Volume 17, Number 1

Printed ISSN: 1078-4950
PDF ISSN: 1532-5822

JOURNAL OF THE INTERNATIONAL ACADEMY FOR CASE STUDIES

Editors

Inge Nickerson, Barry University

Charles Rarick, Purdue University, Calumet

The *Journal of the International Academy for Case Studies* is owned and published by the DreamCatchers Group, LLC. Editorial content is under the control of the Allied Academies, Inc., a non-profit association of scholars, whose purpose is to support and encourage research and the sharing and exchange of ideas and insights throughout the world.

Authors execute a publication permission agreement and assume all liabilities. Neither the DreamCatchers Group or Allied Academies is responsible for the content of the individual manuscripts. Any omissions or errors are the sole responsibility of the authors. The Editorial Board is responsible for the selection of manuscripts for publication from among those submitted for consideration. The Publishers accept final manuscripts in digital form and make adjustments solely for the purposes of pagination and organization.

The *Journal of the International Academy for Case Studies* is owned and published by the DreamCatchers Group, LLC, PO Box 1708, Arden, NC 28704, USA. Those interested in communicating with the *Journal,* should contact the Executive Director of the Allied Academies at info@.alliedacademies.org.

EDITORIAL BOARD MEMBERS

EDITORIAL BOARD MEMBERS

EDITORIAL BOARD MEMBERS

EDITORIAL BOARD MEMBERS

JOURNAL OF THE INTERNATIONAL ACADEMY FOR CASE STUDIES

TABLE OF CONTENTS

EDITORIAL BOARD MEMBERS III

LETTER FROM THE EDITORS IX

PEANUT VALLEY CAFÉ: WHAT TO DO NEXT? 1
Lee E. Weyant, Kutztown University
Donna Steslow, Kutztown University

COMPETING IN THE AGE OF WAL-MART:
A BOUTIQUE BUSINESS CASE STUDY 11
Michael L. Thomas, Georgia Southern University
Linda Greef Mullen, Georgia Southern University
J. Michael McDonald, Georgia Southern University

BYD OF CHINA: ELECTRIFYING THE WORLD'S AUTOMOTIVE MARKET 19
Charles A. Rarick, Purdue University Calumet
Kasia Firlej, Purdue University Calumet
Arifin Angriawan, Purdue University Calumet

PEGASUS RESEARCH INSTITUTE—THE DEVELOPMENT OF A COST
ACCOUNTING AND PROJECT MANAGEMENT SYSTEM FOR A
SMALL DEFENSE CONTRACTOR 29
Richard E. McDermott, Weber State University

AUSTRALIAN DREAM: AN AMERICAN DREAM 49
Stephen L. Loy, Eastern KentuckyUniversity
Steven Brown, Eastern Kentucky University
Mark Case, Eastern Kentucky University

CHIROPRACTIC MARKETING: MARKET SEGMENTATION
& GROWTH STRATEGY 65
Jeanny Y. Liu, University of La Verne
Stephanie N. Van Ginkel, University of La Verne

ST. LOUIS CHEMICAL: COST OF CAPITAL 83
David A. Kunz, Southeast Missouri State University
Benjamin L. Dow III, Southeast Missouri State University

FEMSA 2007: THE FINANCIAL STATEMENT ANALYSIS IMPACT OF
DIFFERENCES IN MEXICAN AND US GAAP........ 89
Kevin L. Kemerer, Barry University 89
Michael L. Tyler, Barry University

ANDERSON'S DEPARTMENT STORE: A COSMETIC DILEMMA 109
Regina A. Julian, Stephen F. Austin State University
Elton L. Scifres, Stephen F. Austin State University

MIXED SIGNALS AT GABBA ENTERPRISES 115
Kurt Jesswein, Sam Houston State University

HSN, INC.: WEATHERING THE RETAIL STORM 121
Alexander Assouad, University of South Florida St. Petersburg
William T. Jackson, University of South Florida St. Petersburg
James A. Fellows, University of South Florida St. Petersburg

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 cases contained in this volume have been double blind refereed, and each was required to have a complete teaching note before consideration. The acceptance rate for manuscripts in this issue, 25%, conforms to our editorial policies. The Instructor's Note for each case in this volume will be published in a separate issue of the JIACS.

If any reader is interested in obtaining a case, an instructor's note, permission to publish, or any other information about a case, the reader must correspond directly with the Executive Director of the Allied Academies: info@alliedacademies.org.

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

PEANUT VALLEY CAFÉ: WHAT TO DO NEXT?

Lee E. Weyant, Kutztown University
Donna Steslow, Kutztown University

CASE DESCRIPTION

The primary subject matter of this case involves the management of a quick service restaurant (QSR). The case has a difficulty level of three, appropriate for junior level courses in management or hospitality management. The case is designed to be taught in 1, 75 minute class period and is expected to require 2 hours of outside preparation by students.

CASE SYNOPSIS

This case focuses on the operational and strategic management issues faced by a family owned quick service restaurant (QSR). The case explores the operational issues with a multi-unit restaurant. What are the operational decisions necessary to effectively manage QSR facilities? What are the strategic issues facing a QSR owner?

[NOTE: This case is a fictionalized version of a real-life situation. Names and other potentially identifying information have been changed to protect identities. The applicable fact situation is true to the real case.]

THE PEANUT VALLEY CAFE

Peanut Valley Café is a family owned, ethnic food quick service restaurant (QSR). The company has two locations in the southwestern part of the United States. The two facilities are 20 miles apart with one facility located in Plainsville and the other in Pleasant Valley. Both facilities are equidistant, about 8 miles, from a major military base that is in the process of expanding operations. The population of Plainsville is nearly 33,000 and the population of Pleasant Valley is approximately 11,000. Plainsville is the county seat for Mountain County. The city has a small, regional shopping mall, a civic center, a hospital, and Mountain Community College. Pleasant Valley is the county seat for Lovely County. The town has an ethanol processing plant, milk processing facility, several peanut processing facilities, and Regional State University (RSU). RSU is a small regional university providing undergraduate and graduate programs for approximately 4,000 students. Both cities are about 100 miles from a metropolitan area with a population greater than 50,000 and more than 120 miles from a population centers greater than 150,000. (See Appendix C: Map).

Peanut Valley Café started in 1967 serving Mexican-American fast food. Sam Snow joined the company in 1969 as a management trainee after graduating from a prestigious land-grant college with a degree in Hotel, Restaurant Management (HRM). By 1970, Peanut Valley Café had grown to five locations. In 1971, the owner of Peanut Valley Café offered Sam the opportunity to buy the Plainsville restaurant. This facility was located in front of a new shopping center, across the street from the Plainsville Park, and within a block of the Plainsville High School. In 1971, this was an ideal location since the highway had been expanded to three lanes to handle the traffic to the hospital and the military base located west of town. In 1975, Sam received permission from Peanut Valley Café general management to open a restaurant in Pleasant Valley across the street from a RSU dormitory and the RSU administrative building. Additionally, this location was along the main highway to Desert Sun, a city of 55,000 located about 90 miles southwest of Pleasant Valley.

In 1979, Peanut Valley Café's operations were facing financial difficulties. Originally, the locations in small towns resulted in little competition with national franchise operations such as McDonald's and Burger King. With increased competition from national chains, three of the five Peanut Valley Cafés reported their third consecutive annual loss. Only Sam's operations in Plainsville and Pleasant Valley posted profits during this time. When Peanut Valley Café's general management decided to close the business, Sam offered to buy the company's name and continue operating his two facilities. On January 1, 1980, Peanut Valley Café was officially sold to Sam Snow's new corporation – High Plains Restaurant Management, Inc., dba Peanut Valley Café. Sam has operated the two restaurants in the same location since 1975. Over the years Sam has experienced the typical business cycles of all small businesses. Likewise he has experienced his share of attempting new projects. For example, from 1998 to late 2004 Sam operated a food court version of his café in the local mall with a limited menu. Also, during this time period, his corporation owned an Orange Julius franchise in the local mall. For simplicity, the gross revenue figures for the Plainsville operation during those years reflect these additional ventures. Moreover, in 1996 Sam was offered the opportunity to buy the gas station adjacent to the Pleasant Valley facility. This venture accounts for approximately 10% of the total revenue at the Pleasant Valley facility. (See Appendix A for current organizational chart and Appendix B for selected financials.)

Last July, Sam met with Dr. Abraham, Associate Professor of Management, RSU. Dr. Abraham was designing the curriculum to support a new Hospitality Management degree at RSU and needed the input of industry leaders such as Sam Snow. Their initial conversation covered a variety of topics including the local economy, community growth, entrepreneurship, and the need for a hospitality degree in the area. During this conversation, Sam stated that he wished he had the time to implement the systems that would really help his business. "My managers are not a part of this operation. Sure, they try, but there is no follow through on items. I feel like we are not on the same page." Sam asked Dr. Abraham if he could help in facilitating a discussion between Sam and his managers. Dr. Abraham agreed to assist Sam, but wanted to observe the operation before conducting the meeting. Over the next several months, Dr. Abraham visited each facility, met with the employees, and received a tour of the operation. By November, it was agreed that Dr. Abraham would attend the employee meetings being conducted by Sam.

The employee meeting for the Pleasant Valley facility was scheduled for late November. Following his normal procedure for these meetings, Sam decided to close the facility at 8:30PM versus 10. About ten minutes into the meeting a bus from Mountain Plains University arrived with the women's basketball team and coaches. The team had played the RSU women's team earlier in the evening. When the coach came to the door, a member of Sam's management team answered the door and told the coach they were closed. Without prompting, the Peanut Valley Café employees asked Sam to open the restaurant for the team. Sam agreed and the team was invited into the facility. While the restaurant employees were busy preparing the food for the team, Sam overheard one of his Assistant Manager's remark "We can't afford to let that much revenue be turned away. I can't believe this meeting is more important than servicing the community!" After the team completed their meal, Sam resumed the employee meeting. During a conversation about hours, one of the morning managers, Jesus, started complaining about the lack of support from the other managers, especially Daniel. This continued for several minutes with both managers and their respective subordinates trading barbs about the operational procedures. Finally Sam stopped the meeting and looking at Jesus stated "We'll continue this conversation in private after the meeting." The meeting ended with Sam and Jesus going to the manager's office. As Dr. Abraham was collecting his materials, several employees stopped to talk. One employee commented, "This has been brewing for some time. Jesus and Daniel have not gotten along since Daniel was promoted to manager. Jesus is a great cook, but he is not a strong manager." Another employee added, "You know this all began when Daniel started going to RSU for his management degree and doesn't have to work the early morning shifts." The next day Sam called Dr. Abraham to apologize for the incident with Jesus. "He probably has the best overall culinary skills of all my managers. But he is very narrow-minded about what needs to be done. He is not a good manager and tries to tell the others how things should be done. I had planned to talk to him about his overall performance for several weeks but never got the time to drive to Pleasant Valley for the talk". About a week later, Sam and Dr. Abraham were coordinating a time for Sam to be a guest speaker in a hospitality management class when Sam stated, "Well, Jesus quit. Called me at 6:25AM last Tuesday and quit. That hurt since we open at 6:30AM. I had a young employee waiting outside the door for about 45 minutes until I got there to open. The young man was upset that he had to wait and tersely told me about 20 people stopped by and wanted to know why the restaurant was closed. When I explained what happened, he added 'I should have known. Jesus and Daniel had words yesterday'."

During the spring, Sam and Dr. Abraham met to discuss managerial operations. They discussed the employee training programs. They reviewed the various videotapes Sam had collected over the years concerning customer service, sales, and safety. Sam stated that the Plainsville facility has an extra room above the restaurant that can be used for small groups or individuals to view the tapes. "Unfortunately, I do not have the same luxury in Pleasant Valley. It's a space issue. So I will periodically show a tape at Pleasant Valley as part of the employee meeting." When asked who is responsible for the training, Sam stated it was the General Manager and Assistant Manager's responsibility. "But they don't have time to do the training. We get done what we can. I know some of my people are not very good at teaching others, but when you live on the margins, you do what you have to." Additionally, Sam and Dr. Abraham discussed the menu. Dr. Abraham raised the issue, "Sam, there appears to be a lot of items on the menu from traditional Mexican cuisine of tacos and burritos to American cuisine of hamburgers and fried chicken. Doesn't this cause inventory and production issues?" Sam responded "Not really. I use the same ground beef for the hamburgers that I use in the tacos and burritos. There is a longer prep time for the hamburger, but it's not a big seller and whoever wants a burger is willing to wait." As they talked about the size of the menu, Sam stated that he was proud of the fish taco. "I was in Hawaii for a conference and saw a restaurant similar to mine offering a fish taco. It's been great, though not a big seller. I think we sold 10 fish tacos last week between the 2 facilities. I use fresh fish and created my own seasonings. Since we are using fresh fish, I've created a separate prep area to eliminate any cross contamination."

During a meeting in April, Sam lamented that he was 62. He had been in this business for is entire life. "I started with this venture on a lark. No clear plan. This was just a stopover until I found what I really wanted back in the northeast. Here I am 40 years later. I've done well. Had several years when I did not take a salary. Man, that was the closest to bankruptcy I've ever been. I enjoy this business, but for how long? I know I need help. I'm sorry my son lost his job with a major corporation. But he got a good buyout and has decided to come live with us for the next six months to help me get some of the systems I've always wanted to do in place."

About a month later, Dr. Abraham was ready to facilitate the meeting between Sam and his managers. Sam arranged to have the meeting in a location away from the restaurants. After introductions, Dr. Abraham started the meeting.

> *"The purpose of today's meeting is to discuss Peanut Valley Café – where you are, where you want to go, and your role in the journey. To start we will begin with "Through the Looking Glass". Our initial goal is to identify as many items as possible. So please hold your comments until later. We will list the ideas on the flip chart and post these on the wall for ease of reference. Let's begin. Where do you see Peanut Valley Café five years from now?"*

Please refer to Figure 1.

> *"Look out the window. What do you see?"*

Please refer to Figure 2.

Figure 1 **Through the Looking Glass – Peanut Valley Café in 5 years**
Participate in city events
More automation
Better advertising
Tours by elementary schools
Training programs
More family friendly
Higher presence in community
Keeping up with IT
More managers
Bigger Pleasant Valley store
Double sales – customer count
Work with Military base
General Manager
Faster service
Menu redesign/simplify
Advertise birthday parties
Online orders
Expand

Figure 2 **Out the Window – What do we see?**
RSU
Businesses
Banks
Fire department
Hospital
Schools: Public and Private
Travelers
Military Base
School Athletic teams
Competitors (Partial List)
McDonald's
Dairy Queen
Burger King
Taco Bell
Wendy's
Juan's Authentic Mexican Restaurant
Price of Gas Increasing

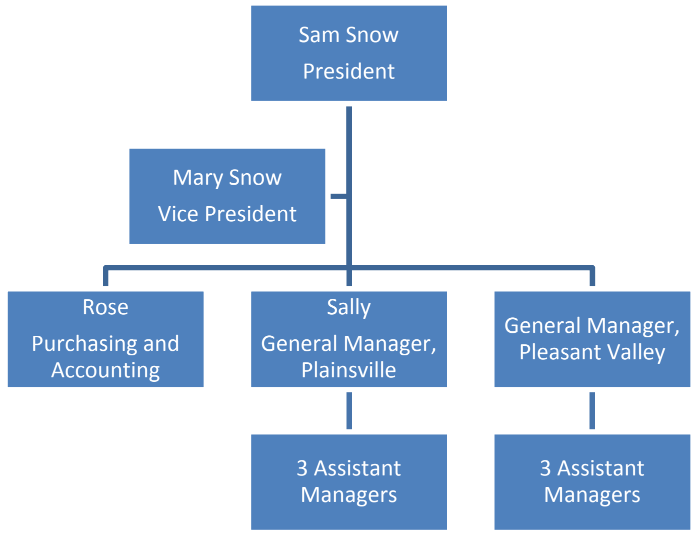
"What are the roles the people in the room should have?"

Please refer to Figure 3.

Figure 3 **Managerial Roles**	
Sam	
	Face of the Business
	Provide vision leadership
	Be supportive
	Marketing
	Vendor support
	Update stores
	Moral support
Son	
	Implement programs/IT
	Short term – implementation
	Training development
Your	
	Face of the store – true managers
	Hiring employees
	Smoother running crews
	Better customer service
	Follow through – see beyond the shift
	Administrative Organizer – Rose

Sam called Dr. Abraham, a week after the manager's meeting. "Dr. Abraham, I'd like to meet with you next week to discuss what I plan to do next." At this meeting, Dr. Abraham presented Sam a copy of the notes made during the manager's meeting. After discussing their general impressions of the manager's meeting, Dr. Abraham asked Sam, "What is next for Peanut Valley Café?" Sam expressed doubt on what should be the next step. Dr. Abraham discussed with Sam that the manager's meeting provided a basis for doing a strategic analysis of Peanut Valley Café. Dr. Abraham stated, "At least at the end of the analysis, Sam, you will have the framework to make an informed decision." Dr. Abraham provided Sam with a handout outlining the strategic analysis process. They decided to meet in a month after Sam had worked on the analysis.

Appendix A: Peanut Valley Café's Organizational Chart



Rose, Purchasing and Accounting Rose was one of Sam's first hires in 1975. Rose became an Assistant Manager at the Plainsville facility within six months. By 1977 Sam had promoted Rose to General Manager for the Plainsville restaurant. Rose served in this capacity until 1991.

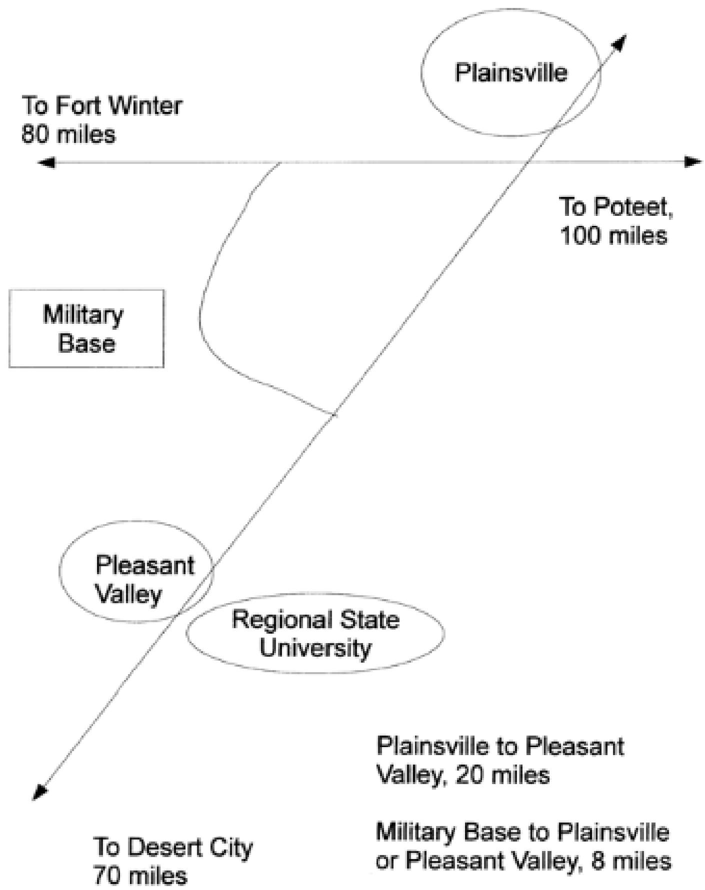
Sally, General Manager at the Plainsville facility Sally was hired in 1981 as a Cashier/Cook at the Plainsville restaurant. After a year, she was promoted to Assistant Manager. When Rose was promoted in 1991, Sally was promoted to replace Rose as General Manager.

Assistant Managers The Assistant Managers are responsible for the operations of the facility during their shift. They open and close their respective facility. These individuals are responsible for training the individuals assigned to their shifts.

Appendix B: Peanut Valley Café Income Statement 1998-2007					
	Plainville	Pleasant Valley	Total Revenue	Expenses	P/L
1980	$250,000	$50,000	$300,000	$285,000	$15,000
1981	$275,000	$50,000	$325,000	$308,750	$16,250
1982	$290,000	$60,000	$350,000	$332,500	$17,500
1983	$325,000	$70,000	$395,000	$375,250	$19,750
1984	$310,000	$55,000	$365,000	$346,750	$18,250
1985	$325,000	$65,000	$390,000	$370,500	$19,500
1986	$350,000	$70,000	$420,000	$399,000	$21,000
1987	$375,000	$75,000	$450,000	$427,500	$22,500
1988	$400,000	$80,000	$480,000	$456,000	$24,000
1989	$410,000	$90,000	$500,000	$475,000	$25,000
1990	$400,000	$75,000	$475,000	$451,250	$23,750
1991	$425,000	$80,000	$505,000	$479,750	$25,250
1992	$430,000	$90,000	$520,000	$494,000	$26,000
1993	$445,000	$90,000	$535,000	$508,250	$26,750
1994	$460,000	$100,000	$560,000	$532,000	$28,000
1995	$450,000	$105,000	$555,000	$543,900	$11,100
1996	$475,000	$120,000	$595,000	$583,100	$11,900
1997	$500,000	$140,000	$640,000	$627,200	$12,800
1998	$550,000	$150,000	$700,000	$686,000	$14,000
1999	$650,000	$160,000	$810,000	$830,250	($20,250)
2000	$800,000	$150,000	$950,000	$973,750	($23,750)
2001	$900,000	$150,000	$1,050,000	$1,102,500	($52,500)
2002	$1,000,000	$175,000	$1,175,000	$1,233,750	($58,750)
2003	$875,000	$190,000	$1,065,000	$1,043,700	$21,300
2004	$800,000	$190,000	$990,000	$970,200	$19,800
2005	$775,000	$210,000	$985,000	$935,750	$49,250
2006	$775,000	$210,000	$985,000	$935,750	$49,250
2007	$750,000	$250,000	$1,000,000	$950,000	$50,000

These financials are not the actual figures from the company upon which the case is based. However, they do represent the general trends that the owner expressed to the author over the time period covered.

Appendix C: Map of Plainsville/Pleasant Valley



COMPETING IN THE AGE OF WAL-MART: A BOUTIQUE BUSINESS CASE STUDY

Michael L. Thomas, Georgia Southern University
Linda Greef Mullen, Georgia Southern University
J. Michael McDonald, Georgia Southern University

CASE DESCRIPTION

This case is intended for use in undergraduate marketing, management, fashion merchandising, entrepreneurship, or retailing courses. The purpose of the case is to demonstrate how small boutique businesses can compete against chain stores and large discounters such as Wal-Mart. Particularly, the concepts of key client management and customer delight are highlighted. Students are encouraged to evaluate the company's strategy, tactics and uncover areas of potential customer delight. Additionally, students should attempt to provide thoughts on other strategic and tactical activities the business should pursue considering the recent economic downturn. The case is designed for a one-hour class and should require two hours of outside preparation.

CASE SYNOPSIS

The Thomas Shop is a women's clothing boutique located in Effingham, Illinois. The business was started in 1936 and has since been handed down through the family with the second and third generations currently handling operations. Originally, the business offered approximately 2000 square feet of space, but was doubled in size in the early 1990's to accommodate shoes and other accessories. The store moved to its current location, (owned by the business owners) in the downtown shopping district of Effingham in the early 1970's. The town's population is approximately 20,000 and is the main shopping district for the surrounding county of approximately 35,000 residents, and further, draws customers within a fifty-mile radius. The nearest major city, St. Louis, Missouri is 100 miles to the west.
The Thomas Shop has thrived for over seventy years with superior service and merchandise adaptability. However, the recent downturn in the economy has Kathy worried. Kathy is concerned that consumers will become more and more price conscious and may gravitate to the large discounters such as Wal-Mart and other chain stores (i.e. Kohls) for price reductions, even though the merchandise quality is below that of The Thomas Shop.

THOMAS SHOP OVERVIEW

The atmosphere in downtown Effingham was bleak when Wal-Mart opened in the community. First, the hardware stores closed. Next, the pharmacies and small grocers disappeared; then other retail businesses ranging from pets to clothing left. The Thomas Shop owners watched as Wal-Mart steamrolled many long-standing local businesses. The owners are concerned that the current economic downturn is going to push more consumers toward the discounters. They are unsure as to whether or not they should keep their current business model which is built around key customer management, higher end merchandise, and superior customer service, or should they reduce services and bring in lower tier merchandise so as to better compete on price.

Other small businesses in Effingham and surrounding communities were also feeling the effects of the large discounters. Several firms failed in their efforts to compete with Wal-Mart as they had difficulty offering similar products and services at competing prices. For example, Ivan's Shoes and Juanita's Slack Shop closed their doors soon after Wal-Mart arrived. B&H Clothing, a men's clothier, (similar in business model to that of The Thomas Shop) was unable to continue and it too closed its doors. The downtown area was beginning to look like a ghost town.

Alternatively, there were also firms that were successful. For example, Sylvester's Sports Memorabilia (collectables) and Noah's Ark (pet store) were not feeling the negative effects of the large discounter. Sylvester Frazier has been in business for many years and has developed a successful online business in sports memorabilia as well. On the other hand, Noah's Ark recently opened in Effingham and has various pets, supplies, IAMS pet food and grooming services. Business is booming for both of these small firms.

The demographic breakdown of Effingham County (Table 1) shows that it is predominantly white, (98.7%) and has a fairly equal split between males and females. Additionally, the vast majority of residents have at least a high school education, (87.7%) and approximately 20% have at least a bachelor's degree. Finally, the income statistics reveal that while over 27% of families earn less than \$35,000, 45% make more than \$50,000 annually.

The store carries a full selection of merchandise for women from teens to seniors (approximately 75% of the female population). Product lines include slacks, blouses, jeans, dresses, lingerie, costume jewelry, hand bags, hats, jackets, and shoes (Table 2 gives a sales breakdown by line). The focus has always been to provide mid to upper level merchandise for the style conscious woman. In the words of Yves Saint Laurent, "Fashion fades, style is eternal." The style conscious woman wants to make her own unique style and looks for clothiers who can help her accomplish this task. Therefore, The Thomas Shop provides brands and services to assist women in reaching this goal (Table 3 shows major brands by line). Finally, Table 4 shows sales by age groups.

Staff includes the owner, (Kathy) who is also involved in the day-to-day operations, (including sales, displays, cleaning etc…) her daughter, (Stacia) and one part-time sales clerk, (Vickie). In addition to her daily duties at the store Kathy also does the daily bookkeeping, seasonal merchandise buying, payroll and taxes. She is assisted in the daily activities and merchandise buying by Stacia. Kathy has been involved in the business for nearly forty years, while Stacia has been with the store for approximately 15 years. When asked to describe a typical day Kathy responded that the reason she liked retailing so much was that there is no such thing as a typical day. She went on to explain that when customers are in the store her only concern is servicing their various needs. Slow times are opportunities to re-do window displays, (usually done once a week) change in-store displays, and take care of general maintenance.

A major concern for any business is competition. The Thomas Shop is no exception. The owners have seen their share of other women's clothing stores come and go over the years. However, being in a small town the store has never had the direct competition of large department stores. Effingham residents must drive to St. Louis to shop at these stores. While some customers have done this in the past, Kathy and Stacia have prided themselves on their service and merchandising providing department store brands and styles for this rural community. Not only has The Thomas Shop kept more locals from driving to the "big city" to shop, but the shop has drawn a loyal following from other neighboring communities. When Wal-Mart and other large discounters arrived in the early 1990's the proprietors were obviously concerned. Current competitors, (in addition to Wal-Mart) include Maurices, (direct competition for the youth market, but located in a run-down mall) and Kohls (a large chain that challenges The Thomas Shop for their lower tier clients).

Past service successes were many and quite innovative. For example, when Kathy noticed that more and more of her customers were having trouble with bras following mastectomies she investigated what she could do to help. She worked with suppliers (i.e. Amoena) to become registered in providing mastectomy fittings. She enrolled in courses provided by Amoena and after several intensive sessions was certified to provide the service. This allowed The Thomas Shop to be the only one in the area certified to offer this unique service. While mastectomy fittings are a very small part of the market, (4.8% of women in the U.S. will develop breast cancer in their lifetime, and 56% will have a mastectomy) the emotional response from friends and family of the cancer survivor was notable. Kathy's customers not only provided many mastectomy referrals, but also tended to become more loyal for other store merchandise. Additionally, they provided the ever-elusive positive word-of-mouth for the overall business.

Stacia is trained in color analysis which aids in providing customers with outfits that promote their best features. She attended an intensive training course in St. Louis to receive her certification as an image consultant. While this skill had faded from popularity during the late 90's, it has received increased attention recently as a means to offer superior customer service. Stacia can readily assess clients as a spring, summer, fall or winter according to skin tone, hair color and other factors. This aids in finding colors that best promote their respective traits.

One additional service offered by the business deserves special attention. When Kathy goes to market to buy for the next season, she always keeps in mind her best customers. She knows what brands and styles each of these upper tier clients likes and she also knows what sizes they wear and what colors look best on them. With this information in hand, she tries to find one-off items (items that she may not want to carry an entire line of) that may be of interest to one of these special customers. Kathy's purpose here is to not just satisfy her best customers, but to delight them. The response from these purchases has been overwhelming. Kathy cannot remember a time when she made a personal buy at market for a customer who did not in turn purchase that item. This personalized attention extends beyond the upper-tier customer to other regular good customers as well. The store personnel pride themselves on knowing these customers by name, and are regularly complimented on the personal attention they give. For example, sales personnel bring clothes to the dressing room so the customer can find the perfect size and style as conveniently as possible.

Kathy also stated that they don't forget about traditional advertising and promotion. They run weekly local newspaper and radio spots (paper circulation is approximately 12,000 reader/households daily and the radio reaches the entire county), participate in the annual downtown sidewalk sale, pay particular attention to regular (weekly) window display changes, and participate in the Chamber of Commerce and Rotary.

The sidewalk sale deserves additional explanation. It consists of all downtown businesses bringing racks of product out onto the downtown sidewalks and streets (the streets are closed to car traffic). This is a one day only (during June) sale and is always the store's biggest sales day of the year. This day provides an opportunity to clear out summer stock to make room for fall. Kathy is quick to point out that while these activities are important they do not help differentiate themselves.

Specialty promotions and skill development, such as the mastectomy fitting program and color analysis are services that aid more in differentiation and thus are promoted. Top tier clients receive regular mailings to let them know when new lines are arriving and information about upcoming sales. Additionally, biannual style shows at a local club draw 700 women per event and allows the store's products to be displayed in a fun forum. Top tier customers receive special consideration with reserved seats and first access to purchases. Kathy recruits high school students and other local women to act as models for the shows. The great diversity in age allows for demonstrations that meet all their targeted age groups. Some specialty style shows which focus on a theme, such as prom dresses are promoted. Additionally, Kathy is involved in local career programs for junior high students, which allows her to recruit potential future customers.

