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LETTER FROM THE EDITORS

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

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

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

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Inge Nickerson, Barry University

Charles Rarick, Purdue University, Calumet

WAR IS BUSINESS AND BUSINESS IS GOOD FOR THE UNITED STATES: THE MILITARY ARMS INDUSTRY GOES GLOBAL

Charles A. Rarick, Purdue University Calumet
Roberta A. Brooke, Eastern Washington University
Claudia C. Mich, Purdue University Calumet

CASE DESCRIPTION

The primary subject matter of this case concerns international trade and comparative advantage. Secondary issues examined include social responsibility and international relations. The case has a difficulty level of three, appropriate for junior level courses. The case is designed to be taught in one class hours and is expected to require four hours of outside preparation by students.

CASE SYNOPSIS

This case explores the growing international trade in military goods by the United States as the defense industry tries to accommodate a declining domestic market. The case explains the complexities in dealing with exports that require government approval, involve political jockeying, and are controlled by various governmental agencies. The case looks at military markets and manufacturers, and explores the legitimacy of exporting war machinery at record levels and at the same time promoting global peace.

"Every gun that is made, every warship launched, every rocket fired signifies, in the final sense, a theft from those who hunger and are not fed, those that are cold and not clothed. The world in arms is not spending money alone. It is spending the sweat of its laborers, the genius of its scientists, the hope of its children … President Dwight Eisenhower, 1953[1]

INTRODUCTION

President Eisenhower was a general, a man of war. A very successful commander in Europe during the Second World War, and in fact could be argued to have been the most powerful commander in the history of the world given the tremendous powers of the Allied invasion of Europe and the subsequent end of the War. It was General Eisenhower, who as later President Eisenhower in his farewell address to the nation coined the term "military industrial complex." He warned that the military, defense contractors, and Congress had formed a close relationship that was not in the best interests of citizens and taxpayers. A common battle cry of hippies and other anti-war protesters during the Vietnam War, the term has since fallen out of favor. The term could be used again, in a somewhat different context, to describe the growing U.S. trade in military equipment throughout the world. This new "complex" consists of defense companies seeking to sell weapons, politicians seeking to protect jobs, and defense contract researchers seeking to keep their funding.

The United States is the world's largest manufacturer and exporter of military equipment. Not only is the United States the number one exporter of this equipment in terms of revenue, the exports are considered to be the best in the world. For all the talk by politicians in Washington about peace, human rights, and eliminating weapons of mass destruction, there could be a perceived paradox in the United States being the world's largest supplier of goods that kill people. The defense industry of the United States, however, is facing potentially difficult times ahead as two wars come to an end and federal budget deficits become an increasing concern. The likelihood that defense spending by the United States will decrease is very real and American jobs are at stake. A possible solution is to increase the export of military hardware to the many countries that desire such goods.

NOT BUSINESS AS USUAL

The military weapons industry isn't like most. Selling tanks, drones, and attack helicopters isn't quite the same as selling soap or soda. While international business transactions may be more complex than domestic sales, the marketing and selling of war equipment is far more complex and regulated. While international business transactions may in some way be affected by politics, arms sales are especially affected by political activities. By the very nature of the business almost all sales are made to governments. Political changes can create or destroy market opportunities for weapons manufacturers. Politicians can be directly or indirectly involved in arms sales as well. While American embassies have for some time been marketing U.S. weapons to their host governments, the Obama administration has been especially active in promoting military equipment exports to strategically friendly countries. For example, at the 2012 NATO summit, President Obama was reported to have been personally pressuring the president of Turkey to purchase U.S. manufactured drones for his country. Earlier in the same year the President took the somewhat controversial move of adding South Sudan to the list of countries approved for military exports. South Sudan, the world's newest country broke away from Sudan in an effort to stop violence in the country. South Sudan faces threats from its neighbor to the north (Sudan) over oil reserves and revenue and has already been labeled a "pre-failed state". President Obama also moved to loosen controls over dual-use technology in order to boost exports. Dual-use technology can have both military as well as civilian applications.

Weapons can be promoted in a number of ways, from diplomats hawking a country's goods, to sophisticated arms trade shows which feature the latest in war machinery. The world's largest military and security trade show is called Defense and Security Event International (DSEI). At this annual event companies display their wares which include tanks and trucks, fighter jets, missiles, assault rifles, and other military gismos and gadgets. Weapons can also be promoted to a more general audience in the hope of generating goodwill and support for the company, in addition to reaching key purchasing decision-makers. For example, in 2010 residents of the Washington, DC area noticed a flurry of defense contractor ads appearing on billboards, in newspapers, and on subway trains. The ads were targeting the small circle of defense decision-makers and others who influence domestic defense purchases. Key defense contracts were up for the bidding at the time and the defense companies wanted to positively portray their firms.

International sales of military equipment are controlled by a number of government agencies that seek to protect national security and promote foreign policy objectives. In addition there are laws that regulate the sale of weapons abroad and Congressional oversight of those laws. In some cases the United States Congress may block the sale of military equipment when it feels the sale is not in the best interests of the country. The main piece of legislation covering arms sales abroad is the Arms Control Export Act. The Act authorizes the President to define military arms and to regulate their sale. Which goods and which countries can receive what goods are influenced by this presidential power. There is congressional oversight on sales over \$1M; however, large sales are sometimes broken into smaller orders to avoid the \$1M threshold and oversight. Congressional oversight can also be influenced by which political party holds power at the time of the controversial sale.

When the laws are broken, weapons manufacturers (and others) can be penalized for selling products that are contrary to the law. While selling nuclear technology to North Korea or Iran would obviously be against national security interests, sometimes the situation isn't so easy to determine. In 2006, Boeing was charged with violating the Arms Control Export Act for selling commercial aircraft that contained a gyro-chip considered too sensitive for export to some countries. The chip could be used for guidance in missile systems and some aircraft went to China. Boeing was fined \$15M for violating the Act. This was not the first time Boeing had been fined, and Boeing is not the only company to be charged under the Act.

In addition to the Arms Control Export Act, there are other laws that can control military sales including the Trading with the Enemy Act of 1917. This law gives the President broad powers in terms of trade with hostile countries and could be relevant at times to the sale of arms. Additionally, there are countries sanctioned by the United States and trade is restricted with those countries for a variety of reasons. The United States is also a member of some multinational nonproliferation agreements and groups that can influence military trade such as the Missile Technology Control Regime (MTCR) and the Wassenaar Agreement. The MTCR seeks to regulate the exports of certain types of missiles and the Wassenaar Agreement has provisions covering dual-use technology. When selling weapons, companies must be aware of governmental restrictions, as well as the possible help from the government that may be offered when the sale facilitates national interests.

