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Instructors' Notes

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LETTER FROM THE EDITORS

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The instructors' notes contained in this volume have been double blind refereed, simultaneously with their respective cases. The cases were published in a separate issue of the *JIACS*. The acceptance rate for manuscripts in this issue, 25%, conforms to our editorial policies

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

INCOME SMOOTHING: MANAGEMENT CONSEQUENCES AND AUDITOR RESPONSIBILITES IN THE CASE OF BEAZER HOMES

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CASE DESCRIPTION

The primary subject matter of this case concerns auditor responsibilities when their clients engage in earnings management to achieve income smoothing. Secondary issues examined include internal controls, the accounting for sale-leaseback transactions, the impact of Sarbanes-Oxley (SOX), and the role of industry-level risk assessment in audit planning. The case requires students to access and review U.S. Securities and Exchange Commission (SEC) documents filed by and regarding Beazer Homes USA, Inc. The case has a difficulty level of four or five and can be used in either undergraduate or graduate auditing courses. The case can also be used in advanced financial accounting, financial statement analysis, or accounting research courses in accounting masters degree programs. The case is designed to be taught in two class hours and is expected to require four hours of outside preparation by students.

CASE SYNOPSIS

This case provides students with a real world example of alleged income smoothing and its consequences. Students learn how earnings were allegedly manipulated, why they were allegedly manipulated, and what the ultimate results of these alleged tactics were for the company. They are asked to analyze the earnings management techniques used and identify ways in which the auditors might have identified the activity and how their audit planning could have been modified given the industry-specific risks and the requirements of SOX. The case raises issues related to internal controls, auditor responsibility and professional and ethical principles and standards.

INSTRUCTORS' NOTES

RECOMMENDATIONS FOR TEACHING APPROACHES

This case can be used as the basis for classroom discussion or to motivate a written report. In either case, the questions are direct and elicit fairly specific information as part of the discussion. The information students need to find is located in several U.S. Securities and Exchange Commission (SEC) documents that are referenced in the case. Annual reports and proxy statements can be found on the Beazer Homes USA, Inc. (Beazer Homes) Web site.

Students will need a level of understanding of financial statements that generally obtains on the completion of two semesters of intermediate financial accounting. They should also have some understanding of audit planning and audit risk assessment. These knowledge and skills are typically obtained in the first part of an introductory course in auditing. Since the case requires students to access and read SEC documents, professional standards, and information about the company, it can be used effectively in an accounting research course at the senior undergraduate or graduate levels.

Questions in the case can be discussed in a general class session, with all students participating, or they can be individually assigned to student teams, who can prepare a presentation of their proposed answers as a springboard for full class discussion.

QUESTIONS FOR DISCUSSION (WITH SUGGESTED ANSWERS)

1. Did the company, its independent audit firm, or any of its officers, other than the CAO, face consequences as a result of the company's settlement with the SEC?

A comparison of the executive officers listed on pages 15-16 of Beazer's September 30, 2006 Form 10-K with the listing of executive officers available on pages 113-114 of the September 30, 2007 Form 10-K reveals that the Chief Executive Officer (CEO) and the Chief Operating Officer (COO) are the same. All the other officers appear to have been replaced.

This question could serve as the starting point for a discussion of what the consequences of earnings management should be compared with what they typically are. Chokkavelu (2008) reports that in November 2006, before the accounting issues came to light, the CEO sold $7.7 million worth of Beazer common stock. When given this information, some students might argue that the CEO should be fired or should resign. Others may argue that firing the CAO, especially in this case, is sufficient punishment.

In 2007, a class-action lawsuit was filed on behalf of people who bought Beazer common stock between January, 2005 and May, 2008. The lawsuit alleged that the company and its executives made false statements about its business that caused shareholders to be misled about the company's prospects and invest in the company. The lawsuit named the company, the top managers of the company, and the company's independent audit firm, Deloitte & Touche, LLP. The defendants agreed to settle the case in 2009 out of court, and without admitting any wrongdoing, for $30.5 million. The bulk of the settlement was paid by the Beazer's insurance provider, but $950,000 of the settlement was paid by the audit firm (Reuters, 2009).

You could lead a discussion of this question toward raising broader issues of corporate governance, such as the question of who really wields the power in our system of corporate governance. Is true power in the hands of managers (the officers of the corporation) or the shareholders? For further reading, the instructor may want to refer students to Monks and Minnow (2008) and Rezaee (2009). Students that take the view that managers exercise more power than shareholders will find Bebchuk and Fried (2004) to be an interesting book.

2. Why did Beazer Homes' management fire their CAO for destruction of documents rather than for carrying out the alleged accounting irregularities?

Any answer to this question is going to require speculation, but good answers would include one or more of the following: (1) At the time management wanted to remove the CAO from his position, the exact nature and extent of the accounting issues had not yet been identified, (2) destruction of documents is a more tangible activity and one that the company would find easier to prove, or (3) the company wanted to fire the CAO, but did not want to use a reason that could later be used to establish a legal cause of action against the company itself (which would be the case with any allegations of specific accounting improprieties).

3. Most auditing textbooks outline procedures for identifying accounting irregularities that overstate income, such as recording revenue from fictitious sales. How are the alleged earnings manipulation schemes at Beazer different from the irregularities you have discussed in your auditing classes?

Most auditing students have heard of companies where earnings were managed upwards to portray the company as being more profitable than it was or where outright fraud, such as the recording of revenues from fictitious sales, was committed. Most students are not, however, familiar with income smoothing, which is what the SEC alleged was occurring at Beazer Homes.

4. What are the most likely reasons that Beazer engaged in the alleged accounting irregularities?

The most likely reason to engage in this would be to meet or exceed the expectations of Wall Street analysts for quarterly and annual net income and earnings per share (EPS). This is the explicit reason referenced by the SEC on pages 3-4 of its Administrative Proceeding (SEC, 2008).

At this point, it would be useful to ask students about common incentives managers might have for manipulating earnings, then ask whether any of those incentives existed at Beazer Homes. Accounting researchers have identified two broad reasons that managers engage in earnings management or fraud, valuation and contracting (see Watts and Zimmerman, 1986 and Lev, 2003 for details). Corporations manage earnings to meet or beat analyst forecasts of EPS since these forecasts serve as inputs into valuation models used to price these companies. Research has established that the share price of companies that miss analyst forecasts, even by a small amount, decline drastically on the news that their actual EPS fell short of what Wall Street was expecting.

The other main incentive for managing earnings is that accounting numbers are used in contracts such as loan agreements, and executive compensation contracts etc. If students look at the proxy statements of Beazer Homes, they will see that accounting numbers are, in fact, used in their executive compensation contracts. This could provide another strong incentive for managers at Beazer to manipulate earnings. You can refer students to Lev (2003) and Weil (2009) for background reading on the compensation contracts issue.

5. Is it possible to identify a pattern of earnings management in Beazer's restated earnings?

Yes, income smoothing is most clearly evident in the fiscal 2005 and fiscal 2006 restatements. Restated fiscal 2006 net income was about five percent lower (from $389 million to $369 million) and restated fiscal 2005 net income was about five percent higher (from $263 million to $276 million). Thus, it appears that Beazer had smoothed its income by recognizing fiscal year 2006 expenses in fiscal 2005, which increased fiscal 2006 net income.

6. Did the passage of the Sarbanes-Oxley Act of 2002 appear to have any impact on the alleged accounting manipulations at Beazer Homes?

Apparently not. Section 302 of the Sarbanes-Oxley Act requires the principal officers (typically interpreted as those officers whose title begins with or includes the word "Chief") to certify that the financial statements accurately portray economic reality. Also, section 402 of the Act requires the senior financial officers to follow a Code of Ethics to ensure that financial statements are an accurate reflection of economic reality. If students look at the annual reports of Beazer Homes during the period from 2002 through 2006, they will find that the CEO and CAO both certified the financial statements even though the SEC alleged the company was managing its earnings throughout that time period.

7. Why did Beazer's independent auditor raise concerns over the accounting for the sale-leaseback transactions that had written side agreements giving Beazer an interest in the appreciation of the model homes it sold and leased back?

In a sale-leaseback transaction, the owner of the asset sells it to a third party and then leases it back. The original owner may be referred to as the seller-lessee, while the new owner is typically referred to as the buyer-lessor. Current accounting rules state that for a transaction to be accounted for as a sale and leaseback, the seller-lessee must not have any "continuing involvement" in the sale-leaseback transaction (SFAS 98, see also SFAS 66). If any such "continuing involvement" exists, then the transaction cannot be recorded as a sale. Instead, the transaction is to be recorded as a financing (borrowing) transaction.

An example of "continuing involvement" that is explicitly stated in SFAS 98 is "the buyer-lessor is obligated to share with the seller-lessee any portion of the appreciation of the property" (SFAS 98, Paragraph 13). Beazer Homes entered into sale-leaseback arrangements for a number of its model homes. According to the SEC, by the end of fiscal year 2006, Beazer had increased the number of model homes that it leased back to approximately 70 percent of all of its model homes, up from approximately 30 percent in prior years. Moreover, Beazer (the seller-lessee) required the third party buyer-lessor to share in any portion of the appreciation of the model home. This qualifies as a "continuing involvement" under SFAS 98, and thus recording these transactions as sale-leasebacks violates GAAP.

Of course, Beazer is alleged to have worked around the auditor's stipulation by making the side agreements that provided the continuing involvement oral instead of written and then hiding their existence from their auditor.

8. What could the independent auditors have done to detect the alleged earnings management at Beazer Homes?

Regarding the land inventory accounts, the auditors could have dug deeper into the details of the inventory accounts and thus discovered the negative balances. Regarding the sale-leaseback transaction accounting, it appears that the auditors did alert Beazer's management to a possible GAAP violation. However, according to the SEC, Beazer's management made sure that all references to Beazer's participation in the model homes' appreciation (the prohibited "continuing involvement") were omitted from the written sale-leaseback agreements. The auditors based their conclusions on these written agreements, and since they did not include any indication of "continuing involvement" concluded that sale-leaseback was an appropriate accounting treatment.

According to the SEC, Beazer entered into oral side agreements that gave it a share of any price appreciation. It would be very difficult for the auditors to have discovered the existence of these oral side agreements. The auditors would have had to question the third parties directly and the third parties would need to have been honest with the auditors.

Given the issues with income smoothing in this case, it is worth considering whether audit firms train their staff to be aware of income smoothing and give them specific guidance in how to identify it when conducting an audit. Akers et al. (2007) surveyed the top 100 accounting firms and found that most of these firms do not have formal training courses that address the topic of earnings management. The survey focused on how audit firms train staff to identify abusive earnings-management practices. When Akers et al. (2007) reviewed the continuing education courses offered by each of the state CPA societies (including Washington, D.C.) and the AICPA, they found that of the 52 organizations, 34 did not offer courses with earnings management content. The other 18 offer a combined total of eight courses that include earnings management topics. Only three of those 18 courses were focused on revenue recognition and dealt with earnings management issues.

It appears that the pervasiveness of earnings management is not convincing audit firms (or the providers of continuing education programs for audit firms) to educate and train their staff regarding the issue. Class discussion could include exploring possible reasons why audit firms do not appear to train their staff in this area.

9. What specific audit standards apply to earnings management and what is the auditor's responsibility under those standards?

The auditor has responsibilities for detecting earnings management under SAS 53, SAS 82 and SAS 99. The auditor is responsible for planning and performing the audit in a manner that yields reasonable assurance that the financial statements are free of material misstatement, even if that misstatement is caused by fraud. SAS 82 provides specific guidance to auditors to help them detect material misstatements resulting from fraud.

10. What were the specific effects on the financial statements of the restatements to which Beazer agreed?

Beazer restated its financial statements to reflect adjustments for fiscal 1998 through 2006, as well as the first two quarters of fiscal 2007. Beazer restated its fiscal 2006 net income from $389 million to $369 million (a reduction of $20 million or five percent). Beazer also restated its fiscal 2005 net income from $263 million to $276 million (an increase of $13 million or five percent) and increased its beginning retained earnings for fiscal 2005 by $34 million (from $742 million to $776 million or five percent) to reflect the cumulative effect of adjustments for fiscal 1998 through fiscal 2004. Finally, Beazer also restated its net loss for the first quarter of fiscal 2007 from $59 million to $80 million (an increased loss of $21 million or 36 percent), and its net loss for the second quarter of fiscal 2007 from $43 million to $57 million (increasing the reported loss by $14 million or 33 percent).

11. Some accounting researchers have argued that companies in some industries might be more likely than companies in other industries to engage in income smoothing. Do you believe that companies in the home building industry would be more likely tempted to engage in income smoothing? If so, explain why. Also outline how a higher likelihood of firms engaging in income smoothing should affect audit planning.

Income smoothing is especially tempting to an industry that is highly vulnerable to business cycles. The home building industry is certainly such an industry. The section of the case that outlines the past two decades of the home building industry contains several suggestions that this industry reacts strongly to changes in the general economy and to specific conditions that affect business in the industry itself. Pincus and Shivaram (2002) found that managers of oil and gas producing firms manage residual earnings volatility by using abnormal accruals to smooth income.

Auditors should evaluate whether a particular client is in an industry that is highly volatile with respect to changes in the business cycle. Clients in such industries will be tempted to a much greater degree than other clients to engage in income smoothing earnings manipulations. This will increase the level of inherent risk for these clients. Audit plans should identify likely areas for such manipulation and the study and evaluation of internal control in those areas, as well as the extent of substantive testing in those areas, will be affected by the overall increase in the inherent risk of irregularities for these clients. You can lead the discussion of this question in the direction of SAS 42 and the assessment of risk and how the audit can be designed to achieve an acceptable level of achieved audit risk.

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CAUTIONS WHEN USING WORKING CAPITAL METRICS TO ASSESS FIRMS' FINANCIAL HEALTH

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CASE DESCRIPTION

The primary subject matter of this case explores expectations regarding short-term liquidity across different industries. Secondary issues examined include working capital management and signals of working capital efficiencies. The case requires students to interpret varying working capital and liquidity ratio levels across companies. This case has a difficulty level of two, three, or five; the case is appropriate for financial accounting principles, introductory financial management, intermediate accounting, and introductory financial accounting for MBAs. This case is designed to be taught in one hour of class time and is expected to require one hour of outside preparation by students.

CASE SYNOPSIS

Using data from Bon Ton Stores, TJX Companies, Wal-Mart Stores, Brinker International (Chili's) and Southwest Airlines, students learn about basic liquidity analysis. Students will observe significant differences in key liquidity metrics both within and across industries. Students will consider the overall liquidity positions of the firms by comparing their working capital levels and their current ratios. Students will identify the driver of the differences in the current and quick ratios, and will explore issues in managing working capital. In the process, they will uncover some surprising findings. Some working-capital metrics may look good while hiding deficiencies that can be revealed by further analysis. Similarly, working-capital metrics may look bad, but further digging uncovers efficiencies. The case also highlights the interesting tension that exists between a lender's perspective about liquidity (more is better) versus a company's desire to increase profitability, which necessitates efficiently managing its working capital.

INSTRUCTORS' NOTES

Recommendations for Teaching Approaches

The case features non-manufacturing firms since these are typically the focus of introductory accounting courses. The case can be used at the undergraduate level in introductory financial accounting or when discussing liquidity analysis in intermediate accounting. The case can also be used early in an introductory financial accounting class for MBAs.

The case could be assigned after having briefly discussed the basic liquidity metrics during a class meeting or after having assigned a relevant reading from a textbook. Students should be familiar with accounting for accounts receivable, inventory, prepaid expenses, accounts payable, and unearned revenue. Students should be able to distinguish current assets from long-term assets and current liabilities from long-term liabilities (elements of a classified balance sheet).

Instructors can proceed through the six case questions in numerical order or alter the sequence. However, the last question builds on answers to some of the earlier questions. Depending on the course level, time constraints, or topic preferences, instructors can also eliminate questions. An extension to this case is presented at the conclusion of these instructors' notes. It can be used to introduce students to the ratio of operating cash flow to average current liabilities, a lesser known, but useful short-term-liquidity metric. The instructor can direct students to the SEC's EDGAR website to gather data necessary to see how seven identified pairs of peer retailers fared when measured on this metric vis-à-vis the current ratio.

To facilitate answering the questions, the financial data contained in Table 1 of the case are repeated below. Balance sheet data are as of year-end unless labeled as an average for the year.

Table 1: Selected Financial Data – Fiscal Year 2010
Bon Ton Stores, TJX, Wal-Mart, Brinker International, and Southwest Airlines

Company	BON TON	TJX	WAL-MART	BRINKER (CHILI'S)	SOUTHWEST
Line of business	Discount Department Store	Discount Department Store	Discount Department Store	Restaurant	Airline
Quick assets	$16,339,000	$2,018,159,000	$12,484,000,000	$389,764,000	$3,733,000,000
Inventory	$682,324,000	$2,765,464,000	$36,318,000,000	$26,735,000	Not applicable
Current assets	$777,081,000	$5,099,527,000	$51,893,000,000	$501,067,000	$4,279,000,000
Current liabilities	$413,871,000	$3,133,121,000	$58,484,000,000	$449,877,000	$3,305,000,000
Working Capital	$363,210,000	$1,966,406,000	($6,591,000,000)	$51,190,000	$974,000,000
Current ratio	1.88	1.63	0.89	1.11	1.29
Quick (acid-test) ratio	0.04	0.64	0.21	0.87	1.13
Net sales	$2,980,479,000	$21,942,193,000	$418,952,000,000	$2,858,498,000	$12,104,000,000
Cost of goods sold	$1,860,182,000	$16,040,461,000	$315,287,000,000	$816,015,000	Not applicable
Cash flow from operations	$141,135,000	$1,976,481,000	$23,643,000,000	$297,402,000	$1,561,000,000
Average inventory	$670,861,500	$2,648,891,000	$34,515,500,000	$30,290,000	Not applicable
Average current liabilities	$406,974,500	$3,014,053,500	$57,013,500,000	$434,189,500	$3,000,000,000

QUESTIONS FOR DISCUSSION (WITH SUGGESTED ANSWERS)

1. **Despite having $363 million of working capital at F2010 year-end and a 1.88 current ratio that is the highest among the Table 1 firms, Bon Ton was included in a *Forbes* list of 10 retailers flirting with trouble (Hawkins, 2010). Which data in Table 1 suggest that this retailer's liquidity position was not as favorable as it initially seemed?**

   Because the current ratio and the working capital amount can create an illusion of favorable liquidity when none may exist, many analysts also calculate the quick ratio. As seen in Table 1, Bon Ton's quick ratio was the lowest among the five firms. The firm went from having the *highest* current ratio to the *lowest* quick ratio because 88% of its current assets are tied up in inventory. Perhaps its impressive working capital amount results from the retailer having difficulty in selling its inventories. In comparison, inventory represented 54% and 70% of current assets for TJX and Wal-Mart, respectively.

2. **Which ratios could help an analyst appraise the liquidity of Bon Ton's inventory as compared to that for TJX and Wal-Mart? Explain whether relatively high or low values on these metrics would suggest less liquidity risk.**

   An analyst could compare the three firms' inventory turnover ratios (cost of goods sold divided by average inventory). Inventory turnover indicates the number of times during the period that a firm sells its average balance of inventory. The higher the inventory turnover ratio, the lower the liquidity risk. Similarly, the analyst could compare the average days in inventory, also known as the days' sales in inventory, (365 days divided by the inventory turnover). The lower the average days in inventory, the lower the liquidity risk because inventory is held for a shorter period of time. The current ratio is thus a more accurate indicator of liquidity if a firm has a low average days in inventory. Alternatively, an analyst is likely to place less reliance on the current ratio and more reliance on the quick ratio for firms with slow-moving inventory.

Table 2: Retailers' Inventory Ratios Fiscal Year 2010

	Bon Ton Stores	TJX	Wal-Mart
Cost of goods sold	$1,860,182,000	$16,040,461,000	$315,287,000,000
Average inventory	$670,861,500	$2,648,891,000	$34,515,500,000
Inventory turnover	2.77 times	6.06 times	9.13 times
Average days in inventory	132 days	60 days	40 days

As seen in Table 2, it takes Bon Ton 132 days to sell its average balance of inventory which, respectively, is 72 and 92 days longer than it takes TJX and Wal-Mart. It takes Wal-Mart less than a month and one-half to sell its average balance of inventory. Some of this difference is due to the different composition of merchandise inventories between Wal-Mart and the two other firms. Analysts would expect that Wal-Mart's inventory turnover would exceed Bon Ton's because Wal-Mart sells many food products. However, as is the case for Bon Ton, TJX does not stock food products and yet its inventory turnover is more than twice that of Bon Ton's.