Table 1: Effingham County Demographics

	N	Frequency (%)
Gender	**34,264**	**100**
Male	16,983	49.57
Female	17,281	50.43
Age	**34,265**	**100**
Under 18	9,800	28.6
18-24	2,810	8.2
25-44	9,662	28.2
45-64	7,230	21.1
65 and over	4,763	13.9
Race	**34,264**	**100**
White	33,819	98.7
Black	69	0.2
Asian	103	0.3
Hispanic	240	0.7
Other	34	0.1
Education	**22,265**	**100**
High school or higher	19,526	87.7
Bachelor's degree or higher	4,542	20.4
Family Income	**9,207**	**100**
Less than $20,000	657	7.14
$20,000 - $34,999	1,869	20.3
$35,000 - $49,999	2,061	22.39
$50,000 - $74,999	2,442	26.52
$75,000 - $99,999	979	10.63
$100,000 - $199,999	596	6.47
$200,000 or more	134	1.46
(Source: 2000 US Census)		

Table 2: Sales by Line	
	% of Sales
Slacks and Jeans	25
Blouses and Tops	40
Dresses	8
Shoes	10
Lingerie	12
Accessories	5

Note: Accessories include: handbags, jewelry, & hats.
Lingerie includes mastectomy fittings.

Table 3: Top Brands by Line	
Slacks, Jeans, Blouses and Tops:	Windridge
	Tribal
	Joseph Ribikoff
	UBU
	600 West
Dresses:	Alyce
	Bella Formals
	Josh & Jazz
Shoes:	Mephisto
	Birkenstock
	Merrill
	Dansko
Lingerie:	Maidenform
Accessories:	Brighton

Table 4: Sales by Age Group

Age	**Sales**
18-24	15%
26-44	35%
45-64	35%
Over 64	15%

REFERENCES

Berman, B. (2005). How to Delight Your Customers. *California Management Review*, 48(1), 129-151.

Clow, K.E. and Cole, H.S. (2004). Small Retailers' Road to Success: The Customer Value Concept. *Services Marketing Quarterly,* 26(2), 69-81.

Coyne, K.P. (1989). Beyond Service Fads—Meaningful Strategies for the Real World. *Sloan Management Review,* 30(4), 69-76.

Edwards, D. (2003). Delight Moves Customer Response to Next Level. *Business Wire*, (January 3) 52.

Fornell, C., Johnson, M.D., Anderson, E.W., Cha, J., and Bryant, B.E. (1996). The American Customer Satisfaction Index: Nature, Purpose, and Findings. *Journal of Marketing*, (Oct.) 42, 7-18.

Hallowell, R. (1996). The Relationship of Customer Satisfaction, Customer Loyalty, and Profitability: An Empirical Study. *International Journal of the Service Industry Management,* 7(4), 27-42.

Johnston, R. (2004). Towards a Better Understanding of Service Excellence. *Managing Service Quality,* 14(2-3), 129-133.

Kano, N. (1984). Attractive Quality and Must-Quality, *Journal of the Japanese Society for Quality Control,* 14(2), 39-48.

McCaig, M. (2000). A Small Retailer Uses CRM to Make a Big Splash. *Apparel Industry Magazine,* 61(10), 30-36.

McDonald, M.H.B., Millman, A.F. and Rogers, B. (1996). Key Account Management—Learning from Supplier and Customer Perspectives. *Research report for the Cranfield KAM Best Practice Research Club, Cranfield School of Management*.

Ngobo, P.V. (1999). Decreasing Returns in Customer Loyalty: Does it Really Matter to Delight the Customers? *Advances in Consumer Research*, 26, 469-476.

Piercy, N. F. and Lane, N. (2006). The Hidden Risks in Strategic Account Management Strategy. *Journal of Business Strategy,* 27(1), 18-26.

Ryals, L. and Rogers, B. (2007). Key Account Planning: Benefits, Barriers and Best Practice. *Journal of Strategic Marketing*, 15, 209-222.

Smith, P. (2000). Only Some Customers are King, *New Zealand Management*, 47(3), 24-26.

Strange, M. (1996). Transforming the Rot Belt, *Des Moines Sunday Register,* Feb. 25, C1-C2.

BYD OF CHINA: ELECTRIFYING THE WORLD'S AUTOMOTIVE MARKET

Charles A. Rarick, Purdue University Calumet
Kasia Firlej, Purdue University Calumet
Arifin Angriawan, Purdue University Calumet

CASE DESCRIPTION

The primary subject matter of this case concerns the move towards utilizing electricity to power automobiles and the potential of a Chinese company to become the world's largest automaker, as well as the strategic fit of its innovation with the current external environment. Secondary issues examined include issues of trade, public policy, and the environment. The case has a difficulty level appropriate for junior level students. The case is designed to be taught in one class hour and is expected to require three hours of preparation by students.

CASE SYNOPSIS

The Chinese company BYD hopes to soon become the world's largest car company. With the support of American Warren Buffett, the company which has only been in existence for a few years, mostly making batteries, has caught the attention of not only Mr. Buffett, but also many in the auto industry. This case examines the favorable conditions that are propelling the Chinese company to the forefront of the not so distant future of the auto industry.

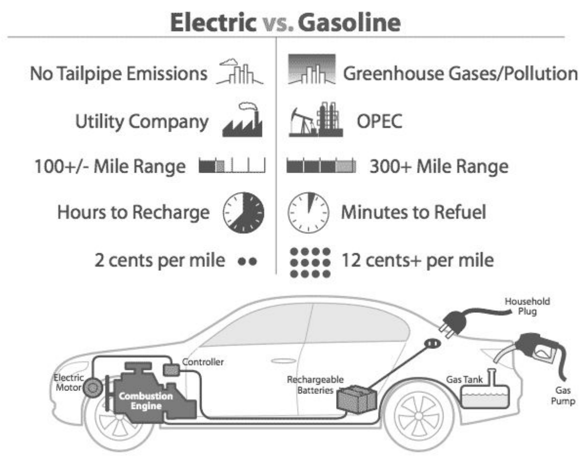
BYD OF CHINA

Many Americans have never heard of the Chinese firm called BYD. In fact, it isn't really clear what the letters representing the company's name stand for, although some joke that recently it has meant "Bring Your Dollars." The company’s latest PR message states that BYD stands for “Build Your Dreams.” BYD is a privately owned company which started making batteries in 1995. Although Chinese-made batteries were already available, they were of poor quality. Imports of higher quality batteries were available in China mostly from Japan, but they were quite expensive. To satisfy the need for high quality and low cost batteries, Wang Chuan-Fu started BYD. Wang, who was a graduate of the Beijing Non-Ferrous Institute, found his competitive advantage by studying Japanese batteries and finding creative ways of making similar batteries at a lower cost. Wang had been fascinated with batteries as a graduate student at the Institute and now seeks to take that passion to the global automobile market.

ELECTRIC AND HYBRID CARS

Electric cars (also known as electric vehicles or EVs) rely exclusively on battery power. With an EV there is no internal combustion engine, muffler, gasoline tank, air and fuel filters, and other parts needed to run a gasoline powered system. The vehicle itself also produces no tailpipe emissions, and by getting its power from a more efficient utility company, overall it produces fewer greenhouse gases. This is especially true if the electricity is produced with nuclear power. EVs are also less expensive to fuel on a per mile basis. Electric cars, however, have a shorter driving range and are difficult to operate with long distance travel (Figure 1). There are also some safety concerns associated with using a lithium ion battery, as lithium is a highly reactive material prone to explosion.

FIGURE 1



Source: www.hybridcars.com

Hybrid vehicles run on battery power until the battery reaches exhaustion and then a gas-powered engine kicks in to power the vehicle and to recharge the battery. Given the relatively short driving range of electric vehicles, hybrid vehicles have been the logical first step towards all electric cars and the replacement of the internal combustion engine. Hybrid cars became hot selling items when the price of gasoline soared in 2008, and then fell back sharply as the price of gasoline fell. Gasoline prices appear to be rising as the world's economy slowly rebounds from the economic slowdown and the appetite for oil increases worldwide. Some have proposed that electric vehicles can save the struggling U.S. auto industry. According to Andy Grove (of Intel fame), "batteries will become a competitive advantage for the automakers of the future." He supports a position whereby the government takes a more active role in promoting and protecting an "infant industry" in new battery technology. The Obama administration took steps in 2009 to provide significant funding of battery research and the production of environmentally friendly automobiles. New mileage standards were also proposed that will make electric vehicles more attractive to consumers.

Many companies have begun to think electric automobiles will have a promising future. In addition to the world's largest automakers who have begun to develop electrical cars, some upstarts have been established. One of these companies is Detroit Electric. The company represents an auto brand from the past and has teaming up with Proton of Malaysia to manufacture electric cars under the Detroit Electric name. Detroit Electric is a privately held company that got its brand name from a defunct 1907 company. The company hopes to sell its cars in China, Europe and the United States. Planned prices for the new all electric cars will be $23,000-25,000 range for the entry models, with a driving capacity of a little over 100 miles on a single charge. More expensive models will be available for $29,000-33,000 with a driving range of a little under 200 miles before needing to be recharged.

GM, Ford, Toyota, Daimler Benz, Volkswagen all have moved into the electric or hybrid market. It is likely that most of these companies will offer electric vehicles soon. Troubled auto maker, Chrysler, showcased five electric concept cars at its recent Detroit Auto Show and is working with battery manufacturer A123 Systems and other suppliers to attempt to produce an electric vehicle. With its financial troubles and other obstacles Chrysler, it doesn't seem likely that the company will be producing electric vehicles anytime soon. The success or failure of electric cars and the companies that enter this market is strongly related to the batteries that will power the vehicles. Troubled General Motors, who used to dominate the automobile market is touting the introduction of its electric-gasoline-ethanol hybrid in late 2010. The catch, however, is the price tag: the Chevy Volt will be offered at the hefty price of $30,000 to $40,000 at the retail level and will only be able to run about 40 miles on a single charge before switching over to the gasoline or ethanol powered engine.

IT'S ALL ABOUT THE BATTERY

Lithium ion is the current choice for batteries to power electric cars. Lithium ion batteries are lighter and more powerful than traditional batteries. Lithium, a metal compound, can be found in large quantities in South America, especially in Bolivia, Chile, and Argentina. Chile is currently the world's largest producer of lithium, however, Bolivia has the largest known deposits of lithium in the Salar de Uyuni region. It is estimated that the lithium supply in Bolivia is somewhere around 5.4 billion tonnes. Significant deposits of lithium can also be found in China. The Chinese government has declared the lithium battery industry to be a "strategic industry" and will likely support its development.

While lithium batteries are currently the most popular option for automobiles, they are still heavy and expensive. For example, GM's electric car, the Volt, has a battery that is six feet long and weighs around 400 pounds. The cost of an electric car battery is in the range of $10,000-$20,000 each. Lithium batteries can store up to three times the power of nickel-metal hydride batteries. They are clearly superior to conventional batteries. Further advances in lithium battery production may be able to produce smaller, lighter, and faster charging batteries. At least one reported research study shows this promising development. BYD's advantage in this technology is the productions of ferrous lithium ion batteries, which are safer and cost about half of those of the competition, according to BYD's general manager of its Export Trade Division, Henry Z. Li.

With a big shift towards lithium batteries as a power source for vehicles is the possibility of supply problems. Bolivia, the largest potential source of lithium has a socialist president and an indigenous population not keen on development of the region. The possibility of undersupply, and or a cartel similar to OPEC would reduce the viability of electric cars.

The United States is behind Asia in battery production and research. Sanyo, NEC, and LG have created core competencies in batteries and achieved economies of scale that will require the Americans some time to catch up U.S. firms in the industry are relatively small upstarts such as A123 Systems and Ener1 (ENERDEL). Even GM's proposed electric car, the Volt, is powered by the Korean company, LG. American automakers have yet to establish firm strategic alliances with American lithium-ion battery producers. Serious movement into electric vehicles will require investment money, long term commitment and strategic alliances. Nissan has partnered with NEC to allocate $1B towards battery development. Toyota-controlled Panasonic EV Energy recently bought Sanyo for its battery making ability. While the U.S. is behind Asia in battery technology, a number of promising companies have arisen to research and develop batteries needed to fuel electric cars. Ener1 already operates two factories in Indiana and one in Korea, and is building another factory in Michigan. The Big Three: General Motors, Chrysler and Ford, have been considering alternative vehicles since the 70's, however there is still a lack of knowledge about this technology and its useful application in the automotive market. An Indiana based company, Bright Automotive, has been working on a commercially viable plug- in electric vehicle, but does not anticipate rollout of the all electric powered vehicle until late 2012 or early 2013. Another Indiana based company, EnerDel, sees its primary focus as the automotive market, but is also actively working with the aviation, aerospace, and industrial markets. EnerDel works closely with the automotive industry and is excited about the prospects of its lithium ion battery, which is 100% recyclable, but the company representative admits that the batteries are still fairly expensive to produce and the firm continues to work on issues of energy storage and offloading electricity. It seems that BYD is moving much faster and much more aggressively in the direction of introducing an all electric car. Its e6 model is scheduled to be released at the end of 2009 and is much more competitively priced than the offerings of its Western competitors. Furthermore, BYD has tapped into a cost innovation strategy by reducing manufacturing costs through reverse engineering the expensive Japanese battery models and substituting the expensive raw materials with cheaper substitutes.

FIGURE 2 Key Players in the Electric Auto Battery Industry	
A123 (USA)	M.I.T. spin-off with $250M in venture capital
AESC (Japan)	Joint venture between Nissan and NEC
BYD (China)	Largest battery producer in China
ENERDEL (USA)	Once part of Delphi. Invested $200M in Indiana plant
Johnson Controls/SAFT (USA/France)	Joint venture with plant in France
LG (Korea)	Leading producer of lithium-ion batteries for cell phones
Panasonic (Japan)	Owns Sanyo Electric, the largest producer of rechargeable batteries.
Source: Business Week, February 23, 2009.	

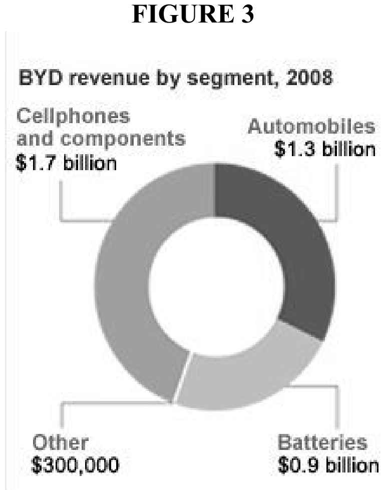
BYD

Perhaps the most interesting player in the electric car arena is BYD. While most Americans had never heard of the company with its headquarters in Shenzhen, China, the company captured international attention when Berkshire Hathaway bought a 10% interest in the company. Warren Buffett wanted to buy 25% of the company, but BYD refused the offer. A company known for being cost-conscious and frugal, BYD has consistently been profitable. Located in Shenzhen, a manufacturing megacity better known for electronics, the company gained a competitive advantage by finding creative and innovative ways to manufacture batteries of high quality at costs lower than rival Japanese and American brands. The founder of the firm has bet on the substitution of low-cost labor for expensive machinery, and attention to detail, and these strategies have proven to be successful. By 2000, BYD had become the biggest producer of cell phone batteries. BYD raised capital through a public stock offering on the Hong Kong Stock Exchange in order to increase the size of its battery business. In 2003 company founder, Wang had the opportunity to purchase a failing state-owned automobile manufacturer. He thought that the company could leverage its battery competence in the auto industry by producing electric cars. While many thought that BYD was making a mistake in moving into automobiles, others thought differently. As Joann Muller of Forbes magazine stated in 2004: "*In the vast and looming Chinese automobile market now dominated by foreigners, a small Chinese company called BYD is barely noticeable ... Amateur hour maybe, yet it would be foolhardy for General Motors, Volkswagen and other foreign makers to ignore Chinese companies like BYD*." (Muller p. 76). It appears that she was right. With the capital injection from Berkshire Hathaway and a focus on an increasing share of the auto market, BYD has positioned itself well to compete internationally.

BYD seeks to position itself as an innovator and to tap into the growing green business by not only producing electric automobiles, but also making its batteries environmentally friendly. BYD is producing batteries that contain nontoxic fluids and thus do less harm to the environment, if the battery is discarded instead of being recycled. In addition to being environmentally friendly, BYD believes that it has made a major breakthrough in battery technology which will produce a longer lasting charge and allow the battery to be recharged numerous times, at the same time keeping the costs significantly lower than those of its competition. The U.S. Department of Energy is studying the claim made by BYD concerning its new battery technology.

BYD operates eleven factories and employs 130,000, with most production facilities in China, but also operates factories in India, Hungary, and Romania. BYD employees, including engineers and scientists typically live on the company grounds with BYD providing housing and other living expenses. The labor cost is a fraction of the costs found in the United States or Europe. BYD has two offices in the United States, both close to important customers. BYD offices can be found in Elk Grove, Illinois and San Francisco, California, based on the location of its two major U.S. customers, Motorola and Apple. Most of the firm's revenue comes from cell phones, components, and batteries, but automobile sales have been playing an increasingly significant role (Figure 3).

FIGURE 3



Source: Fortune April 27, 2009

Revenue has increased consistently, and with the exception of 2005, BYD has had consistent profitability (Figures 4 and 5). BYD has achieved an impressive record in its short life utilizing low labor costs, little outsourcing, and successful innovation. The company is transferring its cutting edge technology innovation to the automotive market and at the same time closely following the global trends in green marketing that focus on a higher level of cost consciousness. BYD was named the second most innovative company in China in 2009 by *Fast Company* magazine.

FIGURE 4

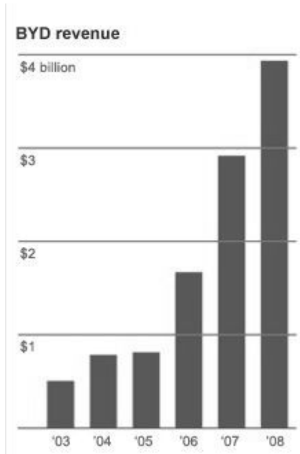
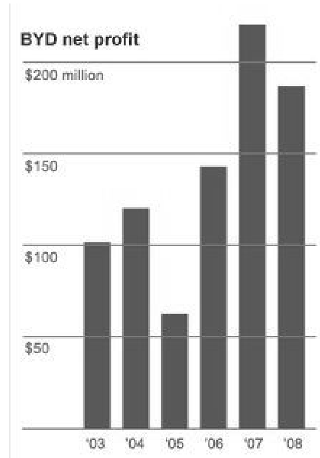


FIGURE 5



Source: Fortune April 27, 2009

BYD currently produces a number of vehicles including the F3DM : DM stands for dual mode, which means that the car can run on dual energy sources. The environment-friendly battery can be fully charged in as little as an hour. This model sells in China for around 22,000 USD. This hybrid car can travel 62 miles on a single charge and is the first mass produced plug in hybrid in the world. The difference between it and the Toyota Prius is that it is less expensive, has a very small engine and relies significantly on battery power, cutting down the costs of utilization and its carbon footprint. The F6 CVT has been widely distributed in the European market since 2008. BYD prides itself on equipping this particular model with a gasoline engine that possesses an innovative electronic fuel injection system that features high power to oil ratio, compact structure, low oil consumption and low emissions.

The e6 is the latest addition to the BYD lineup of models. According to optimistic BYD predictions, it is slated for introduction the at the end of 2009 and could be sold in the United States as early as 2011. The e6 is an all electric vehicle that offers zero pollution, low noise, and guarantees that all the chemical substances in its battery can be recycled. It also offers 0 to 60 MPH acceleration in 8 seconds and is roomy enough to seat five adults. The best part of the vehicle utilization is that it can be plugged into a household socket to obtain a charge, and doesn't have to rely on special "juicing stations" and can drive almost for almost 250 miles on a single charge. The estimated cost of this groundbreaking vehicle would be $30, 000 to 40,000.

CONCLUSION

With the American auto industry in a tail-spin, and the world's supply of oil limited, BYD hopes to position itself to become the world's largest car manufacturer. The Company is attempting to leverage its core competencies in battery production and development to meet the future needs of the driving public. It believes that the future of the auto industry will be in electric vehicles.

In order for electric cars to replace gasoline powered one, infrastructural changes will have to be made to quickly charge depleted batteries, much like present day gasoline stations. Another possibility would be a battery replacement station in which a depleted battery is quickly replaced with fully charged one. Such battery changing stations are currently being developed in Japan, Denmark, and Israel. While Mr. Buffet may agree with BYD's vision of the future, the company faces many challenges as it attempts to compete with the world's largest automakers.

DISCUSSION QUESTIONS

Do you think electric cars are a viable alternative to gasoline-powered vehicles? What is the future of the electric car? Explain your answers.

What are the strengths, weaknesses, opportunities, and threats of BYD?

What suggestions would you make to BYD in order for it to achieve its goal of becoming the world's largest automobile manufacturer?

REFERENCES

Balfour, Frederick (2008). *China's First Plug-in Hybrid Car Rolls Out.* Business Week, December 16, 13-13.

Bulkeley, W. (2009). *Obama administration sparks battery gold rush*. The Wall Street Journal, May 26.

Castaldo, J. (2009). *The lithium deficit*. Canadian Business, 82(7), 17-18.

Engardio, P., K. Hall, I. Rowley, D. Welch, and F. Balfour. (2009). *The electric car battery war*. Business Week, February 23, 52-54.

Garthwaite, J. (2009). *Battery breakthroughs: Progress on electric cars*. Business Week, March 18.

Grove, A. (2009). *Andy Grove on battery power*. Fortune, April 27, 62.

Gunther, M. (2009). *Buffett takes charge*. Fortune, April 27, 45-50.

Haung, K. (2008). *China's BYD plans U.S. hybrids*. Automotive News, November 27, 6.

Kahya, D. (2008). *Bolivia holds the key to electric car future*. BBC News, November 9.

Keegan, P. (2009). *Recharging Detroit*. Fortune, April 27, 55-60.

Lee, A. (2009). *Most innovative companies in China*. Fast Company, February 11.

Muller, J. (2004). *Thanks, now more over*. Forbes, July 26, 76-78.

Raymond, C. and N. Shirouzu. (2009). *Volkswagen, BYD may team up on plug-in cars*. The Wall Street Journal, May 26.

Reed, J. (2009). *Proton to build cars for Detroit Electric*. Financial Times, March 30.

Vlasic, B. (2009). *Detroit goes for electric cars, but will drivers?* The New York Times, January 11.

Wernle, B. (2009). *Chrysler is several steps away from electrics*. Automotive News, January 1, 10.

White, J. (2009). *Kiss the guzzler goodbye*. The Wall Street Journal, May 26.

Winter, D (2009). China's BYD Promises EVs in U.S. by 2011. Ward's Auto World, February

Walters, J., Kamischke, R. (2009). New Economy, New Rules (webinar), June 4.

Williamson, P. Zeng M., (2009) Value-for-Money Strategies for Recessionary Times, Harvard Business Review, March.

http://www.byd.com. Accessed on May 14, 2009.

http://www.ford.com. Accessed on May 14, 2009.

http://www.gm.com. Accessed on May 14, 2009.

http://www. hybridcars.com. Accessed on May 14, 2009.

http://www.toyota.com. Accessed on May 20, 2009.

PEGASUS RESEARCH INSTITUTE—THE DEVELOPMENT OF A COST ACCOUNTING AND PROJECT MANAGEMENT SYSTEM FOR A SMALL DEFENSE CONTRACTOR

Richard E. McDermott, Weber State University

CASE DESCRIPTION

This case addresses cost accounting for contractors, a topic neglected in many cost accounting courses. It focuses specifically on contractors who work within the defense industry. The defense industry was chosen for its rich array of incentive-based contracts, which provide unique challenges to management accountants.

The case is based on an actual firm, although names and places have been changed for the purpose of confidentiality. Although the firm explored is a defense contractor, most principles taught are applicable to contractors in other industries. The case is written in an easygoing style with language and humor intended to appeal to college students, and is designed to be covered in three one-hour class periods. Student preparation time should be approximately two hours for each hour of class. The difficulty level is five to six and is best suited for advanced or graduate cost accounting courses. The case is best worked in groups of three to five students. An appendix provides definitions of terms unique to the defense industry.

CASE SYNOPSIS

Evan Elmore, a graduate of a master's program in accountancy, has recently married and accepted a job as a chief accountant of a small defense contractor. After spending his savings to move himself and his new bride to a distant town, he discovers that his employer is on the verge of bankruptcy. Reasons for the firm's marginal performance include: (1) a lack of understanding of how to bid and later bill the various forms of incentive payment contracts awarded by the Department of Defense (DOD), and (2) an inability to produce cost reports that provide the information needed for managers to control costs. The survival of Evan's employer, and the possible viability of his own career, is dependent upon his ability to fix these problems.

SECTION ONE

INTRODUCTION

Evan Elmore drummed his fingers impatiently on the gray metal table in the boardroom of the Pegasus Research Institute. The furnishings looked like they had been purchased from an Army surplus store. He smiled cynically―it was quite different from the work environment described to him when he accepted the job as the company's new chief accountant.

For the third time in as many minutes, he checked his watch. His lips drew into a thin line of I

rritation. The president had scheduled his first meeting with the management committee at 12:00 noon. It was now 12:15, and no one was there. Was this characteristic of the way management ran the company? He shook his head in disgust. This was his first day of work―it had not been a stellar morning.

Four weeks earlier, Evan had been preparing to graduate from the Masters of Accountancy program at Oklahoma State University. Unlike many of his classmates, he shied away from public accounting.

"Public accounting recruits are nothing more than cannon fodder!" Barry Cohen, a classmate, told him over lunch one day in the student union. Barry wore large horn-rimmed glasses that magnified his eyes in a scary sort of way when he got excited. "The firms work you 16 hours a day at starvation wages, and when they've used you up, they spit you out!" he exclaimed. Barry leaned forward as though sharing a secret. "If you want a life," he said, "work in industry, be a management accountant."

Barry's judgment wasn't the best. Still, for someone with Evan's interests, a job in industry seemed like a reasonable alternative. The problem, however, was that a suitable position had not presented itself, at least in the time he had spent hunting for a job. Spring semester of his senior year, Evan met and fell in love with Susan Holloman, the daughter of a prominent Tulsa judge, and spent more time courting her than he did looking for a job.

Two weeks before graduation, Susan accepted his proposal of marriage. There was just one problem, her father wanted to know how Evan planned to support his daughter. The judge realized that by the end of May, most accounting graduates had a job. All Evan had was Susan.

On May 22, just as Evan was starting to panic, he received a call from Lewis Levine, a former fraternity buddy. Levine had graduated in December, and gone to work in contract administration for the Pegasus Research Institute, a defense contractor in Dayton, Ohio. The company needed a new chief accountant, and the President, Charles Anderson, asked Levine to help identify candidates. Anderson, it turns out, was Levine's Uncle.

Levine explained the company was small but had great growth potential. "We are just five miles from Wright Patterson Air Force Base," he said, "home of aeronautical research and development for the U.S. Air Force."

Evan discussed the job with his future wife, and with Judge Holloman. Following a brief telephone interview with the president, Evan accepted a job offer.

The young couple was married June 1st, and now two weeks later, they were moving into a small apartment in downtown Dayton—if you can call moving in without furniture, moving in. Susan had called Evan earlier that morning to remind him that the moving company was not going to deliver their furniture until they a received a check. The firm had yet to send the $1,000 for moving expenses promised at the time Evan accepted the job.

Susan's call came as Evan was completing his orientation with Levine. Levine, it turned out, had quit his job. "Too much pressure," he reported. He was taking a year off to find his "inner self." Evan's eyes reflected surprise and disappointment. He planned on leaning heavily on Levine, as he knew little about defense contracting. There was an awkward silence.

Levine grabbed his name badge. "Let's go on a tour of the plant," he said, in an effort to cheer his old friend up. For the next hour, he introduced Evan to many of the firm's employees. After their tour, he filled Evan in on the strengths and weaknesses of each member of the management committee.

Evan learned that the president, Charles Anderson had worked for 20 years as a chief engineer at Northrop before buying Pegasus from Wright State University. Wright State's faculty had long opposed the acceptance of research contracts from the Department of Defense (DOD), and finally persuaded the university to negotiate the transfer of their contracts to a for-profit institute, which the university then sold to Anderson.

"Charles Anderson is a good engineer," Levine said, "but not very good with people." He paused for a moment trying to find just the right words. "I would probably describe his style as management by intimidation," he said.

"Anderson's right hand man is Henry Frye," Levine continued. "He's vice president of marketing. Anderson hired him from Air Force Procurement. It raised eyebrows at the base, as Frye had just awarded Pegasus a large fixed-price contract.

"Big time violation of revolving-door legislation," Levine continued. "Through legal maneuvering, however, Frye was able to keep both of them out of jail."

"Gotta watch Frye," Levine advised. "Since he's paid on a commission, his incentive is to sell contracts. Sometimes, he promises more than the firm can deliver. David Lee is the other key player. Like Anderson, his background is engineering. He serves as project director on several key projects, but hasn't been able to get a handle on cost control." Levine looked at his watch. "Time to go," he said. "Another appointment."

"Anything else you want to tell me?" Evan asked skeptically as Levine turned to leave.

"Actually, there is one more item," Levine said, pausing at the door. "The company has yet to be paid on its largest contract." He scratched his scruffy beard as though considering the problem for the first time. "Something about defective pricing," he continued. "Unless you and Anderson can work something out with the Defense Contract Audit Agency (DCAA), you won't be able to make payroll Friday."

Evan's eyes grew wide with astonishment. It was clear now why his moving check hadn't arrived─the company had cash flow problems. As he tried to picture how Susan would react to eating off a card table, the door to the boardroom flew open and the management committee marched in. Anderson first, followed by Frye, then Lee. Behind Lee was a slight man with a weak chin and rooster-like eyes. "That's Arnold Sprouse," Levine whispered, "our purchasing agent."

Last through the door was the president's secretary. She pushed a serving table loaded with sack lunches, which she distributed as the committee members took their seats around the board table. The room was heavy with tension as President Anderson took his chair at the end of the table. He had just been on the phone with an auditor from DCAA about a certified letter he had received earlier that morning.

"Gentlemen!" he began, "This is the most serious crisis we have ever had at the institute!" Pausing for dramatic emphasis, he slowly looked around the table, making eye contact with each member of his management team. Satisfied he had their complete attention, he retrieved the certified letter, detailing DCAA's findings during its most recent audit. Anderson read from the letter. "Contract FFP-0001, a firm-fixed price contract. Contract price bid─one million dollars." He turned and glared at David Lee, project manager. "How much have we spent contract-to-date?" he asked.

Lee gulped. "Almost one million dollars," he replied.

"How much will it cost to complete?"