MAJOR MARKETS AND MANUFACTURERS

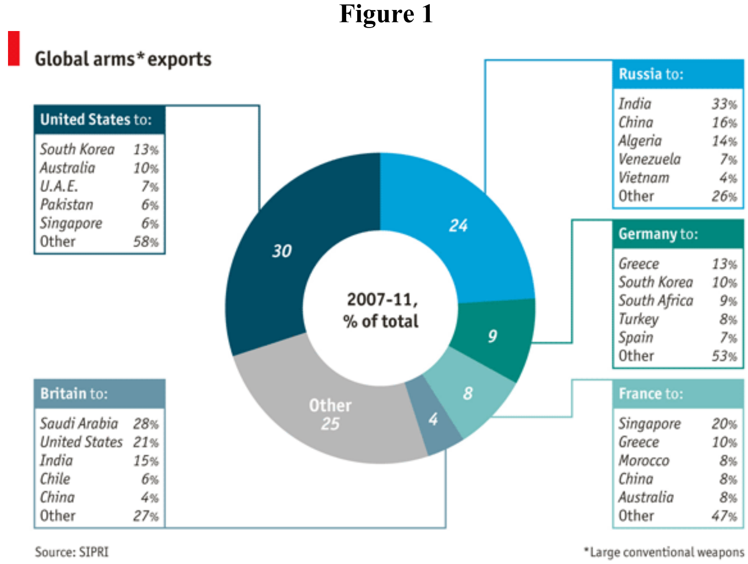
With the easing of restrictions on foreign sales, increased tensions in some parts of the world, and some economies experiencing rapid economic growth, foreign weapon sales are at record levels. Newer weapons and security systems such as the unmanned drone, as well as the continued popularity of older products such as the F-15 fighter jet have boosted U.S. exports. Between 2000 and 2011 signed orders for military equipment for export tripled. Drones in particular may prove to be a popular export in the future with the government of Iraq already placing a large order, and serious consideration of large orders being pondered by Japan, Australia, Holland, Kuwait, Pakistan, and others. Drones equipped with weapons (or the weapons sold as attachments to existing drone) such as the Hellfire missile may soon also be sold to a select group of allied countries. Currently only Britain is eligible to purchase this technology, however, the Obama administration is seeking to expand sales of the weapon. Not everyone in Congress agrees with selling the latest in American military technology abroad including Senator Dianne Feinstein, chairman of the Senate Intelligence Committee.

Iran's efforts to enrich uranium have been good for military sales in the Middle East. Export markets for U.S. arms include Saudi Arabia, Kuwait, Iraq, the United Arab Emirates, Oman, Qatar, Turkey, and Israel. Southeast Asian countries are also good potential customers for American-made weapons. According to the Stockholm International Peace Research Institute, the sale of weapons to Southeast Asia has been growing very significantly, up some 185% in recent years. Three reasons account for the rapid increase in Southeast Asian military spending. One reason is the growing economies of the region and the ability to upgrade defense abilities. Another reason is the rapid rise in spending of China on its military. China's rise is seen by many in the region as a potential threat to their own security and sovereignty. While some countries in the region resented the influence of the United States in their part of the world, attitudes have changed a bit as China has advanced towards superpower status. Lastly, a potentially significant threat to peace in the region has emerged over a group of islands in the South China Sea which up until recently were not considered of much importance. The Spratly Islands, located in between Vietnam and the Philippines are claimed by a number of countries in the region, perhaps most significantly by Vietnam and the Philippines. China, using an old map referred to as "nine-dashed line" has claimed ownership of the islands. The islands are in the South China Sea (recently renamed the West Philippines Sea by the government of the Philippines) but are far from China's coast. The islands recently became of interest as their potential for delivery of a very significant quantity of hydrocarbons became known. The "nine-dashed line" has questionable legal standing; however, military strength could settle the argument. Consequently, while Vietnam, the Philippines, and other small countries in the region could not match China in military power, more modern weapons could send a signal to China that at least negotiations of legal claims to the islands is prudent. Vietnam has registered strong and vocal protests to China's claim and the Philippines is talking about its 1951 Mutual Defense Treaty with the United States. The Treaty, in theory, would compel the United States to protect the Philippines if attacked by a foreign power such as China. The situation is potentially troublesome and complex, and its outcome far from certain, but additional military might looks appealing to countries in the region and both have increased their spending on military equipment.

In addition to the Middle East and Southeast Asia, another potentially large customer for U.S. military equipment is India. India is already the world's largest importer of military equipment, and future U.S. sales are promising. As a country allied with the United States, Indian military sales only became possible after 2001 when President George W. Bush lifted a ban on selling weapons to the country. India had been banned from purchasing American weapons due to the development of its nuclear weapons program. In late 2011, Lockheed Martin sold India \$900M worth of Super Hercules turboprop planes. Previously the Indian government purchased \$2.1M worth of surveillance planes and \$4.1B worth of Boeing transport planes. More orders from India appear to be on the way.

In the world of global arms manufacturing there are many manufacturers, but most of the manufacturing for export comes from five countries, with the United States being the largest manufacturer and exporter. Countries tend to establish relationships with other countries when it comes to arms sales due to historical reasons, political reasons, or the financing of the weaponry. For example, South Korea has been a major customer of U.S. arms, while India has in the past bought mostly from the Russians. The relationships are not static, however, as countries compete to sell their exports. The top five countries and their customers can be seen in Figure 1 below.

Figure 1



Note: Actual figure is from *The Economist*, March 23, 2012

Four of the top five defense companies in the world are American with Lockheed Martin being the largest. Included in Lockheed Martin's military products are the Trident missile and the F-16 and F-22 fighter jets. In second place is a British company, BAE Systems. The British company also has an American subsidiary. BAE manufactures the Bradley fighting vehicle, nuclear submarines, and other weapon systems. In third place is Boeing whose military line included aerial refueling tankers and the F-15 fighter jet. In fourth place is Northrop Grumman which manufacturers Nimitz-class aircraft carriers and their replacement super carriers, and different versions of unmanned drones. In fifth place is General Dynamics, which produces the M1 Abrams tank, submarines, and other military products. Figures on arms sales and employment can be seen in Figure 2 below.

Figure 2: World's Top Five Defense Companies

1. Lockheed Martin		
	Arms sales	$35.7B
	Arms as percentage of total sales	78%
	Employment	132,000
2. BAE Systems		
	Arms sales	$32.9B
	Arms as percentage of total sales	95%
	Employment	98,200
3. Boeing		
	Arms sales	$31.4B
	Arms as percentage of total sales	49%
	Employment	160,500
4. Northrop Grumman		
	Arms sales	$28.1B
	Arms as percent of total sales	81%
	Employment	117,100
5. General Dynamics		
	Arms sales	$23.9B
	Arms as percentage of total sales	74%
	Employment	90,000
Source: MSNBC News. 10 Companies Profiting from War, May 25, 2012.		

As can be seen in Figure 2, the sale of arms is a big global business from which the United States benefits in terms of profit and employment. There is a dark side to the global industry with arms sales made to dictators and tyrants who use the weapons to oppress their people, and a dangerous black market in mostly small arms (but not always) that can cause human suffering and social instability. A large arms exporter is Russia who is accused of supplying large quantities of military equipment and armaments to Syria's oppressive ruler, Bashar al-Assad. While an international outcry against the brutal crackdown in Syria continues, Russia continues to ignore international pleas and quietly supplies Assad with what he needs to stay in power. It is estimated that over 9,000 men, women, and children have been killed by Assad's forces, mostly using Russian-made weapons. Frustrated by the long and bloody conflict in Syria, there have been calls for Western countries to supply arms to Syrian freedom fighters who oppose the Assad regime.

The United Nations has been working on an agreement called the Arms Trade Treaty (ATT) to regulate international arms trading which currently has no international oversight. The treaty would prohibit sales to countries where there is a credible threat that the weapons would be used to violate international human rights, be used in acts of terrorism, or cause genocide. Earlier attempts at such a treaty in 2008 resulted in 133 member states voting in favor of the agreement, 19 countries abstaining, 41 countries not voting, and one country voting against the treaty, the United States.