Wal-Mart also uses technology and its power within its supply chain to achieve efficiencies that minimize the amount of inventory it carries. Wal-Mart maintains tight inventory control through its supply-chain management. Given its economic muscle, Wal-Mart achieves many concessions that transfer risk from Wal-Mart to its suppliers. Wal-Mart accelerates delivery times, getting suppliers to replenish inventory frequently. Some speculate that Wal-Mart will eventually use its technology for scan-based trading, in which manufacturers own each product until Wal-Mart sells the item (Hays, 2004). This would further lower reported inventories on Wal-Mart's balance sheet.

3. What contributed to Wal-Mart's *negative* working capital of $6.6 *billion* and how can a firm survive, let alone thrive, with such an excess of current liabilities over current assets?

As noted above, Wal-Mart has taken the lead among retailers in achieving inventory efficiencies. At the same time, it has used its power over suppliers to increase its days' purchases in accounts payable. This combination of better inventory management and accounts payable stretching has allowed the firm to simultaneously reduce a major current asset while increasing a major current liability. The combined reductions in its working-capital investment that Wal-Mart achieved through carrying less inventory and taking longer to pay suppliers was measured in a 2005 study. It was estimated there that Wal-Mart achieved a *117% reduction* in its working-capital amount over the 1995 to 2003 period by reducing its days' sales in inventory and increasing its days' purchases in accounts payable compared to their 1995 levels (Gosman and Kohlbeck, 2005). The study reported that Wal-Mart's 2003 working capital of a *negative* $2.4 billion would have been a *positive* $14.0 billion had it not achieved efficiencies over that 8-year period.

A firm can survive with little or no working capital as long as it has large, steady inflows of cash from operations. As seen in Table 1, Wal-Mart's cash from operations exceeded $23 billion in Fiscal 2010.

4. Explain why it is not surprising that the two Table 1 firms with the smallest differences between their current ratios and quick ratios are Brinker and Southwest Airlines.

Current and quick ratios differ significantly from each other only when a sizable portion of the firm's current assets are in the form of inventories. Restaurant businesses and airlines require relatively low inventory as compared to retail department stores such as Bon Ton, TJX, and Wal-Mart. Restaurants maintain low inventory because food items are perishable. Airlines have always had low inventory levels and with their reduced food offerings on flights, you could say that it now "amounts to peanuts."

5. How might the composition of current liabilities at Southwest Airlines contribute to low current and quick ratios?

Southwest Airlines has a significant current liability in the form of unearned ticket revenue from customers paying in advance of flights. This liability will be satisfied as the customers fly (i.e., when the service is provided). While these obligations increase current liabilities in the denominator of both the current and quick ratios, they will not require significant incremental cash for settlement of the obligation. All other things being equal, the presence of sizable unearned revenue means that current and quick ratios can be expected to be lower and still be adequate.

6. Summarize factors that should affect one's assessment of the adequacy of a firm's investment in working capital and the level of its liquidity ratios.

(1) *The extent to which the line of business does not require large inventories.*

Airlines and restaurants carry less inventory than department stores, and thus they would be sufficiently liquid with a lower current ratio than department stores would require. In fact, in light of these firms' insignificant inventory amounts, the adequacy of their current ratios is best judged by examining desired threshold levels for quick ratios.

(2) *Receivable and payable management (the speed of the cash cycle).*

The operating cycle is the sum of the average days in inventory and the average collection period. In general, the shorter the operating cycle, the lower the necessary investment in working capital. By minimizing the number of days a firm holds inventory until sale and/or by quickly converting sales into cash, a firm can be liquid with less working capital.

The longer that a firm is able to stretch its payables, the lower the minimum investment needed in working capital. For example, if a firm sold goods in 40 days like

Wal-Mart does and had very few accounts receivable, then so long as it could negotiate credit terms from its suppliers that were not far from 40 days, there would be less need for alternate sources of financing in order to pay suppliers for the inventory purchases. Their customers, in effect, could be paying their suppliers. This creates working capital efficiencies, minimizing the level of working capital needed in order to satisfy short-term obligations as they become due.

Bon Ton suffers here relative to Wal-Mart because Bon Ton is taking 92 more days to sell its inventory. In addition, it is not in as strong a position to negotiate longer payment terms with its suppliers. Thus, Bon Ton has a much greater need to look for other sources to finance its purchases of inventory, whereas Wal-Mart can essentially delay paying suppliers until close to when it has collected cash from the sale of that inventory to customers! Increasing the speed of a cash cycle through inventory and accounts payable management allows firms to carry less working capital.

(3) *The extent to which the firm's current liabilities do not require significant incremental cash outflows.*

Like Southwest Airlines, any business that typically receives significant amounts of cash in advance for future goods or services should have lower thresholds for adequate working-capital levels and current and quick ratios. Examples would include newspaper and magazine publishers, theater groups, and cruise lines.

Extension

Instructors who wish to consider how Bon Ton would compare to TJX and Wal-Mart on an alternative liquidity measure could introduce the ratio of operating cash flows to current liabilities, calculated as follows:

$$\text{Operating cash flow to current liabilities ratio} = \frac{\text{Cash flow from operations}}{\text{Average current liabilities}}$$

This ratio recognizes that successful firms do not liquidate their current assets to pay their current liabilities, but instead use operating cash flow for that purpose. Some research suggests that a level of 40% or higher on this ratio often presents itself for a healthy retailer (Casey and Bartczak, 1984).

Operating cash and average current liabilities are from Table 1. Interestingly, as shown in Table 3, both TJX and Wal-Mart are above 40% on this financial measure and Bon Ton, the firm with the highest current ratio, was below 40%.

Table 3: Retailers' Operating Cash Flow to Current Liabilities Fiscal Year 2010			
	Bon Ton Stores	TJX	Wal-Mart
Cash flow from operations	$141,135,000	$1,976,481,000	$23,643,000,000
Average current liabilities	$406,974,500	$3,014,053,500	$57,013,500,000
Operating cash flow to current liabilities ratio	35%	66%	41%

Instructors who wish to pursue this point further could direct students to the SEC's EDGAR database to gather data necessary to make the following comparisons for peer retailers:

Table 4: Comparison of Current Ratio and Operating Cash Flow to Current Liabilities for Peer Retailers Fiscal Year 2010			
Line of Business	Retailer	Current Ratio	Operating Cash Flow to Current Liabilities
Jeweler	Zale	1.99	14%
	Blue Nile	1.34	44%
Pharmacy	Rite Aid	1.82	17%
	Walgreen Co.	1.60	53%
TV and Electronics	Conn's	3.00	-15%
	Best Buy	1.21	13%
Restaurant	Denny's	0.69	42%
	Frisch's	0.36	94%
Women's Clothing	Christopher & Banks	2.86	18%
	AnnTaylor Stores	1.95	59%
Supermarket	Winn-Dixie Stores	1.36	26%
	Publix Super Markets	1.37	111%
Office Supplies	Staples	1.51	36%
	Office Depot	1.32	8%

For the first five comparisons included in Table 4, the retailer with the *higher* (often much higher) current ratio had the *lower* (often much lower) ratio of operating cash flow to current liabilities. And three of the retailers with impressive current ratios – Zale, Rite Aid, and Conn's – were, like Bon Ton, included in a *Forbes* list of 10 retailers flirting with trouble (Hawkins, 2010). In the sixth pairing, two supermarkets with practically identical current ratios had, nevertheless, dramatically different ratios of operating cash flow to current liabilities. In the last comparison, Staples' edge over Office Depot in terms of the current ratio understated the magnitude of the former's advantage on the operating-cash-to-current-liabilities metric.

Given that current liabilities are more likely to be paid out of operating cash flow than current assets, the current ratio provides only partial insight into retailers' ability to meet their short-term obligations. In four of the seven pairings shown in the above table, retailers that seemed to be awash in liquidity – as measured by a current ratio of 1.82 or higher – were seen in a much different light when measured by their ratios of operating cash to current liabilities, which ranged from -15% to +18%. Clearly the ratio of operating cash flow to current liabilities should represent an additional arrow in the quiver of the analyst as he/she assesses a firm's ability to meet its short-term obligations.

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ACCOUNTING FOR REVENUE AND THE FASB/IASB CONVERGENCE PROJECT: A CASE STUDY EXPLORING THE NEW EXPOSURE DRAFT

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CASE DESCRIPTION

The primary subject matter of this case concerns significant changes to revenue recognition that are proposed under the joint exposure draft issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) as part of their convergence efforts. The case focuses on fundamental changes to the revenue recognition model and potential changes to the timing and measurement of revenue and related transactions such as product or service warranties, merchandise returns, uncollectible accounts, and multiple deliverables.

Secondary, strategic business and ethical considerations that companies and accounting professionals should consider are explored. This case has a difficulty level of three to four and can be taught in about 40 minutes. Approximately two hours of outside preparation are needed for students to address every question. The case can be used in an Intermediate Accounting course to help students understand the expected changes to revenue recognition and the financial reporting issues that may arise, but can also be utilized in a more advanced course by focusing on the strategic business issues. The case has technical, analytical, and research aspects. Utilizing this case may enhance students' communications skills.

CASE SYNOPSIS

Accounting for revenue and sales/service related transactions will change significantly. In June of 2010, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) jointly issued an exposure draft that will change accounting for revenue and related transactions under both U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). The exposure draft, which introduces a five-step performance obligation model, proposes significant changes to the measurement, classification, and potentially, the timing of recognition of revenue and related transactions, such as warranty costs, returns and allowances, provisions for uncollectible accounts, and multiple deliverables. This case focuses on these key issues that are common and important to most business entities.

Because of the importance of revenue and the expected significant changes to revenue recognition, accounting students must begin to learn about these changes, understand the potential effect on financial reporting, and become aware of the business and ethical issues that may arise. Educators play an important role in helping students accomplish these goals. This *case focuses on the new revenue recognition model, provides an overview of key changes to current requirements that are proposed under the new exposure draft, and explores strategic business as well as ethical considerations.*

This case can be utilized in an Intermediate Accounting course focusing primarily on the technical accounting, financial reporting and ethical issues, or in an advanced course focusing primarily on the strategic issues. The case includes questions that can be addressed using the case specific information, but also includes questions that require research. Using this case can enhance students' critical thinking, research, analytical, and communications skills.

INSTRUCTORS' NOTES

Teaching Strategies

The pace of standard setting has increased significantly during the last few years and particularly during the last twelve months. Currently, the FASB and IASB are actively working on ten convergence projects. Of these projects, nine are scheduled to be issued as final standards by the end of 2011. Information on the status of these projects is available on the FASB website (fasb.org) under their projects link.

While the SEC is planning to make a final decision on the potential mandatory adoption of IFRS for U.S. public companies by the end of 2011, the accounting standards issued under the converge project will change U.S. GAAP, as well as IFRS, regardless of the SEC's decision. Revenue recognition is one of the FASB/IASB priority projects. The Boards planned to release a final standard by June 30, 2011, but recently decided to re-expose the proposed standard and to issue a final standard during the second half of 2011 (FASB, 2011).

The more than 170-page exposure draft shows that revenue recognition and the recognition (and measurement) of related transactions and events likely will change dramatically. Educators can start to help students become familiar with the proposed changes by discussing the major requirements of the ED in class.

This case is designed to help educators introduce the proposed changes to revenue recognition in their classes and can be used to accomplish several objectives. It includes technical content that helps students become familiar with the expected changes; it facilitates comparison of the current revenue recognition requirements with the proposed requirements; and it helps students consider related issues and strategies, ethical considerations, as well as the economic consequences of accounting rules.

The information provided in the case's "Margot's Seminar" section can be used in class to teach students about the significant new revenue recognition concepts and the proposed new model. This discussion should follow coverage of current revenue recognition related GAAP.

Each suggested case question can be assigned independently. Some of questions can be answered from the case specific information and also provide the opportunity for students to review their knowledge of current revenue recognition related GAAP, while other questions require research.

The primary purpose of the research questions is to help students become familiar with the availability of authoritative sources, including proposed changes to accounting standards, and the format in which that information is available. This will help students enhance their research skills and to develop the confidence to research current and emerging issues in accounting.

In class discussion of the case will take about 40 minutes. If all the questions are assigned to the students, approximately two hours of outside preparation will be needed to address all the questions. A preliminary version of this case was successfully tested in an International Accounting course and subsequently utilized in two sections of Intermediate Accounting I.

ASSIGNMENTS

Students should pretend that they are a member of the accountant staff of Vielfalt Corporation and that they have participated in “Margot’s Seminar.” Their daily responsibilities include accounting for the revenue and receivable cycle. The following questions can be assigned by the instructor. Suggested answers to each question are shown in the “Answers to Suggested Questions” section.

1. Review the case background information and the section detailing the company’s revenue related business environment and strategies. Compare and contrast accounting for (1) warranties, (2) equipment returns, and (3) uncollectible accounts. Organize your answers by preparing a five-column table indicating (a) the accounting issue, (b) the current accounting treatment under U.S. GAAP, (c) the proposed accounting treatment under the joint revenue recognition ED, (d) the financial statement(s) that would be affected by the proposed changes, and (e) what specific financial statement items would be affected and what the expected effect (increase or decrease) would be.

2. What accounting issues will tend to arise as a result of the requirements under the new ED with respect to product warranties, returns, and uncollectible accounts?

3. Review the case information and the section detailing the company’s sales channels. Indicate how the proposed changes could affect the amount of revenue recognized from contracts involving both equipment and service. Also consider how revenue from (a) direct sales to customers and (b) indirect sales through third parties could be affected.

4. What positive consequences could arise from the requirements of the ED with respect to financial reporting? What ethical considerations and challenges could arise from the proposed changes? Review the recently issued FASB/IASB Concept Statement No. 8, Chapter 3 and summarize the guidelines that are available from the conceptual framework. (May require some research).

5. Access the FASB or IASB website, and research the objective of the Boards’ revenue recognition project. Provide a brief synopsis of the Boards’ objectives for revising the revenue recognition requirements. (Research question).

6. Research the perceptions of financial statement preparers in (a) the telecommunication industry and (b) in an unrelated industry regarding the revenue recognition project. Choose two sources and summarize which provisions of the proposal they agree with and which they do not agree with. (Research question).

7. Research the perceptions of accounting professionals regarding the revenue recognition project. Choose two sources and summarize which provisions of the proposal they agree with and which they do not agree with. (Research question).

8. Access the FASB or IASB website, review the FASB/IASB revenue recognition exposure draft and find a general definition for "control." (Research question).

9. Access the FASB or IASB website and review the FASB/IASB revenue recognition exposure draft and especially the section regarding transfer of control. List factors that according to the ED may be indicators of the transfer of control. (Research question).

10. Access the FASB or IASB website and review the FASB/IASB revenue recognition exposure draft. Research the conditions for recognizing revenue on long-term construction projects. What revenue related issues should Vielfalt consider regarding its overall profitability if the company were to acquire the construction company referred to in the "Diversification Strategies" section of the case.

SUGGESTED ANSWERS TO QUESTIONS

1. Review the case background information and the section detailing the company's revenue related business environment and strategies. Compare and contrast accounting for (1) warranties, (2) equipment returns, and (3) uncollectible accounts. Organize your answers by preparing a five-column table indicating (a) the accounting issue, (b) the current accounting treatment under U.S. GAAP, (c) the proposed accounting treatment under the joint revenue recognition ED, (d) the financial statement(s) that would be affected by the proposed changes, and (e) what specific financial statement items would be affected and what the expected effect (increase or decrease) would be.

The table shown below addresses all aspects of this question.

Accounting Issue	Current Accounting Treatment	Proposed Accounting Treatment	Financial Statement(s) Affected	Potential Financial Statement Effect(s)
Warranties	Accrue expense and contingent liability during year of sale. Typically adjusted at year end.	Differentiate between latent and subsequent defects. Latent defects: defer revenue and expense related to defective products. Subsequent defects: allocate contract price and expense to this (separate) performance obligation.	Income Statement Balance Sheet	Initially lower revenue and lower expense. Cost of goods sold relating to defective products not recognized. Likely to affect timing of recognition of revenue and expense.
Equipment returns	Sales revenue is recognized at time of sale; an allowance for estimated returns is made at end of accounting period	Estimated returns must be estimated at time of sale; revenue and related cost not recognized until return right expires	Balance sheet Income statement	Cost related to estimated returns are treated as return assets; sales price related to estimated returns is treated as a return liability. Initially lower revenue and cost of goods sold; lower income.
Uncollectible accounts	Sales revenue is recognized; bad debt expense and an allowance (contra accounts receivable) are recognized at end of accounting period.	Estimated at time of sale using a probability-based measurement; the estimated amount of uncollectible accounts is excluded from revenue.	Balance sheet Income statement	At time of sale: lower revenue and expense. Lower income; lower assets

2. What accounting issues will tend to arise as a result of the requirements under the new ED with respect to product warranties, returns, and uncollectible accounts?

The requirements of the proposed revenue recognition standard would necessitate many additional estimates at the time of sale or service. For example, while most companies will estimate uncollectible accounts (bad debt expense) at the end of the accounting period, under the proposal this would have to be estimated at time of sale or service and would immediately lead to lower revenue at that point of time. Thus, the timing of recognition tends to be affected by the requirements in this ED. In addition, additional analysis, estimation, and projections would be necessary; this includes analyzing contracts to identify separate performance obligation within the same contract and assigning revenue and cost to each performance obligation; estimating defects covered by warranty from existing and subsequent causes; and deriving probability weighted estimates of returns (and uncollectible accounts receivables) at time of sale or service.

3. **Review the case information and the section detailing the company's sales channels. Indicate how the proposed changes could affect the amount of revenue recognized from contracts involving both equipment and service. Also consider how revenue from (a) direct sales to customers and (b) indirect sales through third parties could be affected.**

Vielfalt Corporation sells telecommunication equipment directly to customers and to third parties (for indirect sales) at different prices. Under the ED, revenue would be allocated based on the respective stand-alone prices of the equipment and service. Since the equipment is typically discounted for customers who sign or renew service contracts, some of the revenue could be reallocated to the equipment. In addition, the amount of revenue allocated to equipment and service may differ depending on whether the sale/contract was direct between the company and the customer, or indirect through third party sales channels. Thus, initial sales revenue as well as service revenue during subsequent months and years may differ depending on whether the contract was initiated directly with Vielfalt or through an indirect channel.

4. **What positive consequences could arise from the requirements of the ED with respect to financial reporting? What ethical considerations and challenges could arise from the proposed changes? Review the recently issued FASB/IASB Concept Statement No. 8, Chapter 3 and summarize the guidelines that are available from the conceptual framework. (May require some research).**

The proposed requirements would necessitate additional estimates and judgment. This may have positive, but also potentially negative implications.

Positive implications: Because companies must identify separate performance obligations; allocate the contract price to each performance obligation; estimate returns, covered defects, and uncollectible accounts (some using probabilities and time value of money concepts); the measurement and recognition of related financial statement amounts may better reflect the underlying economic events.

Ethical considerations and challenges: Enhanced need for judgment and estimation could provide opportunities to manage earnings. From the perspective of financial statement users, earnings management is always an undesirable event.

Concept Statement No. 8 was issued jointly by the FASB and IASB (2010). Chapter 3 addresses the qualitative characteristics of useful financial information. The boards identify relevance and faithful representation as fundamental qualitative characteristics. Faithful representation replaces reliability set forth in concept statement No. 2. According to FASB and the IASB, "…financial information not only must represent relevant phenomena, but it also must faithfully represent the phenomena that it purports to represent." (Concept Statement No. 8, 3, QC12). Information must represent an economic events' substance, instead of the form of the contract (FASB & IASB, 2010). This is commonly referred to as "substance over form" and could lead to interesting class discussions. Students can be asked to discuss how separation of contracts into performance obligations (such as product sales, service, and related warranty obligations) and allocating respective revenue and cost to each performance obligation could enhance the relevance and faithful representation of the information provided in the financial statements.

