, the code should be a reminder of the pitfalls associated with making shareholders or investors, whether long-term or short-term oriented, the primary stakeholders, even to the detriment of all other stakeholders. Thus, students should be able to identify that ethical decision-making is facilitated when the company's moral base, or set of criteria for right and wrong, is well-established and widely communicated. That way management's tendencies toward a short-term investing horizon can be tempered when long term investors are considered important stakeholders in business decisions. To the extent that there is no breach of trust and there is full transparency in managerial decisions, then management can be responsible to both current and future shareholders.

7. It depends on the management's compensation schemes, but in general, the longer management's anticipated retirement, the more likely management's incentives are aligned with long-term investors.

Much has been written about the role of temporal immediacy of an issue in ethical decision- making. In general, moral issues with a shorter length of time between the managerial decision and the onset of consequences raise the intensity of the issue in the minds of stakeholders (Jones 1991). Thus in this case, having a management decision by a near term retiree should raise more concerns about misalignment of incentives between management and investors than a management decision by a longer-term perspective retiree.

8. Emphasizing the differences between those who may have a long versus short-term perspective will increase student participation. Those with a long-term perspective include but are not limited to those investors practicing a buy and hold strategy, employees not participating in an accounting or market based bonus plan, state and local governments relying on the jobs provided by and any tax revenue from the company. Those with a short-term perspective might include market participants who regularly trade stocks and employees who are part of an accounting or market based bonus plan. This is an excellent opportunity to remind the students about the long-term consequences of real earnings management, emphasizing that reducing research and development or advertising expenditures may allow a firm to meet current period earnings forecasts but may reduce the underlying intrinsic value of the firm. At this point, the primary discussion point is that those with a long-term perspective are not necessarily concerned with violent movements in stock price that are related to missing earnings forecasts.

   At this point, the instructor has the opportunity to introduce "operations management fraud" and discuss its effects on long and short-term stakeholders and customers. To facilitate this discussion, we focused on the fraud occurring in the supplement industry. Having the students read the articles at the following websites provides an opportunity to discuss how ratio analysis may be helpful in determining if the company is substituting cheaper/dangerous products into the supplements.

   http://www.usatoday.com/topic/a6a2541c-0b71-46bf-81a5-c3d21ba55b2d/supplement-shell- game/

   http://www.usatoday.com/story/news/2015/10/22/oregon-lawsuit-gnc-supplements/74344318/

   With respect to ethics, student answers will vary, but the instructor should expect them to identify that this is an invitation to engage in individual moral rationalization (Johnson et al. 2012). Moral rationalizations to commit unethical acts can include: appealing to a higher purpose; blaming others; diffusion of responsibility; advantageous comparison; distorting the consequences or minimizing the potential harm; and euphemistic labeling.

9. Again, student answers will vary, but they should be expected to explore the dilemma of motivating executives to make value-maximizing decision through compensation packages, including bonuses, while creating a situation where executives are also motivated to make self-serving decisions to enhance their compensation (Craft 2013, Dunham and Washer 2012).

The role of accounting earnings in determining executive compensation may produce some reference to stakeholder theory or the notion that businesses are more than about making money and have other stakeholders than their investors and executives (Orts and Strudler 2002). Stakeholder theory suggests that firms should consider the views of all stakeholders, not just the shareholders. Additional stakeholders include groups as diverse as employees, governmental entities, and lenders. Stakeholder theory suggests that firms should take the interests of all stakeholders into account when making business decisions. While outside the scope of this case, the faculty member may want to use this as an opportunity to introduce corporate social responsibility. Stakeholder theory is often utilized in corporate social responsibility. At this time, the instructor may want to discuss the incentives of varying stakeholders and the delicate balancing act that firms who engage in corporate social responsibility must perform.

However, more recently, management theorists have come to terms with the idea that suggesting that businesses are more than their profits is not enough to satisfy societal expectations. Thus, simply encouraging students to think about balancing the interests of stakeholders does not adequately address the many ethical dilemmas and stakeholder conflicts they will face as business professionals.

For that reason, it is expected that following exploration of this case, students will demonstrate that they are developing greater self-awareness of their moral responsibility in the workplace, and perhaps potential personal challenges and limitations, with the further recognition that not all aspects of business can be sufficiently regulated to avoid harmful acts and schemes (Welker and Berardina 2013). To that end we suggest using a rubric to assist in assessment of the level of students' cognitive moral development (Kohlberg 1981) as well as their recognition of role of often changing social influences on ethical decision-making (Baker 2014).

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INSTRUCTORS' NOTES
DETOURS TOURING: FIGHTING CITY HALL

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CASE DESCRIPTION

The primary subject matter of the DeTours Touring case concerns entrepreneurial decision-making and negotiation. Secondary issues examined include governmental regulation, resource constraints, the competitive environment, and the business startup process and challenges. The case has a difficulty level of three and above, as it has been taught in junior/senior level and MBA classes. This negotiation works with classes ranging from 12 to 60. As a fishbowl exercise, a class size of under 20 is best. As a one-on-one exercise, larger class sizes also work well. The case is designed to be taught in one to one and one-half class hours It works best in a class of at least 75 minutes. Allow15 minutes for the precis, initial discussion and introduction. There should be 15 to 30 minutes for negotiation and an additional 30 to 45 minutes for post-exercise discussion and debriefing. The case is expected to require approximately one hour of outside preparation by students.

CASE SYNOPSIS

The founder of DeTours Touring LLC, Rasa Vella, was on the verge of launching her new venture when the process was brought to a sudden stop. She was a young entrepreneur with a graduate degree in sport and tourism management from Temple University and related past experiences from around the world, including working in eco-tourism in the Amazon rainforest. From the inception of her business idea in September 2009 to the end of the case in June 2010, she succeeded in assembling all but one of the resources needed to launch a guided touring company in the Old City district of Philadelphia. Her concept was based on active outdoor pursuits, such as gliding on Segways, biking, and running. The missing piece was a permit from the Fairmount Park Commission (FPC), which controlled activities in and around 63 neighborhood and regional parks in Philadelphia. Under a week before the scheduled launch date, the previously unresponsive FPC demanded $5,600 for a permit to operate in the Park Commission's jurisdiction. Vella was faced with the choice of paying from her operating reserves, seeking additional funds, negotiating with the FPC, or delaying the launch of her business to change her routes.

LEARNING OBJECTIVES

- To formulate the best alternative to a negotiated agreement (BATNA) in an unstructured situation.
- To determine that less powerful parties can obtain leverage over more powerful parties.
- To assess the role of third parties in improving negotiation leverage.

TEACHING STRATEGY

The case is particularly well-suited to instructors using Shell's (2006) book *Bargaining for Advantage,* because of its emphasis on improving leverage in negotiation. The case would work best in the middle of such a course between Part I: The Six Foundations of Effective Negotiating and Part II: The Negotiation Process. The case can also be used with Lewicki et al's (2009) well-known *Negotiation* text; being particularly well suited to Chapter 18 on managing negotiation mismatches. Or, for a single session undergraduate course, assignment of an article regarding negotiation including the topics in the objectives would be beneficial.

The DeTours Touring case works well as a fishbowl or role-playing exercise with a discussion to assess the need for negotiation in light of the options available to Vella. In the fishbowl approach, a pair of students negotiates while the rest of the class observes them and then discusses the process. In the role-playing approach, students are paired up and each pair negotiates the case with one student playing Vella from DeTours and the other playing a representative from the Fairmount Park Commission.

All participants should have read the case before participating in the exercise. Each DeTours player should be given a copy of the DeTours Role Information document. The instructor should also be prepared to distribute the Philadelphia Inquirer story to all parties if the DeTours player chooses to exercise the media option. Role-players should be encouraged to write their agreement down in a basic contract.

Ideally, there are separate negotiating areas for each role-playing pair. A common room for setting up the role-play, the fishbowl exercise, and for the debriefing discussion should be available. Flip charts, boards, or an (projected) electronic spreadsheet should be available for comparing contracts during the discussion period.

Operating Procedures

The case should be read before the class session with negotiation and discussion during class. Begin with a student delivered *precis* and a brief discussion of the options available to Vella. Generally, it is useful to have a 5 to 10-minute question period at the beginning of class to clarify facts or interpretations before negotiations begin. Students quickly realize that paying the fee is not a practical option nor is delaying opening to redesign the route and gain approval. The most efficient option is to avoid the high costs of overhead losses and a missed peak season.

Regardless of the choice between a fishbowl and one-on-one negotiation, a fixed time limit should be assigned for the negotiation (15 to 30 minutes), and the remainder of class should be used for comparison of settlements, evaluation of stalemates, and discussion of strategy. Clearly, the fishbowl process will create a single example of the negotiation and results, while the one-on-one will generate more robust options.

At the start of the negotiation, hand each DeTours player the Additional Role Information found. If a DeTours player chooses the option of going to the *Philadelphia Inquirer,* then pass the *Philadelphia Inquirer* story to all participants in the specific negotiation (including the observers in the fishbowl). In the one-on-one version, this will yield pairs that chose to use the press option and ones that did not.

Once participants have arrived at a settlement (or agreed not to settle), signed "contracts" should be submitted to the instructor or discussed in a general session.

Debriefing the Exercise

Instructors conduct these debriefing discussions in a number of different ways, but the suggestions below can be used to stimulate discussion. Then, the discussion questions can be introduced to ensure that learning objectives are met.

- Review the exercise, emphasizing the key facts in the case, and the key facts in the DeTours Player Role Information sheet (i.e. the option to go to the media).
- Review the strategies planned by each side.
- Compare actual settlements for some of the pairs in the game. If possible, actual settlements should be compared with the DeTours players' initial goals.
- Discuss the way that each group arrived at its settlement and the strategic factors in the negotiation, particularly the option to involve the press or not.

DISCUSSION QUESTIONS

1. What is the best alternative to a negotiated agreement (or BATNA) for DeTours and the Fairmount Park Commission?
2. Why might the FPC be the more powerful party in this negotiation?
3. How can a less powerful party obtain leverage over a more powerful one?
4. If you were Vella, how would you negotiate with the FPC?

THEORY DISCUSSION

The pedagogical method in negotiation classes involves learning by doing and social learning (learning through others). The role of the instructor is to act as a facilitator to draw attention to examples of effective negotiation. Nevertheless, theoretical principles should be used to guide the discussion.

The central issue in the case is the power imbalance between a small startup (DeTours) and a section of the city government, known as the Fairmount Park Commission. A power imbalance arises when there is little incentive for the more powerful party to negotiate. In this case, the FPC has little incentive to negotiate and can simply choose to not issue the permit if the payment is not received. Moreover, the FPC can point out that iGlide, DeTours' competitor, has already paid the fee. In Shell's (2006) bargaining model, the ability to draw on authoritative norms and standards is a powerful tactic.

Lewicki et al (2009) suggest that low power parties should first protect their interests by understanding and improving their BATNA and setting 'trigger points' in the negotiation to walk away from negotiation when an offer from the more powerful party gets close to the walkway point. The additional role information for the DeTours player asks for 'the highest fee you would pay' and students should recognize that this is an invitation to consider their BATNA or walkaway point.

It is fairly easy to demonstrate that paying the $5,600 fee is preferable to delaying the opening of the business once Vella's fixed costs are factored into the equation. Some students may argue that the route should be modified to avoid the park (and corresponding need for an FPC permit). The validity of this decision is more difficult to ascertain – how important is the proposed route for the success of the business? Is it important to have a route that mimics your competitor? How long will it take to change the routes, obtain Streets Department approval, and retrain guides (thus incurring further costs of delay)? Will these changes adversely affect revenue or demand?

The second strategy in unbalanced negotiations is to attempt to change the power imbalance. Lewicki et al (2009) suggest that a powerful party may give power to a weaker party (which is unlikely in this case), a third party might at as a mediator or arbitrator (also unlikely in this case), or a weaker party can seek to take power. Shell (2006) unambiguously recommends seeking ways to improve one's leverage with the other party, including seeking the help of third parties.

In this context, the option to involve the media can be viewed as the use of a third party to gain leverage in the negotiation. Students will likely differ in their opinion of how effective this tactic might be and whether this tactic could backfire. Other third parties are also mentioned in the case materials – could Councilman Green be used to influence the FPC? The news story itself mentions a number of DeTours supporters, such as lender Cooperative Business Assistance Corporation (CBAC) and the City's own Business Services Center. As the epilogue shows, the local Fox News affiliate also became a supporter after the *Philadelphia Inquirer* story. This allows the instructor to show how negotiation situations can evolve and how selecting negotiation tactics involves judgments about which reasonable people can disagree.

ANSWERS TO DISCUSSION QUESTIONS

1. What is the best alternative to a negotiated agreement (or BATNA) for DeTours and the Fairmount Park Commission?

DeTours

One clear alternative for DeTours was to simply to pay the full fee and open the business. According to Exhibit 4, the fixed monthly expenses of the business are $4,500. This was the minimum amount DeTours would lose each month by not opening the business. Vella would either have to use her precious cash reserves or request additional equity from her family members. This may not be the *best* alternative to a negotiated agreement.

Some students may argue that the route should have been dropped or modified to avoid the park thus eliminating the need for an FPC permit. DeTours only operated seven months per year so it had to generate an extra $800 in sales a month (or 11 rides @ $75) to pay for the permit. The attractiveness of not seeking a permit depends on one's judgment of the effects on demand. The company needed to generate 100 rides per month to break even without the permit costs. Would sticking to one route or creating a new route enable the company to generate at least 100 rides? One line of reasoning might be to look at the four million visitors to Philadelphia each year and the high occupancy of its hotels and argue that the 100-ride requirement would be easily exceeded. Others may counter that the demand is highly uncertain and that Vella should have stuck with her original intuition on the best route. In addition, changing the route would require a delay while Vella submitted a new proposal and got approval for it.

One of the objectives of the case is to provide students with experience in determining BATNAs in unstructured situations. Exactly which of the two options outlined above is the best alternative is not clear. The indeterminacy of this case is indicative of the real world where probabilities and payoffs are not readily determined. Students should be encouraged to make judgments about the best course of action and support their line of thinking with arguments based on the available evidence.

Fairmount Park Commission

The FPC may have felt there was a strong probability that Vella would pay the full amount if they refused to negotiate. If they assigned a 90% probability of the fee being paid without negotiation, then the BATNA was 0.90 x $5,600 = $5,040. There was also the problem that if they negotiated with one business owner then they may have encouraged other park users to negotiate for lower permit fees. Thus, the FPC may have been reluctant to grant any concessions at all.

Of course, this assumes that the FPC was a unitary entity that was attempting to maximize profit. In reality, there was also a human element to the decision. The decision maker in the FPC could easily have concluded that that it was not worth his or her time to enter into a negotiation even if the fee was not paid. The $5,600 permit fee was a tiny fraction of the park's $12.6 million operating budget and would probably not have been missed. Regardless of the reasoning, it was likely that the FPC had little incentive to negotiate.

2. Why might the FPC might be the more powerful party in this negotiation?

The FPC has power for a number of reasons. First, it has the legal authority to issue permits for activity in the park. Second, it has the rights and the resources to enforce its decisions through legal remedies, including criminal and civil actions. Finally, it has already negotiated a permit with DeTours' competitor, iGlide, providing it with a precedent in this area. The latter is an example of an appeal to a norm or authority that Shell (2006) sees as a powerful tool for gaining leverage.

3. How can a less powerful party obtain leverage over a more powerful one?

There are a number of ways that weaker parties can increase their bargaining power. The methods that seem most applicable to this situation include:

- Increasing leverage through norms and authorities (Shell, 2006)
- Improving leverage through third parties (Lewicki et al, 2009; Shell, 2006)

The case indicates that Vella only paid $40 for a permit from the Streets Department. Presenting this fact to the FPC would be an example of trying to gain leverage by pointing to a reasonable norm or standard. Another norm-setting ploy would be pointing to the fact that her tour would not consume any FPC resources (for security or sanitation). However, it is likely that the FPC would respond with the fact that iGlide was already paying the full fee to operate Segways in the park. A counter-argument might be that she intended to spend much less time in the park than iGlide. This would be an attempt to establish a new norm based on time utilization rather than a flat usage fee.

A potentially more viable strategy would be to attempt to involve third parties to gain leverage over the FPC. The additional case information indicates that Vella has spoken to a business-friendly City Council Member (Green) and a major local newspaper has also offered to cover the story. The use of the media to tell your story is a classic third party strategy. Another potential third party is the Streets Department which may be interested in using the case to establish their right to regulate the streets and sidewalks abutting the park. A victory for the

Streets Department would enable the $40 permit from the Streets Department to cover her entire route.

Another potential strategy is to leverage Philadelphia's desire to appear small business friendly. Enlisting the aid of the Business Services Center (BSC) to intercede with senior city officials on this basis would combine an appeal to authority ('the need to appear business friendly') and leverage from third parties (BSC and the mayor's office). The FPC may not listen to the OBS, but intervention from the mayor's office might cause them to reconsider their position as the mayor sits on their board.

4. If you were Vella, how would you negotiate with the FPC?

One school of thought is that Vella should pay the fee and start the business because either a) demand is likely to greatly exceed 100 riders a month and/or b) fixed costs will start to mount during an extended fight. A more nuanced approach might be to attempt to extract some minimal concessions (such as paying in installments) and then concede. The imminent launch date did not give Vella a lot of time to negotiate.

A more confrontational approach would be to exercise the media option immediately (either alone or in concert with some other third party option). The outcome of this approach is likely to be highly uncertain. It might generate concessions or it could cause the FPC to harden their position. It would definitely take valuable time away from launching the business. A better approach might be to pay the fee and then start a third party campaign once the business had commenced operation.

EPILOGUE

Vella was able to extract some concessions from the FPC in her initial attempt to negotiate the fee. The first concession was the ability to pay the fee in monthly installments of $466.66 per month over 12 months. She was also given permission to operate for 12 months of the year for the one fee (even though iGlide only operated from May to October). Agreement was finally reached by July 5 and the permit period was backdated to July 1 – her official launch date. On July 14, she ran her first Groupon campaign which attracted 500 new riders.

After securing the permit she needed to start her business, Vella reopened negotiations by pursuing a third party strategy that involved the media and friendly politicians at City Hall. She proceeded to go public with an appearance on Fox News and an article in the Philadelphia Inquirer criticizing the FPC. She also re-contacted her local councilman, Bill Green and his staff, and sought alliances with other tour operators and business groups. Although her competitor, iGlide, declined to participate in a united campaign, the FPC bowed to the pressure and reassessed the fee for herself and iGlide, adjusting it down to just $500 a year in January 2011. On July 1, 2011 Vella celebrated the start of her second year in business having toured more than 1,200 patrons and achieving consistently high ratings on Trip Advisor and Yelp.

ROLE INFORMATION FOR DETOURS PLAYERS

Before beginning this negotiation, set the following targets for yourself.

1. The fee you would like to pay for the annual FPC permit - $__________
2. The fee you will initially request from the FPC - $ __________
3. The highest fee you will pay for the permit - $ _________

Special Information:

While attending a meeting of the Greater Philadelphia Tourism Marketing Corporation (GPTMC), you were introduced to a local city council member, Bill Green, who seemed sympathetic to your plight. A reporter at the meeting also offered to cover your story in the *Philadelphia Inquirer*, the highest circulation newspaper in the city.

For the purposes of the negotiation, you may choose to have the newspaper release your story any time after the first ten minutes of the negotiation. If you choose to do so, please ask your instructor to distribute the story to all participants in your negotiation (including observers, if any). Note, the story should be generally supportive of your efforts to lower the fee but you do not know exactly what the article will say in advance.

Fairmount Park fee gives new business 'sticker shock'
By Monica Yant Kinney, Philadelphia Inquirer Columnist
POSTED: August 01, 2010

Vella is the kind of preternaturally optimistic and exuberant entrepreneur Philadelphia craves. The Syracuse grad became an Eagles fan because of Donovan McNabb, then earned a master's of education degree in sport and recreation management at Temple. Vella went to Guinea with the Peace Corps and worked in ecotourism in Ecuador, but it took seeing Paris on two wheels to inspire her American dream: DeTours, a "green" company showing off Philly to visitors who jog, bike, or glide through town on a Segway.

In keeping with her youthful yaysaying, the 29-year-old raves about her experience with City Hall. "The Office of Business Services at the Commerce Department, those people are *angels*," Vella gushes. "The director came to my grand opening on his day off!" She even emerged unscathed from the gauntlet that is the Department of Licenses and Inspections. "I walked in with a Sudoku and a coffee, ready to wait, but I was in and out quickly." Vella knew she had to pay hundreds in permits to do business in the city, but admits to "sticker shock" upon learning what Fairmount Park would charge her to operate six months a year: $5,600. "They say it's for using the park, but we don't really *use* the park," she says. "We stop *across* from JFK Plaza. We ride *in the street* on the Parkway. We're not even allowed to go in Rittenhouse Square."

Two of a kind?

DeTours (www.DeTourstouring.com), which opened last month, was a tough sell to investors. Skittish banks passed, so Vella tapped family and a nonprofit microlender. "She was very well-prepared, forthcoming, and knowledgeable," says Harry Stone of Camden's Cooperative Business Assistance Corp., which gave DeTours $25,000 of its $70,000 start-up money. "She didn't do this on a whim." With "hand-holding" from city officials - Commerce's Curtis Gregory calls DeTours "a wonderful business model from a wonderful person" - Vella cleared licensing hurdles. But she almost tripped over Fairmount Park's price. "I'm not basing my business *in* the park," she contends. "I'm just passing through." Fairmount Park director Mark Focht says the unique users' fee dates to the 2004 arrival of the city's first Segway company, I Glide (www.igliDeTours.com). He can't recall how the $5,600 figure was reached.

I Glide tours take place entirely within the park. DeTours' route stretches from the Betsy Ross House to the Schuylkill River Trail, but it's not like Vella's customers to stop on city property to play Frisbee. Focht says the Segway companies are similar enough to pay the same rate as a matter of fairness. "These tours are for-profit businesses using public land," he reasons. "They want to be in the park because it's beautiful, and we maintain it. They have to pay for that."

Ready, set, budget

Don't city residents fund parks with taxes? If the Segways must pay, why aren't bus tours charged for driving to the zoo? "They're going through the park," Focht explains, "because that's where the roads are." Vella could have owed even more. "We're not charging her to do biking and running tours," Focht says, "because anybody can run on the sidewalks or bike in a bike lane."

Vella spent half her seed money buying bikes and Segways; each "personal transporter" cost $6,000. She budgeted $7,000 a month for fixed costs like insurance and rent. DeTours embark from Third Street in Old City. The six-mile guided adventure costs $55 to $79. (Guides earn $50 plus tips.) Runners (in packs of eight) keep a 10-minute-mile pace; six-person bike tours and five-person Segway trips last three hours.

Short on cash after paying the first $466.66 park fee, Vella sublet her living room. "I'll be 30 next month," she jokes, "but I'm back on the Ramen Noodle Diet." Here's a thought: Why not eat dinner by moonlight in the park? She'll save on electricity. And surely Vella has paid enough to picnic.

Source: http://articles.philly.com/2010-08-01/news/24969685_1_segway-DeTours-sticker-shock

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WALMART IN INDIA

Pradeep Gopalakrishna, Pace University
Ram Subramanian, Stetson University
David Fleischmann, Pace University

CASE DESCRIPTION

The primary subject matter of this case concerns international business strategy. This case is appropriate for senior level and first year graduate level courses. The case is designed to be taught in 3 class hours and is expected to require 2 hours of outside preparation by students.

CASE SYNOPSIS

In 1962, Sam Walton, opened the first Walmart in Arkansas. Unlike other retailers that had frequent sales, Walmart used an Every Day Low Price strategy. This required a strong emphasis on searching for lower costs, through economies of scale in purchasing, delivery, and information systems. As Walmart's growth in the US eventually began to slow, global expansion became imperative. Walmart had several clear successes, as well as outright failures, in applying its expertise abroad. However, one country that seemed on the verge of either was India. Upper management needed to carefully consider past lessons learned overseas, as well as weigh the unique benefits and challenges of doing business in India, to decide if and how Walmart should continue its presence there.

RECOMMENDATIONS FOR TEACHING APPROACHES

This case is appropriate for an undergraduate Introduction to Marketing Course. This case can be used with the textbook Kerin, Hartley, & Rudelius, *Marketing*, New York, NY: McGraw Hill, to accompany the chapter on International Marketing. This case also can be used with the textbook Cateora, Gilly, & Graham, *International Marketing*, New York, NY: McGraw Hill, to accompany the chapter on market entry and/or global marketing strategies.

This case is also appropriate for a graduate Introduction to Marketing Course. This case can be used with the textbook Kotler & Keller, *Marketing Management*, Upper Saddle River, NJ: Prentice Hall, to accompany the chapter on international marketing.

The following website deals with PESTLE, a method of analyzing a country's political, economic, social, technological, legal, and ecological industry environment: PESTLE Analysis. (2014). Retrieved from http://pestleanalysis.com/what-is-pestle-analysis/

The following article deals with CAGE, a method of analyzing the cultural, administrative, geographic, and economic differences between a company's home market and other countries: Ghemawat, P. (2001). Distance Still Matters: The Hard Reality of Global Expansion. *Harvard Business Review*, *140*, 144-145.

A relevant video is publicly available. "Will Walmart Help India or Destroy It?" is produced by RT. This video explains some of the controversy regarding foreign retail's impact on India. (2:44 minutes). Available at: https://www.youtube.com/watch?v=Ltu5M5ycpmc

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Time management is very important, especially if the case is taught in one class session. Figure 1 shows a suggested board plan to assist in this regard.

Figure 1
SUGGESTED BOARD PLAN

Left Whiteboard	*Middle Whiteboard*	*Right Whiteboard*
• Demographics • Culture • Politics • Geography • Competition • Natural Environment	Market entry strategies • Exporting • Franchising • Licensing • Joint venture • Acquisition • Greenfield	Global market strategies • Exporting • Global standardization • Localization • Transnational

The instructor should help students reflect on the case discussion and associated key point: When choosing market entry and marketing strategies, it is important to consider political, demographic, cultural, geographic, competitive, and environmental challenges.

RESEARCH METHODS

This case was written based on secondary research. No information has been disguised.

LEARNING OUTCOMES

Students should be able to:

1. Analyze markets using the PESTLE criteria.
2. Determine the most appropriate international business strategies for a country.
3. Analyze markets using the CAGE criteria.
4. Determine the best course of action in a country as the market significantly changes.

DISCUSSION QUESTIONS

1. Conduct a PESTLE scan of the macro environment in India. (LO 1)
2. Apply the international business strategies of standardization, localization, etc. to Walmart in India. (LO 2)
3. PESTLE pertains to the macro-environmental framework of one country. CAGE pertains to a country pair comparison. Conduct a CAGE analysis for Walmart in India vs in the US. (LO 3)
4. Should Walmart continue its presence in India? If so, what should the company do? (LO 4)

ANSWERS TO DISCUSSION QUESTIONS

Conduct a PESTLE scan of the macro environment for Walmart in India. (LO 1)

The PESTLE framework analyzes a country's political, economic, social, technological, legal, and ecological industry environment (PESTLE Analysis, 2014). The political environment reflects the country's government structure and function. The economic environment can influence consumers' ability to purchase foreign brands, and their price sensitivity. The cultural environment reflects consumers' psychographs and demographics, which may offer clues to the appropriate marketing channels and messages for the target audience. The technological environment reflects the extent of the country's participation in e-commerce, the country's supply chain quality, and the ease of monitoring operations. The legal environment identifies threats that may result in legislation restricting foreign trade. The ecological/natural environment identifies threats to employee and consumer health in the country.