"Dunno sir."

Anderson's face reddened as he continued reading. "Delivery date June 15th." He lifted his beefy arm and glared at the calendar on his watch for effect. "It is now June 18th," he drawled. He refocused his eyes on the project manager. "When will it be done?" he asked.

"Not sure," Lee replied.

"And why not?" Anderson asked, feigning benevolence.

"The scope of work keeps changing," Lee replied.

Anderson turned to Levine who was providing contract administration on the project. "The scope of work keeps changing?" the president asked incredulously.

Levine had just taken a generous bite of cold slaw. His response was muffled. "Don't know nothin' about it," he said, wiping his chin with a napkin. He nodded at the vice president of marketing. "Frye mentioned some time ago his friends at Wright-Patt wanted a few more bells and whistles on the system." He shook his head. "Haven't seen a shred of paperwork."

Anderson shot a withering look at Frye. "You're not going to tell me we've added new features to the system, without an amendment to the contract?" he asked.

"Small technicality," Frye sniffed.

"Small technicality!" the president shouted, tossing aside any trace of false geniality. "Without an amendment, we won't get paid!"

Frye dismissed the idea with a wave of his hand. “We’ll make it up someplace else,” he said. “I have friends in procurement. I can get them to issue a cost-reimbursement contract with a vague work statement,” He nodded in agreement with himself. “We’ll charge the cost overruns there!” he said.

“That's illegal!” the president said.

“Only if we get caught,” Frye replied.

“You’ll get us all thrown in jail!” the president retorted.

“Not all of us,” Frye mumbled, more to himself, as he flecked a shred of coleslaw on his tie.

“Part of the problem is the purchasing department’s fault,” Lee said. “Contract-to-date material costs are running 20% higher than bid.”

The purchasing agent, Arnold Sprouse, joined in. “That’s because no one gave my department the opportunity of pricing materials when the bid was prepared,” he said.

“Then who priced them?” the president asked.

“Our marketing VP―Henry Frye,” Sprouse replied. “He also provided the estimates for labor and tacked on the overhead.”

“I thought that’s what our engineers are supposed to do,” Anderson said.

Frye shrugged. “I was in a hurry,” he said. “Wrestling with our bureaucracy would have delayed the bid at least two weeks.”

President Anderson took a deep breath in anticipation of the answer to the next question. “Tell me,” he asked. “Without input from anyone, how did you come up with a price of $1,000,000 for the bid?”

“One of my friends in procurement tipped me off that was what the Air Force set aside for the project.” Frye shrugged. “Heck, you can do anything for a million dollars.”

The president threw his hands in the air in disgust. The gesture failed to impress Evan. Where was the president when all this was going on? Certainly, this is not the first he has heard of these problems. President Anderson, either enjoyed dramatics, or was a master at blame passing.

David Lee, project manager, now spoke. “Even if the bid had been accurate, it would have been hard to bring the project in on budget, given the reports we get from accounting.”

Evan, who would be assuming responsibility for cost accounting, injected himself into the conversation for the first time. “What’s wrong with the reports?” he asked, ready to take notes.

“There’s not enough detail―little we can use to control costs.”

“Such as?” Evan asked, writing Lee’s comment on a notepad.

“The reports tell how much has been spent for labor, but provide no detail on how much work has been done. Without that, there is no way to tell if we are over budget.”

Evan nodded, as he considered the problem.

"I've tried to get contract costs broken into milestones and tasks," Lee continued. "Your predecessor said he couldn't do that in the general ledger; if I wanted that detail, I would have to track the costs myself."

While Evan took notes, the president moved onto another topic. Once again, he read from the certified letter. "In violation of section 31.203 of the Federal Acquisition Regulations (FAR), the pricing rates used in billing cost-plus-fixed-fee contract CPFF-0001 were never approved. Until approved rates are in place, we have suspended progress payments on all cost-reimbursement contracts."

Anderson's brows drew together in a questioning expression. "What in the Sam Hill does that mean?" he asked.

"It means our former chief accountant didn't do his job," David Lee replied.

There was a pause—

"That's why we hired Evan Elmore, isn't it? To fix this mess?" Lee looked around the room at the other members of the committee. "Last time we met, Levine told us Evan was a guru in defense contractor accounting," he said, stressing the word guru.

Evan's eyes opened wide—it was news to him. He shot a questioning look at Levine, who refused to return eye contact.

President Anderson nodded. A light came on in his eyes, and for the first time during the meeting, his body relaxed. "That's right," he said, nodding in agreement with himself. "That's why we hired Evan Elmore, isn't it?"

A benevolent smile spread expansively across Anderson's face as he turned to Evan. "I was wondering what to do about tomorrow's board meeting," he said. "Now, I can report to the directors that we have handled the problem!" He continued with an air of self-approval. "That should clear the way for me to approach the chairperson for another loan."

As the committee left the room, everyone smiled in recognition that the president had found a way to avert disaster. Everyone, that is, but Evan Elmore.

* * *

It was evening and most of the employees had gone for the day. Evan sat quietly in his office, building a model of a funeral pyre from a box of pencils on his desk. He had yet to call his wife about the moving expenses. Most likely, they would borrow $1,000 from her father to get their furniture out of hawk.

He shook his head ruefully and reviewed his options. The company was in trouble, and so was he. He could bail out, break and run, but where would he go? Back to Tulsa where they could move in with his wife's folks? And then what? A one-day tenure as chief accountant of Pegasus would do little for his resume. His job prospects would be as bleak as before.

He wondered if he had the training or experience to solve the problems President Anderson and his former controller had created. He placed one more pencil on the pyre and it collapsed, strewing pencils across the desk and onto the floor.

As ill advised as accepting the job had been, quitting was not an option. As he gathered the pencils, it occurred to him that many important decisions in his life had been made with little forethought. Before the wedding, life had been "fun and games." Now he had the responsibility of providing for a family, it was time to "grow up."

Evan turned and stared out the small window at the vacant parking lot below. He was on his own. Where do I start? he wondered.

On the far wall of his office was a blackboard. He crossed the room and picked up the chalk. One by one, he began to list the problems he uncovered his first day of work. When finished, he prioritized them into the order in which he would address them.

ASSIGNMENT ONE

1. Prepare a list of the problems facing Pegasus Research Institute. Prioritize them in order of importance.

2. Evan's situation illustrates the importance of performing "due diligence" before accepting a job offer. Prepare a list of questions you feel accounting graduates should ask whenresearching a potential employer. Tell where one might find the answers.

3. President Dwight Eisenhower was the one who coined the terms "military-industrial complex" and "government-industry revolving door." Using the internet as a resource, define both terms. Explain why the practice exists, and discuss the problems it causes.

SECTION TWO

Forward-pricing Rates

Having prioritized the problems facing the firm, Evan decided the most pressing problem was the cost-reimbursement contract. Without approved forward-pricing-rates, DCAA would not authorize periodic payments, and the company would be unable to make payroll.

Tuesday morning, Evan called the Dayton office of DCAA and was routed to Frank Davis, the auditor assigned to provide field support to Pegasus Research Institute. As Evan was to learn, the government has a strong interest in preserving the financial viability of its defense contractors. Without contractors, there would be no one to build weapon systems. Davis, consequently, was responsive to Evan's request for help and agreed to meet with him later in the day. At 2:00 p.m., Davis arrived at Evan's office.

Frank Davis had learned by experience that contractors vary greatly in their understanding of the rules of defense contracting. He began with a discussion of application of overhead costs to work-in-process, as he knew Evan would be familiar with that concept from his accounting training.

"The Financial Accounting Standards Board (FASB) mandates that overhead be treated as a product cost," Davis began. "Contractors typically apply overhead through the use of an overhead rate. The overhead rate is calculated by dividing estimated overhead by some base. This base can be direct labor dollars, direct labor hours—anything that correlates with or drives overhead costs," he said.

"Other indirect costs receive no such treatment, but are shown on the income statement as period costs.

"Since our objective is not inventory valuation, but contract pricing, we recommend that all indirect costs be applied to defense contracts through the use of rates. " Davis pulled a file containing the notes of his first meeting with Pegasus from his briefcase.

"When Pegasus began operation," he said, "I recommended the company select three rates for use in bidding contracts: (1) an overhead rate that uses as its base direct labor dollars, (2) a materials handling rate that uses as its base direct materials, and (3) a G&A rate that uses as its base total contract costs (the sum of direct labor, direct materials, overhead, and material handling costs).

Davis explained that DCAA must approve, through an audit, a contractor's proposed rates prior to the award of any cost-reimbursement type contract.

"In some situations," he said, "contractors can apply for forward-pricing rates. These save the firm from having to request an audit every time they bid a new contract." Davis looked at Evan over the top of his glasses. "Somehow, we missed this step when we accepted the bid for your first cost-type contract."

For the remainder of the day, Frank Davis and Evan Elmore worked on a proposal for forward-pricing rates for 2009 calendar year. The source document was Pegasus' 2009 budget shown as Table 1.

ASSIGNMENT TWO

1. From the 2009 pro forma income statement for Pegasus (Table 1), prepareforward pricing rates using the formula given above.

2. Use these forward-pricing rates to calculate a bid price for a firm-fixed-price contract with an estimated $450,000 of direct labor, and $600,000 of direct materials. Assume that management wishes to earn a 10% fee or profit on this contract.

Table 1 Pegasus Research Institute Pro Forma Income Statement; Fiscal Year 2009	
Sales	$ 22,306,125
Less contract costs	
Direct labor	5,500,000
Direct materials	7,800,000
Material handling cost	1,170,000
Overhead	3,025,000
Contract costs	7,495,000
Gross margin	4,811,125
G&A	4,373,750
Income before tax	$ 437,375

Bidding Procedures

Two days after submitting his proposed forward-pricing rates for 2009, Frank Davis notified Evan they were approved. Evan was then able to renegotiate the price of the contract and the government paid for the work done to date. Evan now turned his attention to the problems of contract bidding and cost control. To gain a better grasp of these topics, he once again sought help from Frank Davis, DCAA auditor.

Davis began by reviewing the procurement process for all Department of Defense (DOD) contracts. He explained that when the DOD wishes to buy goods or services, procurement issues either an Invitation for Bid (IFB), Request for Quote (RFQ), or a Request for Proposal (RFP).
If procurement knows exactly what it wants (i.e. the product specification, the quantity, and delivery date), it uses an IFB. If procurement only wants current market pricing data, it uses an RFQ. If procurement is not sure what it wants, but wishes to have the contractor work with it to develop a specification, it uses an RFP. RFPs can be either competitive or non-competitive.

Review and Approval

Evan recognized that many of the firm's problems had arisen because Henry Frye had prepared bids for contracts without input from those who would be doing the work, and without approval from finance or contract administration. Davis provided Evan with a bid release form used by another contractor. This, Evan used as the basis for a new bid release procedure at Pegasus.

Prior to the release of a bid, the chief accountant would sign to verify that the company had sufficient working capital to complete the contract, and that the contract provided for periodic payments, and that the approved forward-pricing rates had been used. The director of human resources would verify that salaries were correct. The director of purchasing would review the proposed bill of materials, verifying with vendors that prices were correct and including an adjustment for inflation, when the contract would run over an extended time period. The firm's attorney would review the contract to see that terms were favorable to the company.

Lastly, Evan got the management committee to agree that the only individual with the authority to sign or change a contract was the contract administrator.

Analysis of Performance—Management Accounting

By August, Evan was familiar enough with the unique problems of defense contracting to start analyzing why Pegasus was doing so poorly. He gave special attention to the company's first firm-fixed-price contract FFP-001, which the project manager still estimated would overrun its budget by approximately $500,000.

In his spare time, Evan had studied the Federal Acquisition Regulations (FAR). One section that caught his interest reviewed techniques for estimating contract costs. The only one that made sense for Pegasus was detailed estimating.

Detailed estimating involves the preparation of a detailed design, from which work is broken into tasks, each with a budget for labor and materials. These tasks then become the cost centers for the job costing system. Avery Mitton, a project manager recently hired from Boeing provided some interesting insights about Pegasus's traditional job cost reports.

"The problem at Pegasus," she said, "is that management often doesn't learn a project is in trouble until it is too late to take corrective action. On FFP-001, for example, engineers reported they were on budget up until 95% of the labor budget was spent. It now appears that the last 5% of the contract will cost as much as the first 57%. The problem, of course, is that management assumed that a 95% labor dollar expenditure implied that 95% of the work had been accomplished." She shook her head. "That assumption was deadly wrong."

To prevent similar occurrences in the future, she suggested that the new job costing system report both "labor spent" and "labor earned." Since Evan didn't know what the term 'labor earned' meant, she explained.

"By labor earned, I mean the actual amount of work done. In a small company like this, the best way to do this is to have the project leader provide an estimate of the amount of labor required to finish a task. This should be done at the end of each payroll period. This amount would then be subtracted from the labor budgeted to determine earned labor." She gave an example.

"Let's assume," she said, "that a new contract has 25 tasks. Task 1 has a budget of $10,000. During the first pay period, $7,000 of labor is charged against this task. As the project manager submits the time cards, she is asked to estimate the labor dollars still needed to complete the task. The estimate is $6,000.

"To calculate the labor dollars earned, the cost accountant would subtract that $6,000 from the initial budget of $10,000. The result would be $4,000; the amount of labor actually earned which is synonymous for the amount of work actually done."

"To calculate what the total cost of the task will be, the accountant would now add the labor spent-to-date, $7,000, to the labor estimated to complete the task, $6,000. Task 1, with an original budget of $10,000, would now be estimated to cost $13,000. It would be up to the project manager to find a way to eliminate the potential $3,000 overrun. This could be done by completing the current task for less, or completing a future task for less than budget. The nice thing about publishing a report every two weeks is that the information is available early enough to take corrective action."

ASSIGNMENT THREE

1. Explain why it is not enough to know only the labor budget and the labor dollars spent-to-date when managing a fixed price contract.

2. The cost reports previously received by project managers provided three figures: (1) budget, (2) costs spent contract-to-date, and (3) percent of total costs spent. Identify additional information that you think would be useful for a project leader managing a complex firm-fixed-price contract, and prepare a direct labor job cost report using the data from Table 2.

Table 2
Actual and Estimated Labor Dollars for Firm-fixed-price Contract FFP-0010 as of July 2009

	Contract Labor Dollar Budget	Labor Dollars Spent Contract To date	Estimated Labor Dollars to Complete Contract
Task 1	$ 85,500	$ 50,000	$ 25,000
Task 2	200,000	120,000	100,000
Task 3	20,000	25,000	500
Task 4	167,000	95,000	65,000
Task 5	205,000	200,000	25,000
Task 6	22,500	15,000	
Task 7	65,000	45,000	10,000
Task 8	90,000	55,000	55,000
Task 9	10,000		10,000
Total	$ 865,000	$ 605,000	$ 290,500

SECTION THREE

Evan's job was complicated by the fact that the DOD uses many incentive contract types, each requiring separate procedures for bidding, cost control, and revenue recognition. These can be classified into two general categories: fixed-price and cost-reimbursement contracts. Fixed-price contracts are designed for situations where the work can easily be estimated. Fixed-price contracts place the risk of contract overruns on the contractor.

Cost-reimbursement contracts are designed for situations where the cost of work cannot be accurately estimated, such as when a project requires state-of-the-art technology or technology yet to be developed. Cost-reimbursement contracts place the risk of contract overruns on the government.

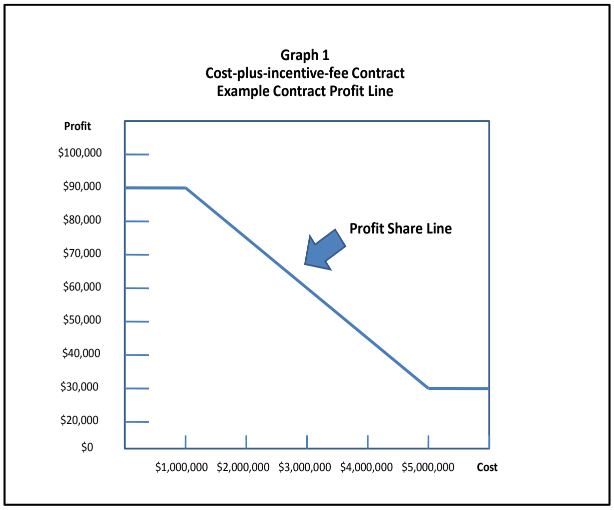
The problem with cost-reimbursement contracts is that they provide few incentives for contractors to control costs. To address this problem, the DOD has developed what are called incentive-payment contracts. Both fixed price and cost-reimbursement contracts can have incentive provisions. The four contract types that Pegasus currently had in-house were:

Firm-fixed-price contract: With a firm-fixed-price contract, the price is agreed to before the contract is awarded. It remains fixed for the life of the contract, regardless of the cost to perform the contract. In other words, the contractor accepts full financial risk. In the terminology of defense contracting, the risk sharing arrangement is 0/100. If actual costs exceed budgeted costs, the government pays 0% of the cost overrun, while the contractor pays 100%.

Fixed-price-firm-target contract: With a fixed-price-firm-target contract, the contractor negotiates a target profit, target price, ceiling price, and share ratio. The target cost is the estimated direct cost to complete the project, loaded with overhead, material handling costs, and G&A. The target profit is the profit initially negotiated. The target price is the target cost plus the target profit. The share ratio specifies what percentage the government and contractor will each pay of cost overruns, after the target price has been reached through contract overruns, up to the ceiling price. The ceiling price is the maximum price the government will pay for the contract. Once the ceiling price is hit, the contractor is responsible for all remaining costs.

Labor-hour contract: Labor hour contracts are used to buy labor at a fixed hourly rate that includes direct labor, indirect costs, and profit. The contract is designed for situations where the amount or duration of work cannot be predicted, and as a result, where costs cannot be realistically estimated. The fixed labor billing rate for each labor category (engineer, software programmer, technical writer, and so on) is calculated by taking the estimated labor rate, including fringe benefits, and burdening it with overhead, G&A, and profit or fee. The government is billed the actual number of hours used for each labor category times the fixed labor billing rate.

Cost-plus-incentive-fee contract: This incentive contract type involves the sharing of risk between the government and contractor for cost overruns, but is unique in that the risk sharing arrangement is defined by a graph (see Graph 1). The Y-axis shows earned profit. The X-axis shows loaded costs (direct labor + overhead applied + direct materials + materials handling costs applied + G&A applied).



Graph 1
Cost-plus-incentive-fee Contract
Example Contract Profit Line

The first step in calculating the earned profit in a cost-plus-incentive fee contract that is complete is to calculate the slope of the profit line. The slope defines the amount of profit the contractor gives up for every dollar of costs exceeding target costs. The calculation of the slope and its use in calculating earned profit is illustrated below.

HIGH-LOW METHOD ILLUSTRATED

The formula for the slope of the line is: (Change in Y) ÷ (Change in X) where, the Y-axis is the fee or profit axis, and the X-axis is the cost axis. In this situation illustrated by the above graph:

($90,000 - $30,000)/($5,000,000 - $1,000,000) = - 0.015

The negative slope of 0.015 means that for every dollar for which actual costs exceed $1,000,000, the contractor gives up $0.015 of profits.

Illustration:

If actual costs on the contract illustrated above were $1,000,000, then the contractor would bill: $1,000,000 cost + $90,000 fee = $1,090,000. If actual costs were $2,500,000 then the contractor would bill:

Cost + (maximum fee – ((actual costs – minimum target costs) x contractor sharing arrangement)) =

$2,500,000 cost + ($90,000 – (($2,500,000 - $1,000,000) x .015)) fee =
$2,500,000 + ($90,000 – ($1,500,000 x .015)) =
$2,500,000 + ($90,000 - $22,500) =
$2,500,000 cost + $67,500 fee after cost sharing =
$2,567,500.

If actual costs are $6,000,000, then the contractor would bill:

$6,000,000 costs + $30,000 fee = $6,030,000

ASSIGNMENT FOUR

Assume:

1. There were no continuing contracts at the end of 2009.

2. The forward-pricing rates shown in Table 3 have been approved for 2010.

3. The following contracts (data shown in Tables 4, 5, 6, 7, and 8) were bid and won for 2010.

4. The four contracts for which data is provided will be started and completed in 2010.

From this information:

1. Calculate the bid submitted in 2009 for each contract to start Jan 2010.

2. From the bids, prepare a pro forma financial statement.

   The contract shown in Table 5 has been loaded by the author to provide all the data needed to prepare the pro forma income statement for the fixed-price-firm-target contract as shown in its traditional format in Table 6. If costs exceed the target costs, the contractor will share in the overrun (paying in this instance 35% of the overrun).

Table 3
Forward-pricing Rates for 2010

Overhead rate	60.00%
Materials handling rate	12.00%
G&A rate	22.00%

Table 4
Estimated Direct Costs for Firm-fixed-price Contract FFP-0014, Fiscal Year 2010

Direct labor	1,250,000
Direct materials	875,000
Fee as % of total loaded costs	20%

Table 5
Estimated Direct Costs for Fixed-price-firm-target Contract FPFT-0019, Fiscal Year 2010

Direct labor	850,000
Overhead applied	0
Direct materials	1,300,000
Material handling costs applied	0
Contract costs	2,150,000
G&A applied	0
Total loaded costs	2,150,000
Profit	215,000
Total Bid	2,365,000

Table 6
Incentive Cost Data for Fixed-price-firm-target Contract FPFT-0019, Fiscal Year 2010

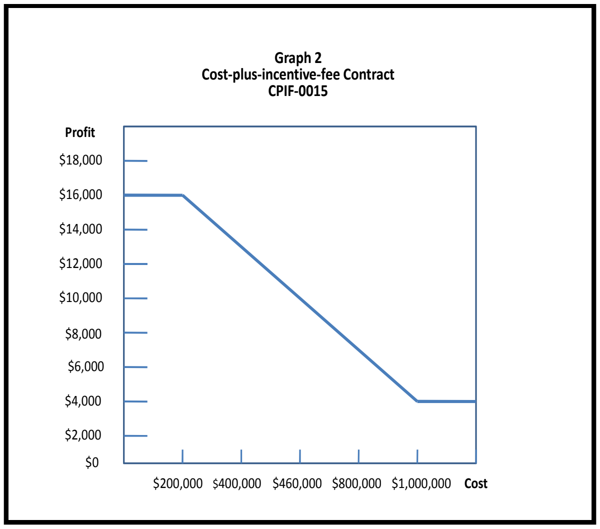
Target costs loaded	3,435,520
Target profit	343,552
Target price	3,779,072
Price ceiling	4,417,097
Share Arrangement	
Government	**Customer**
65%	35%

Table 7
Estimated Direct Labor Costs for Labor-hour Contract LH-0016, Fiscal Year 2010

Hourly rate hardware engineer	55
Hourly rate software programmer	34
Estimated paid hours hardware engineers	6,000
Estimated paid hours software programmers	10,000
Fee as % of total loaded costs	6.00%

Table 8
Estimated Costs Cost-plus-incentive-fee Contract CPIF-0015, Fiscal Year 2010

Direct labor	102,459
Target fee	16,000



* * *

As Evan Elmore implemented these new programs, the company prospered and so did he. He was promoted to controller and with this came a raise that allowed Susan and him to purchase their first home. As the company grew, he was able to hire a contract administrator to negotiate contracts and supervise billing. By the end of 2010, the company had completed and invoiced the four contracts listed above. To assist his new contract administrator, he prepared the following guidelines for billing and revenue recognition.

1. The invoice amount for a firm-fixed-price (FFP) contract is always the bid price, regardless of the actual costs incurred.

2. The invoice amount for a fixed-price-firm-target (FPFT) contract is the sum of the actual loaded contract costs (up to the price ceiling) plus allowable profit, if any.

3. The invoice amount for a labor hour (LH) contract is the product of the negotiated loaded labor rate times actual hours worked.

4. The invoice amount for a cost-plus-incentive-fee (CPIF) contract is the sum of the actual loaded contract costs and profit as calculated from the slope of the profit line. Unlike the fixed-price-firm-target contract, a cost-plus-incentive-fee contract has no ceiling for actual loaded costs, and there is always a minimum profit.

Actual costs for the four contracts completed in 2010 as shown in Tables 9 and 10.

Table 9 Actual Costs During 2010 (Taken from General Ledger), Fiscal Year 2010					
	FFP-0014	**FPFT-0019**	**LH-0016**	**CPIF-0015**	**Total**
Actual direct labor	1,280,000	900,000	735,100	155,000	3,070,100
Actual overhead					1,730,676
Actual direct materials	888,000	1,390,000	0	0	2,278,000
Actual materials handling cost					255,000
Total contract costs					7,333,776
Actual G&A					1,525,000
Total costs					8,858,776

Table 10 Actual Labor Costs and Actual Billing on Labor Hour Contract LH-0016, Fiscal Year 2010					
	Actual			**Negotiated**	
Title	**Actual Hours**	**Actual Labor Cost/Hour**	**Total Actual Labor Costs**	**Negotiated Billing Rate**	**Total Billing**
Hardware engineer	7,600	57	431,300	0	0
Software programmer	9,800	31	303,800	0	0
Total			735,100		0

ASSIGNMENT FIVE

1. From the information provided, prepare the actual income statement for the 2010 fiscal year showing revenues and direct costs for each contract in a separate column, consistent with the format shown in Table 11.

Table 11 Format for 2010 Income Statement					
	FFP-0014	**FPFT-0019**	**LH-0016**	**CPIF-0015**	**Total**
Revenue	$xxxx	$xxxx	$xxxx	$xxxx	$xxxx
Less contract costs					
Direct labor	xxx	xxx	xxx	xxx	xxx
Overhead					xxx
Direct material	xxx	xxx	xxx	xxx	xxx
Material handling cost					xxx
Contract costs					xxx
Gross margin					xxx
G&A expense					xxx
Income before tax					$xxx

2. Provide a brief analysis of what caused the variation of profit from the pro forma to actual income statement.

TERMS USED IN CASE STUDY

Burdened costs: Direct costs plus indirect costs applied.
Burdening a contract: See "loading a contract."
Contract administrator: The person responsible for seeing that work performed is completed consistent with the scope of work of that contract, and the rules and regulations pertaining to that contract.
Contract costs: The sum of direct labor, direct material, overhead, and material handling costs.
Contract overrun: The amount by which costs incurred in completing a contract exceed the amount bid.
Contract underrun: The amount by which costs incurred in completing a contract are less than the amount bid.
Cost Pool: A group of costs accumulated for any specific purpose.
Cost-reimbursement contract: A class of contracts where the contractor receives as payment the actual costs incurred, regardless of the original cost estimate.
Defense Contract Audit Agency (DCAA): A government agency responsible for providing accounting, auditing, and financial advisory services to the Department of Defense on defense contracts including contract audits.
Federal Acquisition Regulations (FAR): The policies and procedures mandated by Congress for use by federal agency procurement officers in awarding government contracts.
Fee: Synonym for contract profit.
Fixed-price contract: A category of contract where the price is determined prior to the work being done. The contractor is paid the fixed price negotiated, regardless of the actual cost of the contract.
Forward pricing rates: A set of indirect rates (the overhead rate, materials handling rate, G&A rate, and so on) submitted for approval by a contractor to the DCAA for approval for use in bidding all cost-based contracts for a fiscal year.
G&A Rate: An indirect cost rate used to apply general and administrative costs to contracts.
General and Administrative (G&A) Costs: Period (as opposed to product) costs, not commonly included in cost of goods sold.
Government-industry revolving door: The practice of the Department of Defense and private defense industry rotating employees between industry and government.
Incentive Fee: An incentive payment for specified cost control on a contract.
Indirect costs: Costs that are not readily identifiable with a product but must be included in a contract bid. These include fringe benefits, overhead costs, materials handling costs, and general and administrative costs.
Indirect cost rates: Rates used to apply individual indirect costs to contracts.
Interim billings: Billings made for work done prior to the completion of a contract. Interim payments provide the working capital for contractors to perform on large contracts.
Invitation for bid: A competitive method of government contracting used for purchases over $100,000 when the government knows the exact specification, number, and delivery date of the product it wishes to purchase.
Labor dollars spent: The amount of labor dollars that have been spent as of a specified date on a contract.
Labor dollars earned: The amount of labor dollars that should have been spent as of a specified date on a contract for work actually performed. Synonym for labor dollar budget at a specific point of contract completion.
Loaded costs: Direct costs that have been burdened with all indirect costs.
Loading a contract: Allocating indirect costs such as overhead, material handling, and general and administrative costs to direct costs for the purpose of bidding.
Materials handling rate: An indirect cost rate use to apply indirect materials handling costs to contracts.
Overhead cost: Product (as opposed to period) indirect costs.
Procurement: The government agency responsible for purchasing goods and services.

Request for quotation (RFQ): A non–binding request for quote issued by procurement when a government agency is merely checking into the possibility of purchasing a product or service.

Request for proposal (RFP): A document issued by procurement on highly technical products exceeding $100,000 in price. This document solicits proposals from contractors on how they intend to perform the scope of work, and at what price.

Scope of work: A written statement of the activities that must be completed for a defense contractor to successfully complete a government contract.

AUSTRALIAN DREAM: AN AMERICAN DREAM

Stephen L. Loy, Eastern KentuckyUniversity
Steven Brown, Eastern Kentucky University
Mark Case, Eastern Kentucky University

CASE DESCRIPTION

The primary focus of this case is on how a small business that has been successful selling an over-the-counter arthritis cream in a regional market can refocus to compete in a national market. The secondary issues include marketing, strategic management, entrepreneurship and e-commerce issues.

Students are provided a scenario of a small business that is on the verge of taking off. The case requires students to do a SWOT analysis, analyze the market environment using Porter's five forces model, and to analyze the business philosophy and practices of an emerging company. Students could be assigned the critical task of developing a plan for moving the firm's product from a regional market to a national market and to generate sufficient sales to stay on the store shelves of a major retail chain.

The case has a difficulty level of four and is appropriate for senior level classes or higher. It can be taught in two to three hours of class time, with students spending six to twelve hours of outside preparation. At the request of the company, this case does not contain any detailed financial data or financial strategy.

CASE SYNOPSIS

Phil and Mark Maddox formed a small company, Nature's Health Connection (NHC), to market a skin cream that was being sold through Phil's pharmacy. NHC own the small company that makes the skin cream with the distinguishing ingredient of emu oil. In 2000, an FDA approved ingredient was added to the cream to create Australian Dream® Arthritis Relieving Cream (AD).

Over the last ten years, managing the company has been difficult and at times nerve racking. However, growth has been steady due to learning from mistakes, a little luck, and the sheer determination of the brothers. Phil is the entrepreneur and risk taker, while Mark is more conservative. The brothers have an excellent personal relationship and compliment each other's strengths.