5. Access the FASB or IASB website, and research the objective of the Boards' revenue recognition project. Provide a brief synopsis of the Boards' objectives for revising the revenue recognition requirements. (Research question).

The FASB website provides an official answer to this question. Instructors can direct the students to the FASB website, "Current Technical Plan and Project Updates" link. According to the FASB and IASB, "The objective of the FASB and IASB's project is to clarify the principles for recognizing revenue and to develop a common revenue standard for U.S. GAAP and IFRSs that would: (a) remove inconsistencies and weaknesses in existing revenue recognition standards and practices; (b) provide a more robust framework for addressing revenue recognition issues; (c) improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets; and (d) simplify the preparation of financial statements by reducing the number of requirements to which entities must refer." (FASB, 2011).

Students should paraphrase these objectives and properly cite the source.

6. Research the perceptions of financial statement preparers in (a) the telecommunication industry and (b) in an unrelated industry regarding the revenue recognition project. Choose two sources and summarize which provisions of the proposal they agree with and which they do not agree with. (Research question).

The FASB and IASB received 972 comments on their revenue recognition exposure draft. The comment letters are available on-line at http://www.fasb.org/jsp/FASB/CommentLetter_C/CommentLetterPage&cid=1218220137090&project_id=1820-100. Many of those who submitted comments agree with the objective of the project and applaud the boards' efforts to jointly develop a single revenue recognition standard. However, concerns are also expressed regarding the initial and continuing cost and difficulties of implementing the new requirements; the need to separate contracts into performance obligations; the retroactive provision for contract modifications; and other provisions. All student answers that are well written and properly cited should be accepted.

7. **Research the perceptions of accounting professionals regarding the revenue recognition project. Choose two sources and summarize which provisions of the proposal they agree with and which they do not agree with. (Research question).**

The FASB and IASB received 972 comments on their revenue recognition exposure draft. The comment letters are available on-line at http://www.fasb.org/jsp/FASB/CommentLetter_C/CommentLetterPage&cid=1218220137090&project_id=1820-100. Many of those who submitted comments agree with the objective of the project and applaud the boards' efforts to jointly develop a single revenue recognition standard. However, concerns are also expressed regarding the initial and continuing cost and difficulties of implementing the new requirements, as well as some of the specific issues/requirements. All student answers that are well written and properly cited should be accepted.

8. **Access the FASB or IASB website, review the FASB/IASB revenue recognition exposure draft and find a general definition for "control." (Research question).**

According to the ED, control includes the "ability to prevent other entities from directing the use of, and receiving the benefits from, a good or service" (FASB & IASB, 2010, IG44-73, 26).

9. **Access the FASB or IASB website and review the FASB/IASB revenue recognition exposure draft and especially the section regarding transfer of control. List factors that according to the ED may be indicators of the transfer of control. (Research question).**

In their exposure draft (FASB & IASB, 2010), the FASB/IASB list the following indicators that may indicate a transfer of control:

- Legal title passes to the customer
- Customer takes physical possession
- Customer has the obligation to pay contract price and the obligation is unconditional
- Product or service is based on customer-specified design

10. **Access the FASB or IASB website and review the FASB/IASB revenue recognition exposure draft. Research the conditions for recognizing revenue on long-term construction projects. What revenue related issues should Vielfalt consider regarding its overall profitability if the company were to acquire the construction company referred to in the "Diversification Strategies" section of the case.**

Vielfalt is considering acquiring a construction company that utilizes the percentage of completion method, which currently is a choice under U.S. GAAP and required under IFRS. The ED (FASB & IASB, 2010) stipulates that revenue cannot be recognized until a transfer of control occurs. Typically, a transfer of control does not occur until a construction project is completed. The ED indicates that a continuous transfer of control would allow partial recognition before the project is fully completed but only if certain criteria are met. An important criterion is that the costumer can take control of the project before it is complete and can choose to have someone else complete it without re-performance of already finished aspects of the project. This requirement will tend to make it difficult to recognize any revenue and related expense until construction projects are finished.

This can significantly affect the timing of recognition of revenue (i.e., delaying the recognition, which will affect Vielfalt's overall profitability in a given year). Also progress payments that are common in the construction industry will have be recognized as unearned revenue (a liability). The company's financial statements may be affected quite significantly by this requirement.

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SOCIAL MARKETING AND ROCK'N'ROLL: THE POWER OF THE U2 BRAND

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CASE DESCRIPTION

The primary goal of this case is to demonstrate an applied example of social marketing, covering topics of brand positioning, global targeting and positioning, global sponsorships, and social media. It is therefore targeted towards a Buyer Behavior or Global Marketing course at the undergraduate or graduate level, or a Principles of Marketing course at the graduate level. This case has a difficulty level 3-5. Students should be able to identify U2's product mix and brand image. Given the current shifts in the economy, students will be able to discuss strategic initiatives for U2, both on touring and social media avenues as they are planning the upcoming 30 year anniversary of their first album. Students appreciate the opportunity to study a popular rock band that works hard at promoting social causes. At the same time, there is room for effective class discussion and argument given the extraordinary operating costs and environmental impact of their current tour.

CASE SYNOPSIS

This case was written to demonstrate the power of social marketing in adding to the success of the band U2. The case first reviews the history of the Irish band up to their 2010-2011 360° tour and their rise to fame and concludes with questions on future decisions to be made. Keys to their success have been their focus on the U.S. market, their touring choices and their close relation to fans. From their early beginning, the band also chose to support various social causes, from fighting aids devastation, malaria and famines in poor developing Africa to the defense of human rights in Burma, to the protection of the environment. The case explains how U2 communicated about the causes they support via their web site and how they were integrated in their product delivery. Finally, choices of sponsors, whether global or local, are discussed. The conversation between Paul McGuinness, U2's manager, and the band demonstrates that all band members are involved in the planning process, marketing strategies, and are aware of the environmental impact and high cost of tour operations. The case ends with a conversation between the band and their manager as they are discussing future strategies.

INSTRUCTORS' NOTES

Recommendations For Teaching Approaches

This case is appropriate for marketing lectures on social marketing, brand positioning, global targeting and positioning, global sponsorships, and social media. It is therefore targeted towards a Buyer Behavior or Global Marketing course at the undergraduate or graduate level, or a Principles of Marketing course at the graduate level.

- For a Buyer Behavior course, this case illustrates the current trend in social marketing or cause-related marketing and gives the example of a successful social marketer (U2). This case also presents U2's brand image and positioning. Finally, this case can lead students to discuss what direction U2 should take in future tours and promotion.
- For a Global Marketing or graduate Principles course, this case exemplifies an undifferentiated targeting strategy, as well as a global positioning strategy. Country choices is also introduced and justified. Additionally, choice of global and regional sponsors and web site and social media strategies would complement global communications lectures. Finally, students can be assigned to deal with the situation as the case concludes: what should U2 do next, especially considering the current environment?

SAMPLE DISCUSSION QUESTIONS

The professor can start out the session by playing a U2 song (available for purchase in iTunes or other digital music site) or a video from the U2.com website. Listening to the words, students can begin to identify and reflect on the meaning behind the music.

1. Should U2 change anything, given the high costs of the *360°* tour?

This question should lead to a lively class discussion and students may have various opinions. There is some contradiction in U2's touring, especially looking at their stance in defense of the environment while their carbon footprint is so significant. Couldn't the money spent be used for one of their causes instead? Students will realize that many of the costs are fixed expenses and the U2 is working hard to make sure that people can purchase tickets by lowering costs through global and regional sponsorships.

U2 has actually already made a profit on this tour and is at the top of the 2010 Forbes Music Earners List, having grossed $311 million, each stop grossing ticket receipts of $10 million. The band's bottom line was also boosted by healthy merchandise sales, as well as strong radio play for their deep back catalog, which continues to sell well (Kaufman, 2010).

Students may question the location choices of the concerts, especially since the case makes mention that the Russia performance was not sold out. This may be due to a number of circumstances, notably that the cultural Russian music is significantly different than the music performed by U2. Overall, the performances have been more sold out than not sold out and a goal of U2 has been to continuously expand to new venues.

2. Shouldn't U2 be more concerned about the environmental impact of its tours?

As mentioned in question 1, this is clearly a contradictory situation, which a lot of companies are facing today. How can U2 justify their impact on the environment when they are having such a direct harmful effect on it – especially when they are outspoken about their defense of it? The issue of sustainability can be brought up too. Unlike companies who have been admired for their sustainability efforts (e.g., Starbucks and their coffee farms), it is much more difficult to think of sustainability and U2. Some students may actually conclude that from a sustainability point of view, U2 may be better off not touring and focusing on virtual delivery. But would that be sufficient to keep the brand alive in the consumers' mind?

3. Why is U2 involved in social marketing? How?

Obviously this issue is a very personal one for all the members of U2, particularly Bono. Students can refer to the case and review the history of the band and how it got involved with Live Aid from the beginning and in a variety of causes afterwards. U2 has incorporated their social agenda in their concert, for instance by dedicating *Walk On* to Aung San Suu Kyi and their communications. The band members have also donated their time to non-profit organizations. Finally, beyond personal motivations of band members, students should review the benefits of social marketing for a business like U2 and how it increases the size of their target audience.

4. Do you think U2 has more to gain or lose from their social marketing focus? Explain the pros and cons.

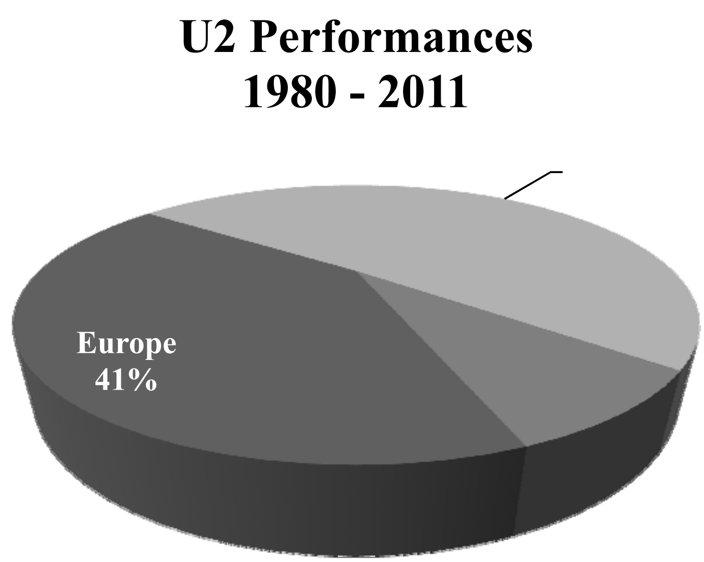
This question is a nice follow-up to the previous one and will receive varied answers. Multiple factors are in play, from the sheer personal satisfaction and immortality that such activities will give the band (beyond the great music), to the risks of alienating listeners and sounding too political. The case explains well what U2 has to gain from their social marketing approach. For the cons, students will find it interesting to review negative comments present on blogs and discussion boards, such as www.experienceproject.com, http://u2blog.com/ or http://www.p2pnet.net/.

5. Why did U2 focus first on the U.S. market?

This different approach in their targeting strategy proved to be a winning one. Paul McGuinness, the case central character is actually credited for this clever choice. U2 was able to create a very strong following in the USA first and became a global phenomenon. This question will lead students' realization of the impact of America on the world consumption choices. There is historical justification for this choice: the Beatles.

Table 5 in the Case, U2's Performance Timeline, students can analyze the number of performances in Europe, North America and other locations. Teaching Note Illustration 1 provides an example of a pie chart that identifies the number of performances in North America, Europe, and other locations. Based on this information, students can identify that just over 50% of U2's concerts have been performed in North America. Using the data in Table 1 and Table 2, students should recognize that Dublin, the band's home town, is the where the band has played most frequently. Although a focus has been on North America, clearly the band is very loyal to its fans in Dublin.

Figure 1:



6. What is U2's global positioning strategy?

As stated at the end of the case, U2 has always planned to become a global brand (not interested in being a local "indie" band). Have they succeeded? The case gives multiple data to that effect. U2 has chosen to position itself as the best rock band coming out of the 80s. Students will find it interesting to list current musical acts from all periods and to position them compared to U2 on a perceptual map.

7. Review the elements of U2's global strategy discussed in the case. What is their approach?

To answer this question students may find it beneficial to review U2's marketing mix. Their product will include their music, tours and services, including their contribution to their causes. Price issues will include pricing surrounding the concerts but also issues of royalties. Distribution involves new technology now that music has become a binary stream easily available at your local coffee store or on your home computer. Finally, promotion is really very important for U2 and their social marketing approach, but also in their choice of sponsors. Paul McGuinness realized from the beginning of U2's history that promotion was important. As an important icon in the digital music industry, he has followed technology and media trends.

8. What other musicians/bands have developed a socially conscious following?

Although it is too long to list, and since student interest varies in music, we suggest a website to review is http://www.looktothestars.org. This website is dedicated to providing a detailed account of celebrity charity and giving. The list is quite impressive; as are the numbers of supported charity organizations and donated funds.

This topic offers a good opportunity for classroom discussion. Using the websites listed above, have students research their favorite music groups and the charities that they support.

9. Does music that has a social mission make you follow/support them more?

Students will have multiple responses for this question. It should come as no surprise that there are many dedicated and involved individuals and groups that support numerous charity organizations, events, and sponsorships. After the Live Aid concert in 1985, focusing on hunger and famine in Ethiopia, the Live 8 concert was a worldwide event that many students may recall. This benefit concert for poverty had more than 1000 musicians and reached an estimated 3 billion people in 2006. Several days after the Live 8 concert, leaders from the G8 (France, UK, US, Canada, Russia, Germany, Italy, Japan) promised to increase funding for poverty, with a large earmark towards Africa. Many songs have been written in the name of social justice. Another opportunity for classroom discussion: have students research the lyrics to songs that have social meaning and play a 30 second snippet of the song and explain why this song is important.

10. Is the band aging beyond its ability to sell their brand?

Given the sold out crowds (with a few exceptions, such as Moscow), as well as the 7+ million followers on Facebook, it should be clear to students that the band still has the energy and desire to continue their performances. It would be interesting to ask students how they feel about U2 and test their familiarity with the band. If today's students can relate to the band, then there is a future for U2; otherwise, this should lead to lively class discussions. There are a lot of older ‘classic’ performers, such as Cher, Mick Jagger or Paul McCartney, who are well past their fifties that can be mentioned to add to the debate.

Moreover, students familiar with the band may recall that the band had to cancel a few concerts back in the summer of 2010 due to health problems encountered by Bono. Thus keeping all members healthy and wanting to perform may be difficult in the long term.

Bringing up the age of U2’s band mates can lead to a discussion of generational marketing. Does U2 have universal appeal or is it appealing to specific generations, such as Generation X, Baby Boomers, etc.? Are they using different outlets for their communications to appeal to younger generations? The following article by the Pew Research center can add to the discussion (http://pewsocialtrends.org/2009/08/12/forty-years-after-woodstockbra-gentler-generation-gap/#prc-jump).

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STARBUCKS: MAINTAINING A CLEAR POSITION

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CASE DESCRIPTION

The primary subject matters of this case are Marketing and Branding. Secondary issues examined include brand equity and brand positioning. This case has a difficulty level of three (appropriate for junior level courses or higher). This case is designed to be taught in one and one half class hours and is expected to require four hours of outside preparation by students.

CASE SYNOPSIS

When Starbucks originated in Seattle, Washington in 1971 as a purveyor of dark roasted coffee beans and coffee merchandise, its founding owners didn't anticipate the extraordinary brand evolution to come. Under the direction of Howard Schultz, who became sole proprietor in 1987, Starbucks transformed into a beverage provider that mirrored the experience of Italian coffee houses including espresso drinks, and elegant camaraderie. This strategy, as part of Starbucks' brand positioning as the consumer's "Third Place" to spend his/her time between home and work, ignited a period of extraordinary expansion.

By the 1990s, however, Starbucks had begun offering specialty coffee-based drinks (such as its trademarked Frappuccino® drinks, etc.) through mass retail stores. The company also licensed Sodexho to operate Starbucks on naval bases that, despite being traditional Starbucks stores, served a wide variety of other products including pastries, sandwiches, salads, and various merchandise.

As higher-end competitors began serving gourmet coffees, Starbucks reacted by increasing its product offerings. By 2005, many Starbucks locations offered a variety of pastries, deserts, and lunch items. Additionally, many Starbucks had begun offering customers drive-through service. Each of these new additions (both the food and the drive-through additions) was successful in increasing immediate sales and profits and, therefore, in pleasing Starbucks investors.

In 2007, Starbucks executives received a memo from Schultz expressing significant concerns that Starbucks was weakening its brand image with these ongoing modifications. Questions arose regarding a decision-making bias towards brand extensions that increased profitability in the short-term, but that threatened Starbucks' long-term brand equity. By 2008, Starbucks executives worried about the company's financial declines.

The authors have received positive responses from upper level undergraduate students and from graduate students in analyzing this case. Invariably, students' affinity for or against Starbucks' products increases their interest in the case and their satisfaction in the analysis.

INSTRUCTORS' NOTES

Introduction

The Starbucks case is designed both for graduate and for undergraduate courses in Marketing Management, in Marketing Strategy, in Branding, and in Consumer Behavior. The case illustrates the potential trade-offs that can occur when satisfying shareholder demands for immediate profit maximization risk the brand equity of a highly valuable brand name. Within courses in Marketing Management/Strategy or in Branding, this case should be utilized when studying concepts of brand equity or of brand positioning and/or when evaluating brand strategy alternatives. Within a Consumer Behavior course, this case should be utilized when studying brand positioning and/or when examining the impact of consumer social class, consumer perceptions, and/or consumer attitudes on decision-making.

In discussing this analysis, the professor may wish to present a visual illustration of the Starbucks' competitive risks in extending its brand. While extending a brand name can enhance brand equity, if the extension is too far from the brand positioning it could also allow opportunities for competitors to compete more directly against an overextended brand. Within a competitive marketplace, therefore, brand equity can be enhanced through extensions that fit the brand positioning but could decline if the extensions are too extreme.

The diagram in Appendix 1 depicts this relationship. The diagram is presented as an appendix to allow the instructor to utilize it easily in the classroom.

The blue line depicts the value of a brand's equity as the brand is extended. Moving to the right of the horizontal axis depicts brand extensions that progressively move further from the original brand positioning in customers' minds: new flavors, new concepts, licensing, new product categories, etc.

Brand equity is maximized at the point of the recommended brand extension. Brand extensions that are not consistent with the consumers' perception of the original brand (those furthermost to the right) reduce brand equity significantly. The midpoint line is not relevant, and is only added as a point of reference.

The instructor should ask students to consider if/how the Starbucks brand had moved along the continuum. Many students, but likely not all, will conclude that Starbucks has moved its brand toward the right of the continuum.

The graph is intentionally abstract, allowing the student to name the values that move the brand along the continuum. Some examples of these values are: number of product extensions, a progressive list of extension types (new product categories, licensing, etc.), number of possible extensions exploited, and degrees of separation. This degree of freedom allows the student to demonstrate subject matter comprehension and critical thinking skills to the professor.

Students should recognize quickly the brands at the far left extreme of the continuum are more susceptible to faulty positioning of the core brand. An organization that manages its brand equity for one primary brand will likely suffer significant financial harm as a result of the damage to the brand. Conversely, when a diversified company such as Philip Morris USA suffers damages resulting from adverse legal action, the parent company (Altria) has other successful lines of business to dampen the financial impact of brand risk and adverse outcomes. In Starbuck's case, the value of the entire company is directly tied to the value of a single brand. Risking the brand equity of the Starbuck's name is, therefore, risking the value on the entire organization.

The student should identify a point on the continuum as the current brand extension of Starbucks, as well as identify the ideal point on the continuum, here represented by the larger line. The "Dollar value of brand" across the top should maximize at the ideal point on the continuum, representing the ultimate purpose of firms to maximize value to the shareholders.

Advanced students may add a time dimension, recognizing that brand extensions are more successful as brand recognition and entrenchment deepen. Advanced students may also note the reason the "Dollar value of brand" line is lowest at both beginning and end, recognizing that a narrow product focus often comes at the expense of sensible product extensions (like an espresso bar for serving the coffee one sells).