THE GOOD, THE BAD, AND THE DANGEROUS

While few people in the United States would argue that creating more jobs is a bad thing, the recent boom in foreign weapon sales does have its supporters as well as its critics. Those supporting increased sales point to job growth and the fact that defense jobs tend to be well-paying work. Foreign sales, it is alleged, kept Boeing's St. Louis facility from closing and secured employment until at least 2018. Increased exporting also reduces the trade deficit of the United States. Supporters also posit that by arming our allies with better weapons the allies can do a better job of sharing the burden of international peacekeeping. Arming allies with more advanced and extensive weapons allows these countries to better handle conflict in their regions of the world and rely less on the United States to intervene in these matters. Weapon sales also can act as a bargaining chip in international negotiations.

Critics of the export boom in weapons feel that increased war machinery sales represent increased potential for death and destruction. They feel the more bombs, guns, and tanks exported to the rest of the world increases the chance that they will be used in hostile action. Critics also point out the fact that many foreign sales contracts require an offsetting countertrade agreement in which part of the production is performed in the buyer's country. Offset essentially acts as outsourcing of American jobs. The argument against export sales can also be fueled by the possibility of arming an enemy. If a friendly country has a drastic regime change the arms may fall into the hands of a hostile government. Also, the sale of military equipment to friendly countries may be used against the citizenry of those countries. Early efforts to suppress democratic reforms in Egypt in 2011, for example, saw the use of American made tanks, tear gas, and fighter jets. When Bahrain's Crown Prince Salman bin Al Khalifa went to Washington in 2012 to see his son graduate from American University he was also able to secure approval from the State Department for a long list of military equipment. The ruling family of Bahrain, who hold absolute power in the country, has been criticized by international human rights advocates for its continued crackdown on its citizens. Protests by the Shia majority in 2011 led to violence by the mostly Sunni government headed by the royal family. The approval of additional military equipment to Bahrain is sanctioned by the State Department due to the importance of the relationship between Bahrain and the United States, in a volatile and strategically important part of the world.

Supporters counter the arguments made by critics with sometimes compelling statements. For example, the weapon that is probably most responsible for most human deaths isn't made by the United States. The AK-47 and its different spinoffs is the weapon of choice of warlords, criminals, thugs, and terrorists. The AK-47, or Kalashnikov, named after its Russian inventor, was placed into service in 1947 and has killed far more people than drones, missiles, or tanks. Loved by some (even featured on the national flag of Mozambique) and hated by others (especially international peace groups), the AK-47 is a cheap assault weapon that when placed in the hands of warlords and their sometimes child soldiers can not only destroy human life but can also destroy a country through internal conflict and violence. Small arms manufactured in large quantities by low-cost countries can be very dangerous. As far as the problem with offsetting and outsourcing of jobs, supporters point to the fact that these agreements are necessary to secure business, and without them the contracts would go to competing countries. Decisions on selling military equipment to countries that may have a regime change, or use the equipment on its own citizens often involves a delicate balancing of national security priorities, it could be argued.

Despite the critics, U.S. arms exports continue to increase, and U.S. policy is increasingly in support of greater sales. In the 2005 movie, *Lord of War*, Nicolas Cage plays the part of an international arms dealer who sells weapons to anyone who can afford to buy them. Cunning, clever, and lacking a moral code, Cage's character is believed to be based on real-life arms dealer, Viktor Bout (currently serving a 25 year prison sentence). With a rapidly increasing trade in weapons for exports by the United States some may begin to perceive the USA as the true Lord of War.

DISCUSSION QUESTIONS

1. The United States it could be argued has an absolute advantage in the production of military weapons, or at least in some weapon systems. Using a completely free market perspective in terms of economic freedom in general, and in particular international trade, companies should be allowed to sell whatever and to whomever they want. Explain how this thinking is either valid or flawed.
2. Does a United Nations treaty making for multinational regulations of arms exports make sense to you? Why do you think the United States isn't enthusiastically supporting the agreement?
3. Take a position either in support or against increased U.S. arms exports and explain your position in detail.

4. Consider the concept of Corporate Social Responsibility (CSR). What obligations do corporations have toward their various constituencies? Do these obligations conflict? Is it possible for the defense industry to balance these obligations?
5. What are the short-term and long-term implications for the U.S. both economically and politically? What effect could the U.S. arms industry potentially have over the next 5 years? Over the next 50 years?

ENDNOTES

1 Quote from President is from Global Issues at www.globalissues.org. May 25, 2012.

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SMART MOVES NIGERIA, LTD.

D.K. (Skip) Smith, Baze University

CASE OVERVIEW

Ever wished you had a case to expose students to the issue of "difficult customers" and to provide them with one or two theory-based conceptual frameworks for working through the challenges they themselves or their friends and colleagues are likely to encounter when faced with customers (either internal or external to their organization) who fall into this category? The case is appropriate for senior-level undergraduates as well as students in MBA and Executive Development programs. It is designed to be taught in a one hour and a half class session, and is likely to require at least a couple hours of preparation by students.

CASE SYNOPSIS

Mr. Albert Youngman is Head of HR at Smart Moves Nigeria, Ltd., a British-based consulting company operating in Nigeria. His boss, Mr. Kingsley Michaels, the Chairman of Smart Moves Nigeria (hence, SMNL), is notorious for making plans but then changing them at the last minute. The most recent example of this behavior: Late yesterday afternoon, Michaels asked Youngman to book him a first class ticket tomorrow night, to travel from Abuja Nigeria to London using Global Airlines, Ltd. (a real airline whose name, in this case, must be disguised). Using his contacts at the Global Airlines office in Abuja, and by calling in some favors from those contacts, Youngman had been able to get Michaels a confirmed first class ticket for tomorrow's flight. Getting the first class tickets on such short notice had been very tough; at the end of the day yesterday, however, Youngman had the tickets and had been pleased with the results of his efforts. This morning, however, in his just-concluded early morning meeting, Michaels indicated that he had changed his mind, and that Youngman should cancel the first class tickets he had worked so hard to procure yesterday afternoon. As indicated above, this is not an isolated incident; this sort of thing happens frequently. Youngman finds that the stress associated with Michaels' behaviors is not only giving him headaches but also keeping him awake at night. Youngman believes he needs to take action to address this situation; the alternatives he has identified include: 1) Continue on in his role at SMNL and live with the consequences of that decision; 2) Request a change in his role at SMNL; or 3) Resign from SMNL. At this point, he has not decided what action to take.

Additional data and information in the case include:

1. *Regarding the situation: Information on the dilemma Mr. Youngman is facing is provided.*
2. *Regarding the company: A bit of background is provided on the company.*
3. *Regarding Chairman Michaels: Information is provided on the background, characteristics, and accomplishments of the chairman.*

4. *Regarding Mr. Youngman: Information is provided on his background, characteristics, and accomplishments.*

SMART MOVES NIGERIA, LTD.

The Situation

The early morning meeting with Chairman Michaels was over. Feeling a mixture of disappointment and despair, Mr. Albert Youngman, Head of HR for Smart Moves Nigeria Ltd., walked slowly back to his office. The reasons for feeling the way he does included:

1) Late yesterday afternoon, Mr. Kingsley Michaels, Chairman of Smart Moves Nigeria Ltd , had called and asked him to book a first class ticket for the next evening, traveling from Abuja Nigeria to London, using Global Airlines, Ltd. (a real airline whose name, in this case study, must be disguised).
2) Using his contacts at the Global Airlines office in Abuja, and by calling in some favors from those contacts, Youngman had been able to get Mr. Michaels a confirmed first class ticket for tomorrow's flight. Getting the first class tickets on such short notice had been very tough; at the end of the day yesterday, however, Youngman had delivered the tickets to Michaels and had been very pleased that he had been able to do so.
3) In his just-concluded early morning meeting, Michaels had indicated that he had changed his mind and that the first class tickets Youngman had worked so hard to procure yesterday afternoon should be cancelled.