Their initial strategy was to market AD to independent pharmacies in the southeast United States. The product has a high price relative to its competitors, but provides an attractive profit margin for the pharmacies. Advertising has been limited to in-store displays and local *newspaper ads. The product has a loyal customer base and appears to be recession proof, but sales have not grown much recently.*

A year ago, Walgreens began stocking AD in some of its stores across the country. Once this happened, AD was quickly picked up by a few other large chain stores. The capital investment required to meet the sales quotas of the chain stores has almost caused Phil to throw in the towel. Going national requires costly changes in advertising strategy that seem insurmountable. However, Phil and Mark are adapting quickly.

NHC's growth has caught the attention of a business broker who represents a group of venture capitalists that might want to buy NHC or to provide needed capital for NHC to go national. Phil strongly believes NHC will be worth a lot more if they can create a national brand image, introduce other products, and expand their distribution through other national and regional chains. The big questions facing NHC is: How to do it? Should they go it alone? Bring in investors? Sell NHC now, or wait for the company establishes itself as a national brand?

INTRODUCTION

Nine months ago, Phil Maddox almost called it quits. He was getting very discouraged with the way things were going with Nature's Health Connection (NHC), a company he co-found in 1998 with his brother Mark. Phil's had always wanted to grow NHC into a viable national company. Through a series of shrewd promotional moves, the sales of their sole product, Australian Dream® Arthritis Relieving Cream (AD), have grown, despite the national economy diving into the worst recession since the 1930s.

According to Phil, the journey over the past ten years has been filled with plenty of bumps, pitfalls and sleepless nights. Managing NHC has been difficult and stressful. However, the company has grown, sometimes rapidly and sometimes slowly, through trial and error, well-calculated decisions, and sheer luck. The Maddox brothers have taken AD from a local market product the verge of becoming a viable national market product.

This growth has caught the attention of a business broker who has approached the Mattox brothers to see if they are interested in selling NHC. While the idea of selling NHC is tempting, Phil and Mark think the value of NHC would be much greater if they can make AD national brand and widely sold in national retail chains, such as Walgreens, CVS, Rite Aid, and others.

PHIL'S BACKGROUND

"I'm a marketing guy. It's what I have always done. It's what I enjoy. My dad was a doctor who ran a small clinic in small town in Kentucky. My brothers and I helped in the clinic when were kids. After high school, I enrolled in college with the thought of following my father's footsteps. However, I found the courses in the pre-med program, especially chemistry, uninteresting and often fell asleep in class. The thing I enjoyed most was my work-study job at the campus TV studio. I enjoyed so much, that I switched my major to Radio and Television."

After graduating from college, Phil moved to California where he worked for a national photographic distributor for several years, before moving back to Kentucky and opening a pharmacy next door to his father's medical clinic.

AUSTRALIAN DREAM® ARTHRITIS RELIEVING CREAM

When Mark and Phil were in high school, they purchased a used coffee vending machine and placed it in the office of a local business. Whenever the coffee machine broke down, one of them would voluntarily fix it, without squabbling about whose turn it was, "just to keep the nickels flowing." From this experience, they discovered that they made a good business team because they had complementary skill sets, were good at making joint decisions, and trusted each other to do whatever needed to be done without complaining. So, after Phil moved back to Kentucky, they kicked around the idea of going into some sort of business together. They decided to open a pharmacy, because the small where their father medical clinic was located did not have one.

According to Phil, "local independent pharmacies operate much like convenience stores in that they have little pulling power to attract new customers and expand their market base and revenue. What we needed was a product that no other pharmacy in the area had." In 1998, they purchased a local small business that made a skin cream that contained emu oil. Emu oil is a good skin cream ingredient because it is odorless, greaseless and penetrates the skin quickly. The product was successful in drawing customers who bought other products when they came to the pharmacy to buy the skin cream. In fact, sales were so good that Phil and Mark decided to start a company, Nature's Health Connection (NHC), to market the skin cream to other pharmacies.

Two years later, a second product was developed by adding histamine dihydrochloride (HD) to the skin cream. The new product was named Australian Dream® Arthritis Relieving Cream (AD). HD is not a true pain reliever. It works by relaxing the blood vessels to stimulate blood flow to the applied area. Medical research has found that creams containing "cetylated fatty acids -- similar to omega-3 fatty acids such as those found in fish oil" to be "a promising arthritis treatment, improving the flexibility of achy joints" ("Arthritis Treatment Cream Shows Promise," 2003). Emu oil has omega-3 fatty acid, omega-6 fatty acid and omega-9 fatty acids (Appendix A). HD and emu oil work together to provide a natural anti-inflammatory, anti-bacterial, anti-fungal, healing, moisturizing product. NHC owns the registered trademark rights for "Australian Dream"

The Maddox brothers marketed AD to independent pharmacies in the southeast United States. AD has a high price relative to its competitors, but a high profit margin which pharmacies find very attractive. The initial competitive strategy was to focus on placing AD on shelves in independent pharmacies, rather than major chain stores such as CVS, Walgreens, et al., because the major chains will not sell a product that is not a national brand.

However, things began to change for NHC in 2005 when Walgreens bought a large independent pharmacy in Florida that was NHC's biggest customer. The store manager, retained by Walgreens, continued to sell AD even though it was not one of Walgreens' national "planogram" products, because the sales volume and profit margin of AD boosted his bonuses. He shared this information with other Walgreens managers at regional sales meetings. Soon, they were stocking AD too. Eventually, word about AD reached Walgreens' corporate headquarters in Chicago. A phone call was made to Phil Maddox to invite him to Chicago to talk about selling AD in Walgreens stores across the nation.

The meeting with Walgreens national sales managers took place in late 2007. A deal was struck in which AD would be placed on shelves to see if it could reach sufficient sales volume to become a planogram product. No specific sales figures goal or time frame were given. In 2008, AD was placed in 6,200 Walgreens stores. Shortly, thereafter, NHC leveraged its Walgreens success with placement in 1,200 Kroger stores, 120 Meijer stores and several SuperValu stores. By the end of 2008, AD was being sold in over 10,000 retail outlets. Maddox brothers now have their sights set on product placement in CVS (6,900+ stores in 41 states) and Rite Aid (4,900+ stores in 31 states).

The big challenge for NHC is to get permanent placement of AD in the big retail chain stores. To do that, they need to make AD a nationally recognized brand name. NHC needs to develop and implement a national marketing campaign, which is something they have never done before. They need to take AD from a regional brand to a national brand to generate sufficient sales to stay on the chain store shelves.

NATURE'S HEALTH CONNECTION

Initially, NHC was incorporated as a C corporation, but changed to an S corporation in 2008. Its primary Standard Industrial Classification (SIC) is Perfumes Cosmetics, and the North American Industry Classification System (NAICS) is Toilet Preparation Manufacturing.

MISSION

The Mission of Nature's Health Connection, Inc. is "to provide arthritis sufferers with effective pain relief. We want to make our product easily identifiable and widely available throughout the United States. Producing quality products and delivering those products with a satisfaction guarantee is our goal."

MANAGEMENT

Australian side of the business and Mark handles the operations side. They work as a team by collaborating on the important issues and supporting each other, especially when the workload becomes demanding.

PRODUCT

AD is an external analgesic for the temporary relief of the minor aches and pains of muscles and joints associated with arthritis. The active ingredient in AD is histamine dihydrochloride which eases pain through vasodilatation. Vasodilatation provides pain relief by widening the blood vessels to increase blood flow to the specific area of pain.

AD has been a popular product in independent pharmacies and health food stores, not only for what is does, but for what it doesn't do. Customers like AD because it is odorless, does not burn and contains no colored dyes that could stain skin and clothing, like many of the competing products.

The primary ingredient in the cream is emu oil. The emu oil absorbs rapidly into the skin and promotes faster absorption of the other active ingredients into the skin and muscles resulting in quick pain relief (Appendix A). Emus are raised on poultry farms all across the United States and Canada. The American Emu Association and Canada Emu Association have set purity standards for the refining of emu oil (see “The Truth about Emu Oil Refining”).

TARGET CUSTOMER AND MARKET SIZE

The primary target customers for AD are females, ages fifty-five and above who have aches and pains from work or exercise. These are the active baby boomers who seek an arthritis product, so they can enjoy playing golf, gardening, hiking, or sewing, etc.

Arthritis comes in more than 100 forms. The most common form is osteoarthritis. Arthritis causes chronic pain and immobility to individuals in every country. Approximately 350 million people worldwide suffer from at least one form of arthritis. In the USA, over 40 million people suffer from arthritis (20 million with osteoarthritis and 3 million with rheumatoid arthritis).

An estimated 46 million Americans have some form of arthritis (National Center for Chronic Disease Prevention and Health Promotion) and approximately 350 million people worldwide. In the US, over 50% are over the age of 65 and 60% of them are women. Arthritis leads to 750,000 hospitalizations and 9500 deaths in 2003. Arthritis accounts for $50 billion in medical costs and $40 billion in lost productivity each year. (National Center for Chronic Disease Prevention and Health Promotion)

In a 2005 report, the CDC stated that women are more likely than men to have arthritis. By 2030, the number of adult Americans with doctor-diagnosed arthritis is expected to climb to 67 million, or 25 percent of the adult population. Twenty-five million adults (37%) will have significant physical activity limitations due to arthritis (National Center for Chronic Disease Prevention and Health Promotion, 2005).

Worldwide estimates reveal that about 420 million people are over the age of 65 years. By 2030, there will be nearly 1 billion people in the world over 65, and over 20% will have some form of arthritis. Currently, the market for arthritis treatment products is a nearly $400 billion a year (Untitled document, 2009).

PRIMARY COMPETITION

Topical arthritis cream products are preparations applied to the skin. Many of the arthritis cream products can be purchased over-the-counter. These products effectively soothe minor arthritis and muscle pain. Many arthritis creams contain the active ingredient salicylate, while others contain capsaicin or menthol (About.com: Arthritis).

The national arthritis cream/liniment market is highly competitive and dominated by long-established companies. The pain relief market is growing as aging baby boomers, and people over 40, are staying physically active longer.

The top selling topical arthritis creams are shown below (Eustice and Eustice, 2009).

1. Zostrix Arthritis Cream

Research has shown this arthritis cream works by reducing levels of substance P, a chemical involved in transmitting pain impulses to the brain. When applied to the surface of the skin, it has a pain-relieving effect. Active ingredient is capsaicin.

2. Bengay Arthritis Cream

It offers temporary relief of minor joint and muscle pain. It is an arthritis cream which has lasted the test of time. Active ingredients found in this arthritis cream are methyl salicylate and menthol.

3. Aspercreme

Arthritis cream temporarily relieves minor pain associated with arthritis, simple backache, muscle strains, and muscle sprains. Active ingredient of this cream is trolamine salicylate.

4. Icy Hot

Topical arthritis formula has dual action - gets icy to dull the pain and then gets hot to relax it away. Fast, long-lasting pain relief for sore muscles, backache, muscle cramps, and joint pain. Active ingredients are methyl salicylate and menthol.

5. Sportscreme

Arthritis cream provides fast, temporary relief from minor pain associated with sore muscles, muscle strain and stiffness. This cream does not smell like medicine. Active ingredient is salicylate.

6. Tiger Balm

Has a soothing action that relieves muscular aches and joint pain. Product contains active ingredients such as camphor, menthol, cajuput oil and clove oil.

7. Mineral Ice Original

Cool, greaseless, pain relieving gel penetrates deep to provide fast, temporary relief of minor aches and pains of muscles and joints. Active ingredient is menthol.

PRODUCTION

The production of AD is outsourced to the Pure Source Company of Miami, Florida. Pure Source manufactures the cream, fills labeled jars and packs them in individual boxes. The individual boxes are packed into larger containers and shipped to NHC's facility in Campton, Kentucky. NHC, in turn, ships the product to brokers and wholesale distributors. Pure Source is an international company that makes cream products for many companies. It has a large production capacity and can ramp up production of AD quickly if needed.

PRICING

The retail price of the 2 oz. jar of AD is $19.95, $29.95 for the 4 oz jar, and 59.95 for the 9 oz. jar. NHC only sells the 4 oz. jars in the chain stores, and the 2 oz. and 4 oz. jars in independent pharmacies and independent wholesalers. Consumers can buy all sizes directly from NHC's Web site. The 9 oz jar has proven to be the most popular on the Web.

The high price of AD differentiates it from the popular national brands of pain relief creams. The high price provides a profit margin for the retailer. Another reason for the higher prices is that NHC anticipated that prices would be sticky and that raising prices in the future would be difficult. In fact, the prices of arthritis creams, in general, have been stable for last several years.

"We feel pain is the prime motivator for people with arthritis, not price. This is why we chose to position AD at the high end of the market. It helps create an image of a superior product. If AD can stop the pain quickly, people will gladly pay the price."

An additional pricing issue is that the large chain stores reserve the right to lower the price of AD periodically for sales promotions. In which case, if Walgreens decides to run a $5 off sale, NHC will be paid $5 less for each jar sold. Walgreens will get its standard cut and NHC still make a net profit on each item sold.

PACKAGING

Phil had a firm develop the packaging for AD so that it takes up less shelf space than the competitor brands. The combination of higher price and using less shelf space gives AD a gross margin per unit of shelf space potential that is three times greater than the competing brands.

PROMOTION AND ADVERTISING

Originally, AD was marketed exclusively to independent pharmacies. To get a pharmacy to agree to have AD placed on its shelves, NHC stocked the shelf space with 2 oz. jars and a sign touting NHC's 100% money back guarantee. There was no upfront charge to the pharmacy. Then, NHC would run advertisements for AD in local newspapers 30 days. After 30 days, the broker servicing AD would return to the store, bill the pharmacy only for the units sold, and pick up the items that had not sold, if the pharmacy did not want to continue carrying the product. If the pharmacy wanted to continue carrying AD, the broker replenished the stock. This marketing strategy work well when applied to a single regional market, but would be prohibitively expensive on a national scale. A different strategy was needed for the national marketing campaign.

The initial national marketing campaign started off with placing advertisements in Reader's Digest and Guidepost magazine to target 55+ year old women. The ad placements were very expensive, and only boosted AD sales slightly. Next, Phil placed ads in Ladies' Home Journal and Woman's Day magazines in order to reach both the 40+ and 60+ year old women. Shortly after these ads appeared, sales of AD increased substantially. Phil thinks this is because younger women purchasing AD for their parents and trying out for themselves.

Two after these monthly magazines come out, sales of AD peaks and then falls off until next issue comes out. This pattern is present for both in-store sales and Internet sales. Fortunately, the sales peeks are increasing each month. Phil thinks that after consumers have seen the AD advertisements in the national publications several times, they begin to perceive it as a legitimate and trustworthy product.

Recently, Phil began buying remnant advertising space (i.e., advertising space that a media company has been unable to sell) through a third party. Buying ad space directly from a magazine publisher at the standard rate costs $69,000 per issue. However, purchasing remnant advertising space through a middle man, costs only $25,000 per issue. Additionally, since Phil is a hard negotiator, he has worked out a deal where NHC pays for the advertisements 30 days after they appear in a magazines issue, rather than the standard of 45 days before. Due to the severe economic recession, the large advertising firms have become very flexible in negotiating with clients.

Phil is now considering the possibly using TV infomercials. Typically, it costs $50,000 to get a telemarketing company to produce and pilot test an infomercial. If the test is successful, the telemarketing company will work with the client to develop and conduct a full-blown advertising campaign. However, the costs are enormous. NHC would have to front all of the infomercial production costs, pay the telemarketing company to take the calls 24/7, do the shipping, processing and everything else that goes with fulfilling orders and customer service. Phil is talking to several telemarketing companies in hope of negotiating a better deal. He hopes to work out a partnership arrangement a reputable company that will handle the phone banks and production costs.

NHC uses the Internet in two ways to spur the sales of AD. First, a high-quality Web site (www.australiandream.com) was created build consumer trust and creditability for NHC and AD. Potential customers can go to the site to get free samples and company information such as: company mission statement, contacts, product guarantee, where to find retail stores that sell AD, promotional video, product information, shipping and placing online orders. The color scheme of the Web pages matches the color scheme of the AD packaging in order to enhance brand recognition.

The primary purpose of the home page is to lend credibility to the product and NHC in order to gain consumer trust. The Web site is not expected to generate a large volume of online orders, however. It is expected that most first-time customers will buy AD from a retail store after visiting the Web site. Loyal customers who want to purchase the 9 ounces jar will buy it from the Web site since few pharmacies or chain stores want to carry the $59.95 product.

Quantcast.com is a Web site traffic monitoring service that collects site traffic data, demographic and lifestyle profiles of online audiences. Their statistics shows that 67% of visitors at www.australiandream.com are female, 91% Caucasian; 83% with no children 17 or under; 23% have household income $60k+; 66% no college.

The second way NHC sells AD via the Internet is through an online healthcare products distributor named 911HealthShop.com. 911HealthShop is an online aggregator or category killer of vitamins and personal care products. According to Quantcast.com, 911HealthShop.com averages about 1,000 unique US visitors per day, 55% are females, 42% are 50+ in age, 76% Caucasian, 12% Black, 7% Hispanic, 4% Asian; 27% have household incomes between $60K-100K, 21% $100K+; 50% at least one college degree; 19% of visitors are regulars who make up 35% of total site traffic. People who visit 911healthshop.com are likely to visit sites in these categories: healthcare (affinity 5x), pharmacy (affinity 3.6x), and seniors (affinity 3.2x). See Table 1 for breakdown on places where visitors to 911HealthShop.com are likely to visit.

Table 1 Other Web Sites Likely to Visit	
Column 1	Column 2
Likely to visit these sites as well:	Affinity
herbspro.com	96.0x
vitacost.com	37.1x
herbalremedies.com	32.5x
iherb.com	22.7x
swansonvitamins.com	19.6x
raysahelian.com	15.4x
w3track.com	11.1x
vitadigest.com	10.2x
seacoastvitamins.com	9.2x
puritan.com	6.4x
gnc.com	6.3x
seniorpeoplemeet.com	5.7x
become.com	5.0x
allegromedical.com	4.9x
bodybuilding.com	4.7x
Source: http://www.quantcast.com/911healthshop.com/demographics#lifestyle, 8-25-2009	

DISTRIBUTION

The NHC warehouse has three employees who unpack shipments from the outsource supplier, Pure Source. They also prepare orders for shipment to commercial and individual customers. UPS is used for shipping orders to brokers and independent pharmacies, while USPS is used to ship small orders to individual consumers who make their purchases through the 911healthshop.com or australiandream.com Web sites.

AD is distributed to Walgreens and Kroger stores through brokers who sift through hundreds of new products to identify which ones would be appropriate for their client, the chain retailer. The broker knows the rules that need to be followed for each chain retailer for choosing candidate products. In the case of AD, a broker will set up and conduct meetings between Mark and Phil and a buyer for a chain store. Once a buyer agrees to carry AD, the buyer communicates with the broker to resolve problems, rather than contacting the manufacturer directly. Meetings the buyer and Mark and Phil occur about once a year. Any problems that arise in between those meetings are generally handled between the chain store buyer and the broker, and, if necessary, between the broker and Mark. The broker is also responsible for ordering, stocking and maintaining the product in the store.

The independent pharmacies deal directly with NHC individually to place orders and to resolve problems. NHC ships these orders directly to the independent's store where the store employees place AD on NHC-supplied custom stands which are positioned near the front check-out counter.

Mark is the eyes and ears of NHC. He is attentive to what is happening in individual pharmacies and the brokers to develop and maintain close relationships with them.

COMPETITIVE STRATEGY

"Our strategy is fairly simple," Phil says. "We have a trial and error approach. If something doesn't work, try something else. Most of our decisions are based on our past experiences, common sense, and taking advantage of opportunities when they prevent themselves."

"I attended a seminar thirty years ago where I learned about risk reversal. If you give guarantees, it shows you are not afraid. As long as you have a good product you believe in and stand by it, you can get others to believe in it. We used this principle in our pharmacy, and we used the principle to convince the independent pharmacies to take a chance on our product. We know there is a lot of competition in the pain relief market, but we have created a product that has a unique formula that we can sell at a premium price. It's all about creating a high-quality brand image. Our customers like what we sell."

NHC has a developed a business model they feel can be used to launch other products or create a new company. The basic principles of the model are:

Develop a good product, make it unique, and stand behind it.
Create a quality brand image and sell at a premium price.
Create and maintain very good customer relations.
Share high margins and promotions with retailers.
Outsource all possible elements to keep capital and operating costs low.
Use the expertise and know-how of others to complement what we know.
Remain flexible and creditable.
Above all, persevere.

PAST AND PRESENT ISSUES

"Hard work and perseverance are keys to our success. We have experienced numerous setbacks, but we learned from them and moved forward. Our first cream manufacturer had undisclosed financial problems. The second one didn't meet the shelf life requirements, which resulted in a major inventory loss for us. We had to redesign our packaging to meet shipping and display restrictions, we had problems with our sales reps, our Web site needed to be redesigned, and we have had to experiment with our advertising to get it to work. I like being creative and solving difficult problems, even though it can be time consuming and nerve wracking."

"I'm a risk taker, and Mark is somewhat risk adverse, probably because of his back ground as an attorney. Sometimes, I wished I owned 51 percent of the company, so I could do what I want. But, I'll have to admit that Mark has saved us from moving down a disastrous path more than once. Like the time I wanted to dump a lot of money into TV advertising. Fortunately, he talked me out of it. We actually make a good team."

"Recently I made a decision to put a lot of my own money into NHC because Mark had cold feet. This was a time when I was tempted to throw in the towel. We had come to a point where we had to decide whether to grow the company to a new level by going national or just remaining a regional company. Walgreens had offered place AD in stores throughout their entire chain. But, we would have to meet certain volume benchmarks or be dropped after a trail period. To meet the benchmarks would require implementing an expensive national advertising plan."

"We knew one of the keys to our past success was advertising at the local level through newspapers. So, we tried to do that in some major cities all across the country. It just didn't work. It was ridiculously expensive. I felt we could get similar results through placing ads in popular nationally distributed magazines, but this was also very expensive and Mark dug his heels on taking this risk. I floated the cost out my own pocket, and it appears to be working. Every time we run ads in the magazines all of our sales increase."

"Even though we are in midst of a major recession, our Walgreens sales are meeting their benchmarks and growing slowly, but steadily. Walgreens recently cut 10 percent of their shelf items, and we survived the cut. It appears that we are on line to meet their first year sales volume target. I attribute this to the fact that we have a good product and that our magazine ads are working. If this trend continues, I feel strongly that we will be able to land the CVS account, other big retail chains like Kroger and Rite Aid.

"If we can get placement in those big chain stores, we could make AD as a household name like Icy-Hot and Bengay. We are already considering launching a new product using our current business model. It would be relatively easy and fairly inexpensive piggy-back it with AD. By making a slight change in the formula of AD, we could produce an anti-wrinkle cream that could be targeted at the same demographic group as AD. We could use the same distribution channels, follow the same promotional strategy and use same outsource manufacturer that makes AD for us. But do we really want to grow by expanding our product line before AD is firmly established as a national brand? Should we be focusing on finding of better ways to position AD in its market first? These are the big issues that confront us now."

Recently, the Maddox brothers were contacted by a business broker who wanted know they are interested in selling NHC. "The amount of money he mentioned was peanuts compared to what we could make if we are successful in turning AD into a national brand with mass distribution. It's tempting to think about cashing out and building another company, but now isn't the right time. Getting the capital for a big marketing campaign to make AD a mass market brand name won't be easy, but I think it can be done," says Phil. "One option is to turn NHC into a publicly held corporation, but I really don't want to do that. I like the freedom to make decisions without having to worry about stockholders."

"At this point, Mark and I need to come to an agreement on how to proceed with marketing AD from here. If we can't, then I'm prepared to buy out his share of the company and go it alone."

REFERENCES

About.com. Accessed August 26, 2009 from http://arthritis.about.com/od/topicalmedications/tp/arthritiscream.htm)

"Arthritis treatment-cream shows promise." Accessed August 26, 2009 from http://arthritis.webmd.com/news/20030604/arthritis-treatment-cream-shows-promise.

Code W. (May 1997). "Emu Cream Assists Lidocaine: Local Anesthetic Absorption through Human Skin." Presented at the 88th American Oil Chemists Society annual meeting. Accessed August 26, 2009 from http://www.emu-oil.com/research.htm.

"Emu Oil Properties: Background, study, and guide for uses." Accessed August 26, 2009 from http://www.chemie.de/lexikon/e/Emu_oil/#_note-2/

"Emu Oil Proven To Be Medical Wonder." *High Beam Encyclopedia,* from Business Wire, 8/10/1998. Accessed August 26, 2009 from http://www.highbeam.com/doc/1G1-162642685.html

"Emu Oil: A Natural Wonder!" Accessed June 24, 2009 from http://www.carlhavenemufarm.com/Body3.htm.

"Emu Oil: Comedogenicity Testing." Department of Dermatology, at University of Texas Medical School, Houston (1993). Accessed August 26, 2009 http://www.emu-oil.com/research.htm.

Eustice, Carol and Richard Eustice. "Top 7 Arthritis Cream Products." March 28, 2009. Accessed August 26, 2009 from http://arthritis.about.com/od/topicalmedications/tp/arthritiscream.htm.

Ghosh P, Whitehouse M. (1993). "Experimental Study to Determine the Anti-Arthritic Activity of New Emu Oil Formulation (EMMP)," North Shore Hospital of Sydney/University of Adelaide. Accessed August 26, 2009 from http://www.emu-oil.com/research.htm.

Hopkins, Leigh and AEA Standards Team (1997). "Composition of Emu Oil: The Micro View." Accessed August 26, 2009 from http://www.outbackmedic.com/studies.htm,

National Center for Chronic Disease Prevention and Health Promotion. "Arthritis: Data and Statistics." Accessed August 26, 2009 from http://www.cdc.gov/arthritis/data_statistics/state_data.htm#gdp.

O'Banion S, Griswold J. "Evaluation of Emu Oil in Lubrication and Treatment of Healed Burn Wounds," Texas Tech University Health Sciences Center, Lubbock, Texas. American Burn Association, March 18, 1998, Chicago, Illinois. Accessed August 26, 2009 from http://www.proemu.com/emu-oil/AEA+Emu+Oil+Burn+Study+Results.

"The Truth about Emu Oil Refining." Accessed August 27, 2009 from http://www.emuoildepot.com/refinery.htm.

Untitled document. Accessed August 26, 2009 from http://dreamnowlivenow.com/Page-76FLX.html)

Whitehouse. M. and Turner A. (1997). "Emu Oil: A Source of Non-Toxic Transdermal Anti-Inflammatory Agents in Aboriginal Medicine." *Inflammapharmacology*, San Francisco, March 1997 conference proceedings. Accessed August 26, 2009 from http://www.emu-oil.com/research.htm.

Woolley, Cole. Untitled document from Ageless Nutrition, 2e. Accessed December 29, 2008 from http://dreamnowlivenow.com/Page-76FLX.html.

Yoganathan, S. et al. (2003). "Antagonism of croton oil inflammation by topical emu oil in CD-1 mice." *Lipids* 38:603-7. PMID 12934669. Accessed August 26, 2009 from http://www.chemie.de/lexikon/e/Emu_oil/

Zemtsov A, Gaddis M, Montalvo-Lugo V. (1994). "Moisturizing and Cosmetic Properties of Emu Oil: A Double Blind Study," Accessed August 26, 2009 from http://www.emu-oil.com/research.htm.

APPENDIX A

Emu Oil: A Natural Wonder! (Source: http://www.carlhavenemufarm.com/Body3.htm, June 24, 2009)

Science is proving emu oil to be a modern miracle for relieving the pain and inflammation of injured tissues and joints. Studies and research are proving this complex and ancient oil to be beneficial not only as a topical application, but also when ingested in supplement form. Many of the claims regarding emu oil are documented by medical research as well as countless positive personal experiences. The accolades are pouring in.
The emu oil has been put through rigorous testing. This safe, sterile oil has proven to be hypoallergenic and will not clog pores. Use of emu oil has increased dramatically over the last several years.

Anti-Aging Effect

Emu oil is unsurpassed for its moisturizing properties. The fatty acid composition of emu oil and the oil in our skin is very similar. This may explain the positive effect that emu oil has on dry skin as well as noticeably diminishing age spots and wrinkles. This amazing oil penetrates through several layers of skin. There is nothing else like it on the market today.

Arthritis

Emu oil comforts stiff muscles and joints, and reduces the inflammation and swelling of arthritic joints. When used regularly, it acts much like an analgesic but with none of the negative side effects.

Burns

Emu oil has been found to be very effective on burns of all types including sunburn, 1st and 2nd degree burns and radiation burns. Emu oil alleviates pain and dramatically reduces scarring and blistering.

Chronic injuries and massage

Muscle strains, sprains, injured ligaments and even heel spurs respond well to treatment with emu oil. Professional sports teams are increasingly using emu oil for massages in their training rooms.

Psoriasis and Eczema

Emu oil acts like a therapeutic balm by moisturizing the skin and reducing the itching, redness and scaling associated with stubborn skin conditions.

Hair Care

Emu oil acts as a fortifying agent for limp, dry hair. It helps to eliminate split ends and will restore a natural, healthy shine to your hair. Treat yourself to a hot oil treatment or add a few drops to your favorite shampoo. You will be amazed at the body, shine and overall health of your hair.

How to Use Emu Oil

Whether you use emu oil topically or in supplement form, this 100% all natural oil is safe to use as often as you like. A small amount is all you will need to feel the difference. Emu oil has no odor and will penetrate the skin within minutes of application. It is safe enough to be used directly on open wounds and is also safe for children and babies.

Recent Scientific Research

In studies conducted at the Department of Pathology, University of Adelaide, Australia (Whitehouse and Turner, 1997) and at the Raymons Purves Bone and Joint Research Laboratories, University of Sydney (Ghosh and Whitehouse, 1993), emu oil had a positive effect in reducing inflammation and pain associated with arthritis.

"Emu oil is made from the fat of the emu, a bird native to Australia. It has been used for thousands of years by the Australian aborigines for the treatment of burns, wounds, bruises, and as a pain reliever for bone, muscle, and joint disorders. Emu oil is approximately 70% unsaturated fatty acids. The largest component is oleic acid, a mono-unsaturated omega-9 fatty acid. Emu oil also contains about 20% linoleic acid (an omega-6 fatty acid) and 1-2% linolenic acid (an omega-3 fatty acid) (Hopkins, 1997). There is some evidence to suggest that the oil may have medicinal benefit (Yoganathan, 2003; Zemtsov et al., 1994).

Emu oil has been shown in studies to aid in reducing scar formation in healed burn wounds, muscle sprains, and arthritis due to its strong anti-inflammatory properties (Emu Oil Properties, 2009). There is evidence that emu oil is also effective against foot fungus. There is also anecdotal evidence of its usefulness in providing relief to sufferers of eczema (Emu Oil: Comedogenicity Testing, 1993).