The most advanced students will place the brand in a portfolio context. Some firms have multiple brand names, none of which are related to the corporation's name (Proctor & Gamble, etc.), and other firms are linked inextricably to their brand (Starbucks). Aaker and Joachimsthaler (2000) describe this difference as being two ends of the "brand spectrum." They label Starbucks' approach of utilizing its corporate name in branding all products as being a "house brand" approach. They label Proctor and Gamble's utilization of different brand names for each product as a "house of brands" approach. Rao, Agarwal, and Dahlhoff, (2004) also label an approach of utilizing the corporate name as one brand among multiple brand names as being a mixed approach. Firms with multiple brands may be more willing to take on additional risk that is unique to an individual brand. Firms with a single brand may be less willing to incur brand risk, as the risk to the firm is more directly tied to the risk of the single brand. A discussion of the advantages and disadvantages of each approach is presented in Discussion Question 2 of this note.

In utilizing this case as a required component of marketing courses as various levels, the authors have discovered a difference in risk tolerance between undergraduate and graduate students in answering this question. Graduate marketing students have tended to be the more conservative in protecting Starbucks' brand positioning and, therefore, its equity based on its positioning. Perhaps graduate students have a better appreciation for maintaining a distinct and valuable brand image than do undergraduates, or perhaps they simply have a better understanding of the fundamental need to maintain a long-term perspective. Either way they have tended to place a higher priority on avoiding long-term brand vulnerability than have undergraduate marketing students. As would be expected, graduate students have also displayed greater skill in supporting their positions and in providing better thought-out estimates of how their decisions would impact future Starbucks' financial performance. Even within a class, however, whether a graduate or undergraduate course, students have varied in their risk tolerance.

Case Overview

This case demonstrates how Starbucks built significant brand equity before attempting to leverage its brand name. The attempt at leveraging the name diluted the Starbucks brand and led its positioning to become less distinctive and less clear.

Starbucks had built its success by offering a relaxing high-end coffee experience. After its originally rapid growth rate began slowing, the company began seeking other avenues for revenue growth, including expanding its product offerings to include sandwiches and other food items; utilizing drive through services at many store locations; and allowing other types of food service businesses to leverage the Starbucks name on a variety of products. While these changes were successful in enhancing revenues, they also moved the Starbucks image closer to competitors and they diluted the brand.

The case effectively illustrates Keller's (2001) theories on customer-based brand equity and Aaker's (1992) theories on the assets and liabilities of brand equity. Starbucks became faced with the decision of continuing a marketing approach that was driving revenues or altering its approach in favor of reestablishing its once clear brand image.

Discussion Questions

1. Define value-expressive reference group influence and evaluate Starbucks' use of value-expressive reference group influence in its brand positioning.
2. Define Starbucks' core brand. Was Starbucks a "house brand" or a "house of brands"? Compare the advantages and disadvantages of each. In light of your responses to these questions, how have Starbuck's brand extensions affected the core brand.
3. Define brand equity. According to Keller's Customer-Based Branding Equity (CBBE) Model, how has Starbucks' branding approach led to its success?
4. As a company evolves, why should its changes be consistent with its desired brand image? Were Starbucks' changes in product strategy consistent with its original Third-Place image?
5. Identify how Starbucks' product modifications might have forced potential trade-offs between the company's immediate profitability and the brand's vulnerability to competitors within the marketplace.

6. Evaluate Starbucks' brand equity in light of Aaker's (1992) proposed assets and liabilities for brand equity both from an historical perspective as well as in relation to Starbucks' more recent changes (i.e., increase in food products, up-selling promotional techniques, drive-through windows).
7. Going forward how should Starbucks evaluate the impact of its potential product offerings on its branding efforts and why? What modifications should Starbucks make if any?

Answers to Questions

1. Define value-expressive reference group influence and evaluate Starbucks' use of value-expressive reference group influence in its brand positioning.

Brand positioning refers to the brand's image against a competitive frame of reference (Aaker & Shansby 1982; Park, Jaworski, & MacInnis 1986). Starbucks positioned itself as a product of an aspirant market. Having a "Third Place" (away from home and work) to relax was considered a luxury by its target consumers. Starbucks had advanced that concept further with its concept of "affordable luxury". It was a way to present a high class image, but for products (coffee and coffee drinks) that are easily affordable by the middle class. Starbucks successfully appealed to the middle class desires to be associated with a higher class (i.e., one to which they aspired as opposed to one in which they actually belonged). In essence, Starbucks became a high-end experience. It allowed the very ordinary coffee drinker to be associated with the aspirant class of the not-so-ordinary coffee connoisseur.

This approach demonstrated a successful application of value-expressive reference group influence (see Bearden & Etzel 1982; Kim & Kang 2001). Bearden and Etzel (1982) define value-expressive reference group influence as "the need for psychological association with a person or group and is reflected in the acceptance of positions expressed by others. This association can take two forms. One form is an attempt to resemble or be like the reference group. The second type of value-expressive influence flows from an attachment or liking for the group" (p. 184). In building its brand positioning, Starbucks had predominantly utilized the former of these two forms of value-expressive influence. The brand had tapped into the ordinary coffee drinker's desires to be associated with coffee aficionados.

Starbucks' traditional approach had remained fiercely consistent with this positioning in terms of its overall experience. Each detail, including the original variety of coffee drinks, the original atmosphere of the stores, and even the fact that the baristas knew the customers by name, had been consistent with this positioning.

The stores more recent changes, however, were less consistent with this positioning. Sandwiches and other lunch items were less consistent with a high luxury experience because of their association with quick-service restaurants. Drive-through windows were also associated with the quick-service industry. Also, attempts to "up-sell" the customer were associated with the quick-service industry. These quick-service (also called "fast food") associations were making Starbucks' positioning of a high-end experience unclear at best and potentially less believable.

2. Define Starbucks' core brand. Was Starbucks a "house brand" or a "house of brands"? Compare the advantages and disadvantages of each. In light of your responses to these questions, how have Starbuck's brand extensions affected the core brand?

The case describes Starbucks' core brand as more than just coffee. It was a high-end coffee experience. Associated with coffee connoisseurs, it appealed to people who sought a high-status coffee context.

As discussed above, Starbucks was a "house brand" under which all Starbucks products share the corporate brand name.

A house brand approach uses the company name to brand multiple products. Rao, Agarwal, and Dahlhoff, (2004) argued the advantages of a house brand approach (which they call "corporate branding") on its efficiency. Developing positive brand equity of one brand name requires fewer resources than developing positive brand equity for multiple brands. With multiple products sharing one brand name, therefore, the company enjoys significant economies of scale in its branding efforts. Aaker and Joachimsthaler (2000) suggested the marketer utilize a house brand approach based on determining if the master brand added to the offering through (p. 16):

- "Associations enhancing the value proposition"
- "Credibility with organizational associations"
- "Visibility"
- "Communication efficiency"

A house of brands approach utilizes a variety of brand names for its multiple products, without using the corporate name. Rao, Agarwal, and Dahlhoff, (2004) based the advantages of a house of brands approach on the ability to tailor brand positioning to meet the specific needs of various target markets. The organization would then develop brand equity for each brand. Proctor and Gamble had been able to utilize such an approach to command significant shelf space for its brands, thereby, leaving little shelf space for competing brands. Aaker and Joachimsthaler (2000) suggested the marketer utilize a house of brands approach based on determining a compelling need for a separate brand to (p. 16):

- “create and own an association”
- “represent a new, different offering”
- “avoid an association”
- “retain/capture customer/brand bond”
- “deal with channel conflict”

Rao, Agarwal, and Dahlhoff, (2004) also distinguished a third category, which they called a “mixed branding” approach. They designated a mixed branding approach as an approach in which the company utilizes both the corporate name in branding some products as well as a variety of other names for other products. They offered PepsiCo as an example, citing Pepsi as well other brand names such as Mountain Dew and Aquafina. They contend the mixed branding approach provides the advantages of meeting varying needs for different markets as well as create branding efficiencies through economies of scale where possible.

Considering the approach in light of Aaker and Joachimsthaler’s (2000) considerations for utilizing a house brand (as shown in TN Exhibit 1) indicates potential areas of concern. Starbucks’ house brand approach allowed for promotional and branding cost efficiencies; however, the weak associations and the potential lack of credibility with the organizational associations indicate that Starbucks’ extensions potentially weakened its branding efforts.

TN EXHIBIT 1
EFFECTS OF HOUSE BRAND CONSIDERATIONS ON STARBUCKS BRANDING

House Brand Consideration	Potential Effect on Starbucks Branding
Associations enhancing the value proposition	Starbucks had based its value proposition on a high-status context in which the consumer could be associated with a connoisseur. The consumer had willingly paid Starbucks a premium coffee price to provide that experience. Increased food offerings and drive-through windows were not consistent with this experience. As such, they likely did not enhance this value proposition.
Credibility with organizational associations	Starbucks’ food offerings and drive-through service were associated more with the fast food industry than with a high status coffee experience. These extensions did not add credibility with Starbucks’ brand associations.
Visibility	The additional offerings might have offered additional visibility.
Communication efficiency	Starbucks did experience economies of scale in promotion through the use of a house brand approach.

3. Define brand equity. According to Keller's Customer-Based Branding Equity (CBBE) Model, how has Starbucks' branding approach impacted its success?

Aaker (1992) defined brand equity as a specific combination of brand assets and liabilities that enhance or detract from the value of a brand. He listed five categories of brand assets/liabilities that have such effects:

- Brand Loyalty
- Brand Awareness
- Perceived Quality
- Brand Associations
- "Other" Brand Assets/Liabilities

The overall effect of these assets and liabilities either increases or decreases the brand value as compared to that of an unknown brand within the same product category.

Keller (2001, 1993) modified the above definition of brand equity only slightly in defining customer-based brand equity. He defined customer-based brand equity specifically as the differential impact derived from brand knowledge on a consumer's reactions toward a brand as compared to the same consumer's reactions toward a fictitious or unnamed brand within the product category. As such, customer-based brand equity refers to the value (negative or positive) that a brand derives from customer knowledge.

Building positive customer-based brand equity consists of four sequential steps (Keller 2001):

1. Developing brand identity
2. Creating brand meaning
3. Eliciting desired customer responses to the brand identity and meaning
4. Translating the customer responses into a powerful, active, and loyal relationship with the brand

Step 1: Brand Identity

Keller (2001) viewed this step as addressing the question, "Who are you?" As such, the brand must become salient within the minds of the customers. To build brand identity, the brand must enjoy high brand awareness across various situations and contexts. Keller (2001) argued for two key dimensions in building brand identity: depth (how easily the brand is recalled and/or recognized) and breadth (the array of contexts in which the brand is evoked).

Although the case does not directly provide statistics for the Starbucks brand identity, it is safe to assume that many consumers are aware of the brand, as evidenced by Starbucks' rapid growth rate. With rapid growth in sales and in number of stores, a strong brand identity for consumption of coffee, its primary product line, had been created. Starbucks' distinctive logo further increased its brand identity with consumers.

Step 2: Brand Meaning

Keller (2001) viewed brand meaning in terms of the brand's image within the marketplace (i.e. brand positioning). As such this step addressed the question, "What are you?" It consisted of functional performance–related considerations and abstract imagery-related considerations.

The performance-related considerations for Starbucks had traditionally been based on coffee attributes such as taste and price. These performance-related attributes had been only a component, however, of the more critical imagery-related considerations that had led greatly to Starbucks' success in developing brand meaning. Schultz originally envisioned Starbucks as a "Third Place" for consumers along with work and home that would appeal to true coffee aficionados. By positioning the brand as a high-end experience associated with coffee aficionados, Starbucks had created a powerful abstract image that hit its broad target market's preferences very well.

Step 3: Brand Responses

Keller (2001) contended that this step incorporates two components, judgments and feelings, in addressing the question, "How does the customer think and feel about the brand?"

Consumers judged Starbucks as offering high quality based on a superior consumption experience. Consumer feelings included high social approval due to associations with the more sophisticated coffee drinker. The association with coffee connoisseurs resonated well with consumers who were attracted to such high-end sophistication (see Question 1 above on value-expressive reference group influence). Starbucks' positioning and imagery, therefore, offered strong appeal to a wide market.

Step 4: Brand Relationships

This step addresses the question, "What kind of association and how much of a connection would the customer like to have with the brand?" Keller (2001) associated this step with brand resonance, which he described in terms of a psychological bond a customer forms with the brand and in terms of subsequent behaviors that bond will elicit from the customer. Keller contended that brand resonance consists of four categories:

- brand loyalty
- attitudinal attachment (for example, the customer "loves" the brand)
- a sense of community (i.e., a sense of belongingness with other brand customers)
- active engagement (spending resources such as time and/or money in activities *other* than consumption -- such as referring the brand to others or visiting the brand website)

Keller argued that the most effective use of customer-based branding equity leads to success in the latter step (Step 4) from a foundation of success in the earlier steps. He stated that, "A brand with the right identity and meaning can result in a customer believing the brand is relevant to them. The strongest brands will be the ones to which those consumers become so attached that they, in effect, become evangelists and actively seek means to interact with the brand and share their experiences with others" (Keller 2001 p. 19).

Starbucks seemed to have created a high level of customer-based brand equity. Many customers were quite loyal to Starbucks.

4. As a company evolves, why should its changes be consistent with its desired brand image? Were Starbucks' changes in product strategy consistent with its original Third-Place image?

As a company makes changes to an evolving brand, the need to stay consistent with the desired brand image is critical for keeping that image clear to its target market. Brand changes that are not consistent with the brand image can potentially weaken brand meaning (as explained above) and confuse customers.

During its brand evolution, Starbucks had made some changes that were not particularly consistent with its Third Place image. Intending to be the customer's "third-place" along with home and work meant that customers would develop a desire to stay at a Starbucks location. Adding drive-through windows to its stores had the exact opposite effect of keeping a customer in the store. The windows, by design, are driven by customers' need for convenience in obtaining product and leaving as quickly as possible. Additionally, drive-through windows are associated with the fast-food industry, which is geared toward moving customers in and out of the store location as quickly as possible to allow for greater customer traffic. Such an association is inconsistent with Starbucks' desired Third-Place image. Starbucks' recent product offerings such as sandwiches, and other food items are also more closely associated with fast-food and; therefore, convey associations that are inconsistent with the desired Third Place image. By more closely aligning the Starbucks' brand with fast-food, these changes likely detracted from Starbucks' desired Third-Place appeal within consumers' minds.

5. Identify how Starbucks product modifications might have forced potential trade-offs between the company's immediate profitability and the brand's vulnerability to competitors within the marketplace.

If not managed with extreme care, a brand extension can negatively impact perceptions of the brand name, thereby, leaving the brand more vulnerable to competitive market actions. If a brand becomes overextended, even if the brand extensions increase short-term sales, the customer associations with the brand could be negatively impacted. If so, the longer-term value of the brand (i.e., its equity) could potentially diminish (Aaker 1992). This effect becomes particularly problematic as the brand becomes more vulnerable to competitor actions. In extending its brand, Starbucks needed to maintain the positive equity of the brand and to avoid weakening the association of the core product (in this case coffee and a coffee house) with its successful positioning.

Several of Starbucks' product modifications had the potential for weakening its high-end/Third Place brand positioning. The case illustrates concerns that the up-selling of a customer's order "had long been popular within the quick-service industry." The tactic's associations with quick-service ("fast food"), coupled with the baristas' uneasiness in selling sandwiches with coffee, could potentially lead consumers to begin associating the Starbucks brand with the fast-food industry, thus moving it away from its successful high-end positioning. The addition of drive-through windows likely only furthered this undesirable association.

While Starbucks appeared willing to take this risk, its success in creating an upper-class image with its stores may also not have translated well to its brand extensions. A significant concern, for example, is how well its image translates into the Starbucks ice cream or other items outside of the Starbucks store. Furthermore, an upper class image may not translate well for stores that have drive-through services. Offering such services may have lead consumers to perceive Starbucks more as a quick-service restaurant and less as a high-class coffee experience. Such concerns were then further perpetuated by offering food items such as sandwiches as well.

Any or all of these product changes could have potentially moved consumers' perceptions of Starbucks' brand meaning away from its strong high-end image. Such a change would have negatively impacted consumers' brand responses, and therefore their brand relationships regarding Starbucks. (See Discussion 2 above.)

The most advanced students will also consider how competitors have positioned themselves relative to Starbucks. Named competitors in the case include McDonald's (hamburgers), Dunkin' Donuts (doughnuts), and Panera Bread (bread and high-end quick serve food items). As Starbucks has potentially moved away from its high-end image in consumers' minds, Dunkin Donuts and Panera Bread have moved into the high-end market space to compete with Starbucks for high-end consumers. McDonald's, meanwhile, has branched from its strictly fast-food image to create an offering that is closer to this high-end market than it had been previously. As competitors move closer to Starbucks' image, it became increasingly important for Starbucks to be consistent in its desired (high-end) image. Since Starbucks had not stayed consistent with this image, but had instead potentially formed associations inconsistent with this image, it allowed competitors access to the high-end marketplace.

6. Evaluate Starbucks' brand equity in light of Aaker's (1992) proposed assets and liabilities for brand equity both from an historical perspective as well as in relation to Starbucks' more recent changes (i.e., increase in food products, up-selling promotional techniques, drive-through windows).

As stated above, Aaker (1992) listed five categories of brand assets/liabilities that can impact brand equity: Brand Loyalty; Brand Awareness; Perceived Quality; Brand Associations; and a fifth category for "Other" Brand Assets and Liabilities (examples could include patents, channel relationships, etc.). The primary four categories are examined in TN Exhibit 2 with the expectation that the "other" category would have had only minimal (in any) impact on Starbucks' brand equity in this case.

TN EXHIBIT 2 STARBUCKS BRAND EQUITY		
Brand Equity Asset	**Historical Evaluation of Starbucks**	**Potential Impact of Brand Extensions**
Brand Loyalty	Traditionally, Starbucks had enjoyed tremendous brand loyalty. The brand had historically maintained a clear upscale image that many coffee drinkers found highly appealing.	As Starbucks' image had moved closer to other less expensive competitors, loyalty has likely been impacted negatively.
Brand Awareness	Starbucks had traditionally enjoyed high brand awareness.	Brand extensions likely did not hurt Starbucks' brand awareness and they potentially strengthened awareness (at least minimally).

Perceived Quality	Starbucks had maintained its success from a high quality image – with quality being defined in terms of coffee flavor, in terms of a high-end atmosphere, and in terms of consumer status.	The case provides no indication that customers' perceptions of Starbucks' coffee (or other product offerings) was no longer of high quality. The market's quality perceptions of Starbucks had more likely suffered in terms of the atmosphere and status aspects. The use of drive-through windows and "upselling" tactics at the counter took on characteristics associated with fast-food, which was generally perceived at the low-end of quality in the food industry. As such, these changes represented a poor fit to Starbucks' traditional high-quality image. As Loken and Roedder John (1993) demonstrate, when a brand extension is a poor fit with the parent brand it can damage the quality association of the parent brand. The proliferation of stores also reduced the uniqueness and exclusivity perceptions of Starbucks. Such loss of exclusivity could have further damaged customers' perceived quality of the brand.
Brand Associations	Traditionally, Starbucks brand associations (coffee flavor, high-end atmosphere, and consumer status) had been important components of its high-quality image. Coffee consumers found Starbucks' associations with European coffee aficionados to be very desirable. Consumers also associated Starbucks with their positive personal interactions with the baristas.	The above discussion on perceived quality indicates that consumer perceptions of Starbucks on these aspects had likely changed. With the high-quality perceptions of Starbucks having changed, the brand associations they generate would likely have been different as well. Starbucks' image had moved closer to that of fast-food, thereby, replacing previously positive associations with more negative.

7. Going forward how should Starbucks evaluate the impact of its potential product offerings on its brand equity? What modifications should Starbucks make if any?

While some students may wish to provide an opinion very quickly in responding to this question, caution should be used to avoid forming such quick opinions prior to a well thought-out analysis. In asking this question, the instructor should require students to support their opinions based on the analysis developed through the previous questions and discussion. The key to how a student will answer this question lies in the student's risk tolerance. In other words, how willing is the student to seek immediate sales increases from moves that might leave the brand more vulnerable to competitor actions. Such vulnerability would create significant risk in impacting long-term sales, hence the measure of the student's risk tolerance.