	Table 1 **PESTLE Analysis for Walmart in India**
Political	• Government corruption. • Opposing political forces regarding liberalization of foreign trade. • Many provinces were unwelcoming towards foreign retailers.
Economic	• A growing and young middle class. • Urbanization. • Easier access to credit. • More widespread Internet access. • India's economic growth rate slowed from 6.2% in 2011 to 5.3% in 2012. • The already-weak rupee fell 25% in 2012.
Social / Cultural	• Increased awareness of foreign brands. • Young adults were inclined to view foreign brands as premium and aspirational status symbols. • Older generations preferred locally owned stores over Western-style shopping malls. • Multigenerational personal relationships with local shopkeepers.
Technological	• Long supply chains. • Poor shipping and storage infrastructure. • Growing use of the Internet and e-commerce.
Legal	• Shopkeepers, intermediaries, market workers, and farmers feared that India's economic liberalization threatened their jobs. • NGOs fought Western retailers that prepared to enter the Indian market, and large Indian retailers about to rapidly expand. • Restrictions on maximum allowable foreign ownership stakes. • Limitations on forming partnerships. • 30% local sourcing law. • Limitations on e-commerce.
Ecological / Natural Environment	• Air pollution destroyed approximately 6.7 million tons of India's crops annually, worth approximately $1.3 billion. • Inadequate municipal waste disposal and recycling facilities.

Apply the international business strategies of standardization, localization, etc. to Walmart in India. (LO 2)

International business approaches include global standardization, localization, a transnational approach, and an international approach. The strategy chosen depends on the relative importance of achieving economies of scale relative to local market responsiveness.

The international strategy involves exporting products with minimal changes. This strategy is effective when universal needs are fulfilled, and when cost, competitive, and market responsiveness pressures are all low. This strategy is inappropriate for Walmart in India. Exporting American-style store formats, operations, and products would clash with long-standing customer loyalty for local shopkeepers, preferences for small purchases that can be carried home, India's cultural diversity, and many consumers' needs for affordable products.

Global standardization involves selling the same product in multiple markets, with perhaps some minor changes in configuration, to achieve economies of scale. This strategy works well when a company wants to minimize costs and there is minimal demand for customized products. Walmart may be tempted to use the global standardization strategy to cheaply purchase large volumes of nearly identical products, sold through a common store format. However, as was seen with some of Walmart's international expansions, consumer shopping behavior differs substantially between geographic regions. This is especially likely to be the case given India's very high level of diversity. Therefore, a purely standardized approach may only work for Walmart in India for products that are less likely to carry an emotional and/or cultural association. Globally standardized, American-style store formats and operations would be inappropriate.

The localization strategy is the exact opposite of global standardization. It involves customizing products to meet the needs of each market (Hill, 2011). This is a much more expensive approach, but it works well when consumer psychographics and demographics are substantially different across markets. This would require Walmart to design custom products for sale in India, sold through a new store format. Localization would result in these products becoming unaffordable to many of Walmart's consumers in India. However, a store designed to resemble what Indian consumers are already used to, such as *kiranas*, may be beneficial.

The transnational strategy attempts to balance the cost effectiveness of global standardization with the market responsiveness of localization (Hill, 2011). For instance, products are modified for local tastes, but use standardized components. This strategy may work for Walmart in India, by slightly modifying some products that Walmart already sells in other growing markets. This may also work for Walmart in India pertaining to store operations and format. Walmart could design store operations and improve local infrastructure to more effectively interface with its global supply chain. At the same time, Walmart could design visible store areas and the customer experience in accordance with local preferences.

PESTLE pertains to the macro-environmental framework of one country. CAGE pertains to a country pair comparison. Conduct a CAGE analysis for Walmart in India vs in the US. (LO 3)

The CAGE framework analyzes cultural, administrative, geographic, and economic differences between a company's home market and other countries (Ghemawat, 2001). Differences in prevailing cultural attitudes strongly influence how a company's products may be perceived, and the extent to which those products are appropriate in the context of local norms. Political differences can hinder international trade with a country. Geographic differences can make it difficult to apply existing distribution processes to other countries. Economic differences indicate the extent to which local consumers can afford to purchase the company's offerings.

Table 2
CAGE Analysis for Walmart in India

Cultural	• Americans were more willing than their counterparts in India to purchase foreign brands. • Americans preferred to purchase items from large retailers and over the Internet. Indian consumers had long-standing relationships with local shopkeepers. • American consumers had grown accustomed to a relatively uniform, big-box retail experience. In India, the customer experience was expected to be more personal.
Administrative (Political)	• India had more government corruption to contend with than the US. • India had more protectionist views than the US regarding the costs and benefits of foreign trade. • India placed more restrictions on foreign ownership stakes than the US.
Geographic	• India was a long distance from Arkansas headquarters, which made oversight more challenging. • Walmart's US operations had evolved in the context of safe supply chains and a comprehensive distribution infrastructure. India's infrastructure had many gaps to be addressed.
Economic	• India's demographic profile involved a growing population of middle-class young adults. • The reach of the Internet and e-commerce was less extensive in India than in the US, but India's population of connected consumers was growing very quickly. • India offered the possibility of higher economic growth than the US, but there were signs that India's growth was also slowing down. • Indian consumers had uncertain purchasing power, partially due to exchange rates that increasingly devalued India's currency relative to the US dollar.

Should Walmart continue its presence in India? If so, what should the company do? (LO 4)

There are several strategies that a company can choose from as its international operations expand and mature. These are exporting, sub-contracting, licensing, franchising, joint ventures, acquisitions, and greenfield development (Hill, 2011). These entry strategies often change as a company's overseas operations mature.

Exporting is when companies provide goods and services already produced elsewhere (Hill, 2011). A major advantage of exporting is achieving economies of scale. Disadvantages of exporting include tariffs and shipping costs. Exporting is also not as useful if the goods can be manufactured more cheaply elsewhere. However, the region where new operations are opened may initially be unable to supply large quantities of goods. Therefore, the export entry strategy is likely to be used as a company initially expands abroad. Walmart may need to export goods to India whenever local suppliers are unable to manufacture them in the very large quantities Walmart usually orders.

In the sub-contracting market entry approach, a strategic partner builds and develops the overseas business, and later relinquishes it to the original company (Hill, 2011). Advantages are using the sub-contractor's local knowledge and reducing risk exposure abroad. Disadvantages are the need to trust and monitor the sub-contractor, especially to guard against intellectual property theft that can later spawn new competitors. Walmart may have inadvertently used this approach when it bought out its Indian partner.

Licensing is when a company gives a partner the right to use its brand and products for a specific period of time in exchange for a royalty fee (Hill, 2011). Advantages of this market entry approach are bypassing restrictions on foreign ownership, accessing local knowledge from the licensee, and transferring start-up costs and risks to the licensee. Disadvantages of licensing are fewer economies of scale, greater difficulty in coordinating global strategy, and the risk that the partner will steal intellectual property. Walmart in India may find licensing somewhat appropriate for India, especially for smaller cities.

The franchising market entry strategy is similar to licensing, but the parent company generally has more involvement in running the business (Hill, 2011). As with licensing, there are potential problems with quality control and inappropriate intellectual property transfer. Walmart may consider the franchising approach as a cost-effective way to reach smaller cities in India.

The joint venture market entry strategy involves co-ownership with a local partner (Hill, 2011). Advantages of joint ventures include sharing local knowledge, reducing the financial risk of expansion, and bypassing political limits on foreign control. Disadvantages are the risk of giving local partners access to the company's proprietary knowledge and techniques, reduced oversight, and the potential for disagreements over strategy. Walmart used this strategy in India when it formed a joint venture with Bharti.

Firms may enter a market by purchasing a foreign business (Hill, 2011). The advantages of acquisitions are tighter control over strategy, as well as sharing the best business practices between the acquired and parent firms, as well as operational synergies. Disadvantages of acquisitions include cost, risk, and clashes in organizational culture. Walmart would probably not pursue an acquisition approach in India due to the higher cost, risky business climate, and different organizational culture.

Some firms may enter a market through greenfield development, in which the firm builds completely new operations and supporting infrastructure (Hill, 2011). Although there is tight control over operations, the parent company bears the full burden of development costs, as well as the political risks. Walmart would be unlikely to pursue greenfield development in India due to the political restrictions on foreign ownership. If such limits were later relaxed, it is possible that Walmart would consider building some of its own supply chain infrastructure. This could offer Walmart a competitive advantage, by allowing it to bypass problems with existing local supply chains. However, a greenfield strategy in India on a larger scale would probably be too expensive and risky for Walmart.

GENERAL DISCUSSION

Students should read about global marketing strategies and market entry strategies, which can be found in any introductory marketing textbook.

Start by asking students, "Has anyone shopped for groceries outside the US? If so, how was the shopping experience different? What did you notice about the size of the store, the store layout, the number of different brands of a single product, and customer service? Did the typical local customer buy in large quantities? How did customers bring their purchases home?"

EPILOGUE

In October 2013, Walmart announced that it would indefinitely suspend plans to roll out hundreds of stores in India, and would buy out Bharti, but keep an independent Indian wholesale operation (Harris, 2013). Bharti would resume full control of the EasyDay retail stores (Mookerji, 2013).

In 2014, David Cheesewright became the head of Walmart's international division (Walmart, 2013c). He continued Walmart's consolidation and slower pace of expansion abroad. This more cautious approach was driven in part by lessons learned from recent mistakes in other international markets.

Walmart had opened several hundred stores in China each year, but in 2014 closed about 30 of them (Bose & Rose, 2014). Many Chinese consumers expected foreign brands to provide reassuring quality and safety that were often lacking in domestic goods. These consumers interpreted Walmart's emphasis on low prices to mean cheap, potentially unsafe products were being offered, which in some cases was discovered to be true. Cheesewright realized that further growth in India could not risk tarnishing Walmart's aspirational image as a foreign brand. Part of this approach would inevitably require more strict, and costly, supplier oversight.

There were lessons to be learned from Brazil, as well. By 2014, it became clear that Walmart's emphasis on one-stop shopping convenience was not as effective in Brazil as hoped. Brazilian consumers were willing to visit multiple stores in search of promotions on every item (Dudley et. al., 2014). Walmart struggled to adapt to such consumer behavior. Cheesewright considered the possibility that price-sensitive Indian consumers might have similar preferences.

Nevertheless, in April 2014, Cheesewright sensed the time was right for renewed efforts in India. Walmart announced plans to increase the number of wholesale outlets from 20 to 50 over the next 5 years (Bose, 2014). In September 2014, Walmart elaborated that most expansion was planned for smaller cities (Zee News, 2014).

In May 2014, Narendra Modi was elected the new Prime Minister (Punj, 2014) by a landslide (Nelson, 2014). This further suggested that Walmart would be able to take advantage of a more friendly business climate to broaden its expansion in India.

In June 2014, Walmart introduced an e-commerce website, which sold goods to members of its cash-and-carry stores in 2 trial cities (Narayan, 2014). Walmart dispatched sales teams to assist the small local merchants understand and use its new platform. In September 2014, Walmart announced that its e-commerce trial was successful, and that in 2015, e-commerce would be extended to all its Indian stores (Business Standard, 2014).

In September 2014, Walmart's rival Carrefour decided to leave the Indian market (Mookerji, 2014). Walmart decided to take advantage of this opportunity by acquiring 3 former Carrefour wholesale stores.

By late 2015, Walmart continued its expansion in India. There were 21 stores in mostly smaller cities (Trefis Team, 2015). Walmart announced that it planned to open 50 new wholesale outlets in India by 2020, and hoped to expand to 500 such stores in the next decade or so. Walmart also investigated partnerships with several locally popular e-commerce sites.

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BUILDING A SYMBIOTIC SUSTAINABLE MODEL: A COMMUNITY BASED ENTERPRISE

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CASE DESCRIPTION

The primary subject matter of this case concerns the community based enterprise, social and sustainable development, and strategic partnering. Secondary issues examined include the corporate social responsibility and strategic positioning of the community based enterprise. The case is at a difficulty level of three and would be better suited for third year junior level students or higher. It can also be used for more advanced levels as well with guidance from faculty. The case is structured to be taught in a 60-minute class with the case assigned to individuals or teams for prior reading before class discussion.

CASE SYNOPSIS

The time has come to make a decision regarding the future. Details from the case evidence Rosa's (ADCAM) commitment to the Maasai (Indigenous tribe) towards building a community based initiative. Rosa believes in the rights of indigenous people to define the type of work they want to engage in that respects their culture. She carefully negotiates the cultural divide and ensures that the stipulated agreement is considerate and beneficial to the Maasai community. The community based initiative takes some time to get established but after strategically partnering with a Multinational Corporation (Pikolinos Group Incorporated) it becomes successful in the global marketplace. The resulting success greatly impacts the community positively as evidenced by the establishment of a school and other individual entrepreneurial ventures. ADCAM's pivotal role of an international non- governmental organization (NGO) role is to link community-based entrepreneurs to the fashion industry in Western Europe, North America, Japan, etc. while empowering the local community to take on a leadership role in coalescing the product on the ground.

Students take on the role of Rosa in evaluating the external in internal environment. It is recommended that students use the case appendices, research databases and textbooks to assist in the formulation of their recommendations.

Key Issues and Discussion Points

The essence of this case is its depiction of the challenges, opportunities and intricacies of creating a Community Based Enterprise (CBE). A few things that make this an interesting case is the participation of the bridging agent (the NGO - ADCAM International - based in Europe), the community based entrepreneurs (the Maasai Communities in Kenya and Tanzania with their unique cultures) and a family owned multinational corporation (Pikolinos Group, Inc.). This case can be used to supplement discussion when addressing topics on social capital theory, family owned businesses and their approaches to corporate social responsibility (the doing well while doing good approach), as well as definitional issues surrounding social, sustainable entrepreneurship and corporate social responsibility. There is a paucity of teaching cases that bring these issues to the forefront. Hence, this is a rich, interesting, and versatile case for introductory classes in entrepreneurship.

Target Audience

This is a unique case with an intriguing storyline. It is likely to ignite students' interest given the paucity of teaching cases focused on Community Based Enterprises (CBEs). While this case is primarily targeting undergraduate courses in entrepreneurship and social entrepreneurship, it may also be used in other business courses including general management, strategic management, and global business.

LEARNING OUTCOMES

Audience	**Learning Outcomes**
	Students will be able to:
Undergraduate Entrepreneurship	• **Understand** differences between sustainable and social entrepreneurship. • **Identify** steps in establishing sustainable businesses in 3rd world countries. • **Apply** analytical tools including Porter's 5 Forces and SWOT analyses on the existing *Pikolinos* and Maasai operations in order to learn how to identify viable investment sectors for a community based enterprise in a given industry. • **Develop** recommendations for the key issues facing Ms. Rosa Escandell.
Undergraduate Strategy	• **Understand** strategic alliances. • **Understand** potential of social responsibility as a strategy. • **Identify** the impact of alignment of NGO and community assets • **Apply** analytical tools including Porter's 5 Forces and SWOT analyses on the existing *Pikolinos* and Maasai operations in order to learn how to identify viable investment sectors for a community based enterprise in a given industry. • **Develop** recommendations for the key issues facing Ms. Rosa Escandell.
International Business (Global)	• **Understand** the role of intermediaries, in this case NGOs. • **Understand** the impact of cultural differences on business relationships. • **Identify** opportunities in working with 3rd world resources. • **Identify** entry strategies of NGOs. • **Develop** recommendations for the key issues facing Ms. Rosa Escandell.

A Detailed Teaching Plan and Analysis

IM Exhibit 1 shows a detailed layout of suggestions for how instructors may approach the use of this case. The exhibit also contains an outlined systematic approach and suggested timeline for each activity as well as a recommended reading list.

Im exhibit 1
TEACHING PLAN

Topics	Allotted Time
Pre-Work	Instructor may to want assign students some relevant readings especially if s/he wishes to use the case for in-depth discussion of any of the following topics: a) Social Capital- Bridging social capital - Davidsson & Honig (2003); Structural holes - Burt (1980); Nicolaou & Birley (2003); Social capital as a community's major resource (Bourdieu, 1997; Coleman, 1988; Flora, 1998). b) Community Based Enterprises (CBEs) - Theoretical frame of CBEs - Peredo & Chrisman (2006); previously developed skills and capabilities greatly influence entrepreneurial activity and entrepreneurial opportunities of CBEs (Ensley, Carland, & Carland, 2000).
	c) Corporate Social Responsibility among family owned businesses - Dyer & Whetten (2006). d) Sustainable Entrepreneurship – Definition, distinction and demarcation among the terms social enterprise, sustainable enterprise and corporate social responsibility – (Patzelt, 2011); the role of sustainable entrepreneurship in enhancing education, productivity, socioeconomic status, physical health, and self-reliance of individuals & societies (Wheeler et al., 2005).
In-class Icebreaker	Ask students if they are familiar with the Maasai. Some students may know a few things about the Maasai. Encourage them to share what they know with the class. A great way to present this case is to take the students on an exotic journey that illustrates how a Maasai community leader met the bridging agent and eventually the multinational corporation. A brilliant animated video that depicts this can be found on YouTube.com (https://www.youtube.com/watch?v=DnJEztni168). The video will greatly enrich the discussion around social capital issues. The video clip is 4:02 minutes long. This link is an active hyperlink that may not be available if deactivated. Another approach is to ask the students if they are familiar with any NGOs in developing nations. A brief discussion of a familiar organization may help the students relate to the material.
Group Discussion	a) Begin with an easy, noncontroversial question that all the students should be able to answer readily. This first question is designed to facilitate conversation. b) If groups are used for the case study, the instructor may assign discussion questions prior to the class period. The teams may then be asked to present their analysis and recommendations in class. To encourage participation you may randomly select one person in each group to defend the group's position or elaborate on its reasoning. Time Allotted: At least 40 minutes
Individual Discussion	a) The authors prefer to begin with an easy, noncontroversial question (Dunne and Brooks 2004). Beginning the discussion with relatively simple questions helps students gain confidence and prepare for the more challenging questions that follow (Brown and Ettington, 2012). b) If the instructor chooses to have open class discussion, he/she must be prepared to grade participation both in terms of frequency (quantity) of contributions, and more importantly, the quality of those contributions. c) The grading method could be a simple check, check-plus, check-minus or zero (Dunne and Brooks 2004). It is important to involve as many students as possible. Assigning the questions prior to the class meeting helps the students to prepare more in-depth analysis prior to the class discussion. Time Allotted: At least 40 minutes

Accompanying Readings	The amount of emphasis to be placed on the use of assigned outside readings during the case discussion depends on the complexity of the concept and depth of coverage. The case can be used to discuss any of the aforementioned topics, some being more complex than others. The instructor may need to guide students (especially undergraduates) through the case application and interpretation of the analysis. Time Allotted: Instructor’s discretion
Wrap Up	**Correct any errors:** There are two commonly used approaches to gauge any misunderstandings: (1) ask if anyone has any contrary evidence or some statements need to be reconsidered in light of points or evidence introduced during discussion; e.g., “how would you answer a critic who made this point…?” (2) Preface correcting comments by challenging the student to defend his/her response. **Closure:** Ask students to summarize what they have accomplished before highlighting the key learning points. **Time Allotted:** 10-15 Minutes

Suggested Student Assignment

This case study primarily targets undergraduate students. As a case in an introductory class in either entrepreneurship or social entrepreneurship, it can be used to introduce definitional issues surrounding concepts such as Sustainable Entrepreneurship, Social Entrepreneurship and Corporate Social Responsibility (CSR). A discussion of why such demarcations are significant can be highlighted.

As a case in general management, strategic management or global business, it can be used to generate discussions of a wide range of topics including, but not limited to: (a) the fashion industry’s competitive environment; (b) potential of social responsibility as a strategy; and (c) role of intermediaries.

Refer to IM Exhibit 2 for theoretical linkage of concepts covered in the case. This is particularly important for the use of the case for senior or graduate level courses.

DISCUSSION QUESTIONS

1. Use the information given in the case and Appendix 1 to complete a SWOT analysis on the existing (a) Maasai operations; (b) Pikolinos operations.
2. Use the information given in the case and Appendix 1 to complete a Porter’s Five Forces analysis on the fashion industry.
3. Based on your industry analysis in question 1 and 2 as well as the information given the case and Appendix 1, propose likely sectors in which the Maasai have the potential to be successful.
4. Does the Massai – Pikolinos project fit the model of a social enterprise? Does it fit the model of a sustainable enterprise? Differentiate a social enterprise from a sustainable enterprise and corporate social responsibility.
5. Develop a plan needed for Maasai to successfully transition to working independently with markets.
6. Develop a model of the capacity building steps.
7. What leadership qualities does Rosa bring to the project? Why is her experience and vision relevant to our discussion?
8. a) Assume the role of Rosa Escandell, and evaluate the following issues based on the information given in the case. Is the Maasai community ready to continue this project

independently? Is this model sustainable without the presence of ADCAM (International)?
b) What factors must be present in the symbiotic business model? Is the relationship between the Maasai community and Pikolinos symbiotic?

Discussion

1 a). Use the information given in the case and Appendix 1 to complete a SWOT on the existing Maasai operations.

Strengths	**Weaknesses**
• Craftsmanship in beading. • Social capital- can tap into collective resources/communal resources. • Current Maasai - Pikolinos collaboration. • Visionary leader, William Ole Pere Kikanae. • Gender impact - phenomenon of role reversal. • Entrepreneurial training and microcredit facilities – opening opportunities in the local market. • Other income generating projects – Charity Camp/tourists' Camp.	• Low education level among community members, thus limiting their ability to negotiate and explore additional international markets in the absence of an intermediary. • The crafts are vulnerable to imitations since there is no patent.
Opportunities	**Threats**
✓ Entering other western markets such as beading costume jewelry and clothing. ✓ Expanding into the local and regional markets - currently largely untapped ✓ Branching into commercializing	• Heavy reliance on a single collaboration. • Reliance on a fast evolving fashion industry.

1 b). Use the information given in the case and Appendix 1 to complete a SWOT on the existing Pikolinos operations

Strengths	**Weaknesses**
• Player in the high fashion industry that tends to be less price sensitive. • Reliance on international business – 80% of total sales revenue based on exports to over 60 countries across the globe. • Unique and competitive products – enhanced brand recognition based on collaboration with marginalized communities.	• Dependence on an intermediary. • Language and cultural barriers as well as geographical distance with its partner.
Opportunities	**Threats**
• Expanding product line to include beaded accessories such as leather belts, handbags, and wallets.	• Highly competitive industry. • Vulnerable to cheap imitations. • Low-cost manufacturers from the Asian markets.

2. Use the information given in the case and Appendix 1 to complete a Porter's Five Forces analysis on the fashion industry

Bargaining Power of Buyers

Buyers, with respect to the footwear market, are defined as end-user consumers and Business to Business (B2B) buyers which comprises of retailers and distributors.

1. No switching costs especially in the mass-market for men's and children's footwear. As stated in Appendix 1, male footwear exhibited slower changes in styles and also tended to be more generic than women's footwear. Likewise, most children's shoes are value driven rather than design and/or brand names. Thus, buyer can easily switch from one brand to another without incurring psychological or financial costs.
2. End-users are fragmented - no buyer has any particular influence on pricing- limiting the bargaining power of end users.
3. Footwear is a necessity especially in the mass-market; therefore, buyers are compelled to buy leading to low bargaining power for end-user.
4. In the case of producers, such as Pikolinos who have a strong online presence as well as company-owned stores, the threat for forward integration is credible – the producer can undertake its own distribution/retailing. That reduces the bargaining power of B2B buyer. This tends to be true for most moderate to high fashion brands. As depicted in Exhibit 7, a number of the leading brands tend to have company-owned retail and wholesale outlets.
5. Overall, buyer power with respect to the footwear market is low-moderate.

Supplier Power

Bargaining power of supplier varies with the targeted sector. Suppliers to the footwear industry are defined as footwear manufacturers, designers, and suppliers of raw materials.

1. Many competitive footwear manufacturers. Most of the footwear is sourced from manufacturers in low-cost manufacturing locations, especially South-East Asia. Given that these manufacturers are primarily responsible for production while the design may be done by different entities, their contribution is standardized which weakens their bargaining power.
2. Due to the high cost of manufacturing and labor, many western countries' domestic manufacturers lack the ability to compete effectively within the mainstream footwear market.
3. Many western suppliers have gained power within the market through differentiating their offerings. They have achieved this by both producing specialist footwear for specific applications and by producing high-end designer footwear.
4. Given their economic advantages, and the large number of manufacturers in low-cost manufacturing regions, Western retailers and wholesalers can readily switch manufacturers without incurring substantial switching cost.
5. Forward integration is rare - Creating brand recognition in the western markets takes substantial financial and time investment. Therefore, it is difficult for manufacturers to establish themselves in retail especially in elite markets.
6. Overall, supplier power with respect to the footwear market is low to moderate.

Threat of New Entrants

1. Threat of new entrants varies with the targeted sector (see Exhibit 8).
   a. Fixed costs for retail operations are relatively low and new entrants are common. However, there exists in this market a number of large established retail groups (see Exhibit 7) who wield significant economies of scale through bulk purchasing and pooling certain back office operations. Consequently, it is difficult for such new entrants to increase in size considerably.
   b. Entry into the elite high end fashion is very difficult given that this sector is driven by brand equity and high customer loyalty.
   c. Entry as a designer is moderate to high depending on the sector – differentiated sectors are tougher.
   d. Entry into supplying high-tech synthetic material such as Kevlar, which is said to be 10 times the strength of leather is challenging. Kevlar has been in the market for over 45 years (since 1970) and has many applications beyond the shoe industry. Supplies of the high-tech material require great investment in technology and skill. Therefore, supplying them is a lot more difficult than supplying commodity input such as natural leather.
2. A retailer can readily establish the required supply chain given the large number of low cost manufacturers. This reduces entry barriers for new entrants into the retail sector.
3. Brand recognition of footwear retailers is relatively low with the exception of certain specialist types of footwear, such as sportswear and designer products. This leads to low entry barrier.
4. Overall, the threat of new entrants is low to moderate.

Threat of Substitutes

1. As footwear is a basic necessity, the threat of substitutes to the market is very low.
2. Overall, the threat of substitutes is very low.

Intensity of Rivalry

1. Brand Recognition - The industry is characterized by a highly fragmented retail sector; however, there are a few renowned brands (Exhibit 7) that dominate the industry amongst whom there is a high degree of rivalry.
2. Low fixed costs - Retail operations require relatively low fixed costs which allows smaller companies to co-exist within the market. Additionally, low fixed cost can often lead to overcapacity/excess capacity, which enhances rivalry.
3. As depicted in exhibit 7, there is a high degree of diversity between retailers, with dedicated shoe retailers competing with apparel retailers and large supermarket chains.
4. Overall, rivalry between footwear retailers is high.

3. Based on your industry analysis in question 1 and 2 as well as the information given the case and Appendix 1, propose likely sectors in which the Maasai have the potential to be successful.

1. In the SWOT analysis the following opportunities were identified
   a. Possibility of tapping into other western markets such as beading costume jewelry and clothing.
   b. Expanding into the local and regional markets that are currently largely untapped.
   c. Branching into commercializing herbal remedies.
2. The analysis of Porter's Five Forces has revealed that although entry into the shoe industry has relatively low barriers the intensity of rivalry is high and overall it is not a very easy industry in which to create and sustain a competitive advantage.
3. Appendix 1 identified two sectors that are a natural fit for niche players: World Fashion and Fashion Systems. The Maasai community with the help of ADCAM may consider seeking collaborations with the global players in the World Fashion sector such as Adiree,
4. Bibi Russel projects and Fashion for Development Movement (F4D). Getting the attention

of a trendsetter like Lupita Nyong'o, a well-known fashion and film industry personality – who was born and raised in Kenya. She won the Academy Award for Best Supporting Actress and an Oscar for her role in a historical drama 12 Years a Slave.