Emu oil is a complete neutral lipid, since emu oil lacks phospholipids, making it highly penetrating to the skin (Code, 1997; Yoganathan, S. et al., 2003). It has been shown in studies to aid in reducing scar formation in healed burned wounds (O'Banion and Griswold, 1998), muscle sprains, and arthritis due to its strong anti-inflammatory properties (Whitehouse and Turner, 1997).

CHIROPRACTIC MARKETING: MARKET SEGMENTATION & GROWTH STRATEGY

Jeanny Y. Liu, University of La Verne
Stephanie N. Van Ginkel, University of La Verne

CASE DESCRIPTION

The primary subject matter of this case concerns changing trends within the chiropractic industry in which the Segmentation-Targeting-Positioning (STP) process becomes the main emphasis for understanding consumer behavior as well as assessing markets. Secondary issues examined include: competitive advantage, differentiation, social trends, and consumer behavior. The case has a difficulty level appropriate for senior level. The case is designed to be taught in two (2) class hours and is expected to require three (3) hours of outside preparation by students.

CASE SYNOPSIS

In January 2008, Roseville Chiropractic changed its name to Roseville Family Chiropractic (RFC) to provide a more family-oriented chiropractic and health wellness appeal in an uprising, metropolitan area of Sacramento, California. Being in practice for close to 10 years, RFC's stifling growth brought about a need for rethinking the marketing strategy. High volumes of competition are beginning to encroach on the market and RFC is in need of differentiating its services in order to secure their market share.

Kevin Sherwood, RFC's current Director of Marketing, is looking to discover the environmental and behavioral changes of its consumers as well as identify potential target markets for future sustainability. Based on the researched information, he is expected to recommend segmentation, positioning, and communication strategies to the partners of the practice.

The following case study provides a thorough look for discussion of the chiropractic industry, a niche, but fragmented industry that is interesting to explore. It emphasizes and explores STP concepts that are essential for entrepreneurial and marketing students to understand in order to be competitive in today's markets. This study includes the major marketing concepts arising within study today, such as: consumer behavior and social trends among different generations, traditional marketing converging on digital and social networking techniques, the need for strategic repositioning to attract new markets, and the development of differentiating elements in order to assist in sustaining market share.

INTRODUCTION

Kevin Sherwood has been assisting his wife, Jennifer Cox, with her chiropractic practice doing various tasks from marketing to management for just as long as it has been in operation. In January 2008, one of the practitioners left the practice, leaving only Dr. Jennifer Cox and Dr. Juli Rodrigues as the lead chiropractors available for patient care. This was not the first time that a practitioner had left the practice. Practitioners have come and gone over the years after bringing in their own marketing strategies custom for their target markets, building a patient clientele, and eventually leaving with that clientele and marketing base. Frustration, inefficiencies, and loss of revenue continued to build with a negative aura among the staff and confusion among the patients as to the type of services that were offered in the practice. Luckily, both practitioners saw eye-to-eye on everything as far as the practice was concerned. They agreed after the last practitioner left, it should be only themselves in the partnership and re-branding of the practice. However, both practitioners also agreed they needed Kevin's help to build-up their practice after the last practitioner left. (Sherwood, 2009)

The business Kevin’s wife had worked so hard on for so many years now seemed to have limitless opportunities and possibilities. Knowing she would need more assistance in developing the practice in order to stay competitive, as well as re-build the patient-base, Kevin decided it was time to come on-board permanently as the practice’s Marketing Director. With a background in real estate, Kevin knew the basics of marketing to gain respective sales and clientele. When he started working for the practice, he began to do a number of tasks from suggesting new ways to increase productivity and visibility to developing a general marketing strategy for the practice. The business his wife had worked so hard on for so many years now seemed to have limitless opportunities and possibilities. (Sherwood, 2009)

Kevin began to think of all the redundancies and inefficiencies there were in the current marketing plan. He realized nothing was ever marketed “jointly” or cohesively among the practitioners, which proved to be a disconnect between the practice and the market due to each practitioner having their own belief of what the target market should be as well as the basic components of the marketing strategy. He also knew to compete among the industry competition locally and regionally, he would have to reintroduce the practice to the current target market and determine which additional or potential target markets to reach out to. Kevin also had to provide realistic segmentations of the current and potential new markets in order to determine which were primary as well as the growth sustainability over time. In addition, Kevin had to determine the need for repositioning the practice from a strategic marketing standpoint in order to stay competitive as well as build it for future growth. A new marketing strategy was needed immediately to show the practice’s differentiation qualities in order to sustain it above the competition as well as capture new market share. (Sherwood, 2009)

THE CHIROPRACTIC INDUSTRY

"Chiropractic is the largest, most regulated, and best recognized of the complementary and alternative medicine (CAM) professions. It is the third largest doctoral-level health care profession after medicine and dentistry" (American Chiropractic Association, 2008). The chiropractic industry has been considered as an alternative treatment to those with disorders of the spine, pelvis, and joints. It is a drug-free, non-invasive treatment approach, when compared to many types of traditional medical treatments (Weeks, 2005). According to the Association of Chiropractic Colleges (1996), "the purpose of chiropractic is to optimize health" and "…is a health care discipline which emphasizes the inherent recuperative power of the body to heal itself without the use of drugs or surgery". After the sanctions were lifted in 1987 between doctors' associations and chiropractor referrals, relationships between the two treatment methodologies has improved as well as the interest of patients towards alternative health care (Stevens, Mansfield, & Loudon, 2005). In 2006, there were 53,000 chiropractors employed in the US with a 14 percent change expected by 2016, in which 60,000 chiropractors are expected to be employed; a change that is faster than any other occupational average (Bureau of Labor Statistics, 2007). Of all alternative medicine services, which include chiropractic care, there is a projected growth of 88 percent between 1994 and 2010 – which is 72 percent higher than the expected growth of physician care during the same period (Stevens, Mansfield, & Loudon, 2005).

The overall industry is considered a niche industry at best, however, it is a growing one due to the physical demands many have in their daily lives as well as a distinction of a wellness need to many. Among many of today's patients, many have been seeking chiropractic care under the buzz marketing term of "wellness prevention" or other noted terms, such as "optimizing health" or "preventing illness" (Painter DC, 2008). To show this growth, "in 2002, approximately 7.4 percent of the population used chiropractic care - a higher percentage than yoga, massage, acupuncture or other diet-based therapies" (The American Chiropractic Association, 2008). Chiropractors do not just focus "…on disorders of the musculoskeletal system and the nervous system, and the effects of these disorders on general health," but "more than 40 [percent] of chiropractic patient visits were initiated for the purposes of health enhancement and/or disease prevention" (American Chiropractic Association, 2008; Painter DC, 2008).

There are many perceptions of chiropractors and of the overall industry, negative and positive. Chiropractors see themselves as "…qualified as primary care providers…", although patients do not always match this perception, therefore, affecting practice success (Foundation for Chiropractic Education and Research, 2007). A study completed in 2005 attempted to analyze the perception of the public's image on chiropractors and their care. This study showed that when asking a group of 250 non- and practicing consumers of chiropractic care whether chiropractors were a part of the medical profession or not, 79 percent felt chiropractors were and

91 percent felt chiropractors were not (Stevens, Mansfield, & Loudon, 2005). In addition, not all patients know exactly what chiropractors specifically practice. In a research survey conducted, one-in-five saw chiropractors as dealing with aliments not specific to their training, such as broken bones and blood disorders. Some even saw a chiropractor's training as being combined with such direct practices as reflexology, chiropody, and acupuncture (Carluccio, Norton, & Vasickova, 2004). Most patients feel that chiropractors have the ability to treat musculoskeletal conditions, such as spine ailments, but many "patients [still] have varied views of what chiropractors can and cannot treat" (Foundation for Chiropractic Education and Research, 2007).

PATIENT'S (CONSUMER) BEHAVIOR

Traditionally, the medical industry has been based upon the face-to-face interaction of the physician-patient relationship. However, "interactions between doctors and patients are inherently complex, and events in recent years have further compounded these relationships...[and] the Internet and related technologies [has added] to an already labyrinthine doctor-patient relationship" (Friedewald, 2000). Patients have now become "empowered" by utilizing the Internet for their instant gratification of information by knowing what potentially could be ailing them, how to cure it, and other alternatives, now available 24-7 without waiting in an office. "Inevitably, the most important Internet-generated change in the physician-patient relationship will be the reduced need for face-to-face contact (Friedewald, 2000).

The chiropractic industry is just as affected by this increasing social relationship trend. However, as a medical niche and alternative in some terms, this trend is also an advantage for tech-savvy practices to shift elements of their marketing strategy to the Internet to capture the market looking for alternatives to traditional managed care. In addition, it allows these practices to potentially capture new and increase current markets by using Internet-based marketing that is vital in today's integrated marketing communication (IMC) mix.

Social trends change constantly, challenging businesses in all industries to stay abreast of consumer behavior changes in order to stay competitive. The observable trend in medical businesses is the development of hybrid-practices that not only have traditional care, but also combine alternative or luxury-based care, i.e. plastic surgery, holistic care, massage therapy. This trend is not recent and has been developing for almost two decades:

"One such recent and apparent trend has been the horizontal and vertical integration between health care facilities. Combining practices of complementary or different specialties can centralize a large number of needed services and provide customer convenience – a golden rule in service marketing" (Hanna, Kizilbash, & Wagle, 1991).

Chiropractors are seeing this trend and beginning to capture it by not only offering the traditional services, but instituting wellness and alternative health prevention services as well. "Keeping up with a market driven by client demand keeps business owners on their toes. Baby boomers comprise 28 percent of the U.S. population and 50 percent of the U.S. economy" (Travis, 2006).

How to market to these target markets is essential for success. Social trends can influence perceptions in a positive and negative manner. These trends are acknowledged via the Internet more today than ever before. From social networking sites that can create instant viral marketing to personal blogs to simple e-mails, each plays an important role in consumer perception. Peer-to-peer communication is just as influential in technology as well. This type of communication, via the Internet or other digital means, allows users to gain feedback as well as disseminate information instantly to assist in making important decisions. In today's market, consumers are in need of instant information gratification and being able to satisfy this instant need via digital means allows for clusters of information to be available from personal to professional venues.

ROSEVILLE FAMILY CHIROPRACTIC – BACKGROUND

RFC opened its doors in 1999 and is located conveniently near a major transportation freeway corridor as well as within a large target market of proposed patients. They have been through one full name change during their practice operations, adding "Family" to the original Roseville Chiropractic name in 2008. This change was in an effort to increase patient awareness on adopting chiropractic care for the entire family, from children to the elderly, as a means of wellness prevention as well as building this type of practice ambiance. The practice is home to two licensed, female Doctors of Chiropractic, whom each have graduated from a Top-5 chiropractic school in the nation. RFC prides itself on the notion that they are one of the few practices regionally that have multiple and only female practitioners. The practice's staff is composed of three members, not including the practitioners, whom take the role of numerous job descriptions ranging from: office management, marketing, human resources, billing/collections, reception, front office, purchasing, website management, and office ambiance. (Roseville Family Chiropractic, 2008) SEE EXHIBIT A for Aerial View Maps

PATIENT PROFILE

According to statistics from the National Board of Chiropractic Examiners (2005), most patients who seek chiropractic care had chief complaints of pain in the low back/pelvis (23.6 percent), neck (18.7 percent), headache/facial (12 percent), and mid-back (11.5 percent). Approximately 20 million Americans use chiropractic services each year and spend at least $50 billion per year on back pain (Homola, 2000; American Chiropractic Association, 1994). Of chiropractic patients, 60 percent are female, 56.7 percent are Caucasian, and 66 percent have graduated or attended college (NBCE Publications, 2005; MPA Media, 2009). A recent research study indicated that people do not use chiropractic treatment because they believed that chiropractic treat was ineffective, produced negative side effects, and/or practitioners were not available in accessible locations (Astin & Jain, 2001). Additionally, the study further indicated that the people who are less likely to use complementary alternative treatments (CAM), which include acupuncture, physical therapy, herbal remedies, and chiropractic care, are more likely to be male, in good health, believe therapies are ineffective or inferior, and do not have adequate knowledge of CAM.

The demographics of RFC's patients are lifestyles of desk-bearing jobs that are of a typical 8:00 am to 5:00 pm schedule to multi-tasking mothers who are highly active with their children. Many of these patients come to RFC due to stress, concerns about their health, fatigue, overwork, and pain. The chief complaint is pain, in order of frequency: headache, low back, neck, injury-related (car, personal, recreation, and work) and pregnancy; these cases are the most often seen. The average RFC patient is a Caucasian, female, 30 to 54-years-old, married, working in a professional/technical status, earning $30,001 to $50,000 annually, and having chiropractic care often at approximately 6 to 10 times per month. (Roseville Family Chiropractic, 2008) SEE EXHIBIT B for RFC and Industry Patient Profiles

SERVICES PROVIDED BY ROSEVILLE FAMILY CHIROPRACTIC

A variety of services and treatments are offered for a wide range of patients by RFC. Their primary therapy includes spinal adjustments for various diagnoses from, but not limited to, injury, personal wellness, and other diagnosed medical issues. Their adjunctive therapy includes therapeutic exercise and stretches, physical modalities, personal health education (employee, family, student), and nutritional counseling. In addition, the RFC offers services such as major insurance carriers for patient utilization, payment plans, attorney and medical doctor referrals, secondary evaluations, online specials and discounts, traction rollers, foot and posture products, family-style patient service, and a comfortable atmosphere with large treatment rooms accompanying city-views. (Roseville Family Chiropractic, 2009)

One of their major offerings is their in-practice wellness boutique that allows patients to learn more about and utilize simple tools for better personal wellness as well as products that aid in their consistent wellness while they are at home, work, and/or play. These items range from daily exercises, nutritional information, and wellness products. Specialized products include, but not limited to, pillows, products to enhance posture, ergonomic products, and nutritional needs. In addition, they provide services and products specific to pregnancy, infants/children, athletes, and "baby boomers". RFC also offers the Foot Levelers products. This allows patients to have a simple scan in which a profile is given to the patient to allow them to see how they can correct specific areas of their body, such as posture and joint pain, with recommended products. (Roseville Family Chiropractic, 2009)

RFC creates a specific ambiance among all its patients with the objective of becoming a part of the overall family's wellness from grandparents to parents to children. This is done not only through the comradely within the office during patient visits, but the communication and community involvement outside of the office with participation in city events to sending messages to patients for special events. RFC does not just want to be another "medical visit", but rather a family outing that improves the wellness of each person throughout their life. (Roseville Family Chiropractic, 2009) EXHIBIT C for Products and Services Offered

ADVERTISING AND PROMOTIONS

Current advertising for RFC consists of local yellow pages, online via their website, a newsletter subscription that is given to all walk-in patients, a monthly events calendar available for all patients, and raffles. Word-of-mouth and patient referrals are a large source of viral and buzz marketing promotions. Coupons, free initial examinations, and trade shows are of the highest preferred method of sales promotions. A limited budget hampers major marketing and sales promotions as well as additional advertising opportunities. RFC measures their success through revenues received and tracked on their specialized client database and billing system. Monthly statistics are printed and analyzed to determine total monthly visits, new patients, accounts receivables, and outstanding balances. (Roseville Family Chiropractic, 2008)

RFC also holds and participates in many community events for their patients, such as Downtown Tuesday Nights, $20 Tuesdays, Walking Wednesdays, and various raffles. Weekly and monthly themes are developed for their patients with certain days having specific discounts for specific segmented markets, i.e. 55 and older. RFC utilizes such practices in order to provide a sense of community not only with their current patient-base, but also within the community they provide a service to, a means of "giving back". In addition, this allows them to build their patient-base with a community-esque marketing theme. (Roseville Family Chiropractic, 2008)

INTERNET PRESENCE

For RFC, the website is a primary area of promotion and marketing of its services as well as additional products. The website is hosted by a third-party company in which the client can select a template at a base rate per month with the optional features that can be added for an additional cost. Options available are ones such as blogs, live chat, auto-text reminders, personal patient profiles and log-ins, e-commerce, and streaming. Depending on the budget, the website can be very elaborate or very simple. The website has the function of being able to view web statistics directly to each page as well as unique visitors. RFC has a basic package with 1,000 pages available of content, showing such content as the history of chiropractic, about the practice, medical condition information, treatments, and payment information. They have their promotions on the site as well as any activities or events they are involved in. There are very limited features, such as interactivity, due to a limited marketing budget. (Roseville Family Chiropractic, 2008)

COMPETITIVE ANALYSIS

In addition to the increase competition from local competitors, RFC also faces threats from acupuncturists and massage therapists, which are growth venues for chiropractors in today's market. "…acupuncture has led to a sixfold increase in its training capacity …the ranks of practicing acupuncturists can be expected to swell from their current number of 15,000 to as many as 30,000 by 2015…The same is true for massage therapy" (Cooper & Heather, 2003). Approximately 85 percent of chiropractors provide massage therapy sessions directly or through certified massage therapists. Acupuncture treatments are utilized as a treatment for many disorders, such as fibromyalgia, headache, and some chronic musculoskeletal syndromes; approximately 20 percent of chiropractors perform acupuncture and other related techniques. Natural products as well as the use of homeopathic products within the practice, such as herbals, vitamins, minerals, antioxidants, food supplements, and glandular extracts, are also growing. Although it may be reasonable for chiropractors to seek various methods in alternative medicine, there is a danger for chiropractors in moving too far from their core knowledge. (Cooper & Heather, 2003)

There are 62 (valid, licensed chiropractors) competitors within Roseville; this is the most in the entire Placer County area. Practices range from single to multi-doctors as well as from small to large business distinctions. Services range from basic treatments of the musculoskeletal to wellness services, such as massage and holistic alternatives. Two of the other major cities in the county as well as the closest to Roseville, Auburn and Rocklin, are the next highest with 40 and 32 valid, licensed chiropractic competitors each, respectively. (State of California: Department of Consumer Affairs, 2009)

The major competitors around RFC offer not only basic chiropractic care, but also specialty services that may give them a competitive advantage among target markets that RFC is attempting to capture. One such practice offers cellular detoxification, specialty wellness classes from nutrition to time management, a new digital x-ray system, and the latest technology in spinal correction in a rehab setting (Chiropractic Health Centre, 2009). Another practice offers six specialty massage treatments by a certified therapist while a chiropractic clinic offers physiological therapeutic services, such as ultrasound and cryotherapy (Zawada Chiropractic, 2008; Jennings Chiropractic Neurology Clinic, Inc, 2009).

A competitive analysis was performed in relation to RFC's competitors focusing on their website functionality, in which six were selected. The website function is crucial for those who successfully use them as a main digital medium to attract their target markets. These competitors are within the same region, some relatively in close proximity of the same building to others or opposite locations of the city. The basis was on a high to low value of each competitor's own website as well as the high to low value of the services each offered. The competitors selected were Dr. Z-Chiropractic Clinic, River City Chiropractic, Steven Elsea D.C., Jennings

Chiropractic Clinic, Roseville Chiropractic Health Center, and Zorich Chiropractic & Wellness. SEE EXHIBIT D for Perceptual Map

ROSEVILLE, CALIFORNIA – BRIEF HISTORY AND STATUS

With a rich history and retention of their railroad roots and times of the Gold Rush, Roseville is a progressive city looking towards the future. Incorporated on April 10, 1909, Roseville was a town developed originally by miners after the Gold Rush in the 1850s whom decided to farm rich agricultural lands of Placer County. It was also a haven for the growth during the time of the railroads. Many of the descendants of the first families of Roseville still reside in the city even today. As of January 2009, the population was 112,343 with expected growth of 133,680 in 2015. There is a predominantly Caucasian ethnicity of 79 percent, majority population age of 10 to 49-year-olds, and a median income of $57,637 with 20 percent earning over $100,000 according to the US Census Bureau American Community Survey. (City of Roseville, 2009)

CRITICAL DECISIONS

Being in practice for close to 10 years, RFC's growth has developed a need for a comprehensive marketing plan in order to: gain a stronger presence in their main target market, expand to new markets, and build healthier revenue generation. High volumes of competition are beginning to encroach on the County as well as the city itself. Therefore, RFC is in need of bringing out their differential qualities in order to secure their patients.

External factors that have forced RFC to rethink their marketing strategy include: current economic issues, social factors focusing on generation differences and industry perceptions, consumer behavior and social trends among the market segments, advertising strategies changing from traditional to digital to social networking, and industry changes in business development with "wellness" practices supplying a range of services versus the traditional chiropractic-only practice. With their overall objective to become the top-referred chiropractor and the most visited chiropractic website in South Placer County, RFC is faced with the issue that their current marketing strategy is neither relevant nor competitive in terms of future sustainability and the changing trends in the industry.

Timing was crucial and focus on the right marketing tools was needed. Kevin knew digital advertising and Internet presence was the future for businesses to get the lead on their competition, but its appropriateness for RFC. Social trends within the medical industry, specific to wellness prevention, were expanding as traditional service-only business plans were decreasing to the increasing wellness-derived plans. The need to expand to new markets was an important element for RFC. This was due to potentially repositioning the practice while utilizing differentiated services that would allow RFC to become a niche among the industry and stay highly competitive among the market. If the right opportunities were not capitalized on at the right time, as well as the weaknesses not solved timely, any strengths the practice had would soon weaken and the threats would supersede their goals. Competition would continue to strengthen around them and their patient-base would diminish.

Kevin began to gather all the relevant information and prepared to make recommendations to Dr. Cox and Dr. Rodrigues. He was risking the practice that both practitioners had built in the toughest economic climate they had ever seen. Kevin wanted to explore other target markets in order to build the patient-base, while both practitioners were seeking to rebrand the practice and accentuate the "family" appeal to Roseville Family Chiropractic. He understands that their marketing budget is limited, which increases the need to use their resources on the correct patients. There are many questions that need to be addressed in the meeting: What should RFC's role be in the minds of its patients? Should they expand their services and seek to position themselves as the wellness expert for the entire family? Should they care for the children of existing patients? How could they market their message effectively in order to build their patient-base? A number of factors would have to be considered in addition to how to approach the new marketing strategy, if any, as well as culminate all the new elements needed to revamp RFC successfully.

Table 1
RFC – Patient Demographics "Ethnicity"

Column 1 – Ethnicity	Column 2 - Percentage
Caucasian	80%
Hispanic/Latino	5%
African American	5%
Asian	5%
Other	5%
Source: Roseville Family Chiropractic, 2008	

Table 2
Industry – Patient Demographics "Ethnicity"

Column 1 – Ethnicity	Column 2 – Percentage
Caucasian	56.70%
Hispanic/Latino	14.40%
African American	14%
Asian	9%
Native American	5.30%
Other	0.60%
Source: NBCE Publications, 2005	

Table 3
RFC – Patient Demographics "Age"

Column 1 – Age Range	Column 2 - Percentage
0-12	10%
13-29	15%
30-40	30%
41-54	30%
55+	15%
Source: Roseville Family Chiropractic, 2008	

Table 4
Industry – Patient Demographics "Age"

Column 1 – Age Range	Column 2 – Percentage
0-5	8.20%
17-Jun	10%
18-30	17.30%
31-50	29.80%
51-64	21%
Source: NBCE Publications, 2005	

REFERENCES

American Chiropractic Association. (1994). *Back Pain Facts & Statistics*. Retrieved from American Chiropractic Association: http://www.acatoday.org/pdf/back_pain.pdf

American Chiropractic Association. (2008, November 4). *General Information about Chiropractic Care*. Retrieved from ACA Today: http://www.acatoday.org/pdf/Gen_Chiro_Info.pdf

American Chiropractic Association. (2008). *What is Chiropractic?* Retrieved from American Chiropractic Association: http://www.amerchiro.org/level2_css.cfm?T1ID=13&T2ID=61

Association of Chiropractic Colleges. (1996). *Bylaws - Chiropractic Paradigm*. Retrieved from Association of Chiropractic Colleges: http://www.chirocolleges.org/paradigm_scope_practice.html

Astin, J., & Jain, N. (2001). Barriers to Acceptance: An Exploratory Study of Complementary/Alternative Medicine Disuse. *The Journal of Alternative and Complementary Medicine* , 689-696.

Bureau of Labor Statistics. (2007, December 18). *Occupational Outlook Handbook, 2008-09 Edition*. Retrieved from United States Department of Labor: http://www.bls.gov/oco/oco2001.htm#projections_data

Carluccio, A., Norton, A., & Vasickova, D. (2004). *Awareness and Perceptions of Chiropractors.* MORI.

Chiropractic Health Centre. (2009, August 20). *Chiropractic Health Centre*. Retrieved from Chiropractic Health Centre: http://www.rosevillechiros.com/

City of Roseville. (2009). *City of Roseville*. Retrieved from City of Roseville: http://www.roseville.ca.us/

Cooper, R., & Heather, M. (2003). Chiropractic in the United States: Trends and Issues. *The Milbank Quarterly*, 107-127.

Foundation for Chiropractic Education and Research. (2007, January 23). Patient Perceptions of Chiropractic Treatment for Primary Care Disorders. Norwalk, Iowa, United States of America.

Friedewald, V. (2000, November). *The Internet's Influence on the Doctor-Patient Relationship - Internet/Web/Online Service Information.* Retrieved from BNET: http://findarticles.com/p/articles/mi_m0DUD/is_11_21/ai_67373716/

Google Maps. (2009, June 26). *Google Maps*. Retrieved from Google: http://maps.google.com/maps?q=5%20sierra%20gate%20plaza%2C%20roseville%2C%20ca&oe=utf-8&rls=org.mozilla:en-US:official&client=firefox-a&um=1&ie=UTF-8&sa=N&hl=en&tab=wl

Hanna, N., Kizilbash, A., & Wagle, J. (1991). The Chiropractic Market Segment: A Viable Market Opportunity for M.D.'s? *Health Marketing Quarterly* , 155-165.

Homola, S. (2000). Chiropractic - Conventional or Alternative Healing? *SKEPTIC* , 70-75.

Jennings Chiropractic Neurology Clinic, Inc. (2009). *Services & Techniques*. Retrieved from Jennings Chiropractic Neurology Clinic, Inc: http://dredjennings.com/custom_content/c_15245_services__techniques.html

MPA Media. (2009). *Target Audience - Chiropractic Patients.* Retrieved from MPA Media: http://www.mpamedia.com/audiences/target_tyh.php

NBCE Publications. (2005). *Job Analysis of Chiropractic 2005.* Greeley: National Board of Chiropractic Examiners.

Painter DC, F. (2008, September 9). *Multinational Survey of Chiropractic Patients: Reasons For Seeking Care.* Retrieved from Chirowebs: http://www.chiro.org/ChiroZine/ABSTRACTS/Multinational_Survey_of_Chiropractic_Patients.shtml

Roseville Family Chiropractic. (2008, April). Practice Survey. Roseville, CA, United States of America: Roseville Family Chiropractic.

Roseville Family Chiropractic. (2008, April). *Roseville Family Chiropractic*. Retrieved from Roseville Family Chiropractic: http://www.rosevillefamilychiropractic.com/index.php?p=15031

Sherwood, K. (2009, June 21). Roseville Family Chiropractic. (S. Van Ginkel, Interviewer)

State of California: Department of Consumer Affairs. (2009, February 6). *License Search for Chiropractors*. Retrieved from Department of Consumer Affairs: http://www2.dca.ca.gov/pls/wllpub/wllqryna$lcev2.startup?p_qte_code=DC&p_qte_pgm_code=8500

Stevens, R., Mansfield, P., & Loudon, D. (2005). The Public's Image of Chiropractic Services: A Pilot Study. *Services Marketing Quarterly* , 19-37.

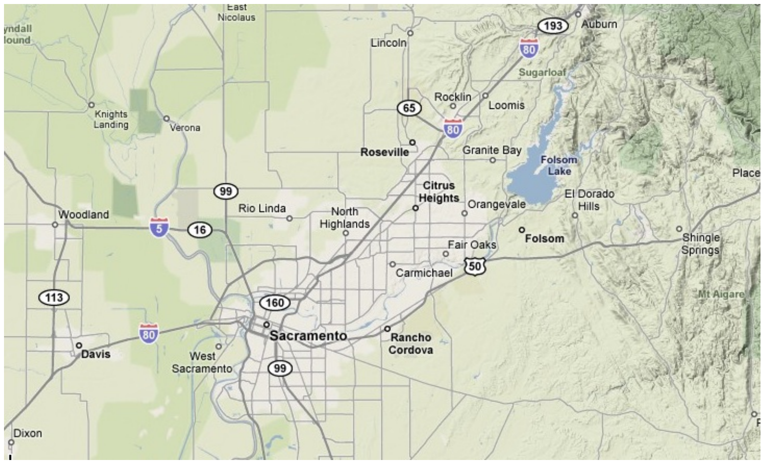
The American Chiropractic Association. (2008, November 4). *General Information about Chiropractic Care*. Retrieved from The American Chiropractic Association: http://www.acatoday.org/pdf/Gen_Chiro_Info.pdf

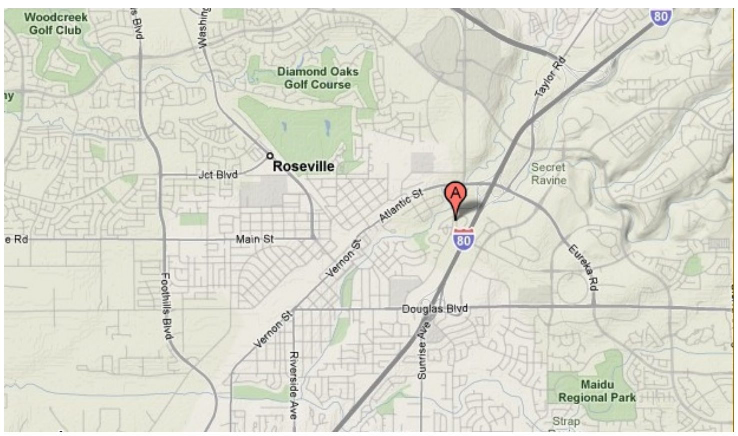
Travis, L. (2006). *Medical-Spa Trends & Your Bottom Line.* Retrieved from spa 20/20: http://www.spa20-20.com/articles/591cover1.html

Weeks, K. (2005, October). Proper Alignment. *Contract*, 68-70.