As he picked up his phone to call his contacts at the Global Airlines office in Abuja, Youngman found himself feeling that:

1) For many reasons (including the fact that his boss changes his mind so often), working for Michaels is creating huge amounts of stress for him.
2) Youngman enjoys many aspects of his work at SMNL Nigeria very much. However, he now finds that the stress associated with Michael's behaviors is not only giving him headaches but also keeping him awake at night. Youngman believes he needs to take action to address this situation; the alternatives he has identified include: 1) Continue on in his role at SMNL and live with the consequences of that decision; 2) Request a change in his role at SMNL; or 3) Resign from SMNL. At this point, he has not decided what action to take.

Additional Information: Chairman Michaels

Kingsley Michaels, Chairman of Smart Moves Nigeria, Ltd. (hence, SMNL) was born in Liverpool England in 1955. Michaels was an exceptional athlete, and at 17 years old, he was selected to play amateur football for England. After wrapping up his football career, Michaels did a multi-year apprenticeship in electrical engineering; after that, he took a job with a British public company as a sales engineer in Nigeria. After several years in Nigeria, Michaels left the British public company to start his own consultancy. His new company, based in the Nigerian city of Calabar, specialized in rural development, with an emphasis on water-related projects including boreholes and holding tanks. Throughout his many years in Nigeria, Michaels continued to be deeply involved in amateur athletics; teams he organized won a number of competitions. Through athletics, Michaels met a number of people who ended up contributing importantly to his success. Over the years, Michaels' company continued to do rural development projects in Nigeria; the company has completed several hundred such projects.

As indicated above, Michaels has been highly successful; he has become wealthy as well. It is also true, however (former employees have testified to this) that he can be a difficult person to work for. As indicated earlier, Michaels is notorious for changing plans at the last minute. Individuals who know him indicate that the sort of terms they would use to describe Michaels include: competitive, unconquerable, stubborn, determined, optimistic, self-reliant, controlled, persistent, lots of will power, bold, positive, forceful, daring, outspoken, risk-taker, assertive, powerful but yet surprising timid sometimes, adaptable, aggressive, restless, nervy, persuasive, and high-spirited.

Additional Information: The Company, The Market, And The Business Model

The Company: As indicated above, Michaels and his company (that is, Smart Moves Nigeria Ltd, or SMNL), have over 40 years experience in project work in Nigeria. The company has a very strong (millions of dollars) balance sheet, and is debt free. Michaels' mantra (for himself and his company) is: "world class projects delivered to clients on time, every time."

The Market: Nigeria is the leading oil producer in Africa with oil revenues averaging more than $50 billion per year. The economy is growing 7% per year. In a June 2010 report by the McKinsey Global Institute (MGI) titled "Lions on the Move," the authors noted that, thanks to a series of economic reforms, "Nigeria... is beginning the transition to a more diversified economy. [These reforms] have unleashed growth: in the telecom sector, the number of subscribers increased from practically zero in 2000 to 90 million, while banking assets grew fivefold. Nigeria's manufacturing sector, while small, is also growing." SMNL expects to continue to be deeply involved in projects which will contribute to Nigeria's ongoing growth.

The Business Model: SMNL uses the following three key competitive advantages to compete for business:

1. Expert Knowledge of Nigeria, based on the knowledge and contacts Michaels has developed over his years in Nigeria.
2. Strong Balance Sheet and Financial Profile.

3. Ability to identify projects which require technical skills and/or expertise not available in Nigeria, and then bring to Nigeria world-class technical partners to do the work.

Additional Information: Mr. Albert Youngman

Mr. Youngman grew up in South Africa. While his first job after completing secondary school was with a bank, after a couple of years he switched from banking to working in accounts for the airline industry. By taking night courses, he acquired a number of certificates in accounting; when presented the opportunity to join the Johannesburg accounts office of Global Airlines, he took that opportunity. Over the nearly 20 years that he worked for Global Airlines, Youngman attended a number of training sessions and greatly improved his accounting skills. After taking a buyout package from Global Airlines and prior to taking up his current job at SMN, Youngman spent one year as Assistant Director of Financial Operations at a non-for-profit organization in Nigeria. Part of the reason he resigned from the non-profit to take up the job of Head of HR at SMNL is that the salary and benefits SMNL pays him are the highest he has ever received.

Everywhere he has worked, Youngman has developed and maintained very good relationships with his co-workers. He describes himself as focused, resourceful, and a good team player with a "let's get it done" attitude. People who know him well use the following sorts of terms to describe him: considerate, unconquerable, attractive, good natured, eager to please, patient, decisive, generous, cheerful, loyal, positive, kind, diplomatic, companionable, willing to help, sympathetic, organized, inspiring, adaptable, aggressive, abides by rules, even-tempered, gentle, and willing.

THE CHALLENGE

Assume you are Mr. Youngman. What action will you take, to resolve the situation which is causing you distress (headaches, sleepless nights, etc.).

ZBN NEWS: AN EXAMINATION OF ISSUES RELATED TO THE CORPORATE OWNERSHIP OF MEDIA

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CASE DESCRIPTION

The primary subject matter of this case concerns business ethics and media ethics. The case can be used to explore the important connection between TV news and corporate ownership of the news in a business ethics or media ethics course. A secondary issue examines outsourcing. **.** *Students are asked to analyze data and issues in order to determine whether corporate ownership of the news media presents a conflict of interest among SBUs. The case has a difficulty level of two. The case is designed to be taught in two class hours and is expected to require 8-10 hours of outside preparation by students.*

CASE SYNOPSIS

Walter Lipscott, VP of the News Division of ZBN, a wholly owned media subsidiary of the LRV conglomerate, Scott Drewhurst, the 30 year old nephew of the majority stockholder, Merrill Chandler, and Thadius Rockwell, Washington veteran investigative reporter for 45 years sat in Walter's office sharing a bottle of scotch and ruminating over how journalism has changed over the past 4-5 decades. "In the old days, journalists were tough-nosed, no nonsense reporters who went after the story," Walter stated. "Those guys who covered the White House were considered the 'elite' of our industry; they were not afraid to ask the tough questions of the administration. Today, journalism has become a matter of sound bytes, selectively edited for marketing appeal." "You are right, Walter," chimed Thadius. "In my early career as a cub reporter, I was 'hungry' for a news story. The editorial staff trained me to find the truth—go after the facts no matter where they may take you. It seems we lost our way when the news became big business in the 80s and 90s."