In answering this question, students may take one of two sides: Starbucks is over-extended or Starbucks is under-extended. Typically, students will vary on the extent of brand risk they are willing to tolerate, as will be demonstrated by their various recommendations for Starbucks' future directions.

Status Quo

Some students may have difficulty taking a position that would limit Starbucks' brand extension in any way arguing that these extensions increased (short-term) sales. Such students likely will argue Starbucks should not make any changes going further, but should continue its course of action despite the risks involved. As such, the authors suggest that the instructor require such students state how far they are willing to extend the brand and letting those students who desire extreme extensions state their reasons for doing so.

Product Deletion

The authors' experience with the case has been such that a majority of students, particularly graduate students, have argued that Starbucks is over-extended. Such students have posed various options for Starbucks in reducing its product offerings, typically centered on reducing its food offerings (dropping food offerings not directly relating to the high-end positioning) and no longer asking baristas to "up-sell" customer orders. The authors suggest the instructor should require such students to consider whether Starbucks should attempt to move its brand image back to its previous positioning and how easily such an objective could be achieved. Considering these questions should lead the student to strengthen his/her support for this position.

Market Development

Some students have argued for Starbucks to create a second brand of store. Such an approach would allow Starbucks to stay with its traditional coffee and related products while developing a second store brand that would open in separate locations and appear to be independent of Starbucks. The second store brand would compete more directly with fast food offerings, but at the higher-end of the fast-food industry. As such, this second store could target a different market from Starbucks (hence, market development) and offer the company a high growth potential without continuing to extend the

Starbucks' name. This more extreme approach is far more costly than other options. As such, it requires a long time horizon for Starbucks to achieve a desirable rate of return and carries significant risk of loss. Although potentially a feasible option, when students are questioned about this approach they often find it more difficult to support other approaches. Successfully supporting this option invariably requires very aggressive sales expectations.

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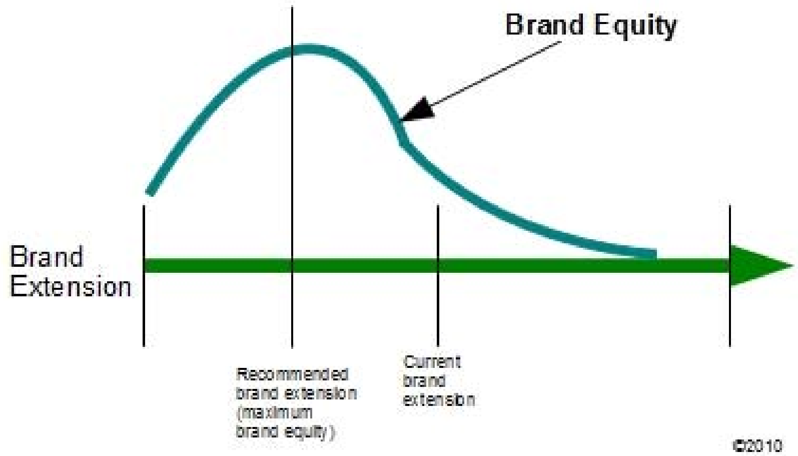
APPENDIX 1


Brand Equity
Brand Extension
Recommended brand extension (maximum brand equity)
Current brand extension
©2010

TO BREW, OR NOT TO BREW—THAT IS THE QUESTION: AN ANALYSIS OF COMPETITIVE FORCES IN THE CRAFT BREW INDUSTRY

Jack Kleban, Barry University
Inge Nickerson, Barry University

CASE DESCRIPTION

The primary subject matter of this case is a competitive analysis of the craft brewing industry in the U.S. The case is appropriate for courses in strategic management and entrepreneurship. The case has a difficulty level of three or four. The case is designed to be taught in 1 – 2 class hours.

ABSTRACT

This case analyzes the craft brewing industry in the U.S. It encompasses a description of what defines craft brewers, the different categories of craft breweries depending on size in the U.S. and the major competitors in the industry according to annual volume output of craft beer. Recent growth in the craft beer industry compared to the general U.S. beer industry is detailed.

In addition to craft beer brewer characteristics, the case outlines market structure, competition, and business strategies of craft breweries. Also considered are branding and social media marketing and social responsibility considerations, followed by distribution, and regulation and taxation of the craft brewing segment of the beer and beverage industry .

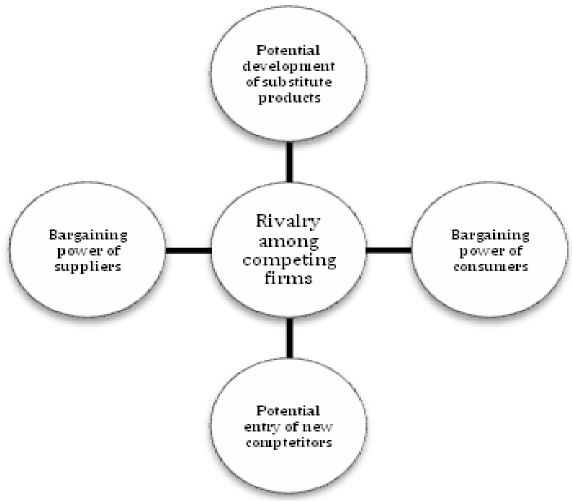
INSTRUCTORS' NOTE

ANALYSIS

Students are asked to supply answers to one instruction given at the end of the case. Additional questions/instructions could be supplied by the instructor to supplement this question as deemed necessary. The case lends itself to a rich discussion of factors (as outlined in the summary above) related to making a decision about possible entry into an existing market.

Porter's five-forces model is a frequently used vehicle to determine the nature of competitiveness in a given industry.

Porter's Five-Forces Model



Instruction: "Analyze the competitive nature of the Craft Brewing Industry using Michael Porter's "Five Forces Model" as your guide."

The Porter five-forces model considers the following five factors:

1. *Barriers to Entry into the Industry*--Potential entry of new competing firm*s* is facilitated whenever the barriers of entry to the industry are low. Entry barriers could include the need for large capital investments, regulatory stipulations, intellectual property protections, technology, contractual agreements with suppliers, distribution channels or customers, availability of suitable locations, and customer brand loyalty, for example.

In the case of the Craft Brew Industry, the barriers to entry relate particularly to capital requirements, technical know-how (experienced brewmaster), and available distribution channels. In this industry, it is possible to begin with limited capital (nanobreweries) and expand production as demand warrants it. It is essential to have technical know-how to be able to create appealing brews. Therefore, the entry barriers are relatively low in this industry.

2. *Bargaining Power of Suppliers* depends upon the total number of suppliers, the ease/difficulty of obtaining substitute materials, and the cost of switching to such substitute materials. The fewer the number of suppliers and the more difficult it is to obtain substitute raw materials, the higher the bargaining power of the suppliers, and the higher the price of those raw materials is likely to be.

In the case of the Craft Brew Industry, there are a handful of large suppliers each of hops and malt, and there are two main suppliers of yeast. In this industry, the bargaining power of suppliers is high.

3. *Bargaining Power of Consumers* depends on whether customers are concentrated, large, or buy in volume. Their bargaining power represents a major force affecting the intensity of competition in the industry. Bargaining power of consumers is higher when the products being purchased are undifferentiated or standardized.

In the case of the Craft Brew Industry, customers are individual aficionados who are seeking a "taste revolution." That is, they are enamored of the craft brew drinking experience, and, more directly, by individual brews' tastes. These consumers tend to buy in small quantities, preferring the taste of freshly brewed beer. Therefore, in this industry, the bargaining power of the consumer is low.

4. *Development of Substitute Products* creates competitive pressures for an industry and, thereby, puts a ceiling on the price that can be charged before consumers will switch to a substitute product. The competitive strength of substitute products can be measured by the inroads into market share those substitutes can make, as well as those firms' plans for increased capacity and market penetration.

In the case of the Craft Brew Industry, statistics indicate that major producers of regular beer have seen decreasing sales and craft brewers have gained volume. However, with the recent legal revision of the upper limit volume from 2 million to 6 million barrels to still be classified as a craft brewer, the stakes have changed for the major producers of regular beer. They may now be interested in acquiring craft brewers or starting their own craft brewing operations. This will likely increase the rivalry among all craft brewers.

5. *Rivalry Among Competing Firms* is usually the most powerful of the five competitive forces. That is so because strategies that have proven to be successful for one competitor are often quickly adopted by other competitors seeking to level the competitive playing field. <u>Example Gas Price Wars</u>: One gas station in a given neighborhood lowers the price of its gasoline to attract new customers. It is likely that in very short order his competitors will lower their prices to his new price or respond with an even lower price, which could in turn result in a retaliatory spiral by others until all competitors realize that they are playing a "no win" game. Behavior like this was quite common in the U.S. at one time. Retaliatory moves by competitors can extend not only to price but to other issues such as, for example, product features, quality enhancements, terms and conditions of sale, and advertising as well.

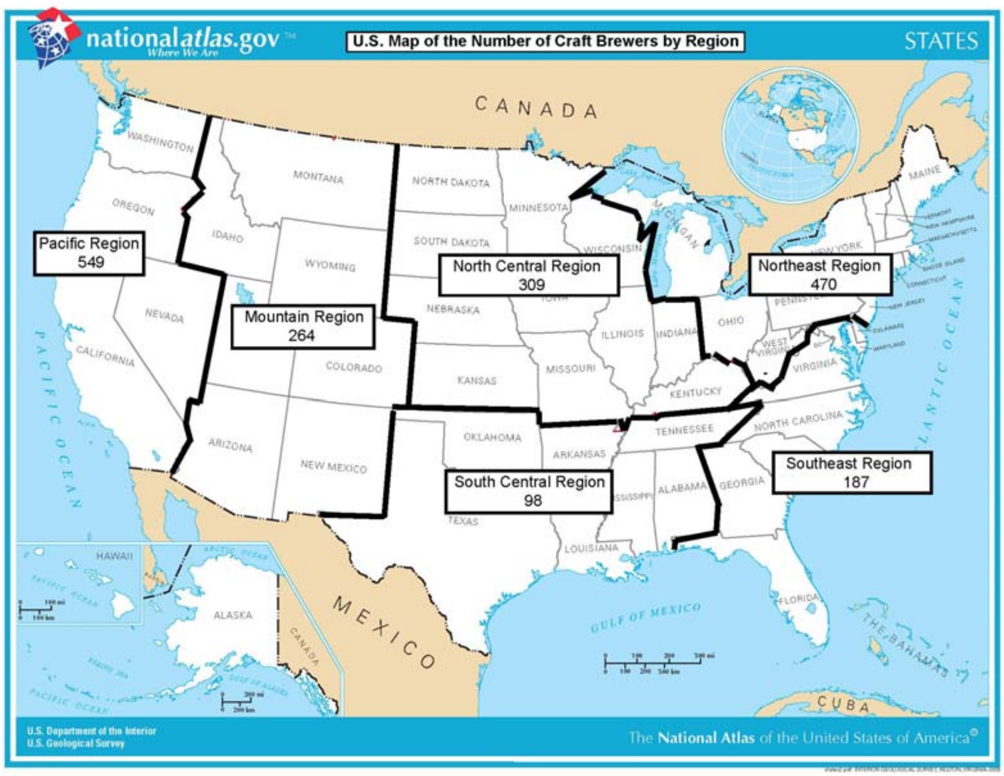
The intensity of rivalry among competing firms in an industry is influenced by:

a. the number of competing firms
b. the more equal in size and capability (power) the firms are
c. the demand for the industry's product increases or decreases
d. the ease/difficulty with which consumers can switch to other brands
e. the ease/difficulty with which firms can enter/leave the industry

f. the level of fixed costs
g. the extent to which the product is perishable
h. the diversity of strategies employed by competitors
i. the extent of merger and acquisition activity in the industry

As rivalry among competing firms intensifies, industry profits decline to perhaps the point where an industry becomes inherently unattractive. In cases like this, new firms entering such a market would find themselves struggling not only with already low profits but also hostile behaviors by existing firms attempting to protect their customer base, which would likely lower profit margins even further.

In the case of the Craft Brewing Industry, there appears to be limited competition at this time. However, as detailed in the *Substitute* section, there was a recent modification (January 2011) in the law applicable to craft brewers. The new law allows brewers to produce up to 6 million barrels and still retain their classification of craft brewers, which is a differentiating and valuable moniker in the market place. The larger volume (coupled with the higher profit margin of the craft brew industry) may make entry into this brew category more appealing to the majors, thereby potentially increasing competition in the craft brew segment.



YOUTUBE CRAFT BEER INDUSTRY VIDEOS

THE CRAFT BEER INDUSTRY

- History Channel Series: Beer Documentary-5 part series

http://www.youtube.com/watch?v=_DbPUtXtudE&feature=related

  - It's the most popular beverage on the planet - mankind's first recipe carved in stone ten thousand years ago, and today, beer still rules. The history channel journeys to find the timeless secret to beer's magic: how it's made, how it's marketed, how new beers are invented and tested and how the giants jockey for global supremacy.

- Allagash Beer - Interview with Brewmaster Rob Tod

http://www.youtube.com/watch?v=uu6MP8xYMZc&feature=relmfu

  - Meet Allagash Brewery owner and Brew Master Rob Tod up at American Flatbread in Burlington, VT, during an annual Allagash beer shindig. He shares some history of the brewery and future outlook.

- Maine Beer Company - Portland Maine

http://www.youtube.com/watch?v=q0Igw3_obc0

  - Maine Beer Company is a very small microbrewery located in Portland, Maine. They don’t concentrate on any particular style of beer. We don’t do just big beers or small beers or light beers or dark beers. Our production is limited and our process is slow (our beers are 100% bottle conditioned) but our dedication to brewing really good beer and doing what’s right always comes first.
  - http://mainebeercompany.com/About_the_Trainer.html

- Anchor Brewing Company: A conversation with craft beer pioneer Fritz Maytag

http://www.youtube.com/watch?v=0zc4p9Uwa_s

  - Fritz Maytag, longtime owner and brew master of the Anchor Brewing Company, is a central figure in the story of the American craft beer revolution. When Maytag bought Anchor Brewing Company in 1965, he blazed a new trail in the beer industry. At a time when the market was increasingly dominated by big breweries selling inexpensive, watery lagers, Maytag decided to devote his life to creating more flavorful and traditional beers.

- Dogfish Head Bitches Brew | Craft Beer Review

http://www.youtube.com/watch?v=2m0jnlwDWvA

- Marcus Guiliano, Chef and Owner of Aroma Thyme Bistro located in Ellenville, NY in the scenic Hudson Valley. Aroma Thyme is known for their "stealth health"(Zagat). The Bistro has an award-winning wine list from Wine Spectator Magazine and over 200 beers. Aroma Thyme is certified green by The Green Restaurant Association.

CRAFT BEER INDUSTRY GROWTH

- "I Am A Craft Brewer"

http://www.youtube.com/watch?v=ev5OZS75qaY

  - A collaborative video representing the camaraderie, character and integrity of the American Craft Brewing movement. Created by Greg Koch, CEO of the Stone Brewing Co. and Chris & Jared of Redtail Media...and more than 35 amazing craft brewers from all over the country. The video was shown to a packed audience of 1700 craft brewers and industry members at the 2009 Craft Brewers Conference as an introduction to Greg's Keynote Speech entitled "Be Remarkable: Collaboration Ethics Camaraderie Passion."

- Brewpot.com interviews Paul Philippon Brewmaster of The Duck-Rabbit Craft Brewery

http://www.youtube.com/watch?v=I1MgoFqg5GI&playnext=1&list=PL7E484421D5AAF404

  - Brewpot.com Craft Brewers Conference Interview Series
  - Paul Philippon
  - Craft Brewers Conference
  - Boston, MA
  - 20th-24th April, 2009

- Earnings Report: The Boston Beer Co. (NYSE:SAM) Misses Estimates, Top Line Up 3%

http://www.youtube.com/watch?v=jaot-tYhX8o

  - The Boston Beer Co. (NYSE:SAM) reported Q4 EPS of 52 cents, missing consensus estimates of 58 cents. Revenues for the quarter rose 3% year-over-year to $107.2 million, falling short of consensus estimates of $110.83 million. For 2010, the company expects EPS in the range of $2.35 to $2.65, versus consensus estimates of $2.47.

- Craft Beer Culture

http://www.youtube.com/watch?v=q-4FU0cf_VU

- Craft brewers around the nation are reporting big gains in the first half of 2010. I went over to the Craft Lager Fest in Manitou Springs and spoke to some breweries to see why craft beer's popularity continues to grow.

THE CRAFT BEER BREWING PROCESS

- How is Beer Made? The Brewing Process

http://www.youtube.com/watch?v=Ycnwc5vPaAo

  - Have you ever wondered how beer is actually made? In this video, featuring Daniel Kahn of Buckbean brewing company in Reno, NV you can learn all about the brewing process, including specifics on the importance of many of the elements that go in.

- Beer Brewing with Fritz Maytag: Anchor Brewing Co. | Pottery Barn

http://www.youtube.com/watch?v=zs4nIUsJ_ps

  - Get an inside look at the art of beer brewing, as Fritz Maytag, owner and master of Anchor Brewing Co, explains the process that goes into producing quality beer. Not only does Fritz reveal how to make beer but also how to incorporate beer into any outdoor party planning ideas.

- How to Brew Ale Beer : Tips for Brewing Award-Winning Beer: Part 1

http://www.youtube.com/watch?v=U8WjtnHgNzo

  - Learn tips and techniques for home brewing award-winning beer with expert beer tips in this free home brewing video clip. Expert: Eddie Leal Bio: Eddie Leal is an award winning Master Brewer at the Steelhead Brewing Company in Irvine, California. Filmmaker: Joseph Mann

- How we make organic beer at Orlando Brewing

http://www.youtube.com/watch?v=rj1v5g8rejg

  - Ed Canty the Brewmaster explains the organic brewing process at Orlando Brewing.

THE CRAFT BEER INDUSTRY VALUE AND SUPPLY CHAIN

- Public Hearing Feb 8, 2011 - Part 1

http://www.youtube.com/watch?v=oM-j7tSwMVQ&feature=related

- Connecticut's five breweries and several of the state's brewpubs and other beer related companies have come together to promote the local craft beer culture through a new social media website which enables beer fans to virtually connect with their favorite beer producers and each other. The web site's launch comes at a very interesting time for Connecticut beer as local legislators introduce a new bill, which, when passed, will establish official state support for the development of the CT Beer Trail.

TYPES OF CRAFT BEER COMPANIES

- What is a NanoBrewery?

http://www.youtube.com/watch?v=Qsa3agRVh_Q

  - More beer history for you, *What is a NanoBrewery* explores a new concept of brewing beer. The specifications define how to be licensed and more.

- How to Brew Ale Beer: Brewpubs Vs Microbreweries

http://www.youtube.com/watch?v=D9xmODfwaJ8&feature=fvsr

  - Learn the differences between brewpubs and microbreweries with expert beer tips in this free home brewing video clip.

THE LITTLE BEE THAT COULD: JOLLIBEE OF THE PHILIPPINES V. MCDONALD'S

Charles Rarick, Purdue University Calumet
Gideon Falk, Purdue University Calumet
Casimir Barczyk, Purdue University Calumet

CASE DESCRIPTION

The primary subject matter of this case concerns the growth of a Filipino fast food chain. It started from a single ice cream store, which later moved into hamburgers, Filipino style. Over the years Jollibee, a multi-national corporation in the restaurant industry, expanded its operation both in the Philippines and in neighboring countries. At the end of 2010 it operated 2316 stores in eight countries including the Philippines, China, Brunei, Vietnam, Spain, Indonesia, Dubai and the United States. It is now facing increased competition and a dilemma as to what direction it should go. A secondary issue examined in this case is Jollibee's unique business strategies. The case is written at a difficulty level of three, appropriate for junior level courses. The case is designed to be taught in one class hour and is expected to require 2-3 hours of outside preparation by students.

CASE SYNOPSIS

The Filipino Company, Jollibee, is imitating McDonald's in some ways but has its own twist on offering unique products that emphasize local spices and local taste preferences. This fast growing restaurant chain has benefited from the increased demand for fast food in Southeast Asia and has developed a unique business strategy. This case examines Jollibee's success and how the company is successfully competing with McDonald's. With its rapid growth, the company is now ready to expand with new concept restaurant to the rest of the world.