5. Furthermore, in June 2015, WildAid, an international conservation organization, announced Lupita as their Global Elephant Ambassador. Although some students may not know all these facts about Lupita, they are certainly aware of the opportunities celebrities with ties to marginalized communities are worth. The example in the Appendix is Bibi Russel, who through the Bibi productions works with indigenous women and infuses indigenous Bengali cultural elements into her lines. Some students may also mention Michelle Obama given her ties to the country.
6. The fashion industry is fast changing and the Maasai/Pikolinos collaboration has been lucky to have such a long run (6 years). Both parties have been anticipating and proactively preparing for the day that this current venture will conclude.
7. Juan Peran Bazan - Vice President, Pikolinos Group, made it clear that in about five years, he hoped that the Maasai community would not need his company. His group was keen on developing the entrepreneurial skills of the community because it knew that in the fashion industry, no product line lasts forever.
8. Issues of sustainability are at the forefront for ADCAM since it understands the fashion industry and its temporal nature. While the Maasai sandals have been well received by the market, they are still susceptible to market forces, and the day is fast approaching whereby they will no longer be fashionable. In preparation for this inevitability, Pikolinos designers and ADCAM are constantly trying to create fashionable innovative product lines that incorporate the Maasai beading technique. Originally, they started with a limited product line of women's shoes which has grown over the years. With the realization that the shoe cycle may be nearing its end, they have expanded into bags and accessories.
9. ADCAM has also been actively searching to find other viable partners for the Maasai. Maasai would definitely be successful in any fashion segment that can incorporate beading since the style is authentically Maasai.

4. Does the Massai – Pikolinos project fit the model of a social enterprise? Does it fit the model of a sustainable enterprise? Differentiate a social enterprise from a sustainable enterprise and corporate social responsibility.

This question requires the students to draw from their conceptual understanding of key terms that are necessary to have a meaningful discussion. Shepherd and Patzelt (2011:142) argue that if a term captures everything then it represents nothing." Some researchers use the term social enterprise interchangeably with the term sustainable enterprise. Shepherd and Patzelt (2011) help clarify what "Sustainable Entrepreneurship" is and what it is not. The instructor may want to highlight why that distinction is important.

Shepherd and Patzelt (2011:142) define sustainable entrepreneurship as *the preservation of nature, life support, and community in the pursuit of perceived opportunities to bring into existence future products, processes, and services for gain, where gain is broadly construed to include economic and non-economic gains to individuals, the economy, and society.*

The collaboration between the Maasai community and Pikolinos fits this definition on all counts.

a) Nature: The case states that for generations the Maasai shared habitat with the wildlife. "…We have moved from the blended life with the wild animals, and we now live on the peripheral areas of the Mara…." - William Kikanae. The Maasai have great respect for Mother Nature, and this is a value they share with Pikolinos. The case states that Pikolinos Group is environmentally conscious, and it uses natural and non-toxic components in the tanning of its leather.

b) Community - The Maasai, at the core, would like to create economic opportunities for themselves while preserving the integrity of their heritage. Both ADCAM and Pikolinos Group were respectful of the Maasai culture, and they both worked out a model that blended well with the traditional roles and lifestyle of the community.

c) Life support - Broadly speaking, this term refers to preserving the environment, natural resources, and ecosystem services. This attribute focuses on nature as a source of resources and services for the utilitarian life support of humankind as opposed to nature simply as a physical world. The case states that the Maasai's traditional diet consists of renewable natural resources such as honey, herbs and blood. The case further states that the Pikolinos Group leather tanning process is briefly mentioned. Student may infer that it is environmentally conscious of how it uses natural resources in its operations.

d) The economic and non-economic gains - Exhibit 6 depicts the details of the economic and non-economic gains of the Maasai community - Pikolinos collaboration.

Whereas there are overlaps between sustainable entrepreneurship, social entrepreneurship and corporate social responsibility (CSR), social entrepreneurship does not necessarily seek to sustain current sources of life support or a community's substance. Likewise, CSR does not necessarily lend itself to entrepreneurial action nor innovation, which are vital components of sustainable entrepreneurship.

5. Develop a plan to guide the Maasai to transition successfully to working independently with markets

Students' response will vary. The two key things that are needed for the Maasai to transition successfully to working independently with markets are: (a) ability to recognize the opportunities and negotiate gainful deals; and (b) capacity to deliver on quality and timely execution. Exhibit 2 depicts elements of building a sustainable enterprise. All these elements are discussed in the case and are in the curriculum ADCAM has meticulously developed and executed in preparing the Maasai community.

The students can deviate from these elements but a stronger answer will reflect the elements of entrepreneurial theory, especially the entrepreneurial opportunity/alertness theory (Ardichvili, Cardozo, & Ray, 2003). The four steps highlighted in entrepreneurial opportunity/alertness theory are as follows:

a) Entrepreneurial alertness – The basic argument is that any recognition of an entrepreneurial opportunity is preceded by a state of heightened alertness to information. In the case of the Maasai, the entry of ADCAM International has influenced their entrepreneurial mindset. The case states that tribal narratives and a tribal worldview largely guide their entrepreneurial activities. The exposure to a different world through ADCAM activities hopefully will influence their worldview.

b) Information asymmetry and prior knowledge - The basic argument is that people tend to notice information that is consistent with information they already know and therefore cannot discover opportunities without prior knowledge that triggers recognition of the value of the new information. Having more Maasai community members traveling to trade shows within the local and regional markets can be particularly useful. Involving the community leader, William Kikanae in the marketing campaign for Pikolinos is particularly important.

c) Social networks - This viewpoint holds that entrepreneurs who have diverse networks identify significantly more opportunities than those with more homogenous networks or loners. Davidsson and Honig (2003) discussed how bridging social capital (weak ties) becomes increasingly more important relative to bonding social capital (strong ties) and even human capital as nascent entrepreneurs progress from mere start-ups towards an actual launch. This is particularly true for the Maasai community. It has high bonding social capital but is rather low on bridging social capital. The case states that over the years, the Maasai preserved their cultural heritage by excluding themselves from mainstream communities. There is a need for the community to invest more in bridging social capital. The presence of ADCAM International in the community is a great addition to this end, but the community must continue to invest more in bridging social capital.

6. Develop model of the capacity building steps

Students' response will vary. As stated in the case, capacity building and succession planning constitute a process, not a single event. In some communities it may take a few years while in others it may be perhaps a couple of decades before transition is a viable possibility. In this particular community, it may take a couple of decades. Students should use Exhibit 2 to build their arguments. Phase 1 is summarized in Exhibit 2, and students are asked to define ongoing relationships in phase 2. Some of the key arguments are as follows:

a) Education - Educating the next generation to college level in order to equip them with adequate skill sets to engage in strategy formulation and negotiating international collaborations.
b) Entrepreneurial training - Extending the entrepreneurial training beyond the once- a-year event, and using local (not necessarily Maasai) experts to facilitate the trainings. This step could be particularly important in opportunity recognition.
c) Formalize and scale up the microcredit facilities - The case states that Rosa Escandell started a low-key microcredit scheme to help the Maasai women own cows for the first time in their lives. For the community to participate competitively in the local economy and the regional markets, it has to go beyond investing and trading in cows, and such a move would require additional financial resources.
d) Additional product line – The case states that the Maasai women sell crafts such as carvings, embroideries, footwear, baskets, accessories as well as hair braiding, etc. These are possible avenues to collaboration with corporations within the region as well as western markets. Exhibit 5 highlights existing market linkages, the challenge is how to expand these linkages.

7. What leadership qualities does Rosa bring to the project? Why is her experience and vision relevant to our discussion?

Students responses will vary but the following are some relevant characteristics that can be discussed.

a) Proactive vs. Reactive – Thinking several steps ahead

1. Ms. Rosa Escandell is proactive – when she failed to procure a contract after the Maasai Community submitted samples, she immediately told the community and sought its permission to go in search of a new partner.
2. Her succession planning is also evidence of the same.

b) Knowledgeable

1. Ms. Rosa Escandell is well educated on community policies, procedures, organizational norms, etc.
2. Ms. Rosa Escandell has more than twenty years' experience in the corporate and microcredit fields before she founded ADCAM.
3. She worked in a number of developing nations such as Bangladesh, Brazil, India, Colombia, Mexico, and Argentina among a host of others.

c) Respectful

Ms. Rosa Escandell is respectful of both the indigenous communities and prospective corporate clients. She is able to speak the corporate language as well as understand and relate to the cultural and spiritual issues of the marginalized communities. This trait has helped to bridge the divide.

d) A Good Communicator

Being a good communicator goes beyond merely being an effective orator; one must be a good listener as well. The best illustration from the case of this point occurs during the *baraza* (a traditional official meeting) with the entire clan.

e) Delegator/Ability to Delegate

Ms. Rosa Escandell is an effective delegator. The session on succession planning clearly illustrates how ADCAM has incorporated the local community in all aspects of leadership and operations. See Exhibit 5.

f) **Flexible/Adaptable**

An effective leader will adapt to new surroundings and situations, doing his/her best to adjust.

Ms. Rosa Escandell pitched a tent among the Maasai *manyattas* (a settlement or a compound established by a Maasai or Samburu family/clan) for interim periods of three months at a time for a period of two years. During that period, she learned about the Maasai culture and its challenges as well as its hopes and aspirations.

g) **Honesty**

False Start - When the deal fell through, Rosa got on the next plane to Kenya and went straight to Mara to let the community know what happened. The people appreciated her honesty and asked her to continue searching for a suitable partner.

Other relevant characteristics

resourcefulness, consistency, positive attitude, creativity, etc...

Some students may choose to use the leadership literature to discuss Ms. Escandell's leadership style. Some of the likely frameworks may include strategic leadership, visionary leadership or transformational leadership. Ms. Rosa Escandell is a seasoned transformational leader who plays a catalyst role in providing strategic direction to both the Maasai and Pikolinos. Transformational leaders are highly respected and referred by their followers.

Furthermore, transformational leaders seek to develop their followers to their highest potential. We find that early in the relationship that Rosa earned respect from the Maasai by respecting their culture as well as seeking opportunities that were a win-win for both Pikolinos and the Maasai. It is also in ADCAM's vision to empower and to pursue projects that are sustainable to the earmarked community.

Why is her experience and vision relevant to our discussion?

Having a great idea, compassion and a burning desire to make a difference in the world and even assembling a team to bring that concept to life is not enough to create a competitive and sustainable model. While finding a combination of those characteristics is rare enough; the ability to execute these ideas successfully is what separates the dreamers from the entrepreneurs. That ability rests in one's leadership skills, experience and vision.

8. **a) Assume the role of Rosa Escandell, and evaluate the following issues based on the information given in the case. Is the Maasai community ready to continue this project independently? Is this model sustainable without the presence of ADCAM (International)? b) What factors must be present in the symbiotic business model? Is the relationship between the Maasai community and Pikolinos symbiotic?**
Are They Ready?

Responses will vary

1. Better informed positions will highlight Exhibit 2 to identify areas where the Maasai community has built sufficient capacity such as coordinating the entire production process and record keeping. However, it is also evident that when it comes to marketing especially in the international markets, the Maasai community is not ready.
2. The SWOT analysis identified the low education level among community members as a weakness, and that remains a hindrance to the transition.
3. Porter's Five Forces has identified salient features in industry context in terms of the likelihood of profitability and the overall attractiveness. Entry into the elite designer sector is challenging. Whereas entry into the mass market could be easier, given that Maasai designs and crafts are not patented, having a presence in the mass market may expose them to exploitations by cheap factory made imitations. An evaluation of Porter's Five Forces may lead the students to conclude that the Maasai community does not have the capacity necessary to transition.
4. The students need to articulate whether the Maasai have a viable talent that can be marketable to the free market. The Maasai have been beading for generations, and the point to be made is that the partnership has added to their skills thus making it possible for them to seek other opportunities past the ADCAM Pikolinos partnership.

What factors must be present in the symbiotic business model?

This question may be appropriate for Strategic Management students, the other classes may find it rather challenging unless they have covered strategic alliances in other classes.

1. Mutual benefits to all parties involved
2. Partners should bring competencies that complement rather than duplicate
3. Collaborative approach
4. Learning mediums

Adler (1966) defined symbiotic marketing as "an alliance of resources or programs between two or more independent organizations designed to increase the market potential of each."

Is the relationship between the Maasai community and Pikolinos symbiotic?

Yes.

1. Mutual benefits to all parties involved (Maasai Community - jobs, entrepreneurial training, social projects provided by ADCAM - see Exhibit 6; Pikolinos - Brand recognition; ADCAM - creating social impact/fulfilling the organization mission).
2. Furthermore it is evident that the partners benefit and rely on each other. The Maasai are dependent on the Pikolinos for marketing their wares. Pikolinos is dependent on the Maasai to make a quality product that is marketable to the western world. ADCAM is the intermediary and relies on the Maasai to maintain quality and to deliver a quality product to the Pikolinos, and Pikolinos expects ADCAM to manage the relationship between itself and the Maasai. Finally, the Maasai community expects ADCAM to represent it fairly and to identify new markets for it in the western world.
3. Partners bring competencies that complement rather than duplicate (Maasai - beading/artisans craftsmanship; Pikolino - manufacturing and marketing; ADCAM - bridging capital).
4. Collaborative approach - The model represents a complex situation where the Maasai community is totally isolated from the international markets and is in need of access to such

markets. It lacks the capacity to make the connections. Pikolinos, which represents such a market, had never thought of a collaboration with a tribal community in Africa. In fact, the Vice President of Pikolinos said when it finally consented to the Maasai project that he thought of it as a social project and not the big business collaboration it grew to be. The collaboration was made possible through the bridging capital provided by ADCAM.

5. ADCAM International was able to speak the corporate language as well as understand and relate to the cultural and spiritual issues of the Maasai community, thus bridging the divide. The collaboration is effected by each party bringing complementary competencies.
6. Learning mediums – As a symbiotic relationship all parties acquire new competencies –

a. The Vice President of Pikolinos spoke of the complementary nature of the Maasai culture and Pikolinos Culture. He also noted that his group has realized that the Maasai women can create unique color combinations that Pikolinos designers could not possibly visualize. According to Juan Peran Bazan-Vice President, Pikolinos Group, by the second year of the collaboration relied on the Maasai women to create the color combinations.
b. “There is something about the way the Maasai women combine colors. It is in the animals, the sunset and sunrise on the horizon of the Mara; it is in the way they dress. It is just something so African, so unique, that we quickly realized that we could not master it. They combine white, red, orange and black, and it looks astonishing. It is Maasai, it is African, you can pick it out anywhere you go around the world and say…Aha! That is Kenyan.” - Juan Peran Bazan - Vice President, Pikolinos Group
c. The Maasai community is certainly learning a lot in terms of entrepreneurial skills.
d. ADCAM is working with an African community for the first time, a competency that it can transfer to future projects in the region.

IM Exhibit 2
LINKAGE TO CONCEPTS AND THEORIES

Social Capital
n a review of social capital, the instructor may want to discuss how the NGO used bridging social capital to successfully connect the Maasai community to the multinational corporation and subsequently to the North American & European markets. Davidsson and Honig (2003) discussed how bridging social capital (weak ties) becomes increasingly more important relative to bonding social capital (strong ties) and even human capital as nascent entrepreneurs progress from mere start-ups to an actual launch. **Social Capital: Structural holes** Burt (1980) argued that open networks with non-redundant ties create greater economic returns than closed ones, which tend to have redundant ties. He referred to these open (sparse) networks - which are essentially gaps between groups in a social network where there are few relationships bridging the groups - as structural holes. According to him, the highest economic returns lie between (sparse/open) not within dense (closed) regions of relationships. The structural holes that exist among the social groups creates opportunities for brokering information to flow among otherwise disconnected groups. As such, it is possible to create prospects for arbitrage in the market. For social entrepreneurship to be effective and sustainable, identifying new structural hole linkages between different communities is essential. Nicolaou and Birley (2003) discussed four distinctive benefits that non-redundancy gives: 1. Opportunity enhancement - ADCAM makes the discovery of entrepreneurial opportunities in the Maasai- Pikolinos collaboration a possibility. 2. Access to vital information and resources that could otherwise be inaccessible- The Maasai live in isolation without access to a domestic market let alone the international market. ADCAM connects the communityto western markets. 3. Timing - The story of the Maasai community is not well known globally and therefore, without the presence of ADCAM, it is possible that Pikolinos could have missed out onthis opportunity. 4. Positive recommendations and evaluations - The Vice President of Pikolinos Group - Juan Peran Bazanmakes it clear that their company knew nothing about the Maasai community or the feasibility of the project. ADCAM invests in creating the prototype, trains the artisans on quality and dealing with the logistics. Without their recommendation and coordination of these efforts, the collaboration may have not taken off. **Discussion:** Use Nicolaou and Birley's (2003) framework to generate a discussion…such as the benefits and role of ADCAM in the Maasai- Pikolinos collaboration.
Community-based enterprises (CBEs)
In a special issue of the Journal of Business Venturing (JVB), Hall et al. (2010) decried the paucity of research on the role of entrepreneurs within impoverished communities from developing economies. Peredo and Chrisman (2006) argued that Community Based Enterprises (CBEs) could provide potential strategies for sustainable local development in poor populations. This case can help bridge that gap by stimulating conversation among students who may have little exposure to the literature and may have never encountered such forms of entrepreneurship.
Family Business & building positive moral capital through Corporate Social Responsibility
Dyer and Whetten (2006) argued that those families who have a considerable amount of their wealth tied to a particular firm are more likely to invest in building positive moral capital. Clearly, Pikolinos Group's commitment to creating social value is evident in their collaboration with over 16,000 families in countries such as Peru, Guinea-Bissau, India, Bangladesh, Pakistan and now Kenya and Tanzania, among a host of others. More importantly, it is imperative that the instructor points out that doing good (creating a social good) can often deliver dividends beyond identity,

pride and reputation of the family.

Discussion:

1. Analyze the strategic decisions of the President of ADCAM (International) in the context of the short term and long-term goals.
2. Analyze Pikolinos' approach to Corporate Social Responsibility (CSR) and discuss the issues surrounding CSR among family owned businesses.

Discussion on Sustainable Entrepreneurship, Social Entrepreneurship and Corporate Social Responsibility (CSR)

Shepherd and Patzelt (2011:142) argue that 'if a term captures everything then it represents nothing.' Some researchers use the term Social Enterprise interchangeably with the term Sustainable Enterprise. Shepherd and Patzelt (2011) help clarify what "Sustainable Entrepreneurship" is and what it is not. The instructor should to highlight why that distinction is important.

Whereas there are overlaps between Sustainable Entrepreneurship, Social Entrepreneurship and Corporate Social Responsibility (CSR), Social Entrepreneurship does not necessarily seek to sustain current sources of life support or a community's substance. Likewise, CSR does not necessarily lend itself to entrepreneurial action nor innovation, which are vital components of Sustainable Entrepreneurship.

Discussion: Why do family owned businesses engage in corporate social responsibility? How does this case demonstrate the role of entrepreneurs within impoverished communities from developing economies?

ROLE OF AUTHORS

One of the authors traveled to Kenya and Spain to interview key personnel in ADCAM (International), ADCAM (Kenya) and Pikolinos Group Inc. The three authors jointly wrote the case based on the interview scripts, published interviews and published annual reports.

SUPPLEMENTARY MATERIAL

Video links:
The story of the Maasai Project Maasai
Project by Olivia Palermo
The main Players/leaders of the Maasai Project

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TO DISRUPT OR NOT DISRUPT THE INDUSTRIAL FLUID VALVE INDUSTRY

R. Barth Strempek – Elon University

CASE DESCRIPTION

The primary subject matter of this case concerns evaluation of an entrepreneurial opportunity in an industrial (B2B) setting. Secondary issues examined include disruptive technology, late career entrepreneurship, and intellectual property protection. The case has a difficulty level of: appropriate for senior level courses. The case is designed to be taught in 1.0 to 1.5 class hours and is expected to require 2.0 to 3.0 hours of outside preparation by students.

CASE SYNOPSIS

Can and should an older entrepreneur embark on an entrepreneurial venture to disrupt a major industry? If he does, the world could gain a more sustainable technology that can enhance processes in numerous other industries. If he does not, the technology and its benefits may be lost to history.

Fifty-six year old entrepreneurship/strategy professor, Barth Strempek, is presented with an opportunity to commercialize a potentially disruptive technology capable of revolutionizing the industrial fluid valve industry. Inventor Gene Feild (91 years old) has recently passed away, leaving his unique technology unexploited. Strempek, having previously been a consultant to Feild, is evaluating whether or not to reassemble the pieces and attempt to structure a new venture. Several valve prototypes exist but may not be in working condition. Over fifty valve designs, most of which have not been prototyped, are sitting in the files. Patents have expired on the original designs. However, an advanced version of the technology (full-balance) that greatly improves valve control and actuation (operation) has been designed and prototyped. A patent application for the advanced technology has been written and could be filed quickly.

Technology ownership and intellectual property issues play a central role. It is unclear who actually owns the pieces of the technology. Gene's heir, Susan Ferm, has possession of the prototypes and files and probably owns the old flat-plate technology. It is likely that the advanced full-balance technology is owned by the shareholders of Gene Feild's company, Feild Technologies Limited (FTL). Sorting out the technology ownership question is imperative. Primary issues revolve around evaluation of a complex entrepreneurial start-up involving the potential disruption of a mature industry. The case also presents some of the numerous practical and idiosyncratic issues involved in trying to get a start-up off the ground.

LEARNING OBJECTIVES AND DISCUSSION QUESTIONS

Learning Objective #1: Evaluate a complex industrial entrepreneurial opportunity
Learning Objective #2: Introduce the concept of disruptive technology in a mature industry

Learning Objective #3: Identify and evaluate strategic issues including competitive advantage, protection of intellectual capital, and market positioning
Discussion Questions:
Learning Objective #4: Identify practical considerations involved in assembling a complex new venture including technology ownership and protection issues, early seed funding, and legal structure
Learning Objective #5: Explore the characteristics of the entrepreneur, particularly an older entrepreneur

RELATED MATERIALS

Instructors might utilize an approach to opportunity evaluation such as the Timmons Model (Opportunity, Resources, Team). This approach can be found in*: Spinelli, S. Jr. and Adams, R. 2012. New Venture Creation: Entrepreneurship for the 21st Century, Ninth Edition. McGraw-Hill.*

Also, investors look for ventures with certain characteristics. Guy Kawasaki provides a clear and very readable description of these characteristics in*: Kawasaki, G. 2004. The Art of the Start. Portfolio.*

Another relevant topic area is the introduction of disruptive technology which was popularized by Clayton Christensen over 15 years ago in: *Christensen, C. M. 1997. The Innovator's Dilemma. Harper Business.* Dr. Christensen has expanded these ideas over the years in: *Christensen, C. M. and Raynor, M. E. 2003. The Innovator's Solution. Harvard Business School Press.* and *Christensen, C. M., Horn, M. B., and Johnson, C. W. 2008. Disrupting Class: How Disruptive Innovation Will Change the Way the World Learns. McGraw-Hill.*

INITIAL QUESTION

The instructor might initially pose what seems like a simple question:

Should Strempek pursue this venture or not?

Given the complexity of the issues and lack of industry familiarity, it would not be surprising to see substantial fence sitting and "No Go" responses here. To spur discussion it would be helpful to prompt the students to consider the substantial upside should this technology catch hold. The industry is huge, and the technology, if not moribund, is quite static. It is possible that existing firms could exhibit significant organizational inertia and be hesitant/unable to adjust a well-established business model that is based on periodic product failure/replacement and regular repeat sales through an established direct sales force. The new technology argues for a new business model based on providing long-lasting premium products that solve previously insoluble customer problems. This is a huge risk, huge potential reward opportunity.

DISCUSSION QUESTIONS

Evaluation of the Entrepreneurial Opportunity (Learning Objective #1)
Discussion Question: ***What factors would you consider when evaluating this opportunity?***

Technological Opportunity

Somewhat more technical detail has been included than may be absolutely necessary to evaluate the business opportunity so that the student must sort through relevant and non-relevant information. One of the key questions is: *Is this technology a disruptive one or simply an incremental improvement?* If it is a disruptive one, will the traditional business model be adequate/appropriate, or is an entirely different approach required? If it is an incremental improvement, is there enough benefit to be derived to support a business opportunity/investment?

It might also be appropriate here to bring up a common issue in technological development. Technical entrepreneurs are often enamored with their technology and become blinded to the practical business consideration that turn a technology into a successful business. Could that have been one of the reasons that this technology has not been successfully commercialized to date?

Entrepreneurial Opportunity

Using the Timmons Model (Opportunity, Resources, Team) framework:

Business Opportunity

Market Size

Quite large: $24.8 billion US domestic [$34.9 billion (total valve industry revenues) X 71.2% (Industrial and Fluid Power segments)]. Worldwide opportunity is substantially larger.

Market Growth

Keeping pace with the general economy. The market has grown almost 7% per year (in current dollars) for the past three years ($28.6 billion - $34.9 billion). Real GDP has grown in the 3% range while inflation has also been in the 3% range (Bureau of Labor Statistics).

Competitive Advantage, Margins

If a new patent can be obtained for the advanced technology, it might be possible to carve a defensible niche in the high performance segments of the market. Solution of thorny customer fluid control problems could provide substantial room for premium value–based pricing, thus providing the potential for superior margins. However, the education phase of the sales cycle could be substantial. Customers have no knowledge that this technology exists and that their problems may now be solvable. Sales cycle could be quite extended. The business plan must ultimately address this issue.

Capital Intensity

This is a heavy manufacturing industry that would require substantial capital for machining and assembly facilities. However, outsourcing of manufacturing is feasible. This might allow the structuring of this venture as a design and marketing/licensing firm which would greatly reduce the required capital.

General Discussion Question: Does the potential exist here to structure an industrial product venture with high-technology-like margins?

Resources

Positives

1. The technology is mostly developed and demonstrated. However, definitive test results must be generated for technical and marketing purposes.
2. Several prototypes exist and over 50 valves have been designed and are in the files. Those files however are most-likely hard copy that would eventually need to be converted to CAD-CAM designs.
3. The advanced full-balance valve has been designed, prototyped and tested. It is likely that this advancement is patentable and will provide protection for high performance applications.
4. Lawyer who structured Gene Feild's last company (FTL) is still practicing in Maine. Will be helpful to sort out FTL ownership and technology ownership issues.
5. Patent attorney who helped write the patent application for the full-balance valve is still practicing in Portland, OR. May significantly reduce patent development costs and time.

Negatives

1. Original patents on the flat-plate technology have expired.
2. Capital is required to acquire the prototypes and files, and to cover the costs of setting up a legal entity to negotiate with the technology owners.
3. Condition of the prototypes is unknown since they have been unused for several years and are now stored in a garage in California.
4. Legal advice will be needed (maybe from multiple states) to determine current ownership of the technology.

The Team

1. Strempek is in his mid-fifties with business strategy and entrepreneurship experience, and a full-time job as a business professor. This is rather late in life to embark upon a major industrial venture for the first time. His skill set will need to be supplemented.
2. Tom Christensen (late 50s) is a professional engineer and professor of Fluid Power at the University of Maine who co-invented the full-balance technology. Tom is willing to assist with the start-up of this venture but is likely not interested in permanent employment. Tom's technical expertise will be critical to the start-up. New engineering talent will need to be recruited quickly in case something happens to Tom.
3. Substantial additional human resources will be needed depending upon the structure of the venture and how much is done internally versus outsourced. The skills and experience required may include valve design and engineering, manufacturing, testing, quality control, fund raising, manufacturing operations, industrial marketing with vertical market experience, etc.
4. **Conclusion:** The team is very thin and will need to be supplemented before major funding can be raised. This is not impossible but it will substantially dilute Strempek's ownership at a very early stage in the venture.

Considerations for Introduction of Disruptive Technology (Learning Objective #2)
Discussion Question: ***What is different about this potential opportunity as compared with a more incremental innovation?***

Disruptive technologies are notoriously difficult to introduce due to numerous inertial effects. In this case the valve industry has the following characteristics:

1. Large established customer base
2. Large established manufacturers with established business models. Traditional sales forces that take orders from customers when industrial valves invariably wear out. Therefore, a major portion of revenues is generated from repeat customers that require mostly order-taking.
3. Tradition of minor incremental improvements over time. "Common knowledge" that valves have known drawbacks (turbulence) that cannot be substantially improved.
4. Established "science" of valve design preventing radical innovation through "out of the box" thinking. Existing valve designers may have difficulty adapting to a new design paradigm.