In order to address industry-wide declining viewership, and "corporate's" push for profits, Walter established a strategy team to plan a direction for the news division. The team discussed two primary options: charge other LRV SBUs (Strategic Business Units) for positive "news" coverage of their operations, in essence covert advertising; and outsourcing of the news. In the former case, the team is faced the issue of how ZBN should cover a story about a LRV power plant which is dumping a highly deadly poison into a rural watershed. In the latter case, *the team must consider the human toll involved in further reducing its staff. In both scenarios, the team must evaluate profits juxtaposed with ethical considerations.*

ZBN NEWS

Walter Lipscott, VP of the News Division of ZBN (Zephyr Broadcast Network), a wholly owned media subsidiary of the LRV conglomerate, Scott Drewhurst, the 30 year old nephew of the majority stockholder, Merrill Chandler, and Thadius Rockwell, Washington veteran investigative reporter for 45 years sat in Walter's office sharing a bottle of scotch and ruminating over how journalism has changed over the past 4-5 decades. On the wall behind Walter's desk were photographs of several giants in the industry, including Edward R. Morrow, Don Hewitt creator of *60 Minutes*, Ben Bradley of *the Washington Post*, and news icon Helen Thomas of the Associated Press. There was even one of Lipscott and legendry CBS news anchor Walter Cronkite playing golf together.

"In the old days, journalists were tough-nosed, no nonsense reporters who went after the story," Walter stated. "Those guys who covered the White House were considered the 'elite' of our industry; they were not afraid to ask the tough questions of the administration. If the Press Secretary's responses did not 'smell' right, the journalists would probe deeper until a satisfactory response was given. Today, journalism has become a matter of sound bytes, selectively edited for content and marketing appeal. The more sound bytes you can get into a 22-minute newscast, or fit into a 2" by 6" newspaper column, the better the marketing appeal."

"You are right, Walter," chimed Thadius. "In my early career as a cub reporter, I was 'hungry' for a news story. The editorial staff trained me to find the truth—go after the facts no matter where they may take you. It seems we lost our way when the news became big business in the 80s and 90s."

BACKGROUND

LRV (Longworth, Rollins, and Voight, Inc.) is a large conglomerate owning diverse companies including interests in mining, timber, electronics, healthcare/medical equipment, appliances, energy equipment, capital financing and media. Its media holdings include the ZBN network and affiliates. The ZBN network is a large media outlet which encompasses 24-hour news, finance, sports, and movie television channels, as well as ZBN-World, a 24-hour news television channel operating in Europe and Asia. The news division, which includes both the news and financial channels, is the most profitable of ZBN's holdings. As VP of the news division, Walter reports to Bill Hadley, President of ZBN networks, who in turn reports to Robert Preston, President and CEO of LRV, Inc. While Walter views his primary responsibility as producing a quality news product, he is well aware that Preston's focus is on the financial bottom line of the division. Preston has made it clear that he expects a 5-8% profit margin each year.

In the 1980s, as a means of increasing profits, many large corporations sought to expand their business portfolios by diversifying into new business enterprises. One strategy used by some large organizations who sought such diversification was to expand into media outlets. Such an expansion provided not only the potential for increasing profits, but as some media critics claim (see for example Naureckas, 1995; and Wolff, 2008) and academic studies (Williams, 2002), also provided strategic opportunities for their other interests. In some cases, the acquisition of a news organization had no strategic fit to other strategic business units (SBUs) in the company. The value chains of each SBU were disconnected from one another with no synergistic effects. An example of an unrelated diversification strategy is General Electric (GE) who was the parent company to NBC from 1986 to 2011. While broadcasting was unrelated to GE's other SBUs it did add to the profit stream by providing a new source of revenue. On the other hand, The Walt Disney Company, the parent company to ABC and ESPN is an example of a related diversification strategy. The value chain matchups among the various related business units of the Walt Disney Company provided the potential to achieve strategic synergies such as research and development, skills transfers, and marketing expertise. These value chain synergies were pursued as they were expected to result in lower costs and flexibility of company resources.

LRV is a company with unrelated SBUs in both product-related divisions and a media division. While, as the name implies, unrelated SBUs typically operate as totally independent units, the inclusion of a media SBU creates a unique relationship with the other unrelated SBUs. Since either positive or negative "news" coverage of other SBUs can affect both the perception of those SBUs and their potential profits, news divisions have the potential to cross over into the realm of other SBUs. This potentiality has not gone unnoticed by media critics:

> Representatives of corporations will say that good journalism is good business, and so there is no conflict. It is true that a news outlets' credibility is one of its assets, which can be eroded by blatantly biased reporting. But to corporate owners, the value of that asset may be far outweighed by the gains to be made by using their media to promote their other lines of business. As news operations become smaller and smaller parts of ever larger conglomerates, that trade-off will become more profitable--and news decisions will more often be subordinated to corporate strategies (Naureckas, 1995).

Thus, for LRV a potential conflict of interest may occur when the media division supports one of its product divisions and uses its media influence for current and future profits.

One of the results of diversification, whether it was SBU related or unrelated, news became business … BIG business. Some media critics have argued that the shift to a focus on the "business" portion of "the news business" has affected television news coverage. They "charge that TV journalism is more entertainment than news, more style than substance" (Merrill, Lee, & Friedlander, 1990, p. 223). Some media critics further claim (see for example, Naureckas, 1995; and Wolff, 2008) that the emphasis on the bottom line lead to a shift in focus in the newsroom, from journalism to reporting, from investigative, intensive probes to more of a focus on hype and entertainment. The critics claims have been supported by academic studies which indicate that the hype ranges from that which might be expected, the political (Fox, Angelini, & Goble, 2005), to less obvious areas such as medical reporting (Caulfield, 2004).

The style over substance issue is also reflected in a change in the hiring process, most notably in the "qualifications" being sought in a news reader or anchor. Hiring journalists of an earlier era required problem finding skills, the ability to sort through large amounts of complex interrelated information and data to find the "truth," to think critically on the issues, and to write or communicate the story grounded in facts (Auletta, 2003). Today, however, some media critics have argued that staffing qualifications for reporters and news anchors require individuals to have the on-camera presence of physical attractiveness, charm, and entertainment/sex appeal (Robertson, 2001). Robert Thompson (cited in Roberson, 2001), professor of media and popular culture at Syracuse University in describing the three principle TV anchors ("the big three"), at the time, of Tom Brokaw (NBC), Peter Jennings (ABC) and Dan Rather (CBS), claims that there is "a lot of show business mixed in with journalism." The "show business" aspect of the news has been satirized by Hollywood in such movies as *Network* (Lumet, 1976), where a television newscaster's mental breakdown turns him into a celebrity as the network tries to profit from his illness, and *Broadcast News* (1987), where a no nonsense producer committed to fighting the trend toward flashy, style-over-substance "personality" news must turn the "perfect modern anchorman," who is lacking journalistic skills, but is handsome and has charm, into a newsman. The qualifications issue was illustrated in a *People* magazine article (The News, 1988) which pointed out that the "big three" (the three primary) TV anchors at the time (from the early 1980s to 2005) did not graduate from prestigious journalism programs, as Dan Rather graduated from Sam Houston State University (Texas), Tom Brokaw from the University of South Dakota and Peter Jennings dropped out of high school in the 10th grade. Of the current "big three," only Diane Sawyer of ABC is a college graduate. She received a degree in English from Wellesley College (Wellesley, Massachusetts) (Diane Sawyer Biography, 2011), Scott Pelley of CBS studied journalism at Texas Tech University (Scott Pelley Hall, 2011), and Brian Williams of NBC completed a total of 18 college credits at George Washington University and The Catholic University of America, both in Washington, D.C. (Williams, B., 2011).

