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LETTER FROM THE EDITORS

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

The Instructors' Notes contained in this volume have been double blind refereed, and each was required to have a complete Case before consideration. The acceptance rate for manuscripts in this issue, 25%, conforms to our editorial policies. The Case for each Instructors' Note in this volume is published in a separate issue of the *JIACS.*

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

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

Inge Nickerson, Barry University
Charles Rarick, Purdue University, Calumet

NOTES

THE TROPICAL FISH FARM: TRANSITIONING FROM HOBBY TO BUSINESS

Jon G. Fields, University of Wisconsin – La Crosse
James E. Finch, University of Wisconsin – La Crosse

CASE DESCRIPTION

The primary purpose of this case concerns the transformation of an interest and skill into a successful entrepreneurial enterprise in a competitive marketplace through effective use of the four Ps of the marketing mix. Secondary issues examined include effective use of essential business-building concepts such as product quality, differentiation, market research on a shoestring, premium pricing strategies, relationship selling, dual channels of distribution, and cost controls. This case has a difficulty level appropriate for college juniors. The case is designed to be taught in one class period and is expected to require two hours of outside preparation by students.

CASE SYNOPSIS

All too many people with particular skills or talents decide to start their own businesses only to fail because they focus on using those skills in their business rather than on building and developing the business itself. This case traces the transition of one person's leisure interest in tropical fish to the development of a successful business in direct competition with large established domestic producers and international importers. Since many students have had aquariums or known friends that have had them, the case is easy for them to relate to on a personal level. As the case unfolds, the hobbyist expands and progresses through a series of expansion phases that soon involves several retail and wholesale buyers. The decision presented to the students is whether to expand into a major player within the region and, if so, which of three expansion alternatives should be pursued.

INSTRUCTORS' NOTES

Recommended Teaching Methods

One or two class periods prior to discussing this case in class, advise students to set aside two hours to read and prepare answers for the questions. The instructor may suggest that students have a 'study partner' for this preparation step.

On the day the case is reviewed in class, ask students to form groups of three or four people to compare answers and to develop group responses to the questions. Have all groups focus on Question #1 for 5-7 minutes. Then call on a few of the groups to report their findings. On a white board or projection screen,

prepare a composite list of all the responses provided. Add points from the answer key that no group reported.

Ask student groups to focus on Questions #2 and #3 for a total of 5-7 minutes. Call on some of the same and different groups to report their findings on Question #2. On a white board or projection screen, prepare a composite list of all the responses provided. Add points from the answer key that no group reported. Then ask groups to report their responses to Question #3. The point to be made by the instructor here is that basic marketing principles and business development concepts are universal to all types of businesses! The same principles apply whether the business is a fish farm, a cabinetry shop, or a CPA firm – the same basic principles apply!

DISCUSSION QUESTIONS

I. What did Diane do well as she transformed her hobby into a business? Comment on her research and each of the 4 Ps of the marketing mix.

RESEARCH

1) Identified *then* solved customer problems *before* expanding
2) Evaluated and established demand *before* expanding
3) Sought methods to keep expansion costs at a minimum *then* initiated efficient purchasing and bartering strategies
4) Sought relevant information on the internet and other sources *then* incorporated that information into her business strategy and operations
5) Test marketed product prototypes (samples) *before* expanding
6) Sought feedback from existing and potential customers *before* making decisions

PRODUCT

1) Invested in high quality breeding stock
2) Differentiated her product from the competition by offering varieties, colors, and fin types not offered by competitors
3) Fish were raised in local water that easily acclimated to local aquariums
4) Quality genetics and growing environment reduced fish mortality rates and customers' frustrations and expenses
5) Fish were sorted and delivered by size and other characteristics

PLACE

1) Located production facilities closer to customers than competitors. Fish were in shipping bags for less than 24 hours
2) Personal delivery ensured high survival rates
3) Personal delivery strengthened relationships with customers

PRICE

1) Established price variations for various varieties of angelfish to maximize revenues
2) Premium prices provided sufficient revenue
3) Premium price-quality relationship was an added value to the wholesaler
4) "Free" fish to offset delivery charges produced a win-win situation

PROMOTION

1) Offered free samples to prospective buyers to open doors and to build rapport
2) Free samples provided prospective buyers with a no-risk opportunity to evaluate quality of the fish before making a purchase, thus reducing their risk and buyer reluctance.
3) Presented breeding stock invoices as proof of quality genetics
4) Built customer relationships and credibility before expanding
5) Shared information and challenges with customers. The cooperative environment produced win-win outcomes and strengthened business relationships

II. What were Diane's most important guiding principles that ensured her early success?

a) Diane developed the demand for her product *before* providing the supply.
b) Diane supplied fewer fish than the customers wanted, keeping the balance between supply and demand in her favor. This ensured the continuation of a premium pricing structure.
c) Diane *avoided debt* expenses through effective negotiations and internal financing.
d) She was willing to seek advice from others, was an effective, *active listener* and applied what she learned to solve customers' problems.

III. Which of the marketing concepts and guiding principles identified in questions #1 and #2 are universal to all other types of products, services, and businesses?

a) All of the basic, underlying marketing principles reflected in #1 and #2 are universal to other products, services, and businesses.

IV. Complete the shaded portions of the spreadsheet below. Should Diane make an offer to purchase cheese factory? If so, what should she offer, and what should be her maximum offer? Justify your answers.

a) Diane's initial offer should be *very* low. Since the factory will not likely be reopened and is not an attractive asset to the corporation, it may be willing to sell it at a low price just to get rid of it, especially for a non-competing enterprise. If the offer is too low, the corporation can simply decline the offer. Diane can then make a higher offer if she wishes.

b) An offer of $1,100,000 and the estimated profit that option would produce (2nd year and later) would only be a few thousand dollars more than the rental option. The additional risk and work for the small additional gain is not justifiable. Diane's maximum offer should be $1,000,000.

Annual Estimates	Current Set Up	Rented Building	Cheese Factory
Maximum Fish Production	104,000	624,000	1,560,000
Average Price Per Fish	1.15	1.00	0.50
Maximum Gross Reverse	**119,600**	**624,000**	**780,000**
Operating Costs Per fish	0.91	0.70	0.25
Total Operating Cost	94,640	436,800	390,000
Net from Operations	**24,960**	**187,200**	**390,000**
New Vehicle Pinc. & Interest	na	9,840	9,840
New Vehicle Insurance	na	1,000	1,000
* New Equipment Expense	na	24,000	15,000
* New Equipment Loan Interest	na	1,920	6,000
Employee Wages @ $15/hr	na	62,400	124,800
Employee Exp & B enefits @ 15%	na	9,360	18,720
New Rent	na	18,000	na
New Rent Insurance	na	2,000	na
New 20-Year Mortgage @ 8% Int	na	na	110,400
New Building Ins @ 1% Purchase Price	na	na	11,000
New Utilities Expense	na	3,600	7,200
Profit Before Taxes	**24,960**	**55,080**	**86,040**

* The New Equipment under the Rental Option is paid off in the first year.

V. **a) List the pros and cons of each of the three expansion options Diane is facing (no expansion, rental option, purchase option). Consider such things and profit potential, risk, and lifestyle.**

b) Considering the pros and cons you've identified, choose and defend the one option you would recommend.

Current Set Up	
Pros	**Cons**
Low risk or no risk	No opportunity for expansion
No loans or debts	No opportunity for diversification
Part-time income	Can't get away from the business
No employees	Current supply may be too small for expanded wholesaler to bother with
Minimum management requirements	Leaves entry opportunity for competitors

Rented Building	
Pros	**Cons**
Substantial profit potential	Production could outpace demand
Lease allows for easy exit from the business if needed	Employee management hassles
Expansion would approximately match the demand of existing customers	Split business locations would make the sale of the business difficult
Expansion involves current knowledge with familiar species	Cusomers are not committed by contract to continue buying from Diane
Less risk if market should change	Limited opportunity for diversification

Cheese Factory	
Pros	**Cons**
Opportunities for fish spieces diversification	New learning curve for new species
Could accommodate basement operation to free up the basement for family	Demand for alternative spieces is unknown
Substantial profit potential if purchase price is low enough	Substantial debt load and risk
	Liquidation of assets would be difficult
	Employee management hassles
	Customers are not committed by contract to continue buying from Diane
	Production could outpace demand
	Greatest risk if market should change
	Short-term cash flow may not be sufficient for short-term cash needs

OPTIONS

a) For simplicity, minimum risk, and personal ease, stay with the current set up.

b) For profit potential and reasonable risk, proceed with the rented building option. The cheese factory will probably remain unsold and could be purchased at a later date if additional expansion is desired. Diane could negotiate a *first option to buy* agreement with the corporation to protect that option for the future.

c) Proceed with the factory option only if it can be purchased at a very low price to compensate for high risk. Negotiating contracts with buyers *before* making this purchase, would be advisable.

EPILOGUE

Diane's husband accepted a job in another state and they decided to sell the business. Their total investment in the equipment and breeding stock was approximately $4,000. They sold the existing setup and breeding stock for $10,000. The husband and wife that bought the businesses wanted to find a way for the wife to earn money from home and to capitalize on her interest in animals gained from her farming background. Diane and her husband helped to set up the system in the buyer's basement. The new owners changed the name of the business to include the wife's name and were reluctant to ask questions or to seek or receive operational advice from Diane or any source. Within nine months they were looking for a buyer.

PROJECT MANAGEMENT: USING EARNED VALUE ANALYSIS (EVA) TO MONITOR A PROJECT'S PROGRESS

Sharad Maheshwari, Hampton University
Sid Howard Credle, Hampton University

CASE DESCRIPTION

This case illustrates one of several important project monitoring and controlling techniques available for project manager use in construction and other related fields. The case highlights that the lack of proper project monitoring could lead to cost and schedule run-ups that eventually could result in complete failure of a project and financial loss. The case illustrates how a project manager could use variance analysis as an effective tool for project monitoring and controlling. The problem presented originated from a real-life situation of an actual federal building contractor. In this particular scenario, the contractor had incurred losses as a result of project delays due to multiple business factors. The issue became problematic since the responsible project manager lacked knowledge of sophisticated project control and monitoring tools, and relied primarily on his memory and intuition-based physical assessments of activities. The case is an attempt to show that if an appropriate project monitoring technique, earned value analysis (EVA), had been used, this contractor potentially could have avoided losses or even made some profit. This case is appropriate for senior or graduate level courses in project management or operations management. The case will require an estimated 2-3 hours of classroom lecture time. Students might have to spend 4-6 hours of time depending upon their prior experience and knowledge of the project management environment.

CASE SYNOPSIS

A small federal government contractor, Environmental Services, is located in the Virginia Beach area of Virginia. It has incurred losses on some of its projects due to poor cost controls and schedule overruns. The company executes 10 to 30 small to medium-size projects at any given point of time. The company is growing and wishes to find a way to cut its losses due to cost and/or schedule overruns. These overruns occur due to several internal and external factors. The internal factors include the loss of key personnel, improper supervision, the lack of technical skills, poor understanding of the scope of projects, etc. External factors such as vendor delays, quality of supplies, unclear designs, weather and similar factors may also cause a project activity to miss an established deadline or to cost more than the estimated budget. The company largely relies on the experience of the project managers to make a decision based on their assessment whenever a problem arises. Currently, there is no system in the company to keep track of the impact of cost and schedule overruns on a given project. The company recognizes profit or loss once projects are completed and final performance analysis is performed.

The company gave the task of establishing procedures and developing an ongoing monitor/control system to an outside consultant. The consultant reviewed several old projects and presented an analysis to the company. It was suggested that the company establish a proper mechanism for recording cost and budget details during the life of each project. Furthermore, it was suggested that the company use an Earned Value Analysis (EVA) tool to monitor the cost and schedule overruns and adjust project tasks, schedules and resources accordingly.

INSTRUCTORS' NOTES

This case would be useful to demonstrate a monitoring and controlling technique of projects. While teaching project management to the business students, it can be compared with budget control techniques. It is one thing to set budgets; however, it is a very different thing to control budgetary expenditures. As we know that simply setting a budget for an organization can't guarantee a successful utilization of funds. Similarly, planning for a project is not sufficient to assure its successful execution. Most basic project management courses will teach planning techniques including scheduling tools like PERT, CPM, etc., however, without tools and techniques to monitor a project plan, it might be unrealistic to assume a successful execution of the project plan.

The following section will demonstrate the application of an important project controlling techniques called Earned Value Analysis (EVA)-- how EVA calculations are made for the related case problem. It will calculate cost and schedule variances, as well as cost and schedule-related indexes. Students will not require any special project management software as all calculations can be done using Excel or a basic calculator. The cost variance (CV) calculates difference between budgeted and actual expenses. The schedule variance (SV) calculates difference between budgeted costs of work scheduled and work completed. The cost performance and schedule performance indexes (CPI and SPI) are a ratio of the budgeted cost of completed work to the actual cost of work completed, and the budgeted cost of work scheduled respectively. Overall index cost schedule index (CSI) is multiplication of CPI and SCI. The CSI gives the overall performance of an activity.

TERMINOLOGY

ACWP	Actual cost of work performed (same as ACWC)
BCWS	Budgeted cost for work scheduled
BCWP	Budgeted cost of work performed
CV	Cost variance; BCWP – ACWP
	Overrun is negative
SV	Schedule variance; BCWP-BCWS
	Behind schedule is negative
CPI	Cost performance index; BCWP/ACWP
	Index < 1.0 means cost overruns
SPI	Schedule performance index; BCWP/ BCWS
	Index < 1.0 means project is behind scheduled work

CSI Cost-Schedule index, a critical ratio to combine two indexes
CPI*SPI
Index < 1.0 means problems

NOVEMBER EARNED VALUE ANALYSIS

Table 1 contains the variance analysis for the month of November. The EVA calculations showed that the project plans needed to be modified to avoid future problems. The cost schedule index (CSI) of "site development" was only 0.45 as opposed to a desired value of 1 or more. Hence, it was clear to the management that the additional resources and money were needed to keep the project on track. Other CSIs in the November report are not raising any concerns, as their values are either 1 or close to 1. This delay was due to natural causes and the management had no direct control over it. The project manager must determine to make an additional expenditure (crashing this activity) on the site development to recover more than half of the time lost due to the storm. Schedule arrangements must also be made in November to keep the project on track.

Table 1: Progress Report November

Task	BCWS	BCWP	ACWP	CV	SV	CPI	SPI	CSI
A	$35,714	$35,714	$35,714	$0	$0	1	1	1
B	$180,000	$90,000	$100,000	($10,000)	($90,000)	0.9	0.5	0.45
C	$15,500	$15,500	$17,500	($2,000)	$0	0.886	1	0.886
D	$28,500	$28,500	$28,500	$0	$0	1	1	1
E	$35,000	$35,000	$35,000	$0	$0	1	1	1
F	$ -	$ -	$ -	$0	$0			

HOW TO PERFORM EVA CALCULATIONS

The following section will show the arithmetic calculation for EVA for Task B in the month of November: All calculations for other tasks for this month and the subsequent months are performed similarly.

BCWS Budgeted cost of work scheduled--$180,000.
$180,000 is given in the Table (4) of the case description.

BCWP Budgeted cost of work performed--$90,000.
In the month of November 40% of Task B was scheduled (see Table (3) of the case description.) Also from Table (3) of the case description, actual work completed on Task B was 20%.
BCWP=BCWS*(Actual percentage work performed on Task B/Scheduled percentage work on TaskB).
5BCWP=$180,000*(40%/20%) = $90,000.

ACWP	Actual cost of work performed--$100,000. $100,000 is given in the Table (4) of the case description.
CV	Cost variance. CV = (BCWP-ACWP), CV = ($90,000-$100,000) = -$10,000.
SV	Schedule variance. SV = (BCWP-BCWS), SV = ($90,000-$180,000) = -$90,000.
CPI	Cost performance index. CPI = (BCWP/ACWP), CPI = ($90,000/$100,000) = 0.90.
SPI	Schedule performance index. SPI = (BCWP/BCWS), SPI = ($90,000/$180,000) = 0.50.
CSI	Cost-schedule index. CSI = (CPI*SPI), CSI = (0.90*0.50) = 0.45.

DECEMBER EARNED VALUE ANALYSIS

December's EVA analysis is presented in Table 2. It showed a CSI of 0.25 for the wood and roofing task. This is obviously far below the desired level of 1. The below-par performance should prompt the project manager to take a quick action. This was largely due to failure to meet the standard of the contract. The project manager has to decide whether to take any action. The action will require a commitment of additional budget to refurbish the rejected wood and roofing task. The additional cost will also keep the project on-track and avoid any future delays in the project. It appears that there is enough slack built into this task, so no rescheduling may be needed to complete the additional job of refurbishing. Another area of concern is activity F where CSI is 0.5. Action should be taken there as well. It assumes that the project management decides not take any action now, as this is an outside contractor problem and the project manager wishes to give time to the subcontractor to sort out the problem.

Table 2: Progress Report December

Task	BCWS	BCWP	ACWP	CV	SV	CPI	SPI	CSI
A	$35,714	$35,714	$35,714	$0	$0	1	1	1
B	$135,000	$135,000	$135,000	$0	$0	1	1	1
C	$62,000	$62,000	$62,000	$0	$0	1	1	1
D	$ -	$ -	$ -	$0	$0			
E	$35,000	$17,500	$35,000	($17,500)	($17,500)	0.5	0.5	0.25
F	$30,000	$15,000	$15,000	$0	($15,000)	1	0.5	0.5

JANUARY EARNED VALUE ANALYSIS

Table 3 has the EVA for January. The CSI for the task F was 0.5 in December. The project management did not take any action in December, as this was an outside contractor. However, the project manager has to be vigilant. The CSI for this task was 0.5 again in January. For two months in a row the CSI was at an unacceptable level of 0.5; the manager should have discussed the issue with the subcontractor to assess his problems. As indicated, the subcontractor was having problems with labor and finances. Hence, the project manager should have considered hiring a labor contractor to supplement the work of the original interior subcontractor. Additional expenses should be considered necessary to complete the project on time. Furthermore, the project manager can recover some cost by renegotiating the rate of his services on other ongoing or future company projects.

Table 3: Progress Report January

Task	BCWS	BCWP	ACWP	CV	SV	CPI	SPI	CSI
A	$35,714	$35,714	$35,714	$0	$0	1	1	1
B	$90,000	$90,000	$100,000	($10,000)	$0	0.9	1	0.9
C	$77,500	$77,500	$77,500	$0	$0	1	1	1
D	$47,500	$47,500	$47,500	$0	$0	1	1	1
E	$17,500	$17,500	$17,500	$0	$0	1	1	1
F	$60,000	$30,000	$30,000	$0	($30,000)	1	0.5	0.5

No further variance analysis is included in the report as no variance parameters were given for February through May. The actual cost of the total project would be slightly higher than $1,454,500. The project cost may be 5%-10% more than initially planned. The consultant estimated that the project adjustments would have cost about 6% more than the budgeted amount, which was less than 12% of the penalty for not completing on time for the May ceremony scheduled in the building.

RESULTS

This solution shows how a project manager could have used the use of EVA to resolve potential future problems for this project. For example, the problems that the interior subcontractor was having were not very obvious to the management. Without an early warning system provided by the EVA parameters and a timely action taken by the project manager, the project would have been delayed, causing higher losses to the company. It must be stated however, that the use of EVA as an effective project-monitoring tool depends upon a project manager's understanding of EVA and its parameters.

THIEL MACHINERY: THE CASE OF THE DISAPPEARING LIFO

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CASE DESCRIPTION

This case requires the student to examine how a significant change in accounting principle will likely affect the financial condition and future funding situation of Thiel Machinery. Specifically, the student will examine how the probable abolition of the LIFO inventory costing method (as the U.S. moves towards acceptance of the International Financial Reporting Standard) will affect various financial ratios of the company, most notably the Altman Z-score. The student must make pro forma adjustments to the company's existing financial statements that account for the elimination of LIFO and calculate the expected change in the Z-score. Because the company is currently privately-held, the student will also need to estimate the market value of the company's equity using a free cash flow valuation model and examine how reduced cash flows from higher tax payments affect not only financial ratio calculations but potentially the value of the company itself.

CASE SYNOPSIS

Thiel Machinery, a successfully growing machinery company, is grappling with the potential impact of losing the ability of using LIFO inventory costing methods on its current and future funding sources. The student is placed in the role of a recently-hired assistant to the president and founder of the company. The student is charged with providing an analysis and summary report of the likely implications for the company's current financing situation and its upcoming stock issue.

INSTRUCTORS' NOTES

Pedagogy

The primary focus of the case is the financial statement adjustments and then re-calculation of the Altman Z-score for Thiel Machinery because of its inability to continue using LIFO. The student must take the perspective of a company analyst needing to not only be able to make the proper calculations but also be able to sufficiently explain to a supervisor the implications of his or her findings. The case would be appropriate for senior-level and graduate students with some prior

exposure to inventory costing methods and financial statement analysis. The case i designed to be taught in two class hours and is expected to require two hours of outside preparation by students.

Teaching Plan

Class discussion should begin with a review of LIFO and FIFO inventory costing methods and the Altman Z-score model. Instructors may wish to structure the case discussions as follows:

1. Summarize the differences between LIFO and FIFO.
2. Describe the use of the Altman Z-score, both from a calculation and an interpretive perspective.
3. Summarize the use of free cash flow models to estimate the market value of a company's equity.
4. Calculate the Altman Z-score based on the reported financial statement data and an estimate of the market value of the company's equity.
5. Summarize the balance sheet and income statement adjustments associated with the abolition of LIFO-based accounting.
6. Recalculate the Altman Z-score after having made the adjustments to the financial statements and interpret the results.
7. Present a short report or memorandum on the assessment of the switch away from LIFO on the current financing situation of the company as well on its prospective issuance of common stock.

1. Summarize the differences between LIFO and FIFO.

Although a brief summary of LIFO and FIFO is presented in the case, a more thorough review may be necessary. LIFO (last-in, first-out) and FIFO (first-in, first-out) are both methods for allocating the total costs of inventory between the costs associated with inventory items sold during a period and the costs remaining in the unsold inventory. (There are other methods, most notably average-cost and specific identification, but these are not germane to the case). Both methods are acceptable under U.S. Generally Accepted Accounting Principles (GAAP) and U.S. tax regulations (Congress first approved the use of LIFO for tax purposes in the Revenue Act of 1939), but LIFO is not acceptable under the International Financial Reporting Standards (IFRS) to which the U.S. is currently moving towards.

LIFO associates the costs of the most recently acquired inventory with the inventory items sold (with the older inventory costs remaining on the balance sheet and reported as inventory on hand). Because prices and costs generally rise over time because of inflation,

the LIFO method typically reports higher costs of goods sold and thereby lower profits, and, more importantly, lower amounts of taxes paid. Because more of the costs are assigned to the inventory sold, the remaining inventory on hand tends to be undervalued. Companies using LIFO are required to report an estimate of how much the inventory is likely undervalued relative to the current costs of replacing that inventory. In contrast, FIFO associates the older inventory costs with the inventory sold, reporting higher profits but also inventory that more closely resembles current market values.

2. Describe the use of the Altman Z-score, both from a calculation and an interpretive perspective.

The Altman Z-score is a model for predicting financial difficulties of companies based on readily available finance and accounting data. It was first developed over forty years ago (Altman, 1968) yet remains a widely-used tool in assessing the credit risk of borrowers. Through his use of discriminant analysis, Altman was able to isolate five ratios, which, when weighted in the proper proportions, combines to produce a score that is useful in determining which publicly-traded companies were likely to suffer financial defaults and which were not.

The five variables used in the formula are as follows: working capital to total assets (X_1); retained earnings to total assets (X_2); EBIT, or earnings before interest and taxes, to total assets (X_3); market value of equity to book value of liabilities (X_4); and sales to total assets (X_5). The formula itself is as follows: $Z = 1.2X_1 + 1.4X_2 + 3.3X_3 + 0.6X_4 + 0.999X_5$. Z-scores above 3.0 are typically associated with companies that are not expected to suffer financial defaults and Z-scores below 1.8 with companies expected to suffer such defaults. Scores between 1.8 and 3.0 were found to be in a zone of uncertainty but common sense would lead one to assume higher Z-scores are preferred over lower ones.

Note: More recently Altman (2002) has proposed a similar model applicable to privately-held firms. In this iteration, the model replaces the market value of equity with the book value of the equity in calculating a value for the X_4 variable and then reweights the variables in the updated formula as follows: $Z = 0.717X_1 + 0.847X_2 + 3.107X_3 + 0.420X_4 + 0.998X_5$. The interpretation of the results remains the same. Although it would seem to be more appropriate to use this formulation of the model because Thiel is a privately-held company, students (and instructors) will not likely have been exposed to this version of the formula so it is not recommended except in situations where the calculation of ratios is a significant component of the course (e.g., a course in financial statement analysis or in credit analysis).

3. Summarize the use of free cash flow models to estimate the market value of a company' equity.

Many basic stock valuation models are variations of traditional dividend valuation models where the price of the stock can be estimated as the present value of a perpetual dividend as in the case of preferred stock or the present value of a constantly-growing perpetuity for common stock. Because Thiel does not pay dividends nor is it publicly-traded, such a model would not be applicable. A variation of this type of model instead is based on the company's free cash flows and is therefore more useful in a greater variety of situations such as this one.

Free cash flows are typically defined as the amount of cash generated by the company's operations that is available for future investment opportunities, after having made any required investments in fixed assets or working capital to sustain current operations. Given a base amount and some assumption of the future growth of those cash flows, the present value is calculated in a similar fashion to the dividend valuation models. After valuing the total amount of free cash generated by the operations, the amount necessary to pay off existing holders of the company's debt is subtracted, leaving the remaining value to the equity holders.