INSTRUCTORS' NOTES

RECOMMENDATIONS FOR TEACHING APPROACH

This case explores the activities, culture, and business strategy of Jollibee Foods Corporation (JFC), a rapidly growing multi-national company having humble beginnings. Started in 1975 as a family ice cream parlor, Jollibee has a mission to serve great tasting food that brings the joy of eating to everyone. Company founder, Tony Tan Caktiong, seeks to make Jollibee a global brand. While the company is Filipino in origin, it has expanded into a number of other countries with its unique concept restaurants. The case is diverse enough to be of value to international business, marketing, and strategy courses.

TEACHING OBJECTIVES AND TARGET AUDIENCE

This case has a number of objectives, including introducing readers to a unique Filipino business in the restaurant industry. The case examines an innovative company that has grown by developing concept restaurants using a culture-sensitive business model and a related (concentric) diversification strategy. The case is instructive in presenting a global view of business by examining the growth of a family-based ice-cream parlor in the Philippines that successfully expanded into a multi-national chain of concept restaurants. It seeks to have readers think critically about the future of international business and how cultural factors may affect a company's global strategies.

The Jollibee case is aimed at undergraduate and graduate business as well as management students. While the case is primarily targeted toward the audience in an introductory international business course, it would be a good supplement to many courses that touch upon global business issues. For example, it could be used in a strategic management as well as strategic and retail marketing courses. The case could also be used in hospitality courses focusing on the restaurant industry. This updated case demonstrates how a small company can compete with large multinational corporations in the global market.

The authors have proposed four questions appropriate for classroom discussion. However, instructors may add additional questions to fit their courses or the specific concepts they want to emphasize.

TEACHING APPROACH AND STRATEGY

The Jollibee case can be used in a variety of ways. It is appropriate for general class discussion, group project assignments, or as individual homework. The case is believed to be most useful when students have the opportunity to develop their analysis in small groups and then discuss their findings in an open forum. The case presents questions that are best explored through interaction with students having differing perspectives. A discussion of how international expansion facilitates organizational learning, for example, can lead to a rich exchange of ideas.

Since Jollibee Foods Corporation is evolving rapidly in a period of economic turbulence, it might be instructive to have students explore how the company is changing since the case was written. An investigation of changes could provide an opportunity for additional discussion and learning.

BACKGROUND

Tony Tan Caktiong is a man with a very ambitious vision. The Filipino entrepreneur who founded Jollibee in 1975 and then expanded into other franchises wants to change the way the fast food business is conducted in East Asia and beyond. He wants to develop a business model to satisfy the needs of his working customers. By 2010 he successfully operated nine restaurant chains consisting of 2,316 stores (See Table 1). Mr. Caktiong has been very successful and he plans to further expand his fast-food empire.

Table 1

Worldwide Number of Stores by Chain
Jollibee Foods Corporation

NAME OF CHAIN	YEAR			
	2007	**2008**	**2009**	**2010**
Jollibee	652	700	743	784
Chowking	402	418	431	438
Greenwich	245	231	226	223
Red Ribbon	212	239	242	259
Yonghe King	99	141	160	200
Delifrance	26	26	24	-
Chun Shui Tang	1	2	-	-
Manong Pepe’s	2	9	15	12
Hong Zhuan Yuan	-	38	41	52
Caffé Ti-Amo	-	-	-	3
Mang Inasal	-	-	-	345
Total	**1,639**	**1,804**	**1,882**	**2,316**

Source: Jollibee Annual Report, 2009, page 34 and Jollibee 4th quarter 2010 report.

Table 2

Consolidated Revenue and Income in PHP 2007 – 2010*
Jollibee Foods Corporation

	YEAR			
	2007	**2008**	**2009**	**2010****
Consolidated system-wide sales	51,550,858	58,162,821	63,729,418	70,254,000
Gross revenues	38,693,662	43,891,559	47,957,693	53,352,871
Net Income	2,388,358	2,321,817	2,666,900	3,100,630
Net Income attributable to parent	2,386,722	2,319,088	2,664,623	3,089,675
Payroll and benefits	6,308,609	7,049,833	8,170,786	NA
Personnel	32,918	39,599	38,932	NA
At year-end				
Total assets	21,945,002	27,125,701	29,727,493	32,662,246
Total property, plant and equipment	7,491.045	8,274,919	8,350,573	8,706,620
Total equity	23,648,337	14,139,831	16,285,206	17,108,036
Current ratio	1.38	1.43	1.45	0.95
Debt-to-equity ratio	0.42	0.48	0.45	0.48
Per share data				
Basic earnings per share	2.36	2.27	2.61	3.13
Diluted earnings per share	2.34	2.25	2.58	2.97
Cash dividend	0.80	0.84	0.85	2.25
Book value	12.43	13.81	15.73	16.53
Share information				
Outstanding shares - net of treasury shares	1,017,337	1,024,558	1,035,010	1,034,982

* All numbers reported, except for personnel, ratios and per share data, are expressed in thousands

** Unaudited data reported for 2010

Source: Jollibee Annual Report, 2009, page 34.

ANALYSIS

Possible answers to the discussion questions can be found below. While these are the recommendations of the case writers, they are not intended to be the definitive answers to the questions.

1. What advantages does a domestic firm have over a MNC in its local market?

The main advantage a domestic firm would have over a large multinational corporation like McDonald's or Dunkin Donuts is that it is more familiar with the domestic market and its culture. It can easily develop and offer products to match cultural traditions and domestic taste perceptions. Furthermore, the name of the stores or chain would match the language and mirror the local culture. Specifically, the arguments are the following:

a. In this case three of the chains, Yonghe King, Chun Shui Tang, and Manong Pepe's are the names of stores that fit local culture and languages.

b. The products offered by the domestic firm would specifically meet the taste preferences of the local populations.

c. The spices used in the preparation of the products would match the preferences of domestic consumers.

d. The structure housing the restaurant, as well as the colors and ambiance of its interior, are consistent with the culture of the target market.

e. Because of their networks and local connections, it is easier for a domestic company, as compared to a multi-national firm, to provide value packages that are consistent with local consumers' expectations.

f. Promotion and advertising should use domestic best practices.

2. Can Jollibee Foods Corporation continue to successfully leverage its brands and products in other geographic markets, including the United States? Explain.

Yes, Jollibee Foods Corporation can continue to successfully leverage its brands and products in other geographical markets. The following strategies are suggested as a way to achieve this end.

a. It should focus on geographical market taste preferences and try to develop products that respond to those preferences.

b. It should respond to customer preferences in terms of location, infrastructure, color, and ambiance appreciated by the local populations when designing restaurants.

c. It should invest significantly in the advertising and promotion of its products to increase consumer awareness so as to ultimately impact revenues.

d. It should develop and maintain a focus on product and service quality.

e. The products should be designed in ways that add more value and help increase customer satisfaction.

3. In what way should Jollibee expand? Which countries are likely to be profitable markets?

a. Jollibee should add a second or third restaurant chain in the countries where it currently operates.

b. India would be a good and very large target market for Jollibee. However, India is not homogeneous in terms of its population, taste preferences, and spice usage. The country's GDP is growing at an average rate of 8%. A key difficulty for foreign investors is the legal limitation which maximizes foreign ownership to 49%.

c. The United States would be another attractive market for Jollibee. One segment would be Filipino immigrants living in the U.S. Some of them may be familiar with Jollibee and its chains. Most may have preferences for Filipino foods and spices. If the company can identify cities and regions with high concentrations of Filipinos, these would be good potential markets. The two main advantages of the U.S. market are its large size and minimally restrictive entry requirements for potential businesses. A key disadvantage is the large degree of competition in the fast food industry.

d. Myanmar is still another potential market for Jollibee. This Southeast Asian country is one whose citizens may like Jollibee products, their spices, and method of food preparation. One main concern for investors and owners might be the legal requirements imposed by the military government and consumers' income level.

4. What strategic direction would you suggest for Jollibee Foods Corporation?

A proposed strategic direction for Jollibee Foods Corporation might consist of the following:

a. It should strengthen its existing brands in the countries in which it currently operates.

b. Gradually, it should expand into other geographic areas. In these new areas it may add new products that match the taste preferences of the local culture. See question 2 for additional insights to this strategy.

c. Jollibee should focus on the products that provide the most consumer satisfaction and add value to them. This approach is advocated because the quality and marketing literature consistently maintains that the cost of retaining existing customers is significantly lower than the cost of attracting new ones.

d. Lastly, Jollibee should introduce a second or third chain in those countries where it already operates.

CHANGES IN THE GLOBAL MOBILE MARKET AND NEW CHALLENGES FOR LG MOBILE

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CASE DESCRIPTION

The primary subject of this case study falls within the scope of strategy. The secondary issues examined in this case study include globalization, marketing, decision-making, growth management strategy, industry structure attractiveness analysis, and understanding competitive advantage. The case has a difficulty level of four out of five, and is appropriate for the senior level. The case is designed to be taught in one hour, and is expected to require three hours of outside preparation by students.

CASE SYNOPSIS

The global mobile phone market has long maintained a double-digit growth rate, and its total sales volume has reached 1.24 billion. Today, the global market is dichotomized into developed markets and developing markets; alternative demands dominate the former, and new demands dominate the latter. The rise of smartphones is one of the hottest issues in developed markets. Recent changes in the global market landscape, initiated by the arrival of smartphones, is bringing to an end the market domination by the top five companies—Nokia, Samsung Electronics, LG Electronics, Motorola, and Sony-Ericsson. The decline of Motorola and Sony-Ericsson, and the sudden rise of smartphone specialists such as RIM, Apple, and HTC are disrupting the market structure, and causing increasing uncertainty within the wireless business.

Despite increasing market uncertainty, LG Electronics (LGE) managed to become the third-largest global mobile phone manufacturer by 2009. However, it might be too early to celebrate, as no one can guarantee the sustainability of LGE's growth in today's highly uncertain environment. Inadequate distribution channels are preventing LGE from catching up with Nokia in the developing markets, and competition in the developed markets among high-end manufacturers is becoming fiercer by the day. Moreover, LGE lacks competitive advantage in the smartphone market, which is the only market with high growth potential. LGE's smartphone manufacturing capacity falls behind that of RIM and HTC, and LGE has to depend on Microsoft and Google for the operating system software. LGE's application store (app store) is still in a nascent stage, and its growth potential is yet to be proved. In this context, this case study will lead the discussions on how LGE can survive in this challenging new environment as a late mover in the smartphone market. Besides, with the app store—a disruptive innovation that is rearranging how digital contents are distributed—expanding its territory, discussions about

LGE's strategies and its future prospects will provide meaningful suggestions not only for the mobile phone industry but also for other IT industries.

INSTRUCTOR'S NOTES

INTRODUCTION

The global mobile phone market has long maintained a double-digit growth rate and its total sales volume has reached 1.24 billion. However, the market size in 2009 was projected to decrease by 3.2%. Despite the increasing market uncertainty, LG Electronics (LGE) took over the third place in the global mobile phone market in 2009. Besides, it achieved 23% of market share in North America, which marks the highest in its corporate history. Nevertheless, it is too risky to guarantee the sustainability of LGE's success in today's highly uncertain environment.

This case study will lead the discussions on how LGE can survive in this challenging new environment as a late mover in the smartphone market. This case study is intended to teach various aspects of strategic analysis, including internal and external analysis, and strategic choice as a function of SWOT analysis. In addition, this case study will provide students the opportunity to examine the dynamics of the mobile phone industry.

CASE OVERVIEW

Since companies operate on an open system, whether or not the company's strategy is appropriate depends on its environmental factors (Lawrence & Lorsch, 1967; Van de Ven & Drazin, 1985). Different outcomes are driven from corporate strategies, especially since the corporate environment changes dynamically (Zajac, Kraatz, & Bresser, 2000; Jansen, van den Bosch, & Volberda, 2006). Therefore, companies actively search for new success factors in a volatile environment, and continuously adjust their strategies. When companies implement wrong strategies, or change their strategies later than others, any advantages that they had can suddenly become disadvantages. LG Electronics (LGE) responded early to the WCDMA trend in order to avoid the difficulties it had faced as a late mover in the GSM market. Its success in the WCDMA market made LGE a noted global brand. However, LGE's strategic response to today's ever-growing smartphone market is relatively slow. Accordingly, finding the methods for LGE to secure its competitiveness in the new industry paradigm becomes important, and thus, this is one of the main issues taken up in this case study.

DISCUSSION QUESTIONS

(1) Evaluate the traditional mobile phone industry and the smartphone industry using Michael Porter's Five Forces Model.

The Five Forces Model, developed by Michael Porter, provides multiple criteria in evaluating the external environment of a firm (Porter, 1985, 1996). Comparing and analyzing the factors that influence the traditional mobile phone industry and the smartphone industry will provide an opportunity to discuss the core competencies that LGE needs to pursue in the future.

(2) Evaluate the key success factors of the application store (app store).

Many of the smartphone market players are concentrating their resources and capabilities on the app store, a contents market for smartphone users, due to its high value creation and switching cost for customers. LGE recently participated in this trend by opening its own App Store. Therefore, analyzing the core success factors of app stores in general will provide a basis for discussions on the kind of strategic decisions that should be made by LGE.

(3) Among the various strategies that LG Electronics can adopt (such as independent vertical integration, establishing partnerships based on strategic cooperation with OS and application providers, and partial integration through acquisition), which will be the optimal strategy to secure competitiveness in the smartphone market? Why or why not?

As this case study has suggested, in order to succeed in the smartphone market, competitiveness should be secured on the three axes of competition—handset, OS, and application. Further, to catch up in the smartphone market, where LGE is lagging behind, the possible strategies for consideration would be independent vertical integration of handset, OS, and application; partial integration through acquisition of OS or application providers; and establishing partnerships based on strategic cooperation with OS or application providers. After examining the pros and cons of each strategy, discuss what the best strategy will be for LGE.

ANALYSIS

(1) Evaluate the traditional mobile phone industry and the smartphone industry using Michael Porter's Five Forces Model.

Here, we evaluate the differing dynamics of the traditional mobile phone market and the smartphone market, using Michael Porter's Five Forces Model.

(A) Five Forces in the traditional mobile phone market

- Competitive rivalry within the industry (high)

Growth in the traditional handset market that maintained double digits for the past several years is now stagnating due to the slowdown of the global economy. Accordingly, the market leader Nokia and many other handset makers are trying to stabilize their financial status. Gartner forecasted that the mobile phone market would decrease in size by 3.2% in 2009. In this case, there would be excessive supply and short demand, which would make companies suffer from a surplus of manufacturing capacity and decrease in product price.

- Bargaining power of suppliers (high)

There are mobile communications service providers and contents providers in the traditional handset market. The mobile communications network is an essential infrastructure for the handset makers' products to function as a mobile phone. These communications networks are owned by a limited number of service providers. As for the contents, there are limits placed on their distribution by the mobile communications service providers due to wireless communications protocol regulation. Because of such factors, handset makers are highly dependent on service providers (Pfeffer & Salancik, 1978).

- Bargaining power of customers (high)

In many countries, handsets are distributed by communications service providers. Hence, handset makers have no direct distribution channel to sell their products. Even the contents services are provided by the service providers. Therefore, the quality of the product, loyalty of customers, and branding through advertisement are the only ways for handset makers to influence the consumers' decision-making process.

- Threat of new entrants (low)

The growth rate of the global mobile phone market is decreasing, and most of the market is shared among the Big 5 players: Nokia, Samsung, LGE, Motorola, and Sony-Ericsson. Moreover, achieving economies of scale is an important aspect of the handset manufacturing business. It is also very costly to construct global distribution channels. Thus, for potential entrants, the handset business is basically an unattractive market with high entry barriers.

- Threat of substitutes (low)

Although it lacks mobility, the personal computer (PC) overrules the mobile handset in data delivery performance, in the variety of contents, and in computing performances. Most consumers perceive the mobile phone as a communication tool and the PC as a computing performance tool. Traditional phones also function as a communication tool, but have very low mobility compared to mobile phones. Therefore, the threat of substitutes is relatively low.

(B) Five Forces analysis of the smartphone market

- Competitive rivalry within the industry (high)

There are five major players from the traditional market and smartphone specialists, such as RIM, Apple, and HTC, competing in the smartphone market. Besides, since smartphones use an operating system (OS), major PC makers like HP, Dell, and Acer are entering the smartphone market. Therefore, the competition within the smartphone market is expected to be highly intensive.

- Bargaining power of suppliers (high or low)

Currently, data transmission on smartphones is done through the Internet rather than a mobile communications network, due to the universal usage of a full browser. This trend is expected to extend to voice calls. Therefore, handset makers in the smartphone business would have to rely less on service providers. In the case of applications, the bargaining power of suppliers will be low if an app store established by a handset maker attracts many users, and provides sufficient incentives to application developers. Nonetheless, if the smartphone manufacturers are being supplied with applications from app stores of other companies, or if the competitiveness of their own app store is very low, the bargaining power of suppliers should be relatively high. Moreover, in the case of smartphones, there is a need for an exclusive OS that creates a new supplier-consumer relationship. Nokia and Apple, which have their own OS, might not be highly influenced by OS operators such as Google and Microsoft. However, LGE and Motorola, which do not have their own OS, show absolute reliance on such OS operators. Therefore, it can be concluded that the bargaining power of suppliers in the smartphone market will be different depending on the handset maker's capabilities.

- Bargaining power of customers (high or low)

In the case of the smartphone market, handset makers can approach customers through an app store without having to go through the service providers. Besides, if the app store continues to create customer value, the switching cost will increase. However, if the handset maker does not have its own app store, it can only approach customers through other app stores, which still gives them great bargaining power. Moreover, the increasing number of app stores provides more options to the customers.

- Threat of substitutes (high)

PCs with increased mobility, such as the UMPC, are set to be released. Of course, their communication performance is very weak, but such PCs allow data transmission and application downloads that outperform smartphones. A consumer who wants powerful computing performance will choose a UMPC and a mobile phone, rather than a smartphone. In other words, a PC can be a partial alternative to a smartphone. Consequently, PCs pose more threats to smartphones than they did to traditional mobile phones.

- Threat of new entrants (high)

There are high threats of new entrants in the smartphone market. The smartphone device manufacturing market has a high growth potential. Although some companies have insufficient production capacity, they can supplement it by forming partnerships, as iPhone and HTC successfully did. Moreover, there is a high possibility of OS operators with high software manufacturing skills entering the market in this way.

(C) Conclusion

As we can see from the above discussion, the relationship with the service providers determines the distribution coverage and the supply of contents of the handset manufacturers in the traditional market. Manufacturers who maintain close relationships with service providers, therefore, are the ones with access to distribution channels and contents. At the same time, strategies to increase the switching cost for consumers are limited, and only those manufacturers who make what the consumers demand can be favorably positioned. In this context, it is very important to achieve a successful platform strategy, and release various products at a reasonable price through economies of scale. Nokia's success derives from securing these success factors.

On the other hand, in the smartphone market, there are new ways for manufacturers to approach content developers and customers. Handset makers can create their own ecosystem by establishing their own app stores. If this ecology is successfully adopted, they can increase the switching cost for customers, and provide more incentives to contents developers. Therefore, establishing a successful app store is a core success factor in the smartphone market.

(2) Evaluate the key success factors of application stores

An application store (app store) that is in operation, or is planned to be in operation, is open to application developers. However, this openness differs from the customers' perspective. First, there are exclusive app stores such as Apple's, which only those customers with the company's device can access, and which is the only store for them to download applications. Second, there are app stores such as LGE's, which allows downloads from other app stores. Third, there are partially open app stores that do not allow other device users to access the applications but allow their customers to use other app stores.

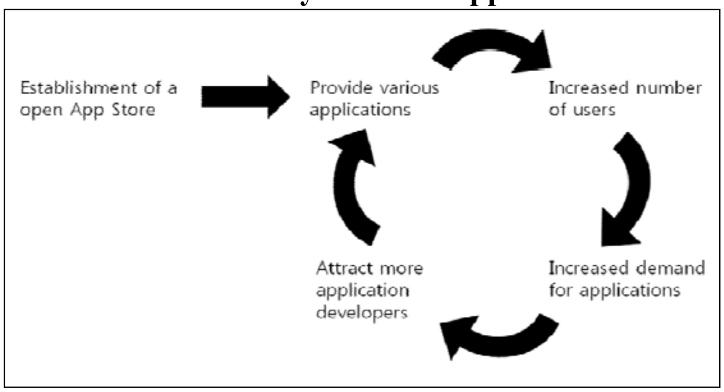
It is difficult to say which form of app store is more advantageous. In the case of an app store with an exclusive format, the users have no other choice but to purchase from their app store, so the fixed demand is always present. However, if the applications do not provide differentiating values, it will be hard to attract customers. In the case of a partially or completely open format app store, it is easier to attract new users, but there is no control over the purchase choices of the users.