These factors provide a substantial roadblock to a new firm employing a traditional business model. The large players are likely to react defensively to attack any new upstart that threatens to take away traditional customers. However, this industrial/organizational inertia can also provide a substantial opportunity for a firm that employs a new business model. The challenge here is to figure out what the elements of that new business model will be. A direct attack on the markets of established firms is unlikely to work. Small tangential penetration on the fringes would be a better start-up strategy. How to effectively accomplish that is a major question.

Strategic Options for the Venture (Learning Objective #3)
Discussion Questions: ***What are the basic operational models available for this type of venture? What challenges and risks does each entail?***

Although the ongoing strategic and operating structure of the venture is not the primary focus of this case, it is nonetheless prudent to understand the general options that might be considered and the risks that they entail. Following acquisition of the technology there are four basic options (with variations) that could be considered:

1. Full Operations and Control including Valve Design, Manufacturing, and Marketing
   - Will require a substantial amount of capital and a full complement of skills and capabilities.
2. Valve Design and Marketing, Outsource Manufacturing
   - Would require less capital than option #1. Substantial engineering and marketing skills still required.
3. Valve Design and Licensing
   - Would require the addition of valve design and testing capabilities, a marketing effort that promotes the technology and identifies potential licensees, and legal skills to close and enforce licensing deals.
4. Sell the technology
   - To a major valve competitor
   - To a minor/fringe player

Additional information (not included in the case) is required to fully analyze these alternatives. However, it is fair to say that the low capital intensity options would be preferable (2, 3, 4). The primary value in this venture will be in technology design and problem solving (customer industries), not manufacturing.

Market Positioning (Learning Objective #3)
Discussion Question: ***Can this technology be positioned in a way that it has a sustainable competitive advantage?***

According to Guy Kawasaki, a new product has the best chance of success if it is unique and provides high value to the customer. These are the kind of ventures that investors want to fund. In this case, the full-balance valve has the potential to be unique (clearly better than other valves) and provide high value to high performance segments of the market where not having a working valve causes process disruptions or heavy maintenance costs. These valves may also allow firms to do things they cannot currently do such as precise control, quick response, stability, quietness, etc. Therefore, this venture has a chance to find funding from the right sources due to its ability to provide high value to the customer and the possibility of patent protection.

Initial Start-up Resources for Technology Acquisition (Learning Objective #4)
Discussion Question: ***How might Strempek move forward to acquire the technology?***

If he decides to move forward, Strempek has two main options:

1. Bear all of the risk and expense of acquiring the technology himself
2. Assemble an initial investor group

It appears that the ownership situation could be quite complex. Legal advice will be required from the attorney in Maine and likely one in California (where Gene’s heir, Susan Ferm, resides). In addition, if Strempek elects option #2, legal assistance will be required to set up a legal entity. If he establishes an LLC, it will require the drafting of Articles of Organization and an Operating Agreement for the partners. At legal fees that might range between $300- 500/hr., the expenses would add up quickly. It is not inconceivable that the cost of acquiring control of the technology could be $10,000-20,000 or more. Ultimately, venture feasibility may depend on whether Strempek can reach reasonable deals with FTL owners and Susan Ferm.

Intellectual Property Protection (Learning Objective #4)
Discussion Question: ***What is required to protect the intellectual property in this situation?***

The basic flat-plate technology is no longer protected. Therefore, it is critical to protect the advanced full-balance valve technology as soon as possible. The expense of filing a patent application will depend upon the completeness of the existing draft and how extensive a preliminary patent search is required. In addition, a decision needs to be made about the filing of domestic and foreign patents which will add significantly to the expense. This activity could run anywhere from a few thousand dollars to tens of thousands. One will not know until a patent attorney reviews the current state of the application.

Suitability of Strempek as an Entrepreneur (Learning Objective #5)
Discussion Question: ***Does Strempek have what it takes to undertake this venture?***

Strempek is a 56 year old business professor with some real business experience (20 years ago). He directed a university entrepreneurship program and has likely performed sporadic consulting but has not had major direct business operations experience for quite some time. Retirement (perhaps) looms on the horizon in about ten years. The question here is whether Strempek has the background and fortitude to start a new venture at this stage of his career. Of course, only he can ultimately answer that, but there are some key considerations facing a later stage entrepreneur. Beginning any entrepreneurial venture is a grueling endeavor but to start a new industrial B2B venture is especially daunting.

Pros:

1. Huge upside potential
2. Strempek has some engineering and substantial business experience
3. The challenge of doing it "for real"
4. Static industry with well-established competitors employing well-worn business models provides a potential opening for an upstart with a new technology and new business model

Cons:

1. Funding a 56 year old college professor who has not started a major business before could be a significant challenge.
2. Industrial ventures are more difficult to fund than tech ventures.
3. Health becomes a real consideration. Any major health disruption could tank the venture.
4. Strempek has very little experience in valve technology and the major industries to which valves are sold.

Additional Discussion Question

Would the analysis change if you also knew that Strempek had a civil engineering degree from MIT, and MBA from Harvard, and was once Director of Corporate Planning for a $10 billion conglomerate? These are serious credentials, but Strempek still lacks valve technology knowledge, vertical industry experience, and a business operational background. People with supplemental capabilities will still be needed.

EPILOGUE

LiQuest Labs, LLC (LQL) was formed in 2009 to acquire the pieces of the Feild Valve technology. To spread some of the risk and provide venture support, Strempek recruited two partners to join him:

Darrell Gauthier – CEO and owner of International Inventory Management (IIM), Elon, NC, a specialty manufacturing and logistics firm that produces and distributes replacement parts for pharmaceutical manufacturing machines.

Dexter Barbee – retired CEO and former owner of Apollo Chemical Company, and member of the Board of Directors of MidCarolina Bank, Burlington, NC.

It took over two years to put the pieces back together. Legal advice was solicited from lawyers in Maine, North Carolina, and California, concluding that the advanced full-balance technology was indeed owned by the former FTL shareholders and the old flat-plate prototypes and files were owned by Gene Feild's heir, Susan Ferm. LQL paid $700 in back fees to reconstitute FTL in the State of Maine. Subsequently, LQL negotiated deals with FTL and Susan Ferm that would provide the parties with modest royalty payments (based on LQL profitability) for a period of time once LQL became profitable. In order to maintain financial flexibility and the ability to attract new partners and investors, these payments were capped at a reasonable amount. Once the cap is reached, royalty payments stop.

Over the 2010 Thanksgiving college break, Strempek flew to Northern California on Wednesday, rented a Chevy Equinox (SUV) one-way, picked up the valves and files from Susan Ferm, had Thanksgiving dinner with the Ferm family, began the drive back to North Carolina, seriously considered stopping in Las Vegas on the way but resisted, drove nearly the entire length of Interstate 40 stopping a couple of times to see the remnants of Route 66, dropped off the valves and files at IIM headquarters in Elon, NC, returned the SUV to the airport at Raleigh- Durham at 9PM on Monday evening, and showed up to teach his 8AM class on Tuesday. Finally, after a long and sometimes frustrating process, all the parts of the revolutionary valve technology were back together in one place at a total cost of nearly $20,000, mostly legal fees. The next day Strempek stared at the valve prototypes and files stacked up in milk crates and boxes on the IIM warehouse floor and asked himself three questions: *What have I gotten myself into? Am I crazy? Now what?*

FINAL QUESTION FOR THE STUDENTS

Given that Strempek has decided to go forward with the valve venture, the instructor might ask the students: *What are the next steps?*

1. Some of the tasks might be:
2. Check the condition of the prototypes
3. Review and organize the files
4. Recondition important valves for testing and demo
5. Write a business plan
6. Determine the ongoing structure and strategy of the venture
7. Identify potential demonstration projects
8. Recruit additional talent
9. Raise additional capital

RESEARCH METHODS

This case is a description of the actual events experienced by the author, and the decision process leading to the formation of LiQuest Labs, LLC and the acquisition of the Feild valve technologies.

MAGICBANDS IN THE MAGIC KINGDOM: CUSTOMER-CENTRIC INFORMATION TECHNOLOGY IMPLEMENTATION AT DISNEY

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CASE DESCRIPTION

The primary subject matter of this case concerns customer-centric information technology implementation. Secondary issues examined include customer experience, innovative technology development and adoption, customer relationship management, and big data. The case has a difficulty level appropriate for junior level courses or higher. The case is designed to be taught in three class hours and is expected to require three hours of outside preparation by students.

CASE SYNOPSIS

Imagine a child watching Snow White and The Seven Dwarfs on DVD before visiting the Magic Kingdom in Orlando, Florida. Once on vacation, the child rides the Seven Dwarfs Mine Train. While on the ride, the child hears the same music played in the movie, visualizes the same characters, and smells the mine that was featured in the movie. Afterwards, the child attends a meet and greet with the Snow White princess and a couple of the dwarfs. Nowadays, with IT processes that will be discussed in this case study, Snow White can call on the child by their name if they are wearing a special RFID-enabled wristband known as a MagicBand. That personal touch and experience is something the child will likely remember for many years to come.

This case examines the Walt Disney Company's use of information technology in the theme parks, especially, the recent introduction of MagicBands at the Orland Disney World. Disney has always prided itself on being one of the best service providers in the world. They have long used the slogan "happiest place on earth" to describe their amusement parks. The introduction of MagicBands exemplifies what Disney does so well in connecting their customers to a memorable personalized experience. Overall, this case illustrates a company's application of information technology to serve a customer-centric business model.

INSTRUCTORS' NOTES

Recommendations for Teaching Approaches

This case is primarily based on secondary sources, including company websites, company's annual report, media reports, and literature from research databases. This case is designed for an upper level information systems or marketing course, or an MBA course with the specific focus on the implementation of a new information technology to improve customer experiences. As mobile technologies have advanced rapidly, this case offers students the opportunity to examine the advantages, opportunities and challenges of implementing MagicBands, an RFID-enabled wristband, at the Walt Disney World. In this process, students learn the features of new customer-centric mobile technologies, the process and benefits of collecting and managing big data through MagicBands, and the role of innovative technologies in improving customer experiences. Group discussion following the instructor's guideline is recommended as the most appropriate teaching method for this case study.

Learning Objectives

After reading this case, students should be able to:

1. describe critical processes and challenges during the implementation of new customer-centric mobile technologies.
2. analyze how to use emerging information technologies to improve customer experiences.
3. analyze how to collect, analyze, and manage big data to help a company gain competitive advantages.
4. identify opportunities and risks offered by integrating innovative technologies into a company's technology infrastructure and business model.

Suggested Discussion Questions

1. **Describe Disney's development of the MagicBands in three to five words**

   This quick exercise can be given at the beginning of the class to allow each student to express their overall impression of the case. It could also be used as the icebreaking exercise if the class discussion is conducted in small groups. Student answers will vary and may range from positive (e.g., "innovative") to negative (e.g., "expensive"). We recommend the instructors to write down the words provided by students on the whiteboard, and ask follow up questions that lead to the other discussion topics.

2. **What are the challenges faced by the Walt Disney Company in their theme park business?**

   Disney has a few aspects of their theme park business that could be considered as challenges:

   - One of the main drawbacks is their high operating expenses. Most of this expense came directly from service costs. Disney invests significant capital into building and maintaining their theme parks. Those expenses are usually directly tied to improving the guest experience. If the total guest spending decreased, these costs could be a major strain on their bottom line.
   - Competition within the industry is also intensifying for Disney. Most notably, Disney's major competitors (in terms of theme parks only) are Six Flags Entertainment, Cedar Fair, and Universal Studios. Right now, Disney parks command some of the highest admittance prices in the industry, and customers continue to pay for them regardless of what other competitors are charging. But, there is a certain price point that customers will become indifferent. Considering the unique customer experience their competitors are also striving for (e.g., the Harry Potter themed attractions in Universal Orlando Resort), Disney needs to provide superior customer experience to justify the higher price.

- With little room for building new parks in the United States, Disney has to rely on expansion into other emerging markets outside of the U.S. for further growth. Currently, Disney operates theme parks in Hong Kong, Paris, Shanghai, and Tokyo. Emerging economies can create future opportunities for Disney, and will provide more cost effective land opportunities in most cases better than that of its American counterparts. With each country, there will be different barriers to entry, but it would give Disney a great opportunity to enhance its overall global presence.

3. **Imagine that you are responsible for managing a large and complex IT project similar to the MagicBands development project, what "good practices" you have learned from the development and implementation processes of MagicBands that could be applied to the project you manage?**

This question is most suitable for Information Systems students who have taken an introductory project management class, or students who have learned the basic concepts of project management through a chapter on developing IT solutions in a general MIS course. Some of the items students may identify include:

- Disney choose to develop the MagicBand mainly as an in-house project. Nowadays companies have many choices when developing IT solutions. They can buy existing software and hardware products from vendors. They can outsource the development to IT solution providers such as IBM. They can also rent a growing number of IT applications from cloud-based solution providers. While costly and time-consuming, in-house development may still be the best choice for a project that's highly innovative, industry specific, and tightly related to a company's core competency.
- The team applied the prototyping methodology during the development of MagicBand. There are several advantages of building a prototype when a project is large, complex, and innovative (i.e., no similar products or solutions used by other companies that could serve as a blueprint). The prototype of the MagicBand allows the development team to assess the technical feasibility of the band. By building the independent rooms on the sound stage to simulate the real world experience guests will have with the MagicBand, the team also assesses the operational feasibility of the solution before more resources were committed to the project. A working prototype also helps the team to gain support and buy-in from the top executives and other key stake holders, crucial to the success of any IT projects.
- The deployment of MagicBands at the Orlando location effectively served as a pilot for the program. For a potentially disruptive IT project, piloting at a single location or business unit before rolling out to the entire company generally reduces the risk of the project and increases the chance of success.

4. **The case introduced the concept of Internet of things (IoT). How can other consumer-facing industries take advantage of IoT to improve customer experience?**

Instructors should encourage students to use their imaginations in coming up with ideas on the use of IoT. Students' answers will vary. Some common examples of the use of IoT include home appliances, cars, medical devices, sport accessories, entertainment equipments, and so on. Each example involves some form of real-time status tracking and data communication, making the device a "smart" device.

5. Are there any risks and disadvantages of MagicBands or IoT in general?

The purpose of this question is to encourage students to also consider the negative aspects of new technologies. One obvious concern would be the security and privacy of customer information collected through MagicBands or other wearable items. Another issue would be customer acceptance, since one hundred percentage acceptance is usually an elusive goal when introducing a new technology to consumers. User rejection is typically a major issue for any IT project, and the leading cause of many project failures. The prototyping and piloting approaches discussed in question 3 will help reducing the risk of user rejection. Also, one fact not disclosed in the case body is that Disney still provides the old-fashioned access card as an alternative to the MagicBand for visitors who are not keen on wearing a wristband in the park.

6. How could Disney utilize the big data collected through the MagicBands?

Students will most likely propose ways to use big data to personalize guest experience, similar to those approaches discussed in the case body. Instructors should point out that the main advantage of big data is to help companies identify and evaluate useful trends and patterns, and it doesn't require a clear explanation for a pattern to be useful. For example, Disney may discover that for unknown reasons families who have visited a particular ride and dined at a themed in-park restaurant afterwards are much more likely to revisit the park within two years. In this case, they could issue digital coupons to the specific restaurant in the My Disney Experience mobile app immediately after a family has completed the ride, in the hope that this family will replicate the same experience and become a returning customer in the future. In addition to targeted marketing, the operations of the park could also benefit from analyzing the data. For example, if Disney could better understand and predict the size of the crowd at different rides, shops, and restaurants of the park, they would be able to manage the staffing levels more efficiently, therefore reducing costs.

7. With the successful rollout of MagicBands in the Disney World in Orlando, what should be the next steps for Disney to take in regard to the wearable technology?

Some of the opportunities students may identify include:

- Disney needs to implement MagicBands throughout the US (Disneyland) and, ultimately, their global operations. With Walt Disney World Resort serving as somewhat of a pilot site for the MagicBands, they now can see the benefits the bands provide to customers. They need to shift their technology focus to expand the use of their bands to multiple locations outside of only Florida. The cost of the infrastructure to support the MagicBands in different locations will initially be high (just like Florida), but the long-term benefits would outweigh these initial costs.

- There are some additional features and improvements that could be made to the MagicBands before a rollout on a global scale. For example, since Disney is able to track the location of each MagicBand through scanners installed throughout the park, one possible improvement is to allow family members to locate each other via the Disney mobile app. This would allow parents to find their children should they get lost in the park, wander away from their group, or are riding an attraction that the parents do not want to ride. This would provide a safety feature that customers want, and also reduces the amount of time and resources that Disney currently dedicates to finding guests lost throughout the parks and resorts.
- Disney has many opportunities to deploy new marketing strategies through the use of the data collected from its customer base utilizing the MagicBands. Through this data, Disney can create personalized, targeted advertisements using the data gathered from the MagicBands. This would provide Disney with potential for increased revenue, while providing the customer with advertisements or promotions that are specifically tailored to them.

8. The case was written mainly based on the initial launch of the MagicBands. Please conduct a quick research of the current status of the MagicBands and discuss any new developments and updates.

Students' response will vary depending on the information accurate at the time of the class. At the time of this writing, the MagicBands are still only available at the Walt Disney World Resort in Orlando, although there has been unconfirmed reports that rollout to the Disneyland in Anaheim will take place in the near future. Consumers now can purchase MagicBands that feature Disney intellectual properties ranging from R2-D2 and C-3PO of the Star Wars fame, to Judy Hopps and Nick Wilde (characters from the recently released Zootopia movie) at roughly twice the price of the model with the basic colors. Additional revenue was also achieved through selling add-on items to the MagicBands, such as MagicBandits (as shown in Figure 1) and MagicSliders.

Figure 1
MAGICBANDS WITH MAGICBANDITS (Source: The Disney Store)

ACCOUNTING FOR LEASES: A CASE EXPLORING THE EFFECT OF THE NEW LEASE ACCOUNTING STANDARD ON THE FINANCIAL STATEMENTS

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CASE DESCRIPTION

The primary subject matter of this case deals with the new lease accounting standard recently issued by the Financial Accounting Standards Board (FASB). The primary objective of this case is to help students learn and understand the major changes to accounting for leases, especially with respect to leases currently classified as operating leases. The case focuses on lessees' accounting and reporting since the new standard affects primarily lessees. Secondarily, the case explores some of the financial reporting issues that motivated FASB to issue this new standard, as well as some of the potential strategic and economic implications for organizations with significant lease obligations.

The case has a difficulty level of three to four and can be taught in about 40 minutes. Approximately two hours of outside preparation are necessary to fully address the suggested case-specific analysis and research questions, which are largely independent providing instructors with considerable flexibility. The case can be utilized in an Intermediate Accounting course, where accounting for leases is typically covered, and serves to reinforce the related concepts and issues discussed in class. It can also be used in an advanced level undergraduate or graduate course focusing primarily on the research components and the strategic implications of the new accounting standard.

Using this case can enhance students' technical, analytical, research, and communication skills. Furthermore, the case also provides students with some insights into the economic effect of accounting standards and the potential effect on managements' strategic decisions.

CASE SYNOPSIS

After nearly ten years of collaboration with the International Accounting Standards Board (IASB), two exposure drafts, and extensive due process; in February 2016, the FASB issued Accounting Standards Update (ASU) No. 2016-02, "Leases." Once implemented into the FASB Accounting Standards Codification (ASC), the new standard will supersede all currently existing Generally Accepted Accounting Principles (GAAP) related to leases. ASU 2016-02, which includes several appendices and spans nearly 500 pages, is quite complex and significantly changes lessees' accounting for and reporting of leases.

This case explores the effect of the new lease standard on the measurement, recognition, and reporting of leases and the effect on the financial statements of a company with significant lease commitments. Furthermore, the case explores some of the issues surrounding this accounting change and the potential impact on managements' capital budgeting decisions.

The main character in this case, with which students are asked to identify, is a highly motivated accounting major who interviews for and accepts an entry-level position at a mid-tier accounting and consulting firm whose clients tend to lease a significant portion of their plant *assets. The characteristics ascribed to the character; which include currency in the professional field, excellent technical knowledge, high motivation to excel, and ability to impress interviewers with detailed knowledge of the firm's clients and niche; are those that accounting majors would likely aspire to.*

The case includes selected company-specific financial statement information, including lease related disclosures. The case also includes an exhibit comparing major provision of the new lease standard applicable to lessees with current GAAP.

This case may enhance students' understanding of changes to accounting for leases and the effect on lessees' financial statements, and serves to enhance their research, technical, critical thinking, and communication skill. The context of the case may also enhance students' understanding of characteristics that help future accounting professionals prepare for and succeed in a challenging career.

INSTRUCTORS' NOTES

After years of deliberation and two exposures drafts (also referred to as proposed Accounting Standards Update or ASU), in February 2016, FASB finally issued its standard on leases. A month earlier, the IASB issued IFRS No. 16, which in some respects differs from the FASB standard and thus is not fully converged with U.S. GAAP. Both standards provide for adoption dates for the 2019 fiscal period for public companies and the 2020 fiscal period for private companies. Earlier adoption is permitted under ASU 2016-02; early adoption is permitted under IFRS only if the entity also adopts IFRS 15 – the IASB/FASB converged standard on revenue recognition (Deloitte, 2016).

Accounting majors, the future accounting professionals, must learn about the new lease accounting standard and understand its major provisions; they must also understand the effect on the financial statements. Furthermore, for the next few years, accounting majors must continue to learn and understand current GAAP pertaining to leases. Current editions of Intermediate Accounting textbooks do not yet include information about the finalized lease standard; hence, this case can be used to discuss the new lease standard, its major provisions, and implications.

The case includes technical accounting information that helps students understand major differences between current and future lease-related GAAP and the effect of these differences on the financial statements of companies with significant lease commitments. The information provided in Exhibit A, "Comparison of Current and New GAAP on Lessees' Accounting for Leases" can be used by instructors to discuss major changes to accounting for leases. The case provides the opportunity to consider and discuss the link between accounting for leases and the related financial reporting effects. The case may also motivate students to consider related financial reporting issues as well as strategic business considerations; all of which represent very important issues for accounting professionals.

The case includes both case-specific analysis and research questions. Each suggested question can be assigned independently providing instructors with considerable flexibility. Since some of the suggested questions require that students research the original FASB pronouncement (ASU 2016-02), the case also provides the opportunity for students to become familiar with the information content of an original accounting standard. The case setting addresses some aspects of the interviewing process for future accounting professionals; thus, the case can serve as an opportunity for instructors to briefly discuss professional issues, such as the key attributes of highly successful accounting professionals and may help students appreciate the importance of preparing for interviews.

Learning Objective Addressed

This case addresses several learning objectives and can be utilized to assess students' achievement of these learning objectives. After completing this case and the related suggested questions, students should be able to:

1. Understand the financial reporting related issues of accounting for leases
2. Describe the primary objective of the new lease accounting standard
3. Describe the prevalence and financial significance of operating leases
4. Understand the major differences between the current lease accounting standard and the new lease accounting standard with respect to lessees' recognition, measurement, and reporting of leases
5. Know the required implementation date and the adoption choices for the new lease standard
6. Understand the potential financial statement effects of the new lease accounting standard on the financial statements of a company with significant operating lease obligations
7. Know how to conduct research utilizing authoritative sources, such as original pronouncements issued by FASB and documents available on the SEC's website
8. Identify and describe the potential effect of the new lease accounting standard on managements' strategic decisions with respect to capital budgeting decisions
9. Describe some of the key characteristics of successful accounting professionals

Implementation Guidance

This case can be utilized as part of an in-class discussion of the key provisions of the new lease accounting standard to enhance students' understanding of the potential effect of the new standard on the measurement, recognition, and reporting of leases. It also can be used to discuss related strategic capital budgeting decisions with respect to property, plant, and equipment or as part of a discussion about the economic consequences of accounting standard changes. The case can be assigned as an individual or group project to reinforce lease related accounting concepts discussed in class. The case can also be assigned for in-class group presentations.

Students should be instructed to pretend that they are in Skylar's place, interviewing for an entry-level accounting position, and asked to address all or some of the case-specific analytical and research questions. The suggested questions are shown in the assignment section. Suggested answers to each question are shown in the "Answers to Suggested Questions" section. Instructors should specify the expected answer format. Case-specific analysis question No. 1 does not require calculations and can be answered by adding a column to Exhibit A and asking students to indicate the expected financial statement effects of implementing the new lease standard. Analysis question No. 2 requires that students estimate the effect of the new lease standard on key financial statement ratios. Instructors could choose to assign either question No. 1, question No. 2, or both questions. Students should be reminded to include complete reference information for cited source materials.

Suggested Grading Rubric

The following grading rubric is based on the learning objectives/outcomes addressed in this case. Alternative grading rubrics can be found in Schaefer and Stevens (2016).

SUGGESTED GRADING RUBRIC				
Learning Objective Assessed	Relevant Suggested Questions	Student fully addresses	Student addresses key	Stud ent correctly

		all aspects of the question and exceeds expectations (total possible points earned)	aspects of the question, but may miss or fail to address some part of the question (partial points [50-95%] earned)	addresses only a relatively small portion of the question and fails to meet expectations (less than 50% of points earned)
Student understands the major differences between the current and the new lease accounting standard with respect to lessees' recognition, measurement, and reporting of leases and correctly interprets and describes the effect on lessees' financial statements	Case-specific question No. 1			
Student understands the potential overall financial statement effects of the new lease accounting standard on the financial statements of a company with significant operating lease obligations and correctly estimates the effect on key financial statement ratios	Case-specific question No. 2			
Student identifies, analyzes, and describes the potential effect of the new lease accounting standard on managements' strategic decisions with respect to capital budgeting decisions.	Case-specific question No. 3			
Student understands the financial reporting related issues and consequences related to accounting for leases and effectively conveys this understanding	Case-specific question No. 4,5			
Student accurately researches and analyzes information provided in FASB ASU 2016-02 and other authoritative pronouncements including the objective the new standard, required implementation date, required implementation method, and adoption choices. Student correctly interprets and describes the information	Research questions No. 1-6			
Student researches the prevalence and financial significance of operating leases and correctly interprets and describes the information	Research question No. 7, 9			
Student effectively researches lease-related information in public company financial statements, including note disclosures, correctly interprets and describes the information	Research question No. 8			

ASSIGNMENTS

Suggested point allocations are shown in parenthesis and are based a total of 200 points (100 points for case-specific and 100 points for research questions). If selected questions are assigned, points should be adjusted accordingly.

Case-Specific Analysis Questions

1. Review Exhibit A and consider the effect on the financial statement of a lessee with significant lease commitments. Add a column to the right of exhibit A and indicate the effect of the new standard on specific financial statement categories (40 points).
2. Review the selected financial statement information and lease related note disclosures provided for Merburg's clients. Based on the information provided, estimate the effect of the new lease standard on the company's key financial statement ratios; including the (1) debt-to-equity ratio, (2) debt-to-asset ratio, (3) return on assets, and (4) return on equity. For simplicity, you may ignore the time value of money. Draw some general conclusions regarding the effect of the new lease standard on Merburg's client. (30 points)
3. How could the new lease standard's provisions affect the capital budgeting decisions of lessees, such as Merburg's clients, with significant operating lease commitments? (10 points)
4. Explore potential economic consequences of the new accounting standard. What type of company likely will be most affected by the new standard? (10 points)
5. What opportunities for keeping lease-related liabilities off the balance sheet are still available under the new lease standard? (10 points)

Research Questions

Questions 1-5 require research of the new lease standard – ASU 2016-02, available at http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176156316498#2016.