4. Calculate the Altman Z-score based on the reported financial statement data including the estimate of the market value of Thiel' equity.

Five of the values used in the formula (total assets, retained earnings, EBIT, total liabilities, and sales) are found on the balance sheet and income statement. Working capital is found as the difference between the company's current assets and its current liabilities, or, in this case, $161.1 – $74.6 = $86.5 million. The remaining variable, market value of equity, would need to be found using the free cash flow methodology. The free cash flow for 2008 is given in the case ($25.0 million). Assuming a constant growth rate of three percent per year [any growth rate could be assumed but three percent is often assumed in many undergraduate textbooks], and then discounting the future cash flows at ten percent (the required rate of return of similar publicly-traded companies discussed in the case), the present value of the company's free cash flows is found as follows: [FCF x (1 + g)) ÷ (r – g)], or [($25.0 million x 1.03) ÷ (0.10 – 0.03)] = $367.9 million. Subtracting the $125.1 million of outstanding short-term and long-term debt leaves $242.8 million as the estimated market value of the company's equity.

The variables in the formula would then be determined as follows:

X_1 = working capital ÷ total assets = \$86.5 ÷ \$400.6 = 0.2591
X_2 = retained earnings ÷ total assets = \$125.1 ÷ \$400.6 = 0.4372
X_3 = EBIT ÷ total assets = \$65.6 ÷ \$400.6 = 0.1638
X_4 = market value of equity ÷ total liabilities = \$242.8 ÷ \$244.5 = 0.9929
X_5 = sales ÷ total assets = \$486.4 ÷ \$400.6 = 1.2142

The Z-score itself is then calculated as Z = 1.2 (0.2591) + 1.4 (0.4372) + 3.3 (0.1638) + 0.6 (0.9929) + 0.999 (1.2142) = 3.05. Because the score if above the 3.0 threshold, Thiel is in compliance with the loan covenant.

Note that if the book value variation of the Z-score model was used instead (substituting the book value of equity of \$156.1 for the market value of \$242.8), the Z-score would instead be calculated as Z = 0.717 (0.2591) + 0.847 (0.4372) + 3.107 (0.1638) + 0.420 (0.6384) + 0.998 (1.2142) = 2.41, which is considerably below the 3.0 threshold.

5. Summarize the balance sheet and income statement adjustments associated with the abolition of LIFO-based accounting.

The focus of the adjustments will be the found in the LIFO reserve balance that the company reported because of its use of LIFO. This amount (Thiel reported \$42.8 million in 2008) would be added to the inventory value reported on the balance sheet as it would more closely approximate the replacement value or FIFO value of that inventory. Adding this amount to the inventory would result in similar increases to the amount of current assets and total assets, two of the variables used in the Z-score calculation.

The opposite side of the balance sheet would also need to be adjusted by the same amount (to keep the balance sheet balanced). This would be accomplished by accounting for the amount of taxes that would now be owed on the undervalued inventory (35 percent of the LIFO reserve to be reported as additional liabilities) and the remaining amount (65 percent) reported as additional retained earnings. Because of the current U.S. Treasury Department' recommendation that the previously deferred taxes be paid up over eight years, only one-eighth of the increased tax liability would be accounted for as a current liability with the remaining seven-eighths as a long-term liability. The adjustments to current liabilities, total liabilities, and retained earnings adjustmets would all affect the Z-score calculation.

Furthermore, the *increase* in the LIFO reserve during the year (\$8.6 million) can be seen as an approximation of how much the cost of goods sold was overstated (and gross profits and operating profits understated) during the year. Increasing the operating profits

(EBIT) by this amount will affect the Z-score calculation. In addition, given the tax rate of 35 percent, the company would also have reported and paid higher taxes of $3.0 million, leaving $5.6 million in additional net income for the year. These additional taxes would likely have decreased the free cash flows of the company by $3.0 million, with a resulting reduction in the market value of the company's equity, which would in turn affect the Z-score calculation.

A summary of the calculations is as follows:

1) Inventory as-reported + LIFO reserve = Adjusted inventory
$116.8 million + $42.8 million = $159.6 million

2) Current assets as-reported + LIFO reserve = Adjusted current assets
$161.1 million + $42.8 million = $203.9 million

3) Total assets as-reported + LIFO reserve = Adjusted total assets
$400.6 million + $42.8 million = $443.4 million

4) Current liabilities as-reported + (LIFO reserve x 35% tax rate) ÷ 8 years = adjusted current liabilities
$74.6 million + ($42.8 million x 35%) ÷ 8 = $76.5 million

5) Adjusted working capital = Adjusted current assets – adjusted current liabilities
$203.9 million – $76.5 million = $127.4 million

6) Total liabilities as reported + (LIFO reserve x 35%) = adjusted total liabilities
$244.5 million + $15.0 million = $59.5 million

7) Retained earnings as-reported + (LIFO reserve x 65%) = adjusted retained earnings
$125.1 million + $27.8 million = $152.9 million

8) EBIT as-reported + Change in LIFO reserve = adjusted EBIT
$65.6 million + $8.6 million = $74.2 million

9) Adjusted market value of equity = [(Adjusted free cash flows x (1 + g)) ÷ (r – g)] – value of debt

[(($25.0 – $3.0) x (1.03)) ÷ (0.10 – 0.03)] = $340.3 million – $125.1 million = $215.2 million

6. Recalculate the Altman Z-score after having made the adjustments to the financial statements and interpret the results.

The recalculated or adjusted variables in the Z-score formula would be as follows:
X_1 = working capital ÷ total assets = $127.4 ÷ $443.4 = 0.2874
X_2 = retained earnings ÷ total assets = $152.9 ÷ $443.4 = 0.3449
X_3 = EBIT ÷ total assets = $74.2 ÷ $443.4 = 0.1673
X_4 = market value of equity ÷ total liabilities = $215.2 ÷ $259.5 = 0.8294
X_5 = sales ÷ total assets = $486.4 ÷ $443.4 = 1.0959

The adjusted Z-score would be Z = 1.2 (0.2874) + 1.4 (0.3449) + 3.3 (0.1673) + 0.6 (0.8294) + 0.999 (1.0959) = 2.97. So despite the improvements to the ratio caused by the increased amount of working capital and EBIT, the lower market value of the equity and lower amount of retained earnings and of sales as a percentage of total assets causes the Z-score to fall below the 3.0 threshold and Thiel would not be in compliance with the loan covenant. This might be very significant, possibly jeopardizing its current financing arrangement. Note that if the book value variation of the Z-score model was used instead, the Z-score would have been Z = 0.717 (0.2874) + 0.847 (0.3449) + 3.107 (0.1673) + 0.420 (0.8294) + 0.998 (1.0959) = 2.37, slightly lower than originally calculated.

7. Present a short report or memorandum on the assessment of the switch away from LIFO on the current financing situation of the company as well on its prospective issuance of common stock.

As documented by the calculations asked for, losing the ability to use LIFO accounting can have negative effects to a company's financial ratios. Thiel could possibly be facing a short-term financing crisis if it is deemed that that company is no longer meeting its loan covenant of maintaining a Z-score above 3.0. Likewise, given the increased amount of taxes the company is likely facing, the reduction in free cash flows may have a detrimental impact on the amount of money the company might be expected to generate through a stock offering. The market value of the equity falls more than ten percent (from $242.8 million to $215.2) million using the free cash flow valuation model. If prospective investors use similar valuation models, the company will not be able to raise as much money per share. Thiel will either need to issue more shares than i had anticipated which will dilut

the ownership share that Mr. Minnie was expected to maintain, or reduce its expansion plans.

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ENTERING THE ICE CREAM BUSINESS: A CASE STUDY OF KLEINPETER FARMS DAIRY

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CASE DESCRIPTION

The primary subject matter of this case is strategic management for small business, specifically developing a new product and entering into a new competitive arena for an established small family business. Secondary issues examined include marketing strategy, human resource management, and operations management in the small family business. The case is appropriate for junior and senior level undergraduate courses. The case is designed to be taught in one class hour and is expected to require approximately three hours of outside preparation by students. The events described in this case are based on real world experiences.

CASE SYNOPSIS

Jeff Kleinpeter, fourth generation CEO of Kleinpeter Farms Dairy, has boldly led his family's business into a new product/market area, specifically the production and distribution of ice cream. For nearly one hundred years, Kleinpeter Farms Dairy has served the south Louisiana area as the leading milk processor and distributor, but now the company has invested millions of dollars in a new, but related product. Jeff seeks to build on the loyalty and goodwill generated among consumers because of Kleinpeter's excellent reputation for high quality milk products in the south Louisiana area. Kleinpeter appeals to local customers through cross-branding other Louisiana products, such as Ponchatoula strawberries, Bergeron pecans, and Elmer's Gold Brick Eggs. After the new product is launched, the company experiences challenges in marketing, operations, and human resource management.

Key words: small business strategy, new product development, marketing strategy, family business

INSTRUCTORS' NOTE

We portray a small business in the midst of a large expansion into a new but related product line. Kleinpeter Farms Dairy, under the leadership of fourth generation family owner-manager Jeff Kleinpeter, has introduced ice cream to its south Louisiana market area after nearly one hundred years of service in milk processing and distribution. The company is well known for its superior quality and good tasting milk. The top management team at Kleinpeter must integrate what amounts to a new division into its company and supply strategic direction for the firm in terms of marketing, sales, and advertising. Determined to impact the ice cream market in south Louisiana, Jeff Kleinpeter spearheads marketing research to develop localized flavors beyond the common vanilla and chocolate. Jeff uses cross branding with Ponchatoula strawberries, Bergeron pecans, Aunt Sallies' pralines, and Elmer's Gold Brick Eggs to produce unique local flavors. Meanwhile, the company is growing geographically, expanding into new market areas to the east and west of its established base in Baton Rouge, LA.

METHODOLOGY

We performed in-depth qualitative interviews of the owner-managers at Kleinpeter Farms Dairy. Headlining these interviews were three formal interviews with CEO Jeff Kleinpeter. The tape-recorded interviews were semi-structured in nature and conducted individually with the owner-managers, totaling four participants. We transcribed approximately seven hours of interviews, which varied in length from one hour to two hours, averaging 75 minutes each. This totaled approximately one hundred pages of transcripts. We asked members of the management team to supply company documents and information as available. Independently, we gathered journal, magazine, and newspaper accounts as well.

TEACHING APPROACH

The case's focus on leadership issues in a small business makes it appropriate for use in Entrepreneurship or Small Business Management courses at the undergraduate level. Small business and entrepreneurship textbooks often include a chapter on strategic management in small business. Our case serves as an appropriate companion exercise for such chapters. We recommend that the case be assigned before the class covers the leadership chapter. Each student should individually prepare written answers for the discussion questions attached to this Instructor's Note before the class meets. During the class period, the instructor should first introduce the case and lead a general discussion of the facts of the situation. The instructor should apply principles from the textbook to the case. Then, the instructor may place the students in small groups and assign different roles or vantage points for discussion, such as family members, retailers, consumers, and competitors.

CASE OVERVIEW

The case begins as Jeff Kleinpeter excitedly relates the news of the purchase of ice cream production equipment for Kleinpeter Farms Dairy, which had been a milk-processing firm for ninety-five years. An ice cream maker in Dallas, Texas had decided to shut down their operations and auction off their equipment. Then, the case shifts to a discussion between Jeff and his father, Ben Kleinpeter, concerning possible advantages to the company in the production of ice cream. The primary advantage for Kleinpeter is the ability to profitably use the cream that is separated from milk in processing. Cream, a huge by-product in milk processing is, of course, a primary ingredient in ice cream. For many years, the company had been forced to sell cream on the spot market, often at a loss, but now there would be a use for the by-product. While other uses for cream exist, such as cheese, ice cream uses more cream and was perceived to have a larger upside potential than cheese.

We note the history of the Kleinpeter family in Louisiana beginning in 1774. Then, we describe the opening of the milk processing company, Kleinpeter Farms Dairy, in 1913. Founded by Sebastian Kleinpeter and his son, Leon, the company served south Louisiana remarkably well. Sebastian and Leon brought in Guernsey cows from Wisconsin and laid a solid foundation for the company for years to come. Leon's children managed the company from the late 1940s until1987. After Leon passed away, his son, Ben, bought out his siblings' interest in the company and consolidated the ownership of the firm in his hands. As soon as Ben purchased control of the company, his son, Jeff, joined the family business. Ben hired Tom Zicarelli to serve as president of the company and prepare Jeff and his sister, Sue Anne Kleinpeter Cox, to manage the company. For the past five years, Jeff has managed the company as CEO and Sue Anne has been the CFO. Kleinpeter processes and distributes milk up and down the I-10 corridor across the state of Louisiana and is the leading milk producer in the state.

Jeff led the company's investment of approximately $5.5 million in ice cream making equipment in 2008. Especially enjoying marketing research and the process of developing new ice cream flavors, Jeff decided upon a cross branding campaign, using other Louisiana ingredients in the ice cream. Examples include Ponchatoula strawberries, Bergeron pecans, Aunt Sallie's pralines, and Elmer's Gold Brick Eggs. In the case, we describe Kleinpeter's efforts to differentiate their products as they enter into a new product market area. We note external challenges in the nation's poor economic condition and the existence of sharp competition in both the milk and ice cream product markets.

In closing the case, we present the operational challenges that arise for Kleinpeter to manage the growth of the company. Jeff and his top management team must overcome challenges not only in terms of strategy and marketing decisions, but also in terms of human resource management and operations management.

LEARNING OBJECTIVES

Through analysis of this case, students will be expected to:

1. Evaluate the business-level strategy of a small business and estimate its suitability to the environment.
2. Assess human resource and organizational structure challenges for a small business as it introduces new products and enters new markets.
3. Analyze the appropriate rate of growth for a small business given its resources and industry positioning.
4. Propose creative additions to augment new product introductions for a small business.

DISCUSSION QUESTIONS

1. Which business-level strategy best describes the competitive positioning of Kleinpeter Farms Dairy? What characteristics helped you decide on this labeling?

In terms of its source of competitive advantage, most students should recognize that Kleinpeter seeks to differentiate itself from the majority of its direct competitors. They certainly do not strive to be the low-cost producer. In terms of the scope of its operations, most students should recognize that Kleinpeter seeks to target a relatively narrow geographic market with only two product lines—milk and ice cream.

Kleinpeter clearly seeks to differentiate itself from other brands of milk and ice cream. This is reflected in its pricing strategy. As stated in the case, Kleinpeter milk is not the cheapest on the shelf. Prices are generally one to two dollars higher per gallon than the low price leaders. Sources of differentiation include a superior taste (resulting from using milk from Guernsey cows), a product that is rBGH free, and the promotion of local production and ingredients. These same sources of differentiation are used in the ice cream business. In the case, Jeff states, "In order to differentiate ourselves, we have to make ice cream as good or better and give it more value. Our ice cream is rBGH free. We market the fact that we are a Louisiana product and that we are buying other Louisiana products to put in our ice cream, which is called cross branding. People here in Louisiana like to use local products."

In terms of the competitive scope, Kleinpeter Farms Dairy seeks to serve the needs of a relatively narrow target market with relatively few products. This remains true, despite recent expansion of their geographic scope--west into Lake Charles and to the east into Mississippi, and the scope of their product line—ice cream. Focusing on a specific niche

with a relatively narrow product line allows Kleinpeter to appeal to specific needs valued by that target market—local production, home grown ingredients, and good taste.

As a result, most students should recognize Kleinpeter's business-level strategy as one of focused differentiation. According to Porter (1980), meaningful differentiation in is accomplished by developing and promoting one's product or service as having attributes which customers' value. This allows a company to command a premium price, and potentially earn higher profit margins, for its products or services.

2. In addressing Kleinpeter's human resource and organizational structure issues, what are some of the pros and cons of the current situation? What changes would you suggest? What are the pros and cons of those potential changes?

The obvious question here is what to do, if anything, concerning oversight of the ice cream and milk divisions. As mentioned in the case, while the divisions share some synergies, each has it own sales manager and the sales representatives report to both—a dual reporting relationship. Such dual lines of reporting and authority are generally associated with the matrix structure of organizations (Galbraith, 1973). A matrix structure is based on multiple employee reporting relationships--both vertical and horizontal. Most common is a combination of both functional and product departments in a dual authority system. Although Kleinpeter's dual reporting system is not cross functional in nature, much of the discussion on the structural issues can be drawn from the matrix literature.

The simplest (and maybe most obvious and sensible) answer to the question of what to do about the current situation is nothing. Arguments in favor of maintaining the status quo might include the close proximity of the two sales managers (they are in the same office) can overcome any potential confusion or frustration that is often associated with dual reporting relationships. In addition, the sales representatives report to two sales managers, not managers in separate functional areas or one functional and one divisional area (the most common reporting relationship in a matrix structure). As a result, Kleinpeter is unlikely to see conflicts over the allocation of resources or the balance of power sometimes seen between or amongst functional and/or project managers.

It is quite possible that any perceived need for a solution to the current situation may make things worse, not better. Ben states, "One rep having two bosses is really not a good thing." However, there is no mention of actual problems the current reporting relationship has caused. In fact, Jeff suggests that one person checking both product lines and then reporting to each sales manager makes more sense than having two sales reps constantly walking into the same stores with one checking the milk and the other ice cream. The current situation is necessary because milk is delivered every day, but ice cream can be delivered every two or three days because of a slower turnover.

The only real option to the current situation would be to create a complete support staff for the ice cream division. One advantage would be to clarify reporting relationships within the firm. A separate and complete support staff might also result in increased flexibility and more focus on the division and its specific needs or demands. However, because the volume of ice cream sold by Kleinpeter is relatively small, this seems unwarranted, at least at the present time. Jeff stated that management recognized that despite the potential synergies gained by the introduction of a line of ice cream, some aspects of the additional operations would also create potential problems. It is management's responsibility, not just at Kleinpeter, to recognize both the potential advantages and disadvantages of expanding operations or other strategic moves. It seems in this case, as it should be, long-term potential outweighs the any associated costs.

3. **In assessing Kleinpeter's growth, both geographically and in terms of their new product line, do you believe that the firm has expanded too aggressively? Defend you answer.**

At the time of this writing, Kleinpeter distributes its products to approximately 3,000 outlets within a 150-mile radius of Baton Rouge (Riegel, 2009). This includes a recent expansion west into Lake Charles, LA (approximately 120 miles) and east into Biloxi MS (approximately 140 miles). Considering that the company has been in business for nearly one hundred years, students might be reluctant to suggest that Kleinpeter's geographic expansion has been too aggressive. In fact, arguments to the contrary, that Kleinpeter's geographic expansion has been too conservative, may have some validity. Some might suggest that due to recent environmental trends—an economic downturn, a focus on healthier eating, etc., firms such as Kleinpeter should be more aggressive in expanding their target market (and product line) so as to attract additional customers.

However, geographic expansion in the dairy industry is constrained, at least to some degree, by the ability to locate processing facilities. Products must be delivered fresh and this requires, among other things, a certain nearness to the customer (retailer). As a result, aggressive geographic expansion, and the accompanying expansion in facilities, may distract from some producers' mission to serve a select group of customers with the highest of quality products. Additionally, geographic expansion requires dairy producers to secure retail space in supermarkets (supermarkets account for 70% of Kleinpeter's sales). Relationships such as the one Kleinpeter enjoys with Rouse's Supermarkets may be unattainable in more distant markets. As with Rouses, local and regional retail outlets often look to local producers in selecting items to carry on their shelves. At present, Kleinpeter, with its one facility in Baton Rouge has little regional "flavor" outside of its current target market, and thus may be less attractive to these potential retailers.

In terms of its' product line expansion, students should recognize the synergies and potential cost savings (i.e., economies of scope) resulting from the additional of a line of ice cream. As mentioned in the case, growing demand for low-fat or skim milk resulted in a surplus of cream (six thousand gallons a week) that Kleinpeter was selling each week at a loss. Ice cream's high butterfat content provided the firm with a means of creating value with this surplus cream. Other common ingredients (e.g., milk), the production of all natural ice cream, and promotion and co-branding opportunities, also provide Kleinpeter with means to create additional value while generating costs savings through the sharing of resources and competencies.

Students might also suggest that Kleinpeter, despite some sales in butter, whipping cream, half-and half and juice, is overly dependent on milk in generating revenue for the firm. By increasing product lines, or the scope of its product line, firms can reduce their susceptibility to changing environmental conditions. Finally, the introduction of ice cream into its product line provides Kleinpeter with an additional means of growing the firm. Expanding product lines can be an attractive means of growth when a firm's existing products or services are faced with unattractive or uncertain long-term prospects.

4. While continuing Kleinpeter's theme of Louisiana flavors, what new ice cream flavors would your suggest for extending the product line?

Obviously, this question is designed to generate light-hearted discussion about ice cream flavors that could be introduced in the future. However, it can also serve to reinforce to students the need for companies to maintain some degree of consistency in its product offerings and its sources of competitive advantage. Brand consistency helps to generate familiarity and thus credibility, trust, and confidence, not only with customers but also within the firm. These factors in turn help firms to generate loyalty amongst its customers which in turn can serve as a source of sustainable competitive advantage and help generate above-average returns. In addition, maintaining a Louisiana theme in future ice cream flavors allow Kleinpeter to remain true to the mission and vision of the firm. Such "internal" consistency can help guide firms in areas such as decision-making and ethics.

Current flavors produced by Kleinpeter Dairys Farm include vanilla, chocolate, strawberry, buttered pecan, pralines and cream, gold brick, sweet potato, cafe au lait, banana pudding, rocky road, banana foster, no sugar added vanilla, and no sugar added chocolate. Potential flavors mentioned in the case include Heavenly Hash, bananas foster, blueberry made with Louisiana blueberries, or Ruston peach. There has also been some talk of a Satsuma flavor being developed. Each of these flavors could allow Kleinpeter to maintain their focus on co-branding with Louisiana companies.

Students doing a bit of research might suggest an orange flavor developed with citrus grown in the southern part of the state. In addition, Louisiana is one of the largest growers of sugarcane in the United States. As a result, some students might suggest an ice cream developed for those consumers with an especially sweet tooth.

VALUING A TURNAROUND PLAN FOR A COMPANY IN THE RESTAURANT EQUIPMENT BUSINESS

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CASE DESCRIPTION

The primary subject matter of this case concerns the valuation of a proposed turnaround plan using a discounted cash flow approach. Secondary issues examined include Spreadsheet modeling, sensitivity analysis and indentifying the fundamental drivers of value. The case has a difficulty level four, appropriate for senior level. The case is designed to be taught in one class hour and is expected to require four hours of outside preparation by students.

CASE SYNOPSIS

How could the company that virtually invented the frozen margarita dispenser find itself on the verge of ruin? Throughout its history, TastySlush frozen desert and beverage equipment was known for quality, durability and ease of use. Clients include many high-profile restaurants and fast-food chains. However, competition and a failure to maintain the high quality standard on which the company built its reputation have lead to stagnant sales growth and a steady decline in market share.

Frustrated and seeking new ideas, the management team hired an outside consultant. The consultant is currently working with management to put together a multi-stage plan to ensure TastySlush's long-term viability and restore the company's reputation as an innovator that produces high quality equipment. A critical aspect of the first stage of the consultant's turnaround strategy is the identification of potential undeveloped markets and the key factors that will drive value and growth. In order to realize the strategy's full potential, TastySlush needs to purchase new equipment and expand warehouse capacity. Management is hesitant to commit scarce funds to the project and requires a quick return if the project is accepted.

INSTRUCTORS' NOTES

Recommendations for Teaching Approaches

The TastySlush case is based on a (Authors' School) Business Accelerator client. At the request of management, the fictitious name "TastySlush" was used to hide the company's identity. TastySlush manufactures a line of frozen dessert and beverage equipment for the restaurant and food industry. Many national restaurant chains use its equipment but the company has lost business to its competitors and also experienced a reduction in quality.

TastySlush management approached the accelerator consulting team for some help after the company began having trouble making payments on debt. The consultants developed a plan with the goal of restoring TastySlush's reputation as an innovator and a manufacturer of quality equipment. The first stage of the plan which is the focus of the case, is to ensure the company's survival given the threat of default looming on the horizon. This goal is accomplished with a modest capital investment and a marketing plan to increase sales. The rationale for the capital expenditure is that current production equipment needs to be updated to reduce factory defects. At the same time, plant capacity needs to be expanded to handle increased sales, and handle increased inventory needed to facilitate a sell-direct strategy in the local market. Currently, TastySlush uses a network of distributors who carry their own inventory. If TastySlush wants to sell direct, they need larger inventory capacity.

The capital expenditure supports the marketing thrusts outlined in the case. The two are linked because the success of one depends on the success of the other. Thus, the baseline case assumes an all-or nothing approach. However, an interesting discussion revolves around a bootstrapping approach, or pay as you go method. In fact, this is the path TastySlush followed. They went with some 'quick-hits' to increase sales by adding distributors, pushing service kits and patching the fabrication equipment to improve quality. The increase in sales will now support additional investment in capacity for the sell-direct thrust and additional investment in equipment.

The spreadsheet that accompanies the case has 3 main purposes:

1. Allow students to create a simple forecasting model based on the percent-of-sales approach.
2. Allow students to translate income and balance sheet items into cash flows used to compute NPV.
3. Allow students to perform sensitivity analysis.

The case is intended for use in an upper level undergraduate or MBA course in financial management. The elements of the case are best suited for the 'project evaluation' section of the course. The case provides students with a general example of forecasting cash flows using a percent of sales approach, building a pro forma income statement, deriving project cash flows, computing

net present value and internal rate of return, and performing sensitivity analysis. The case also provides sufficient information on the turnaround plan to generate additional discussion on the fundamental drivers of value within the turnaround plan.