Zawada Chiropractic. (2008). *Massage Therapy*. Retrieved from Zawada Chiropractic: http://www.drzawada.com/massagetherapy.html

EXHIBIT A: Aerial View Maps



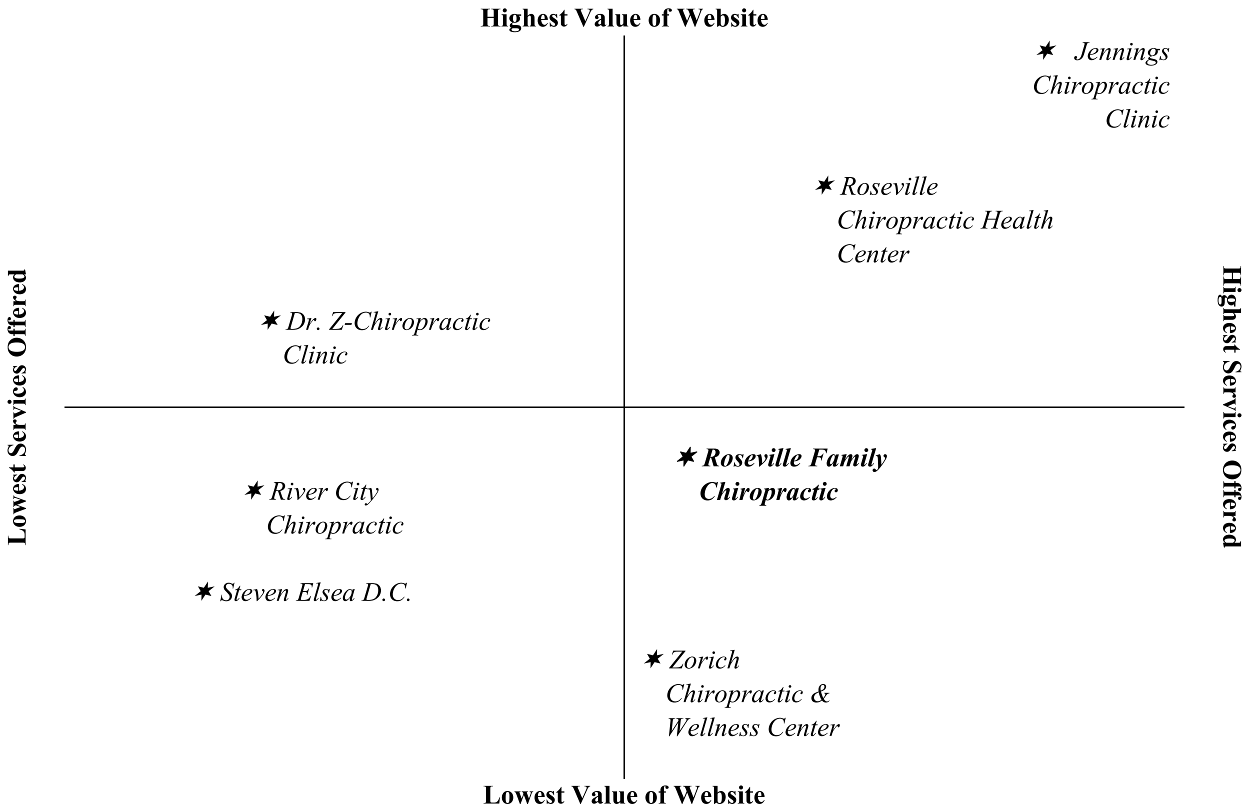


(Google Maps, 2009)

EXHIBIT B: RFC and Industry Patient Profiles	
PATIENT DEMOGRAPHIC	
Ethnicity	
Caucasian	80%
Hispanic/Latino	5%
African American	5%
Asian	5%
Other	5%
Age	
0-12	10%
13-29	15%
30-40	30%
41-54	30%
55+	15%
Gender	
Male	40%
Female	60%
Status	
Single	30%
Married	50%
Divorced	20%
Unknown	0%
PATIENT PROFESSIONAL STATUS	
Profession	
Professional/Technical	25%
Manager/Official/Proprietors	15%
Clerical/Sales	15%
Homemakers	15%
Work-Related Injury Workers	5%
Students	5%
Unemployed	5%
Retired	15%
Level of Annual Income	
$10,000 or less	5%
$10,001 - $15,000	5%
$15,001 - $20,000	5%
$20,001 - $30,000	15%
$30,001 - $50,000	40%
$50,001 - $100,000	20%
$100,001 or above	10%
PATIENT VISITS	
Frequency	
Often	55%
Somewhat Often	30%
Occasional	15%
Times per Month	
Often	10-Jun
Somewhat Often	05-Jan
Occasional	05-Jan
(Roseville Family Chiropractic, 2008)	

EXHIBIT C **Products & Services Offered**
PRIMARY THERAPY
* Diversified Chiropractic Care
* Range of chiropractic treatment methods to adjust
* Activator Chiropractic Care
* 'Activator' to hone in on more "harder to get areas" such as ribs and sometimes cervical vertebrae
PRIMARY PRODUCT LINES
* Pillows
* Brands including TempurPedic, Core, and Chiroflow (adjustable water pillow)
* Nutritional Supplements
* Pure Encapsulations, and BioPharma
* Supports & Braces
* Neck, low back, knee, maternity, and cervical supports
* Therapy Supplies
* Ice/heat packs, BioFreeze (topical deep penetrating ointment), Kool 'n Fit, Neti Pots (for allergy and sinus relief), White Flower Chinese Herbal inhalant (for allergy and sinus relief)
* Miscellaneous Items
* Pedometers, hand therapy/stress balls, ZippFizz energy drinks, RFC T-Shirts
SPECIAL SERVICES
* X-Ray
* Full spinal series
* Upper cervical, upper back, mid back, low back
* Cervical, thoracic, lumbar
* Custom Orthotics – Foot Levelers custom-made pelvic stabilizers
* Patients can get a FREE foot scan (takes less than 5 minutes for the whole test/analysis) whenever they need one
* Custom inserts within days for any patient type
TRADITIONAL AND SPECIAL CASES
* Full insurance-based
* Cash payments
* Worker's Compensation cases
* Personal Injury cases
* Consultation
* Referral
(Roseville Family Chiropractic, 2009) (NBCE Publications, 2005)

EXHIBIT D
Perceptual Map: Chiropractic Websites versus Services



(Casewriters, 2008)

ST. LOUIS CHEMICAL: COST OF CAPITAL

David A. Kunz, Southeast Missouri State University
Benjamin L. Dow III, Southeast Missouri State University

CASE DESCRIPTION

The primary subject matter of this case concerns the issues surrounding a firm's weighted average cost of capital (WACC). Case provides a review of cost of capital issues. The case requires students to have knowledge of accounting and finance, thus the case has a difficulty level of three (junior level) or higher. The case is designed to be taught in one class session of approximately 1.25 hours and is expected to require 2-3 hours of preparation time from the students.

CASE SYNOPSIS

The case tells the story of Don Williams, President and primary owner of St. Louis Chemical. By most measures, the performance of St. Louis Chemical has been very good over the last three years, with sales and income increasing each year Business growth has been steady but a recent increase in demand has placed a strain on existing operations. To keep pace with demand, the capacity of the current warehouse and packaging operations need to be increased. The cost of the facility expansion has been estimated to be $900,000 by St. Louis Chemical's operation manager.

Since beginning operations, Williams has been reluctant to borrow funds. He has been content with limited growth, financed with internally generated equity.

Recently hired Edison Hesselbach, the company's first finance professional, has recommended borrowing the required funds. Williams indicated he may be willing to consider a change in his long-standing policy against debt, but wants more information regarding using debt in the firm's capital structure.

BACKGROUND

St. Louis Chemical is a relatively new regional distributor of liquid and dry chemicals, headquartered in St. Louis, Missouri. The company, founded by Don Williams, has been serving primarily eastern Missouri and western Illinois for four years and has developed a reputation as a reliable supplier of industrial chemicals. Williams' previous business experience provided him with a solid understanding of the chemical industry and the distribution process. As a general manager for a chemical manufacturer, he had profit and loss (P&L) responsibility, but until beginning St. Louis Chemical, he had limited exposure to company accounting and finance decisions.

The company reported small losses during its early years of operation, but performance in recent years has been very good. Sales have grown, new product lines have been added and reported profits have been steadily increasing. The growth has required the acquisition of additional land, equipment, expansion of storage capacity and an increase in work force. Williams has proven to be an expert marketer, and St. Louis Chemical has developed a reputation with its customers of providing quality products and superior service at competitive prices.

Despite its business success, St. Louis Chemical is still a “large” small business with Williams making all important decisions. He recognized the need to develop a professional managerial staff, particularly in the area of finance. Recently, he hired Edison Hesselbach as the company’s first finance professional and placed him in charge of the company’s accounting and finance activities.

St. Louis Chemical’s board of directors is composed of Williams, his father and the company’s attorney. The board’s existence satisfies state regulatory requirements for corporations but provides little, if any, input to business operations.

CHEMICAL DISTRIBUTION

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

In addition to operating efficiently, a successful distributor will possess 1) a solid customer base and 2) supplier contacts and contracts which will ensure a complete product line is available at competitive prices.

THE SITUATION

Because of his lack of finance expertise and his desire to maintain St. Louis Chemical's annual dividend, Williams has taken a conservative approach to growing the business, avoiding any action perceived as potentially risky. Capital expenditures have been tightly controlled, and this has, at times, restricted St. Louis Chemical's ability to take advantage of growth opportunities. Business growth has been steady but a recent increase in demand has placed a strain on existing operations. To keep pace with demand, the capacity of the current warehouse and packaging operations need to be increased. The cost of the facility expansion has been estimated to be $900,000 by St. Louis Chemical's operation manager.

In addition to avoiding risky capital expenditures, Williams has also followed a conservative financing policy. Since beginning operations, he has been reluctant to borrow funds, content with limited growth, financed with internally generated equity. The only long-term debt on the company's balance sheet reflects vehicle financing. If the facility is to be expanded, additional external financing will be necessary and the current shareholders are reluctant to invest additional funds. St. Louis Chemical's income statement and balance sheet for the years 2007-2009 are provided in Schedules One and Two, respectively.

Hesselbach, using input from an investment-banking firm, has estimated the company's cost of equity to be 14%. A St. Louis bank has indicated a long-term bank loan can be arranged to finance expansion at an annual interest rate of 10%. The bank would require either loan to be secured with expansion and other company assets. The loan agreement would also include a number of restrictive covenants, including a limitation of dividends while the loans are outstanding. Only a small amount of long-term debt is included in the firm's current capital structure, the firm's debt ratio at the end of 2009 was 21% and long-term debt was only .28% of total assets. Hesselbach calculated that if a long-term bank loan was used to obtain the needed $900,000, the firm's debt ratio would increase to 30%. He believes a 30% debt and 70% equity capital mix would be conservative and a starting point for introducing long-term debt into the firm's capital structure. Last year the company's federal-plus-state income tax rate was 35%. Hesselbach does not expect the income tax rate to change in the foreseeable future.

Hesselbach has recommended borrowing the required funds. Williams indicated he may be willing to consider a change in his long-standing policy against debt, but wants more information regarding the advantages and disadvantages of using debt in the firm's capital structure.

THE TASK

Assume the role of Hesselbach to answer the following questions.

Prepare a presentation for Williams regarding the concept of a firm's weighted average cost of capital (WACC).

Calculate St. Louis Chemical's WACC using a 30% debt and 70% equity capital structure.

Recalculate St. Louis Chemical's WACC (round to the nearest whole number) using a 40% debt and 60% equity capital structure.

Explain the difference between your answer to questions 2 and 3.

What arguments should be made to convince the Williams of the advantage of using long-term debt in the firm's capital structure? What are the disadvantages?

Explain why an accurate WACC is important to a firm's long-term success.

REFERENCES

Brigham, Eugene and Joel Houston, *"Fundamentals of Financial Management,"* Concise 6th edition, Thomson South-Western, a part of the Thomson Corporation, 2009.

Brigham, Eugene, and Michael Ehrhardt, *"Financial Management: Theory and Practice,"* 12th edition, Thomson South-Western, a part of the Thomson Corporation, 2008.

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

	2007		2008		2009	
	$	%	$	%	$	%
Revenue	14,378	100	16,470	100	17,970	100
Cost of Goods Sold	12,145	84.47	13,916	84.49	15,172	84.43
Gross Profit	2,233	15.53	2,554	15.51	2,798	15.57
Operating Expenses						
Selling	756	5.26	842	5.11	885	4.92
General & Administrative	588	4.09	701	4.26	791	4.4
Total Operating Expenses	1,344	9.35	1,543	9.37	1,676	9.32
Operating Profit	889	6.18	1,011	6.14	1,122	6.25
Interest Expense	6	0.04	4	0.02	2	0.01
Earnings Before Taxes	883	6.14	1,007	6.12	1,120	6.24
Income Tax Expense	309	2.15	352	2.14	392	2.18
Earnings After Taxes	574	3.99	655	3.98	728	4.06

Schedule Two

St. Louis Chemical

Balance Sheets (000's/$)

	2007		2008		2009	
	$	%	$	%	$	%
Current Assets						
Cash	25	0.42	22	0.34	23	0.32
Receivables	1,432	24.07	1,654	25.24	1,876	26.36
Inventory	1,682	28.27	1,898	28.97	2,013	28.28
Other current assets	32	0.54	37	0.56	46	0.65
Total current assets	3,171	53.29	3,611	55.11	3,958	55.61
Fixed Assets						
Land	443	7.45	443	6.76	443	6.22
Gross plant,property & equip	3,318	55.77	3,627	55.36	3,989	56.05
(less accumulated depreciation)	(982)	(16.50)	(1,129)	(17.23)	(1,273)	(17.89)
Net plant, property & equip	2,336	39.27	2,498	38.13	2,716	38.16
Total fixed assets	2,779	46.71	2,941	44.89	3,159	44.39
Total Assets	5,950	100.00	6,552	100.00	7,117	100.00
Current liabilities						
Account payables	839	14.10	947	14.45	1,043	14.66
Short-term notes payables	-	0.00	-	0.00	-	0.00
Accrued liabilities	421	7.08	480	7.33	441	6.20
Total current liabilities	1,260	21.18	1,427	21.78	1,484	20.86
Long-term liabilities	60	1.01	40	0.61	20	0.28
Total liabilities	1,320	22.19	1,467	22.39	1,504	21.14
Shareholders' equity						
Common stock	2,000	33.61	2,000	30.53	2,000	28.10
Retained earnings	2,630	44.20	3,085	47.08	3,613	50.76
Total equity	4,630	77.81	5,085	77.61	5,613	78.86
Total liabilities & equity	5,950	100.00	6,552	100.00	7,117	100.00

FEMSA 2007: THE FINANCIAL STATEMENT ANALYSIS IMPACT OF DIFFERENCES IN MEXICAN AND US GAAP

Kevin L. Kemerer, Barry University
Michael L. Tyler, Barry University

CASE DESCRIPTION

The primary goal of this case is to have students recognize the impact that the use of a different set of generally accepted accounting principles (GAAP) may have on the analysis of an international company's financial statements. Another goal of the case is to reinforce to students that in order to make sound judgments when evaluating the performance of any corporation that the financial information analyzed needs to be prepared on a consistent basis. This case has a difficulty level of three to five and is targeted for use by accounting or finance students in any of the following: 1.) the last course of the intermediate accounting sequence; 2.) a senior level international accounting course, 3.) an undergraduate or graduate level financial statement analysis course or 4) a graduate level financial accounting course. One hour of class time should be sufficient to handle the case discussion and students should budget 1-3 hours of time for the preparation of case responses.

CASE SYNOPSIS

Recently graduated from college you are hired as a Financial Analyst. Your first task is to evaluate FEMSA, the largest beverage company in Latin America, as a potential investment for your firm. Browsing through FEMSA's Annual Report you note that the company produces and bottles several well known brands of beer and soft drinks such as Carta Blanca, Tecate, Sol, Dos Equis, Coca-Cola, Sprite, Fanta, Fresca, and Power Ade. You discover almost immediately that the financial statements have been prepared in accordance with Mexican GAAP, not the US GAAP that you learned in college and are familiar with. Furthermore, the major financial statements have been issued in constant Mexican pesos for comparative purposes with a translated US dollar amount for the most recent year. Thus, you have a challenging task ahead of you. Do you analyze the financial statements prepared under Mexican GAAP and in constant Mexican pesos? Or do you analyze the financial statements prepared under Mexican GAAP but using US dollars? If so, you don't have the comparative financial information. Is the information available for you to analyze FEMSA's financial statements based upon US GAAP? Does it matter which financial statements that you use or which currency?

INTRODUCTION

Having recently graduated with a bachelor's degree in accounting you have been hired by a mutual fund as a Financial Analyst. As a staff analyst your job is to perform an analysis on investment candidates. Natu Wurrie, your supervisor, has asked you to prepare an analysis on a company called FEMSA. Naturally, you immediately obtain a copy of the company's most recent annual report for the year ending December 31, 2007. After browsing through the MD&A section of the 2007 annual report and going to their web-site to get additional up-to-date information you have accumulated the following background information.

FEMSA

FEMSA, the largest beverage company in Latin America, started operations in 1890. The company exports its products to the United States and select countries in Latin America, Europe and Asia. In May 1998 FEMSA stock was listed on the New York Stock Exchange (NYSE). As of December 31, 2007 FEMSA employed 105,020 workers, owned 5,563 OXXO stores in Mexico, had 91 different beverage brands and annual revenues of $13.5 billion (US).

FEMSA operates through three subsidiaries: Coca-Cola FEMSA , FEMSA Cerveza and FEMSA Comercio. Coca-Cola FEMSA is the largest Coca-Cola bottler in Latin America and the second largest in the world, measured by sales volume. It has operations in 9 countries throughout Latin America, including Mexico, Brazil, Argentina, Colombia, and Venezuela. FEMSA Cerveza is one of Mexico's leading brewers, producing and distributing such brands as Tecate, Sol, Dos Equis, and Carta Blanca; it also exports beer to over 70 countries worldwide. FEMSA Comercio operates Oxxo, the largest convenience-store chain in Mexico with more than 5,500 stores strategically located throughout the country's most important metropolitan areas.

Although the corporate offices of FEMSA are located in Monterrey Mexico and its shares are traded on the Bolsa Mexicana de Valores [BMV] under the symbols FEMSA UBD and FEMSA UB, its FEMSA UBD units are also traded on the NYSE in the form of level 2 (listed) American Depositary Receipts (ADRs) under the symbol FMX.

While the core businesses are soft drinks and beer, the fast-growing chain of Oxxo convenience stores and its packaging and logistics operations appear to foster and accelerate the strategic growth of the core beverage businesses by increasing the availability of its products. The combination of the company's production, distribution, and sales infrastructure has created a strong platform for growth in Latin America. FEMSA is among the largest beverage companies in the markets it serves. The total population of those areas exceeds 350 million. The company has a well-developed distribution network selling at more than 2 million points of sale throughout Latin America. The company has a growing presence in the U.S. beer market with Tecate being the fourth largest imported beer brand in the United States based on annual sales.

From 1998 to 2008, total sales and income from operations have increased at compound annual growth rates of 16%.

ANALYSIS PROBLEMS

After obtaining an understanding of the background of the company and it business strategies and strengths you turn your attention to the company's financial statements and discover that they have been prepared in accordance with Mexican GAAP, not the US GAAP that you learned in college. Furthermore, the major financial statements have been issued in constant Mexican pesos for comparative purposes with a translated US dollar amount for the most recent year. Thus, you have a challenging task ahead of you. Do you analyze the financial statements prepared under Mexican GAAP and in constant Mexican pesos? Or do you analyze the financial statements prepared under Mexican GAAP but using US dollars for which you don't have comparative information? Is information available for you to analyze FEMSA's financials based upon US GAAP? Does it matter which financial statements that you use or which currency?

REQUIREMENTS

Compute the following ratios for 2007 using the financial statements prepared using Mexican FRS and expressed in pesos. [Assume the weighted average number of shares outstanding is 17,891,000]

Current Ratio:	Current assets/Current liabilities
Inventory Turnover:	Cost of Goods Sold/Average Inventory
Profit Margin on Sales:	Net Income/Net Sales
Debt to Assets Ratio:	Total Liabilities/Total Assets
Book Value per Share:	Common Stockholders' Equity/Outstanding Shares

Compute the same ratios listed in 1 using the amounts expressed in US$. What are the implications for international financial statement analysis?

Compute the same ratios listed in 1 using the financial statements prepared using the financial statements prepared using US GAAP. Compare these results to those obtained in 1. What causes these differences?

Determine the percentage difference between the results of your computation in requirements #1 and #3 by using #1 as the base [ie., (#3 -#1) /#1]. Which ratio has the biggest difference? Smallest difference? What difference in US and Mexican GAAP do you suspect had the biggest impact on financial statement differences? What are the implications of differences between US GAAP and foreign GAAP for international financial statement analysis? Do you think the cause of the biggest difference here is unique to FEMSA?

Obtain through your library, internet sources or others resources some analyst reports on Femsa. Determine how their reports are prepared: based upon Mexican GAAP or US GAAP. If they report using Mexican GAAP do they report using the Mexican Pesos or translated US$? Which form of analysis would you prefer to have?

Consolidated Balance Sheets

FOMENTO ECONOMICO MEXICANO, S.A.B. DE C.V. AND SUBSIDIARIES

At December 31, 2007 and 2006. Amounts expressed in millions of U.S. dollars ($) and in millions of constant Mexican pesos (Ps.) as of December 31, 2007.	2007		2006
ASSETS			
Current Assets:			
Cash and cash equivalents	$ 958	Ps. 10,456	Ps. 8,766
Accounts receivable	854	9,329	7,747
Inventories	919	10,037	8,704
Recoverable taxes	156	1,699	1,341
Investment in shares available for sale	63	684	—
Other current assets	117	1,280	1,271
Total current assets	3,067	33,485	27,829
Investments in shares	171	1,863	824
Property, plant and equipment	5,011	54,707	52,960
Intangible assets	5,518	60,234	57,906
Other assets	1,018	11,117	9,878
Bottles and cases	286	3,125	3,067
Deferred income taxes asset	116	1,264	2,052
TOTAL ASSETS	$ 15,187	Ps. 165,795	Ps. 154,516

Consolidated Balance Sheets

FOMENTO ECONOMICO MEXICANO, S.A.B. DE C.V. AND SUBSIDIARIES

At December 31, 2007 and 2006. Amounts expressed in millions of U.S. dollars ($) and in millions of constant Mexican pesos (Ps.) as of December 31, 2007.	2007		2006
LIABILITIES AND STOCKHOLDERS' EQUITY			
Current Liabilities:			
Bank loans	$ 316	Ps. 3,447	Ps. 4,183
Interest payable	44	475	461
Current portion of long-term debt	542	5,917	2,563
Suppliers	1,251	13,657	12,479
Taxes payable	335	3,658	2,845
Accounts payable	427	4,658	3,911
Other current liabilities	145	1,592	1,618
Total current liabilities	3,060	33,404	28,060
Long-Term Liabilities:			
Bank loans and notes payable	2,809	30,665	35,673
Deferred income taxes liability	328	3,584	3,995
Labor liabilities	341	3,718	3,269
Contingencies and other liabilities	437	4,771	5,311
Total long-term liabilities	3,915	42,738	48,248
Total liabilities	6,975	76,142	76,308
Stockholders' Equity:			
Minority interest in consolidated subsidiaries	2,297	25,075	21,554
Majority interest:			
Capital stock	490	5,348	5,348
Additional paid-in capital	1,888	20,612	20,557
Retained earnings from prior years	3,491	38,108	32,529
Net income	780	8,511	7,127
Cumulative other comprehensive income	(734)	(8,001)	(8,907)
Majority interest	5,915	64,578	56,654
Total stockholders' equity	8,212	89,653	78,208
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 15,187	Ps. 165,795	Ps. 154,516

The accompanying notes are an integral part of these consolidated balance sheets.
Monterrey, N.L., Mexico, February 18, 2008.

José Antonio Fernández Carbajal
Chief Executive Officer

Javier Astaburuaga Sanjínes
Chief Financial Officer

Consolidated Income Statements

FOMENTO ECONOMICO MEXICANO, S.A.B. DE C.V. AND SUBSIDIARIES

For the years ended December 31, 2007, 2006 and 2005. Amounts expressed in millions of U.S. dollars ($) and in millions of constant Mexican pesos (Ps.) as of December 31, 2007, except per share data.		2007	2006	2005
Net sales	$ 13,472	Ps. 147,069	Ps. 135,647	Ps. 118,799
Other operating revenues	44	487	473	663
Total revenues	13,516	147,556	136,120	119,462
Cost of sales	7,310	79,801	73,366	63,721
Gross profit	6,206	67,755	62,754	55,741
Operating expenses:				
Administrative	842	9,191	8,973	7,957
Selling	3,571	38,995	35,314	30,345
	4,413	48,186	44,287	38,302
Income from operations	1,793	19,569	18,467	17,439
Other expenses, net	(119)	(1,297)	(1,650)	(1,108)
Integral result of financing:				
Interest expense	(417)	(4,554)	(4,299)	(4,759)
Interest income	70	769	792	765
Foreign exchange gain (loss), net	63	691	(217)	318
Gain on monetary position, net	151	1,639	1,488	1,204
Market value gain (loss) on ineffective portion of derivative financial instruments	6	69	(113)	(166)
	(127)	(1,386)	(2,349)	(2,638)
Net income before income taxes	1,547	16,886	14,468	13,693
Income taxes	454	4,950	4,608	4,620
Consolidated net income	$ 1,093	Ps. 11,936	Ps. 9,860	Ps. 9,073
Net majority income	780	8,511	7,127	5,951
Net minority income	313	3,425	2,733	3,122
Consolidated net income	$ 1,093	Ps. 11,936	Ps. 9,860	Ps. 9,073
Net majority income (U.S. dollars and constant Mexican pesos):				
Per Series "B" share	$ 0.04	Ps. 0.42	Ps. 0.36	Ps. 0.31
Per Series "D" share	$ 0.05	Ps. 0.53	Ps. 0.44	Ps. 0.39

The accompanying notes are an integral part of these consolidated income statements.

NOTE 26 DIFFERENCES BETWEEN MEXICAN FRS AND U.S. GAAP.

As discussed in Note 2, the consolidated financial statements of the Company are prepared in accordance with Mexican FRS, which differs in certain significant respects from U.S. GAAP. A reconciliation of the reported majority net income, majority stockholders' equity and majority comprehensive income to U.S. GAAP is presented in Note 27. It should be noted that this reconciliation to U.S. GAAP does not include the reversal of the restatement of the financial statements as required by NIF Bulletin B-10, "Recognition of the Effects of Inflation in the Financial Information," of Mexican FRS.

The application of this bulletin represents a comprehensive measure of the effects of price-level changes in the Mexican economy and, as such, is considered a more meaningful presentation than historical cost-based financial reporting in Mexican pesos for both Mexican and U.S. accounting purposes.

The principal differences between Mexican FRS and U.S. GAAP included in the reconciliation that affect the consolidated financial statements of the Company are described below.

A) CONSOLIDATION OF COCA-COLA FEMSA:

Under Mexican FRS, the Company consolidates Coca-Cola FEMSA since it owns a majority of the outstanding voting capital stock and exercises control over the operations of Coca-Cola FEMSA in the ordinary course of business in accordance with the requirements of Mexican NIF Bulletin B-8 "Consolidated and Combined Financial Statements and Valuation of Long-Term Investments in Shares." Pursuant to NIF Bulletin B-8, Coca-Cola FEMSA meets the criteria of a subsidiary for consolidation as FEMSA holds more than 50% of Coca-Cola FEMSA's outstanding voting stock and has not yielded control to a minority shareholder. NIF Bulletin B-8 establishes that control has been yielded when a minority shareholder obtains:

Control over more than 50% of the voting rights through a formal agreement with other shareholders;
The power derived from by-laws or formal agreement by shareholders to govern the operating and financial policies of a company;
The power to appoint or remove a majority of the Board of Directors or any organization that governs the operating and financial policies of the company; or
The power to decide the majority of the votes of the Board of Directors.

No minority shareholder of Coca-Cola FEMSA has obtained any of the rights described above.

The shareholder agreement grants The Coca-Cola Company substantive participating rights. The affirmative vote of two Directors appointed by The Coca-Cola Company is, with limited exceptions, required for matters considered by the Board of Directors, including the designation of the Chief Executive Officer and the Chief Financial Officer, the annual business plan, capital investment plan and asset disposals, mergers, acquisitions or sales of any line of business. Under Emerging Issues Task Force ("EITF") 96-16, "Investor's Accounting for an Investee When the Investor Owns a Majority of the Voting Stock but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights," such approval and veto rights held by The Coca-Cola Company qualify as substantive participating rights and therefore do not allow FEMSA to consolidate Coca-Cola FEMSA in its financial statements for U.S. GAAP purposes. Therefore, FEMSA's investment in Coca-Cola FEMSA is recorded by applying the equity method in FEMSA's consolidated financial statements under U.S. GAAP.

Summarized consolidated balance sheets and income statements of Coca-Cola FEMSA and subsidiaries under U.S. GAAP as of December 31, 2007 and 2006 and for the years ended December 31, 2007, 2006 and 2005 are presented as follows:

Consolidated Balance Sheets	2007	2006
Current assets	Ps. 18,065	Ps. 11,942
Property, plant and equipment	22,968	21,242
Other assets	47,550	45,370
Total assets	Ps. 88,583	Ps. 78,554
Current liabilities	Ps. 16,245	Ps. 12,618
Long-term liabilities	21,213	22,906
Total liabilities	37,458	35,524
Minority interest in consolidated subsidiaries	1,653	1,260
Stockholders' equity	49,472	41,770
Total liabilities and stockholders' equity	Ps. 88,583	Ps. 78,554

Consolidated Income Statements	2007	2006	2005
Total revenues	Ps. 69,131	Ps. 59,940	Ps. 51,196
Income from operations	10,741	8,749	8,720
Income before income taxes	10,225	7,700	7,404
Income taxes	3,271	2,420	2,467
Minority interest in results of consolidated subsidiaries	189	176	128
Net income	6,765	5,104	4,809
Other comprehensive income	1,768	1,023	(336)
Comprehensive income	Ps. 8,533	Ps. 6,127	Ps. 4,473

B) RESTATEMENT OF PRIOR YEAR FINANCIAL STATEMENTS:

As explained in Note 4 A), in accordance with Mexican FRS, the financial statements for Mexican subsidiaries for prior years were restated using inflation factors and for foreign subsidiaries and affiliated companies for prior years was restated using the inflation rate of the country in which the foreign subsidiary or affiliated company is located, then translated to Mexican pesos at the year-end exchange rate.

Under U.S. GAAP, the Company applies the regulations of the Securities and Exchange Commission of the United States of America ("SEC"), which require that prior year financial statements be restated in constant units of the reporting currency, in this case the Mexican peso, which requires the restatement of prior year amounts using Mexican inflation factors.

Additionally, all other U.S. GAAP adjustments for prior years have been restated based upon this methodology.