1. ASU 2016-02 will be integrated into what topic area of the FASB ASC? (10 points)
2. When must companies adopt the new lease accounting standard? Be sure to differentiate between public and nonpublic companies (Hint: search for the standard's "effective date"). (10 points)
3. What is the first fiscal period for which public and private companies must derive lease-related information consistent with the new lease standard? (10 points)
4. Describe the adoption method required by FASB for the new lease standard? (10 points)
5. What were FASB and IASB's motivation/objectives for issuing a new lease standard? (10 points)
6. How do ASU 2016-02 and IASB's IFRS No. 16 differ? Identify at least one substantive difference. (10 points)
7. Research the prevalence of off-balance sheet financing with respect to leases. Hint: You can find information in a report issued by the Securities and Exchange Commission (SEC). (10 points)
8. Select your favorite public company and retrieve its most recent annual report. Utilize a keyword search for "operating lease" and "financing lease" and determine the relative importance of operating and financing leases for this company in terms of future monetary commitments. Also search for any information pertaining to (1) the company's plans for implementing the new lease standard and (2) the expected financial statement effect of the new standard. Briefly summarize your findings. (20 points)
9. Based on their current lease commitments, what well-known Fortune 500 Company will likely experience the greatest financial statement impact from the implementation of the new lease standard? (10 points)

ANSWERS TO SUGGESTED QUESTIONS

Suggested Answers to Case-Specific Analysis Questions

1. Review Exhibit A and consider the effect on the financial statement of a lessee with significant lease commitments. Add a column to the right of exhibit A and indicate the effect of the new standard on specific financial statement categories.

EFFECT OF THE NEW LEASE STANDARD ON LESSEES' FINANCIAL STATEMENTS			
Accounting/Reporting Issue	Currently Effective GAAP	New Accounting Standard – Future GAAP	Potential Effect on Lessee's Financial Statements
Leases Classified as Financing Lease			
Recognition and reporting of leased asset	Recognize and report as asset classified as property, plant and equipment on the balance sheet (statement of financial position)	Recognize and report as right-of-use asset recognized on balance sheet (statement of financial position)	Balance Sheet: reclassification from property, plant and equipment to right-of-use asset. No effect on total assets or other balance sheet categories Income statement: no effect
Recognition and reporting of related future lease payments	Recognize and report the present value of future lease payments as a liability	Recognize and report the present value of future lease payments as a liability	Virtually the same as under current GAAP
Subsequent measurement	For depreciable assets, asset-related depreciation and lease liability related interest expense are recognized separately on statement of comprehensive income	Amortization of the right-of-use asset and lease liability related interest are reported separately on statement of comprehensive income	Virtually the same as under current GAAP
Amortization of lease asset and liability	The related asset is depreciated/amortized using the same method utilized for assets purchased outright. Interest expense is based on the present value of the remaining lease payments multiplied by the lessee's implicit interest rate or incremental borrowing rate. The difference between the lease payment and the interest expense represents a reduction of the lease liability	The related asset is depreciated/amortized using the same method used for assets purchased outright. Interest expense is based on the present value of the remaining lease payments multiplied by the lessee's implicit interest rate or incremental borrowing rate. The difference between the lease payment and the interest expense represents a reduction of the lease liability	Virtually the same as under current GAAP
Recognition of lease related cash payments	Payments related to interest are classified as operating cash flows; re-payment of lease liability principal are classified as financing cash flows	Payments related to interest are classified as operating cash flows; re-payment of lease liability principal are classified as financing cash flows	Virtually the same as under current GAAP

Leases Classified as Operating Lease – Except for Those with Lease Terms Twelve Months or Less for Which Lessee Selects Exception			
Recognition and reporting of leased asset	Leased asset is not recognized on balance sheet	Right-of-use asset is recognized on balance sheet; typically classified as long-term asset	Balance sheet: Increase in assets, classified as long-term "right-of-use" asset
Recognition and reporting of related future lease payments	Not recognized as liability. Future lease payments are disclosed in financial statement notes	Recognize and report the present value of future lease payments as a liability (initial amount will be the same as if it were classified as financing lease)	Balance Sheet: Increase in long-term liabilities
Recognition on statement of income/comprehensive income	Total periodic lease payments are typically recognized as operating expense	Total periodic lease payments are recognized as single line item. For unequal lease payments, total lease payments are expensed straight-line over the lease term.	No effect on the income/comprehensive income statement if periodic lease payments are equal. If periodic lease payments are not equal, lease expense under the new standard typically will be recognized straight line (sum of payments divided by number of periods).
Recognition on statement of cash flows	Periodic lease payments are classified as operating cash flows	Periodic lease payments are classified as operating cash flows	No effect on the statement of cash flows
Amortization of lease asset and liability	The related asset and liability are <u>not</u> recognized on balance sheet; thus, no amortization is recognized	The right-of-use asset is adjusted for (1) the difference between the current period lease payment and the lease expense, which consists of the total lease payments divided by the number of payments, and (2) the current period decrease in the present value of the future lease payments, which also reduces the lease liability	Amortization of right-of-use asset and related liability are reported as described. If contractual lease payments are unequal, amortization for a specific reporting period may differ from the lease (rent) expense reported under current GAAP. Over the lease term, total lease related expense will be the same as under current GAAP
Recognition on statement of cash flows	Periodic lease payments are classified as operating cash flows	Periodic lease payments are classified as operating cash flows	No effect on the statement of cash flows

2. Review the selected financial statement information and lease related note disclosures provided for Merburg's clients. Based on the information provided, estimate the effect of the new lease standard on the company's key financial statement ratios; including the (1) debt-to-equity ratio, (2) debt-to-asset ratio, (3) return on assets, and (4) return on equity. For simplicity, you may ignore the time value of money. Draw some general conclusions regarding the effect of the new lease standard on Merburg's client.

The estimated ratios are based on the following selected financial statement information and lease related note disclosures presented in the case.

SELECTED FINANCIAL INFORMATION – 2016 FISCAL PERIOD	NUMBERS ARE IN THOUSANDS
Current assets	$ 11,595
Long-term assets	24,520
Total assets	36,115
Total liabilities	19,250
Total stockholders' equity	16,865
Total revenue	42,400
Net income	3,600

The note disclosures provide the following information under the heading of "Contractual Obligations."

NOTE DISCLOSURES - LEASES				
Contractual Obligations	Total Payments	Payments due during 2017	Payments due during 2018-2019	Payments due thereafter
Financing leases	$290	35	35	220
Non-cancellable operating leases	$2,280	540	490	1,250
Off-balance sheet arrangements relate to operating lease commitments detailed in the footnotes to the consolidated financial statements.				

Answer to Suggested Case-Specific Analysis Question No. 2:

Ratio (Formula)	**Current Lease Standard is Applied**	**Estimated Effect - New Lease Standard is Applied (for simplicity, present value concepts are ignored)**
Estimated debt-to-equity ratio (total liabilities/total stockholders' equity)	Reported total liabilities, divided by reported total equity $19,250/$16,865 = 1.14	The sum of total liabilities plus non-cancellable future operating lease payments; divided by total equity ($19,250+$2,280)/ ($16,265) =1.28 (an increase of approximately 12%)
Estimated debt-to-asset ratio (total liabilities/total assets)	Reported total liabilities, divided by total assets $19,250/$36,115 = 0.53	The sum of total liabilities plus non-cancellable operating lease payments; divided by the sum total assets (as reported), plus operating lease related right-of-use asset $19,250+$2,280)/($36,115+$2,280) = 0.56 (an increase of approximately 6%)
Estimated return on assets (net income/total assets)	Reported net income, divided by reported total assets $3,600/$36,115 = 9.97%	Reported net income, divided by the sum of total assets, plus operating lease related right-of-use asset $3,600/($36,115+$2,280) = 9.38%

		(a decrease of approximately 6%)
Return on equity (net income/total stockholders' equity)	Reported net income, divided by reported stockholders' equity \$3,600/\$16,865 = 21.40%	Reported net income, divided by reported stockholders' equity \$3,600/\$16,865 = 21.40% (unchanged)

Thus, for lessees with significant operating lease commitments, the new lease standard will tend to have the following effect on key financial ratios: The debt-to-equity ratio and the debt-to-asset ratio, both reflecting a company's solvency, will tend to increase; increases in those two ratios may be interpreted by lenders as indicative of higher credit risk. In addition, the return on assets, a profitability ratio, will tend to decrease under the new lease standard.

The results shown in the table above are based on estimates. The total future lease payments and the right-of-use asset capitalized under the new lease standard will need to be discounted to present value. So, actual results would differ slightly. Since both current and future GAAP require the use of an appropriate interest/borrowing rate to calculate the present value of the liability, for simplicity purposes, interest rates were ignored. Instructors may wish to discuss the effect of the choice of discount (interest) rate on the present value of the lease obligation as well as the right-of-use asset. This requires the assumption of an appropriate interest rate as well as more detail about the estimated lease payments due after 2019 (i.e., estimated amount for each subsequent year, as well as number of years). A higher discount rate will result in a lower present value and thus a lower reported liability (and asset); while a lower discount rate will increase the present value of the liability.

3. How could the new lease standard's provisions affect the capital budgeting decisions of lessees, such as Merburg's clients, with significant operating lease commitments?

Leasing, rather than buying long-term assets, provides companies with the opportunity to frequently replace their plant assets, without the commitment of ownership. Consistent with current GAAP, operating leases also provide the opportunity to keep lease-related payment commitments off the balance sheet; thus, improving key financial relationships and ratios. This can be perceived as an advantage by companies that do not want additional debt on their balance sheet. This advantage will largely disappear under the new lease standard because all leases with lease terms of more than one year must be capitalized on the balance sheet. Hence, in the future, more companies may decide to purchase their plant assets or enter into financing-type lease agreements.

4. Explore potential economic consequences of the new accounting standard. What type of company likely will be most affected by the new standard?

Every company that leases assets and classifies them as operating leases will be affected to some degree. This includes large, midsize, and small companies across most industries. The reason for this is that many companies lease their equipment, which allows them to maintain state-of-the art equipment while avoiding purchase and ownership commitments.

Information regarding operating lease commitments of Fortune 500 companies can be found in a study published by "LeaseAccelerator." According to their analysis, the company with the largest amount of operating lease commitments currently is Walgreens with more than \$33 billion in (undiscounted) future operating lease commitments (LeaseAccelerator, 2016).

Consistent with the new lease standard, the related leases (except for those with very short-term commitments) will have to be reported on the balance sheet of those companies.

5. What opportunities for keeping lease-related liabilities off the balance sheet are still available under the new lease standard?

Consistent with ASU 2016-02, only leases with lease terms of twelve (12) months or less can be excluded from capitalization with no related liability on the statement of financial position. In determining whether a particular lease qualifies for this exception, a lessee's option to extend the lease is included in the lease term provided that the lessee is likely to exercise the option. Thus, lessees' ability to keep leases off the balance sheet will be limited under the new standard. This expected outcome is consistent with one of the primary objectives of the new lease standard.

Suggested Answers to Research Questions

Answer to Question 1-5 are based on ASU 2016-02 (FASB, 2016)

1. ASU 2016-02 will be integrated into what topic area of the FASB ASC?

The new standards (ASU 2016-02) will be integrated (codified) into topic 842 of the FASB Accounting Standards Codification (ASC).

2. When must companies adopt the new lease accounting standard? Be sure to differentiate between public and nonpublic companies (Hint: search for the standard's "effective date").

The new standard is effective for fiscal periods starting after December 15, 2018 for public companies and for fiscal periods starting after December 15, 2019 for nonpublic companies (FASB, 2016). Thus, for most public company lessees, the standard must be adopted for the 2019 fiscal period and for nonpublic company lessees the standard must be adopted for the 2020 fiscal period. Early adoption is permitted.

3. What is the first fiscal period for which public and private companies must derive lease-related information consistent with the new lease standard?

Since companies typically provide comparative information for three years and must report comparative information for those prior years, their accountants must start deriving information starting with the 2017 fiscal period. For private companies, the first comparative year for which information is needed is 2018. Early adopters will need to derive information for earlier fiscal periods, depending on the adoption date.

4. Describe the adoption method required by FASB for the new lease standard?

Entities should adopt the standard using the modified retrospective approach. This approach permits some practical expedients. For example, entities may continue to treat leases existing prior to the new standard's effective date using current (pre ASU-2016-

02) GAAP. However, if the existing leases are modified after the new standard's effective date, the new lease standard's provisions must be applied.

5. What were FASB and IASB's motivation/objectives for issuing the new lease standard?

As set forth in ASU 2016-02, "The FASB is issuing this Update to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements" (FASB, 2016, summary). FASB further elaborates that because of the prevalence of leases, it is very important that "financial statement users have a clear and understandable picture of an entity's leasing activities" (FASB, 2016, summary). FASB also indicates that this goal is not always achieved under the current standard. What FASB appears to be referring to is the currently prevalent off-balance sheet financing of long-term lease commitments which results from companies accounting for long-term leases as operating leases.

6. How do ASU 2016-02 and IASB's IFRS No. 16 differ? Identify at least one substantive difference.

This question can be answered with reference to either ASU 2016-02 (the new lease standard), available on the FASB.org website, or utilizing an internet search. ASU 2016-02 summarizes the differences between the new FASB standard and IFRS No. 16, IASB's new lease standard, under the heading, "*How Do the Provisions Compare with International Financial Reporting Standards"* (IFRS)?

One of the primary differences between the FASB and IASB standards is that IFRS No. 16 does not differentiate between operating and financing leases. Specifically, IFRS No. 16 requires that all leases are accounted for as financing leases. Thus, while leases classified as financing leases are accounted for the same under U.S. and GAAP and IFRS, those classified under U.S. GAAP as operating leases are not. Other differences include an exception for lessees for leases below $5,000; reference to collectability of lease payments and residual value; lack of differentiation between direct-financing and sales type leases under IFRS; allowing lessors to recognize profit at lease commencement for leases that may in essence be direct-financing leases; and additional choices in measuring the right-of-use asset. Additional differences can be found on pages 8-9 of ASU 2016-02.

7. Research the prevalence of off-balance sheet financing with respect to leases. Hint: You can find information in a report issued by the Securities and Exchange Commission (SEC).

In its 2005 report, the U.S. Securities and Exchange Commission (SEC) estimates that SEC registrants reported $1.25 trillion in non-cancellable future lease-related obligations as operating leases, rather than capitalizing the related obligation as liabilities. The estimated amount is non-discounted (i.e., not adjusted for the time value of money).

8. Select your favorite public company and retrieve its most recent annual report. Utilize a keyword search for "operating lease" and "financing lease" and determine the relative importance of operating and financing leases for this company in terms of future monetary commitments. Also search for any information in the annual report pertaining to (1) the company's plans for implementing the new lease standard and (2) the expected financial statement effect of the new standard. Briefly summarize your findings.

Answers will vary depending on the company chosen and the timing of assigning the question. Students should be asked to provide either direct hyperlinks or hardcopies of information cited from the company's 10-K filing or annual report.

9. Based on their current lease commitments, what well-known Fortune 500 Company will likely experience the greatest financial statement impact from the implementation of the new lease standard?

According to an analysis by *LeaseAccelerator* (2016), Walgreens may experience the greatest impact under the new lease standard. Based on the report, Walgreens currently has total (undiscounted) operating lease obligations of $33,721 million. The report provides a complete listing for Fortune 500 companies.

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EXPLORING PRICE DISCRIMINATION IN AN E-COMMERCE ENVIRONMENT INSTRUCTOR'S NOTES

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CASE DESCRIPTION

This case study focuses on e-commerce price-setting practices and provides an opportunity to review the underlying principles of price discrimination as well as other pricing strategies. Its instructional value extends beyond its focus on the growing specialty tea market. The case is designed to address a number of learning outcomes in a managerial economics course at the M.B.A. or upper undergraduate level and has been tested in M.B.A. economics courses at two business schools over several semesters. The content of this case may also be relevant to other business disciplines concerned with pricing issues, such as marketing.

CASE SYNOPSIS

The market for specialty teas in the USA is experiencing robust growth. The US is now the second largest importer of tea in the world. A small specialty tea store featured in the case seeks to participate in the growing market, but must adjust to the online environment in which consumers find pricing information easily and many sellers offer similar products. A number of recent studies have demonstrated that charging customers different prices for the same product or service is becoming more common in the online marketplace. This case asks students to evaluate the feasibility of non-trivial pricing, in particular third-degree price discrimination, in an e-commerce setting. It is designed to help students better discern between different pricing strategies and review the conditions for their successful implementation.

INSTRUCTOR'S NOTES

This case study is designed to cover a number of learning outcomes typical for a managerial economics course at the upper undergraduate or M.B.A. level and may be integrated with any typical managerial economics textbook such as Baye and Prince (2013). Price discrimination and pricing strategies are a challenging topic that requires careful exposition in the economics classroom (Carroll and Cates, 1999; Clerides, 2004).

In completing this case study assignment, the students need to apply economic theory along with critical thinking to develop their conclusions. Upon the completion of this case study, students will be able to: (1) Critically evaluate pricing strategies; (2) Recognize the conditions for successful price discrimination and other non-trivial pricing strategies; (3) Apply theoretical foundations to forecast the expected outcomes of various pricing strategies. This case includes sufficient detail to provide depth to the students' analysis and is grounded in both academic (Hannak et al., 2014; Turow et al., 2005) and popular press sources (Dworkin, 2014; Mattioli, 2012). While the case discusses a specialty tea store and provides background information about the market for tea in the US (Tea Association, 2015), its pedagogical focus is on the broad issue of pricing strategies and the majority of the discussion is purposefully dedicated to this topic. The case most naturally fits with the chapter on pricing strategies, however it also provides the instructor with an opportunity to discuss various other topics that are typically part of a managerial economics course. In order to ensure meaningful discussion and exchange of ideas, students should be familiar with the principles of economic welfare analysis as well the concepts of pricing power and price elasticity of demand.

Despite the fact that the case was designed for a managerial economics course, its broad appeal makes it adaptable for use in other business disciplines, such as marketing, due to the fact that a discussion of product pricing is an integral part of such courses. The appropriate depth of the pricing analysis can be chosen by the instructor of a specific course.

Notes for Question 1

What are the conditions for a successful implementation of price discrimination? In your opinion, can price discrimination help increase Jason's profits? Why or why not?

It is beneficial to begin with a brief overview of different types of price discrimination since their names may be confusing for a person unfamiliar with the topic. Those definitions are provided in the case body at the beginning of the section entitled "Can Price Discrimination Help?" As for the list of conditions itself, it is fairly standard and can be found in any economics text covering these topics. We like to list those conditions starting with the more trivial ones and proceed to those that require more careful consideration on the seller's part.

First, the seller has to have some pricing power. Here, students may benefit from a reminder that this is not always the case. In perfectly competitive markets or markets that closely resemble them due to product commoditization and a large number of substitute alternatives, price discrimination attempts are unlikely to be successful. However, whenever the issue of price setting can be reasonably discussed, this condition is automatically satisfied.

Second, consumers have to be heterogeneous in their preferences. In other words, there have to be at least two groups with known (or reasonably inferred) demand differences. There should be little disagreement with the statement that some heterogeneity in individual demand characteristics is always present. It can be expressed in different ability/willingness to pay, or in different degree of sensitivity to price variations (elasticity of demand). Therefore, this condition is also a fairly trivial one. It is, however, of little help in itself and works only with the next condition.

Third, the seller has to be able to distinguish among groups of consumers. Some methods of identifying groups are quite straightforward. For example, if there are reasons to believe that students have distinctly different preferences for a specific product, this condition can be satisfied by checking student IDs. At the same time, quite often sellers have to devise more intricate means of telling different types of consumers apart. As such, this topic deserves a separate discussion, which we try to instigate by Questions 5 and 7 of the present case.

Fourth, the possibility of product resale has to be eliminated. In some cases such as airline tickets, hotel and car reservations, this condition can be satisfied by personalizing the product and making it non-transferrable. Other cases such as student discounts at a bookstore require sellers to be more careful and invent ways to minimize resale. Note also that resale is less of a concern in the case of services than in the case of tangible goods, since services such as a haircut or dental work cannot be resold in principle.

It is a useful exercise to ask students to see if each of the four conditions is satisfied in the context of the case under consideration. Given the broad geography of customers and the competition from other online sellers in e-commerce, product resale is not practical. Thus, it is reasonable to the fourth condition from the list above to be satisfied. Consumer heterogeneity – condition 2 – is definitely present. In addition to this fact being overall intuitive, the case explicitly mentions several different categories of consumers – millennials, baby-boomers, expatriate and immigrant communities, elderly. Identifying these customer groups – condition 3 – is an entirely different issue. E-commerce does provide the seller with a variety of data about the buyer including registration profile data from the website, the IP address, and site visit statistics, as well as the data that is available from online "scraping" services that build profiles on users based on their online activities. Students may perform additional research in this area and use their findings in formulating their answers.

Students can be expected to differ in their opinions on the extent of pricing power Lee's Teas has – condition 1. On the one hand, the case talks about "plenty of other online stores selling a similar selection of teas" as well as thin profit margins resulting from that fact. On the other hand, the specialty tea market definitely has potential for product differentiation. It is therefore natural for the class to discuss possible ways to achieve greater product differentiation before proceeding to discriminatory pricing implementation details. Ideas for the product differentiation discussion include but are not limited to appealing gift packaging, possibility of customized packaging, different sizes and samples of the product, as well as using informative commentary on the history, health benefits, and origins of the tea varieties, and personal stories of tea growers in Asia. Yet another way to increase consumer preference for the product is loyalty programs, which are explored and discussed in Question 8 below.

Another useful exercise is to ask students for their insights regarding the effect of the Internet emergence on sellers' ability to implement each type of price discrimination. The significant reduction in search costs resulting from the much wider availability of information in the e-commerce environment has reduced the seller's ability to isolate individual consumers for first-degree price discrimination. At the same time, e-commerce makes it easier to track volume of purchases and offer the various volume-based pricing options typical of second-degree price discrimination, as well as track customer data necessary for segmentation of customer groups within third-degree price discrimination.

Notes for Question 2

Which of the companies mentioned in this case – Orbitz, Expedia, Hotels.com, Home Depot, Budget – actually uses price discrimination? Provide argumentation to support your opinion.

In our experience teaching this topic, we discovered that some of the disagreements between students on these issues result from misconceptions about what constitutes price discrimination. Therefore, the objective of this question is to ensure that all students fully and clearly understand that price discrimination exists when different consumers face different prices for the same product. Or, to be more precise and quote the definition in the Robinson-Patman Price Discrimination Act of 1936 "different purchasers" face different prices for "commodities of like grade and quality".

If we apply this definition, then Budget, Cheaptickets and Orbitz do price discriminate whereas Expedia and Home Depot do not. The latter two companies simply adapt the way in which they present their product offerings to a customer, according to their beliefs regarding customer characteristics. This is not conceptually different from the practice of reallocating items on a shelf in a brick-and-mortar store, or customizing the selection of product choices to a specific customer, a practice that is at the heart of good customer service. An affluent client may be offended by an offer of cheaper products that are of subpar quality. Likewise, showing expensive items to a frugal customer would also miss a point and may make the customer feel uncomfortable. Either type of mismatch may result in losing customers to competition.

Since the price of any given item remains the same across customers, there is no price discrimination involved. It is worth pointing out that given the existence of multiple intricate ways to track customers' purchasing behavior in electronic commerce, such matching can be achieved much more accurately in an online environment.

It is also important that students understand that not every price difference can be attributed to price discrimination. The case mentions that electronic commerce websites such as Amazon change prices often and without a set schedule. This is indicative of randomized pricing which reduces the incentive for the customers to continue their price search and delay a purchase. Such a practice is not necessarily limited to online sales. The argument provided by Orbitz mentions K-Mart Blue Light specials that change often and do not antagonize customers.

Another example of a differential price setting practice is peak load pricing. The pricing data for the Budget car rentals comes from the Christmas holiday period. Higher amounts of customer demand may take the seller closer to their capacity constraints and therefore result in the optimal increase in price due to a change in the elasticity of supply. In a similar fashion, airfare prices rise as the travel date gets closer.

Notes for Question 3

Should Jason experiment with first-degree price discrimination? Why or why not? Which type of price discrimination would you recommend Jason consider?

Students should be able to reason that first-degree (or "perfect") price discrimination requires the seller to have perfect knowledge of every buyer's individual willingness to pay. Naturally, this is practically impossible to achieve in the real world, which makes first-degree price discrimination a rare event. Its analysis is nevertheless useful because it serves as a best-case reference point scenario for sellers.

Furthermore, as the size of the customer pool increases, acquiring such knowledge about the entire set of customers becomes more and more costly. However, sellers dealing with a small number of individual customers may (and often do) attempt to achieve better knowledge by taking time to learn additional information about each customer. This can be achieved through extensive back-and-forth price negotiations, or by direct extraction of information about occupation, family, housing situation, etc. disguised as "small talk". Typical examples of situations resembling first-degree price discrimination include car dealerships and ticket scalpers.

Since Jason seems to be dealing with a fairly large set of customers in his e-commerce business, the effort he needs to put into inferring the willingness to pay is large and his means of doing that are limited. Furthermore, search engine technology on the Internet made it easier for buyers to access pricing information from a variety of sellers, which consequently made it more difficult for the sellers to extract rents from their customers. All this makes first-degree price discrimination unlikely to succeed in Jason's case.

The other two price discrimination types show much more promise for Lee's Teas. Third-degree price discrimination involves segmenting the entire customer pool into groups according to the different average willingness to pay or price sensitivity, and setting different prices for each group. Using the customer registration data as well as the various Internet tracking technologies, Jason could monitor his customers' demographic information, geographical location, history of prior purchases, and other characteristics correlated with their willingness to pay. Second-degree price discrimination, which can be essentially framed as volume discounts, can be implemented in the form of bulk purchase discounts or a loyalty program, which is addressed further in Question 8.

Notes for Question 4

Do the Internet and e-commerce make the implementation of price discrimination easier or harder for sellers? Provide your argumentation.

The impact the Internet had on the feasibility of price discrimination is twofold. On the one hand, it reduced the cost of tracking such characteristics of an individual shopper as the number and frequency of site visits, prior purchases, browsing patterns, geographical location, etc. via the use of online analytics tools. Better knowledge of those characteristics helps predict consumers' willingness to pay more accurately. Furthermore, personalization of a price offer to individual consumer characteristics is also more cost-effective in e-commerce than in the traditional brick-and-mortar commerce environment. Both considerations increase the likelihood that price discrimination enhances seller's profit, although exercising first-degree price discrimination continues to be the most difficult among the three types.

On the other hand, several features of the e-commerce environment make implementing price discrimination more difficult. First, the Internet has substantially reduced consumers' costs of searching for the best price, therefore reducing the market power each seller has. Second, multiple social media portals enable consumers to disseminate and share the information about the prices they paid. This also reduces sellers' ability to price discriminate. As a side note, this is one of the reasons why, for example, hotel booking sites do not allow any mention of actual prices paid in their hotel reviews. Third, the emergence of online auctions and trading portals increases the possibility that consumers eligible to pay lower prices will choose to resell the product to those consumers who would normally pay a higher price. This further dilutes the sellers' ability to price discriminate.

In summary, the overall effect of internet technologies on the feasibility of price discrimination is ambiguous. Arguments supporting either side of the story are valid and students' opinions may vary substantially. Note that the discussion of this question provides another opportunity for the instructor to reference the list of necessary conditions for successful price discrimination and underscore the importance of these conditions.

Notes for Question 5

When implementing price discrimination for Budget car rentals, for which customer groups would you charge higher prices and for which lower? What could be the rationale for the price differences reported in the case?

In our experience, this question generates the most interesting discussion, especially because in several examples presented in the case the reason for the price differentials is not entirely clear. The considerations at play here also provide students with an opportunity to expand their knowledge and understanding of the more sophisticated pricing strategies.

We find it instructional to split this larger question into two parts. The first step is to establish how the customer groups differ in demand elasticity or the ability to pay. When students share their ideas, it is instructive to ask them to explain what in their opinion drives those differences. This may also provide an opportunity to review the conditions for the successful implementation of price discrimination discussed above in Question 1. The second step is to identify such differences in customer groups, which may require additional effort on the seller's part.