The accompanying spreadsheet allows students to change assumptions related to weaknesses in the percent of sales forecasting model and generate new results. For example, the basic model links all costs to percent of sales but some costs may be less sensitive to changes in sales. The spreadsheet also allows students to perform sensitivity analysis. Students can create upper and lower bounds for the problem by finding break-even points for key variables. Students will also discover which variables have the largest impact on NPV and hence, deserve additional attention from consultants and management.

The instructor may find it worthwhile to spend time discussing the aspects of the turnaround plan that are critical to success. Success depends critically on 3 marketing thrusts to increase sales. The 3 marketing thrusts are: expanding the distributor network, sell direct in the local market, and increase the sale of parts kits. Industry sales growth also plays a role as does the ability of TastySlush to grab an increasing share of industry sales growth. Success will depend on the willingness of current distributors to increase the promotion of TastySlush equipment to existing customers as well as new customers. Similarly, new distributors need to be added to the network in order to expand geographically and further penetrate underserved markets. Distributors will also play a key role in increasing the high margin parts replacement business. Finally, the push to sell locally will require TastySlush to hire a sales person. The success of the sell local thrust will depend on the ability of the sales person to sell TastySlush equipment to new users.

The case ends with the following instructions. I have added some comments to help guide discussion.

In order to respond to Ms. Rozen's requests and concerns, the summary must include:

1. A Pro Forma Income Statement.
   (The accompanying spreadsheet contains the solution.)
2. A discounted cash flow analysis based on an all-or-nothing approach to the 3 marketing thrusts.
   (The accompanying spreadsheet contains the solution.)
3. A section that quantifies the potential impact of errors in your forecasts of key variables.
   (The accompanying spreadsheet contains the solution.)
4. A discussion of the fundamental drivers of value.
   *. The 3 marketing thrusts are: expanding the distributor network, sell direct in the local market, and increase the sale of parts kits. Industry sales growth also plays a role as does the ability of TastySlush to grab an increasing share of industry sales growth. Success will depend on the willingness of current distributors to increase the promotion of TastySlush equipment to existing customers as well as new customers.

Similarly, new distributors need to be added to the network in order to expand geographically and further penetrate underserved markets. Distributors will also play a key role in increasing the high margin parts replacement business. Finally, the push to sell locally will require TastySlush to hire a sales person. The success of the sell local thrust will depend on the ability of the sales person to sell TastySlush equipment to new users.

5. A summary or your recommendations and concerns.
   (Students will find NPV > 0 and recommend accepting the project.
   * Note that much of that positive NPV comes from unwinding the ending balance in Net Working Capital. Technically, the project does not end after 4 years. We only stop at that point because Ms. Rosen indicates she requires a 4 year payback period. Thus, it may make sense to use the change in Net Working for the final period rather than unwind the entire balance in Net Working Capital.)
   * Students may notice that the cash flows are based on a static percent of sales over the life of the project. It is reasonable to assume that these percentages will change. It is also reasonable to assume that the historical averages on which the baseline percentages are based, may not apply to the future. If you have time, students can break into groups and discuss these simplifying assumptions and how they would change them.
   * Many students may question the need to assume an all-or-nothing approach. That leads into the next topic below on bootstrapping.

6. A discussion of the feasibility of rolling out the plan in stages rather than an all-or-nothing approach.
   * *In fact, this is the path TastySlush followed. They went with some 'quick-hits' to increase sales by adding distributors, pushing service kits and patching the fabrication equipment to improve quality. The increase in sales will now support additional investment in capacity for the sell-direct thrust and additional investment in equipment.*

TN Figure 1: Assumptions					
	2007	2008	2009	2010	
Incremental Sales	23,012	27,352	31,694	36,624	
Working Capital	Initial Investment	2007	2008	2009	2010
A/R	0	2,531	3,009	3,486	4,029
Inventory	2,025	3,682	4,376	5,071	5,860
A/P	2,025	2,209	2,626	3,043	3,516
Total	0	4,004	4,759	5,515	6,373
Change in Working Capital	0	4,004	755	756	858
Unwind Working Capital					6,373
Capital Expenditure, Depreciation and Interest					
Expense	Initial Investment	2007	2008	2009	2010
Capex*	2080	0.0	0.0	0.0	0.0
MACRS Schedule		20.3%	32.0%	19.2%	11.5%
5 Year MACRS Depreciation		422.7	665.6	399.4	239.6

*After-Tax Salvage Value is ignored in order to be consistent with Ms. Rozen's desire to have the project pay back within 4 years.
**TastySlush had $15 million in debt at the end of 2006. A portion of positive CFFA is used to reduce debt. Negative CFFA does not increase debt.
All calculations for the entire case can be found in the spreadsheet that accompanies the case.

TN Figure 2: Proforma Income Statement				
	2007	2008	2009	2010
Sales	23,012	27,352	31,694	36,624
Freight:	230	274	317	366
	1.0%	1.0%	1.0%	1.0%
Direct Materials Total	13,807	16,411	19,016	21,975
	60.0%	60.0%	60.0%	60.0%
Direct Labor:	115	137	158	183
	0.5%	0.5%	0.5%	0.5%
Variable Overhead:	161	191	222	256
	0.7%	0.7%	0.7%	0.7%
Fixed Cost of Sales (Plant Support):	1,611	1,915	2,219	2,564
	7.0%	7.0%	7.0%	7.0%
Marketing & Sales Expense:	2,071	2,462	2,852	3,296
	9.0%	9.0%	9.0%	9.0%
General & Administrative:	1,841	2,188	2,536	2,930
	8.0%	8.0%	8.0%	8.0%
Depreciation Expense	422.66	665.60	399.36	239.62
EBIT	2,753	3,109	3,974	4,815
Tax 38%	1,046	1,181	1,510	1,830
Net Income	1,707	1,928	2,464	2,985

TN Figure 3 : Cash Flow From Assets					
		2007	2008	2009	2010
Depreciation		423	666	399	240
EBIT		2,753	3,109	3,974	4,815
Tax 38%		1,046	1,181	1,510	1,830
Net Income		1,707	1,928	2,464	2,985
OCF		2,130	2,593	2,864	3,225
Ch NWC	0	4,004	755	756	(6,373)
NCS	2080				
CFFA	(2,080)	(1,875)	1,838	2,108	9,597
WACC 15%(1-.38)	9%				
NPV	$6,082.48				
IRR	50%				
Discounted Payback and Accumulated CFFA.	3 years	(1,875)	(37)	2,071	11,669

SOLUTIONS

	TastySlush		Industry
Year	Sales	Share	Sales
1998	22,500,000	9.0%	250,000,000
1999	26,125,000	9.5%	275,000,000
2000	24,640,000	8.0%	308,000,000
2001	24,948,000	7.5%	332,640,000
2002	26,877,312	8.0%	335,966,400
2003	21,286,831	6.6%	322,527,744
2004	20,754,660	6.5%	319,302,467
2005	19,400,818	6.2%	312,916,417
2006	19,150,485	6.0%	319,174,746
2007	23,012,499	7.0%	328,749,988
2008	27,351,999	8.0%	341,899,987
2009	31,694,129	9.0%	352,156,987
2010	36,624,327	10.0%	366,243,267
	Sales Growth		Sales Growth
2007-2010	13,611,828		37,493,279
TastySlush share of industry sales growth necessary to achieve market share projections.		36%	
Note that TasstySlush sales forecast depend on both increases in industry sales and an increase in market share.			

Note: This table demonstrates how company-wide sales can be forecasted using a company's market share of industry sales. However, These are company wide sales.

The assumption is that the increase in market share and sales for the period 2007 - 2010 are a direct result of the turnaround plan. This is a good place begin a discussion on the fundamental drivers of value that create this growth and the reasonableness of the forecasts. Note that TastySlush is gaining market share by grabbing a larger share of industry growth. How will competitors react? Will their reaction effect our price and margin estimates?

TastySlush Economic Analysis Tool TN Exhibit 1					
Top Line Assumptions		2007	2008	2009	2010
Incremental Sales		3,862,014	8,201,514	12,543,644	17,473,842
Working Capital	Initial Investment	2007	2008	2009	2010
A/R	0	424,822	902,167	1,379,801	1,922,123
Inventory	339,857	617,922	1,312,242	2,006,983	2,795,815
A/P	339,857	370,753	787,345	1,204,190	1,677,489
Total	0	671,991	1,427,063	2,182,594	3,040,448
Change in Working Capital	0	671,991	755,073	755,531	857,854
Unwind Working Capital					3,040,448
Capital Expenditure, Depreciation and Interest Expense	Initial Investment	2007	2008	2009	2010
Capex*	2,080,000	0.0	0.0	0.0	0.0
MACRS Schedule		20.3%	32.0%	19.2%	11.5%
5 Year MACRS Depreciation		422,656	665,600	399,360	239,616
*After-Tax Salvage Value is ignored in order to be consistent with Ms. Rozen's desire to have the project pay back within 4 years. **TastySlush had $15 million in debt at the end of 2006. A portion of positive CFFA is used to reduce debt. Negative CFFA does not increase debt.					

Driving value - go for easy wins and low hanging fruit by selling direct to Indiana. Distributors have dropped TastySlush in Indiana. Expand distributor network and offer TastySlush equipment in new markets.

Initial investment in NWC is 0 assuming inventory investment is 100% Acct's Payable financed. This is a simplifying assumption to reduce confusion regarding the timing of investment in NWC.

(857.8 is both invested and disinvested during the final period so the final balance to unwind is 3040.448) The unwind of NWC has a large impact on NPV. We should carefully consider accepting a project in which disinvestment in working capital drives significant value. Enter 0 in cell I44 and see how NPV changes. This issue is caused by our simplifying assumption that inventory, AR, and AP all grow in constant proportion to sales. If we realize some efficiency gains in inventory and AR management then the importance of NWC will be reduced. For example, we will build inventory prior to rolling out the 'sell Indiana' thrust. However, once we observe the degree of success, we can fine tune the level of inventory necessary to support the thrust, or build to order, if given sufficient lead time.

Exhibit 3: Expected percent of sales for the period 2007 - 2010.	
Item	Percent of Sales
Freight	1.00%
Direct Materials (COGS)	60.00%
Direct Labor	0.50%
Variable Overhead	0.70%
Fixed Cost of Sales (Plant Support)	7.00%
Marketing & Sales Expense	9.00%
General & Administrative	8.00%
A/R	11%
Inventory	16%
Item	Percent of Inv.
A/P (60% of inventory)	60%

TN Exhibit: Proforma Income Statement Percentages are Linked to the Sensitivities Worksheet				
	2007	2008	2009	2010
Sales	3,862,014	8,201,514	12,543,644	17,473,842
Freight:	38,620	82,015	125,436	174,738
Percent of Sales	1.0%	1.0%	1.0%	1.0%
Direct Materials Total	2,317,209	4,920,909	7,526,186	10,484,305
Percent of Sales	60.0%	60.0%	60.0%	60.0%
Direct Labor:	19,310	41,008	62,718	87,369
Percent of Sales	0.5%	0.5%	0.5%	0.5%

TN Exhibit: Proforma Income Statement Percentages are Linked to the Sensitivities Worksheet				
	2007	2008	2009	2010
Variable Overhead:	27,034	57,411	87,806	122,317
Percent of Sales	0.7%	0.7%	0.7%	0.7%
Fixed Cost of Sales (Plant Support):	270,341	574,106	878,055	1,223,169
Percent of Sales	7.0%	7.0%	7.0%	7.0%
Marketing & Sales Expense:	347,581	738,136	1,128,928	1,572,646
Percent of Sales	9.0%	9.0%	9.0%	9.0%
General & Administrative:	308,961	656,121	1,003,492	1,397,907
Percent of Sales	8.0%	8.0%	8.0%	8.0%
Depreciation Expense	422,656	665,600	399,360	239,616
EBIT	110,302	466,209	1,331,663	2,171,774
Tax 38%	41,915	177,159	506,032	825,274
Net Income	68,387	289,050	825,631	1,346,500

Use sensitivity analysis to determine how sensitive NPV is to changes in percent of sales assumptions. Find NPV breakeven points. You can also assume that the percentages change during the life of the project.

TN Exhibit : Cash Flow From Assets					
	0	1	2	3	4
Depreciation		422,656	665,600	399,360	239,616
EBIT		110,302	466,209	1,331,663	2,171,774
Tax 38%		41,915	177,159	506,032	825,274
Net Income		68,387	289,050	825,631	1,346,500
OCF		491,043	954,650	1,224,991	1,586,116
Ch NWC	0	671,991	755,073	755,531	(3,040,448)
NCS	2,080,000				
CFFA	(2,080,000)	(180,947)	199,577	469,460	4,626,564
WACC 15%(1-.38)	9%				
NPV	$1,522,779				
IRR	26%				
Discounted Payback and Accumulated CFFA.	3 years	(180,947)	18,629	488,090	5,114,654
NPV >0, IRR > WACC and Payback within 4 years. We meet Ms. Rozen's criteria for an acceptable project.					

Do we really need to undertake all the capital expenditure at once? Can we find a pay as you go strategy? For example, push service kits (a high margin product), establish new distributor relationships. However, if we don't fix the quality issues we will have a difficult time sustaining any growth in market share.

SENSITIVITIES

Change the Percent of Sales by X %.	
Variable	Percent Change
Baseline	0%
Freight:	0%
Direct Materials Total	0%
Direct Labor:	0%
Variable Overhead:	0%
Fixed Cost of Sales:	0%
Marketing & Sales Expense:	0%
General & Administrative:	0%
Enter a whole number in a "Percent Change" cell.	
Change 1 variable at a time then reset to 0.	
Change TastySlush Market Share.	
Year	Percent Change
2007	0%
2008	0%
2009	0%
2010	0%

Couch sensitivity analysis in terms of the assumptions within the marketing thrusts. For example, what if we are not able to expand our distributor network and market share is 15% lower than we estimate? Answer by entering -15% in cells for the Percent Change, above.

Base NPV	New NPV	% Change in NPV	Recommendation
$1,522,778.95	$1,522,778.95	0.00%	ACCEPT
Base IRR	New IRR	Base WACC	
44%	26%	9.30%	ACCEPT
Direct Materials (COGS) is the most sensitive variable. Copy and 'paste values' from your base NPV into cell E4.			

Large errors in estimates of TastySlush market share do not change the recommendation. The reason is that in a percent of sales model, costs change with sales. If some costs are fixed in the short run then sales that do not materialize will have a significant impact on NPV. The interested student can explore the impact of fixed costs by holding Some costs, like fixed cost of sales, constant in the spreadsheet.

The interested student can explore a variety of similar sensitivites by making similar changes to the model. Break-Even values for NPV Tare also easily computed using trial and error.,

INCOME INFLATION: ABSORPTION COSTING VS. VARIABLE

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CASE DESCRIPTION

The primary subject matter of this case concerns income inflation opportunities when GAAP based absorption costing is used as compared to internally used variable costing when more inventory is produced than sold. Secondary issues examined include distinctions between financial and managerial accounting; ethical responsibilities of managers, Certified Public Accountants and Certified Management Accountants; organizational climate of institutions; fixed costs vs. variable costs; and how inaccurate reporting in one year may affect financial statements in other years. This case can be tailored to three different difficulty levels; level two , appropriate for sophomore Principles of Managerial Accounting; level three, appropriate for junior Cost Accounting; and level five, appropriate for graduate level Managerial Accounting. This case is designed to be taught in one-half hour of class time and is expected to require one hour of outside preparation by students.

CASE SYNOPSIS

Robert had no idea how much his life was about to change. He thought he had acquired a "forever" career with a financially strong company. What he had not considered, though, was the effect his new supervisor could have on his career.

This case examines the income inflation opportunities available to unethical managers. These opportunities arise when production exceeds sales and occurs as a result of the differences between absorption costing and variable costing.

An absorption costing income statement is provided at three different sales levels with production remaining constant. The case asks students to use that information to prepare a variable costing income statement at those same levels assuming production remains constant. The case also asks students to differentiate between fixed and variable costs, to discuss ethical choices, and to discuss the "tone at the top".

INSTRUCTORS' NOTES

In General

Generally Accepted Accounting Principles (GAAP) are only required for external financial accounting and reporting. There are no mandatory requirements for a company's own internal financial record keeping. Therefore, each company has the ability to specify how it will account for transactions internally. Of course, a company may choose to simply adopt GAAP internally and also prepare additional reports and analysis to assist with decision making and other operations. Regardless of the internal methods chosen by the company, though, the financial information should accurately reflect operations and not mislead decision makers.

The clear distinction between financial and managerial accounting is clearly highlighted by this case. The case assists students in better recognizing the limits placed on a company's external reporting choices because of GAAP and the freedoms and negative aspects of those freedoms associated with internal, or managerial, accounting. As the case displays, with freedom comes a significant amount of responsibility.

While managers and other executives within an organization may choose to account for financial events and other transactions in any way that they desire, they have a responsibility to present the information in a way that shows the whole financial condition of the organization regardless of the effects such presentation will have on their jobs or compensation. Ultimately, when employees, managers, and other decision makers are not presented with accurate information, poor decisions are made and the results of such poor decisions can often be devastating to the organization. An individual in a key position has an ethical responsibility to look out for the interests of the entire company and not just himself or herself. In this case, the main character, Robert, has to face making a decision in regard to that very fine line.

The case also touches upon the organizational climate of institutions. Normally, the behavior and attitudes displayed by the top officials of the organization trickle down and permeate the employees throughout the rest of the organization. Thus a poor attitude or, even worse, an unethical climate at the top can result in corrupt practices throughout the rest of the organization as well. Top officials must lead by and employees primarily learn by example. Gail Smith, Robert's supervisor, was clearly a key financial decision maker, or at least, an influential employee in regard to financial decisions at the plant. Gail, though, was clearly looking out for herself. If she could behave that way and benefit why also couldn't Robert just turn his head the other way to the less than truthful financial reports and benefit as well? That is clearly what organizational behavior theory predicts is likely to happen. Hence, Robert is faced with a serious ethical dilemma that he may or may not respond to appropriately. This situation provides your students with the opportunity to analyze the situation and determine what they think Robert will do as well as what, based upon their ethical and accounting training, he should do.

As the case indicates, the Certified Public Accountant (CPA) and Certified Management Accountant (CMA) designations hold those who have those designations to additional responsibilities. Not only does each designation require an initial demonstration of adequate knowledge to serve the public and organizations, but each also requires a code of conduct to be upheld. In both cases, revocation of the designation can occur as a result of not upholding such codes including the ethical elements embedded into each of them. Robert not only stands to lose his job if he ignores this situation, but he could also lose his certifications that he has worked so hard to obtain.

Principles / Introductory Level Managerial Accounting Class

This case is most appropriate for use either at the beginning of the course when the differences between financial and managerial accounting are discussed and the need to be ethical in professional conduct is addressed or after fixed and variable costs are defined and discussed.

Before introducing the case, lead the class in a discussion of the differences between the purposes of financial and managerial accounting (i.e. the users of each type of information, the sources of authority for reporting, the time frame for the reported information, the type of information, the statement format, and the decision focus).

Also, briefly mention the CMA designation and the responsibilities associated with being a certified member of the professional organization. Providing students with a copy of the CMA's Code, *Statement of Ethical Professional Practice*, would provide students with an idea of the expectations placed upon them as members of the profession and especially as members who may someday hold the CMA designation.

Conclude the initial discussion with some brief comments about the differences between fixed and variable costs. Ask students if they can provide some examples of fixed and variable costs and ask them to explain why they are categorized as such. Discuss how knowing the manufacturing cost of a particular product influences the pricing of the item.

Then, either instruct the students to form small groups (3-4 members per group) or choose to allow them to work individually on the case. After the students have had a chance to read, think about, and if in small groups, discuss the case for a few minutes, ask for their feedback and ideas concerning the case. Specifically, have them address the following questions.

1. **How can you apply the facts of this case to the distinctions between financial and managerial accounting?**

   External financial reporting (financial accounting) would require that Generally Accepted Accounting Principles be followed and that absorption costing be used. However, in this case, the financial reporting dilemma concerns internal reporting which no specific

body oversees. Here, managers are concerned with using the financial information to determine the success of the firm as is the case with external users, but the managers would also like to use the information for making forecasting decisions (e.g. how many SUVs to produce in the next quarter, year, etc.). Inaccuracies in even a single element may cause other projections to be off and for future operating income to decline, a situation that is undesirable for both employees and stockholders. Therefore it is imperative that not just the short term, but also the long term be considered in internal financial reporting decisions.

2 Just because there is no single standard setting body of authority for internal financial reporting does that mean managers and accountants can present information to employees and decision makers however they choose or are they still faced with some limitations?

No. Just because there is no single set of standards for internal reporting does not mean that managers and accountants can disregard the accuracy of the information provided to decision makers. Actually, since there is no standard setting body and nobody specifically overseeing them, it is more important for accountants to choose the methods of reporting that are most accurate. Management accountants' primary obligations in their professional positions are to look out for the welfare of the company and ensure that the proper data to make adequate decisions is presented even if that ultimately might not be the best for their personal interests.

3 Do the specific numbers really matter to employees?

Yes, employees do care about the numbers that appear on the financial statements. Both good and poor results can, and do, affect employees' compensation as well as the security of their jobs. In the case of good financials, employees may be provided with a bonus on the amount of profit achieved. In the case of poor results, employees' jobs may be in danger as a result of layoffs. However, positive financial results that are inaccurate may actually result in a greater chance of employees losing their jobs because management is not informed of the poor outlook and by the time they realize the organization's predicament it may be too late to amend any practices.

4. How can inaccurate reporting in one period or year, affect an organization in the following years (in your answer, specifically refer to the events of this case)?

Inaccurate reporting in one reporting period not only affects that reporting time frame but subsequent periods as well. In this particular case, if more SUVs are produced than

sold, then, under absorption costing, there will be fewer expenses because the additional fixed costs will be tied up in inventory and will appear on the balance sheet. Then, when those goods are later sold, such expenses will be accounted for and will be a deduction from net income. However, if variable costing is used, expenses will be higher in the period of production because the fixed portion will be immediately expensed. Later, net income will be higher because such costs will have already been deducted in the period of production. (Emphasize to students that this provides the opportunity for income manipulation).

5. What are some fixed costs that may be incurred by this plant? What are some variable costs that may be incurred? Which are affected when quantity produced shifts and which are unaffected?

There are a number of fixed costs that may be incurred by the plant. Some may include rent, registrations/licenses, telephone/internet service, salaries for executives, etc. Basically any cost that does not vary with production levels may be considered fixed. Students may name others and some costs may be either fixed or variable depending on contract terms, etc. Ask students to explain items that are questionable. There are also a number of variable costs that may be incurred by the plant. Some may include parts for each SUV (wheels, frames, brake pads – the list could go on and on), wages for production supervisors (more supervisors may be needed when more is produced), wages for line employees, etc.). In addition to both fixed and variable costs, some costs may be considered mixed because they include both a fixed and variable element. As noted above, fixed costs do not change with varied production levels while variable costs do change.

6. Based upon the CMA's Statement of Ethical Professional Practice, what is Robert expected to do? What do you think he will do? What would you do?

There are two standards of the CMA's *Statement of Ethical Professional Practice* that apply to this case and which Robert should follow. Those standards are below.

I. 3. Competence: Provide decision support information and recommendations that are accurate, clear, concise, and timely.

IV. 2. Credibility: Disclose all relevant information that could reasonably be expected to influence an intended user's understanding of the reports, analyses, or recommendations.

Based upon this information, Robert is expected to notify management about the reporting issue and his thoughts regarding its inappropriateness to ensure that he has

complied with his duty to provide decision support information and recommendations that are accurate and has disclosed all information that may be relevant to users' analysis of the information.

Students' answers to the remaining parts of the question will vary. It is expected, though, that students will recognize the ethical dilemma involved and respond appropriately.

Cost Accounting Class for Accounting Majors

This case is most appropriate for use when discussing the differences between variable and fixed manufacturing costs and specifically when covering the topics of absorption and variable costing.

Before introducing the case, lead the class in a discussion of variable and fixed costs and the differences between the two. Discuss overhead as a fixed cost and explain that it may be allocated to the products produced and recorded as part of inventory. Review the idea that inventory costs are recorded on the balance sheet and not shown on the income statement until actually sold. Ask students to comment on how that may affect a company's income levels in different reporting periods. Briefly discuss how pricing strategies may be affected by the choice of costing method (i.e. absorption vs. variable).

Asking students to identify the uses of financial data internally should be combined with a discussion of the responsibilities of members of the profession. Ensure that students are aware of the importance of accurate financial reporting to an organization and the various types of decisions that may be made based upon the cost data.

Then, either instruct the students to form small groups (3 -4 members per group) or choose to allow them to work individually on the case. After the students have had a chance to read, think about, and if in small groups, discuss the case for a few minutes, ask for their feedback and ideas concerning the case. Specifically, have them address the following questions.