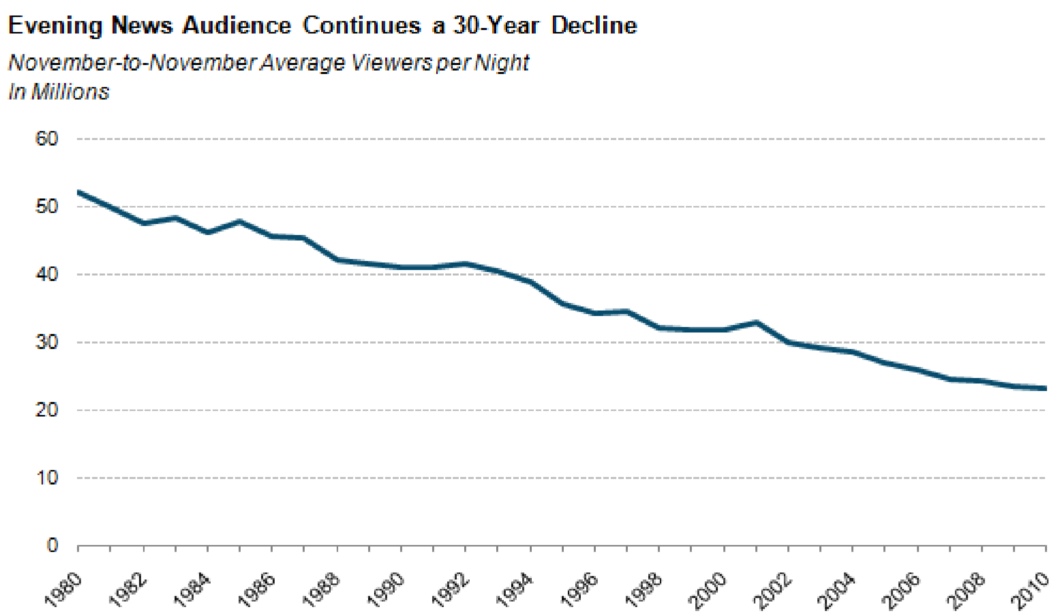
VIEWERSHIP AND ECONOMICS

Each year, the Pew Research Center's Project for Excellence in Journalism prepares an annual Report on American Journalism entitled: *The State of the News Media* (stateofthemedia.org). This on-going project provides both analysis and data of the current status of the new media. Guskin, Rosenstiel, & Moore (2011a, 2011b) provide a detailed analysis of the state of television news.

The PEW data reveals that with the exception of a spike in viewership a few months immediately before and a few months immediately after presidential elections, there has been a steady decline in viewership. "In 2010, the audience for network news programs continued its quarter-century decline. … Since 1980, the three commercial evening newscasts [ABC, CBS, and NBC] have lost 28.9 million viewers, or 55.5% of the audience they once had" (Guskin, Rosenstiel and Moore, 2011b) (See Figure 1).

Viewership is only one measure of the health of the news divisions; profitability and staffing are two other indicators. However, as Guskin et al (2011b) note "determining the economic health of network news divisions is a challenge. Networks do not break out financial data for their news divisions publicly." The PEW Project estimates that two network news divisions (NBC and ABC) were profitable in 2010 (Guskin, Rosenstiel, & Moore, 2011a). NBC, the most profitable news division with an estimated operating profit in double digits, generates most of its profits from its multiplatform format, with MSNBC and CNBC providing the lion's share of the profits. PEW estimates that due to drastic budget cuts, ABC News might have doubled its operating margins to 8%. Further, they estimate that in 2011 when the full effects of the cost cutting are in place, margins might increase to double digits. CBS, however, is estimated to be at about the breakeven point (Guskin et al 2011b) (See Table 1).

Figure 1



Source: Nielsen Media Research
PEW Research Center's Project for Excellence in Journalism, 2011 State of the News Media

Table 1: News Divisions Profits for 2009-2010		
Network	**2009**	**2010**
ABC	$636M	$600M
CBS	$424M	$400M
NBC	$2.0B	$2.0B
ZBN	$215M	$200M
Source: ZBN Internal data, others are estimates made by PEW Research Center Project for Excellence in Journalism, 2011 State of the News Media		

Beyond profits, the size of the news division staff also is an indicator of the health of the division as it is a gauge of how much the organization is willing to invest in the news gathering / reporting process. The overall situation doesn't paint a very positive picture, as "available information suggests these newsrooms are less than half the size they were in the 1980s" (Guskin, et al, 2011b). Specifically, in 2010, ABC News had the largest overall staff reductions by eliminating close to 25% of the roughly 1,500 employee it had at the beginning of 2010. CBS had fewer staff reductions, eliminating 75 of its 1,400 staffers. NBC staffing stayed relatively stable in 2010, after five years of scaling back (Guskin et al). In 2010, ZBN reduced the size of its staff by about 11%, 27 out of just over 250 staffers.

Given declining viewership, reduced staffing and pressure for profits, the PEW organization notes that there has been increased speculation that ABC and CBS were looking to increase their alliances with cable news channels. The most likely partnerships are CBS News and CNN with ABC News and Bloomberg. These alliances seek to counterbalance NBC News use multi-platforms, most notably, MSNBC and CNBC (Guskin et al 2011a).

In sum, the network news programs are facing a difficult future – declining viewership, while "corporate" pushes for profits. One of the results of this situation has been the creation of what Lipscott calls "story journalism." Lipscott, as reflected in his conversation with Drewhurst and Rockwell, feels that there has been a shift from investigative journalism, where reporters would "dig out" the information, to one of just re-telling (or in Lipscott's terms "parroting") the story that has been given to you. Since the story is given to you, no fact checking or double checking of sources is required. While, in Lipscott view, this is not "real" journalism, it is quick and efficient, and most importantly cost effective. Such an approach, Lipscott feels, has created a culture of get it out quickly and gets it out cheaply. This change in the journalist culture has also had effects on the bottom line pressures. As reflected above, one of the methods to stretch the bottom line was in reducing costs, most notably in reducing the size of the news staff. However, the strategy of reducing the size of the news staff has increased the pressure for Lipscott to use "parroting" journalism.

As staff size decreases, one method of reducing costs is to outsource the news. In print journalism, "more major media companies are looking for ways to find cheap content. … There is now a move toward outsourcing stories traditionally done by professional reporters. … Contributors [are] paid anywhere from $75 to $120 per article as well as a share of any related ad revenue. Full-time staffers or even traditional freelancers working directly with publishers cost considerably more" (Lee, 2010). In television news, costs can be reduced by sharing reporters and stories across platforms, as NBC does with its various networks and as the alliances of CBS-CNN and ABC-Bloomberg TV.

This information illustrates what is becoming an increasingly difficult situation for the news divisions of the various networks. ZBN is no exception. The ZBN news division is facing an assault on at least two fronts: First, they face the issue of declining viewership, but they are experiencing pressure to increase advertising revenue. Second, in an effort to fend off additional operating losses, they have had to cut the size of their news division. While this is an industry-wide issue, VP Lipscott is only concerned about the financial and news product health of ZBN News. As "an old newspaper man," Lipscott's conversation with Chandler and Rockwell reflected nothing new in his thinking. He had repeatedly expressed his dismay to both Hadley and Preston at what he sees as a change in the news culture from one which focused on investigative journalism to one of a get it out as quickly and cheaply as possible. However, Lipscott is, if nothing else, a very pragmatic person, thus partially allowing for his longevity in the industry. In order to deal with the issues which faced ZBN News and to plan for its future, Lipscott created a strategy team. The team, which he chairs, consisted of Scott Drewhurst, Thadius Rockwell and 4 others (Darrell Simpson, CFO, Sarah Maynard, Chief Marketing Officer, Bradley Warren, VP of Operations, and Hadley Polk, BNN alliance partner.