Perhaps the example that is most easily explained by price discrimination is the practice used by Staples. Modern technology allows the seller to track an online buyer's location fairly accurately, and it is reasonable to assume positive correlation between buyer's proximity to a rival's store and the elasticity of their demand for Staples' products. It is optimal for the firm to charge higher prices to groups with the less elastic demand. It is worth pointing out, however, that in this particular example consumer income, another important determinant of demand elasticity, seemed to have secondary importance in assigning prices to geographical locations. (Valentino-Devries et al., 2012).

The pricing pattern used by Budget rent-a-car is harder to explain. The difference in prices across countries may be due to different market characteristics, regulations, etc. However, this does not help us explain the paradox in which both versions of the Budget website charge the customers who are domestic in relation to the rental a higher price.

A number of ideas may be helpful here. Foreigners appear to have a higher elasticity of demand or a lower willingness to pay, which results in a lower optimal price for them. One possible explanation is that customers are often reluctant to drive in a foreign country due to their unfamiliarity with the road system, road signs, traffic rules and regulation, driving styles, and so forth. Furthermore, domestic customers may have existing relationships such as rewards program memberships and preferences affected by prior experiences and/or advertising. This increases their loyalty to a specific company and therefore makes their demand less elastic. Foreigners do not have such constraints and so have more elastic demand. Finally, the prevalent notion that travelers in general are less sensitive to price may not be entirely correct. Budget may have empirically established that international travelers have more elastic demand. After all, they are already facing significant unavoidable travel costs for flights and accommodation, and are therefore more likely to shop around for deals once they arrive.

Several additional considerations may also play a role here. For example, U.S.-based drivers have strong preference for automatic transmissions, whereas the majority of rental vehicles in Europe are equipped with a manual transmission. That reduces U.S. renters' willingness to pay for a standard option and makes them instead select the more expensive automatic transmission options. Additionally, European customers are typically more used to public transportation. This means that they are more open to alternative modes of transportation, which leads to more elastic demand, and ceteris paribus a lower price for their rental in the US.

In this entire discussion, it is important to highlight the idea that the correlation between the consumers' demand parameters and their external characteristics is never perfect. As such, neither are any formal separation criteria. It is important to recognize, however, that the discussion of these issues results in students clearly understanding that even a less-than-perfect separation tends to produce higher profits than charging uniform prices.

It may also be helpful to point out that sometimes even if a firm cannot think of a specific reason for differences in demand due to the presence of a variety of conflicting factors, the presence of such a difference can still be inferred empirically. Once again, online tracking tools provide an excellent opportunity to measure such characteristics accurately in electronic commerce. For example, it may be possible to measure price sensitivity of a pool of visitors to various websites, people logging in from various types of devices or operating systems, at different times of the day, etc. Of course, not understanding the underlying reasons for such differences puts the firm at a disadvantage. The difference may be due to some transient circumstances. Furthermore, the price discrimination patterns may become apparent to buyers so, unless there are sound exogenous differences in consumer characteristics, more customers will be drawn to the websites with lower prices.

We also find it important to highlight that, when dealing with price discrimination, the size of a specific group is not a factor in deciding which group should face a higher or lower price the only factor that matters is each group's demand characteristics. The independence between the size of the group and the price that group faces can be easily demonstrated using real-world examples.

The explanation for Orbitz charging lower rates to those who are logged into their website is also not obvious. Orbitz may just be providing its customers a reason to create a profile and self-identify each time they search for a hotel, in essence paying the customers for information in the same way as a grocery store providing discounts to customers that have rewards cards at checkout. Using such cards allows the store to collect valuable information by tracking customer purchases, and the discounts are a way to incentivize the customers for allowing to track their behavior. This may also generate brand loyalty and allow the store to charge a premium over other stores' prices, knowing that the idea of collecting reward points makes consumers more tolerant to the slightly higher prices.

A similar idea of cross-subsidies may be behind the example of Travelocity charging Apple iOS users lower prices, except it is enhanced by the presence of network effects. The eligibility for a discount on a travel site and other perks exclusive to the iOS platform naturally increases the perceived value of an iPhone for potential buyers/adopters. Conversely, a large population of iPhone adopters who think of Travelocity as a travel site of choice benefits Travelocity. This practice of subsidizing products or services that complement their main product is widely used by tech firms. For example, many apps used by private pilots are available only on iPad, making iPad the tablet of choice for yet another segment of the market.

Note that any attempt to analyze the Travelocity example using reasoning consistent with the demand-driven price discrimination argument is likely to result in an opposite pricing pattern prediction. For example, mobile users may be more likely to look for a hotel in an emergency and/or to have higher search costs than users looking at the same hotel from their home PC. Mobile users may be more affluent, compulsive shoppers, or just too busy to do this from a home computer. Any of the above arguments would suggest that they should be charged a higher, not lower price.

In summary, the bigger lesson stemming from the analysis of such a variety of examples is that not every difference in prices can be explained by a textbook model of price discrimination. Therefore students have to fully engage their critical thinking in order to produce explanations that make sense. In the most difficult cases when the answer is not straightforward, we find it is helpful to run an in-call discussion in the brainstorming format, where every idea is given consideration and no ideas are rejected upfront. More often than not, such a group discussion helped students discover and find support for ideas that may not have occurred to them at first.

Notes for Question 6

In your opinion, are price discrimination practices ethical? Is price discrimination good or bad for the society? Should it be illegal to engage in such practices? If Jason decides to go that route, should he alert his customers to the fact that he uses these practices?

This question and this topic in general offer a rare and valuable opportunity to explore the connection between economics and ethics. The role of markets is to help buyers and sellers meet and conduct mutually beneficial transactions in an efficient manner, and most people would agree that there is nothing unethical about that. Actions that cause harm, on the other hand, are frequently viewed as unethical and, ideally, illegal. It is therefore important to agree what aspects of price discrimination are likely to result in potential harm. It is also helpful to discuss how tangible benefits are generated by market transactions and who appropriates those benefits.

This discussion creates an opportunity for the instructor to review with students the standard analysis tools of economic welfare using the concepts of consumer surplus (CS) and producer surplus (PS). Under the uniform pricing of the standard price setting model for a firm with some degree of monopoly power, different consumers derive different amounts of CS from the transactions. In this setting, one argument in favor of price discrimination is that it creates a closer match between prices and individual willingness to pay. Additionally, price discrimination eliminates the deadweight loss that is a standard feature of the monopolistic price setting model and allows a larger amount of consumers to receive the product or service. Third, by expanding the profit potential of monopolistic markets, price discrimination increases the incentives for product differentiation and creation of new products and services. A contrary argument is that the seller appropriates most if not all of the welfare gains from price discrimination in the form of higher profits, which many view as unfair.

Even though economics acknowledges both benefits and flaws of price discrimination, using such practices in wholesale trade was pronounced unlawful by the Clayton Act of 1914 and the Robinson-Patman Price Discrimination Act of 1936 (US Code, 1936):

"It shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly, to discriminate in price between different purchasers of commodities of like grade and quality, … where the effect of such discrimination may be substantially to lessen competition … or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them."

As a side note, classroom discussion of this question is best done in conjunction with Question 2. Such an approach allows the instructor to focus on the importance of exact definitions and what we really mean by saying "price discrimination". Note that in order to constitute price discrimination, the products sold to different consumers at different prices don't have to be "the same", it is sufficient if they are "of like grade and quality". Many students find such strong language surprising. A natural next question from them is usually why then we see so many examples of price discrimination. At that point, it is useful to inform them of the limitations that are also explicitly stated in the law.

First, the practice of price discrimination is unlawful "… where the effect of such discrimination may be substantially to lessen competition … or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them".

Therefore a party willing to challenge price discrimination needs to prove that the use of such practice lessens competition. If price discrimination is a standard industry practice such as it is in the travel industry, a legal challenge may prove to be difficult. A number of travel-related examples may be used to illustrate price discrimination that falls within the confines of the law.

Furthermore, the law states:

"Provided, That nothing herein contained shall prevent differentials which make only due allowance for differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which such commodities are to such purchasers sold or delivered;

And provided further, That nothing herein contained shall prevent persons engaged in selling goods, wares, or merchandise in commerce from selecting their own customers in bona fide transactions and not in restraint of trade;

And provided further, That nothing herein contained shall prevent price changes from time to time where in response to changing conditions affecting the market for or the marketability of the goods concerned, such as but not limited to actual or imminent deterioration of perishable goods, obsolescence of seasonal goods, distress sales under court process, or sales in good faith in discontinuance of business in the goods concerned."

All these limitations provide ample opportunities for the sellers to practice price discrimination while disguising them as one of the aforementioned circumstances. For example, a drop in the price of original iPhone shortly after its introduction in 2007 was most likely an example of intertemporal price discrimination but was nevertheless framed as driven by seasonality and cost reduction (Chulkov and Nizovtsev, 2014). In another example mentioned in the case, Staples attributed the difference in prices charged to different online buyers to "a variety of factors, including rent, labor, distribution and other costs of doing business" (Valentino-Devries et al., 2012). Differences in the costs of sale and delivery of goods are a common occurrence therefore presenting evidence in support of that is rarely an issue.

This discussion of the legal aspect of price discrimination helps students see how being informed about the exact phrasing and limitations of business laws enables companies to make more informed decisions.

As a follow-up example to this topic, the students may be asked to review the legal challenge mounted in California to price discrimination in dry cleaning (Brooks, 2001; de Turenne, 2008). Can the students recognize the rationale for the price differences between male and female customers in these cases?

Overall, the discussion of this question provides a good example of using economic analysis as a foundation for judgments about what is "fair" and ethical and which practices are candidates for being deemed illegal. This also applies to Jason's dilemma: If he alerts his customers that "prices may differ", that may deter quite a few of his potential customers right away. On the other hand, if he doesn't but that fact becomes known, would the consequences be even worse?

From the economic point of view, there seems to be little justification for announcing the use of price discrimination. The more consumers realize that a different price is offered to some group of buyers, the more of them may see an additional reason to conceal their buyer type or engage in resale of the product. It's the ethical aspect that really makes it a dilemma. Occasionally, this prompts a discussion in our Managerial Economics classes. One camp argues that a firm should be conscientious and truthful about everything it does, therefore Lee's Teas should have a disclaimer on their site that "prices may differ" and then deal with any possible fallouts this may cause. The opposite camp's argument usually revolves around the idea that anything that is not illegal, is allowed. A firm should not be required to disclose every little aspect of their operations. This camp is also able to soothe their conscience by recalling that differential pricing is essentially a version of product customization to customer needs and desires. Other arguments that students use to support the ethicality of such practices is that price discrimination was shown to be welfare improving, and that it enables the seller to keep prices low for their least wealthy customers while charging more affluent customers a higher price.

Notes for Question 7

If Jason uses price discrimination, what criteria do you recommend he uses to estimate his customers' willingness to pay?

Technology is changing the face of commerce. The rise of electronic commerce not only allows retailers to reach new customers, but also provides opportunities to collect new data about customers and use these data in new ways. As mentioned in the notes for Question 1 above, e-commerce helps the seller access a variety of data about the buyer including registration profile data from the website, the IP address, and site visit statistics, as well as the data that is available from online "scraping" services that build profiles on users based on their online activities.

The case describes the use of the customer's geographical location estimated by IP address in pricing decisions on the Staples and Budget websites. In the context of the present case, the geographical information may be used in a similar fashion to identify locations with higher or lower income, locations with a higher concentration of competitor tea stores, places that have a higher proportion of tea-drinking immigrant and expatriate communities, as well as urban or rural areas.

Utilizing cookies and user profiles helps establish the pattern of purchases by each customer of a business. Separating customers by the quantity, value, and frequency of purchases may help infer the buyer's type in terms of their willingness and ability to pay. Furthermore, utilizing cookies helps identify the pattern of websites visited by the buyer. This data alone may help separate, for instance, customers who fall into the millennial generation from the baby boomers. In another example, cookie data may help identify customers particularly interested in the health benefits or customers from immigrant or expatriate communities. A more difficult question remains in establishing the link between a group's demographic characteristics and their willingness to pay, which should guide the seller towards the appropriate price adjustments. Students may perform additional research in this area and apply their findings to this question.

Service providers often identify groups of consumers who are the premier customers and merit additional services and better pricing, using the concept of service customer pyramid (Zeithaml et al., 2001). This concept is similar to price discrimination in that it requires segmentation of customers in strata according to their impact on the profitability of the firm. The seller needs to be able to tell customers apart and the customers must differ in the way they view the service provided by the firm. Stratification of customers is performed in order to identify the most profitable ones, as well as plan actions to move customers from the lower levels of the pyramid to the higher ones. Robinson (2011) explores the links between the pyramid model and loyalty programs discussed further in Question 8 below.

Notes for Question 8

The case mentions frequent flyer programs. What is the rationale for the firms to offer such programs? Would you recommend Jason to implement a similar scheme?

The discussion of Budget car rental pricing in the case mentions prices contingent on a customer's membership in a frequent flyer program. Frequent flyer programs along with other forms of "loyalty programs" enable customers to collect "points" for purchases from a specific provider and redeem those points for future purchases from the same provider. The ability to receive benefits from repeat purchases increases customer loyalty and generates repeat business by de-commoditizing the product offering and making the cost of switching to another retailer or service provider non-trivial. Since consumers in this case no longer see products sold by different retailers as identical, it is effectively one of the ways to differentiate a firm's products.

Economic textbooks also often classify frequent flyer discounts as an example of second-degree price discrimination since its implementation effectively results in lower prices for customers who purchase a larger volume of a product or service. For further readings on this topic, students may be directed to the study by Robinson (2011) which provides a clear and concise analysis of best practices in implementing such programs.

Devising and implementing a loyalty program for his clients is a promising avenue for Jason. Implementation of such a program is easier in an e-commerce setting since all the purchase records are already conveniently stored on a server. An investment in a database and a Web interface that will conveniently prompt consumers about their status in the program and/or display special deals available to them will be required but it could be well worth the projected increase in consumer traffic and sales.

There is also an opportunity to expand on the second-degree price discrimination aspect of such programs. Jason could charge lower per-ounce prices for bulk packages than on individual or sample-size purchases.

CONCLUSION

In conclusion, this case provides sufficient detail to address a variety of pricing-related concepts and questions. This case has been tested in M.B.A. managerial economics classes at two business schools over several semesters. Class sizes ranged from twelve to thirty students.

The topic is typically of interest to students as they have experience with and opinions on pricing in the online marketplace. Many students in fact go beyond the information provided in the case and contribute the results of their own research. Thus, the use of the case helps not only achieve specific learning outcomes, but also improve student engagement in the classroom. The case also enhances the students' critical thinking skills and challenges the students to place each case of non-trivial pricing in the correct context and pay attention to product and market characteristics that drive the use of specific pricing strategies.

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TEACHING NOTES: THE CURSE OF KNOWING TOO MUCH

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GENERAL CASE INFORMATION

The case is designed for accounting majors and works well in an auditing class where the code of professional conduct is usually covered. It could be used in other accounting classes as well but a familiarity with the American Institute of Certified Public Accountants' (AICPA) code of conduct including the rules of conduct is helpful. It would also be appropriate for an accounting ethics class if one is offered. It is suitable for either upper-level undergraduate classes or graduate classes.

This can work in a 50-minute class period but is probably better suited for a 75-minute class. Discussion is usually brisk because students can easily understand the issues involved and usually have an opinion about how to solve the dilemma.

The case is a fictionalized account of a real dilemma which was faced by a friend of the author. The characters in the case are entirely fictional and the facts are altered slightly to emphasize the dilemma, to make it applicable for an accounting audience, and to disguise the identity of the true persons and company involved. The bitter dispute between Fred and Tom is based on another situation observed by the author during his professional experience.

The case has the following objectives. After analyzing this case, students should have a better understanding of:

- Employment responsibilities and how these responsibilities can be affected by conflict of interests.
- Confidential information and of the importance of non-disclosure of confidential information.
- The codes of conduct of the three major accounting certifications.
- Real and apparent conflicts of interest.
- "Spirit versus letter" in the interpretation of the ethical rules in codes of conduct.
- The potential difficulty of ethical behavior.

Administration of the Case

The case should be distributed in the preceding class period, along with instructions on how to access the codes of conduct. Typically, I show students how to access the code of conduct from the AICPA's website (www.aicpa.org) under information "for the public" tab. Access to this information can also be obtained in any data base which has the professional accounting standards in the ET sections. The codes of conduct for the Institute of Management Accountants and the Institute of Internal Auditors can be found by following the links from their homepages, www.theiia.org and www.imanet.org, respectively.

Students are required to answer all four suggested questions citing the codes of conduct where necessary. Students typically report that this assignment takes about 2 - 4 hours to complete including time to write out the answers. If students are working in groups that time is reduced by an hour or so.

Suggested Questions

1. Clearly state Jean's dilemma.
2. Can Jean inform her friends of the potential sale of the division? Cite relevant ethical standards. Remember that Jean holds three professional certifications each of whom have ethical standards which must be followed.
3. Assume at the time of the projections, Jean and Eric agree to become investors in the horse stable. Does this change Jean's situation? If so, how? Can Jean act on this information? Cite relevant ethical standards.
4. Assume that Tom Wales and Fred Tyson were CPAs and members of the AICPA rather than engineers. Would their actions in their conflict on pages 4 and 5 violate the AICPA Rules of Professional Conduct? If so, cite relevant rules. If not, explain why not.

Proposed Solutions

Clearly state Jean's dilemma

Jean obviously is torn between her professional responsibilities and her loyalty to her friend. Her professional responsibility precludes her from disclosing the proposed sale of the division. Her loyalty to her life-long friend would suggest that she disclose the information about the proposed sale to prevent him from a catastrophic financial decision. What makes this a dilemma is that Jean cannot meet both desires simultaneously.

The class is challenged to provide a one-sentence statement of Jean's dilemma. The dilemma could be stated in various ways but a suggested dilemma statement would be:

Jean would like to warn her friend of the potential problem but is prevented by her professional obligations.

Once a good one-sentence statement is developed, I record it on the white board or overhead for future reference. Then I ask the class for the elements which contribute to the dilemma. Lots of elements exist but at a minimum, I would like to see these:

1. Jean has a professional obligation to look out for the interests of her employer and this requires non-disclosure of the potential sale of the division.
2. The sale of the division is clearly in the best interests of Jean's employer.
3. Jean and Fred are lifetime friends and non-disclosure of the proposed sale of the division could be viewed by Fred as a personal betrayal.
4. There is a very short window (about 48 hours) in which Fred can act if he learns about the proposed sale of division.
5. The proposed sale of the division will not go through if disclosed.
6. Fred's purchase of the land and loss of his job would result in catastrophic financial difficulties for Fred and his family.
7. If Fred acquires the land and needs to sell it, he is unlikely to be able to do so.
8. Jean is serious about her career and does not want to jeopardize it.
9. Tom Wales would undoubtedly remove Fred from his position if Wales Medical obtains MedAssembly.
10. Fred would likely nix the proposed sale of the division by disclosing it if he learns about it to protect himself and to spite an old enemy.

Can Jean inform her friends of the potential sale of the division? Cite relevant ethical standards. Remember that Jean holds three professional certifications each of whom have ethical standards.

No. Jean may not disclose the information to Fred. As detailed in the next few paragraphs, each professional organization's ethical standards prohibit disclosure of confidential information and each impose on Jean an obligation to act in her employer's best interest. Disclosure would seem to violate at least two rules of conduct of each organization. Jean must keep in mind that her professional obligation is to her employer. As an employee, she owes a fiduciary duty to her employer to look out for the employer's best interest. In this case, the employer's best interest is at odds with her friend's interest.

The rules of conduct of the American Institute of Certified Public Accountants are the enforceable component of the Institute's code of conduct (AICPA 2013). Rule 301 prohibits disclosure of confidential client information without the client's permission except in well-specified situation. None of those exceptions would allow Jean to release this information. Rule 102 requires the CPA to act with objectivity and to not subordinate his or her judgment to others. Implicit in this rule is the idea of discharging professional fiduciary responsibilities with integrity. Meditech has the right to expect Jean, as its professional employee, to act in its best interests.

The standards of ethical professional practice of the Institute of Management Accountants call for the certified management accountant to maintain confidentiality (Standard II) and integrity (Standard III) (IMA 2012). Standard II.1 states that each member has a responsibility to "keep information confidential except when disclosure is authorized or legally required." Standard III.2 states each member has a responsibility to "refrain from engaging in any conduct that would prejudice carrying out duties ethically."

The ethics code of the Institute of Internal Auditors is based on four principles with specific rules derived from those principles (IIA 2013). The principles of integrity and confidentially are pertinent here. Under the principle of integrity, rule 1.1 states that internal auditors "shall perform their work with honesty, diligence, and responsibility" and rule 1.4 states the internal auditors "shall respect and contribute to the legitimate and ethical objectives of the organization." Under the principle of confidentiality, rule 3.2 states that internal auditors "shall not use information for any personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the organization."

This resolution of the ethical issues is not likely to satisfy Jean. Although Jean discharged her professional responsibility, she must feel that she has let down her life friend. When this idea comes up in the discussion, I like to emphasize to students that discharging your professional responsibilities may entail costs. Sometimes, as a professional, you have to make tough calls and live with the fallout. Jean would probably dread the moment when Fred comes to her and says "I thought we were friends. Why didn't you warn me?" In a moment like that, no matter how valid the reasoning, claiming professional obligations would seem pretty inadequate.

The instructor is likely to hear many innovative suggestions about how to communicate to Fred without actually disclosing the information. Almost all of them will suffer from one of two problems. First, the "spirit" of rules on confidentiality is violated, even if the "letter" of the rule is met by many of the suggestions. This case provides a nice opportunity to discuss the professional's responsibility to meet the spirit of the rule, not just the letter. Second, many of the suggestions require Jean to misrepresent the situation in violation of rules of conduct on integrity.

At this point, a student may raise a concern about the conflict of interest. I defer this discussion until the next question.

Assume at the time of the projections, Jean and Eric agree to become investors in the horse stable. Does this change Jean's situation? If so, how? Can Jean act on the information she has learned? Cite relevant ethical standards.

Question three makes explicit the possibility of a real conflict of interest. Actual conflicts of interest make it very difficult, if not impossible, for a professional to remain objective and to fulfill the obligation of rendering unbiased assessments and opinions. Even if the professional can remain objective, his or her judgment might be questioned because of the possibility of bias. This undermining of the credibility of the professional's work may raise questions about the competence of the work. This undermining of the professional's credibility can arise even in situations where the conflict of interest is more of an appearance than a situation which would truly influence a professional's judgment.

Although an instructor may use a more formal definition of a conflict of interest, I typically use this working definition:

> A conflict of interest is a situation where a professional may wish an outcome different than wishes of someone whom the professional owes a fiduciary responsibility.

Even prior to the assumption of ownership by Jean, the issue of a conflict of interest is present. Because of Jean's close relationship to Fred, concerns could be raised about whether she would be more interested in protecting the interests of Meditech or Fred. This is clearly has the appearance of a conflict of interest but a determination of a real conflict of interest depends on whether Jean's objectivity is truly impaired.

Once Jean and Eric become investors, the situation changes and the conflict of interest becomes real. Jean's financial interests are now at odds with her employer's financial interests and the conflict of interest is real. ET § 102.02 of the AICPA's code of conduct requires notification of the conflict of interest and withdrawal from the task if objectivity is compromised (AICPA 2013). Standard III.1 of the IMA's code of conduct requires mitigation of actual conflicts of interests and communications of apparent conflict of interests (IMA 2012). Rule of conduct 2.1 of the IIA's code of ethics prohibit internal auditors from participating in any activity or relationship that may impair or be presumed to impair their unbiased assessment or be in conflict with the interests of the organization for which the internal auditor works (IIA 2013).

Assume that Tom Wales and Fred Tyson were CPAs and members of the AICPA rather than engineers. Would their actions in their conflict on pages 3 and 4 violate the AICPA Rules of Professional Conduct? If so, cite relevant rules. If not, explain why not.

Each organization's codes of conduct seem to suggest a violation, even if the statements made by each man have a reasonable basis in fact. Such unprofessional attacks on one another could violate the AICPA's Rule 501, the IMA's Rule III.3 and the IIA's Rule 1.3, each of which deal with acts discreditable to the profession (AICPA 2013, IMA 2012, IIA 2013). These rules are worded so broadly that any action which brings discredit to the profession can lead to a disciplinary action. What is discreditable to the profession is left to the discretion of the disciplinary board. It is very possible that Tom and Fred's actions could be deemed discreditable.

If Tom and Fred in their exuberant attacks on one another misrepresent the truth of the situation, then several rules of each organization may have been violated. A strong argument could be made that the IIA's Rule 1.1, the IMA's Standard IV.1, and the AICPA's Rule 102 were violated (AICPA 2013, IMA 2012, IIA 2013). Each prohibits a professional from misrepresenting facts. A disciplinary board for any of the three organizations could combine these misrepresentations with the unseemly disparagements of each other in a single violation of the rules against acts discreditable to the profession.

HEARTLAND PHARMACY: TOBACCO OR NOT TOBACCO INSTRUCTOR'S NOTE

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CASE DESCRIPTION

The subject matter of this case concerns the primary objective of the corporation: shareholder wealth maximization. Case examines a situation where profits and "the right thing to do" conflict. The case requires students to have an introductory knowledge of accounting, finance and general business issues thus the case has a difficulty level of three (junior level) or higher. The case is designed to be taught in one class session of approximately 1.25 hours and is expected to require 2-3 hours of preparation time from the students.

CASE SYNOPSIS

At the most recent board meeting, Dr. Allen Springer, a board member of Heartland Pharmacy, suggested Heartland follow the lead of CVS Caremark and announce the removal of tobacco products from its stores by the end of 2014. Springer, a family practitioner, argued that selling tobacco products was inconsistent with the company's objective of improving customers' health care.Springer had not discussed the recommendation with John Wiley, Heartland's President and Chief Executive Officer (CEO), or Robert Davis, Heartland's Chief Financial Officer (CFO) prior to the meeting. Both Wiley and Davis were surprised with the unexpected suggestion. Wiley's initial thought was the proposal had merit, but Davis pointed out sales and profitability would suffer and that the primary objective of Heartland management and board is to increase the wealth of the shareholders. Springer said he expected sales and profits to decrease but that discontinuing tobacco products from their stores was the right thing to do. After a contentious debate, the board of directors of Heartland Pharmacy agreed to table the recommendation until further information and analysis could be obtained.

The learning objectives of the case include: 1) A review of the primary objective of a firm's management: shareholder wealth maximization 2) Identification of the different stakeholder groups of a corporation and how their interests enter into the wealth maximization objective, 3) An examination of the ethical issue regarding the sale of tobacco products, which are a known carcinogen and 4) A review of alternative ethical perspectives.

CVS CAREMARK'S DECISION

In February of 2014, CVS Caremark, the nation's largest drugstore chain in terms of overall sales, announced that it would discontinue the sale of cigarettes, cigars and chewing tobacco at its more than 7,600 drugstores nationwide. According to CEO Larry Merlo, "We have about 26,000 pharmacists and nurse practitioners helping patients manage chronic problems like high cholesterol, high blood pressure and heart disease, all of which are linked to smoking. We came to the decision that cigarettes and providing health care just don't go together in the same setting." (Strom, 2014) It is estimated that this decision will cost the company about $2 billion in annual sales, less than two percent of overall sales of $123 billion in 2012.

In discussing the announcement, Dr. Troyen Brennan, a former professor of medicine at Harvard University, and current chief medical officer for CVS, noted that the decision to drop tobacco products will give his company a “competitive advantage” against other pharmacies because of the credibility it will give CVS when talking to physicians. This “credibility” may be related to participation in Accountable Care Organizations, in which health care providers are paid according to patient outcome, not procedures. Over the past few years, major drugstore chains have become more involved in the provision of health care, with walk-in clinics that treat common ailments and offer flu shots. According to Forbes, “if CVS can help save money or keep patients healthier, it might get a piece of the action.” (Herper, 2014) This is one reason why CSV did not downgrade it earnings forecast for 2014. Some critics note that this attempt to appeal to physicians in order to increase CVS’s business as a health care provider/partner is the real motive behind the decision.