1. **Prepare a variable costing partial income statement and cost of goods sold schedule to compare to the absorption costing numbers in Table 1.**

Table 2: Based on Both Variable Costing and Absorption Costing						
Partial Income Statement						
	Sales of 100,000 units		Sales of 90,000 units		Sales of 80,000 units	
	Variable Costing	Absorption Costing	Variable Costing	Absorption Costing	Variable Costing	Absorption Costing
Sales	100,000,000	100,000,000	90,000,000	90,000,000	80,000,000	80,000,000
Less: COGS	(35,000,000)	(50,000,000)	(31,500,000)	(45,000,000)	(28,000,000)	(40,000,000)
Gross Profit	65,000,000	50,000,000	58,500,000	45,000,000	52,000,000	40,000,000
Less: Fixed Manufacturing Overhead	(15,000,000)		(15,000,000)		(15,000,000)	
Operating Income	50,000,000	50,000,000	43,500,000	45,000,000	37,000,000	40,000,000
Cost of Goods Sold and Ending Inventory	Sales of 100,000 units		Sales of 90,000 units		Sales of 80,000 units	
	Variable Costing	Absorption Costing	Variable Costing	Absorption Costing	Variable Costing	Absorption Costing
Beginning Inventory	3,500,000	5,000,000	3,500,000	5,000,000	3,500,000	5,000,000
Add: Production at 100,000 units	35,000,000	50,000,000	35,000,000	50,000,000	35,000,000	50,000,000
Goods Available for Sale	38,500,000	55,000,000	38,500,000	55,000,000	38,500,000	55,000,000
Less: Sales	(35,000,000)	(50,000,000)	(31,500,000)	(45,000,000)	(28,000,000)	(40,000,000)
Ending Inventory	3,500,000	5,000,000	7,000,000	10,000,000	10,500,000	15,000,000

2 Explain the difference(s) between absorption costing and variable costing as it relates to the differences in operating income. In the case of this manufacturing plant, which is most appropriate to accurately reflect the company's financial position?

Absorption costing incorporates both variable and fixed manufacturing costs into the cost of inventory while variable costing immediately expenses the fixed portion. If more is produced than sold, then, under absorption costing, there will be fewer expenses in the period, and income will be elevated. Under the absorption alternative, the additional costs will be left in inventory and will appear on the balance sheet until sales eventually pick up again and the inventory is transferred to Cost of Goods Sold and expensed. In this case,

especially since production is greater than demand and sales, variable costing is more appropriate because costs for goods are better matched with the revenue generated from the sales of such goods under that method and income is not artificially elevated.

3 As an employee of the company and a CMA, what is Robert expected to do? What do you think he will do? If Robert was not a CMA, would your answers be any different? What would you do?

As an employee of the company and a CMA, Robert is expected to inform management about his concerns and discuss the issue with them. Specific to the CMA's standards, Robert is compelled to the following ones that apply to this case.

I. 3. Competence: Provide decision support information and recommendations that are accurate, clear, concise, and timely.

IV. 2. Credibility: Disclose all relevant information that could reasonably be expected to influence an intended user's understanding of the reports, analyses, or recommendations.

Based upon this information, Robert is expected to notify management about the reporting issue and his thoughts regarding its inappropriateness to ensure that he has complied with his duty to provide decision support information and recommendations that are accurate and has disclosed all information that may be relevant to users' analysis of the information. Robert's designation as a CMA places a greater responsibility on him, but ultimately, his response should not vary. The CMA is just a certification and title, but ethical behavior is expected of all who are consciously aware of possible violations regardless of title or position. A lack of a certification does not authorize irresponsible behavior.

Students' answers to the remaining parts of the question will vary. It is expected, though, that students will recognize the ethical dilemma involved and respond appropriately.

Graduate Level Management Accounting Class

This case is most appropriate for use when discussing the differences between variable and fixed manufacturing costs and specifically when covering the topics of absorption and variable costing. If such topics are not specifically covered in the course, the case may also be appropriate when distinctions between fixed and variable costs are made or when general decision making is covered.

Before introducing the case, lead the class in a discussion of the distinctions between variable and fixed costs. Ask students to provide examples of both variable and fixed costs. See if any students have real-world experience with determining which costs should be fixed and which should be variable. If any of the students have faced the task of trying to determine the treatment of a cost that may be considered either fixed or variable, encourage them to share their experiences including what factors were used in the decision making process.

Review the idea that inventory costs are recorded on the balance sheet and not on the income statement until actually sold. Ask students to comment on how that may affect a company's income levels in different reporting periods. Briefly discuss how pricing strategies may be affected by the choice of costing method (i.e. absorption vs. variable). Encourage students to share personal experiences regarding pricing techniques that they, or their employers, have used and to which they have been exposed. Ask students to share additional experiences regarding income management and why certain techniques were implemented or choices made.

Conclude the discussion by speaking about ethical dilemmas faced by management and how to resolve such issues in regard to financial reporting while still achieving the company's goals.

Then instruct the students to form small groups (4 - 6 members per group) or choose to allow them to work individually on the case. After the students have had a chance to read, think about, and discuss the case for a few minutes, ask for their feedback and ideas concerning the case. Specifically, have them address the following questions.

1 Prepare a variable costing partial income statement and cost of goods sold schedule to compare to the absorption costing numbers in Table 1.

Table 2: Based on Both Variable Costing and Absorption Costing						
Partial Income Statement						
	Sales of 100,000 units		Sales of 90,000 units		Sales of 80,000 units	
	Variable Costing	Absorption Costing	Variable Costing	Absorption Costing	Variable Costing	Absorption Costing
Sales	100,000,000	100,000,000	90,000,000	90,000,000	80,000,000	80,000,000
Less: COGS	(35,000,000)	(50,000,000)	(31,500,000)	(45,000,000)	(28,000,000)	(40,000,000)
Gross Profit	65,000,000	50,000,000	58,500,000	45,000,000	52,000,000	40,000,000
Less: Fixed Mfg Overhead	(15,000,000)		(15,000,000)		(15,000,000)	
Operating Income	50,000,000	50,000,000	43,500,000	45,000,000	37,000,000	40,000,000
Cost of Goods Sold and Ending Inventory	Sales of 100,000 units		Sales of 90,000 units		Sales of 80,000 units	

Table 2: Based on Both Variable Costing and Absorption Costing						
	Variable Costing	Absorption Costing	Variable Costing	Absorption Costing	Variable Costing	Absorption Costing
Beginning Inventory	3,500,000	5,000,000	3,500,000	5,000,000	3,500,000	5,000,000
Add: Production at 100,000 units	35,000,000	50,000,000	35,000,000	50,000,000	35,000,000	50,000,000
Goods Available for Sale	38,500,000	55,000,000	38,500,000	55,000,000	38,500,000	55,000,000
Less: Sales	(35,000,000)	(50,000,000)	(31,500,000)	(45,000,000)	(28,000,000)	(40,000,000)
Ending Inventory	3,500,000	5,000,000	7,000,000	10,000,000	10,500,000	15,000,000

2 Explain the difference(s) between absorption costing and variable costing as it relates to the differences in operating income. In the case of this manufacturing plant, which is most appropriate to accurately reflect the company's financial position?

Absorption costing incorporates both variable and fixed manufacturing costs into the cost of inventory while variable costing immediately expenses the fixed portion. If more is produced than sold, then, under absorption costing, there will be fewer expenses in the period, and income will be elevated. Under the absorption alternative, the additional costs will be left in inventory and will appear on the balance sheet until sales eventually pick up again and the inventory is transferred to Cost of Goods Sold and expensed. In this case, especially since production is greater than demand and sales, variable costing is more appropriate because costs for goods are better matched with the revenue generated from the sales of such goods under that method and income is not artificially elevated.

3 Do the specific numbers really matter to employees? To management?

Yes, employees do care about the numbers that appear on the financial statements. Both good and poor results can, and do, affect employees' compensation as well as the security of their jobs. In the case of good financials, employees may be provided with a bonus on the amount of profit achieved. In the case of poor results, employees' jobs may be in danger as a result of layoffs. However, positive financial results that are inaccurate may actually result in a greater chance of employees losing their jobs because management is not informed of the poor outlook and by the time they realize the organization's predicament it may be too late to amend any practices.

Managers care as well. Like employees, managers may have bonuses that are based upon the profitability of the organization. Therefore, there is an incentive for the managers

to manipulate income. Additionally, the jobs of managers, because they hold decision making positions, may be directly dependent on the financial success of the company so managers often have a tendency to make things look better than they may actually be. Finally, managers must worry about not being able to secure credit or other financing sources when profits appear low. That provides yet another incentive to manipulate profits upward. Managers, though, cannot simply focus on the short-term and present inaccurate financials in an effort to prevent the negative impacts of poor results. The long-term must be considered and, for the best long-term results, decisions must be made when problems arise rather than trying to cover them up.

4 How can inaccurate reporting in one period or year, affect an organization in the following years – (in your answer, specifically refer to the events of this case)? Should management intentionally manipulate income just to achieve certain objectives?

Inaccurate reporting in one reporting period not only affects that reporting time frame but subsequent periods as well. In this particular case, if more SUVs are produced than sold, then, under absorption costing, there will be fewer expenses because the additional fixed costs will be tied up in inventory and will appear on the balance sheet. Then, when those goods are later sold, such expenses will be accounted for and will be a deduction from net income. However, if variable costing is used, expenses will be higher in the period of production because the fixed portion will be immediately expensed. Later, net income will be higher because such costs will have already been deducted in the period of production. (Emphasize to students that this provides the opportunity for income manipulation).

No, managers should not intentionally manipulate income in an effort to achieve certain objectives. Such tactics could ultimately lead to a chain reaction of ill-planned decisions that may result in the downfall of the company.

5 An unethical corporate culture often trickles down from the top of the organization. Is this currently happening in this case? Is it probable that it will happen in the future?

There may or may not be an unethical climate at the top of the organization, and, if there is it may or may not be moving down through the organization. The only ethical perspective mentioned in the case is that of Robert. Additionally, the only other character specifically referred to and described is Gail. From the information, it is clear that there is a good probability that Gail is acting unethically and trying to persuade others to join her. However, we are told that the other management employees seem to not have an adequate background in financial matters. Because of their lack of insight, unless those managers are approached by someone like Robert, they may never realize the inaccuracy in the reports and

would not be acting unethically by just accepting Gail's calculations. Additionally, if Robert follows his gut and speaks up, he would be stopping the chain and thus an unethical climate would not be spreading through the organization. It all depends on the final decisions made and the knowledge level of the managers.

If Robert ignores the situation, it is very likely that the unethical climate will persist and spread further through the organization.

6 From a management perspective (i.e. as Gail's supervisors) how would you like Robert to respond to the situation? Would you want to know about his suspicions concerning Gail? Would you openly welcome comments from such a new employee?

Although, answers from students may vary, it is hoped that they, as the managers, will want obert to approach them and will support an ethical response to this dilemma.

7 Based upon the facts of this case, is it important for a manager to be financially literate and to have, at a minimum, a basic understanding of accounting?

The importance of managers being financially literate should be clearly evident from this case. If the managers here knew even some basic accounting, they might discover that Gail was trying to persuade them to agree to decisions that were not in the best interests of the company. Managers need to be at least broadly aware of the occurrences throughout the organization and should be trained in all aspects of business especially finance and accounting.

MACPHERSON MANUFACTURING COMPANY: STRATEGIC OPERATIONS PLANNING

Patricia LaPoint McMurry University
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CASE DESCRIPTION

The primary subject matter of this case concerns operations management. The case can be used to explore the important connection between sales and operation al decisions in an operations management course. Students are asked to analyze data in order to determine whether models should be retained or eliminated. The case has a difficulty level of four. The case is designed to be taught in two class hours and is expected to require 8-10 hours of outside preparation by students.

CASE SYNOPSIS

As Brian MacPherson gazed from his corner-office window he reflected on the changes to his family's business. The historic building, one of Boston's most distinctive landmarks, was built in 1857 by his great, great, great grandfather, Cyrus MacPherson . Cyrus MacPherson had made his presence known in every aspect of the early company's business. He could be seen on the production floor examining sewing machine parts, giving orders to his operators on how to set up the equipment, and holding the reins of a horse-driven cart to distribute sewing machines to his customers. The elder MacPherson was a demanding tyrant with an unyielding perseverance to insure that the family business grew and survived for future generations of MacPherson 's.

Today, MacPherson produces six models, a basic model and five specialty models. While the growth potential for each model varies, all of the models require significant promotional efforts. In some cases, models need to be redesigned in order to become more competitive. Three models operate at 75-80% of capacity, one at 30-35% of capacity, while two models operate at 15-20% of their capacity. Each product has its own dedicated production assembly line.

As Brian reflected on his heritage, he knew that he must continue this family tradition for the generations of MacPherson 's to come. However, he also knew that the 21st century environment was significantly different than that the Cyrus' day. Brian was wrestling with such questions as: Should the company continue to produce all six models ? Should some models be eliminated or consolidated with other models in production ? When would issues of capacity force

a decision about possible changes? Brian knew that his answer s to the se questions would determine whether MacPherson Manufacturing Company remained viab le for future generations.

INSTRUCTORS' NOTES

This case provides an opportunity for students to examine the connection between sales projections and operational decisions. In order to conduct such an examination, students will have to complete a sales projection analysis of the models produced by company. This analysis will then serve as the basis for making operational decisions regarding which lines should be retained and/or possible consolidation of lines. These instructor notes include information that will be useful to the discussion leader in guiding students through the process of analyzing the decision and examining the potential impact of an elimination/consolidation decision.

The preferred teaching strategy for this case includes student assignments and class discussion. After assigning the case for reading ask the students to prepare written responses to the questions listed below in the "discussion questions" section.

Note that the decision point in this case is very apparent; MacPherson must decide whether to eliminate or consolidate models.

This case will allow the instructor to meet the following objectives: To:

- ♦ make future sales projections based on historical data.
- ♦ make a decision regarding eliminating or consolidating product lines.
- ♦ determine production setup costs based on the EOQ model.
- ♦ determine production schedule based upon sales projections.

CASE OVERVIEW

This case revolves around the decision of whether to eliminate or consolidate product lines. Sales projections, once developed will serve as the basis for operational decisions. The strength of the case lies in demonstrating the relationship between sales projections and operational decisions. Students must realize that decisions regarding sales projections must precede and will affect operational decisions.

DISCUSSION QUESTIONS

1. **Based upon the 10-year historical sales data, what is the projected demand for each product for the next 5 years? When will additional capacity be needed for each product? [Hint: You may want to run a regression analysis of the data.] (Regression and Trend Analysis of the Sales Data: Projected Sales Demand 2010-2014**

Year/Product	A	B	C	D	E	F
2010	29200	27533	10400	26533	2820	2101
2011	30382	28466	11000	27593	2829	2212
2012	31563	29400	11600	28653	2838	2323
2013	32745	30332	12200	29713	2848	2434
2014	33927	31266	12800	30773	2857	2545

Rated Capacity for each of the Production Lines:

Rated capacity in units/Products	A	B	C	D	E	F
	35,625	33250	29858	31250	14250	9500
*based on 2009 sales data, current capacity factors, and an overall rated plant capacity of 95%						

Conclusion: For the next 5-year period, 2010-2014, the company will have enough production capacity for each dedicated production line to meet the projected sales demand during the same period (based upon the regression forecast). However, by Year 2015, Production line A will be at capacity (only 500 units in excess for the forecast for 2015) and Production Line D will be out of capacity (shortage of 683 units of 2015 forecast). A +10% change in the sales forecast for Products A, B, and D could, however, put the Production Lines A, B and D out of capacity in Year 2014.)

2. What factors might affect the projected demand and capacity for each product in the United States and overseas markets?

The sales projections are estimates of demand. The sales demand could vary +/- 10% and affect when new capacity will be needed. Beyond the "normal" business cycle factors, the answer should also reflect an awareness that technological innovation in the sewing machine industry could alter the efficiencies of the production process and the products themselves, therefore, allowing the company to recapture more production capacity. The effect of government policies as to the regulation of NGOs (non-governmental organizations) specifically in international venues could change the demand for the products.

3. Should the company produce all 6 models in the future or eliminate some products and if so which one(s)?

There are several options for students to consider. Option 1: Produce and sell all 6 product models.

Advantages: this is considered a "do nothing" option or status quo option. Individuals who favor the retention of all 6 lines for various reasons – marketing, political, and sentimental – will not have to change. Customers who are serviced by each of the 6 product models will not have to make any changes. There will be no changes to the distribution channels. Disadvantages: continue to incur higher costs per unit in terms of marketing, distribution, and production. Option 2: Eliminate Products E and F. Advantages: both products E and F have limited sales (3% and 2% respectively; the elimination of both products will reduce the marketing sales expenses, distribution expenses, and production expenses. The production unit costs for both products are very high especially the fixed costs per unit. Each product is produced on a dedicated production line currently with a capacity factor of 15-20 percent. If Products E and F were eliminated, the production lines for E and F could either be dismantled and sold off or one line might be retained and converted over with change parts to be produced with another higher demand and growth products such as Products A. Currently, personnel and equipment are significantly under-utilized which wastes the company's resources. Both products have limited growth potential. Disadvantages: the company could lose some of its oldest and most reliable customers if the company cannot convince these customers to switch to products B or C. This would be especially the case for Product E which is one of the oldest products. The 2 managers for production lines E and F, the former a long-term employee with the company, and the latter a relatively new "up and comer" with fresh ideas, will have to be reassigned or terminated. Reassignment and/or termination is/are possibilities for the line operators as well. There is a strong commitment for Product F; promotional activities have already been developed and implemented to increase sales. Option 3: Produce and sell all 6 products, but consolidate the production of the 6 products. Advantages: the advantages of producing and selling all 6 products are the same as in Option #1. By producing and selling the 6 products, the human resources (operators and managers) could be reassigned. Since the Production Line A is compatible with Products E and F, the production of Products E and F could be shifted over to Production Line A, adding a second shift. This option would retain the operators and one of the managers to run the second shift operation. No operator retraining would be required. The production equipment for Production Lines E and F could be dismantled and some of it sold. Some of the change parts on the E and F production lines might be used to changeover Production Line A for the second shift operation. The fixed costs per unit would be reduced. Repair and maintenance costs would also be reduced. Disadvantages: there might be an additional investment of capital for change parts to changeover the Production Line A for a second shift operation. Since all of the operators and management work the

normal day shift operation, adding a second shift might disrupt the employees' schedules. There may be some behavioral resistance to the second shift operation by the personnel.)

4. **What is the production set up costs based upon the EOQ model? Use the projected sales data for each product for Year 2010.**

The basic Economic Order Quantity Model (EOQ) will determine the production set up costs for each product model. The following formulas apply: a. The optimal order quantity (Q*) = the square root of 2DS divided by H, where D = Annual Demand, S= Set up costs per changeover, and H = Holding costs per unit. Based upon the data provided in the case, the costs to changeover a line = $416 per changeover. b. For Year 2010, Q* = : Product A (6490 units); Product B (6282); Product C (3905); Product D (6185); Product E (1980); and Product F (1751). c. The Set up costs = D divided by Q* X S; therefore, the setup cost for each product is: Product A ($1947); Product B ($1885); Product C ($1171); Product D ($1855); Product E ($594); and Product F ($525). d. The number of production set ups based on the EOQ model for each product is: Product A (4.68); Product B (4.53); Product C (2.82); Product D (4.46); Product E (1.43), and Product F (1.26).

5. **Based on your answer to question 3, develop a 6-month production schedule that reflects the projected sales data for each product. Be very specific as to number of production lines, short-term capacity availability, quantities of each product produced, and scheduling/sequencing of each product. Identify all assumptions you have made for the 6-month production schedule**.

Students should recognize that there are two interrelated sets of decisions. Once projected sales are established, they then can move on to consider the operational decisions. The answers should reflect awareness that sales decisions must precede any operational decisions. Students can develop various production schedules for the 6-month period. These production schedules should reflect the monthly sales demand for each product, which products are to be manufactured and sold, which production lines will be used for each product, and which products will be produced on each production line. Students can use a Level Scheduling approach, a Chase Strategy which varies the workforce, or a Mixed strategy. The production schedule should also reflect the sequencing of Products E and F if a second shift is used on Production Line A. The 6-month production schedule should identify the assumptions underlying the schedule. Overall, the development of a 6-month production schedule is fairly straightforward since Products, B, C, and D have dedicated production lines.

6. **Based on your answer to question 3, how would the 6-month production schedule change if demand for each product varied by plus or minus 10%?**

Students could recalculate the Sales Projections for Year 2010 to reflect the 10% sales adjustment for each product. The number of set ups would change as well as the set up costs for Products E and F. However, since the + or – 10% sales adjustment is nominal for Products E and F, the production schedule would not be affected significantly. Most likely, the students will recommend that the production schedule remain the same as identified in Question #5. The regression on sales concludes that no Production line is in jeopardy of being out of capacity until the Year 2014; then Production lines A, B and D will reach their "at capacity levels". There are no short-or near-term shortages of capacity for any production line.

7. **If a decision is made to eliminate a product(s), how should the company deal with its resources (equipment, personnel)?**

Students will respond to this question differently depending upon which option they chose in Question #3. Several methods for handling the equipment and personnel resources are addressed in Question #3. The students may also develop new and creative ways to handle the equipment and personnel resources.

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GENE LIFE S.A. – PARIS

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CASE DESCRIPTION

The primary subject matter of this case illustrates that management styles typically reflect the cultural values from which they evolve, and that management styles are not necessarily transferable across international boundaries. The case should enable students to: (1) Understand the impact of cultural values on managing others. (2) Identify the difficulty of transferring management styles across cultures. (3) Learn about the need for culturally-and country-specific pre-departure training for expatriates. (4) Develop a management approach to accomplishing a specific task in a foreign culture. (5) Examine the characteristics typically associated with success as an expatriate manager.

The case is appropriate for senior level undergraduates, as well as first and second year graduate students. The case is designed to be taught in a 90 minute class and is expected to require 1 – 2 hours of preparation by students

CASE SYNOPSIS

John Williams, armed with an undergraduate degree in biochemistry, an MBA, several years of managerial experience and proficiency in French, was appointed as the Directuer Général of a French medical products company in Paris. The company, Les Medical Equip Direct (LMED), had just entered a partnership with Gene Life, a U.S. firm that had developed an affordable genetic test for type II diabetes. The test kit was tailored to be used by both physicians' offices and hospitals. LMED had a well-developed sales force throughout France and it also afforded Gene Life an entrée to the French market. While John received language training prior to his departure, Gene Life did not provide pre-departure education on either the French culture or its labor laws.

Upon arrival in Paris, John was under pressure to not only reduce what Gene Life considered excessive overhead, but also to quickly get the sales personnel adequately trained to competently sell the test kit. Since genetically based products were a totally new to LMED, training was critical. The time pressures faced by Williams mandated the cooperation and motivation of both the office and sales staff. His first several months in the Paris office were not as successful as he had hoped. His MBA from a prestigious American university had not prepared him for the difficulties in managing a work force in a foreign culture. He must now determine how best to manage in order to successfully lead a new-product launch in an unfamiliar culture.

INSTRUCTORS' NOTES

Case Objectives & Use

Management styles typically reflect the cultural values from which they evolve. This case is designed to illustrate that management styles are not necessarily transferable across international boundaries.

The case should enable students to:

(1) Understand the impact of cultural values on managing others.
(2) Identify the difficulty of transferring management styles across cultures.
(3) Learn about the need for culturally-and country-specific pre-departure training for expatriates.
(4) Develop a management approach to accomplishing a specific task in a foreign culture.
(5) Examine the characteristics typically associated with success as an expatriate manager. This case is developed for use in either graduate or undergraduate courses in: International Business, Comparative Management and Organizational Behavior.

Recommendations for Teaching Approaches

If this case is used in a course where the work of Hofstede, Trompenaars, Hall & Hall, and Kluckhohn & Strodtbeck is covered, it is recommended that the instructor ask the students to fill in the chart provided in Appendix 1. Alternatively, if the case is used in a general international business or organizational behavior course, it would be optimal to copy and disseminate Appendix 2.

Teaching strategies for this case vary. One alternative (IF the class generates the cultural profiles of the U.S. and France) is to start a class discussion of the general cultural differences between France and the U.S. These differences should be written on the board or the posted electronically as students offer suggestions. Once the cultural characterizations are listed, the instructor should lead the discussion of the case questions.

A second alternative is to give the students all of the case questions before they read the case. Upon arriving in class, the students can be put into small discussion groups where they generate (or discuss) the cultural differences between France and the U.S. Each team should be responsible for discussing the case questions and reporting to the class. Before discussing the management issues, it is best to have team representatives post their cultural profiles (if generated by the team) on the board or electronically. I often use the data projector to post the chart contained in Appendix 2 and ask team representatives to fill in the blanks. We have found that asking one team to respond to a question and then asking for rebuttals or comments from other teams generally stimulates arguments

and discussions. We try to avoid the redundancy of asking each team to give its response to every single question.

CASE QUESTIONS:

1. **What are the major differences between the French and the United States' cultures?**

    This question should be used only if the students are responsible for analyzing the culture based upon theoretical frameworks learned in class. To aid in the discussion, the instructor can pass out the chart in Appendix 1 and have students fill in the blanks. The classifications, which are provided in Appendix 2, are based upon the work of Hofstede, Trompenaars, Hall & Hall, and Kluckhohn & Strodtbeck. It should be noted that the in the case, Michel outlines many of the differences between the two cultures.

2. **Describe the management style that John used in the United States. Given the value system, as characterized by the cultural frameworks of Hofstede, Kluckhohn & Strodtbeck or Trompenaars, of the "typical" American, why was John's management style successful? Given the French value system portrayed in the cultural frameworks, will this same style be appropriate in Paris? Why or why not?**

    John used a very participative management style. For example, every two weeks, John met with his regional sales managers to share information and set mutually-agreed-upon goals. Before every meeting, he sent out e-mails asking for agenda items since it was important to discuss issues of interest to his people. He started every meeting by asking the group about the challenges or problems they faced. As he had learned at Harvard, a good leader solicits solutions – not just problems. Hence, he always threw the problem back to the group where lively discussion ensued and creative solutions were generated. John led by example since he expected the regional sales managers to hold the same type of bi-monthly meetings with their subordinates. This style was very successful in the United States due in part to the American values of individualism, low power distance, low uncertainty avoidance, low context (direct) communication, and achievement orientation. Given that time is typically viewed as a commodity to be spent and invested wisely, Americans tend to value schedules and are fairly accepting of deadlines. Other value differences may also apply. Basically, the "typical" American professional does well with a participative management style and deadlines.