STRATEGY TEAM

The first meeting of the strategy team began with Walter describing the history behind forming the team, and then moved into the goals that he hoped the team would accomplish. Walter is a firm believer that in order to predict future directions, one must understand the past which has brought us to this point. Thus, Lipscott set the stage with a brief review of the conversation between Drewhurst, Rockwell and himself. Lipscott also described his view of the shift from "investigative journalism" to that of "parroting journalism." Lipscott's description led to a general discussion of the state of modern journalism.

"When I think of the hours I spent going after the story, often taking days, if not weeks, to get the full story, I can see where it costs the news division a lot of money. Today, my kind of journalism is just too expensive for the 'bottom line,'" Thadius stated. "So we hire and pay reporters for quantity and quick turnaround stories. So, I must agree with Walter, that days of true investigative journalism seem to be long gone"

"I know that I am relatively new at this game, said Scott, but you know my generation of news watchers, doesn't want to wade through all of the facts to get to 'the 'truth,' be it real or fictional. They want small, easy to understand chunks, even if that means it includes hype, marketing and superficial treatment. And they want it delivered via electronic formats such as iPhone, iPad, Blackberry, etc. The rise of handheld journalism has changed the way news is delivered. This is not just my opinion" Scott added. "I read an article which said 'The Internet has changed the way we think. It's changed the way we communicate. …And now with ever smarter devices held in the palm of your hand, it's transforming journalism' (Wilwohl, 2010).

My generation tends to become very impatient pouring through lots of information; they become distracted and bored very quickly. So for them the headline becomes the extent of the probe and the in-depth analysis becomes just someone else's interpretation." Scott distributes the following table saying "Here is some information I ran across which describes the status of TV news viewership.

Table 2: 2008-2010 Evening News Audiences Drop at all Networks **Year-to-Year Average Viewers per Night in Millions**			
	2008	2009	2010
ABC World News	8.17	7.72	7.43
CBS Evening News	6.17	5.98	5.65
NBC Nightly News	8.56	8.62	8.5
ZBN News Hour	4.44	4.35	4.27
All Networks	27.3	26.6	26.0
Source: ZBN Internal data, PEW Research Center's 2011 State of the News Media			

Sarah added, "It seems to me that, given what Scott has said, there was a convergence of viewer/reader loss of interest in investigative reporting occurring at about the same time as BIG Business was taking over the news. The elimination of costly investigative reporting isn't missed at all by the newer generation of consumers of the news. Thus, BIG business is free to focus only on profits, not the public interest." "I agree 1000%" added Thadius, "All 'corporate' wants is profits while the viewer doesn't really care about the quality of the 'information' they are getting."

At this point, Walter summarizes the status of the discussion. "Given our discussion and the directives given to our division from 'above,' here is where we are:

1. Viewership of our news programs is down and declining.
2. As a result, it is a real struggle to maintain advertising revenues.
3. "Corporate" wants a profit of at least 5-8% every year for this division
4. While "Corporate" doesn't really care, a personal concern of mine is that it has been 6 years since ZNB won any of the news awards. To the extent that awards are an external recognition of quality, then that means that the quality of our news product has been declining.

In summary, I created this strategy team to address these issues. The team needs to develop a plan which will focus on strategic goals of increasing revenues and more creative ways to stimulate the delivery of our news products."

Scott says, "Here is an idea, while it would go against the principles I learned in Journalism school, based on comments I have heard from my uncle it seems to me that one option to increase revenue would be to engage in "alternative advertising." We could charge back to LVR for positive coverage of their products from their other various divisions, a form of product placement if you will. Likewise we could also charge them for non-coverage or limited coverage of negative stories related to their other divisions."

Darrell Simpson from finance says, "You mean develop a 'placement rate charge chart?' Something like a positive plug for another SBU is $500,000 per instance, limiting coverage of a negative story could be $750,000, and putting a positive spin on a negative story (i.e. sure the

EPA claims that the product causes cancer, but we did build a playground on top of the old dump site) is $ 1 million? If that is what you mean, then from a financial standpoint, I really like this idea. Without much effort at all, I can see where this could potentially produce $50 million a year."

Sarah says, "I think that Scott's plan is fraught with too many ethical issues not to mention potential legal issues. How about this as an option, we outsource the news. By this I mean that we eliminate ALL investigative reporting; it is just too expensive, and instead we turn to greater use of stories from our affiliates or independent sources. Sarah turns to Thadius and says, "Sorry, Thadius, nothing personal intended. Aren't you about to retire anyway?"

An indignant Thadius says "that seems a little farfetched to me."

Sarah responds, "I don't think so, I remember reading a *New York Times* article (Carter, 2007) that said that NBC was outsourcing some of its news documentaries."

Hadley Polk, BNN alliance partner, said "Yes, this is certainly possible as there is absolutely no reason that the alliance between BNN and ZBN couldn't be strengthened." For $500,000 a week, I am sure that we could produce twenty 2.5 – 3 minute news segments a week.

Scott says, "Let's see, about 22 minutes of news for 7 nights that is about 154 minutes a week. If BNN can provide content for 60 of those minutes, that still leaves 94 minutes a week for us to fill.

Darrell says to Hadley, "that seems pretty pricy to me, any chance of reducing the cost?"

Hadley replies, "That amount, assumed mostly 'hard' news, if we go with all soft, feel good stories, like the mother dog that takes care of a kitten, then we could do it for $350,000 a week. These figures assume 'unique' programming, if you are willing to let BNN also run these same stories, then due to the cost sharing, we could cut that to $150,000 a week."

Darrell replies to the group, "this seems like a no brainer to me, given the expenses of the news division, it cost about $46,000 to produce each minute of news."

Walter replies emphatically, "It can't be all about money! While this may sound financially attractive, what about 'hard news'? We can't just ignore things like presidential elections, natural disasters and the like. We have GOT to cover those events. Beyond that, there are certain fixed costs like anchor salaries, news bureaus, and the like which are a big part of that $46,000/minute."

Thadius sarcastically adds "what about accountability, who would be responsible for the accuracy, although I guess the only 'accuracy' issue would be what bred of dog was doing the mothering."

Scott says, "I don't see an issue with such a shift. Younger viewers don't really want in-depth analysis and really like the 'realism' of You Tube. I can see this as a win-win, a less costly product that produces increased viewership."

Sarah says to Thadius, "Sorry, old timer, the fact is that you and folks like you are just too expensive and no longer relevant to modern news viewers."

Darrell says "a buyout of 50 reporters would cost us $75-100 million up front, but after the initial expense would save us $25 million a year (see Table 3).

"Sarah's ideas may well have some merit," said Darrell, "however, I don't think that we should dismiss Scott's idea out of hand. While I am the CFO and not an attorney, it seems to me that since we don't have to break out the news operation separately in our public financial reporting, as long as we keep this 'in-house' no one ever needs to know about any internal financial arrangements between the various SBUs. Thus, legally, we should be OK, however, before we actually do this, it is certainly something we should run by legal."