CASE OVERVIEW

At the most recent board of directors meeting of Heartland Pharmacy, Dr. Allen Springer, a vocal board member, suggested Heartland follow the lead of CVS Caremark and announce the removal of tobacco products from its stores by the end of 2014. Springer, a family practitioner, argued that selling tobacco products was inconsistent with the company’s objective of improving customers’ health care. Springer had not discussed his recommendation with John Wiley, Heartland’s President and Chief Executive Officer (CEO), or Bob Davis, Heartland’s Chief Financial Officer (CFO) prior to the meeting. Springer had mentioned his proposal to a few of the other board members and received very limited support. Both Wiley and Davis were surprised with the unexpected suggestion. Wiley’s initial thought was the proposal had merit but was concerned with how lost revenues and profits from the sale of tobacco products would impact the firm. Davis pointed out that tobacco and related products are one of Heartland’s higher margin categories and that their removal would most likely result in a reported loss. Davis asked Springer how he thought the company could compensate for the lost sales and profits. Springer said he did not have an answer and he expected sales and profits to decrease but that discontinuing tobacco products from their stores was the right thing to do. After a contentious debate the board of directors of Heartland Pharmacy, agreed to table the recommendation until further information and analysis could be obtained.

Heartland Pharmacy is a closely held corporation headquartered in Poplar Bluff, Missouri. Heartland serves a predominately rural, Midwestern market. It operates forty-three pharmacies in southern Missouri, southern Illinois, northern Arkansas, western Tennessee and western Kentucky. All pharmacies are located in small towns. An additional six stores are scheduled to open over the next two years and expansion into northern Mississippi and eastern Oklahoma is also being studied.

Company growth has been financed with internally generated funds and private equity sales to friends of the Wiley family. The external investors were needed when growth financing requirements exceeded family resources. There are seven major external investors, mostly friends and business associates of James Wiley and all are members of the board. A number of Heartland’s managers are also shareholders, but their holdings are relatively small. The Wiley family owns a controlling interest, but the non-family board members currently control close to forty percent of the outstanding shares.

After the board meeting John Wiley asked Davis to join him in his office to discuss how they were going to address the tobacco issue raised by Springer. Wiley did not think the board was likely to support a decision to remove tobacco products without adding a new revenue source and even then some members may be reluctant to sacrifice profits. Wiley valued Springer's long service and wanted to provide an objective analysis of his suggestion.

Davis stated that tobacco sales varied from store to store, but company-wide tobacco products contributed about ten percent of Heartland's annual revenue over the last four years. He also stated that the average gross profit margin on tobacco sales during that same period was close to twenty percent. Wiley instructed Davis to prepare a report that would quantify (dollars) the impact of removing tobacco products form their stores. Wiley suggested modifying the projected income statement for 2015 and to keep the analysis simple, he suggested they reduce revenues (by 10% to reflect the removal of tobacco products) and remove gross profits from tobacco sales (using a tobacco sales gross margin of 20%) but make no adjustments to selling or administrative expenses and examine the results. In addition, Wiley asked Davis to begin thinking about non-quantitative reasons for continuing the sale of tobacco products other than shareholder wealth maximization.

Davis discussed the task with the company controller, August Sawyer. Sawyer did not think preparing the revised 2015 statements would be difficult particularly with key assumptions provided, but he expressed reservations with non-quantitative analysis. Sawyer stated that a class in his graduate business program examined decision-making from a number of ethical perspectives and suggested this might be a basis for developing non-quantitative reasons to either support or oppose Springer's recommendation. Sawyer explained that teleological and deontological are the most common categories of ethical theories used to analyze the ethics of conduct. He also mentioned utilitarian and libertarian theory. Davis asked Sawyer to prepare a brief description of the various ethical theories and models and to explain where maximizing shareholder wealth fit into the decision-making process.

THE TASK

Students may take many approaches to the case, but their solution should address the following questions/issues raised by Wiley, Davis and Sawyer. A course of action should also be recommended, in particular, how will they deal with Springer's concerns?

1) Review the justification of shareholder wealth maximization as an accepted basis for decision-making.
2) Identify the different stakeholder groups and their interests that should be considered when deciding whether to discontinue the sale of tobacco and tobacco related products. Explain how a firm reconciles the interests of the different stakeholder groups with the shareholder wealth maximization.
3) Use the financial statements provided in Appendices One and Two, to prepare a report illustrating the impact of not selling tobacco products on the financial performance of Heartland. Use Wiley's suggestion regarding selling and administrative expenses.
4) Use ethical theories to develop non-financial reasons why the company should continue to sell or discontinue selling tobacco products.
5) Prepare a recommended course of action with supporting analysis.

Answers to the questions/issues.

1) Review the justification of shareholder wealth maximization as an accepted basis for decision-making.

Shareholder wealth or value is a function of the return shareholders receive on their investment. This return is in the form of cash dividends, an increased stock price or a combination of both. Shareholder value maximization is a long-term target that suggests that management's objective should be to make decisions that result in increased shareholder value. Stock price is used as a proxy for shareholder wealth. Stock price is a function of 1) the timing and amount of company returns, measured as cash flows and 2) the risk associated with the returns. Stock price is increased when cash flows are increased or received sooner rather than later and/or risk associated with receiving the cash flows is reduced. Shareholder wealth is maximized when stock price is maximized.

Shareholders are the providers of equity capital. Without equity capital, debt capital is not available. Debt capital providers require, desire, want equity investors to “put cash into the game” before investing. Without capital, assets cannot be acquired, people cannot be employed and products and services cannot be provided to its customers. If shareholders receive a return that is less than appropriate based on the risk level of the firm, they will cease being investors. Without sufficient capital the company will fail. If the company fails, all stakeholders suffer.

2) Identify the different stakeholder groups and their interests that should be considered when deciding whether to discontinue the sale of tobacco and tobacco related products. Explain how a firm reconciles the interests of the different stakeholder groups with the shareholder wealth maximization.

A typical listing of stakeholders group includes equity investors, creditors (suppliers of debt capital), employees, customers, suppliers, community and government.

Stakeholder	**Primary Interest**
Equity investors	Appropriate return based on the risk level of the firm.
Creditors	Appropriate return (interest) based on the risk level associated with their investment (loans).
Employees	Continued employment, appropriate compensation and opportunity for advancement.
Customers	Quality products or services at an acceptable price.
Suppliers	Timely payment for goods and services provided to the company.
Community	Increased quality of life in the community. A company provides residents employment, pays local taxes and contributes to charitable organizations.
Government	Increased receipt of tax dollars.

To achieve the goal of maximizing long-term wealth of the shareholders, the interests of all stakeholder groups need to be considered. A company cannot achieve long-term success with a dissatisfied or disgruntled workforce. Employees must be adequately compensated and a productive workforce environment cultivated. Inferior products or services that fail to meet the needs and desires of the customer will result in financial failure. Customers must be satisfied that the products or services received are fairly priced and meet their needs better than a competitors. Creditors, suppliers and taxes must be paid in a timely manner. Shareholders are the providers of equity capital. None of the needs of the stakeholder groups can be met if the company is not profitable and meeting the needs of the equity investors. Shareholders receive top position on the stakeholder priority list.

Heartland Stakeholder	**Primary Interest**
Equity investors	Maximize stock price. Removing tobacco products from the shelves of Heartland Pharmacy would result in lower profits and have a negative impact on stock price.
Creditors	Lower revenues will result in lower profits and expose creditors to higher default risk.
Employees	Revenue will decrease as the tobacco products are discontinued. Declining revenues may cause employee wages to stagnate or decline. Continued employment may be at risk as Heartland

	restructures to adjust for lower revenues.
Customers	Tobacco customers will be forced to shop elsewhere and may also shop elsewhere for their other product needs. It should be emphasized that tobacco products will be available elsewhere. The health of the tobacco user will most likely not change as a result of Heartland's decision to discontinue tobacco products.
Suppliers	Tobacco product suppliers will no longer have a major customer but their business may be transferred to other retail outlets.
Community	Heartland's lower revenues and profits will most likely have a negative impact on the quality of life in the community. If Heartland's work force is reduced, there will be less money to be spent in the communities. Income and other taxes will decrease. Heartland's contributions to community and charitable organizations may be reduced.
Government	Lower revenues and lower profits will result in less tax dollars paid by Heartland to all levels of government (local, state and federal).

Satisfying the interests of the various stakeholder groups is not a mutually exclusive task. A productive and content work force will produce quality products or provide superior service. Heartland will be profitable and investors and creditors will receive a return commensurate with risk. A profitable Heartland will pay taxes and contribute to the communities' well-being. All of Heartland's stakeholders depend upon a healthy and profitable company. All stakeholder groups would likely oppose removing tobacco products from Heartland Pharmacy.

3) Use the financial statements provided in Appendices One and Two, to prepare a report illustrating the impact of not selling tobacco products on the financial performance of Heartland. Use Wiley's suggestion regarding selling and administrative expenses.

Davis provided the following assumptions to modify the projections for 2015:

- tobacco sales contribute 10% of revenues
- tobacco products have an average gross profit margin of 20%
- make no adjustments to selling or administrative expenses

Applying the new assumptions to the original 2015 projection indicates net income would decrease substantially from $3,621,760 with tobacco products to $984,307 without the sales of tobacco and tobacco related products. The removal of tobacco products would also impact certain balance sheet accounts. Heartland's investment in accounts receivables and inventories would be reduced, thus reducing financing requirements by about $4,000,000. Using the $4,000,000 to reduce debt would result in reduced interest costs, but the overall impact of removing tobacco and tobacco related products would be negative. Unless a new product line could be added, selling and administrative expenses would also need to be reduced. A major restructuring would be required.

Of major interest to the board would be the reduction in dividends resulting from the lower earnings. Maintaining the same 50% dividend payout ratio would reduce dollar dividends from $1,810,880 with tobacco sales to $492,153 without tobacco sales, a reduction of more than 70%. It is very unlikely shareholders would be happy with the lower dividends. Future expansion plans may also be at risk since Heartland is heavily dependent upon internally generated equity to finance growth.

Heartland Pharmacy

	With Tobacco	**W/O Tobacco**
Income Statement ($000)	Projected	Projected
For the Year Ended December 31	2015	2015
	$	$
Sales revenue	204,100,000	183,690,000
Cost of goods sold	157,136,590	140,808,590
Gross profits	46,963,410	42,881,410
Operating expenses		
Selling expense	27,859,650	27,859,650
General & administrative expenses	9,796,800	9,796,800
Depreciation expense	3,326,830	3,326,830
Total operating expense	40,983,280	40,983,280
Operating profits	5,980,130	1,898,130
Interest expense	806,187	491,977
Net profits before taxes	5,173,943	1,406,153
Taxes (rate = 30%)	1,552,183	421,846
Net profits after taxes	3,621,760	984,307
Dividends	1,810,880	492,153

Heartland Pharmacy

	With Tobacco	**W/O Tobacco**
Balance Sheet ($000)	Projected	Projected
As of December 31	2015	2015
	$	$
Assets		
Current assets		
Cash	1,020,500	918,450
Accounts receivable	13,968,268	12,571,442
Inventory	19,162,999	17,171,779
Total current assets	34,151,767	30,661,671
Gross fixed assets	30,472,130	30,472,130
Less: Accumulated depreciation	13,896,830	13,896,830
Net fixed assets	16,575,300	13,528,087
Total assets	50,727,067	44,189,758
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	11,365,496	10,184,512
Notes payable	660,668	660,668
Accruals	415,828	415,828
Total current liabilities	12,441,992	11,261,008
Long-term debts	9,496,674	9,496,674
Total liabilities	21,938,666	20,757,682

Stockholders' equity		
Common stock (at par)	10,500,000	10,500,000
Retained earnings	18,288,402	16,859,702
Total stockholders' equity	28,788,402	27,359,702
	50,727,067	48,117,383

4) Use ethical models to develop non-financial reasons why the company should continue to sell or discontinue selling tobacco products.

Discontinuing the sale of tobacco products is supported by Kantian ethical theory. According to Kant, respect for people is a necessity, and people should not be treated as a means to an end. Motives are important to a Kantian: people must make the right decisions for the right reasons. The motivation for any action should be a sense of duty and good will. By discontinuing the sale of tobacco products, Heartland Pharmacy is treating its customers with respect. The motive for the decision is to improve the health of its customers.

Utilitarians look at the consequences of an action; an action is ethical if it leads to the best possible net outcome of good over bad consequences. From the perspective of a utilitarian, discontinuing the sale of tobacco products does not lead to the greatest good; gains do not outweigh losses. Stockholders will lose as a result of lower profits. Employees are also likely to lose as some of them may lose their jobs. Likewise, suppliers that provide tobacco products to Heartland will lose a customer, although this loss may be offset by higher sales to other retailers. Heartland's customers will be able to secure tobacco products at other retailers, and so there is no gain to their health as a result of this action. The communities in which Heartland Pharmacies operate will not experience any gain if jobs are lost, and community health is unlikely to improve since tobacco users can purchase products at other retailers. Governments may lose some tax revenue from lost jobs (see Stakeholder Analysis above). The negative consequence of a ban on the sale of tobacco products is further substantiated by industry conditions. With respect to growth potential, "diversification of product lines and general merchandise geared toward customer needs ...may hold the brightest future for the independent drug store." (Lindberg and Vaughn, 2004) Banning tobacco products does not follow this recommendation. Likewise, the growing degree of competition forecasted for independent drug stores suggests that Heartland Pharmacy continue to sell tobacco products in order to maintain the same product lines as its competitors.

A libertarian would not support a ban on the sale of tobacco products. Profit maximization is the primary goal for a libertarian; the social responsibility of a company is to maximize profits for its stockholders. Since discontinuing the sale of tobacco products leads to lower revenue and profits, a libertarian would clearly not support this action.

5) Prepare a recommended course of action with supporting analysis.

From a financial perspective, discontinuing tobacco sales would have a substantial negative impact on Heartland. Projected 2015 revenues would decrease from $204,100,000 (with tobacco sales) to $183,690,000 (without tobacco sales). Profits would suffer a similar to decline from $3,621,760 with tobacco products to $984,307 without tobacco and tobacco related products. Maintaining a 50% dividend payout ratio would reduce dollar dividends from $1,810,880 with tobacco sales to $492,153 without tobacco sales, a reduction of more than 70%. It is very unlikely shareholders would be happy with lower revenues, profits and dividends. The decision is straightforward; continue sales of tobacco and tobacco related products.

Addressing Dr. Allen Springer's objections to the sale of tobacco products is more difficult. An argument can be made that tobacco products are legal and if Heartland discontinues their sale, tobacco users will still have access to tobacco products at other retail outlets. Tobacco users may cease to shop at Heartland for all their pharmacy needs, thus creating additional pressure on revenues and profits.

It can also be argued that tobacco products are not the only products sold by Heartland which have a negative impact on the health of its customers. Alcohol products, snack foods, dessert items, soft drinks, candies, etc. can be viewed as unhealthy. Following Springer's logic, should Heartland consider discontinuing these products as well?

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CONSUMER WHORE: TRADEMARK, DILUTION, PARODY, AND FREE SPEECH: A TEACHING CASE

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INSTRUCTOR'S NOTES

CASE DESCRIPTION

The primary subject matter of this case concerns the legal environment of business and trademark infringement. The case also includes issues of trademark dilution and free speech, especially as it relates to entrepreneurship and business decisions to select trademarks. The case centers on whether comic artist Kieron Dwyer's parody of Starbucks' mermaid logo is trademark infringement, whether it is trademark dilution, or whether the artist has a First Amendment right to parody a famous trademark owner's iconic image in order to make a comment on our consumer oriented society. The case has a difficulty level of three: it is appropriate for junior level students or higher. It is also appropriate for developing MBA students' critical thinking and research skills. The case is designed to be taught in one class hour following advance preparation by students. Most students can prepare in two hours outside of class.

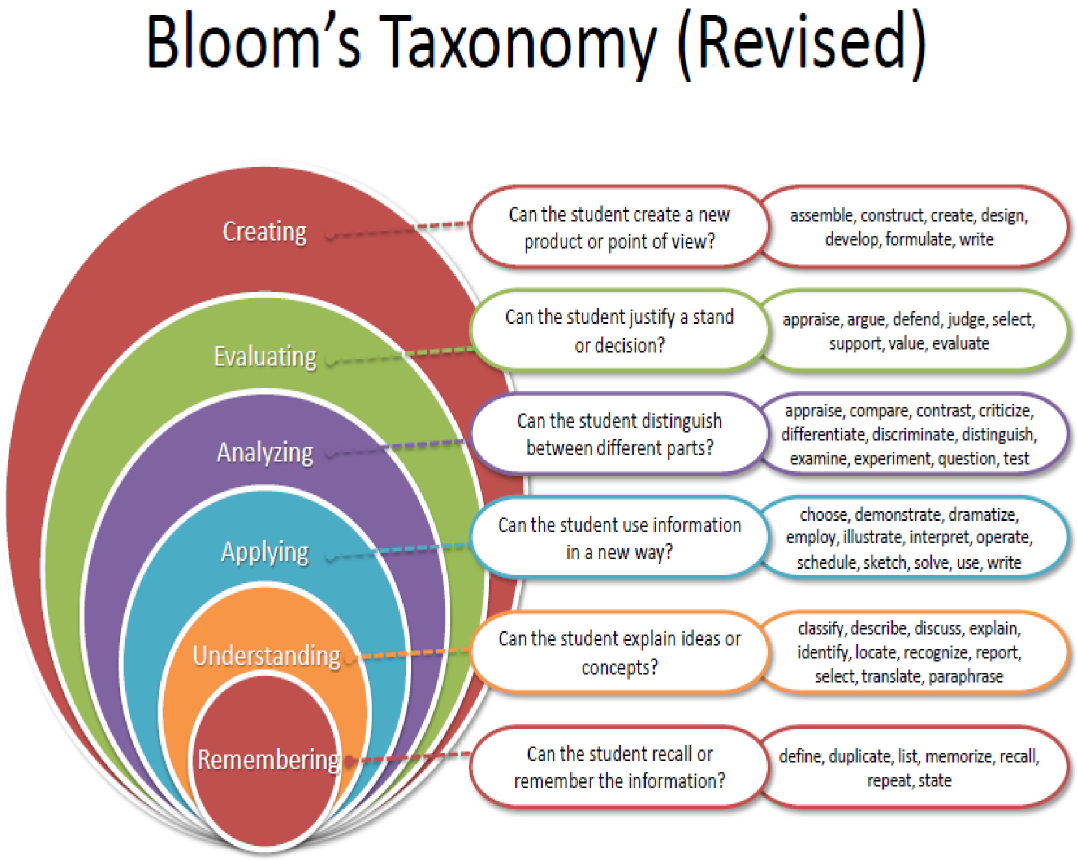
CASE SYNOPSIS

In 2000 Starbucks sued comic artist Kieron Dwyer for marketing a comic book and other products like t-shirts with an image that looked like Starbucks' mermaid logo, but which was named Consumer Whore rather than Starbucks Coffee. Kieron Dwyer claimed that he was making a parody and social commentary on our consumer oriented society. Judge Chesney in the federal court for the Northern District of California, held that while Dwyer had a First Amendment right to comment on society, Dwyer's use of the modified Starbucks logo diluted the value of Starbucks' trademark and was too similar to Starbucks' original. The parties settled when Dwyer effectively agreed not to market or publish the logo. Starbucks claimed copyright infringement, trademark infringement, and dilution. The court found the parody was a fair use of Starbucks' copyright. It also held there was probably no trademark infringement due to little likelihood of confusion. The court, however, granted an injunction prohibiting use of the Dwyer logo on t-shirts, mugs, and even in comic books, on the grounds that the logo tarnished (diluted) Starbucks' logo. The sources of this information are included in this Teaching Note.

CONSUMER WHORE: TRADEMARK, DILUTION, PARODY, AND FREE SPEECH. A TEACHING CASE

Course Learning Objectives

There are a number of course objectives faculty can accomplish using this case. The following discussion includes learning objectives for courses in business law, legal environment of business, marketing, ethics, and entrepreneurship. The authors based the learning objectives on Bloom's Revised Taxonomy, a well-recognized method for analysing levels of critical thinking and learning (Anderson, 2001). The following illustration provides a simple depiction of Bloom's revised Taxonomy.



MODEL COURSE LEARNING OBJECTIVES

The following is a list of applicable course learning objectives for instructors who want to use this case. The objectives are for courses in business law, legal environment, marketing, business ethics, and entrepreneurship.

Business Law/Legal Environment Course Learning Outcomes

1. Know and understand substantive and procedural law relating to intellectual property
2. Evaluate substantive and procedural law relating to intellectual property
3. Evaluate and analyze the business implications of creating and protecting intellectual property
4. Evaluate the legal implications and policies of substantive and procedural law relating to intellectual property
5. Demonstrate the ability to find information about intellectual property law
6. Know, understand, and evaluate the interrelationship between intellectual property law, marketing, and branding

Marketing Course Learning Outcomes

1. Identify strategic marketing opportunities and issues as they relate to choosing and protecting a brand using intellectual property as its basis
2. Make recommendations on solving these strategic marketing problems using legal and ethical analysis
3. Evaluate the role of research in making marketing decisions
4. Conduct research and use those results to develop, inform, and monitor marketing strategy

Ethics Course Learning Outcome

1. Apply ethical principles to real-world decision making in order to assess the legal process and its implications

Entrepreneurship Course Learning Outcomes

1. Understand marketing strategies for small businesses
2. Identify and evaluate the strategies which can be used to protect intellectual property

3. Explain the emotional and financial risks involved in litigation even when the litigation is likely to be successful
4. Identify and develop strategies for new ventures and small businesses to protect their intellectual property resources

Outline of Questions, Learning Outcomes, And Bloom's Taxonomy

This section includes discussion questions for the case, the learning outcome(s) accomplished with each question, and the relevant level of Bloom's Revised Taxonomy (Anderson, 2011). At the beginning of each section of related questions is a table that identifies the question number, learning outcome(s), and Bloom's taxonomy level. Instructors can use this as a basis to select questions for their courses. The explanation of the questions, answers, and sources of additional information such as relevant cases can be found in sections A and C. Section B contains a summary of court decisions which instructors can use to support the analysis in section A.

DISCUSSION QUESTIONS

Faculty should assign students to read the case and read about trademark and copyright in the course textbook or through an internet search of trademark and copyright law. Most business law textbooks have a chapter on intellectual property, which includes trademarks. In the alternative, the instructor could ask that students read an online description of trademark law. Depending on the amount of time the instructor is devoting to this case, the instructor could require that students spend 15 minutes on the internet in class finding and reading the definitions of trademark law or one or two hours of reading prior to class. These instructors' notes contain suggested questions and additional background information to enable the instructor to become familiar with the legal issues and to assign readings to the students should the instructor so choose. The Instructor's Notes are organized around these main topics:

A. Overview of Trademark and Copyright
B. Cases That Might Be Compared or Contrasted to Dwyer's
C. Implications for Business Planning

Overview Of Trademark And Copyright

The instructor should ask basic questions on trademark law and tangentially the basics of copyright law, since often a plaintiff will claim both trademark and copyright infringement. It is helpful if the instructor asks the students to briefly summarize the relevant law. The following 4 questions might be posed and then discussed in class, after the students have searched for and have drafted answers. The possible sources for obtaining the answers include the course text, internet sources such as the Legal Information Institute (LII) operated by Cornell Law School, and the Lanham Act itself. The latter is the primary source of the law since it is the statute that will be applied in a federal trademark case. The U.S. government also provides summaries of trademark and copyright law that are easy to understand. Even if the course text lacks sufficient detail to enable students to understand the areas of law implicated in a case analysis, the information can be easily found from online sources. Fortunately, with the invention of the internet and business interest in trademark protection, finding definitions and explanations of trademark and copyright is a simple task for students to perform right in the classroom with their electronic devices. This is a business topic of interest to entrepreneurs, so accurate online information is readily available.

Table 1
QUESTIONS FOR SECTION A 1-4 OF INSTRUCTOR'S NOTE
Each question in this section is listed, along with its related learning outcome and level of Bloom's Revised Taxonomy.

Section & Question Number	Question	Learning Outcome	Level in Bloom's Revised Taxonomy
A-1	What is a trademark?	• Know substantive and procedural laws relating to intellectual property • Demonstrate the ability to find information about intellectual property law	Rememberi ng
A-2	Is the Starbucks mermaid logo a trademark? Is Dwyer's Consumer Whore image a trademark? Explain.	• Know substantive and procedural laws relating to intellectual property	Applying
A-3	What is a copyright and why should a person dealing with a trademark parody know about copyright also?	• Know substantive and procedural laws relating to intellectual property • Demonstrate the ability to find information about intellectual property law	Understandi ng Applying
A-4	Does Starbucks have a copyright in the mermaid image? Does Dwyer have a copyright in his Consumer Whore image? Explain.	• Evaluate substantive and procedural law relating to intellectual property	Applying

A-1. What is a trademark?

"A **trademark** is a word, phrase, symbol, and/or design that identifies and distinguishes the source of the goods of one party from those of others" (USPTO, c). The Legal Information Institute (LII), also contains explanations of trademark and copyright law. It has the advantage of being more "legal" in that it cites to the Lanham Act and case law that interprets the statute.

> *Trademarks are generally words, phrases, logos and symbols used by producers to identify their goods. See 15 U.S.C. § 1127. …[S]hapes, sounds, fragrances and colors may also be registered as trademarks. … In recent years, trademark law has expanded to include trade dress and antidilution protection. Almost any word, name, symbol, or device capable of distinguishing the source of goods may be used as a trademark subject to few limitations (Trademark, LII, a).*

A-2. Is the Starbucks mermaid logo a trademark? Is Dwyer's Consumer Whore image a trademark? Explain.

Based on the summary above, students will conclude that Starbucks' mermaid logo is a trademark because the Starbucks Mermaid logo is used to identify the goods sold (coffee and related products). The answer is not as clear with the Consumer Whore image. Because the creator, Kieron Dwyer, was "poking fun" at consumerism and not trying to brand and sell a good or service that he produced, the Consumer Whore image is probably not a trademark, although a court could possibly consider it a trademark.

A-3. What is a copyright and why should a person dealing with a trademark parody know about copyright also?

"A **copyright** protects works of authorship, such as writings, music, and works of art that have been tangibly expressed" (USPTO, c).

> *A copyright is a legal device that gives the creator of a literary, artistic, musical, or other creative*

work the sole right to publish and sell that work. Copyright owners have the right to control the reproduction of their work, including the right to receive payment for that reproduction. An author may grant or sell those rights to others, including publishers or recording companies. Violation of a copyright is called infringement (Copyright, The Free Dictionary).

A-4. Does Starbucks have a copyright in the mermaid image? Does Dwyer have a copyright in his Consumer Whore image? Explain.

Starbucks seems to have both a copyright and a trademark in its mermaid image and Kieron Dwyer seems to have both in his Consumer Whore image, at least in the aspects of the image that are not copied or substantially similar to Starbucks' mermaid image. Both have creative elements that give them the sole right to publish and sell their works.

Table 2
QUESTIONS FOR SECTION A 5-7 OF INSTRUCTOR'S NOTE
Each question in this section is listed, along with its related learning outcome and level of Bloom's Revised Taxonomy.

Section & Question Number	Question	Learning Outcome	Level in Bloom's Taxonomy
A-5	Has Dwyer infringed on Starbucks' copyright in his duplication, in part, of the Starbucks mermaid?	• Evaluate substantive and procedural law relating to intellectual property	Analyzing
A-6	What is trademark infringement and its likelihood of confusion test?	• Know substantive and procedural laws relating to intellectual property • Demonstrate the ability to find information about intellectual property law	Remembering
A-7	Will the public be likely to confuse Dwyer's Consumer Whore image with Starbucks' mermaid image?	• Evaluate the legal implications and policies of substantive and procedural law relating to intellectual property	Analyzing

A-5. Has Dwyer infringed on Starbucks' copyright in his duplication, in part, of the Starbucks mermaid?