    Given the potential cultural differences between the U.S. and France, a highly participative management style accompanied by stated deadlines may not be appropriate in Paris. For example, the French values of low context (indirect) communication, flexible

deadlines, high power distance, relatively high uncertainty avoidance, moderate femininity (placing value on the quality of life), ascription, affectivity and moderate particularism, are very different from the typical American values that support the use of participative management. Hence, John's style would probably not be successful in France.

3. John perceived that the Parisians were "rude". How might this value judgment impact upon his interactions at the office? Using what you know about the value system of the French, explain this seemingly rude behavior.

There are several cultural characteristics of the French that John might need to consider before labeling the Parisians as rude. This observation is judgmental rather than descriptive and hence, contributes to a negative stereotype. Often reframing one's understanding of a behavior can assist in eliminating potential negative stereotypes and their possible implications in the work setting. Hence, an understanding of certain French cultural characteristics may help John to reframe his perception. For example, the French focus on perspectives from the past and for many years, theirs was the dominant culture. Since communications are indirect and subtle, a sub-standard command of the language may loose a lot of the intended meaning. Additionally, the French tend to be more affective than do Americans and hence, display their feelings more readily, even if those feelings appear to be rude.

4. How would you explain the behavior of his former secretary?

Under the traditional French hierarchical system, education and where one was educated dictated organizational position. As indicated in the case, people who held secretarial positions generally held Baccalaureate degrees. Hence, John's secretary earned her position by virtue of her degree. The work that John was asking her to do was clerical in nature and should, according to the French hierarchical system, be performed by someone without a degree. Hence, the work request was an affront to Monique.

It should be noted that the traditional hierarchical system of job placements is also in transition. According to the interview with Mr. Christian Pierret, "In short, our educational system is far removed from the ivory-tower model that is sometimes attributed to us." (Deneire and Segalia, 2002, p. 26). Additionally, President Sarkozy, who was elected in 2007, made a very public exception to the educational hierarchical practice. "With seven women in a cabinet of 15, only two cabinet ministers how went to the elite Ecole Nationale d' Administration, and the first Frenchwoman of North African origin in a top post (Rachida Dati, the justice minister whose mother was a cleaning lady), Mr. Sarkozy has stunned those who expected an ideological president. He has put merit before loyalty." (Economist, 2007).

5. Evaluate the appropriateness of John Williams' approach to training his French sales staff. Given the French cultural values, what might he have planned on doing differently? What should John Williams do now with respect to the training?

The training session clearly did not produce the results that Williams has intended. The creative ideas that he hoped would have been generated did not materialize. The sales people did not seem comfortable discussing ideas in groups and did not appear to appreciate the fact that time was of the essence.

Williams should have created as much structure as possible for his sales force. This could have taken any number of formats such as a web site that provided clear directions on what to do in as many foreseeable situations as possible. This approach would be most consistent with the French values, such as power distance and uncertainty avoidance, discussed in the preceding questions. The web site (or printed materials) could have addressed both the technical as well as interpersonal sales issues. Williams could also have created a very structured on-line quiz that each sales person would need to pass before being certified to sell the new text kits.

At this point, John could implement the above ideas in the context of a follow-up to the failed training session. The imposition of structure might come as a relief to the French sales staff after attending what they might have considered a very ambiguous conclusion to their training session.

6. If you were Michel, what would you advise John about his leadership style?

The majority of the cultural characteristics along with the classic work of Sorge (1993) clearly indicate that the French accept the unequal distribution of power and centralization of decision making. French employees tend to avoid risk, prefer strong authority, conformity to rules and regulations yet reserve the right to question rules that threaten their individuality. This paradox was described by Sorge (1993, p. 72) who stated: "…. The French individualist tries to achieve a perfection within a protective niche provided by a stable organization". Hence, he concluded, the French tend to prefer formal organizational characteristics that protect individuality through rules and regulations. This preference for structure and direction applies to both organizational structure and leadership. Thus, Williams would be best advised to put away his American style of participative management and adopt the hierarchical, top down, autocratic management style preferred by the French.

7. At this point, what should John do to ensure that the timely introduction and distribution of the test kit in France?

The combined responses to the above two questions should provide some insights here. Additionally, creative students may generate a host of other suggestions that would be culturally consistent with the French work force.

8. What should John Williams do, if anything, with respect to the issues such as exercising his right to change the number of hours worked and getting rid of the practice of paying for lunch?

French labor laws are viewed as a way to protect the French worker. Given the importance of eliciting his staff's commitment to the product launch, Williams should not, at this point, make significant changes in office policy. While the lunch tickets appear to be an unnecessary expense, motivational theories, such as Equity or Expectancy Theory, indicate that removing an expected perk would most likely result in lowered effort and performance. According to Hofstede's cultural characteristics, the French are relatively Feminine (as opposed to Masculine) indicating a high value on the quality of life. Clearly, a free lunch and a long vacation would be seen as contributing to this value.

9. Evaluate the pre-departure expatriate training that John Williams received from Gene Life. Was it sufficient to immediately step into the job of Directeur Général? Upon his arrival in Paris, what did John do to facilitate his working with the French? What could he have done differently?

While Williams did receive language training, it was apparent that he did not receive any education in the area of French labor laws or the French culture. Effective pre-departure expatriate training should have covered these two important components since they would have given him a solid foundation for taking over as the Directeur Général.

To his credit, upon his arrival in Paris, he did contact his old classmate Michel DeVos. However, Michel's initial advice focused on language, history, cuisine and wine. It was not until well after his problems emerged that Williams again sought Michel's assistance. On their second meeting Michel provided invaluable insights into his view of the differences between American and French managerial cultures.

In the absence of appropriate pre-departure expatriate training, an on-site mentor would have facilitated John's transition to his new leadership position. Michel DeVos could have provided that mentorship.

10. Did John Williams have the potential to be a successful expatriate manager in France? In other words, did he have the characteristics needed to be an effective global manager or leader?

There are many lists of characteristics considered to be necessary to succeed as an American expatriate manager. If desired, a distillation of these characteristics, which were compiled from recent research, can be given to the students to facilitate their analysis. This chart is in Appendix 3. Please note that the importance of these qualities can differ between host country cultures (e.g. Neelankavil, Mathur & Zhang, 2000).

Student opinions of John's prowess as a successful expatriate manager will be varied. However, their analyses will provoke an important discussion about the characteristics needed to work and manage abroad.

EPILOGUE:

John accepted the fact that his secretary had quit her job because of his lack of knowledge about the French labor laws and the status system. He did not make this mistake again when he hired a new secretary. Ultimately, Williams was successful by becoming a "French" manager. He recognized that he should not expect contributions or creative ideas from his staff or his sales organizations. He gave very specific orders to be carried out by his subordinates, and did not criticize them when they did not work. He learned by doing, and often lamented that his trial and error system of management seemed to be mostly learning from errors.

This relatively autocratic approach was used in a second training session where John gave clear instructions on what was expected of his sales people. The training included many potential sales scenarios along with the most "appropriate" response. The day-long session was reinforced by a creative web site that included not only extensive technical information but also specific guidelines for approaching a physician and closing the deal. While John missed his target date for introducing the testing kits to the medical community, the eventual sales targets were met within six months. Hence, it took longer to effectively train the sales force than John had expected, but the product was successful.

It should be noted that within a year, John was a fully converted "French" manager. He spoke the Parisian dialect, and directed his marketing activities with an iron fist. His subordinates came to respect him, and his sales manager François commented "we were very concerned when you first arrived, but you have turned out to be an outstanding Directeur Général". What he really meant was that John had finally learned how to manage in the way that his subordinates expected him to manage. This autocratic style served him well in France and later in Germany as well.

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APPENDIX 1

Instructions: Use the cultural dimensions delineated by Hofstede, Trompenaars, Hall & Hall, and Kluckhohn & Strodtbeck to identify key similarities and differences between the French and American cultures.

Cultural Dimensions Chart		
Cultural Dimension	Americans	French
Communication		
Task Orientation		
Time/Meeting Orientation		
Power Distance		
Uncertainty Avoidance		
Individualism		
Masculine vs. Feminine		
Universalism vs. Particularism		
Affective vs. Neutral Emotions		
Achievement vs. Ascription		
Time Orientation (Past, Present, Future)		
Nature of Relationships		

APPENDIX 2

Cultural Differences Between Americans and the French		
Cultural Dimension	Americans	French
Communication	Low context, direct and to the point	High context, indirect and subtle.
Task Orientation	Monochronic, serial, doing one thing at a time, resolve one & move on to next, sequentially eliminate alternatives.	Moderately polychromic, doing several things at one time, explore alternatives simultaneously and create new ones.
Time/Meeting Orientation	Schedules and deadlines are important, strict meeting agendas; time budgeted, to cover the agenda.	Schedules are subordinate to relationships. Floating agenda, concurrent mini- meetings. No closure.
Power Distance	Low, decentralized authority and decision making responsibility, consultative or participative management style, flat organizational structures, questioning of authority	High, centralized authority, autocratic leadership and paternalistic management style, many hierarchical levels, an expectation of inequality and power differences
Uncertainty Avoidance	Low, implying risk taking, tolerance of differing behaviors and opinions, flexibility, organizations with a relatively low degree of structure and few rules, promotions based on merit	High, implying avoidance of risk, organizations have clearly delineated structures with many written rules and standardized procedures, promotions based on seniority or age, planning is important, high respect for authority
Individualism	Highly individualistic, leaders are individualist, subordinates accept their own responsibility	Moderately individualistic, the leader is primarily responsible for decisions.
Masculine vs. Feminine	Moderately masculine, assertive, emphasis on material trappings of success, live to work	Moderately feminine, emphasis on quality of life and a people orientation, work to live
Universalism vs. Particularism	Highly universalistic, rules or laws apply to everyone, rules are used to determine what is right; contracts should not be altered.	Moderately particularistic, looking at the situation to determine what is right or ethically acceptable, questioning the law.
Affective vs. Neutral Emotions	Moderately neutral: tendency to not reveal inner thoughts or feelings, preference for personal space, lack of physical contact, gesturing or	Affective: nonverbal and verbal display of thoughts and feelings, small personal space, easy flow of emotions sometimes effusively and vehemently

Cultural Differences Between Americans and the French		
Cultural Dimension	Americans	French
	strong facial expressions	
Achievement vs. Ascription	High achievement implying that status is based upon accomplishments, use of titles only when relevant, respect for superior in the hierarchy based on job performance and knowledge	Moderate ascription implying that status is based upon social position, educational level and place of education (e.g. Grandes Ecoles of France), use of titles, respect for superior in the hierarchy
Time Orientation (Past, Present, Future)	Present and the near future, focus on short-term results.	Past with a predilection for a long time horizon either past or future.
Nature of Relationships	Individualistic implying flexible organizational structures and a preference for participative leadership and individually-based rewards.	Hierarchical implying vertically differentiated organizations, and a preference for autocratic leadership and status-based rewards.

CASHLESS AT PAYDAY: FINANCIAL AND ETHICAL DILEMMAS OF CASH ADVANCES

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CASE DESCRIPTION

The primary subject matter of this case is payday loans, which are cash advances on a customer's next paycheck. Payday loans are a large segment of the subprime lending industry. Students examine the industry model, characteristics of payday loans and the people who use them, along with alternatives to payday loans while they calculate the benefits and costs of the various options. Secondary issues include the effect of a bad credit score on a person's ability to obtain credit and employment and along with reasons why people don't use banks. Finally, students discuss the ethical nature of bank fees and payday loan charges. The case has a difficulty level of three and is designed to be taught in one class period. The case should require one to two hours of outside preparation by students.

CASE SYNOPSIS

This case examines the process, costs and alternatives of payday loans. Payday loans are cash advances against the next paycheck. Payday loans constitute a $45 billion business and cater to individuals who are temporarily short on cash, such as college students. Many college students do not understand the true cost of payday loans while others believe it is their only option. The customer must have a checking account and a steady job. Typically, the individual does not have access to a credit card or other means for a cash advance. Students, in the role of Steve, examine the payday loan taken by Scott, Steve's brother. Steve also investigates the industry to learn how payday loans work along with an examination of the viability and cost of alternative sources of cash. During the evaluation process, students calculate the annual percentage rate of the loan and of alternative sources for the money. Furthermore, students discuss the ethical issues regarding payday loans and other alternative sources of quick cash including bank fees and credit cards.

INSTRUCTORS' NOTES

Recommendations for Teaching Approaches

1. What is the interest cost of Scott's payday loan, especially if he rolls it over for the entire year?

Scott pays $80 to borrow $400 for fourteen days. This is an interest cost of 20% ($80/$400) for the fourteen days. There are approximately 26.07 fourteen day time periods in a year (365/14). Thus, the loan could be rolled over 26.07 times in a year. The annual percentage rate is 20% times 26.07 or 521.43%. The 521.43% interest cost assumes that the borrower pays off the $80 in interest and any new rollover fees after each fourteen day period.

If the interest cost is also rolled over, the annual effective interest rate is 11,484.75%.

$$\text{Effective interest rate} = \{[1+ (5.2143/26)]^{26}\} - 1 = 11{,}484.75\%$$

2: What are the dollar and interest rate costs of an overdraft on a checking account? Are there any ethical issues with the fees that banks charge for overdrafts?

There are two main costs to insufficient funds on a checking account. First, one's credit rating is damaged by the overdraft, which will affect one's ability to obtain future credit. The second cost of the insufficient funds is the cost of the various charges and fees associated with the overdraft.

For Scott, each overdraft costs $30 from the bank fee and another $25 to $35 from the merchant. The average would be $60 per overdraft. It the merchant turns the charge over to a collection agency, the additional fee of $35 would be added. The $60 charge is 15% interest ($60/$400).

Scott could have three overdrafts, the utilities bill, the telephone bill, and the car repair bill. This could add to $180 in fees, much larger than the payday loan charge.

Because the charge is the same whether the overdraft is $1 or $100, people who intentionally overdraft will overdraft one large amount instead of several small amounts to save on the fees. The students may find it unfair that a $1 Coke is charged a $60 insufficient funds charge. This allows for a discussion on whether the bank is actually doing its own version of a payday loan. It allows you to overdraft but at a charge of $30. By calling it a fee, the bank is avoiding the regulations of a loan but for a habitual overdrafter, the fees certainly add up and it takes on the appearance of a loan.

Many students will have a free checking account. However, they may not be aware of the fees associated with insufficient funds. A free checking account might not be free in the way that the students are thinking of it. Overdraft charges are a large part of bank profitability, which is why they charge fees for each overdraft and not based on the dollar amount of the overdraft. After this discussion, most students will realize that banks use free checking as a way to get customers, like a grocery store that has a low price on milk. For customers will good credit or income, the bank will sell the customer mortgages, car loans, certificates of deposits, etc. just like a grocery store will sell meat, vegetables and soda. For the customer just able to stay above the account limit, the bank will charge fees including overdraft fees for those customers with insufficient funds.

Scott could utilize the overdraft protection feature of his checking account. Each bad check would cost $100. The bank charges its insufficient funds charge of $30 plus $5 a day until the balance is paid. For fourteen days, this charge becomes $70. Three bad checks would cost Scott $300. However, Scott does not have a bad check on his credit rating unless he doesn't deposit the money within the time frame indicated by the bank.

If Scott were to write a bad check to the electric company, he also runs the risk of having his electricity turned off. He then must pay a hook-up fee on top of all the other insufficient fund fees.

The bank also has other options for people with savings accounts or credit. If Scott had a savings account with the funds in it, he could link to the account at a substantially lower cost, just the $5 transfer fee.

The line of credit is a $15 and 12% on the amount. For Scott's $400 need, it would be $15 + $400*(0.12/365)*14 or $15 + $1.84 or $16.84. This corresponds to an interest rate of $16.84/$400 or 4.2% for the 14 days.

The cash advance on the bank credit card costs $3 plus 18% of the balance. For Scott, the cost would be $3 + $400*(0.18/365)*14 or $5.76, which is a percentage cost of less than 1%. Because this is below the minimum cost of $15, Scott would owe $15 or 3.75% on his $400 loan for 14 days.

For current bank charges, Bankrate.com (http://www.bankrate.com) conducts an annual survey of interest rates and fees from banks around the country.

3. Scott says that he tried to use the bank but they wouldn't help him. Is his reluctance to go to the bank to see if he can find an alternative justified?

Scott indicated that the bank says was not helpful and made him feel uncomfortable. Scott may have previously been turned down for a loan from a bank. Most payday loan customers have been turned down for a loan from a traditional bank.

According to the 2004 Survey of Household Finances, 10.6% of households do not have a checking account. The reasons are varied but 22.6% of households without checking accounts answered that they didn't have an account because banks intimidated them. This provides some support for Scott's fears.

For many students, the idea of being uncomfortable at a bank will be an unusual idea. However, it allows for discussion on what is it like to be turned down for a loan or having to interact with bank employees after you have had insufficient funds charges.

4: What is the dollar and interest rate cost of using the credit card for Scott's expenses? Why doesn't Scott use a credit card?

If Scott had a credit card that charged 15% annual percentage rate, a $400 charge would cost him $2.30 in interest for the fourteen days. The 15% annual rate is 0.04% daily rate. If Scott paid the balance, when he received the bill, there would be no interest charges. More likely, Scott would not pay the balance at the end of the first month and would incur interest charges each day until he paid the balance. Fifteen percent compounded daily for one year is 16.18%.

$$\text{Effective interest rate} = \{[1+ (0.15/365)]^{365}\} - 1 = 16.18\%$$

If Scott took a cash advance from the credit card, he would be charged 22% annual percentage rate or 0.06% daily. For fourteen days, the $400 would cost $3.38. The interest also incurs interest charges during the fourteen days. Annualized, the effective cost is 24.6%.

Using either a cash advance or a credit charge, the charges are substantially less than the payday loan. Scott doesn't use a credit card because he has had one and fell behind on the payments. After almost declaring bankruptcy, Scott hasn't been able to get a credit card and he decided to live on an all cash basis to avoid accumulating debt like that again. Of course, the payday loan can also lead to a spiral of accumulating debt. For people who use payday loans, credit cards are either not available or they have maxed out the available credit and cash advance.

5. What is the dollar and interest rate cost of the loan from the credit union?

The credit union will charge an interest rate commiserate with one's credit rating. Typically, credit unions charge about 2% less than a credit card for a customer will an account. As Scott points out, if he had been able to save the money, he would not have to get a payday loan. At 13% a year, the $400 would cost $2.00 for the fourteen days. This

amount is just 2.5% of the cost of the payday loan. However, it must be reiterated that the rate that the credit union will charge depends upon one's credit rating and whether or not one has an account with the union.

While Scott currently doesn't have the $400, if he was able to save that amount, he could against the collateral at a substantially reduced rate than the payday loan. Because Scott anticipates that he will have to rollover the loan, it is reasonable to assume that he will need money again in the future. By saving $400, Scott is able to borrow another $400 for a year, not two weeks. This would allow him greater time to get his finances in order.

Scott could also check to see if he is eligible for the 50-day payday loan, which is at a lower interest rate than a traditional payday loan.

6. **Scott indicates that he is worried about losing his job and the health care benefits. He does not want to accumulate so much debt that he has to declare bankruptcy. Is this a legitimate concern?**

Many jobs, especially those that deal with money, require the employees to have a good credit rating. It is a very real concern for Scott that if he had financial problems, he could lose his job. Students will wonder why a government facility would care. Financial distress puts employees under additional stress. The additional stress could cause the employee to be more susceptible to bribes or stealing. Thus, it is important for employees to understand this additional cost to bad credit. One can lose an existing job or not be eligible to be hired based on the credit rating and/or debt levels.

7. **The professor gives some figures on the cost of starting a storefront. Assuming that loans average $400 for 14 days and $20 per $100 interest and fees, how many loans must the store have to earn a 15% rate of return?**

The professor states that an average payday loan store costs about $100,000, of which half is available for lending. If the store was to return 15%, that would be a $15,000 return on the $100,000 investment. Because only $50,000 is available for lending, the interest rate is $15,000 divided by $50,000 or 30%. If the average loan is $400, the store can have 125 loans outstanding, $50,000 divided by $400. Each $400 loan brings in $80 in revenue. If the goal is $15,000 and the revenue is $80, the store needs to make 187.5 loans. Since the store can do 125 loans at any one time, the 187.5 loans is very realistic.

If we assume the store averages 100 loans every two weeks, that is 2600 loans in a year. At $80 a loan, the store would have revenues of $208,000. This amount is much higher than what is required and confirms the belief that payday loans stores have a payback period of less than one year.

The cash flow capabilities of a payday loan store reveal several things. First, the required return of 15% must not be enough to compensate for the risk of a payday loan. The required return must be much higher. In addition, the costs of running a payday loan store must be higher than the $50,000. Finally, there are many stores in order to make payday loans convenient but they must not be loaning out anywhere near their maximum amount.

8. Several states that have capped the amount of interest on a payday loan. Do you think this is correct or should payday loan business be allowed to charge what it wants?

After the states limited the interest rates, payday loan businesses left or dramatically reduced their stores in the state. The students can discuss the benefits and costs of increased regulation. While most students will feel sorry for a senior citizen who may be taken advantage of, other students will believe in a more buyer beware philosophy. The students will learn that is a fine line between regulating an industry and over-regulating an industry. Most students will want a fair solution where the firms can still exist but that the customer understands the risks. One of the keys to a fair solution is full disclosure. If the payday loan companies had to provide the customers with the true cost of the loan, some of the people may not take out a loan. With full information, the decision rests with the customer. However, the information must be presented in a way that the customer understands.

Morgan and Strain (2008) find that after a state imposes a cap, the payday loan stores leave and that consumers are more likely to have overdraft charges and more likely to file for bankruptcy. The Center for Responsible Lending (2008) challenges these findings based on the data selection. The increase in bankruptcy could also be due to the bankruptcy law change and that those that file for bankruptcy would have filed whether payday loans were operating in the state or not.

9. Are there any ethical dilemmas with the payday loan industry?

While student answers will vary, it should be clear to the students that the payday loan business caters to those people who believe that they have no other alternatives. In order to get a payday loan, one must have a job and a checking account. Thus, the customers are employed but not able to make ends meet. Loans of this type are classified as subprime lending.

Because most customers roll the loan over four times, it indicates that the customers do not have the ability to pay back the loan in the agreed upon time frame. The payday loan store is simply able to assess charges and keep the customer in debt. The time frame for repayment is too short for most customers. By keeping customers in debt, the payday loan

store is able to add fees and interest charges; sometimes to the point that the fees and more than the amount borrowed.

It could be argued that credit cards also create an environment of spiraling debt. The payday loan industry is signaled out only because of the high interest costs and fees. Even the banks through its insufficient fund fees are profiting from those that need cash quickly.

Payday loans locate near populations that are more likely to use it, which makes good business sense. Some students will point out that the payday loan store may set up an arrangement where it can draft out of a person's bank account. The emphasis on marketing to seniors and their Social Security checks is another ethical dilemma. Many seniors don't have the mental capability to correctly assess the cost of a payday loan.

Another ethical point is the collection of bad payday loans. Because the payday loan business is able to pass the collection process of to the district attorney's office, it is able to pass part of its risk onto the taxpayers. The payday loan client is assessed the charges for collection further reducing the cost to the payday loan store.

Various laws, such as the Equal Credit Opportunity Act and the Truth in Lending Act, require the customers are aware of the true cost of loans and deceptive practices are not used. One could argue that payday loan customers do not know the true cost of the loans. The payday loan stores would reply that they provide that information whether or not the customer understands it. If payday loans stores had to show the effective cost of rolling over the loans, customers might be more hesitant to use payday loans.

10. What should Scott do?

Most students will answer that Scott should try to repair his credit rating in order to be able to use a credit card. However, Scott makes the point that when he had a credit card, his debt level became so high he feared bankruptcy. Certainly, the credit union and the credit card are cheaper alternatives. The bank's overdraft protection saves Scott the bad check mark on his credit report but he ends up paying $60 to $95, in line with the cost of the payday loan. It is because of the lack of a clear alternative for Scott that makes the payday loan industry so viable and profitable.

By examining the weightings in a credit score, students are able to see that the amount of debt and paying regularly on that debt is most important. For Scott, he has trouble paying on the debt regularly even though he doesn't need to borrow much. The students can discuss the importance of building a good credit score when young so credit is available later when one needs it.

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FEDERAL RESERVE DILEMMA: 1974

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CASE DESCRIPTION

The primary subject matter of this case concerns the dilemma facing the Federal Reserve in the mid 1970s when inflation and unemployment were reaching high levels simultaneously. From a historical perspective, the levels of both inflation and unemployment were reaching post war record highs. Secondary issues examined include arguments about proper policies from a variety of economic modeling perspectives. This case has a difficulty level appropriate for upper-level undergraduate courses and perhaps first year masters' level courses, depending on prior monetary economics background of the student population. The case is designed to be taught in one class period and should require two hours of outside preparation by students.

CASE SYNOPSIS

The mid 1970s experienced a variety of economically profound events. Among these were post Vietnam volatility in U.S. markets, oil price shocks, economically questionable fiscal policies, middle-east unrest, and a period of high unemployment combined with high inflation, confounding the conventional economic wisdom of the day. This case presents background, data and commentary concerning this period, and tasks the reader with deriving "appropriate" policy responses by the Federal Reserve. Readers must discern the uniqueness of the situation from past history, reconcile conflicting policies that had been pursued in the past, either targeting high inflation or high unemployment (not both at the same time), and deal with policy prescriptions that differed among various policy objectives.