Therefore, it is unlikely that IBM and Apple's competition in the PC industry, distinguished by openness and exclusiveness, will recur in the app store competition. More importantly, while it would be easy to say that Apple's past failure in the PC industry was due to its exclusiveness, it would be wrong to conclude that IBM's success in the PC market was due to its openness. If openness was the mandatory factor for success, IBM had to be the winner. However, most of the success in this market went to Microsoft and Intel.

If openness is not the factor that drives success for an app store, what then is the key success factor? The success factor can be found in the consumption patterns of the applications. On the development side, individual developers can upload their application to many app stores. However, the story is different at the consumer's end. Even if there are several options in purchasing applications, the consumer will not utilize all of them. For example, a consumer who purchased an LG smartphone with Google Android through Vodafone can have access to the app stores of LG Electronics, Google, and Vodafone. However, if these app stores fail to provide differentiating aspects, the consumer will go back to the app store he/she had dealt with in the past, or to the app store with the highest number of applications.

Therefore, the most important factor in app store competition is to be a pioneer, and to keep as many developers and users occupied as possible. If one app store is established faster than those of the competitors, there will be many more new applications uploaded, and that particular app store's users can be supplied with endless innovative applications. As a result, satisfaction will be higher among existing users, and the number of new users will increase. The higher demand for the app store will consequently attract even more application developers. However, if the competitors have already engaged many users, or if the differentiating value of the focal app store does not surpass the switching cost, it will be difficult to form the virtuous cycle illustrated below.

< Virtuous Cycle of the App Store>



It is important to establish a mobile market faster than the competitors in order to form a virtuous cycle in the app store competition. The communications service providers, OS operators, and device makers will all be in the competition. The OS operators are most likely to form a virtuous cycle, since service providers have a regional limitation and smartphone manufacturers are usually late entrants in the application market. While Apple continues to maintain a closed app store platform, Google's Android has gained great popularity in the market. Apple's case shows that exclusive app stores will be advantageous to players who have already engaged many customers, or have a very attractive hardware that will attract more new customers.

(3) Among the strategies LG Electronics can take to secure competitiveness in the smartphone market (such as independent vertical integration, establishing partnerships based on strategic cooperation with OS and application providers, and partial integration through acquisition), which would be the optimal strategy? Why or why not?

The core competencies of the smartphone market can be categorized into handset manufacturing capacity, securing an independent operating system (OS), and establishing an app store. Evaluating the capability of the current smartphone manufacturers, RIM, Apple, Nokia, and SEC have these three competencies in a vertically integrated form. RIM and Apple produced smartphone handsets based on the capabilities of their own OS and app stores, to secure competitive advantage in the smartphone market. Nokia established an independent OS (Symbian) and app store (Ovi), based on its conventional handset manufacturing capacity and exclusive market status. SEC, the global number two handset manufacturer, announced its independent smartphone OS Bada toward the end of 2009, and it is operating an app store dubbed Shop-in-Shop. Taiwan's HTC is maintaining its status in the smartphone market with its handset manufacturing capacity combined with cooperation from OS providers such as Google, and the utilization of other app stores.

Currently, LGE does not have an independent OS and is running LG Apps, which is still modest in scale and development. In order to gain competitiveness in the smartphone market, where it is lagging behind, LGE will have to quickly establish the capacity for OS and applications. The strategies LGE can take to overcome this issue include vertical integration by securing an OS and app store through independent research and development, partial integration through the acquisition of OS or application providers, and establishing partnerships with OS and application providers. Let us consider the pros and cons of each strategy that LGE could select.

- Independent Vertical Integration

Independent vertical integration refers to the establishment of OS and application capacity within a company based on its handset manufacturing capacity. LGE is focused on handset manufacturing capacity through effective internal supply of various modules for mobile phones. If LGE develops new technologies such as the touchscreen, adopts an independent OS, and establishes or operates a differentiated app store at an early stage, in addition to its existing competitiveness as a handset manufacturer, it will be able to secure competitive advantage in the smartphone market through strategic positioning via differentiation, including both optimized hardware and software. However, developing an independent OS and app store will be a challenge for LGE.

The most distinct characteristic of the competition in the smartphone OS market is that there are virtually no latecomers entering the market. The traditional computer OS providers (Google, Apple, Microsoft) and the smartphone handset manufacturers who used their own independent OS (Nokia, RIM, Palm) have firmly established themselves at the center of the market. This situation seems to have occurred due to the following reasons: a substantial amount of experience is required to develop and constantly improve a stable OS; as users become accustomed to an existing OS, new entrants have to provide value that can exceed the switching cost for consumers; and economies of scale are vital in achieving price competitiveness for the OS market. Moreover, due to its low share in the smartphone market, the mandatory application of an OS produced by LGE on LG-manufactured smartphones would end up lowering the attractiveness of the handsets.

For LG Electronics, a latecomer in the app store market, it is not easy to provide values that can appeal to both content providers and users through an independent establishment. From the content providers' perspective, they can gain profits when their uploaded applications are widely used. Therefore, content providers would naturally flock to those app stores with a sizeable number of users, or those with a high possibility of attaining such numbers in the future. Moreover, the applications provided by handset manufacturers have a low utilization rate as they function only on the particular manufacturer's handset. This will become a stumbling block in commercializing their app store unless they provide differentiated value like Apple's app store. Moreover, the chances of latecomers such as LGE establishing a virtuous cycle of app store are considerably low.

- Partnership with OS and Application Providers

The partnership strategy focuses more on the current competency related to smartphone handset manufacturing, and forges active partnerships with open OS and app store providers such as Google and Microsoft, rather than investing on resources to secure competency in the OS and application market. LGE's handsets hold a strong premium image, and have a high consumer satisfaction rating. Moreover, it can be internally supplied with the necessary modules for manufacturing smartphone handsets in an effective manner. As smartphones become more sophisticated and increasingly resemble the architecture of a PC, the knowledge and capacity accumulated in the PC industry will also contribute to enhancing LGE's competitiveness.

Currently, Google and Microsoft have developed powerful operating systems with the aim of holding Apple in check, and these operating systems are rapidly spreading in the market. Deciding on strategic cooperation at an early stage to establish strong partnerships would serve to bring favorable results. In the case of app stores, handset manufacturers and mobile service carriers who are losing influence in the mobile communications market are aiming to establish an integrated app store through partnerships. As LGE has a mobile service carrier among its subsidiaries, establishing a powerful app store through a partnership with the service carrier would be preferable, rather than establishing an app store independently. Moreover, it is important to actively adopt other app stores. This strategy is expected to achieve operational efficiency and early release of products by forming economies of scale based on LGE's strategic cooperation between its handset production, OS, and app store. However, by sharing the two critical factors of the smartphone market, namely, OS and app store, LGE might face difficulties in securing competitiveness and expanding its market share if it fails to differentiate its products.

- Partial Integration through Acquisition

This strategy refers to a partial integration by acquiring OS or application providers. It is not an easy task to secure an independent OS and an efficient app store internally. If external acquisition allows the OS and app store to be transferred to a manufacturer, it would be possible to establish core competencies at an early stage, not only for handsets, but also for the OS and the app store. Moreover, the cost and time needed for the internal development of an OS can be reduced, while users can obtain various applications. When product differentiation based on partial integration through acquisition and strategic cooperation with external parties is realized, competitiveness in the smartphone market could be secured early. However, this strategy cannot be solely implemented by LGE. It is only possible when the OS and application providers are brought to the market for sale. Currently, the OS and application providers in the market are equipped with strong competitiveness, and there is little chance that they will be offered in the market. In other words, this strategy does not appear to be possible to implement.

All of the strategies that LGE could take to secure competitiveness in the smartphone market have their own strengths and weaknesses. For LGE to secure competitiveness early in this rapidly growing competitive market, establishing partnerships with OS and application providers based on strategic cooperation holds the highest possibility for realizing success. Although this strategy is similar to that of HTC, it must be implemented with differentiation. Product differentiation, a critical factor in the growing stage of the market, is crucial for success in the smartphone market. LGE should actively appeal to consumers by differentiating and providing competitive advantage to its products by securing competitiveness in its weak sectors (OS and application) through active partnerships, and by securing leadership in its specialized sector, namely, handset manufacturing.

INTEREST RATE SWAPS AT HOLOGEN INC

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David Kunz, Southeast Missouri State University

CASE DESCRIPTION

The primary subject matter of this case is the use of interest rate swaps to lower capital costs and manage interest rate risk. Secondary issues include examining market efficiencies. The case requires students to have an introductory knowledge of accounting, statistics, finance and international business thus the case has a difficulty level of four (senior level) or higher. The case is designed to be taught in one class session of approximately 3 hours and is expected to require 3-4 hours of preparation time from the students.

CASE SYNOPSIS

Hologen Inc., a diversified medical technology company, currently operates in three business segments (Breast Health, GYN Surgical, and Skeletal Health). Hologen's CEO has suggested the company pursue an acquisition that would diversify its product line as well as increase its exposure in international markets. Hologen's vision is to become the world's largest pure-play women's health-care company. In order to achieve this status, Hologen would need to enter the diagnostic health-care segment of the industry and expand international sales.

Hologen felt the quickest and more cost effective way to accomplish these goals was through an acquisition of an existing diagnostic company with an international clientele. The company Hologen is interested in acquiring is a British firm, Cybertech. Cybertech, a publicly traded company listed on the London Stock Exchange, has a current market capitalization of about 252 million British pounds. In order to make a tender offer for Cybertech, Hologen will need to borrow the equivalent of about $200 million dollars and is exploring three different borrowing alternatives.

INSTRUCTORS' NOTE

CASE OVERVIEW

Hologen, Inc. is a diversified medical technology company that develops, manufactures, and distributes medical imaging systems and surgical products for serving the healthcare needs of women. The company currently operates in three segments: Breast Health, GYN Surgical, and Skeletal Health. The breast health segment is the Hologen's largest division, contributing to about 60% of sales. Even though Hologen is well positioned in the digital mammography idustry, with a market leading 65% share in the United States, the company is concerned the US market is becoming saturated.

To date, Hologen's current strategy for long-term growth has been focused on the breast health segment. Hologen has continued to invest in research and development to maintain a competitive advantage in the digital market. In addition, the company has focused heavily on 3 D imaging devices, which the company believes is the next frontier for digital mammography. In response to the potential vulnerability to the breast health division, Hologen's CEO has suggested the company pursue an acquisition that would diversify its product line as well as increase its international exposure. Hologen's vision is to become the world's largest pure-play women's health-care company. In order to achieve this status, Hologen would need to become a participant in the diagnostic health-care segment and increase international sales.

Hologen felt the quickest and more cost effective way to accomplish these goals is through an acquisition of an existing diagnostic company with an international clientele. The company Hologen is interested in acquiring is a British firm, Cybertech. Given Hologen's current financial position, the company would need to borrow an additional 125 million pounds (the equivalent of about $200 million) if Hologen wanted to make a cash offer to acquire Cybertech. Three different alternatives exist for Hologen to raise the $200 million. The first two are a fixed rate loan at 5%, or a floating rate note with an interest rate of 6-month LIBOR plus 1.5%. The third alternative is an interest rate swap in which Hologen issues the floating rate note for $200 million and also pays interest of 3.1% in exchange for the 6-month LIBOR on $200 million.

TASKS TO BE PERFORMED

1) *Why might investors prefer floating rate notes over a fixed rate bond?*

Investors may be attractive to floating rate notes because they carry very little interest rate risk. A floating rate note's duration is close to zero and its' price would show very little sensitivity to changes in interest rates. The price of a floating rate note issued at par value would remain constant even during a changing interest rate environment. If interest rates were to increase, the price of the bond would remain close to par value because the coupon interest rate would also increase. If interest rates were to decrease, the price of the bond would remain close to par value because the corresponding coupon rate would decrease. Because floating rates notes carry very little interest rate risk, they may be in high demand during times when investors believe interest rates will rise. For fixed rate bonds, prices and interest rates are inversely related. Hence a fixed rate bond will decrease in price when yields increase. Given the current steep upward sloping yield curve shown in Figure 2, investors may be anticipating that inflation will increase in the near future and future interest rates will be higher than current interest rates. These factors may lead to a higher current demand for floating rate notes. Although floating rate notes do not subject investors to interest rate risk, investors in floating rate notes must consider the credit risk associated with floating rate notes.

2) *Why might Hologen prefer to issue fixed rate bonds rather than floating rate notes?*

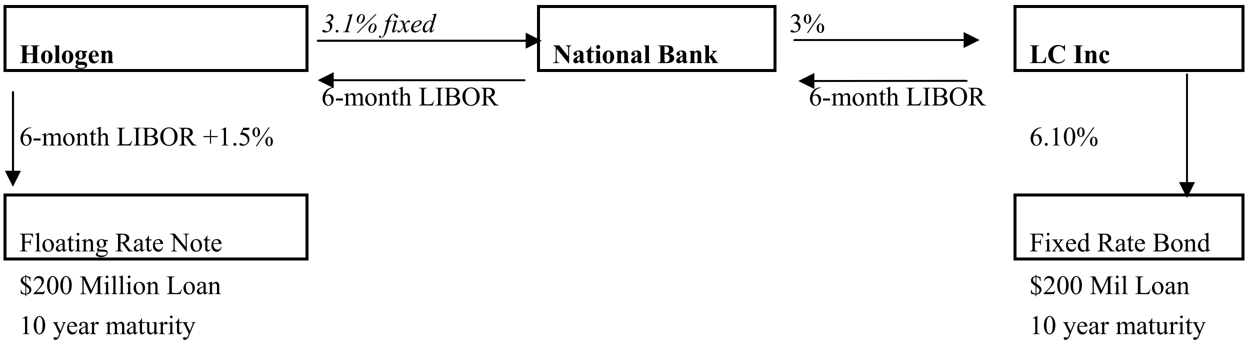
While investors may prefer floating rate notes as a way to avoid interest rate risk, the issuer (borrower) is the one that assumes risk associated with any interest rate increases. If Hologen were to issue floating rate notes, the interest rate on the loan would adjust every 6-months based on current the current interest rate environment. Over the last 10 years, the 6-month LIBOR rate has ranged from about 0.5% to 5.5% (see Figure 4). Recognizing that past interest rates are not necessarily good indicators of future interest rates, but for illustrative purposes, Hologen's range of interest rate payments on a floating rate note issued at 6-month LIBOR plus 1.5% might range from 2% to 7% over the next 10 years. In addition, the interest rate may also be higher depending on the level of future interest rates. This would add to the level of uncertainty and variability in future financial planning and cash flow management. A fixed rate bond with a 5% coupon would ensure stability and certainty in terms of future interest rate payments. Finally, Hologen is using the capital for an international acquisition. This transaction will likely expose Hologen to additional risk in terms of exchange rate risk. Hologen may not want to increase the volatility of future earnings by exposing themselves to both increased interest rate risk and exchange rate risk.

3) *What is the anomaly in current market conditions that makes an interest rate swap a viable option for both parties involved in the swap?*

Interest rates swaps are viable options for both parties due to the quality spread differential that exists in each market. The fixed rate market assigns a credit quality differential of only 1.1% between the A-rated Hologen (5% coupon) and the below investment grade LC Inc. (6.1% coupon). However, the floating rate market has determined that the quality differential is 1.9% between the A-rated Hologen (6-m LIBOR + 1.5%) and the below investment grade LC Inc. (6-m LIBOR + 3.4%). This leads to a quality spread differential (QSD) of 0.8%. Moreover, the quality spread differential may not be a unique one time anomaly as the market for interest rate swaps has grown tremendously over the last 15 years. It may also be argued that all types of debt instruments are not regularly available for all borrowers. Thus, the interest rate swap assists in completing the market for a specific form of financing desired by a particular borrower. Both counterparties engaged in the swap transaction, as well as the swap broker/dealer, can benefit from financing that is more suitable for their asset maturity structure.

Company Issuing Debt	**Fixed Rate Bond at Par**	**Floating Rate Note**	
Hologen	5.0%	6-month LIBOR + 1.5%	
LC Inc	6.1%	6-month LIBOR +3.4%	
Difference	1.1%	1.9%	QSD = 0.8%

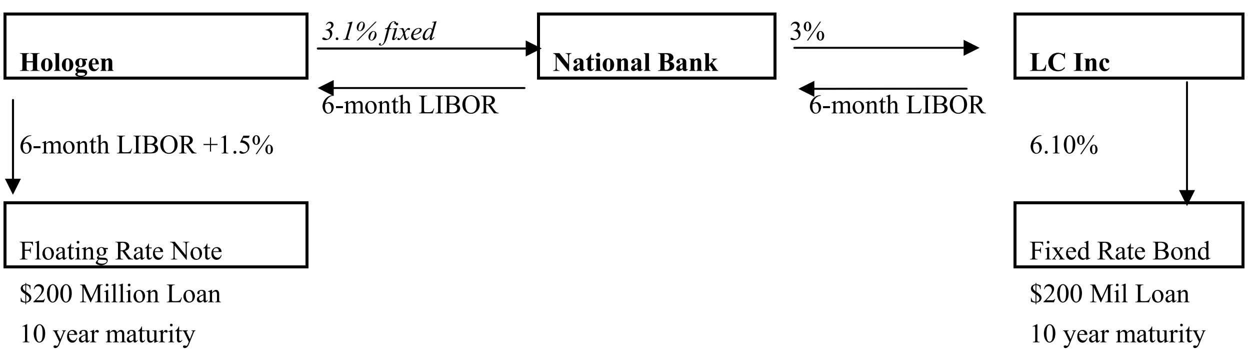
4) *If Hologen issues a floating rate note and engages in the interest rate swap, what is the net cost of financing for Hologen after the interest rate swap? How does this compare to the cost of financing if Hologen issues a fixed rate bond?*



Hologen Net Cost
Pays 6-m LIBOR + 1.5%
Receives 6-m LIBOR
Pays 3.1% fixed
Net Cost = 4.6%

Hologen's net cost after the swap agreement would be a fixed rate of 4.6% per year, which is 40 basis points lower than if they directly issued a fixed rate bond at 5%.

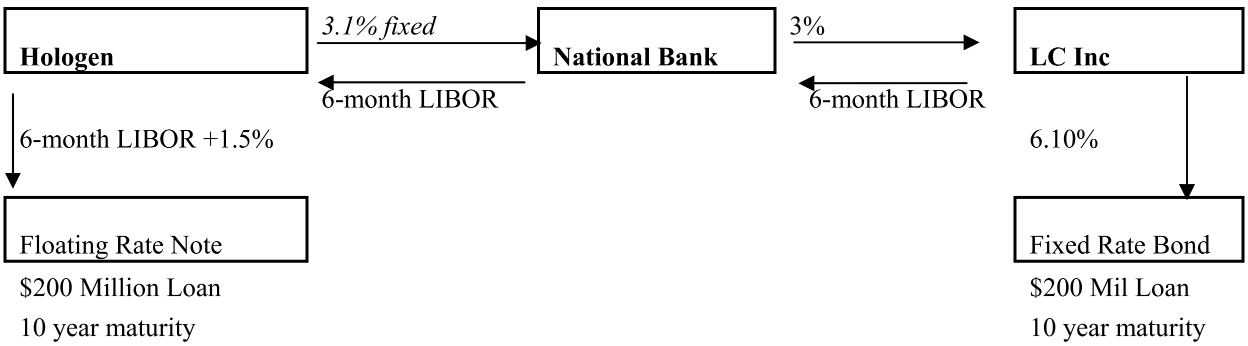
5) *If LC Inc issues a fixed rate bonds and engages in the interest rate swap, what is the net cost of financing for LC Inc. after the interest rate swap? How does this compare to the cost of financing if LC Inc issues a floating rate note?*



LC Inc Net Cost
Pays 6.1% fixed
Receives 3%
Pays 6-m LIBOR
Net Cost = 6-m LIBOR +3.1%

LC Inc.'s net cost after the swap agreement would be a variable rate of 6-month LIBOR plus 3.1%, which is 30 basis points lower than if they directly issued a floating rate note of 6-month LIBOR + 3.4%.