C) CLASSIFICATION DIFFERENCES:

Certain items require a different classification in the balance sheet or income statement under U.S. GAAP. These include:

As explained in Note 4 C), under Mexican FRS, advances to suppliers are recorded as inventories. Under U.S. GAAP advances to suppliers are classified as prepaid expenses;

Impairment of goodwill and other long-lived assets, the gains or losses on the disposition of fixed assets, all severance indemnity charges and employee profit sharing are included in operating expenses under U.S. GAAP; and

Under Mexican FRS, deferred taxes are classified as non-current, while under U.S. GAAP they are based on the classification of the related asset or liability or their estimated reversal date when not associated with an asset or liability.

D) DEFERRED PROMOTIONAL EXPENSES:

As explained in Note 4 D), for Mexican FRS purposes, the promotional costs related to the launching of new products or presentations are recorded as prepaid expenses. For U.S. GAAP purposes, such promotional costs are expensed as incurred. As of December 31, 2007, 2006 and 2005, this difference was reconciled by Coca-Cola FEMSA and its impact in FEMSA is included in the participation of Coca-Cola FEMSA. No other consolidated entity has deferred promotional expenses.

E) START-UP EXPENSES:

As explained in Note 4 i), under Mexican FRS, start-up expenses are capitalized and amortized using the straight-line method in accordance with the terms of the lease contracts at the start of operations. Under U.S. GAAP, these expenses must be recorded in the income statement as incurred, except for the licenses for the sale of beer paid for by FEMSA Comercio, which are considered to be intangible assets and amortized using the straight-line method beginning at the start of operations.

F) INTANGIBLE ASSETS:

As mentioned in Note 4 i), under Mexican FRS, until January 1, 2003, all intangible assets were amortized over a period of no more than 20 years. Effective January 1, 2003, revised NIF Bulletin C-8, "Intangible Assets," went into effect and recognizes that certain intangible assets (excluding goodwill) have indefinite lives and should not be amortized. In accordance with Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets" (effective January 1, 2002), goodwill and indefinitelived intangible assets are also no longer subject to amortization, but rather are subject to periodic assessment for impairment. Accordingly, amortization of indefinite-lived intangible assets was discontinued in 2002 for U.S. GAAP. In 2003, amortization of indefinite-lived intangible assets was discontinued for Mexican FRS and in 2004 the amortization of goodwill was discontinued (see Note 4 i).

As a result of the adoption of this SFAS No. 142, the Company performed an initial impairment test as of January 1, 2002 and found no impairment. Subsequent impairment tests are performed annually by the Company, unless an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. In such case an impairment test would be performed between annual tests.

G) RESTATEMENT OF IMPORTED EQUIPMENT:

As explained in Note 4 g), under Mexican FRS, imported machinery and equipment have been restated by applying the inflation rate of the country of origin and translated into Mexican pesos using the year-end rate.

Under U.S. GAAP, the Company applies the regulations of the SEC, which require that all machinery and equipment, both domestic and imported, be restated using Mexican inflation factors.

H) CAPITALIZATION OF THE INTEGRAL RESULT OF FINANCING:

Through December 2006, the Company did not capitalize the integral result of financing, which was previously optional under Mexican FRS. On January 1, 2007, NIF D-6, “Capitalization of Integral Result of Financing” went into effect. This standard establishes that the integral result of financing generated as a result of loans obtained to finance investment projects must be capitalized as part of the cost of long-term assets when certain conditions are met. This standard does not require retrospective application. The adoption of this standard did not have an impact on the Company’s consolidated financial position or results of operations.

In accordance with SFAS No. 34, “Capitalization of Interest Cost,” if the integral result of financing is incurred during the construction of qualifying assets, capitalization is required for all assets that require a period of time to get them ready for their intended use. Accordingly, a reconciling item for the capitalization of a portion of the integral result of financing is included in the U.S. GAAP reconciliation of the majority net income and majority stockholders’ equity. If the borrowings are denominated in U.S. dollars, the weighted average interest rate on all such outstanding debt is applied to the balance of construction in progress to determine the amount to be capitalized. If the borrowings are denominated in Mexican pesos, the amount of interest to be capitalized as noted above is reduced by the gain on monetary position associated with the debt.

I) DERIVATIVE FINANCIAL INSTRUMENTS:

Beginning on January 1, 2005, in accordance with Mexican FRS, as mentioned in Note 4 r), the Company values and records all derivative financial instruments and hedging activities according to NIF Bulletin C-10, “Derivative Financial Instruments and Hedging Activities,” which establishes similar accounting treatment as described in SFAS No. 133, “Accounting for Derivative Financial Instruments and Hedging Activities.” Therefore, as of such date the Company no longer has any difference as it relates to derivative financial instruments.

J) DEFERRED INCOME TAXES, EMPLOYEE PROFIT SHARING AND UNCERTAIN TAX POSITIONS:

The Company calculates its deferred income taxes and employee profit sharing in accordance with SFAS No. 109, “Accounting for Income Taxes,” for U.S. GAAP purposes, which differs from Mexican FRS as follows:

> Under Mexican FRS, the effects of inflation on the deferred taxes balance generated by monetary items are recognized in the result of monetary position. Under U.S. GAAP, the deferred taxes balance is classified as a non-monetary item. As a result, the consolidated

income statement differs with respect to the presentation of the gain or loss on monetary position and deferred income taxes provision;

Under Mexican FRS, deferred employee profit sharing is calculated considering only those temporary differences that arise during the year and which are expected to reverse within a defined period, while under U.S. GAAP, the same liability method used for deferred income taxes is applied; and

The differences in start-up expenses, restatement of imported machinery and equipment, capitalization of financing costs and pension plan mentioned in Note 26 d), g), h) and k) generate a difference when calculating the deferred income taxes under U.S. GAAP compared to that presented under Mexican FRS (see Note 23 d).

Employee profit sharing is deductible for Mexican income taxes purposes. This deduction reduces the payments of income taxes in subsequent years. Therefore, the Company recorded a reduction to the deferred income taxes liability under U.S. GAAP.

In June 2006, FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an Interpretation of SFAS Statement No. 109," or "FIN No. 48," was issued and became effective as of January 1, 2007. FIN No. 48 provides detailed guidance for the financial statement recognition, measurement and disclosure of uncertain tax positions recognized in a company's financial statements with SFAS No. 109, "Accounting for Income Taxes." FIN No. 48 requires a company to recognize the financial statement impact of a tax position when it is more likely than not that the position will be sustained upon examination. If the tax position meets the more-likely-than-not recognition threshold, the tax effect is recognized at the largest amount of the benefit that is greater than 50% likely of being realized upon ultimate settlement.

The reconciliation of deferred income tax and employee profit sharing, as well as the changes in the balances of deferred taxes, are as follows:

Reconciliation of Deferred Income Taxes, Net		2007		2006
Deferred income taxes under Mexican FRS	Ps.	2,320	Ps.	1,943
Deferred income taxes of Coca-Cola FEMSA		(225)		381
U.S. GAAP adjustments:				
Start-up expenses		(58)		(55)
Restatement of imported equipment		(31)		87
Capitalization of integral result of financing		88		102
Tax deduction for employee profit sharing		(135)		(182)
Labor liabilities		(355)		(468)
Total U.S. GAAP adjustments		(491)		(516)
Deferred income taxes, net, under U.S. GAAP	Ps.	1,604	Ps.	1,808

The total deferred income taxes expense under U.S. GAAP includes the corresponding current portion as of December 31, 2007 and 2006 of Ps. 266 and Ps. 296, respectively.

Changes in the Balance of Deferred Income Taxes		2007		2006
Initial balance	Ps.	1,808	Ps.	2,428
Provision for the year		(539)		(238)
Change in the statutory income tax rate		—		10
Unrecognized labor liabilities		33		(322)
Derivative financial instruments		124		(70)
Cumulative translation adjustment		178		—
Ending balance	Ps.	1,604	Ps.	1,808

Reconciliation of Deferred Employee Profit Sharing		2007		2006
Deferred employee profit sharing under Mexican FRS	Ps.	—	Ps.	—
U.S. GAAP adjustments:				
Allowance for doubtful accounts		(6)		(6)
Inventories		97		129
Prepaid expenses		28		28
Property, plant and equipment		963		974
Deferred charges		(214)		(134)
Intangible assets		10		1
Capitalization of interest expense		31		36
Start-up expenses		(18)		(17)
Derivative financial instruments		5		3
Labor liabilities		(329)		(297)
Other reserves		(84)		(67)
Total U.S. GAAP adjustments		483		650
Deferred employee profit sharing under U.S. GAAP	Ps.	483	Ps.	650

The total deferred employee profit sharing under U.S. GAAP includes the corresponding current portion as of December 31, 2007 and 2006 of Ps. 124 and Ps. 154, respectively.

Changes in the Balance of Deferred Employee Profit Sharing		2007		2006
Initial balance	Ps.	650	Ps.	928
Provision for the year		(180)		(148)
Labor liabilities		13		(130)
Ending balance	Ps.	483	Ps.	650

Any difference between the tax position taken in the tax return and the tax position recognized in the financial statements using the criteria above results in the recognition of a liability in the financial statements for the unrecognized benefit. Similarly, if a tax position fails to meet the more-likely-than-not recognition threshold, the benefit taken in tax return will also result in the recognition of a liability in the financial statements for the full amount of the unrecognized benefit. FIN 48 became effective for fiscal years beginning after December 15, 2006 for public entities and their subsidiaries. The Company adopted FIN 48 as of January 1, 2007, as required. The provisions of FIN 48 were applied to all tax positions under SFAS No. 109 upon initial adoption. The impact of adopting this interpretation was not material to the Company's consolidated financial position, results of operations or cash flows.

K) LABOR LIABILITIES:

Under Mexican FRS, the liabilities for employee benefits are determined using actuarial computations in accordance with NIF Bulletin D-3, "Labor Liabilities," which is substantially the same as SFAS No. 87, "Employers' Accounting for Pensions," except for the initial year of application of both standards, which generates a difference in the unamortized net transition obligation and in the amortization expense.

In January 1997, as a result of the application of inflationary accounting, Mexican FRS determined that labor obligations are nonmonetary liabilities and required the application of real, instead of nominal, interest rates in actuarial calculations. These changes required recalculation of the accumulated transition obligation, and the difference in the transition obligation represents the sum of the actuarial gains or losses since the first year that labor obligations have been calculated. This difference is being amortized over the average life of employment of the Company's personnel. The Company uses the same real interest rate for both U.S. GAAP and Mexican FRS.

Under Mexican FRS, as mentioned in Note 4 l), Mexican standard NIF Bulletin D-3 requires the recognition of a severance indemnity liability calculated based on actuarial computations. The same recognition criteria under U.S. GAAP is established in SFAS No. 112, "Employers' Accounting for Postemployment Benefits," which has been effective since 1994.

Beginning in 2005, the Company applies the same considerations as required by Mexican FRS to recognize the severance indemnity liability for U.S. GAAP purposes. The cumulative effect of the severance obligation related to vested services was recorded in the 2005 income statement since the effect was not considered to be quantitatively or qualitatively material to the Company's consolidated U.S. GAAP financial statements taken as a whole. The transition obligation has not been recorded for U.S. GAAP purposes.

In 2006, the Company adopted SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106 and 132(R)." This statement requires companies to (1) fully recognize, as an asset or liability, the overfunded or underfunded status of defined pension and other postretirement benefit plans; (2) recognize changes in the funded status through other comprehensive income in the year in which the changes occur; and (3) provide enhanced disclosures. The impact of adoption, including the interrelated impact on the minimum pension liability, resulted in an increase in total liabilities and a decrease in stockholders' equity reported under U.S. GAAP of Ps. 192 and 892, respectively.

Prior to the adoption of SFAS No. 158, there was no difference in the liabilities for seniority premiums and postretirement medical benefits between Mexican FRS and U.S. GAAP. The reconciliation of the pension cost for the year and related labor liabilities is as follows:

Cost for the Year	2007	2006	2005
Net cost recorded under Mexican FRS	Ps. 664	Ps. 551	Ps. 495
Net cost of Coca-Cola FEMSA	(176)	(163)	(184)
U.S. GAAP adjustments:			
Amortization of unrecognized transition Obligation	(8)	(5)	279
Amortization of prior service cost	8	----	-----
Total U.S. GAAP adjustment	---	(5)	279
Cost for the year under U.S. GAAP	Ps. 488	Ps. 383	Ps. 590

Labor Liabilities	2007	2006
Labor liabilities under Mexican FRS	Ps. 3,718	Ps. 3,269
Labor liabilities of Coca-Cola FEMSA	(993)	(924)
Restatement effect	—	(8)
U.S. GAAP adjustments:		
Unrecognized net transition obligation	459	526
Unrecognized prior service	781	826
Unrecognized net actuarial loss	444	457
Additional labor liability in cumulative other comprehensive income	(413)	(127)
U.S. GAAP adjustments to stockholders' equity	1,271	1,682
Reversal of additional labor obligation under Mexican FRS	(673)	(1,006)
Labor liabilities under U.S. GAAP	Ps. 3,323	Ps. 3,013

Estimates of the unrecognized items expected to be recognized as components of net periodic pension cost during 2007 are shown in the table below:

	Pension and Retirement Plans	Seniority Premiums	Postretirement Medical Services
Actuarial net loss and prior service cost recognized in cumulative other comprehensive income during the year	Ps. 8	Ps. 2	Ps. 12
Actuarial net loss and prior service cost recognized as a component of net periodic cost	50	1	13
Net transition liability recognized as a component of net periodic cost	50	1	4
Actuarial net loss, prior service cost and transition liability included in accumulated cumulative other comprehensive income	973	25	345
Estimate to be recognized as a component of net periodic cost over the following fiscal year:			
Net transition obligation	1	1	13
Prior service cost	48	—	—
Actuarial loss	48	1	5

L) KAISER AND COCA-COLA FEMS A MINORITY ACQUISITION:

As mentioned in Note 5 c), in 2006 FEMSA Cerveza indirectly acquired an additional equity interest in Kaiser. According to Mexican standard NIF Bulletin B-7, "Business Acquisitions," this is a transaction between existing shareholders that does not impact the net assets of the Company, and the payment in excess of the book value of the shares acquired is recorded in stockholders' equity as a reduction of additional paid-in capital. Under U.S. GAAP, SFAS No. 141, "Business Combinations," establishes that purchases of minority interest represent a "step acquisition" that must be recorded utilizing the purchase method, whereby the purchase price is allocated to the proportionate fair value of assets and liabilities acquired. The purchase price allocation for this acquisition has been completed, and the allocation period was closed. The Company did not recognize any goodwill as a result of this acquisition.

Additionally, on August 31, 2007, FEMSA Cerveza sold 16.88% of Kaiser's outstanding shares to Heineken HV. The excess of the price paid over the book value was recorded directly in stockholders' equity in accordance with Mexican FRS.

As mentioned in Note 5 A), in 2006 FEMSA indirectly acquired an additional, 8.02% of the total outstanding equity of Coca-Cola FEMSA. According to Mexican standard NIF Bulletin B-7, this is a transaction between shareholders that does not impact the net assets of the Company, and the payment in excess of the book value of the shares acquired is recorded in stockholders' equity as a reduction of additional paid-in capital. Under U.S. GAAP, SFAS No. 141, "Business Combinations," purchases of minority interest represent a "step acquisition" that must be accounted for under the purchase method, whereby the purchase price is allocated to the proportionate fair value of assets and liabilities acquired. The difference between the fair value and the price paid for the 8.02% of Coca-Cola FEMSA equity is presented as part of investment in Coca-Cola FEMSA shares in the consolidated balance sheet under U.S. GAAP. The Company did not recognize any goodwill as a result of this acquisition. The acquisition of the additional 8.02% interest in Coca-Cola FEMSA did not affect the consolidation analysis discussed above as it relates to EITF 96-16 given that The Coca-Cola Company's substantive participating rights were not affected.

M) MINORITY INTEREST:

Under Mexican FRS, the minority interest in consolidated subsidiaries is presented as a separate component within stockholders' equity in the consolidated balance sheet.

Under U.S. GAAP, this item must be excluded from consolidated stockholders' equity in the consolidated balance sheet. Additionally, the minority interest in the net earnings of consolidated subsidiaries is excluded from consolidated net income.

The U.S. GAAP adjustments shown in Note 27 A) and B) are calculated on a consolidated basis. Therefore, the minority interest effects are presented as a separate line item to obtain net income and stockholders' equity.

N) FEMSA'S MINORITY INTEREST ACQUISITION:

In accordance with Mexican FRS, the Company applied the entity theory to the acquisition of the minority interest by FEMSA in May 1998, through an exchange offer. Accordingly, no goodwill was created as a result of such acquisition and the difference between the book value of the shares acquired by FEMSA and the FEMSA shares exchanged was recorded as additional paid-in capital. The direct out-of-pocket costs identified with the purchase of minority interest are treated as an additional purchase cost and included in other expenses.

In accordance with U.S. GAAP, the acquisition of minority interest must be accounted under the purchase method, using the market value of shares received by FEMSA in the exchange offer to determine the cost of the acquisition of such minority interest and the related goodwill. Under U.S. GAAP, the direct out-of-pocket costs identified with the purchase of minority interest are treated as additional goodwill.

Additionally, SFAS No. 142 requires the allocation of all goodwill to the related reporting units. The allocation of the goodwill generated by the previously mentioned acquisition of minority interest was as follows:

FEMSA Cerveza	Ps. 10,600
Coca-Cola FEMSA	4,753
FEMSA Comercio	1,085
Other companies	918
	Ps. 17,356

O) STATEMENT OF CASH FLOWS:

Under Mexican FRS, the Company presents a consolidated statement of changes in financial position in accordance with Bulletin B-12, “Estado de Cambios en la Situación Financiera” (Statement of Changes in Financial Position), which identifies the generation and application of resources by the differences between beginning and ending financial statement balances in constant Mexican pesos. Bulletin B-12 also requires that monetary and foreign exchange gains and losses be treated as cash items for the determination of resources generated by operations.

In accordance with U.S. GAAP, the Company follows SFAS No. 95, “Statement of Cash Flows,” which is presented in historical Mexican pesos, without the effects of inflation (see Note 27 p).

P) Financial Information Under U.S. GAAP:

Consolidated Balance Sheets	**2007**	2006
ASSETS		
Current Assets:		
Cash and cash equivalents	**Ps. 2,914**	Ps. 3,593
Accounts receivable	**5,383**	5,012
Inventories	**6,465**	5,473
Recoverable taxes	**1,470**	693
Other current assets	**775**	677
Total current assets	**17,007**	15,448
Investments in shares:		
Coca-Cola FEMSA	**28,188**	24,043
Other investments	**387**	371
Property, plant and equipment	**32,725**	31,151
Intangible assets	**34,830**	33,926
Bottles and cases	**1,950**	1,709
Other assets	**9,688**	8,045
TOTAL ASSETS	**Ps. 124,775**	Ps. 114,693
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Bank loans	**Ps. 2,390**	Ps. 2,489
Interest payable	**202**	162
Current maturities of long-term debt	**2,166**	375
Suppliers	**8,317**	7,104
Deferred taxes liability	**390**	450
Taxes payable	**2,018**	1,576
Accounts payable, accrued expenses and other liabilities	**3,096**	2,658
Total current liabilities	**18,579**	14,814
Long-Term Liabilities:		
Bank loans and notes payable	**16,569**	18,749
Deferred taxes liability	**1,705**	2,018
Labor liabilities	**3,323**	3,013
Other liabilities	**1,295**	2,008
Total long-term liabilities	**22,892**	25,788
Total liabilities	**41,471**	40,602
Minority interest in consolidated subsidiaries	**698**	166
Stockholders' equity	**82,606**	73,925
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	**Ps. 124,775**	Ps. 114,693

Consolidated Statements of Income and Comprehensive Income	2007	2006	2005
Net sales	Ps. 82,887	Ps. 75,288	Ps. 62,709
Other operating revenues	475	416	322
Total revenues	83,362	75,704	63,031
Cost of sales	48,788	44,059	36,594
Gross profit	34,574	31,645	26,437
Operating expenses:			
Administrative	5,944	5,689	5,088
Selling	20,920	18,135	14,438
	26,864	23,824	19,526
Income from operations	7,710	7,821	6,911
Integral result of financing:			
Interest expense	(2,417)	(2,003)	(1,850)
Interest income	158	421	386
Foreign exchange gain (loss), net	592	11	(15)
Gain on monetary position, net	664	429	285
Market value (loss) gain on ineffective portion of derivative financial instruments	(45)	5	(92)
	(1,048)	(1,137)	(1,286)
Other expenses, net	(124)	(298)	(94)
Income before taxes	6,538	6,386	5,531
Taxes	1,610	2,029	1,723
Income before minority interest and participation in affiliated companies	4,928	4,357	3,808
Minority interest in results of consolidated subsidiaries	(32)	169	—
Participation in affiliated companies:			
Coca-Cola FEMSA	3,635	2,420	2,205
Other affiliated companies	26	27	46
	3,661	2,447	2,251
Net income	Ps. 8,557	Ps. 6,973	Ps. 6,059
Other comprehensive income	1,649	346	(1,072)
Comprehensive income	Ps. 10,206	Ps. 7,319	Ps. 4,987
Net income per share (constant Mexican pesos):			
Per Series "B" share	Ps. 0.43	Ps. 0.35	Ps. 0.32
Per Series "D" share	0.53	0.43	0.40

ANDERSON'S DEPARTMENT STORE: A COSMETIC DILEMMA

Regina A. Julian, Stephen F. Austin State University
Elton L. Scifres, Stephen F. Austin State University

CASE DESCRIPTION

This case describes the unexpected conflicts that arise when a heretofore smoothly functioning cosmetic department is asked to temporarily alter its work routines. It could be readily used to demonstrate the benefit of using multiple perspectives to analyze a situation. Secondarily, it could be used to elicit discussion related to motivation, leadership, structure, or politics. The case has a difficulty level of three, appropriate for junior level students. It could be used in a principles of management, organizational behavior, or organization theory class. The case is designed to be taught in one class hour and is expected to require three hours of outside preparation by students.

CASE SYNOPSIS

In this case a successful, locally owned department store initiates a remodeling and expansion project of its cosmetics department. To save money on the upgrade, the store manager solicits the help of cosmetic department employees in dismantling old shelves and equipment and relocating products. A former employee was hired on a temporary basis to help with the move, and the department manager, Mellissa Hart, thought she could rely on her tight knit employees to pull together and finish the project with little supervision. Unfortunately this was not the case. As the project proceeded, employees started grumbling about the extra work, and shirked the remodeling task, leaving Hart and the temporary employee with the bulk of the work. Even worse, morale broke down as employees competed for diminishing commissions. At completion the cosmetic department had a very nice physical space, but its employees were full of hostility and morale was non existent. The entire store was questioning Hart's handling of the project and she was left wondering what she could have done to prevent the problems.

THE COMPANY

Operational for 60 years, Anderson's Department Store is a profitable marketer of quality clothing, skin care accessories, and home décor. It is a family owned business located in Jackson, a town of approximately 30,000 people in east Texas. Despite its rural location and local ownership, it is a fairly large and very modern operation that manages to stay competitive with several national chain stores located in the region. The store carries a number of high end brand names such as Ralph Lauren, Clinique, Tommy Hilfiger, and Donna Karan, and boasts approximately 20,000 square feet of space, twelve departments, and a workforce of 40 full and part time workers. Store manager Jim Lovell is in charge of the overall direction and department managers report directly to him. Department managers are given a great deal of latitude for decisions in their areas. The store has enjoyed over 45 years of annual sales increases and profits, netting approximately $2.5 million in profits in 2005.

THE COSMETIC DEPARTMENT

Anderson's cosmetic department is considered to be an integral part of the store's operation. It sells most of the widely known brand name cosmetics such as Clinique, Elizabeth Arden, Estee Lauder, and Lancôme. Located in the middle of the store, it is anchored by a large fragrance center which is surrounded by four counters. The department is managed by Melissa Hart who maintains a dual role as Lauder counter manager and department manager. Six experienced employees staff the department; three counter managers and two beauty consultants. All employees receive hourly pay, but a substantial part of their compensation comes from commissions. In general, the employees in cosmetics know their job and enjoy a close knit, professional working relationship.

THE STORE EXPANSION PROJECT

Though physically small, the cosmetics department generates approximately $1.5 million in gross sales annually, or more than one fourth of overall store sales. Margins are also quite good as the Lauder counter alone generates a yearly profit of $400,000. In recognition of the department's importance and the general need for an updated appearance, Mr. Lovell secured funding and approved a departmental expansion and aesthetic upgrade in the Fall of 2006. It was hoped that a physical expansion and the movement toward a more classic look would bolster sales even more.

Initial blueprints revealed that all counters were to receive a significant increase in work space, with the Lauder space receiving more amenities than the others. An outside firm was contracted to construct the new units and perform all related carpentry work.

WORK ASSIGNMENTS

In an attempt to reduce the cost of the upgrade Mr. Lovell decided to use employees in cosmetics to dismantle existing fixtures and counters, move all the stock to a temporary location, and then replace the stock upon completion of the project. Furthermore, as most of the dismantling work would be performed during regular store hours, it was decided to recruit former employee Angela Jones to aid with the move and "buffer" the employees in their dual roles of consultant/laborer. Ms. Jones had been employed for four years as a consultant and buyer in cosmetics. The entire project was estimated to last three to four weeks, and Ms. Hart was given full discretion to make employee assignments as needed.

Ms. Hart called a meeting of all her employees and explained that everyone would be expected to do their part in the move and that each consultant would still have the opportunity to earn sales commissions. Hart felt that everyone understood the nature of the project and that there would be no need for formal work assignments. Her workers were known to approach their job in a professional manner and usually required little in the way of direct supervision.

The task at hand in fact was to be quite laborious. Each existing counter was to be unloaded of product piece by piece and relocated on the back storeroom's shelving from which customers could still peruse the merchandise. Following this all hardware was to be dismantled and moved to a separate location. Finally, upon completion of the new fixtures and counters, the merchandise would be moved back to the original location. A concerted effort over a period of weeks would be necessary to complete this task.

THE PLAN IMPLEMENTATION

The first three days of the project seemed to proceed without incident. Everyone performed their usual work and worked on the project within their own counters. On day four Angela Jones overheard some grumbling from several consultants over being asked to do something that obviously fell outside their job descriptions. The most vocal of the group was Clinique counter manager Deborah Moore. She was heard to say, "This job doesn't pay enough for me to get tired and dirty like this. How am I supposed to sell cosmetics looking like I just came off a construction site?" Even more surprising, she was heard to threaten to quit if anyone criticized her performance in anyway.

Within a few days, the dissatisfaction in the department had become evident as departmental employees began to shirk the remodeling tasks. Ms. Hart and Ms. Jones found themselves doing the majority of the heavy work, while the consultants seemed to busy themselves with meager tasks such as cleaning glass surfaces and organizing stock when they weren't attending to customers. Mary Thomas, a sales associate in an adjoining department confided in Hart that the consultants seemed to be pretending to be busy with customers, but were actually engaging in conversation with other employees. Thomas stated that the Lauder consultant, Victoria Jones seemed to be the worst offender and went on to express her concern that Hart and Jones were being taken advantage of. Hart responded that she did not intend to say anything, noting that "they're grown women and I shouldn't have to tell them what to do every minute."

While working in a hidden area of the workroom during the second week of the remodeling project, Ms. Hart overheard some disturbing comments from her employees. First she overheard Victoria Jones telling the Lancôme counter manager Patricia Johnson, “I need this money more than anyone else here because I’m a single mother with two boys. I can’t afford to waste my time on this stuff.” Jones left the room shortly after making this comment and Clinique consultant Deanna Stone entered. Johnson related Jones comment to Stone and went on to say, “Well she can think she’s the only one who needs the money but I have bills to pay too. Two can play that game. Besides she’s with Lauder and they’re the ones benefiting most from this. Let them do the work.” Ms. Hart refrained from commenting to the parties but later mentioned the incident to Jones.

The hostility within the department only worsened in week three. Daily rather than the usual weekly tallying of sales and commissions became the norm for the consultants, with glares often resulting once the calculations were completed. The usual friendly conversations between consultants was replaced by total silence, broken only when customers asked for assistance. Hart and Jones continued to do the bulk of the work. It was obvious to them that tension in the department was high, but Hart decided the best course of action would be to persevere rather than address the obvious dissension among employees. The project was in the finishing stages and things would return to normal soon. She did make a tentative announcement that perhaps they could hasten the project by working after the 8:00 closing time. This was met with immediate resistance, and rather than provoke further hostility she dropped the suggestion.

By the time the project was nearing completion in the fourth week, the problems in the cosmetic department had become the talk of the store. The onslaught of negative comments and anger expressed in the common areas of the store during breaks and lunch was having a negative impact on the entire store. Employees avoided talking about the situation when Hart was present, but a great deal of advice was offered behind her back. Most employees were genuinely concerned about the injured morale in cosmetics and were wondering why no one had intervened in the situation.

Hart and Jones continued to put in some very long and difficult hours to finish up the project themselves. As the project was nearing completion the cosmetics team took some time as the store closed to inspect and admire their new space. There were a few minor details to be finished by the contractors, but their work was finished and the results were quite an improvement. Hart could only grit her teeth in anger as she overheard Ms. Moore state, “This was a lot of work but we actually pulled it off. I hope we never have to do this kind of project again. I don’t think my mind or body could handle it.” As the depth of her resentment against her employees began to sink in, Hart wondered how things could have gotten so out of hand so quickly. The morale in her department was in shambles and she had no idea how to put things back together.

DISCUSSION QUESTIONS:

Q1. Prepare an organizational chart of the Anderson Department Store showing its chain of command and personnel, with special reference to its cosmetics department.

Q2: Do you see any weaknesses in the process of decision making and communication at the Store and/or departmental level? Please recommend strategies/tactics to remove these weaknesses.

Q3: Identify the multitude of problems relating to morale and work performance that you noticed in the case. What were the causes of these problems?

Q4: What can Ms. Hart do to solve these problems and bring normalcy in her department?

MIXED SIGNALS AT GABBA ENTERPRISES

Kurt Jesswein, Sam Houston State University

CASE DESCRIPTION

This case requires the student to understand how a statement of cash flows is related to and can be derived from a company's income statement and balance sheets. Students must produce a complete statement of cash flows using both the direct and indirect methods. The student must then interpret the results of the cash flow statement in light of other information provided in the case and the other financial statements in terms of its impact on the feasibility of financing a major expansion of a business enjoying tremendous growth and expecting continued success. The case has a difficulty level of four to five as it would be appropriate for either senior level or graduate level courses. The case is designed to be taught in two to three class hours and is expected to require three to four hours of outside preparation by students.