INSTRUCTORS' NOTES

Teaching Approach

We suggest using this case in conjunction with coverage of various theoretical perspectives on dealing with separate problems of unemployment and inflation. The textbook remedies are easy to absorb, but the dilemma posed by the case will highlight the conflicting policy prescriptions and introduce the traditional theoretical relationship between inflation and unemployment and the difficulty of dealing with both at the same time.

The case could be used at a variety of course levels, from a brief treatment in principles of economics to advanced Macro levels. The questions are structured to serve a variety of sophistication levels, and have the potential to promote lively discussion in class.

QUESTIONS

1. **What happened to inflation and unemployment in 1973? Why was the situation in 1973 unique?**

   Both inflation and unemployment were rising through 1973. This situation had never occurred in recent U.S. macroeconomic history.

2. **The Employment Act of 1946 instructed policy makers to ensure maximum employment and price stability. What is the dilemma that the Federal Reserve faced in 1974?**

   Utilizing the Phillips Curve, there is a negative relationship between inflation and unemployment in the short run. If the Federal Reserve decided to combat inflation, as it did in late 1973, this could have reduced employment. If the Federal Reserve moved to combat unemployment following the summer of 1974 and the side-effect was higher inflation. The dilemma for the Federal Reserve was identifying the most pressing problem to combat first, inflation or unemployment.

3. **If you were in charge of the Federal Reserve, what policy would you advocate? Justify your answer? (Remember, your stated objectives are low unemployment and low inflation).**

   There is no correct answer. In the short run, any policy designed to combat either inflation or unemployment will aggravate the other. Using the Phillips Curve, there is a negative trade-off between the two in the short run. The objective of this question is to help students understand this trade-off. If the student elects contractionary monetary policy (reducing the growth rate of money) to combat inflation, unemployment may increase. Yet, choosing expansionary monetary policies to combat unemployment may create higher inflation in the short run.

4. **The Federal Reserve responded to the rising unemployment in 1973 by loosening monetary policy. A few months later, they reversed course and tightened monetary policy to combat rising inflation, causing a massive recession. What problems might**

arise if market participants expected the Federal Reserve to succumb to political pressures and change course yet again and reduce the targeted federal funds rate in 1974 or 1975 in response to rising unemployment?

If the Feds vacillation caused an increase in market participants' inflation expectations, then we can experience an increase in unemployment and inflation. This is represented by an upward shift in the short-run Phillips Curve and a reduction in aggregate demand. The result would be a recession that is more severe by creating a rate of unemployment that is higher than would otherwise have existed.

Optional Questions:

5. Which is the greater evil - inflation or unemployment?

The instructor may pose this question to students prior to them answering the case questions. Given their answer to this question, the answers to the case questions should reflect their response.

Advanced Questions:

6. The Fed has three basic tools (reserve ratios, discount rate and open market operations [OMO]) and one rarely used mechanism (margin debt leverage factor) for affecting changes in the macroeconomy, as well as public statements hinting at changes in any of the above. What is the nature of these tools relative to the specific problems present in the economy in 1974?

The Fed can affect system-wide monetary activity with the three policy tools, none of which address specific economic issues. Fiscal policy is much more likely to address specific problems (targeted tax law changes, targeted spending decisions), but the process involves a congressional accord concerning what is wrong and what should be done to fix it- unlikely when political bickering occurs (heightened in 1974).

However, if the only tool you have is a hammer (the general Fed treatments), every problem looks like a nail, even if what you really need to address the specific problem is a saw. This creates obvious side effects when a general policy is implemented in response to a specific problem. Professors can use this question to discuss some specific problems (like oil price spikes) and the inability of the Fed to directly address targeted problems.

EPILOGUE

Starting in the fall of 1973, the Federal Reserve Open Market Committee (FOMC) began to loosen monetary policy in response to the slowing economy, and the Federal Funds Rate fell. However, by the spring of 1974 the FOMC reversed its policy in response to rising inflation at the end of 1973 and beginning of 1974. The effective Federal Funds Rate began to rise. In July 1974 the effective Federal Funds Rate averaged 12.92 percent, signaling the Federal Reserve's commitment to combat inflation.

Through 1974, unemployment rose and aggregate output fell, as the U.S. economy sank deeper into recession. At the end of 1974, unemployment reached 7.2 percent. The FOMC once again reversed itself and eased monetary policy, expanding the money supply. The effective Federal Funds rate fell sharply, reaching 7.13 percent by the end of 1974 and under five percent at the end of 1975. Thus, the Federal Reserve chose to fight slow growth and high unemployment. The result was larger increases in price through 1974. Consumer prices increased over ten percent during 1974.

The price increases diminished during 1975 as the effects of the oil embargo on the U.S. economy eased. Thus, the Federal Reserve's goal of combating unemployment appeared to be the "correct" decision, although actual inflation remained high relative to historical inflation. In addition, unemployment fell slowly through 1975, and the recession reached its trough during the first quarter of 1975. For the remaining three quarters of 1975 real output grew 5.1 percent and unemployment fell to 7.9 percent by the start of 1976.

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ACTIVE INSURANCE, INC.

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CASE DESCRIPTION:

The primary subject matter of this case is strategic management and the organizational decisions related to growth in small businesses. Secondary issues examined include: selecting a growth strategy (internal growth vs. external options); organization culture issues; and the implementation of competitive (focused differentiation) and functional strategies in a service organization. The case has a difficulty level appropriate for junior/senior business students who have completed business core requirements. The course would also be appropriate for graduate business students at the master degree level. The case is designed to be taught in one class hour and is expected to require approximately one hour of outside preparation by students.

CASE SYNOPSIS:

Jeff Ryan, owner of Active Insurance, Inc., faces an important decision concerning the future growth of his business. Ward Stevens, the owner of Ward Stevens Insurance agency, is considering retirement has talked to several individuals, including Jeff, about acquiring his company. Jeff has discussed the possible acquisition with his accountant and together they have several concerns about the potential transaction.

Jeff's primary concern is the difference in the business models used by the two companies. Jeff started Active Insurance ten years ago and the agency has grown steadily to the point that it currently employs fifteen agents. Jeff has worked hard to make Active Insurance a customer-oriented firm and has established policies that make it easy for customers to visit his office and to access products and services. Additionally, Jeff uses agency management software and has implemented several innovative personnel policies that he believes are key to his success. Jeff is committed to training and development and is proud of the fact that he has taken a progressive approach to managing his business.

In contrast, the Stevens agency is a more traditional, slow changing company. The company is well established, with eighteen agents who operate with a great deal of autonomy. However, the agency has not grown materially for a number of years. Mr. Stevens has not updated his operational or personnel practices since he started the firm and does not get involved in the day-to-day functions

of the agency. Customer service, employee training and outside financial advisors all receive low priority from Mr. Stevens. His management philosophy is "if it isn't broke, don't fix it".

So Jeff has to decide. Does he make the acquisition and deal with the operational and cultural differences in the two firms or does he forget the acquisition and focus on internal growth?

INSTRUCTORS' NOTES:

This case covers many issues that are commonly encountered by small businesses. The primary purpose of the case is to contrast the operations of service business that is reasonably successful purposely pursuing a focus differentiation strategy with another service business that has no clear strategy. Other issues that are presented in the case include accounting and related financial reporting, human resource management and decision-making processes that frequently are relevant to small business operations.

DISCUSSION QUESTIONS

1. Describe the major organizational culture differences between the two companies.

From looking at each of the business models created by Jeff Ryan and Ward Stephens it is clear that major differences exist. For example, at Active Insurance, Jeff built a culture that is much more customer focused than the culture of Ward Stephens. From the start, Jeff focused on ease of access for customers. Locating the business just a few blocks off a major roadway, providing ample parking and access for disabled clients are evidence of his commitment to customer service. Requiring agents to work a schedule that included some evenings and Saturdays further demonstrate this orientation.

Jeff's model of requiring customers to come in for an appointment with an agent to set up a policy, rather than issuing the policy over the telephone, further shows this commitment. Jeff stressed building a relationship between agents and customers. Jeff did not believe in using an automated voice mail system. On the contrary, he designed the receptionist job as the top clerical position in the firm. The receptionist was highly knowledgeable, professional and assigned prospective customers to the appropriate person in the agency. Jeff also set up a system so that customers could contact their agent via email. Agents and customers could send and receive documents electronically. His website was very customer focused in that it provided lots of information about all of the companies Active represented as well as bios of agents, a brief history of the firm, and a description of new customer procedures.

Ward Stephens's business model was in sharp contrast to Jeff Ryan's. Stephen's location was difficult to access. Calls into his agency were handled by very inexperienced

high school graduates paid minimum wage. Sales agents at the Stephens agency, most of whom had been with the company between 15 and 25 years, acted with great deal of autonomy compared to the agents at Active who were expected to work a set schedule that included some evening and Saturdays. Active's agents were expected to attend a biweekly meeting during which their sales performances would be compared to one another's. Overall, each of the agent's performance at Active was more closely monitored than the Stephens agents.

Another difference between the two agencies is in the way in which new personnel were hired and trained. Jeff believed in testing and validation. He used panel interviews involving himself, his agents and Customer Service Reps and used structured questions. He devoted a lot of time to training new hires and encouraged and supported continuing education. Ward Stephens, in contrast, did all of the hiring and didn't believe in training. His philosophy was "sink or swim" on your own since that was the way that he'd come up in the business.

Another sharp contrast between the two models was in the use of "non-compete contracts." Jeff Ryan used them for all agents while Ward Stephens did not. An additional difference between the two agencies was the dramatic contrast in how technology was used. Active used a great deal of electronic communication, documentation, and information systems for control while Ward Stephens did not.

Finally at Active, Jeff Ryan had developed a close relationship with a CPA who had lots of experience with insurance companies. He relied on that person's advice. Jeff provided frequent financial updates to that CPA so that he could stay abreast of his firm's financial performance. Ward Stephens, on the other hand, didn't believe in paying "high" fees to accounting firms. As long as he had positive balances in his checkbooks he figured that his firm was doing all right.

2. Describe what organizational changes you think Jeff Ryan should seek to implement if he acquires the Ward Stephens agency. How should he implement these changes?

Initially Jeff should probably go slowly in implementing any major organizational changes. The major reason for this approach is partly seen in what his CPA told him, i.e." without a non-compete agreement in place what is to prevent the agents from starting their own agency and taking their customers with them?" Essentially what Jeff would be paying for the Ward Stephens agency is the market value of the agency based on the agents' current commission income levels. If those agents leave the firm they will take their customers with them. Then Jeff will have lost a great deal of business. Basically their business and whatever business Ward Stephens himself has is what Jeff will purchase.

In his first meeting with the new employees after the acquisition, Jeff should proceed slowly in introducing his business model. Most likely many of the Stephens agents will be aware of the operating practices at Jeff's agency and will be somewhat fearful of the changes that might be made. Especially important to the agents will be their client base and income potential. None of the agents will want to lose any income. Most importantly, Jeff should be careful about not losing his top performers. Jeff needs to reassure them that no one's pay will suffer. In fact he should stress to the agents that they will each have the opportunity to significantly boost their incomes using the support systems that Active can offer them.

The sensible thing for Jeff to do would be to start making organizational changes slowly. At Stephens, the agents are much older and more experienced than Active's agents. They have been doing their jobs for a long time and are very likely to resist any dramatic, quick changes that Jeff might want to put in place. A first, low risk step might be to start implementing his accounting system as he merges the Stephens' agency into his own business. The merger of the two systems will likely require Stephens' long time bookkeeper to either learn the new system, be re-assigned new responsibilities, or possibly gracefully retired. How this woman is treated will be a strong signal to others for how the new "boss" will treat everyone else.

As this new accounting system comes on line, Jeff should gradually make organizational changes in the receptionist and Customer Service Representative positions to bring them in line with how he uses receptionists and Customer Service Reps. As he makes these changes he could begin to ask Ward Stephens's agents and staff to help him do selection interviews. Probably the toughest change he will have to make will be related to converting Stephens's customer base over to the customer tracking software system that is used at Active. This changeover should include lots of teaching, talking and support for the older Stephens's agents who have always been accustomed to a lot of autonomy.

Jeff Ryan should carefully plan for a few meetings with all of the Ward Stephens agents to explain to them how each can increase his/her income by using the new system. Other high performing Active agents can be enlisted to help answer questions and act as coaches. Jeff should not view initial complaints or vocal negative comments as resistance. On the contrary, if the Stephens agents are willing to voice their concerns and complaints about the changes to Jeff, at least he has developed a relationship in which the agents trust him enough to be honest with him.

3. Describe the degree to which Jeff Ryan utilized a strategic planning process to identify and evaluate potential acquisition targets.

Some of Jeff Ryan's major organizational decisions were the result of following a strategic management process, while others were not. He did not regularly review the

strategic direction of his company, the societal environment of his business setting or the task environment that involved stakeholders in his industry. He did seek input from Duane Early, his CPA, and his senior agents regarding matters of strategic importance before making most major decisions. Jeff had identified that he wanted to pursue a directional strategy of continued growth and, through a scanning process he employed while dealing with insurance brokers, he selected a business strategy that differentiated his agency from others based on the elements of superior customer service and making communications with the agency as convenient as possible. He implemented this business strategy by selecting a convenient location, providing extended business hours, instituting a new customer protocol that involved meeting with an agent to assess all the customers' insurance needs, and facilitating communication between customers and agents. In addition, he instituted selection and training programs for both agents and customer service representatives, and conducted regular sales meetings to improve service and promote teamwork.

While, utilizing strategic management techniques in many areas, such a process was not followed in the case of considering the acquisition of Ward Stephens, Inc. Jeff did not first identify a location and type of agency that would be the best strategic fit for his agency. Instead he simply reacted to a solicitation from a person eager to sell an agency. This distinction is important. Many acquisitions are the result of management reacting to solicitations by persons such as commercial real estate sales personnel, business brokers or business owners trying to sell their business themselves. If Jeff were to undertake a strategic management process in identifying an acquisition target he and his team of advisors would first identify what type of agency characteristics would be result in the best strategic fit and then consider numerous alternative agency acquisitions based on decision criteria based on those characteristics.

4. Jeff Ryan is pursuing a growth strategy for his agency and is considering horizontal integration (acquisition) as the vehicle for growth. Describe the pros and cons of this approach versus an internal growth strategy.

The advantages of following a horizontal integration strategy (purchasing a competitor, or a firm in the same business but in a different location) are two fold. First, the strategy allows the purchasing firm to quickly expand its business to new customers and/or new geographic areas. Secondly, the acquisition may provide the acquiring firm with complementary products or services that they can now offer to their existing customer base. Both cases are instant sources of new revenue.

In most cases, the acquiring firm buys the physical assets of the acquired company and also inherits the existing employees as part of the purchase. This means (in Jeff Ryan's case) doubling your physical locations and adding a significant number of new employees.

These additions could be a positive or a negative depending upon the state of the physical assets and the quality of the new employees.

Obvious problems associated with any acquisition are duplications or effort (for instance, two office managers, two payroll clerks, etc.) and differences in processes, software, records keeping, forms used, etc. In many cases, the negotiations and purchase are much easier tasks than the implementation of the agreement and the subsequent merging of the two firms.

The advantage of an internal growth strategy is the continuation and refinement of existing functional strategies as the firm grows. With an internal growth strategy, the owner/leader has a great deal of control on how and where the growth occurs. New employees can be carefully selected and the new members can be trained in the way the firm prefers to operate. That means proven processes and controls are more likely to be applied uniformly.

Additionally, the leader has the opportunity to shape the organizational culture to match his/her personal values system. Policies designed to govern employee behavior and to provide the best possible experience to customers can be easily communicated and monitored.

The disadvantages of internal growth are primarily related to pace and the time required to accomplish organizational goals. Even in a fast-growing company it might take 5-7 years to reach the level of revenue that can be accomplished by the acquisition of a like-sized firm. New employees must be hired and trained to keep up with organizational growth, which may prove to be a difficult task if the company is growing at an extremely fast rate and qualified employees are hard to find. New markets have to be identified, and it is the current employees must develop the new products and services needed to support growth objectives. The company may eventually reach the same level of revenue provided by an acquisition, but it will normally require much more time.

5. What are the facts in the case that argue in favor of the acquisition? What are the facts that argue against the acquisition? If you were Jeff would you make the acquisition? Why or why not?

Factors favoring the acquisition:

a. The Stephens agency has substantial customer base and is well established in its marketplace.
b. The Stephens agency employs eighteen agents (Jeff currently has fifteen) and they are all experienced.

c. Mr. Stephens has a loyal, dedicated bookkeeper who has been with the agency for twenty years and who has a good understanding of how the Stephens agency works.
d. Revenue would increase significantly since the two firms are about equal in size and the company would immediately acquire a second location.
e. The price Jeff would have to pay is market value based upon current commission levels and Jeff believes he could quickly increase commissions by employing his management philosophy.

Factors against the acquisition:

a. Jeff would be paying for an agency based upon an expected stream of income that is far from certain.
b. The Stephens office is located in an old part of town and the population has relocated to outlying areas.
c. The operating strategies and cultures of the two organizations could not be more different.
d. Jeff is a very hands-on leader with progressive ideas about agency management while Mr. Stephens sees himself as a "good-will ambassador" and believes that "if it isn't broke, don't fix it".
e. Jeff works closely with his agents and is actively involved with their training and development. On the other hand, Stephens rarely interacted with his agents and they operate with a great deal of autonomy.
f. There is no guarantee that the Stephens agents will stay with the firm after the acquisition since there is not a non-compete agreement in place.
g. The operational practices of the two firms are radically different. There are major differences in the areas of selection and hiring of new employees, the use of technology, the way employees interact with customers and the extent to which they seek outside help and advice on financial matters.

ACCOUNTING FOR BUSINESS COMBINATIONS AND THE CONVERGENCE OF INTERNATIONAL FINANCIAL REPORTING STANDARDS WITH U.S. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES: A CASE STUDY

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CASE DESCRIPTION

The primary subject matter of this case concerns changes in accounting for business combinations and the convergence of International Financial Reporting Standards (IFRS) with U.S. Generally Accepted Accounting Principles (GAAP). The case focuses on the effect of the changes on financial statements of global entities, as well as strategic decisions made by company executives.

Secondary, continuing significant differences between U.S. GAAP and IFRS and future potential developments in accounting for consolidated multinational entities are explored. This case has a difficulty level of three to four and can be taught in about 50 minutes. Approximately three hours of outside preparation is necessary to fully address the issues and concepts. This case can be utilized in an Advanced Accounting course, either on the graduate or undergraduate level to help students understand changes in and differences between U.S. GAAP and IFRS. Two sets of questions address U.S. GAAP and IFRS and include researchable questions that are especially useful for a graduate level course. The case has analytical, critical thinking, conceptual, and research components. Utilizing this case can enhance students' oral and written communication skills.

CASE SYNOPSIS

Financial reporting in the U.S. is changing dramatically. Consistent with the Securities and Exchange Commission's proposed "Roadmap" (SEC, 2008), the U.S. likely will join the more than 100 nations worldwide that currently utilize International Financial Reporting Standards (IFRS), and require the use of IFRS in the U.S.

Because of the globally widespread use of IFRS, multinational entities with subsidiaries that prepare IFRS-based financial statements already have to be knowledgeable about IFRS as well as the current differences between U.S. GAAP and IFRS. Fortunately, the Financial Accounting

Standards Board (FASB) and the International Accounting Standards Board (IASB) are working together to bring about convergence between the two sets of accounting standards.

Recently, FASB and the IASB issued new and revised several existing standards that eliminate many differences between U.S. GAAP and IFRS with respect to business combinations and consolidated financial statements. However, some significant differences persist. Until the SEC makes a final decision regarding the mandatory use of IFRS, and during the proposed multi-year transition period, current and future accounting professionals must continue to keep abreast of changes in U.S. GAAP, be knowledgeable about differences between U.S. GAAP and IFRS, and, at the same time, prepare for the likely transition to IFRS. In addition, company executives should be cognizant of developments that may affect their strategic decisions as the U.S. moves toward a likely adoption of IFRS during the next five years.

This case focuses on the effect of changes in financial reporting for business combinations. Changes as well as continuing differences between U.S. GAAP and IFRS are explored. Secondarily, strategic decisions arising from the changes and the likely future adoption of IFRS are addressed. This case, which can be utilized in Advanced Accounting on either the graduate or undergraduate level can enhance students' analytical, technical, critical thinking, research, and communication skills.

INSTRUCTORS' NOTE

Teaching Strategies

Accounting educators play a critical role in preparing current and future accounting professionals for the nearly certain adoption of IFRS for financial reporting in the U.S. For several years prior to the actual required adoption and during the expected multi-year implementation period, accounting professionals must be knowledgeable about U.S. GAAP and IFRS and educators must continue to teach U.S. GAAP, while at the same time progressively implementing IFRS into their curriculum. Given the scarce time available for teaching the many topics associated with financial accounting this is not an easy endeavor and is particularly difficult with respect to complex areas of accounting.

Accounting for business combinations and consolidated entities represents a complex issue typically taught in an advanced accounting course. FASB and the IASB recently eliminated many differences in accounting for business combinations; however, some significant differences continue to exist. Effective for the 2009 fiscal period, companies must apply the provisions of one new and one significantly revised accounting standard - FASB Statements FAS 160 and FAS 141R.

This teaching case accomplishes several goals. First, fundamental concepts as well as changes brought about by FAS 160 and FAS 141R are identified and contrasted with the prior rules. Second, significant differences between U.S. GAAP and IFRS are identified. Third, the effects of the changes to U.S. GAAP and the effect of the likely adoption of IFRS are explored. The case

focuses on the financial statement effect as well as business and strategic considerations and challenges that may arise from the changes in U.S. GAAP and the likely adoption of IFRS. Fourth, the case provides a brief overview of expected future changes and developments in the area of business combinations.

Two independent sets of questions - one focusing on changes in U.S. GAAP, and one focusing on the effect of the adoption of IFRS - provide flexibility. Both sets include some researchable questions that are particular useful for graduate level courses. The questions are independent, providing instructors with significant choice and flexibility to match assignments with the needs of their class.

In-class discussions regarding issues that may arise prior to and during the convergence to IFRS and strategic decisions arising from these issues should be encouraged. The case can be solved in groups during class time, or assigned as an individual or group project. Students should review the case prior to discussion in class. Approximately three hours of outside preparation is needed if the case is utilized as an assignment. Detailed in class discussion will require about 50 minutes. Students should be encouraged to focus not only on the financial statement effects, but also on the long-term strategic consequences for global entities.

SUGGESTED ANSWERS TO QUESTIONS

U.S. GAAP Questions:

1. How will adoption of the new accounting standards (FAS 141R and FAS 160) affect Klugen Corporation's financial statements in the forthcoming reporting period?

In the forthcoming balance sheet, non-controlling interest will be reclassified as equity. This will result in an increase in stockholders' equity. In the forthcoming income statement, income attributable to non-controlling shareholders is no longer classified as "other revenue, expenses, gains and losses," instead, non-controlling share of income will be deducted from consolidated income to derive income attributable to controlling shareholders.

2. Utilizing the 2008 numbers, prepare (1) a partial income statement starting at income from operations and (2) the equity section of the balance sheet consistent with the requirements of FAS 141R and FAS 160 (FASB Accounting Standards Codification sections 805 and 810).

Exhibit 1 Partial Income Statement under New Accounting Standards (using 2008 results):		
Operating Income		$ 10,250
Other Income (Expense)		
Interest expense	(820)	
Investment income	405	(415)
Income before income tax		$ 9,835
Income tax		3,250
Consolidated Net Income		**6,585**
Non-controlling interest in Net income		**(1,010)**
Income attributable to Klugen Corp.		**5,575**
Basic Earnings Per Share		$2.08
Diluted Earnings Per Share		$1.92

Exhibit 2 Partial Balance Sheet under New Accounting Standards (using 2008 results):		
Stockholders' Equity		
Common stock ($1 par, 100,000,000 authorized, 60,000,000 issued)	60	
Additional paid in capital	13,095	
Retained earnings	14,588	
Accumulated other comprehensive income	(2,044)	
Non-controlling Interest	5,000	
Total Stockholders' Equity		**30,699**

3. How will adoption of FAS 141R and FAS 160 affect Klugen Corporation's financial statements in the long-run?

In addition to the changes mentioned in Question 1 above, any subsequent acquisitions will be valued at fair market value. This means that even if Klugen acquires less than 100% of a company, all assets and liabilities will be revalued to total fair market value.

In addition, any goodwill and non-controlling interest will be carried at fair market value. This likely will increase total assets and total stockholders' equity. In addition, if depreciable or amortizable assets are revalued to a higher market value, subsequent depreciation and amortization will increase and thus decrease income. Furthermore, Klugen will have to expense the direct as well as the indirect costs of future business combinations. This likely will decrease income during the year of acquisition. In addition, in-process research and development acquired as part of a new business combination can no longer be expensed, but instead, has to be capitalized as intangible asset. This will increase assets and income during the year of acquisition, and increase amortization and decrease income in subsequent years.

4. What key financial ratios will be affected by the adoption of FAS 141R and FAS 160? What will be the likely effect?

Adoption of FAS 141R and FAS 160 likely will decrease the company's debt to equity and debt to asset ratios. This occurs because equity increases through the reclassification of the non-controlling interest. For subsequent acquisitions, the likely increase in assets and equity due to the revaluation to higher market values will further decrease these ratios.

5. What additional estimates have to be made consistent with the new accounting standards?

Klugen holds investments in several non-consolidated entities. If at a future date, the company acquires sufficient additional shares to give it control over these entities (i.e., an acquisition in stages), the net assets associated with previously acquired equity will have to be revalued. This will require significant estimates.