6) *What is National Bank's role in the interest rate swap and how much will they be compensated for their involvement in this transaction?*



National Bank
Receives 3.1% fixed
Pays 3% fixed
Receives 6-m LIBOR
Pays 6-m LIBOR
Receives Net = 0.1%

National Bank acts a broker for the interest rate swap between Hologen and LC Inc. As the financial intermediary for this transaction, National Bank will receive 10 basis points over the notional amount of the transaction or $200,000 per year.

7) *How does the interest rate swap reduce the cost of borrowing for both parties and allow the intermediary to be compensated?*

The ability of the interest rate swap to reduce costs lies in the difference in perceived credit quality across financial markets. The interest rate swap exploits the comparative advantage of different borrows in different markets. For example, Hologen is borrowing in the investment grade market and LC Inc is borrowing in the below investment grade market. Hologen has a lower credit risk and can borrow at a lower rate in both the fixed and variable rate market. However, Hologen's comparative advantage lies in the variable rate market where they borrow at 190 basis points less than LC Inc. LC Inc is a higher credit risk and is forced to pay more in both the fixed rate market and variable rate market. However, they only have to pay 110 basis points more to borrow in the fixed rate market, hence the fixed rate market is their comparative advantage. The quality spread differential is 80 basis points for the proposed interest rate swap (190bps – 110bps = 80 bps). The quality spread differential is shared among the participants to reduce costs or act as compensation for the financial intermediary. In this particular swap, Hologen was able to reduce their borrow costs by 40 basis points, LC Inc. 30 basis points and National Bank was compensated at 10 basis points per year.

MURPHY WAREHOUSE COMPANY

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CASE DESCRIPTION

The primary subject matter of this case concerns how sustainable business practices and increased profitability can go hand in hand. Making decisions that are both environmentally responsible and advantageous to the business often requires the assessment of a variety of tangible and intangible factors and the reconsideration of traditional decision making guidelines. Richard Murphy Jr., the CEO of Murphy Warehouse Company, has spent a great deal of time analyzing sustainable ways to conserve resources, reduce costs, improve the well-being of his employees, and promote his company as an environmentally responsible logistics provider. Murphy also realizes that the benefits of sustainable projects must be weighed against the costs and payback periods of these investments. The case has a difficulty level of three or four, appropriate for junior and senior level students. The case is designed to be taught in a one-hour class period, with two hours of outside preparation by students.

CASE SYNOPSIS

Imagine that you are Richard Murphy Jr., the CEO of Murphy Warehouse Company, a family-run company that began over 100 years ago. You feel the weight of responsibility to maintain the financial viability of the company that is now in its fourth generation of family ownership. One of your biggest challenges is to understand how the company should adapt to a changing business environment while conserving the company's financial resources and protecting the core business model that has sustained it for so long.

One major force in the current business environment is the sustainability movement, which focuses on the responsible use of natural resources. If you are Richard Murphy, you are trying to find the opportunities to adopt sustainable practices that also make financial sense to Murphy Warehouse Company. While you have successfully implemented several sustainable projects in your company, you are now faced with deciding to invest over a half million dollars in a stormwater project that presents an unusually long payback period. It is a complicated decision that involves high expense, multiple tangible and intangible variables, and a fair amount of risk that something might go wrong. What do you do?

INSTRUCTORS' NOTES

RECOMMENDATIONS FOR TEACHING APPROACHES

The case can be used as part of a course module on sustainability in supply chain management. While other textbook and article readings can be used in conjunction with the case, the case can also be used as a stand-alone introduction of sustainability in business decision making. The case contains a detailed background on the evolution of sustainability and its rise in importance to executives in both small and large businesses. It also describes the agencies that provide guidance on best practices, establish and communicate standards for sustainability, and grant certifications for sustainability achievement. These agencies include the U.S. Green Building Council (USGBC), the Leadership in Energy and Environmental Design (LEED), and the International Organization for Standardization (ISO) 14000 series for environmental norms.

The case instructor should have the students read the case outside of class and prepare answers to the discussion questions contained in this note. At the beginning of the class session, the instructor might consider having the students discuss their answers in small groups with fellow students. The instructor might open the class discussion with the question, "Who is Richard Murphy?" This is a great launching point for discussing the case issues. The question fosters discussion of issues such as the culture and business goals of the Murphy Warehouse Company, Richard Murphy's priorities as the CEO, the relevance of his training as a landscape architect, his appreciation for the long-term nature of his business, and the need to project his company as an attractive business partner for companies who include sustainability in their selection criteria.

CASE OVERVIEW

This case is focused on a real company, Murphy Warehouse Company, and its CEO, Richard Murphy Jr. The facts and statistics communicated in the case are real, and the data were collected from interviews with Richard Murphy and the documents, financial figures, and information that he provided.

Murphy Warehouse Company is a family-run company that began over 100 years ago. As CEO, Richard Murphy understands the weight of responsibility he has to maintain the financial viability of the company that is now in its fourth generation of family ownership. One of Murphy's biggest challenges is to understand how the company should adapt to a changing business environment, while conserving the company's financial resources and protecting the core business model that has sustained it for so long.

A major force in the current business environment is sustainable (green) practices, which focuses on the responsible use of natural resources. The case depicts Richard Murphy trying to find new opportunities to adopt sustainable practices that also make financial sense to MWC. Murphy has successfully implemented several sustainable projects that financially benefit the company, but now he must decide whether to invest over a half million dollars in a stormwater project that presents an unusually long payback period. It is a complicated decision that involves high expense, multiple tangible and intangible variables, and a fair amount of risk that something might go wrong.

One of the main goals of the case is to move away from the mindset that green practices are primarily for businesses who are willing to sacrifice sound financial decision making models to pursue ethical and moral imperatives to "do the right thing" for society and the environment. The case strives to show how sustainable practices can be part of running a business that can tout its environmental achievements while maximizing long-term profits.

The case provides financial details on the conversion of lawn to prairie so the students can calculate a payback period that shows this project made financial sense (further discussion in case questions below). The lawn to prairie conversion also introduces several intangible and less quantifiable important benefits, including the reduction in the urban heat island effect, the attractive natural buffers between MWC and adjacent properties, and the attraction of wildlife to the area. Murphy has also gained a great deal of positive publicity for his prairie conversion project by sharing his experience at professional society meetings, local universities, and print media publications.

Other projects at MWC that are described in the case provide further evidence that sustainable investments and profitability can go hand in hand. The purchase of dock blankets, the upgrade in the lighting systems, painting the ceilings white, and installing HAT heating units should be identified in the class discussion as examples where green initiatives and disciplined financial decision making can be complementary.

The decision point of the case, where Murphy is evaluating the feasibility of the stormwater project, challenges the students to put together the lessons of the case and make a decision. The instructor should ask the students to evaluate the pros and cons of the stormwater project, considering both tangible and intangible factors. The payback period should be calculated, using the numbers provided in the case. The students should discuss whether the significantly longer payback period can be justified (compared to traditional business practice and to previous projects at MWC).

Finally, the instructor should demonstrate to the class that sustainability is part of the "continuous improvement" management philosophy. The case demonstrates this by mentioning Richard Murphy's explorations of new energy technologies in solar, wind, and geothermal. He seeks partnerships with local utilities and researches government incentive programs that enhance the financial returns for businesses that adopt green practices. Making sustainability part of on-going company culture and management practice is promoted by the USGBC, LEED, and ISO 14000 organizations, as described in the case. The case also mentions several times that sustainability practice is a necessary part of being a player in the competitive marketplace in terms of attracting clients and building positive public relations.

DISCUSSION QUESTIONS

1. <u>What are the payback periods for the a) lawn-to-prairie conversion project, b) the dock blankets, c) the T-8 lighting systems, and d) the stormwater project?</u>

Answer:

a) The prairie conversion project payback is calculated as the per acre prairie installation cost ($6,575), divided by the difference between the annual per acre cost of lawn maintenance ($5,167.06) and the per acre cost of prairie maintenance ($707).

$$\frac{\$6{,}575 \text{ prairie installation cost}}{(\$5{,}167.06 \text{ lawn maintenance} - \$707 \text{ prairie maintenance})}$$

$$= 1.47 \text{ years payback}$$

b) The dock blankets were paid back "within a few months" in heating bill savings.

c) The T-8 lighting fixtures were paid back in "14-16 months."

d) The stormwater project payback is the installation cost divided by the annual savings from avoiding municipal stormwater fees.

$$\frac{\$580{,}000 \text{ installation cost}}{\$68{,}000 \text{ annual stormwater fees}}$$

$$= 8.53 \text{ years}$$

2. <u>Calculate the Net Present Value (NPV) of the stormwater project, given the financial information in the case.</u>

Answer:

Using the assumptions stated in the case, the total discounted cash flow over 15 years would be $730,630. Subtracting the up-front capital requirements of $458,200 provides a Net Present Value of $272,431.

3. <u>Evaluate the pros and cons of the stormwater project on both financial and non-financial factors and make a recommendation on what Richard Murphy should decide.</u>

Answer:

<u>Financial Factors</u>

Pros:

- The annual savings on stormwater fees are permanent and certain, so the project eventually will pay for itself. Also, these fees are likely to rise over time if the project is not implemented (in the NPV calculation, stormwater fees are assumed to increase at a 5% annual rate).

- The stormwater storage system is a long-lived asset that will produce positive cash flows over a 15 year period, without requiring additional fixed or variable costs to operate.

Cons:

- The payback period of 8.53 years is longer than the 3-4 years that is generally considered acceptable in conventional financial analysis for projects.
- The $580,000 estimate might have to be revised upward if complications with soil, utilities, etc. are encountered during construction.
- The costs of disruptions to normal operations during the construction period (overtime and other costs) are over and above the $580,000 estimate.

Non-Financial Factors

Pros:

- MWC is family-owned and doesn't have to be concerned with outside investors who might want to stick to conventional financial analyses that have shorter payback time horizons for project approvals.
- MWC has a long-term orientation and is closely tied to the community in which it has operated for over 100 years. MWC wants to do the right thing for the community.
- Investing in sustainable projects is a good way to solicit new business and promote the company to the public. In fact, major corporations may soon look for and require service providers to maintain sustainability certifications in order to help them achieve their sustainability goals.
- Researching, planning, and implementing sustainable projects provide significant learning opportunities that will benefit MWC in the long term.

Cons:

- The $580,000 is a significant investment and there are opportunity costs of not using these monies for other worthy projects that benefit the company (e.g. construction of new facilities and purchase of additional equipment).

4. How do sustainability projects fit with the goals of supply chain management strategy in any company?

Answer:

As noted in the case, sustainability projects offer significant opportunities on both the cost side in energy savings and on the revenue side in attracting and keeping business partners who seek relationships that promote environmentally responsible business practices. Supply chain management strategy focuses on the overall performance of all players in the supply chain in serving the end customer. Since customers are increasingly requiring environmentally responsible behavior from providers of products and services, companies can ill-afford to ignore environmental imperatives.

There is convincing evidence that sustainability is a strategic theme that is being adopted by a wide variety of companies and industries. For example, Golicic, et al. (2010) identified 44 Fortune 500 companies that addressed in some fashion transportation emissions in their supply chains. These companies were classified into three categories of involvement: establishing a foundation, changing internal company practices, and impacting supply chain practices.

At the "establishing a foundation" level, a company takes steps to acknowledge the impact of its transportation policies and practices on emissions. In this level, companies develop goals for limiting transportation's impact (e.g., FedEx Corporation has set a goal to improve overall fuel efficiency of its commercial vehicle fleet 20% by 2020), use metrics to measure the impact (e.g., Office Depot Inc. measures its fuel usage and associated greenhouse gas emission improvements), and forms partnerships with other organizations that can help achieve their goals (e.g., partnerships with the U.S. Environmental Protection Agency's SmartWay program).

Twenty-eight companies showed their involvement beyond the foundation level by initiating changes in the internal company practices. These include, educating personnel to reduce their transport related carbon footprint (e.g., establishing employee commuter programs) and using more energy efficient vehicles (e.g., Johnson & Johnson is using a large number of hybrid vehicles in its corporate fleet; Office Depot is replacing oversized diesel delivery trucks by the lighter more efficient cargo vans; Freight carrier CSX Corporation is upgrading its fleet with more efficient clean air locomotives).

Twenty-two Fortune 500 companies in the Gulicic study have entered the third level where companies use technologies and operational tactics in ways that aggressively minimize greenhouse gas emissions from freight management in their supply chains. For example, Tyson Foods Inc. remotely monitors engine diagnostic information and reduces truck idle time; Lowe's strives to switch loads to more environmentally friendly modes from road transport to rail when possible; FPL Group Inc. uses alternative fuels such as soybean diesel, to reduce pollution, and United Parcel Service Inc. uses software to optimize delivery route to minimize distance traveled per delivery.

5. <u>What are the advantages of pursuing LEED, Energy Star, and ISO 14000 certifications?</u>

Answer:

Environmental certifications are a way to objectively demonstrate to customers and the public that the company has achieved noteworthy accomplishments in sustainability. The guidelines and standards of certification processes also serve as tools that the company can use to map its sustainability goals. The certification processes provide structure that the company can use to make sustainability part of its culture of continuous improvement.

EPILOGUE

MWC went ahead with the stormwater retention project. The project went smoothly and did not encounter significant unexpected costs. Richard Murphy Jr. is considering installing solar cell technology on the roofs of MWC's warehouses, as well as possibilities for wind turbines that have low profiles and are also roof-mountable. Murphy considers it essential that MWC never stop learning and experimenting with new ways to use sustainable projects to both strengthen MWC's competitive position while doing the "right thing" for the environment.

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FIGHTIN' MAD IN THE SOUTH: WHAT'S HAPPENING AT WORK?

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CASE DESCRIPTION

The primary subject matter of this case is workplace homicides in the South. Other issues include variations of work-related homicides by region, examples of workplace homicides, reasons why the Southern states have the most homicides, a profile of the Southern workplace killer, and how employers can prevent or mitigate workplace violence. The case has a difficulty level of being appropriate for senior level or first year graduate classes. The case is prepared for two hours of instruction and discussion. The students should receive the case earlier and be prepared to discuss the ramifications of the case together with the instructor.

CASE SYNOPSIS

Workplace violence resulting in homicides continues to be a major concern for companies. While most companies have their Violence Prevention and Management Plan policies in place, it is still one of the most feared management nightmares. Of particular interest is a comparison of workplace homicides in the different regions in the United States. When comparing these regions for a thirteen (13) year period from 1997-2009, (representing the most recent available data), the South easily leads the country in both workplace homicides and violent acts of employees. Of the total 8127 workplace homicides during this period, the South had 3784, representing 46.6% of the total, followed by the West with 1639 or 20.2%, the Midwest with 1491 or 18.3%, and the Northeast with 1212 or 14.9% of the total. There are a number of potential reasons as to why the South has such a profound lead for violence in the workplace. In particular, Southern culture, employee behaviors, the work environment, and the current high unemployment rate are discussed. Actual examples of workplace homicides are provided.

INSTRUCTORS' NOTES

QUESTIONS

1. What are some of the factors that exacerbate workplace violence?

Factors such as stress, job insecurity, corporate downsizing, personal financial problems, and substance abuse are just a few of the trigger mechanisms that may lead to workplace violence. Major layoffs, terminations, early retirements, acquisitions, sales, mergers, takeovers, and corporate restructuring have all been a very real source of fear during the last 30 years.

2. Give a profile of a workplace killer in the South.

- a middle-aged Caucasian male
- is profoundly narcissistic, holds himself out to be superior
- exhibits a great sense of entitlement
- inclined to feeling powerless when rejected
- feels he is a victim of injustice
- are controlling and demanding, making co-workers uncomfortable
- are prone to multiple gun ownership with a fascination for weapons
- are task-oriented rather than people-oriented, insensitive to co-workers
- excessive drinking or drug abuse
- has been laid off or terminated from employment
- finds identity in his job
- blames others for his problems
- sudden changes in behavior (particularly appearance or attitude)
- has a history of depression or paranoia
- files numerous grievances and makes "mountains out of molehills"

3. What can a company do to prevent or mitigate the consequences of violence in the workplace?

Companies are responsible for providing their employees with a safe place to work. To aid in the prevention of workplace violence, companies should offer training to all employees. Training teaches supervisors what to look for in potential violent employees. Outplacement services should be offered by companies who are downsizing. Outplacement can consist of contacting an unemployment agency to expedite claims and contacting temporary agencies to help place workers in jobs. Counseling should also be provided for workers who are laid off or terminated for reasons out of their control. Prescreening potential employees should also be a focus of the human resource management department. While these services may be costly to companies, they will be better off if they are prepared.

4. Why Is It So Difficult To Protect Employees At Work?

Because employees need unlimited access to the workplace and to their co-workers, employee violence is the hardest to control. Interpersonal relationships tend to develop more in a team atmosphere which is frequently found today. The need for the average worker to depend on his or her co-worker puts strain on that relationship and can often lead to violence. Personality conflicts are cited as the leading cause of workplace violence (registering at 38%) in a 2001 report of the Society of Human Resource Management. Family and martial problems accounted for 15 percent of the incidents, drug and alcohol abuse was cited for 10 percent, seven percent was attributed to firing and layoffs, and only two percent of the acts were due to a violent criminal history.

5. In which industries does one find more homicides?

Workplace violence is not distributed randomly across all workplaces but is clustered in particular occupational settings. More than half (56%) of workplace homicides occurred in retail trade and service industries. Homicide is the leading cause of death not only in these industries but also in the financial, insurance, and real estate sectors. Eighty-five percent of nonfatal assaults in the workplace occur in service and retail trade industries. As the U.S. economy continues to shift toward the service sectors, fatal and nonfatal workplace violence will be an increasingly important occupational safety and health issue.

6. Can you find similar characteristics of the perpetrators in the examples given?

Answers will vary for this question.

7, What can an employer do to reduce the risk of workplace violence?

- Implement a “zero-tolerance” policy as to violence that is communicated from, and modeled by, every level of management. Include a statement in that policy that weapons are banned from the premises.
- Train supervisors and managers to recognize and report troubling conduct.

- Require employees to report any threats and abusive behavior. If possible, set up an anonymous system of reporting. Be sure to investigate all threats of violence.
- Have an action plan in place for responding to an incident of workplace violence. Take proactive steps during the hiring process:
- Conduct thorough background checks.
- Make sure applicants identify all prior employers and their reasons for leaving each former place of employment. Ask applicants to explain periods of unemployment.
- Check references.
- Make job offers conditional upon satisfactory results from reference and background checks.
- Make sure reasons for termination are not a surprise. Provide employees with regular oral and written evaluations of their performance, including specific goals, areas of improvement and an express statement of what will happen if no improvement is shown.
- Think ahead and take appropriate precautions when terminating employees:
- Consider offering post-termination assistance such as severance pay, career counseling or your company's employee assistance program.
- Assess your security measures regularly. Easily fixed, but often missed, areas of potential risk include broken or ineffective locks and poor lighting, especially in parking areas.

8. Why is workplace violence in the South so prevalent?

In the South, there is an easy access to guns. Guns can be easily purchased not only at regular gun shops and gun exhibits but also at trade shows, craft and collection gatherings, and parking lot swap meets. At the informal gatherings, no identification is necessary nor is a registration made of the gun transfer. In the South, there is a 'macho' image attached to guns and weapons. The South has a high acceptance and tolerance of guns. In the rural areas, guns are used for protections and hunting. Women have guns and know how to use them. This is acceptable behavior. Children are taught to use guns as they grew up around them. Children are given guns at an early age, with many boys receiving b-b guns or pellet rifles when they are as young as 7 or 8. There is a tolerance of violence (as protection of the 'old way' of life). In addition, for many people there is a tolerance and/or appreciation of the KKK, Alabama Militia and other organizations such as these. Lastly, people take pride in the ownership of their guns, showing them off to their friends and fellow workers. An example, in our immediate area was a terminated worker came in with a shot gun and killed his boss. All the witnesses told police that they thought he was showing off his new gun so no one attempted to stop him.

9. Do you agree with the authors' perceived connection with excessive workplace violence and the South?

Answers will vary for this question.

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