CASE SYNOPSIS

Gabba Enterprises began operations some ten years ago when its founder, Joey Mareno, an experienced and accomplished tool and die maker, decided to start his own business. The company has thrived ever since to the point where the company is planning to undertake a major expansion. Despite its previous successes, the company does not believe it can fund its future growth on its own so Joey has gone to his primary banker seeking the necessary financing. Providing the bank with balance sheet and income statement data along with his well thought out business plan for the future, he was surprised to discover that he also needed to produce a statement of cash flows to help document how the company would generate sufficient cash flows to repay the loan. Given information provided in the case the student is required to create a cash flow statement and then interpret the results. It provides a good review of basic accounting relationships and, more importantly, evidence of how cash flow statements provide important insights into a company's operations that cannot easily be seen from examining balance sheets and income statements alone.

MIXED SIGNALS AT GABBA ENTERPRISES

In the late 1990s, starting out in his own garage, Joey Mareno, an experienced tool and die maker, founded Gabba Enterprises to produce specialized tools and machinery for manufacturing facilities throughout the Mid-South region of the U.S. Given his skills and the high quality of his workmanship, he soon had a steady clientele of small and medium-sized manufacturers impressed by the quality of his work and the professionalism of his businesses operations. This is affording him the opportunity to move into a larger facility, an underutilized warehouse that had recently become available. Although the building itself was obtainable at a reasonably low price given its location and the lack of interest from other businesses moving in, Joey believes that the expense of expanding his operations is beyond his current means. This has forced him to go to his banker, First Security, with a request for assistance in funding the expansion.

Given the success of his business, Joey had not previously needed much financial assistance. He primarily used First Security to handle his cash operational needs, processing payroll, cash flow maintenance, etc., but had not required much in the way of direct financing. He did have a $200,000 line of credit with First Security for emergency purposes and, except for a small amount ($25,000) used at the end of 2009, had not needed to use the line of credit.

But now he was hoping to borrow a much larger amount ($600,000) to help with his expansion plans, and was somewhat unsure of the types of information that would be needed by First Security. His wife, a practicing CPA with a successful tax preparation and advisement service of her own, had prepared an up-to-date balance sheet and income statement that documented the successful growth of the company as well as its current financial strength (Exhibit A). Expecting that the bank would also need information about the company's future plans, Joey and his wife also prepared a pro forma income statement and balance sheet for the coming year. Due to the past success of both of their businesses, providing personal guarantees for the repayment of any new loans needed to finance Joey's business expansion was not believed to be a serious issue.

Despite the long and healthy relationship that the Marenos had with First Security, the lending officer at First Security, Tommy Lydon, has expressed some concerns about the cash flow situation of the company. Despite whatever guarantees or collateral the Marenos could offer, he felt the loan would not be approved without being able to demonstrate that cash flows generated by the expansion would be sufficient to repay the loan used to finance that expansion. He asked Joey and his wife to prepare a cash flow statement that would demonstrate from where they expected cash flows to come and to where they were expected cash flows to go.

The Marenos were concerned because they had little experience in the preparation of formal cash flow statements. Fortunately, Dee Dee Ritchie, the credit analyst working with Tommy Lydon, had recently completed a review course on preparing cash flow statements and provided them with a basic overview of the process that she had compiled during her course (Exhibit B). Dee Dee also sat down with the couple to help them consider various transactions that had occurred and were expected to occur within the business that would have a bearing on their preparation of the cash flow statement. A summary of these points are as follows:

> The new equipment needed for the expansion would cost a total of $1,356,700. Some of the equipment would be used to replace existing machinery that the company expected to sell for $165,750, $30,000 more than its current book value. Included in the new equipment is one large component costing $450,000 that would be acquired by paying one-half in cash and financing the remaining half with a note payable to the supplier at an interest rate of 9 percent.
>
> Joey was expected to draw down the remaining $175,000 of his line of credit with the bank to help finance some of his working capital needs.

Although most of the common stock of the company is owned by the Marenos, some is owned by other close friends and relatives. Therefore, beginning in 2009, the company began paying dividends. They declared total dividends of $20,000 at the end of 2009, payable on January 15 of 2010, and expect to increase the amount of dividends to $30,000 in 2010. Furthermore, one shareholder, Aunt Jonie, was planning to retire in New Mexico and asked that her shares be bought back by the company. The company plans to buy back her shares some time in early 2010 at a cost of $45,000.

The 2009 cost of goods sold was determined as follows: $865,200 for the direct costs of materials ($610,500) and labor ($254,700), $45,600 for the indirect costs such as rent and utilities, and $30,700 for depreciation of the machinery used to made the finished goods. The 2010 pro forma amounts were estimated as follows: $1,828,850 for materials and labor, $179,500 for indirect costs, and $87,000 for depreciation. It was noted that $8,500 of the depreciation amount in 2010 would actually be included in the valuation of the company's year-end finished goods inventory.

The reported 2009 operating expenses included cash operating expenses of $211,850 and a noncash charge of $15,000 for amortization of a patent that the company owned. For 2010, the amounts were expected to be $461,400 for cash expenses and $15,000 for amortization costs.

Given this information, prepare a pro forma statement of cash flows for 2010 using both the indirect method and the direct method of presenting the cash flow from operating activities. Provide a brief synopsis of the main sources and uses of cash revealed by the analysis, especially any specific concerns you might have about approving this loan if you were the lending officer at First Security.

Appendix A
Historical and Pro Forma Financial Statements of Gabba Enterprises

Balance Sheet	2008	2009	Pro forma
Assets			
Cash	$86,200	$232,050	$75,600
Receivables	82,500	175,400	367,200
Inventories	47,500	78,300	152,400
Prepaid expenses	0	0	32,000
Total current assets	216,200	485,750	627,200
Property, plant, and equipment	301,750	301,750	1,459,200
Less: Accumulated depreciation	-107,800	-138,500	-170,500
Net property, plant, and equipment	193,950	163,250	1,288,700
Patents	75,000	60,000	45,000
Total assets	$485,150	$709,000	$1,960,900
Liabilities and Equity			
Accounts payable	0	4,500	11,500
Taxes payable	16,500	19,900	25,400
Accrued expenses	41,700	98,500	188,450
Dividends payable	0	20,000	30,000
Short-term debt	0	25,000	200,000
Total current liabilities	58,200	167,900	455,350
Notes payable	0	0	225,000
Long-term debt	0	0	600,000
Deferred income taxes	14,150	16,700	36,500
Capital stock and paid-in capital	400,000	400,000	400,000
Retained earnings	12,800	124,400	289,050
Less: Treasury stock	0	0	-45,000
Total liabilities and equity	$485,150	$709,000	$1,960,900
Income Statement	2008	2009	Pro forma
Sales	$624,000	$1,354,600	$2,954,600
Less: Cost of goods sold	422,025	941,500	2,095,350
Gross profit	201,975	413,100	859,250
Less: Operating expenses	93,450	226,850	476,400
Operating income	108,525	186,250	382,850
Less: Interest expense	0	750	90,700
Gain (loss) on sale of fixed assets	0	0	30,000
Income before taxes	108,525	185,500	322,150
Income taxes	31,200	53,900	127,500
Net income	$77,325	$131,600	$194,650

Appendix B
Dee Dee Ritchie's Notes on Basic Steps to Preparing a Statement of Cash Flows

1. To compute cash flows from operating activities using the indirect method:

A. Begin with net income as reported on the income statement.
B. Add back noncash expenses such as depreciation and amortization, stock compensation expense, bad debt expense, and add back increases (subtract decreases) in deferred taxes.
C. Remove gains and losses from disposing of or selling assets (add back losses, subtract gains)
D. To offset the impacts of accrual-based accounting
 add decreases in current asset accounts (other than marketable securities) and increases in current liability accounts (other than short-term debt), and
 subtract increases in current asset accounts and decreases in current liability accounts.

2. To compute cash flows from operating activities using the direct method:

A. Begin with cash receipts from customers by adjusting reported sale revenues by any changes in accounts receivable reported on the balance sheets (subtract increases in accounts receivable occurring during the period and add decreases).
B. Add any other cash received from income sources (e.g., dividends and interest received).
C. Subtract cash payments made to acquire inventory by adjusting reported cost of goods sold by any changes in inventory and accounts payable reported on the balance sheets
 add increases in inventory occurring during period and subtract decreases
 add decreases in accounts payable occurring during period and subtract increases
D. Subtract cash payments (not noncash expenses such as depreciation and amortization) made for operating expenses reported on the income statement after making adjustments arising from accrual accounting.
 add cash payments made prior to the recognition of an expense (add increases in prepaid expense items reported on the balance sheet and subtract decreases)
 subtract expense items that have not yet been paid for in cash (subtract increases in accrued expenses such as accrued payables and add decreases).
E. Subtract cash payments made for interest. Adjust the amount of interest expense reported on the income statement by changes in interest payable (subtract increases in interest payable reported on the balance sheet and add decreases).
F. Subtract cash payments made for income taxes. Adjust the amount of tax expense reported on the income statement by changes in taxes payable and/or deferred taxes (subtract increases in taxes payable and/or deferred taxes and add decreases).

3. To compute cash flows from investing activities:

A. Add the cash proceeds from selling or disposing of any fixed assets, investments, and/or other noncurrent assets.
B. Subtract the amount of cash expended to acquired any fixed assets, investments, and/or other noncurrent assets

4. To compute cash flows from financing activities:

A. Add the cash proceeds from issuing new notes payable or other short-term debt, long-term debt, and preferred or common stock.
B. Subtract the amount of cash expended to repay any short-term or long-term debt, repurchase stock (e.g., treasury stock), or for the payment of dividends (subtracting any increases in dividends payable or adding any decreases).

HSN, INC.: WEATHERING THE RETAIL STORM

Alexander Assouad, University of South Florida St. Petersburg
William T. Jackson, University of South Florida St. Petersburg
James A. Fellows, University of South Florida St. Petersburg

CASE DESCRIPTION

This case was developed through the use of secondary research material. The case has a difficulty level of five and is appropriate to be analyzed and discussed by advanced undergraduate and graduate students in a strategic management or accounting class.

The case allows the instructor the flexibility of concentrating on one strategic issue, or examining the entire strategic management process as well as complicated financial accounting reporting. The major focus within the strategic analysis as well as excellent stand alone modules is in the area of legal/political influence, economic, accounting, or the ability to survive in an unattractive industry. The instructor should allow approximately one class period for each element addressed. Using a cooperative learning method, student groups should require about two hours of outside research on each element researched. The case also provides an impetus to explore a once very successful company that existed as a member of a major conglomerate to an stand-alone operation facing significant start-up issues under the new arrangement.

CASE SYNOPSIS

This case is a library, popular press and internet case which examines HSNi- a broad-based retailer that owns and operates an interactive lifestyle network (HSN), a television network, print catalogs, as well as an internet site to support its business-to-consumer business model. The review of annual reports, trade journals, government documents and proposed and enacted regulations must be accomplished carefully. While most students have a general understanding of the home shopping industry, few have the current knowledge to compare this industry against more traditional operations. A review of these resources should lead students in determining the future of the company and the current CEO, Mindy Grossman.

INTRODUCTION

Mindy sat in her office suite overlooking the HSNi campus in beautiful Saint Petersburg while she previewed the soon to be released video detailing the company's Annual Report. She was quite pleased with the positive feel that the video had considering the year the company had just experienced. While she knew that those that understood the industry would agree with the upbeat nature of the presentation, she could not help but worry about the investor reaction—not that she had not already lived that reaction constantly over the last twelve months.

Many thoughts kept rolling through her mind—would the economy finally rebound from the lows experienced over the past 18 months; had the company secured the cable rights necessary to move the company forward; would there be any disruptions due to technological glitches no one could predict; was the government going to constantly interfere with an industry that hardly understood; was there any way to withstand the competition that had finally recognized the potential of the industry; would her studio stars still be icons to the viewing public this time next year; and a thousand other issues she cared not to recall. But mainly her mind kept returning to stockholders—how were they going to understand that on one day the company had an over two billion dollar asset on the next day they did not. Maybe it was time to put on a big smile and face those challenges head-on.

COMPANY HISTORY

HSNi was incorporated in May 2008 as a result of the "spin-off" by IAC/InterActiveCorp ("IAC"). The predecessor company of HSNi initiated operations in St. Petersburg, Florida in 1981. By 1985 the company had established 24 hours a day, seven days a week broadcasting on a national network through a combination of cable satellite and broadcast systems.

Until 2008, the company was reaching approximately 91.9 million homes in the United States. In addition, IAC owned the Cornerstone Brands portfolio. This portfolio included numerous print catalogs and related websites. Both of these operations were a major part of the IAC Retail Group (IAC/InterActiveCorp). However, in May 2008 all of the rules of the game changed for HSNi.

HSNi openly admits in documents filed with the Security and Exchange Commission that the company is subject to numerous threats. These threats that exist in the external environment could also be accentuated due to the potential of various weaknesses within the firm. As will be discussed in more detail later, a few of these concerns include: the eroding economic environment; the reliance on pay television operators in reaching its customers; tenuous vendor relationships; cost conscious consumers; increased distribution costs; pressure from government agencies; potential changes in the sales tax laws; the need to protect sensitive customer information and the reliance on technology to accomplish that required task; protection of its own intellectual properties; heightened competition; and, the impact of the recent spin-off not the least of which includes a two billion dollar plus write-off of goodwill.

COMPANY VISION AND MISSION

Joseph Shumpeter may have been envisioning the likes of HSNi when he referred to creative destruction in regard to entrepreneurial firms. As is stated in the company's vision statement, the company strives "*To be an original brand experience that becomes a disruptive force on the retail and cultural landscapes*." As was the case with other companies that challenged the traditional distribution systems, HSNi has indeed brought about many changes to the retail environment. In addition, the firm's mission statement reinforces the maverick attitude of the company:

> *"Deliver the joy and excitement of new discoveries every day:*
> *Discover new products—You will find things that you can't find anywhere else*
> *Discover new ideas—I get so many ideas…how to make things work for me, how to solve problems*
> *Have fun—Its light, it's fun, it's my time, just for me"*

INTERNAL OPERATIONS

MARKETING:

Retail industry success relies heavily on the success of the marketing efforts within a firm. Most important in that marketing mix will be the efforts in advertising. Due to the unique nature of the multi-channel marketing strategy being followed by HSNi, the company has been successful in promoting each element (and channel) or sales. The television format not only promotes the products it sells but compliments the online options as well as catalog format.

SECURITY CONCERNS:

In an industry that is founded on the concept of "long-distant" commerce, certain internal measures are required to ensure completion of transactions. This activity generally involves collecting sensitive information from customers such as credit card information. While successful companies have specializing in this market have dedicated considerable assets to protect customer information, those seeking to usurp the system have been equally aggressive. Many companies have experienced the impact on goodwill when such breaches of security have occurred.

THE ECONOMY

The retail industry has been especially hard hit by the recent lows in the economy. This has been most apparent in most of the upscale to moderate scale department store chains. A true indicator of this downturn is generally reflected in same store sales as can be seen below.

SAME-STORE SALES OF SELECTED DEPARTMENT STORES AND DISCOUNTERS
(Percent change from previous quarter)

	FISCAL	2008*				2009*			
	YEAR END	1Q	2Q	3Q	4Q	E1Q	E2Q	E3Q	E4Q
BETTER DEPARTMENT STORES									
Nordstrom	January	(6.5)	(6.0)	(11.1)	(12.5)	(13.6)	(13.7)	(11.3)	(7.7)
Saks	January	8.4	(4.0)	(11.5)	(15.3)	(26.5)	(15.0)	(10.0)	(6.7)
UPPER-MODERATE DEPARTMENT STORES									
Dillard's	January	(6.0)	(3.0)	(9.0)	(8.0)	(15.0)	(12.7)	(7.3)	(7.7)
Macy's	January	(2.6)	(2.1)	(6.0)	(7.0)	(8.0)	(8.0)	(6.5)	(5.5)
MODERATE DEPARTMENT STORES									
J.C. Penney	January	(7.4)	(4.3)	(10.1)	(10.8)	(8.4)	(7.7)	(3.3)	(2.7)
Kohl's	January	(6.7)	(4.6)	(6.7)	(9.1)	(4.5)	(7.2)	(6.8)	(3.7)
Sears, Roebuck	January	(9.8)	(6.7)	(10.6)	(11.0)	(11.0)	(12.0)	(8.0)	(6.0)
DISCOUNT STORES									
99 Cents Only Stores†	March	1.5	(0.5)	4.7	4.2	6.2	6.5	3.0	3.5
Big Lots	January	3.4	2.8	(0.2)	(3.2)	(1.0)	(1.0)	0.0	1.5
Dollar Tree Stores	January	2.1	6.5	6.2	2.2	4.0	2.5	3.0	4.5
Family Dollar Stores†	August	0.0	0.1	5.6	2.1	6.4	5.9	1.5	3.0
Kmart	January	(7.1)	(5.6)	(7.0)	(5.0)	(5.0)	(6.0)	(5.0)	(5.0)
Target	January	(0.7)	(0.5)	(3.3)	(5.9)	(3.5)	(3.7)	(2.5)	(0.5)

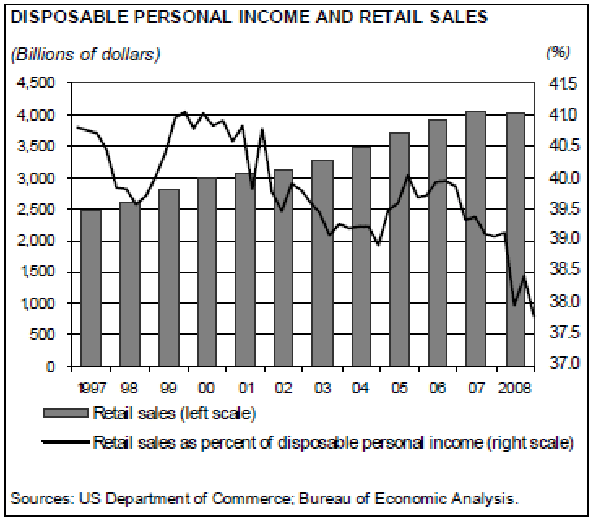
E-Estimated. *Based on a January fiscal year end. †Since fiscal year differs from the rest, data for closest comparable quarter is included.
Sources: Company reports; Standard & Poor's estimates.

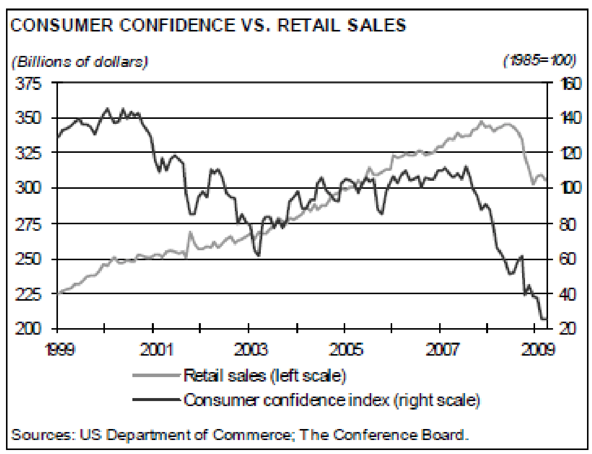
Much of this downturn in upper-end department store spending is a reflection of the conservative approach to shopping being taken in many households. Consumers have not been convinced that the recession is nearly over and in light of this fact there has been a significant trend to reduce spending and debt. Standard and Poor's researchers suggest that this has produced a positive impact on specialty stores and discounters who "accounted for 31.5% and 20.9% of US apparel sales in 2008, up from 30.6% and 20.9% respectively. The influence on retail purchasing is both a reality of lower disposable income levels as well as a lack of confidence in the economy.

In addition, consumers have turned rapidly to convenience in shopping brought about partially due to rising fuel prices—an issue that has also increased distribution costs for the retailers. This has been a positive for those firms that sell through the internet or television media. It has also been beneficial to firms that can convince shoppers of a best value for their money option.

INFLUENCE OF REGULATIONS

HSN has faced more than its fair share of legal challenges since its inception. The most significant action taken against the company occurred when the FTC placed a consent order on the firm in 1996. If at any time prior to April 15, 2019 HSN is found making claims for products that suggest they "can cure, treat or prevent any disease or have an effect on the structure of the human body" without substantiated scientific evidence, they will be subject to significant fines and penalties. In addition, HSN must always be cognizant of their liability associated with any product sold through their network. This liability can related to actions taken over misrepresentation of the facts as well as the result of harm caused by the product.





HSN operates in an extremely fluid industry in regard to the laws governing transactions with consumers. The company must remain aware of laws relating to retail operations not just in Florida where the headquarters are based, but also in any state or territory where the consumer receives purchased goods. These laws pertain to consumer protection, privacy, general retail activity, and that of goods purchased through the internet. This environment is constantly on the move. A good example and one that is viewed as highly volatile in the weak economy relates to the collection of sales tax collection for goods sold on the internet. While the limited collection requirements has afforded internet sales companies a potential advantage over traditional retailers, court activity in this area is increasing.

Other specific regulations impacting the company include: FDA regulations focused on food products; the EPA's concern and control over environmental claims such as "anti-bacterial"; and the FTC as well FCC regulating telemarketing activities. Indeed, there is much required to stay ahead of the regulation game.

DIRECT COMPETITORS

HSN is not alone in its approach to home shopping retailing. Two major competitors are squeezing margins in their pursuit of this retail segment—QVC and Shop NBC. As was the case with HSN, each is a member of a powerful conglomerate.

QVC is by far the strongest competitor in this market. With sales in excess of $7 billion and a comprehensive array of mechanisms to pursue this multimedia retail segment, an eye must always be focused on their operations.

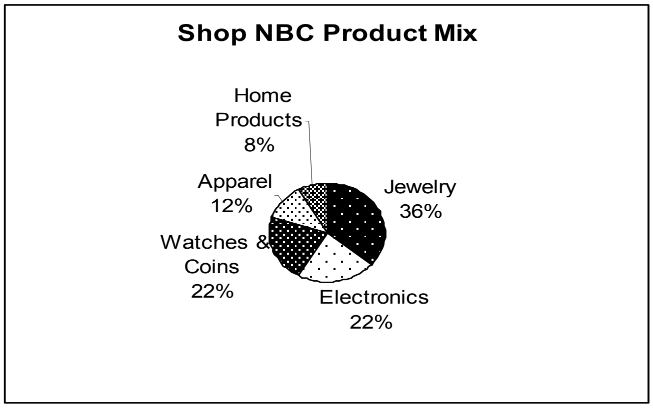
The company is a wholly owned subsidiary of Liberty Media Corporation. Founded in 1986 as a home shopping alternative, the company has branched out to the internet with QVC.com, receiving the unique distinction as the number two web site for customer satisfaction in ForeSee Results' "Top 100 Online Retail Satisfaction Index."

The focus of all segments of QVC is "to draw an upscale, discerning, and loyal customer base." This desire has translated into the ability to represent some of the leading product lines in the world (i.e. Dell and Bare Escentials).

QVC employs over 17,000 employees worldwide, reaches over 96 percent of all US cable homes plus a sizable percentage of the satellite home market (over 166 million households). In April of 2008, the company launched QVCHD capitalizing on this technology to provide a crisper, more colorful and detailed programming format. And, as the company itself states:

> *"The phones are ringing off the hook at television home shopping company QVC. QVC (its name stands for "quality, value, and convenience") offers about 1,600 items each week to TV-tied shopping addicts. Merchandise includes apparel, cosmetics, electronics, housewares, jewelry, and toys. It broadcasts 24 hours a day; viewers call in their orders to one of its six call centers. If you can't find what you're shopping for on the tube, it also sells online and through five outlet stores plus a full-line store at the Mall of America in Bloomington, Minnesota. The company also has shopping channels in Germany, Japan, and the UK."*

Shop NBC, although smaller also has placed significant pressure on HSN. Shop NBC focuses on premium lifestyle brands in each of its product lines. As was the case with many retailers, the last year has created many challenges. Sales plummeted from $781.6 million in the year ended January 31, 2008 to $567.5 million in the year ending January 31, 2009. Most experts suggest this decline was caused by the reliance on high-end products by the company—an issue that is already being addressed by Shop NBC. A breakdown of the company's product mix is shown below.



OTHER COMPETITION

As will be discussed later, the traditional retail industry suffered significant setbacks during the previous year due to the economic downturn. Many of these traditional department stores recognized the shift to "best value" and convenience desires of consumers and began to make changes. Nordstrom and Saks are two examples of companies that elected to follow a more advanced multi-channel retail strategy. This shift, in the case of these two companies, even included movement into their off-price stores—Nordstrom Rack and Saks Fifth Avenue Off 5th.

Discounters too have withstood the economic downturn much better than the traditional department store and added to the erosion of sales coveted by the home shopping networks. Much of this improvement with the discounters, however, has been attributed to a more diverse product offering—not just reliance on apparel.

Another area being focused on by HSN yet one many others see as having high potential is private labels. Retailers in general have recognized that this approach is beneficial in establishing brand identity and customer loyalty. In addition, (and especially important in the down economy) this approach eliminates the middleman associated with national brands and allows for higher profit margins and a perception by the consumer of a greater price-value relationship.

QUESTIONS FOR DISCUSSION

Based upon the analysis of the general environment, which forces present the greatest challenges to HSNi?

After a thorough analysis of the industry environment using the Michael Porter Five Force Analysis, describe the attractiveness of the industry.

Complete a SWOT analysis of HSNi. What are the critical issues facing the company?

What key financial ratios should be focused on for HSNi? How does the company stand in regard to some of its competitors in regard to these ratios?

Analyze the cause of the 2 billion dollar plus write-off of goodwill. Does this write-off doom the company to failure and marginal performance in the future?

REFERENCES

Anonymous (2008). IACInteractiveCorp.; IAC completes spin-offs of HSN, INC., Interval Leisure Group, INC., Ticketmaster and Tree.com, INC. *Investment Business Weekly*, Sept 7, p. 115.

Anonymous (2008). HSN, INC. adopts stockholder rights plan. *PR Newswire*, Dec 29.

Anonymous (2009). Steve Lococo's eco-care hair products to launch on ShopNBC; New color-safe eco-care system debuts on august 9th. *PR NewsWire*, August 6.

Dodes, R. (2009). Style—In fashion: Isaac Mizrahi meets QVC—the network creates a part-pitch, part-reality show to capture the designers outsize persona. *Wall Street Journal*, July 25, p. W4.

HSN, INC. Form 10-k Report, 2008.

Porter, M. E. (1980) *Competitive Strategy: Techniques for Analyzing Industries and Competitors*. New Your: Free Press.

Porter, M. E. (1985) *Competitive Advantage*. New York: Free Press.

Savitz, E. J. (2008). The writing is on the wall for HSN and John Malone. *Technology Trader*, June 19.

Sullivan, S. (2000). Shopping channels: Less of a hard sell. *Broadcasting & Cable*, Nov 27, 130 (49), 86-88.

Thompson, A. A., Strickland, A. J. & Gamble, J. E. (2007). *Crafting & Executing Strategy* (15th Ed.). Boston, McGraw-Hill Irwin.

www.dmwmedia.com/news/2008/06/09.

www.finance.yahoo.com

www.hsni.com

www.hsni.com/index.cfm

www.qvc.com/about

www.netadvantage.standardpoor.com/docs/indsur

HSN, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENT OF OPERATIONS (In thousands, except per share data, for years ended December 31)			
	2008	2007	2006
Net Sales	$ 2,823,593	$ 2, 908, 242	$ 2,877,954
Cost of Sales	1,838,163	1,820,048	1,765,203
Gross Profit	985,430	1,088,194	1,112,751
Operating Expenses			
Selling and Marketing	567,305	595,911	584,997
General and Administrative	220,644	211,955	186,261
Production and Programming	60,217	59,051	56,800
Amortization of Non-Cash Marketing	8,022	4,442	------
Amortization of intangible Assets	7,465	12,681	34,224
Depreciation	37,438	34,363	37,273
Asset Impairments	3,186,650	--------	--------
Total Operating Expenses	4,087,741	918,403	899,555
Operating (Loss) Income	(3,102,311)	169,791	213,196
Other Income (Expense)			
Interest Income	480	252	586
Interest Expense	(16,420)	--------	------
Other Expense	--------	(256)	(1,040)
Total Other Expense, Net	(15,940)	(4)	(454)
(Loss) Income from Continuing Operations before Income Taxes	(3,118,251)	169,787	212,742
Income Tax Benefit (Provision)	730,773	(64,554)	(79,210)
(Loss) Income from Continuing Operations	(2,387,478)	105,233	133,532
Gain of Sale of Discontinued Operations, Net of Taxes	---------	30,572	------
(Loss) Income from Discontinued Operations, Net of Tax	(3,410)	28,999	(10,715)
Net (Loss) Income	$(2,390,888)	$164,804	$122,817
(Loss) Income from Continuing Operations Per Share			
Basic	$ (42.48)	$ 1.87	$2.38
Diluted	$ (42.48)	$1.86	$2.36
Net (Loss) Income Per Share			
Basic	$ (42.54)	$ 2.93	$2.19
Diluted	$ (42.54)	$ 2.91	$2.17
Shares Used in Computing Earnings Per Share			
Basic	56,208	56,206	56,206
Diluted	56,208	56,649	56,649

HSN, INC. AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS (In thousands, except per share data, for years ended December 31)		
	2008	2007
ASSETS		
Cash and Cash Equivalents	$177,463	$ 6,220
Accounts Receivables Net of Allowances of $10,026 and $8,112, respectively	165,114	192,609
Inventories	304,172	317,411
Deferred Income Taxes	21,777	24,606
Prepaid Expenses and Other Current Assets	42,080	55,182
Total Current Assets	710,606	596,028
Property and Equipment, Net	157,832	155,805
Goodwill	----	2,884,389
Intangible Assets, Net	261,747	571,662
Other Non-Current Assets	22,272	12,747
Total Assets	$1,152,457	$4,220,631
LIABILITIES AND SHAREHOLDERS' EQUITY		
Accounts Payable, Trade	$209,615	$260,531
Current Maturities of Long-Term Debt	15,000	---
Accrued Expenses and Other Current Liabilities	179,637	188,312
Total Current Liabilities	404,252	448,843
Long-Term Debt, Less Current Liabilities	393,528	---
Deferred Income Taxes	83,276	819,969
Other Long-Term Liabilities	13,116	8,933
Total Liabilities	894,172	1,277,745
Shareholders' Equity:		
Preferred Stock $0.01 Par Value; 25,000,000 Authorized Shares; No Issued Shares	---	---
Common Stock $0.01 Par Value; 300,000,000 Authorized Shares; 56,222,631 Issued Shares	562	---
Invested Capital	---	4,522,873
Receivables from IAC and Subsidiaries	---	(1,581,157)
Additional Paid-In Capital	2,406,503	---
Retained Deficit	(2,148,534)	---
Accumulated Other Comprehensive (Loss) Income	(246)	1,170
Total Shareholders' Equity	258,285	2,942,886
Total Liabilities and Shareholders' Equity	$1,152,457	$4,220,631