6. Could any of the recent and forthcoming changes affect the company's acquisition strategies and potentially its growth?

Future acquisitions will have to be valued at full market value. This will increase goodwill, non-controlling interest, and, if assets are undervalued, increase assets. If assets are overvalued, assets will decrease by the full amount. Significant costs typically are associated with acquisitions. These will have to be expensed as incurred, decreasing income. If an entity is trying to meet earnings targets, this could affect the acquisition decision.

7. What were FASB's primary reasons for issuing FAS 141R and FAS 160? (Research question)

As expressed in FAS 141R and FAS 160, FASB issued the standards to improve the relevance, reliability, and comparability of financial statements. In addition, FAS 141R and FAS 160, as well as the revisions to IFRS 3 were part of the FASB/IASB joint projects to facilitate convergence in this area of accounting (FASB, 2007).

8. What are qualifying SPE's? Do they exist under IFRS? What is the effect of FAS 166 eliminating the concept of qualifying SPEs on the convergence of accounting standards?

According to the FASB Codification, qualifying SPE's are trusts or other legal entities that meet the conditions set forth in FAS 140 (FASB, 2009, www.fasb.org). These entities typically involve securitization of mortgages. IASB does not recognize the concept of qualifying SPEs. Thus, the elimination of qualifying SPEs by FAS 166 facilitates convergence in this area of accounting.

9. FASB and IASB recently issued an updated Memorandum of Understanding. Retrieve the updated memorandum and identify several issues that the two standard setting boards are jointly focusing on to facilitate convergence. (Research question)

The areas listed in the Memorandum of Understanding are: leases, financial statement presentation, revenue recognition, fair value measurement, financial instruments, liabilities, and the conceptual framework (Completing the 2006 Memorandum of Understanding: A progress report and time table for completion, Sept. 2008, www.iasb.org).

IFRS Questions:

1. From the consolidation perspective, what would be the likely overall effect of adopting IFRS on the company's financial statements?

The new and revised standards issued by FASB and IASB as part of their joint project eliminated many differences. However, some differences persist and would affect Kugen's financial statements upon adoption of IFRS. Specifically, IASB allows a choice in valuing non-controlling interest at fair value either (a) including a share of goodwill, or (b) excluding goodwill. This will affect total assets and equity of the consolidated entity. In addition, since exercisable shares are included under IFRS in determining control, a currently unconsolidated entity could be subject to consolidation under IFRS. Contingent assets acquired in an acquisition are not recognized under IFRS but may be recognized under current U.S. GAAP. This difference could increase assets.

2. What potential effect would arise if Klugen were to select the option under IFRS 3 to value non-controlling interest at the proportionate share of its subsidiaries' net identifiable assets?

If Klugen adopts IFRS and chooses to value non-controlling interest at the proportionate share of its subsidiaries' identifiable assets, the amount of goodwill recognized would be lower, and so would be the valuation of non-controlling interest. This would decrease total assets and equity under IFRS compared to current U.S. GAAP.

3. Do you believe that an impairment of goodwill would be more likely under IFRS or under U.S. GAAP? Why, or why not?

Impairment of goodwill would be more likely, and - if it occurs - higher under IFRS than under U.S. GAAP. This is the case because of the difference between U.S. GAAP in identifying and measuring impairment. The two-step approach under U.S. GAAP makes it less likely that an impairment will occur than the one-step approach under IFRS. In addition, under IFRS, the cash-generating unit is assessed for potential impairment, while under U.S. GAAP, the reporting unit is assessed. Cash-generating units (the smallest unit that has independent cash flows) are typically smaller than reporting units. Under U.S. GAAP, impairment of one cash generating units within a reporting units may be offset by higher market values of another cash-generating unit. Thus, impairment is more likely under IFRS than under U.S. GAAP.

4. What challenges would arise for the accounting staff if the company adopts IFRS? Do you believe that he company is making progress toward meeting some of these challenges?

The main challenges would arise from (1) the need to train the accounting staff, (2) converting the accounting information system, and (3) maintaining a dual system of information. With respect to training, Irma and her staff appear to be making significant progress by implementing periodic training sessions. With respect to the IT system, more information would be necessary. Based on the proactive attitude of the CFO, one may reasonably assume progress in that area as well. Maintaining a dual system for the few years after and during the transition period will be costly and require additional accounting staff resources.

5. What opportunities would arise for the accounting staff if the company adopts IFRS?

Adoption of IFRS and advance training will create significant professional opportunities for the accounting staff. Knowledge of both U.S. GAAP and IFRS will provide many opportunities for accounting staff in the U.S. and abroad; professionals with knowledge of both accounting standards will be in high demand for many years, as U.S. companies prepare for the adoption of IFRS. Accountants who are knowledgeable regarding IFRS will have globally marketable knowledge.

6. What other (non-staff related) factors should Klugen Corporation consider prior to adopting IFRS? Differentiate between advantages and disadvantages.

In addition to staff related issues and training, Klugen Corporation may want to consider investor education, total short-term and long-term costs, future acquisitions, and access to global capital markets. Investor education will be important, particularly if the company adopts at the earliest possible point in time. Klugen will also have to consider the short-term and long-term costs of implementing IFRS. In the short-run, costs will be higher; however, in the long-run, the costs of issuing consolidated financial statements likely will be lower because the company will not have to consolidate financial statements that are based on different accounting rules. In addition, the company likely will enjoy easier and perhaps less costly access to global financial markets.

7. Two of Klugen's non-consolidated entities regularly grant stock options to its employees. How could this affect Kugen's accounting for these entities under IFRS?

Under IFRS, exercisable shares are included when determining whether an investor has obtained control, while under U.S. GAAP these shares are excluded until exercised. The effect on Klugen's accounting will depend on who holds the options and the magnitude of the options involved. If Klugen holds the options, a previously non-consolidated entity may become subject to consolidation. On the other hand, if non-parent investors (e.g., employees) hold the options of a currently consolidated entity, the subsidiary could fall below the consolidation threshold. Thus, in either case, Klugen's accounting and financial statements could significantly be affected by this difference between U.S. GAAP and IFRS.

8. As indicated in the case, Irma previously highlighted some other significant differences between IFRS and U.S. GAAP. Research the issue and find three (3) differences (other than those related to business combinations). You may want to consider accounting for inventory, extraordinary items, property, plant and equipment, and research and development.

A. Inventory: While U.S. GAAP permits the use of the LIFO inventory cost flow assumption, IFRS specifically prohibits use of LIFO. In addition, the lower of cost or market (LOCM) rule is applied differently under IFRS. While under U.S. GAAP, replacement cost generally defines market value, under IFRS, market value is defined as the inventories' net realizable value. Furthermore, inventory write-downs under the LOCM rule can be reversed under IFRS; this is prohibited under U.S. GAAP.

B. Extraordinary items: The classification of extraordinary items, which is a valid income statement classification under U.S. GAAP, does not exist under IFRS.

C. Property, plant and equipment: IFRS allows a choice in the valuation of these long-lived assets. Specifically, companies can value property, plant and equipment at current market value, or at cost less accumulated depreciation. Under U.S. GAAP, revaluation to market currently is not permitted. Furthermore, impairments of property, plant, and equipment can be reversed under IFRS, but not under U.S. GAAP.

D. Research and development costs: Under both U.S. GAAP and IFRS, internal research cost must be expensed as incurred. However, under IFRS, development costs can be capitalized if specific criteria are met. This is prohibited under U.S. GAAP.

(An excellent source of summary information is available from Deloitte; IFRSs and U.S. GAAP A pocket comparison. Available from http://www.iasplus.com/dttpubs/0809ifrsusgaap.pdf.)

9. Assume that the SEC provides a choice in the timing of the adoption of IFRS. What ethical issues could arise for the CFO in deciding whether to adopt IFRS at the earliest possible, or at a later required date? (Research question)

The timing of adoption of IFRS may be influenced by a desire to manage earnings. Overall, adoption of IFRS tends to increase net income, total assets, and total equity. This may be a contributing factor to some company's adoption decision. Accounting choices made in order to manage income is considered earnings managements, which is undesirable.

10. Review comment letters received by the SEC regarding its Roadmap. List two concerns mentioned by those offering comments. (Research question)

Many comment letters are available on the SEC.gov website. Students can access comments at http://sec.gov/comments/s7-27-08/s72708.shtml. Some of the concerns involve the cost of implementing IFRS (including staff training and IT conversion) and the cost of

the proposed required U.S. GAAP-IFRS reconciliations. Also, some were concerned about the multi-year implementation periods and the lack of IFRS-guidance in some areas of accounting.

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THE SHOPPES AT RIVERSIDE

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CASE DESCRIPTION

This case asks the students to recommend a decision to a group of individuals on whether or not to pursue purchasing The Shoppes at Riverside, even when the purchase price is minimal ($1). It is based on the actual experiences of one of the authors. The Shoppes at Riverside is a unique business located in a historic building in a downtown area. The store occupies approximately 5,500 square feet of space (leased from a local foundation) and subleases space to dealers selling upscale merchandise including art, antiques, home accessories, and gift items. The store charges a monthly rent to each dealer (based on their booth square footage) along with a 10% commission on sales. The students are given basic information provided by the present owner and are asked to evaluate the information given to project monthly cash flows and then to make a recommendation to the potential purchasers. They are also asked to evaluate and suggest other lines of business that might be added to the present business to increase the profitability of the store. This case is appropriate to use in an Intro to Small Business Class as the size of the business is ideal for any course that emphasizes entrepreneurs or small businesses. This assignment can be completely individually or as a group assignment.

CASE SYNOPSIS

The primary focus of the case is a purchase decision. The information given to the students to utilize in formulating their decision includes store sales by month for each of the last three years as well as operating expenses. From the information given, the students are asked to construct pro-forma cash flows for the year 2007 by month based on their assumptions regarding sales and occupancy levels. They are also asked to research other product lines the potential buyers could add to the store to complement the present merchandise presently being sold by dealers. Although the store does collect rental income, there is a cap on percentage rents at 10% of sales which in turn limits the total revenues of the store. The students are given some ideas on lines of business to research within the questions of the case. They may have others they would also like to research.

A second phase of the case analysis would be to break the case into group assignments and have each group research and prepare presentation on such topics as (1) the various type of advertising options and the related costs applicable to small retail businesses in order to develop and implement a marketing plan; (2) the type of business formation available to small businesses

(i.e. Corporation, Sub-S Corporation, Partnership, LLP; (3) additional product lines to add to increase revenues of the business; and (4) the advantages and disadvantages of developing a website and selling "on-line" with this type of business. As a result of the individual and group projects, classroom discussions could be held based on the findings of the groups as well as other current issues faced by small businesses. The advantage of this case is that it presents students with a real-life purchase decision and presents relevant topics for in-class discussions.

INSTRUCTORS' NOTES

Discussion Questions

1. **Table One presents monthly sales data for the last three years. Table Two presents the rented booth spaces and their rates. Based on the sales data, the rental data, and the operating expenses outlined in the case, construct a monthly projection of cash flows by month for the year 2007. It is up to the individual or group to be conservative in the occupancy percentages and sales; use averages; or be aggressive in the projections. Based on the completed cash flow analysis, make a recommendation to the three potential purchasers as to whether they should purchase the business. Include in your presentation, both the advantages and disadvantages (identified from reading the case) of purchasing the business.**

Students can interpret the information in a variety of ways and the results of the cash flow analysis depends on the students' projections of sales (to determine the percentage rents) and occupancy levels (to determine rental income and advertising income). While some of the expenses are fixed (rent and insurance), others are variable and assumptions have to be made as to their amounts. This question could be assigned to groups or individuals and then discussed in class. It would be interesting to see if the students were aggressive, conservative or somewhere in between in their projections. A sample of a projection is shown in Table One accompanying these teaching notes.

A second question asks the students to identify the advantages and disadvantage of purchasing the business. Some of these could include those advantages/disadvantages listed below. The students may come up with other insights.

Advantages

- ♦ The most obvious advantage is the purchase of a business for a nominal purchase fee. The only cash outlay is the initial cash investment in the business to supply cash flow.

- ♦ The store has been in operation for almost ten years and has a name and reputation in the community. It is in an established location in an attractive building modified for the specific purpose of selling through different vendors.

- ♦ The rent is actually below market value for other rents in the area.

- ♦ The majority of the store is sub-leased at the present and the rent from the vendors covers the rental payment for the building space.

- ♦ There are large employers in the area that can be target marketed. The store is also across the street from a large hotel and can target tourist traffic.

- ♦ One of the potential purchasers is a CPA and could lend accounting knowledge to the business. She also can prepare all of the business tax returns.

- ♦ The present manager states she would like to continue with the new owners. With present management continuing, there is no need for the new owners to be at the store on a day-to-day business. However, two of the three potential purchasers do not currently work and would have the time to spend at the business as needed.

- ♦ The potential purchasers have other sources of income so that any income from the business does not have to be their primary source of income.

Disadvantages

- ♦ A three-year lease is required to be signed on the building.

- ♦ None of the three potential purchasers have retail experience other than their present booth ownership.

- ♦ Sales have been on a decline since year 2004. The decline is blamed on the road construction in the area but the purchasers do not know if the store traffic will pick up once the construction is completed.

- ♦ Tenants are only required to sign a six-month lease. They can pull out given thirty days notice. There is no guarantee that the present tenants will continue with the new owners.

♦ The uptown/downtown area where the store is located does not have as much retail traffic as the north end of town.

2. **If the three individuals decide to purchase the business, what would be the best type of organization to form? Prepare a presentation to include the advantages and disadvantages of a standard partnership, an LLP, a C corporation and a Subchapter S corporation. Make a recommendation to the owners on your decision.**

There is an abundance of readily available information for the students to research to examine the benefits from various forms of organization.

Partnership – A partnership would probably be the easiest and least expensive type of organization to form. A partnership has to be owned by two or more individuals which fits the situation for the three potential purchasers. There are no formal partnership documents to file with any authorities. However, it is recommended that the partners outline the division of responsibilities and the division of profits in a partnership agreement. The partnership itself is not a taxable entity but does file an informational partnership return. The individual partners report their share of the profits by including a Schedule K in their individual returns. The primary disadvantage of a partnership is the liability issue. With corporations, the liability of the owners is limited to the corporate entity itself. With a partnership, the liability extends to the personal assets of the individual partners for debts of the partnership and negligent acts of the partners or employees on behalf of the business.

Limited Liability Partnership – The primary difference between a generally partnership and a limited liability partnership is the partners are not liable under an LLP for acts of negligence committed by the other partners or employees that are not under their supervision. Income is taxed the same as with a general partnership and is passed through to the owners. However, with a limited partnership the partners may lose their liability protection if they work in the day to day operations of the business. An annual fee is generally required to be paid to the applicable stated based on the number of partners. In some states, an LLP form of organization is only available for professional types of businesses such as law firms and accounting firms

Corporation – A regular "C" corporation form of organization primary advantage is that of limited liability. This means that the individual owners are not responsible for the debts of the business. Of course, many banks that open a line of credit for such a small business may have the owners also personally guarantee the debt. The corporation is a legal entity and incorporation documents have to be filed with the state in which the business intends to

incorporate. State law governs the exact requirements for a corporation but most states require Articles of Incorporation, Bylaws, the issuing of stock certificates, and annual meetings of the board. One of the primary disadvantages of the corporation is the double taxation issue. The business itself pays income tax on the corporate income and then if any dividends are paid to the owners, the owners would then pay tax on the dividends resulting in "double taxation". The owners can get around this issue by paying themselves a salary instead of dividends. Of course with a salary, they would have to pay employment taxes. Since two of the potential purchasers are not currently employed, they may wish to have some salary in order to build up their social security base.

S Corporation – An "S" corporation is a standard corporation that files a special election with the IRS for special tax status. The liability protection is the same of a regular corporation but taxes are not paid at the corporate level on corporate income. Taxes are paid similar to a partnership in that the income is passed through to the owners and the owners include their share of profits on their individual tax returns. There are certain restrictions to obtaining Subchapter S status and they include a limit on the total number of shareholders (100); all shareholders have to be U.S. citizens; and S Corporations cannot be owned by most other forms of businesses including other S Corporations or C Corporations.

3. **One of the lines of business the potential owners are considering is a "Personalization Station" center including custom printed stationery; on-site printing of invitations; customer ordered stationery and invitations sold to dealers printed by the stationery companies; wedding invitations and embossed stationery; monogramming for towels, handbags, and other miscellaneous items (the actual monogramming would be out-sourced); personalized jewelry and other miscellaneous personalized items. The new owners could utilize the space in one of the larger vacant booths to display the merchandise. There is currently only one retailer in the area offering an extensive amount of personalized merchandise and it is in the north end of town. The potential purchasers believe this to be a viable line of business as they are of the opinion that personalized merchandise is very popular in the southern United States. Research the Internet and visit some retailers in your area and interview them on the start up costs for such a business. Develop a presentation to the new owners on the advantages and disadvantages of staring this new line of business.**

With small business owners, the problem is sometimes where to start in obtaining information on the start-up costs for a line of business. Students may want to interview retailers to determine how they started their business and where they found their information to enable them to start-up the business. Most cities or states have small business

development organizations that assist small businesses in this process. Another place to research is the Internet. An abundance of information exists on company websites.

In this particular assignment, the first step could be just to "Google" stationery. A list of online retailers will then appear. By going to individual online retailer's websites, card companies that appeal to the individual performing the search can be identified. It is always a good step to check out the competition or similar companies also and see what they are selling. The next step would be to locate the website for the card companies. Some of the card companies provide information on their website on how to become a dealer.

There are two primary types of card companies. The first is the company that prints personalized stationery, invitations, and cards in-house for their dealers or stores. Some of the more well known are Royal Imprints, Crane, and Embossed Graphics. To become a dealer you generally have to pay a start-up fee ($200) and then purchase individual albums which range from $50 to $250 each. The albums are used to display the samples in the store. The profit to the store is then typically 45% - 50% of the sale. Orders are generally placed by the store online with the use of a dealer number and password. Purchasing from this type of Card Company is advantageous in that there is no inventory to carry and no overhead other than the upfront costs of purchasing the albums.

The second type of company sells designed card stock that can be printed by the store or dealer based on the customer's specific information related to invitations to special events. There are many of these types of companies. Typically, a store can become a dealer just by purchasing a minimum opening order which usually runs from $250 to $300. Once a store purchases the minimum quantity, the card companies furnish sample and catalogs for orders. It is just a matter of how many lines of card stock a store wants to sell that determine the initial investment required. The store would also need a dedicated computer and a high quality color printer. Color printers with multiple ink wells are suggested and can run from $500-$600. There are computer programs that are specially designed for printing invitations. One recommended by multiple card companies is Mountain cow software. The professional version of this software costs approximately $1,000 for one computer.

Students may come up with a multiple of amounts for an initial investment. The advantage of such a start up business such as this is that the store can gradually add lines of stationery to the inventory once they get established. The important part of this exercise is that it teaches student how to do research on starting or adding of business. Often the small business institute in the area can assist them with financial information; it is how to go about learning "what" to sell that is more difficult. In reality, it is also nice to be able to visit the merchandise marts with showrooms. In this particular case, the invitation line of business was added to the store once purchased. A wealth of information was obtained from just talking with the representatives of the card companies during a visit to the Atlanta Merchandise Mart. One showroom or rep group may represent between ten and twenty lines

of cards. In visiting a showroom, dealers can pick out the lines they like and order an assortment of cards. Showroom representatives are a very useful source of information

4. **Another type of business the new owners might consider is a lunch time restaurant or a "tea room" as was located in the previous location. A lunch time menu could be a draw for bringing in the type of clientele shopping for art, antiques and upscale gift merchandise. There is a small space that could be utilized for approximately five to six café type tables and chairs that could seat four diners each. The kitchen is not equipped as a commercial kitchen (as required by regulations) and would have to be renovated. Another idea would be to have a local restaurant deliver the food for the day. Interview a local restaurant owner and research other sources to determine the startup costs for opening a small restaurant. Evaluate the advantages and disadvantages and make a proposal to the potential purchasers.**

Some of the advantages and disadvantages identified by the authors are listed below. Some of the students may have experience in the restaurant industry and may have other insights.

Advantages

- The primary advantages would be a draw to bring additional customers into the store.
- A restaurant would bring an additional source of direct income to the store.
- Space is available for the opening of the lunch time restaurant, although the space is limited.
- No additional overhead from the store as the store is already open for retail sales.

Disadvantages

- In order to prepare food at the store, it would require renovation of the kitchen area to adapt it to a commercial kitchen. The alternative would be to bring in food on a daily basis from a restaurant. If the food is brought to the store, then there is the problem of having enough food and the right kind of food ordered on any given day. It would be possible to run out of food or be left with too much food.
- An additional employee(s) would have to be hired for the lunch time traffic as the employees in the store would not be able to handle the restaurant and the store traffic also.
- The store would now be subject to regulations of the Food Administration.

- ♦ The store would lose the space that could be devoted to retail items and possible rented to vendors with a guaranteed rental amount.
- ♦ There is already a Quiznos restaurant below the store and the lunch time restaurant would be in competition with the Quiznos.

5. At the current time, the business does not have any type of on-line presence other than a two page website. The potential purchasers are interested in developing a more informational website and possibly include information on each vendor. Develop a basic plan for designing the website and the information that should be included. Include in your plan, the anticipated cost for the website design. An additional consideration is the ability to update the website on a regular basis. The cost of the plan should include the cost for updates. Another selling strategy that could be presented to the potential purchasers is the feasibility of selling some of the original artwork and antique furniture on-line. This could be accomplished either through the company's own website or through a website service (such as EBay). Research the options available and the advantages and disadvantages of selling such merchandise on-line.

Again, this is a case that requires the student to research the options available. Since the store already has a website and a domain name, they have a start in developing a website. The next step should be to develop a basic layout or site map for the website. Students may have several different ideas on how to plan the website. For example, the home page may have links to individual booths and a web page on each booth. Another alternative would be to group like vendors into one space (i.e. antiques, art, gift items, etc…) with a link from the home page to each sub-grouping. If they are directed by the instructor to include a more detailed plan, it should include design features, more specific content, and the type of graphics to include.

Once the basic design is completed, students can then research pricing and how to develop the design. The price of hosting is typically about $10-$12 a month and there are a multiple of providers including ATT, Yahoo, and AOL. Once a host is selected, the next step in the process is deciding who will actually develop the website design and publish it to the Internet. This can be done internally by the store if someone has the expertise or it can be outsourced. From the authors' experience, the least expensive method would be to utilize some type of site building product such as Yahoo Site Builder Software. This software can be downloaded free if the store utilizes Yahoo for web site hosting. The software is simple to use and does not require any coding. However, it does not have as many bells and whistles as other more developed software. It may be a good inexpensive start for a startup website. It is as easy to use as any publishing software.

A second alternative would be to utilize some type of more advanced software such as Microsoft Expression Studio. The full version costs approximately $699. This is a user friendly program that does not require knowledge of coding html. However, students will have to design some type of navigation map for the website.

An alternative would be to outsource the website design to a free lance designer. It is the authors' experience that the initial develop of a website can average from $2000 for basic develop to $3000 for a website including ecommerce. The advantage of outsourcing would be more advanced website design and the fact an outside designer should have the knowledge necessary to properly test the website for different browsers. The disadvantages would include the higher costs and the additional factor that any changes to the already designed web pages have to be sent back to the designer for completion. However, some designers have an add-on package to allow the client to edit the web pages once completed.

Once the website is published, there is the challenge of developing a plan to drive internet traffic to the website. The students should research the different search engines (i.e. Google and Yahoo) available as well as their relative cost. They may also include in their plan a way to advertise their website link campaigns. Outside designers allow have plans to assist companies in marketing their website. One was developed for this actual company at $215 per month.

The question of selling such merchandise on-line is challenging. There are two basic avenues of selling on-line. The store can develop their own on-line presence through their own website utilizing or they can create an EBay store. Student could research both EBay and similar companies' website to obtain ideas on how this could be accomplished. Because the merchandise is unique, it presents a unique challenge to selling online.

6. Research the type of advertising available to small retail stores in your area. From the information on advertising options available in your area, develop an advertising budget and make a recommendation for allocation of the advertising dollars between newspaper, local magazines (if any), television (local network and cable), radio, billboards, internet and direct mail for The Shoppes at Riverside.

This question might be utilized in a more advanced course as it requires the student to research the available advertising in the area and then to develop an advertising budget. It is a relevant question to small businesses as they have to identify the available advertising and the relative costs before they can begin to budget their advertising dollars.

Unless small businesses utilize some type of advertising agency, the business is on their own to decide the best avenue of advertising. It is to the small business manager's advantage to develop some type of advertising budget. Businesses receive calls on almost a daily basis from newspaper, radio, magazine, and television sales people all trying to get

the business to advertise with them. When students study marketing and advertising, they are typically given the information in a problem. This case suggests they actually do the footwork to find out the local advertising options and rates in their area. The results from this question depend largely on whether the school is in a small town or a large metropolitan area. For example, in the town where the store in this case is located, there is one local daily newspaper, three cable television carriers, three local network television stations, two bi-monthly upscale magazines targeted for the area, several radio stations, and an Army magazine for the local army base. Advertising rates can be very expensive depending on the advertising median. Other advertising options include direct mail, billboards and internet advertising. The case provides for useful advertising research that can lead to classroom discussion on how information on advertising and advertising rates is obtained.