No, he has not infringed. Copyright law has a fairly clear fair use exception that permits using another's copyrighted work for purposes of parody. Copyright law has a detailed fair use statute (17 U.S.C.A. §107) and a Supreme Court decision, Campbell v. Acuff-Rose, that held that parody, at least in a musical work, is fair use. So Starbucks would not prevail in its copyright infringement claim. Fair use is referenced in the Lanham Act for trademark also. However, fair use is not as clearly defined in the Lanham Act, leaving more latitude for courts to vary in their interpretations of what uses are fair.

A-6. What is trademark infringement and its likelihood of confusion test?

To prevail on a claim of trademark infringement, a plaintiff must establish that it has a valid mark entitled to protection; and that the defendant used the same or a similar mark in commerce in connection with the sale or advertising of goods or services without the plaintiff's consent. The plaintiff must also show that "defendant's use of the mark is likely to cause confusion as to the affiliation, connection or association of defendant with plaintiff, or as to the origin, sponsorship, or approval of defendant's goods, services or commercial activities by plaintiff (citation omitted). Thus, 'use,' 'in commerce,' and 'likelihood of confusion' are three distinct elements necessary to establish a trademark infringment claim. … 'Likelihood of confusion' is the central focus of any trademark infringement claim. A likelihood of confusion exists when consumers viewing the allegedly infringing mark would probably assume that the product or service it represents is associated with the source of a different product or service identified with a similar mark. Courts conducting a likelihood of confusion analysis apply a different standard to directly competing, as opposed to non-competing, goods" (Trademark Infringement, Legal Information Institute).

A-7. Will the public be likely to confuse Dwyer's Consumer Whore image with Starbucks' mermaid image?

In this situation, it is unlikely that consumers would be confused or that they would think Kieron Dwyer's Consumer Whore is the same mark as Starbucks' mermaid. While the question to the students may only ask about likelihood of confusion, it seems the LII quote above is more inclusive of all the requirements of infringement. The instructor may point out that there does not appear to be copyright or trademark infringement. At this point, the instructor may want to begin the transition from trademark infringement to trademark dilution because this is an opportunity for the students to begin to become aware that the concept of trademark dilution goes beyond infringement, possibly entitling the trademark owner to more protection than would traditionally be recognized.

Table 3
QUESTIONS FOR SECTION A 8-9 OF INSTRUCTOR'S NOTE
Each question in this section is listed, along with its related learning outcome and level of Bloom's Revised Taxonomy.

Section & Question Number	**Question**	**Learning Outcome**	**Level in Bloom's Taxonomy**
A-8	What is trademark dilution and why should a person who has created a parody know about trademark dilution?	• Know substantive and procedural laws relating to intellectual property • Identify and evaluate the strategies which can be used to protect intellectual property • Demonstrate the ability to find information about intellectual property law	Remembering Applying Evaluating
A-9	What's the theoretical basis for the trademark dilution laws?	• Evaluate the legal implications and policies of substantive and procedural law relating to intellectual property	Understanding

A-8. What is trademark dilution and why should a person who has created a parody know about trademark dilution?

> *Trademark dilution is a trademark law concept giving the owner of a famous trademark standing to forbid others from using that mark in a way that would lessen its uniqueness. In most cases, trademark dilution involves an unauthorized use of another's trademark on products that do not compete with, and have little connection with, those of the trademark owner. ... Dilution is a basis of trademark infringement that only applies to famous marks (Trademark dilution, Wikipedia).*

The instructor may want to address the reliability of Wikipedia for legal or business research. If the instructor has an objection to student use of Wikipedia, the reference may be replaced with one from LII or from the INTA (International Trademark Association) website.

A-9. What's the theoretical basis for the trademark dilution laws?

The concept of dilution is indeed controversial to this day. The text below explains this controversy.

The concept of dilution developed from the idea that because some marks are so well-known and famous, they deserve an extra level of protection beyond the likelihood-of-confusion analysis. Dilution theory seeks to prevent the coexistence of a mark that is sufficiently similar to a famous mark, regardless of the goods and/or services associated with the allegedly diluting mark. Proponents of the theory argue that it protects the goodwill associated with a well-known mark (which may have been built up over many years) and it reduces consumer confusion. Critics of the dilution theory allege, however, that stringent antidilution laws can stifle market competition (Trademark dilution, Fact Sheets).

Table 4
QUESTION FOR SECTION A 10 OF INSTRUCTOR'S NOTE
Each question in this section is listed, along with its related learning outcome and level of Bloom's Revised Taxonomy.

Section & Question Number	Question	Learning Outcome	Level in Bloom's Taxonomy
A-10	What is a parody and what does Dwyer's Consumer Whore actually parodize? It's not parodying Starbucks, is it?	• Evaluate the legal implications and policies of substantive and procedural law relating to intellectual property • Demonstrate the ability to find information about intellectual property law	Analyzing Evaluating

A-10. What is a parody and what does Dwyer's Consumer Whore actually parodize? It's not parodying Starbucks, is it?

Parody is "an imitation of the style of a particular writer, artist, or genre with deliberate exaggeration for comic effect" (Parody, Oxford Dictionaries).

Dwyer's parody is of consumerism in general. The images from his first Lowest Common Denominator (LCD) comics illustrate that. The images are attached in the Appendix. An instructor could highlight this by comparing Dwyer's image to another similar use of Starbucks' mermaid logo. This may help the instructor and students distinguish between use of a trademark to parody, to make a comment on society, and use of a logo to simply call a famous trademark owner to mind. As a comparison, in the Starbung situation, it appears the coffee seller is trying to make coffee buyers think the coffee is either Starbucks or related to it, due to the similarity of marks. In the Consumer Whore case the comic book artist Dwyer is trying to comment on our consumer oriented society by causing viewers to think of Starbucks coffee and the current trend of carrying around a cup of coffee with the mermaid logo while at work and play as being consumer oriented (Dooley, 2013).

Postscript to Overview Of Trademark And Copyright

After providing the summary of trademark law, the instructor should ask students to apply that law to Consumer Whore. The students should explain that Starbucks has a trademark and the right to protect it against infringements and actions that would dilute the famous mark. Then the instructor should present the "other side" of the Consumer Whore case, the artist's First Amendment right to parody the famous mark while making an artistic or social statement. The latter will be the second part of the exercise. After establishing the competing interests at stake, the instructor might have the students role play out the court case or debate the two conflicting viewpoints.

Cases That Might Be Compared or Contrasted

There are a large number of trademark infringement and/or trademark dilution cases based on the parody of a famous trademark. Fifteen of them are highlighted here. Some of the decisions protect the parodist's free speech rights, while others do not. Therefore, it is difficult to predict what a court will do in a particular situation. This lack of predictability may have a chilling effect on artists' free expression of their ideas. The Lanham Act mentions fair use, but does not define it. The Lanham Act does not mention First Amendment or free speech at all. This case enables business students to grapple with problems that might arise in their business should they decide to "make fun of" a famous trademark.

The instructor could ask students to locate a court case dealing with the parody of a trademark, or could suggest that students compare several cases, perhaps one that protects the parodist's right to make a parody and another that does not, and then to compare them with Dwyer's misfortune with his Consumer Whore logo. It is not suggested that all the cases be reviewed, so the instructor may wish to choose from the following list of cases that are briefly summarized. Some of the cases were decided before enactment of federal dilution statutes, so they do not mention dilution. Dwyer's court found that his logo diluted Starbucks' mermaid and so issued the injunction. The decision might have been different if he had launched a vigorous defense or had appealed. It might be a good exercise to ask students to discuss with one another which of several fact situations in the cases is closest to the Consumer Whore situation. Some of the decisions are identified and briefly summarized here. It might help to remind students of Starbucks' viewpoint, that its mark is being diluted, either by blurring or tarnishment, when viewers of Consumer Whore associate consumerism and its "evils" with the famous coffee company.

Two items might be part of classroom discussions. First, trademark law is unique in that the federal law does not preempt state law, so there are a number of state law causes of action might be brought simultaneously with a federal trademark claim. Second, it is possible that the First Amendment protections courts have traditionally given to parody are reduced in light of the enactment of the federal trademark dilution statutes (Cantwell, 2004, p. 548). Students, through discussion and case exploration, might discover that finding a bright line to allow future parodists to adjust their work to be non-infringing or non-diluting is futile, since it seems there is no bright line and that circuits differ widely. In parody trademark cases decided prior to the federal dilution statutes, the courts were limited to considering whether the junior mark, the parody, was likely to create confusion in the minds of consumers. So there might have been more First Amendment protection in many pre-dilution cases than there are in present day when the courts also have to consider whether the senior mark holder's reputation or mark is being diluted by tarnishment or blurring.

The following list contains brief summaries of some cases, including some discussed by Cantwell in a 2004 article. The purpose of the parody may be the most important factor even though it is not an explicit criterion for courts to consider. For instance, cases involving a political parody might receive more First Amendment protection than ones where the parodist is referencing sexual, obscene, or illegal activity. But some courts permit even sexual or offensive parodic uses. In other situations the courts seem to prohibit the parodic use in order to protect a local business, such as two cases from the Eighth Circuit. The cases decided after passage of the 1995 Federal Trademark Dilution Act and the 2006 Trademark Dilution Revision Act may seem at first blush to be more protective of the senior mark holder, but there are notable exceptions.

Table 5
QUESTIONS FOR SECTION C 1-3 OF INSTRUCTOR'S NOTE
Each question in this section is listed, along with its related learning outcome and level of Bloom's Revised Taxonomy.

Section & Question Number	Question	Learning Outcome	Level in Bloom's Taxonomy
C-1	What should a business consider in designing its trademark and tradename?	• Evaluate and analyze the business implications of creating and protecting intellectual property • Evaluate the role of research in making marketing decisions • Know, understand, and evaluate the interrelationship between intellectual property law and marketing • Make recommendations on solving these strategic marketing problems using legal and ethical analysis • Identify and evaluate the strategies which can be used to protect intellectual property • Explain the emotional and financial risks involved in litigation even when the litigation is likely to be successful	Understanding Evaluating
C-2	How can an entrepreneur find out if a particular trademark or tradename is available?	• Know substantive and procedural laws relating to intellectual property • Demonstrate the ability to find information about intellectual property law • Make recommendations on solving these strategic marketing problems using legal and ethical analysis • Demonstrate the ability to find information about intellectual property law	Understanding Applying
C-3	How does a business obtain legal rights to a trademark? Note that this is about both finding the law and doing a trademark search.	• Demonstrate use of legal sources to find information about intellectual property law • Know substantive and procedural laws relating to intellectual property • Identify and evaluate the strategies which can be used to protect intellectual property • Demonstrate the ability to find information about intellectual property law	Understanding Applying Evaluating

C-1. What should a business consider in designing its trademark and tradename?

Creating a trademark is a 2-step process. The business should create something that is unique and memorable. A trademark must be distinctive. The business also needs to make sure that its proposed trademark is available.

In determining whether a mark is distinctive, the courts group marks into four categories, based on the relationship between the mark and the underlying product. Marks may be: (1) arbitrary or fanciful, (2) suggestive, (3) descriptive, or (4) generic. Because the marks in each of these categories vary with respect to their distinctiveness, the requirements for, and degree of, legal protection afforded a particular trademark will depend upon which category it falls within (The Berkman Center, n.d.). Many business law texts include a discussion of this topic (Davidson & Forsythe, 2014).

The law provides the most protection to marks in category 1. For example, Starbucks trademark is arbitrary or fanciful. Faculty can assign students to research the history of the Starbucks trademark.

It is advisable to make sure that the trademark is available before the entrepreneur becomes too wedded to it. Once an entrepreneur "falls in love" with a trademark, he or she may proceed with using it even if the use is ill advised.

C-2. How can an entrepreneur find out if a particular trademark or tradename is available?

An entrepreneur can search through state and federal trademark registries. Many of the registries are now available online. The entrepreneur can also search the internet. Businesses commonly use their trademark or tradename as part of their presence on the Internet and social media. These are also the places that a business can search to uncover any marks that infringe with its own trademarks. The business can do the search itself or it can hire a firm that conducts these searches. Some examples of firms that conduct searches include **LegalSherpa,** LegalZoom, and TradeMark Express. *(Legal Sherpa, Legal Zoom and TradeMark Express. See also* DeBare, 2011).

C-3. How does a business obtain legal rights to a trademark?

After creating a mark, a business obtains a trademark by using the mark in commerce. This generally means the sale of goods with the trademark attached to them. The federal trademark registry was created under the authority of the Lanham Act. It is not necessary to register a trademark with the U.S. Patent and Trademark Office (USPTO, e). However, it is advisable to register. Federal registration provides a number of benefits including: (1) public notice of the registrant's claim to the trademark; (2) a presumption that the registrant owns the rights to use the mark throughout the United States; (3) a right to file suit in federal court; (4) a right to register the mark with the U.S. Customs and Border Protection (CBP) Service to prevent infringing marks from being imported into the United States; and (5) the trademark will be listed in the USPTO online data base. Unregistered marks are only protected in the geographic area where they are used.

The business owner should consider where to register the mark. For example, the owner may register with the state and/or federal government. If the owner is going to have a web site, the owner should register the name with the web hosting company (Foliono, 2010). Students can be assigned to research the costs to register and maintain a trademark at the state and/or federal level.

Since trademarks are based on use in commerce, the owner of a mark may lose the mark if the owner ceases to use it in commerce.

C-4. What remedies does the plaintiff generally request in a trademark infringement suit against one who "appropriates" the owner's trademark?

A trademark owner can sue for an injunction, money damages, or both. The Lanham Act provides for the following remedies: an injunction, an accounting for defendant's profits, plaintiff's **damages**, a possibility of **treble damages** when the court decides it is appropriate, attorney's fees in "exceptional cases," and **costs of litigation** (**15 U.S.C. § 1117)**. "Exceptional cases" include when the infringement is malicious, fraudulent, deliberate, or willful (15 U.S.C. § 1117(a)). Plaintiffs generally request that all offending goods be destroyed (Lawyer's Cooperative Publishing, 2015). An owner who claims state causes of actions, such as unfair competition, may be entitled to other remedies if he or she wins (Lawyer's Cooperative Publishing, 2015).

Table 6
QUESTIONS FOR SECTION C 4-5 OF INSTRUCTOR'S NOTE
Each question in this section is listed, along with its related learning outcome and level of Bloom's Revised Taxonomy.

Section & Question Number	Question	Learning Outcome	Level in Bloom's Taxonomy
C-4	What remedies does the plaintiff generally request in a trademark infringement suit against one who "appropriates" the owner's trademark?	• Know substantive and procedural laws relating to intellectual property • Identify strategic marketing opportunities and issues as they relate to choosing and protecting a brand using intellectual property as its basis • Identify and evaluate the strategies which can be used to protect intellectual property	Remembering Evaluating
C-5	What should a business consider if it wants to make a parody or "poke fun" at a trademark or company? Why?	• Identify strategic marketing opportunities and issues as they relate to choosing and protecting a brand using intellectual property as its basis • Evaluate the role of research in making marketing decisions • Understand marketing strategies for small businesses • Identify and evaluate the strategies which can be used to protect intellectual property • Explain the emotional and financial risks involved in litigation even when the litigation is likely to be successful	Understanding Analyzing Evaluating

C-5. What should a business consider if it wants to make a parody or "poke fun" at a trademark or company? Why?

In addition to the legal issues raised in Section B, the business should consider the practical aspects of its use. Is it using the trademark because it wants to comment on serious social issues? Is it poking fun to amuse people? Is this an attempt to make money riding on the business's coattails? The legal outcome may be influenced by the court's analysis of the underlying motives.

The business should also consider the morality of its intended use. Does it merely want to free ride on the work and fame of the trademark owner? Does it want to comment on the attributes of the trademark owner, its products, or its customer?

C-6. Which of the following "uses" of Starbucks' trademark will the courts probably allow? Why?

1. Nathan Fielder created a temporary coffee outlet and put "Dumb" in front of the word "Starbucks" (Lee, 2014).
2. Damrong Maslae created and used his Starbung Coffee logo for his Bangkok coffee stall (Dooley, 2013).

These situations have not been litigated yet. Students can side with either Starbucks or the potential defendant. Encourage students to focus on the "why?" Many courts consider whether the defendant intended to confuse the public about the source of its goods. The examples above and the cases described in Section B can be assigned as homework. In the alternative students can be assigned to one side or another to debate the parties' positions. Students could be assigned to try to negotiate a settlement, however, Starbucks generally demonstrates an unwillingness to negotiate questions of potential trademark infringement.

Table 7
QUESTIONS FOR SECTION C 6-9 OF INSTRUCTOR'S NOTE
Each question in this section is listed, along with its related learning outcome and level of Bloom's Revised Taxonomy.

Section & Question Number	Question	Learning Outcome	Level in Bloom's Taxonomy
C-6	Which of the following "uses" of Starbucks' trademark will the courts probably allow? Why? A. Nathan Fielder created a temporary coffee outlet and put "Dumb" in front of the word "Starbucks." (Lee, 2014). B. Damrong Maslae created and used his Starbung Coffee logo for his Bangkok coffee stall. (Dooley, 2013).	• Evaluate the legal implications and policies of substantive and procedural law relating to intellectual property	Analyzing
C-7	Which of the "uses" *should* the court allow? Why?	• Evaluate the legal implications and policies of substantive and procedural law relating to intellectual property	Evaluating
C-8	Does it matter where Dwyer used the image, e.g., comic book covers, mugs, t-shirts, and web sites?	• Evaluate the legal implications and policies of substantive and procedural law relating to intellectual property • Identify and evaluate the strategies which can be used to protect intellectual property	Analyzing Evaluating
C-9	Should it matter where the image was used?	• Identify strategic marketing opportunities and issues as they relate to choosing and protecting a brand using intellectual property as its basis • Apply ethical principles in real-world decision making to assess the legal process and its implications	Evaluating

C-7. Which of the "uses" should the court allow? Why?

Students will have different opinions. Students should be encouraged to use their critical thinking skills and develop cogent arguments about why a use should be permitted or not permitted. Their initial answers may depend on with whom they identify. Do they identify with the large business that has invested heavily in creating, marketing, and defending its trademark? In this case they may take a property rights position and declare that the trademark owner created the property and should be permitted to protect it. Do they identify more closely with small businesses or comic artists? Also they will have different views about the amount of free riding of famous marks that should be allowed. Students may be comfortable with free riding in some situations but not others.

C-8. Does it matter where Dwyer used the image, e.g., comic book covers, mugs, t-shirts, and web sites?

When artists use trademarks and logos, it makes a difference. The artist's legal claim is better if he or she uses the mark on a painting. He or she is on more tenuous grounds if he or she puts the design on mugs and t-shirts. Faculty may want to refer to Steve McKelvey and Ari J. Sliffman, *The Merchandising Right Gone Awry: What "Moore" Can Be Said?* (2015). Professor McKelvey and Mr. Sliffman write about artists who reproduce sports trademarks that are actually in a scene and discuss their proposal for how to improve the law in this area.

C-9. Should it matter where the image was used?

Students will have different opinions. Professor McKelvey and Mr. Sliffman discuss the ability of artists to use trademark images on mundane products, like mugs and t-shirts. However, it may be a different situation for comic book artists. Comic books like LCD are more like political cartoons and mugs and t-shirts may be more like "products." Ask students whether the dichotomy makes sense for artists or comic artists.

Table 8
QUESTIONS FOR SECTION C 10-12 OF INSTRUCTOR'S NOTE
Each question in this section is listed, along with its related learning outcome and level of Bloom's Revised Taxonomy.

Section & Question Number	Question	Learning Outcome	Level in Bloom's Taxonomy
C-10	If Starbucks decides to sue, where should it file its suit? Why? Should it use federal or state courts?	• Know substantive and procedural laws relating to intellectual property	Applying
C-11	Where did Starbucks file its suit? Why do you think it chose that court?	• Know substantive and procedural laws relating to intellectual property	Understanding
C-12	Will the final court decision be affected by who is hearing the case? Why or why not?	• Know substantive and procedural laws relating to intellectual property • Evaluate the legal implications and policies of substantive and procedural law relating to intellectual property	Analyzing Evaluating

C-10. If Starbucks decides to sue, where should it file its suit? Why? Should it use federal or state courts?

Students may have different answers. Their answers may also be influenced by what Starbucks actually did. Most students will probably select Washington state courts because Starbucks started as a small, local company in Seattle. It employs many people in Washington and the community generally embraces Starbucks. In the alternative, students may select the United States District Court for the Western District of Washington that sits in Seattle.

C-11. Where did Starbucks file its suit? Why do you think it chose that court?

Starbucks filed in the federal district court for the Northern District of California. It probably chose this court because Dwyer was living in San Francisco at the time and the court could obtain jurisdiction over him. Starbucks probably chose federal court because they planned on using federal trademark law and they may have thought that they could obtain a preliminary injunction more quickly.

C-12. Will the final court decision be affected by who is hearing the case? Why or why not?

The court hearing the case will affect the result. As indicated in Section B, different states and federal circuits use different legal tests. In the area of parody, some courts seem to have more of a sense of humor than others. In addition, some courts seem to be more protective of home town businesses. For example, in Starbucks v. Dwyer, courts in Starbucks' neighborhood of Seattle might be much more protective of its image than courts located elsewhere. Plaintiffs consider this in deciding where to file their suits.

Table 9
QUESTIONS FOR SECTION C 13-14 OF INSTRUCTOR'S NOTE
Each question in this section is listed, along with its related learning outcome and level of Bloom's Revised Taxonomy.

Section & Question Number	Question	Learning Outcome	Level in Bloom's Taxonomy
C-13	What should a business do if it receives a cease and desist letter? How can it evaluate if the letter has some merit?	• Demonstrate use of legal sources to find information about intellectual property law • Identify and develop strategies for new ventures and small businesses to protect their intellectual property resources • Identify strategic marketing opportunities and issues as they relate to choosing and protecting a brand using intellectual property as its basis • Understand marketing strategies for small businesses • Demonstrate the ability to find information about intellectual property law • Identify and evaluate the strategies which can be used to protect intellectual property • Explain the emotional and financial risks involved in litigation even when the litigation is likely to be successful • Make recommendations on solving these strategic marketing problems using legal and ethical analysis	Applying Understanding Analyzing Evaluating
C-14	How would you structure a survey to determine if there is likelihood of confusion between Starbucks' image and Dwyer's image?	• Conduct research and use those results to develop, inform, and monitor marketing strategy • Evaluate the role of research in making marketing decisions • Identify and evaluate the strategies which can be used to protect intellectual property • Make recommendations on solving these strategic marketing problems using legal and ethical analysis	Evaluating Creating

C-13. What should a business do if it receives a cease and desist letter? How can it evaluate if the letter has some merit?

Business owners should be aware that trademark owners often send threatening cease and desist letters. The letters specify in scary detail all the remedies that the trademark owner will claim in court. In many cases the cease and desist letter is intended to scare and bully the business owner. One fact that is unusual in Dwyer's case is that Starbucks did *not* send him a cease and desist letter. When Dwyer consulted with the attorney prior to publication, the attorney informed him that he might receive a cease and desist letter. Trademark owners find that it is common for cease and desist letters to be effective in stopping the use owners do not like.

The recipient of the cease and desist letter should not panic because the letter may be foundless or the recipient may have a good defense. It helps to remember that a number of trademark users have initiated suit to later discover that they were not the first to use the mark and the court subsequently decided that the defendant was the one entitled to use it. In uses like those involving Keiron Dwyer, the business owner should consider (1) whether the plaintiff is likely to pursue its claim; (2) whether it is likely that the use will confuse the public; and (3) if the owner has a First Amendment claim to use the trademark for parody.

A business can also contact an attorney that specializes in intellectual property. Depending on its industry the business can also contact groups that do pro bono work like the California Lawyers for the Arts or the Comic Book Legal Defense Fund (CBLDF). If the business has copyright or trademark insurance, it should contact its insurance agent or company. The policy may include legal defense for claims against the insured. The business can utilize the USPTO web page entitled "I Received a Letter . . ." which summarizes the possible options (USPTO, a).

The business owner could consider using the press and social media. One author has suggested that trademark bullies be shamed (Grinvald, 2011). Some businesses have been successful by gaining the attention of politicians and the general public. Rock Art Brewery gained the support of a Senator and free advertising for its Vermonster when Hansen Beverage Company tried to stop its use of the product name (Kiser, 2014).

C-14. How would you structure a survey to determine if there is likelihood of confusion between Starbucks' image and Dwyer's image?

This question raises a number of complex questions. Some judges who have considered survey evidence lack the expertise to evaluate both the questionnaire and the sampling. Parties in court have presented data based on biased questions and samples. For example, "Do you think Consumer Whore is created or sold by Starbucks?" is a more fair question. By contrast, "Do you think Consumer Whore is related to Starbucks?" is less fair. What do the researchers mean by "related?" There probably would be no Consumer Whore without the Starbucks logo, and she would probably not be holding a cup of coffee. In that sense, she probably is related. That does not mean that Starbucks licensed the use of their logo or consented to the creation of the Consumer Whore.

There are similar issues with sampling the respondents. Should the sample be consumers of Starbucks coffee, consumers of comic books, or the general public? If the respondents were not aware of Consumer Whore before the survey, how was the Consumer Whore presented to them.

CONCLUSION

This case can be used with upper level undergraduate and graduate students. It encourages them to think critically about the legal and practical issues involved in creating and protecting trademarks. Trademarks play an important role in commerce and enable consumers to recognize the brands the consumers want to buy. The case also includes issues surrounding the use of similar trademarks and parodies of trademarks. Faculty can use the case as a platform to debate policy questions including how much free riding on established trademarks should be permitted and how much free expression should be protected.

There are a number of trademark infringement and trademark dilution cases based on the parody of a famous trademark. Some of the decisions protect the parodist's free speech rights, while others do not. Courts differ in the degree of First Amendment protection they provide to parodists. Therefore, it is difficult to predict what a court will do in a particular situation. This lack of predictability may have a chilling effect on artists' free expression of their ideas. It may also make entrepreneurs more cautious about their selection of a logo for their businesses because they may fear the cost and notoriety of a lawsuit by a famous trademark holder.

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Simon, D.A. (2013). The confusion trap: Rethinking parody in trademark law. *Washington Law Review* 88, 1021. (The author states in the abstract: T]his Article examines the parody doctrine in U.S. trademark law using two lenses. The first lens is trademark doctrine itself. Here I explore the various approaches courts use to resolve trademark disputes involving parody. The other lens is copyright law. Through this lens I examine how courts deciding trademark parody disputes employ the Supreme Court's most recent decision on parody in copyright, *Campbell v. Acuff-Rose Music, Inc.* (1994). I also use this decision to examine the relationship between copyright and trademark parody claims.)

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Starbucks Corp. v. Wolfe's Borough Coffee, Inc., **588 F.3d 97 (2d Cir. 2009).**

Stop the Olympic Prison v. United States Olympic Committee, 489 F. Supp. 1112 (S.D.N.Y 1980) (no likelihood of confusion for "use of an Olympic Games symbol superimposed over prison bars….").

Tommy Hilfiger Licensing, Inc. v. Nature Labs, L.L.C., 221 F. Supp. 2d 410, 420 (S.D.N.Y. 2002) (Timmy Holedigger "with a logo similar to the plaintiff's flag logo, and carrying the tag line, "If You Like Tommy Hilfiger Your Pet Will Love Timmy Holedigger"" not likely to cause confusion) (Cantwell, at 558-559).

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APPENDIX

Kieron Dwyer's COMIC BOOK COVERS FOR FIRST EDITION OF LCD

The cover on the left is the original cover and the one on the right is after Starbucks sued Dwyer.

From Kevin Garcia.com