Table 1: Sample of Projected Cash Flows

	Jan.	Feb.	March	April	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Total
Projected Sales (1)	20867	24592	33300	24240	31491	25477	24081	21173	26462	27529	47857	81253	388322
Rental Income(2)	9119	9119	9119	9119	9119	9119	9119	9119	9119	9119	9119	9119	109428
Percent Rents (3)	2087	2459	3330	2424	3149	2548	2408	2117	2646	2753	4786	8125	38832
Adv. Revenue (4)			6100							6100			11800
Total Revenues	11206	11578	18549	11543	12268	11667	11527	11236	11765	17972	13905	17244	160060
Expenses													
Rent	4322	4322	4322	4322	4322	4322	4322	4322	4322	4322	4322	4322	51864
Utilities	800	800	800	800	1000	1000	1000	1000	800	800	800	800	10400
Payroll (5)	3084	3084	3084	3084	4626	3084	3084	4626	3084	3084	3084	2646	39654
Insurance	183	183	183	183	183	183	183	183	183	183	183	183	2196
Janitorial Service	350	350	350	350	350	350	350	350	350	350	350	350	4200
Telephone	300	300	300	300	300	300	300	300	300	300	300	300	3600
Advertising	600	600	600	600	600	600	600	600	600	600	600	600	7200
Operating Expenses	200	200	200	200	200	200	200	200	200	200	200	200	2400
Wrapping Products	417	492	666	485	630	510	482	423	529	551	957	1625	7766
Payroll Taxes (6)	236	236	236	235	354	236	236	354	236	236	236	1267	4099
Gross Receipts Tax	162	73	100	73	95	76	72	63	79	83	144	244	1165
Total Expenses	12247	12233	12433	12224	14133	12453	12421	13896	12276	12300	12768	14191	135544
Proj. Net Income	-1041	-654	6116	-681	-1865	-786	-894	-2660	-510	5672	1137	3054	24216

Table 1: Sample of Projected Cash Flows				
(1) **Projected Sales** based on average sales for the past 3 years (2)**Rental Income** based on current occupancy levels (3)**Percentage rents** @ 10% of sales (4)**Advertising** rates based on current occupancy				
(5) Payroll Expense	Hours	Rate	Gross	
Manager Employee	32	10	$ 320	(Monday - Thurs @ 8 hours a day)
Employee #2	16	8	$ 128	(Two days during the week @ 8 hours a day)
Employees 3 and 4	30.5	7.5	$ 229	(Remaining two days during the week thru Thursday @ 8 hours a day)
Remaining employees	14.5	6.5	$ 94	(Two employees for Friday for 8 hours & 2 employees for Sat. @ 6.50 hours)
Total est. weekly payroll				* There are 3 weeks of payroll falling in May, Aug. & Nov. for the year 2007
Total esti. bi-weekly payroll for 2 wks			$ 1,542	
(6) Unemp. Taxes FUTA of $244 is computed for the first $7000 (.8%) of the manager's annual salary and then for all of the remaining salaries as no other workers meet the maximums				

AUTHORS' NOTE

Certain names and facts have been disguised in this case.

STOLEN DATA AND FRAUD: THE HANNAFORD BROTHERS DATA BREACH

Danial L. Clapper, Western Carolina University

CASE DESCRIPTION

The primary subject matter in this case is an in-depth look at one of the most well known data breach victims of 2008: the Hannaford Brothers grocery chain. This case can be used as a short case illustrating how an organization can become a data breach victim, the type of data criminals are interested in stealing, how they use stolen data to commit fraud and the possible legal consequences of allowing confidential information to be stolen.

To facilitate a more in-depth analysis if desired, the case and discussion questions are grouped into the following dimensions: Credit card data and processes, Credit card fraud and Identity Theft, Technical details of how the criminals accomplished the data theft and the legal aspects of the lawsuits that resulted from the data breach. Any or all of these dimensions can be explored in more depth by either the entire class or different student groups.

The basic case has a difficulty level of one or two and is suitable for a general undergraduate business course. With a deeper exploration of one or more of the above dimensions the case could be used to better understand criminal data theft and fraud in an upper-level accounting or finance course. More time spent on how the data was stolen would be appropriate for an information security course, particularly with an emphasis on information technology. It could also be used in a business law or issues course to explore the legal environment surrounding data breaches, customer notification and possible legal consequences of a data breach. The basic case is designed to be taught in three class hours and is expected to require three hours of preparation by students.

CASE SYNOPSIS

Hannaford Brothers Company is a regional grocery company with stores throughout eastern United States. On March 17, 2008 Hannaford Brothers announced that it had been the victim of a malware attack it characterized as "new and sophisticated" which resulted in over 4.2 million credit and debit card numbers being compromised. In every one of its close to 300 grocery stores in Maine, Vermont, New Hampshire, Massachusetts, New York and Florida the malware had intercepted credit and debit card data after the customers swiped their card at the checkout counters. This stolen credit card data was fraudulently used in at least 1,800 cases in the U.S. as

well as Mexico, Bulgaria and Italy. On March 19, 2008 an attorney in Maine filed a class-action lawsuit against Hannaford Brothers. Other lawsuits followed shortly.

This case explores one of the most notorious data breaches of 2008 – a year which according to one report had more records compromised than the preceding four years combined. Students will learn how the data was stolen, how criminals used the stolen data to commit fraud, the security standards in place to protect data and the results of the lawsuits against Hannaford Brothers.

INSTRUCTORS' NOTES

Recommendations for Teaching Approaches

In the case typology suggested by Lynn (Lynn, 1999) this case is an "Illustrative Case". It illustrates how an organization -- even when it's IT security meets industry standards -- can fail to protect its customer's data when confronted with clever, high-tech criminals. Because it is an illustrative case it was designed to be used to explore a number of quite different dimensions of a data breach.

It is recommended to first discuss the timeline of the key events and responses for the data breach. That timeline is shown in the next section.

Next the instructor can explore any or all of the following dimensions: the nature of credit card data and the processes and entities involved in making a credit card purchase, how criminals use stolen data to commit fraud, how the criminals engineered the Hannaford Brothers data breach, and the legal issues Hannaford Brothers faced after publicizing its data breach. Although the case is self-contained, it is designed to allow instructors to drill down into any or all of these dimensions. To facilitate that deeper exploration, in these Instructors' Notes answers to the Discussion Questions have been grouped as follows: Credit Card Data (1-4), Fraud (5-6), The Data Theft (7-9), and Lawsuits (10-12). Each of these sections contains specific advice and suggestions for that dimension.

This approach gives the instructor a great deal of flexibility to explore the dimensions most relevant to their course. An introductory course for business students may want to use this as a short case with just the material contained in the case. An accounting or finance course may want to further explore the nature of credit card data, the processes and entities involved in the credit card process and the nature of credit card fraud and identity theft. A Computer Information Systems course could further explore the technical aspects of how the data theft occurred, the IT security standards for the payment card industry and how the data breach was able to occur despite the standards being met. Finally, a business law course could certainly do a much more in-depth exploration of the plaintiff and defendants positions in the class action suit and the ruling of the judge on the case.

It is recommended that some in class time be devoted to students working on their associated questions, but much of their preparation time will likely be spent out of class. To facilitate

independent student exploration, the case Reference section has URLS for almost every resource reference used in the case. In most circumstances these references will be all the resources students need to gain a thorough understanding of all the dimensions of this case.

Timeline

Data breach begins: December 7, 2007**.** The data breach begins – unknown to Hannaford Brothers at the time

A problem is detected: February 27, 2008: Hannaford is notified by First Data – which handles transactions for Discover and American Express -- about a high number of fraudulent charges on credit cards which have previously been used at Hannaford stores (Wickenheiser, 2008). The company notifies the Secret Service which assembles a team of computer forensic experts to investigate. The team of over 30 information technology experts works around the clock for over a week before they discover the malware program which is stealing the credit card data.

The malware is identified: March 8, 2008: The company feels that it has identified the malware that has caused the data breach. It then replaces all of the system hardware and rechecks the software (Hench, 2008).

March 10, 2008: Hannaford sent a list of the compromised customer credit card numbers to the major credit card associations.

March 13, 2008: These credit card associations notified their member banks of the compromised numbers – without naming Hannaford Brothers as the source of the data breach

March 17, 2008: After being asked about this incident by Massachusetts officials, Hannaford Brothers general counsel Emily Dickinson delivers a letter to Massachusetts Attorney General Martha Coakley and the Massachusetts Office of Consumer Affairs and Business Regulation disclosing the data breach and some of the details surrounding it. The letter was not released to the public but Hannaford Brothers notified the public with a press release and information pages on their website. (Pereira, Corporate News: Data Theft Carried Out On Network Thought Secure, 2008; Naraine, 2008; Kerber, Hannaford case exposes holes in law, some say, 2008);

March 19, 2008: An attorney in Maine files a class-action lawsuit against Hannaford Brothers. Other lawsuits follow and are later combined into a class action lawsuit.

May 12, 2009: Federal court judge Brock Hornby dismisses all but one of the class action claims against Hannaford Brothers.

Credit Card Data and Process Dimension

This dimension could be explored by one group or two. If two groups are used, the groups could be Credit Card Data (Questions 1-3) and Credit Card Processes and Entities (Question 4). Either of these topics could be explored by any business undergraduate or graduate student – no particular major is required, although Accounting and Finance students may find it particularly relevant.

The Credit Card Data group can rely on the Wikipedia source (Wikipedia, Viewed: June 22, 2009). While Wikipedia may not be the most ideal source, this article does a nice job of explaining some technical material in a clear manner. Other reference sources are going to be hard to come by and tend to be much too technical for the purposes of this case. This topic is the foundation for understanding the Fraud section and getting students to start looking at data with a finer perspective – not all data is equal and if your organization is a victim of a data breach there are very different responses and likely repercussions depending on the exact data that is compromised.

Credit Card Process and Entities is not core to the case and therefore can be treated as optional. However, if it fits with the course, this would be a nice opportunity for students to gain an understanding of what's going on behind the scenes when they or their customers use a payment card for a purchase. The Hannaford Brothers data was stolen during the Authorization step – so it could be the students focus entirely on that step – but again this might be a good opportunity to get a look at all the steps involved from authorization to funds being transferred. It is not a trivial set of steps and students may find it a little eye-opening. The Visa document for merchants (Visa U.S.A. Inc., 2007) is an excellent reference for this and it contains some nice, clear graphics which the students may be able to incorporate into a presentation. The Bank of America source (Bank of America, 2008) also has an excellent graphic showing both the process steps and the entities involved. These two sources will probably be all the students need for this topic.

1. What data is stored on a credit card?

Credit cards contain data contained in two different types of storage: visible data on the surface of the card itself (either printed or embossed) and data stored in the magnetic stripe on the back of the card which can only be read by a card reader. The most important data stored on the card itself is the credit card number (Primary Account Number or PAN), which is typically embossed on the card and the CCV2 which is usually printed on the back of the card.

The information stored on the magnetic strip is called "Track Data". When the card is swiped the data needed to authorize the purchase is read from the tracks. There are three separate tracks, but typically only the first and second tracks or second tracks are used for a credit card transaction. The key data contained in the tracks are:

Track 1 data: 1. Primary Account Number (PAN) – this should be the same as the number that is embossed on the card, 2. Customer Name and 3. Expiration Date.

Track 2 data: 1. Primary Account Number (PAN) – this should be the same as the number that is embossed on the card, 2. Expiration Date.

The tracks may contain additional data, but this is the key data needed for transactions and which must be protected.

Note that of the two tracks commonly used in payment cards (Track 1 and Track 2) only Track 1 has personal identifying information – the card holder's name. So if a criminal steals only Track 2 data – as was the case in the Hannaford Brothers breach – the stolen data can only be used for credit card fraud, not for Identity Theft. This will be explored in more detail in the Fraud section.

2. Which data is used in Card-Present transactions? Which data is used in Card-Not-Present transactions?

In a typical retail setting -- such as the Hannaford Brothers grocery stores – both the customer and their card is physically present for the transaction. This is the "Card Present" situation. In this situation the card is "swiped" as the customer pays for the purchase. In this setting, the non-stripe data is not used as part of the transaction. So the data either printed or embossed on the card is **not** used as part of the transaction. Instead, as the card is swiped the Point of Sale (POS) card reader obtains the data it needs from the magnetic strip on the back of the card. Typically this will be the PAN and perhaps the Expiration date.

For a typical online purchase neither the customer nor their card is physically present. This is the "Card-Not-Present" situation. In this situation the customer reads the PAN, Expiration Date and CCV2 values from the surface of their card and enters them into an online order form. So for an online purchase – the magnetic strip is not used at all – only the data either printed or embossed on the card is used.

3. Why is some of the data printed on the card and some of it stored in the magnetic stripe?

The CCV2 is used to help prevent fraud in "Card-Not-Present" transactions by helping to verify that the customer actually has physical possession of the credit card and not just a stolen credit card number. This is because the CCV2 value is never stored on the magnetic stripe of the credit card (even in encrypted form) it is only present on the surface of the card. (Visa U.S.A. Inc., 2007).

So if magnetic strip Track Data is stolen (as it was at Hannaford Brothers) the thieves would not have the CCV2 values for the stolen card numbers and thus would not be able to use the stolen cards numbers for online purchases. This limits the types of fraud that can be done using stolen track data—which is exactly the purpose of the CCV2.

4. Describe the credit card authorization process and the entities involved.

In a card-present situation like Hannaford Brothers, credit card authorization happens in real-time while the customer waits. When the card is swiped the POS terminal reads the primary account number from the magnetic stripe on the card and sends this (through the store system) on to the merchant bank for permission to proceed with the transaction. The merchant bank sends the number to the card organization and receives an authorization to proceed. Typically the only data needed from the customer card is the PAN and is most commonly read from Track 2 of the magnetic stripe.

The Fraud Dimension

This dimension probably lends itself to a single group of students working on it. No particular major is required, although accounting and finance students might be particularly interested in learning more about financial fraud. An important objective of this case is to illustrate why criminals perpetrate data breaches – which is to use the stolen data to commit fraud. Although this seems fairly obvious, in the process of answering these questions the students will get a clear view of exactly how criminals convert stolen card data into cash. In addition to learning the how of fraud, students will also explore what type of data criminals need to do what type of fraud. Different types of stolen data are required to commit different types of fraud – some are certainly more valuable to criminals then others. Understanding this will hopefully get students thinking about taking a finer look at the data their organization may collect and use.

5. How does the type of data stolen determine the types of fraud it can be used for and in what settings?

The case describes three types of fraud: Credit Card fraud, Account Takeover Identity Theft and True Name Identity Theft. Both types of Identity theft start with stolen personal identifying information, such as Social Security Number, Name, Address, etc… If the stolen data does not include this type of personal identifying information then it cannot be the basis of Identity theft fraud.

Credit card fraud, however, does not require personal identifying information; it simply requires a stolen primary account number. With simply a PAN the criminal will probably be limited to fraud in a card-present setting. This can be done by creating a counterfeit card with the stolen PAN embossed on the outside of the card and stored in Track 2 of the magnetic stripe. The counterfeit card can then be used to purchase items for re-sale, to purchase items that can be returned for cash, or to purchase gift cards – which can then be sold or used to purchase items. Since the criminals have to be physically present when committing this type of fraud, it is a high risk for the criminals.

Credit card fraud in a card-present situation is a high risk crime. It is much less risk for the fraud perpetrator if they can do their fraud over the Internet, rather than in a face-to-face setting. A card-not-present credit card fraud scenario would typically involve the criminal fraudulently using credit card data to make purchases from an online site. Since they make this order online, it is much less risk to the criminal and so much more attractive. But websites should require online buyers to enter the CCV2 value in additional to the PAN and expiration date. The CCV2 value is not stored on the magnetic stripe of payment cards, so if the thief has managed to steal track data (as in the case of Hannaford Brothers) they will not have the CCV2 values needed to make illegal purchases on the Internet.

6. What type of fraud could the stolen Hannaford Brothers data be used for? What could it not be used for?

Since only Track 2 data was stolen from Hannaford Brothers, the type of fraud it could be used for is card-present credit card fraud – the least attractive and highest risk to criminals. The stolen Hannaford Brothers data could not be used for either of the types of Identity Theft (Account Takeover and True Name), nor could it be used in Card-Not-Present credit card fraud.

The limited fraud options available using the stolen Hannaford Brothers data could be one explanation for the huge difference between the number of credit cards compromised and the actual number of credit card fraud cases reported. While over four million cards were potentially stolen, only 1,800 cases of credit card fraud were reported. So only a very, very small percentage of the stolen Hannaford Brothers customer cards were actually used to commit fraud.

It might be interesting at this point in the class discussion to point out that very often the people stealing the card information are not the same people who are using the stolen information to commit fraud. These two groups may be part of the same criminal organization or they may not. There are a number of websites available for criminals who have stolen data to sell it to other criminals who will use it for fraud. A fascinating article describing these websites is “Data Breaches: What the Underground World of ‘Carding’ Reveals” (Peretti). This could certainly be a topic for a small group to explore and relate to the class.

The Data Theft Dimension

This is the dimension that lends itself to a more technical exploration. Students who are CIS, MIS, or CS majors or who just have a strong interest in computer technology would be ideally suited to explore this dimension. If there are enough students for two groups, they could be divided to

explore how the data was stolen and the PCI standard. Although the case sketches out the key details of how the data was stolen, a more in depth explanation perhaps would likely benefit all students.

A key point for this dimension is that there is no evidence that Hannaford Brothers was negligent in protecting its customer's payment card information. Their approach to security was considerably more thorough than many retailers (ironically, this system was featured in a 2005 Computerworld article as an example of a new, modern POS) (Hoffman, 2005). The questions of how the data theft occurred provide the foundation for understanding the relevant PCI standard requirement and the fact that Hannaford Brothers was in PCI compliance at the time of the data breach. It is particularly ironic that the day the data breach actually began was the same day that Hannaford Brothers was re-certified as PCI compliant.

For the purposes of this case it is really only the PCI standards having to do with securing and protecting customer card data that are most relevant. But the PCI standard document is probably quite accessible to more technical students, so one possible additional exploration is to have a student group do an overview of the entire standard. Regardless of how in depth the standard is explored, a clear learning objective is that – as Hannaford Brothers illustrates – just because your company meets industry security standards doesn't mean that you are immune to criminals trying to steal your data.

7. How was the data stolen in the Hannaford Brothers data breach?

The data was stolen from each of the Hannaford Brothers grocery store in the process of credit card authorization. In each of the stores was one server which received authorization data from the multiple Point of Sale (POS) terminals in the store. When the customer swiped their card at a POS terminal, the Track 2 data from the customer card (the PAN and possibly the expiration date) was transmitted from the POS terminal to the store server and then from the store server out to the bank responsible for authorizing the transaction. This authorization was sent back to the store server which then sent it back to the POS terminal and (assuming authorization was successful) allowed the customer to complete the purchase transaction. This process happened each time a customer swiped their card to make a purchase and happened in real-time while the customer waited.

The criminals were able to steal this data while it was moving through this authorization process (in-transit) by inserting a malware program onto the store server. This malware program was probably a customized packet-sniffing program which was able to read all the packets of data coming to the server, identify the ones containing track 2 data and store that stolen data in a temporary file on the server. The malware then regularly connected to a site outside the United States and sent all of the stolen data to that site.

8. Hannaford Brothers described the cause of their data breach as a new and novel approach. Why?

This data theft approach was unusual for a number of reasons – the first of these is the operating system of the computer the malware ran on. Currently close to 90% of the computers in the world use a Microsoft Operating system (Keizer, 2008). However the malware that stole the data from Hannaford Brothers was designed to run on a computer running the Linux operating system. Although Linux is widely used as a server OS, currently less than 1% of non-server machines run Linux and thus there has been little financial incentive for malware writers to create malware for Linux. This has led some to the conclusion that this malware was custom written to target Hannaford Brothers system. The uniqueness of this malware is also reflected in how difficult it was to find and indentify by the computer forensic team. It took a thirty person team of Secret Service and other computer forensic experts --- working around-the-clock – over a week to find this malware program.

Another unusual aspect of this malware is that the criminals were able to place it on over three hundred store servers distributed from Maine to Florida. Speculation about how this was done ranges from an inside job, to malware that moved from one server to the next until it was on all of the servers. But neither Hannaford Brothers nor the Secret Service has publicly detailed how this was achieved and it is possible that neither know.

A final unusual aspect of this data breach is that the data was stolen in-transit during the authorization process. A more typical approach used by criminals is to target databases containing credit card data "at rest", i.e., stored in a database – possibly during the daily batching process step. A Gartner report states that the Hannaford Brothers data breach was the first publicized case of sensitive card authorization data being stolen in transit (Litan, March 20, 2008).

9. Describe the PCI standard requirements that are most relevant to the Hannaford Brothers breach. Was Hannaford Brothers in compliance with these requirements?

The PCI Data Security Standard objective that is most relevant to data breaches is: Protect Cardholder Data. Under this objective are two requirements: Requirement 3 – Protect stored cardholder data and Requirement 4 – Encrypt transmission of cardholder data across open, public networks. In the Hannaford Brothers data breach the thieves did not target any database of cardholder data (data-at-rest) instead it targeted the credit card authorization data as it moved through the store server (data-in-transit) as part of the authorization process. Therefore, DSI requirement 4 would seem to be most relevant.

The authorization data that the Hannaford Brothers thieves stole in-transit was not encrypted – so it would seem that the requirement 4 was not met. But the requirement specifies only *open, public* networks. The examples it gives are the Internet, wireless technologies, Global System for Mobile communications and General Pack Radio Service. The PCI requirement does not say that cardholder data must be encrypted as it moves around a private, store network – which was exactly where the Hannaford Brothers data was stolen. Therefore, Hannaford Brothers did not violate this requirement of the PCI Data Security Standard.

In fact, Hannaford Brothers does not appear to have violated any of the PCI standards. This is shown by the fact that Hannaford Brothers was re-certified as PCI compliant on February 27, 2008 – the same day that the data breach was discovered. Obviously neither Hannaford Brothers or the security auditors knew early on February 27 that a data breach had begun, but this ironic twist provides a particular highlight on the fact that meeting industry security requirements (in this case the PCI DSS) is no guarantee that your organization is immune from hackers trying to steal your data. Hannaford Brothers is an example of a company that seemed to be doing the right things, was in compliance with industry security standards and still was hit by a massive data breach caused by criminals.

The Lawsuit Dimension

The description of the lawsuit in this case is brief. It conveys the bare essentials but if there are students interested in exploring this dimension, there is a great deal of interesting work to be done. A group of students could certainly do a much more in-depth exploration of question eleven and highlight the plaintiff's specific accusations and the judge's response to them. In addition, a group could compare this case with one of the other high profile data breaches of 2008 – TJ Maxx. The structure of this case provides an excellent foundation for understanding the TJ Maxx data breach and why that data breach led to hundreds of millions of dollars in consequences for the organization, while the Hannaford Brothers class action suit was dismissed before even going to trial.

10. In their public statements about the data breach, why did Hannaford Brother emphasize that no personal identifying information had been compromised?

As discussed in the Fraud section of these notes, stolen personal identifying information (PII) can be used for Identity Theft. However if only credit card numbers are stolen – and not PII – then criminals are limited to credit card fraud rather than identity theft. Since the stolen data could not be used for identity theft, Hannaford Brothers maintained that identity theft disclosure laws did not apply to this data breach. Their position was that they

voluntarily decided to disclose this data breach, they were not legally required to so. This position seems to have been supported by the subsequent lack of lawsuits based on state identity theft laws from customers, states, the FTC or the Department of Justice.

Although it is outside the scope of this case, it is interesting to note how different this is from the array of lawsuits that TJ Maxx experienced after its data breach and which led to hundreds of millions of dollars in expenses. For more legally oriented students it would be very interesting to explore how different the consequences of data breaches were for Hannaford Brothers and TJ Maxx and why they were so different. There would be some interesting and valuable insights into how the consequences of data breaches can vary hugely depending on crucial questions concerning the exact nature of the stolen data and how well the company was judged to have protected it.

11. Although Hannaford Brothers compromised payment card data for over four million customers, the Maine district course judge dismissed the class action suit before it could go to trial. Why?

Because the stolen data could only be used for credit card fraud, not identity theft, the customers who were victims of fraud were reimbursed by their banks. Therefore the losses the customers experienced were not monetary but instead more along the lines of time and inconvenience. The judge ruled that this inconvenience and lost time did not meet Maine's definition of an injury that could merit a legal claim. Therefore the judge dismissed that class action lawsuit. The one exception to this was the one customer who claimed not to have been reimbursed by their bank. The judge ruled that this and only this customer could continue with their lawsuit against Hannaford Brothers.

12. Did negligence by Hannaford Brothers lead to the data breach? Why or why not?

Although it is natural to want Hannaford Brothers to be at fault for having millions of their customer credit card data stolen, it's hard to really find negligence on their part. They were meeting industry security standards (PCI DSS) at the time of the breach. They were using a modern, up to date point of sale system for which they actually received accolades from the technical press (Hoffman, 2005). The malware that was the source of data breach was far from typical and appeared to be custom written to target Hannaford Brothers. It was not one of the many well-known malware programs that can be easily detected and stopped with off-the-shelf anti-virus software. In fact, the malware was so unique it took a large team of experts weeks to find it, even once they knew that some type of data breach must have occurred. As covered in an earlier question, the malware really was – as Hannaford Brothers stated to the press – new and novel.

Although the responsibility of maintaining the integrity of its customer's data is Hannaford Brothers, there doesn't appear to be any negligence on their part that led to the data breach. Instead it appears that they were the victim of a targeted, sophisticated criminal attack that was successful despite a level of security which was quite likely higher than the majority of retail organizations at the time.

EPILOGUE

On August 17, 2009 three individuals were indicted for conspiring to commit the largest data breaches of 2008 (Gaudin, 2009). One of those data breaches was Hannaford Brothers.

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