Table 3: ZBN Expenses from most recent audit	
100 Staffers @ 200,000	20,000,000
100 Reporters @ 500,000	50,000,000
Lead Anchor	10,000,000
8 Anchors @ 2.5 m	20,000,000
6 News bureaus @ 5m	30,000,000
Administrative salaries (40)	75,000,000
Administrative Building	15,000,000
Utilities	8,368,000
Satellite / Communication trucks	56,000,000
Travel	22,000,000
Equipment Replacement - Updates	25,000,000
Office supplies & equipment	2,000,000
Legal / copyright fees	15,000,000
Insurance	8,000,000
Subscriptions (AP, UPI, etc.)	5,000,000
Accounting / Audit	7,000,000
Total	368,368,000
Note: Salaries are averages and include both salary and benefits Source: ZBN Internal Audit	

"Funny thing that you should mention this," chimed in Bradley, VP of Operations. "'Hypothetically speaking' we have a situation where we are dumping the waste water from one of our power plants into an old abandoned water well. The water contains hexavalent chromium. Although this is a highly toxic, cancer causing substance, the concentration falls just under what EPA calls as 'acceptable.' While the plant is in a largely rural unpopulated area, we recently discovered that the well drains into an underground aquifer, which 50 miles down the line is a major source of drinking water for what's say we call an 'unnamed large city.' The issue is that while by EPA standards we are just within their limits, our own internal investigations indicate that there is a higher rate of leukemia in the dump area than is 'normal.' The concern is that, due to the aquifer, as many as 500,000 people could be exposed to the drainage. Our studies indicate that the concentration gets slightly less potent as it disperses into the aquifer. PR wants us to 'come clean,' admit the issue and proceed with a cleanup of the area that would cost in excess of $500 million. So, from what you are saying, for only a few million, we could have ZBN run some positive stories on the power plant, what it means to the community – jobs, charity work, etc., as well as some stories that the concentration level is within government standards, and so on. That sounds very appealing to me."

Darrell adds, "From a financial standpoint, this seems like a no brainer to me."

At this point, Walter asks the strategy team, "Which option do you think we should pursue?"

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THE DIFFICULT BOSS

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CASE DESCRIPTION

This case study demonstrates workplace bullying and its direct impact on the work of an employee. The case revolves around Karen and her relationship with her supervisor, Dianne. Karen feels intimidated by the hostile, rude and untoward behavior of Dianne which negatively impacts her work and personal life. Karen is unable to concentrate on her work, her performance suffers, and she is left wondering on how to resolve this problem. This case could be used by students when learning about the topic of workplace bullying and stress in Organizational Behavior. This case study would be useful for undergraduates in an Organizational Behavior class. This case has been designed for a 90 minute session slot. The instructor can distribute the case study along with the discussion questions to the students during class time. Students would require approximately 30 minutes of class time to read and prepare answers to the discussion questions.

CASE SYNOPSIS

This case examines the concept of workplace bullying within a healthcare organization. Workplace bullying can be defined as repeated "unwelcome negative act or acts (physical, verbal or psychological intimidation) that can involve criticism and humiliation, intended to cause fear, distress or harm to the target from one or more individuals" (Bartlett and Bartlett, 2011: 71). The case revolves around Karen and her supervisor, Dianne. Karen, a pleasant office assistant is confronted with hostile, rude and insulting behavior and comments from her supervisor. The case study traces these various incidents which Karen undergoes at her office. The incidents range from incivility, verbal abuse, unfair criticism and inappropriate performance evaluations. Karen loses her confidence, self-esteem, becomes depressed and stressed out. She starts hating work, is unable to concentrate and wonders about her options.

THE VICTIM

Karen, 30 years old, African American was an attractive, office assistant at an in-school interactive program (NET), which was affiliated with a large hospital in a rural town in Southwest Georgia. NET was an in-school, interactive program delivered by a staff of nurse educators and support personnel. NET had around 33 full time employees consisting of

Registered Nurses (RN), Licensed Practitioner Nurses (LPN), Certified Nurse Assistants (CAN) and an office assistant. NET was part of a large hospital entrusted with the responsibility of providing qualified nurses to all schools located in the nearby counties. It was responsible for educating the school children and the surrounding communities on a variety of healthcare related issues like obesity, hand washing, teenage pregnancies and teen parenting.

Karen had joined NET, after graduating from a local Technical College with a Business Administration Certification. She was highly ambitious and wanted to eventually return back to school and obtain a Bachelor Degree in Business Administration from a four year university. She had so far, enjoyed her office work, mentoring new employees and collaborating with co-workers. Her helpful and easy going professional demeanor made Karen highly popular at the office. At personal level, Karen was happily married with a baby girl. Karen, seemed to have things going for her, both personally and professionally.

But that was three months back. Now, Karen shuddered and swept the hair back from her face and burst into tears. She felt tired, stressed out and very unhappy. She felt like a failure—"*no good*" as mom, wife and working woman. "*How did this happen?*" Karen reflected back on the events during the past few months at her workplace.

THE PROJECT

It all began, when Karen's supervisor, Dianne asked her to work on a project with her. Dianne was a buxom African American woman in late forties. She was the supervisor to all the nurses working at NET. Dianne was a registered nurse. She had an Associate and Bachelor Degree in Nursing and had worked at the hospital as a nurse in all intensive care units. She had been with NET for the last ten years. Dianne had around 15 years of experience as a supervisor at the hospital and at NET.

Karen had known her in the capacity of a nurse supervisor but had never worked with her. Karen had always greeted her every morning. Dianne would stop in her tracks and ask Karen how everything was and inquire if she needed any assistance. Their conversation would always end with a "*Have a great day*" before they headed off in separate directions. But things somehow changed. It all started with Karen's co-workers and team members approaching her for further clarifications and instructions with comments like "*Dianne was so vague…".* They complimented Karen for her assistance in front of Dianne. This starting irking Dianne and she erupted one day in meeting, announcing *"I am the supervisor and I am in charge of this department…Karen should remember her place…just a junior employee…".*

After that incident, Dianne started ignoring Karen completely. Even when Karen greeted her in the mornings with her greetings and smile, she would walk past without a single word. Soon afterwards, as was usual within the department all employees were asked to submit proposals on possible community healthcare initiatives. Karen had always submitted several proposals in the past, which had been appreciated and accepted by the department. Her flair for creativity and originality was always appreciated and encouraged by the department. However this time, her proposal was rejected on the grounds it lacked substance and appeal. When Karen confronted Dianne in private for more feedback. Dianne ridiculed her and told her that her work was "*simple*" and "*rudimentary*" and if this level of performance continued she would have problems in her upcoming evaluation. Further she started raising her voice so loud that outside all other employees could hear the conversation. Karen felt embarrassed and politely left the office towards the ladies room in tears.

From then onwards, Karen decided to avoid her. But now surprisingly Diane went out of her way to speak to her in public. In front of others, Dianne was a nice person. But behind closed doors, it was all criticism, constant humiliations and letdowns. Inspite of Karen's efforts to meet her demands, she was never able to reach Dianne's expectations. Karen's annual evaluations were always excellent, but this time (for the first time), she received "*below satisfactory*".

THE FEAR

Karen started hating work. On Sunday night, her stomach churned and she tossed restlessly in bed dreading the next day. She would drive to work thinking about her supervisor and her insulting behavior. She would think of reasons to call in sick to work. At work, she would keep watching the clock for 5 pm, to leave office.

Karen slowly started getting stressed, her hair started to fall out, and she lost a large amount of weight. At home, she was unable to focus—play with her daughter, cook dinner and fulfill her duties as a wife. She wanted to disappear, sink into sleep, and never wake up in the morning to go to work. The question that kept looming in front of her was "*What should I do*?"

GREENLIGHT PLANET: MADE IN CHINA OR MADE IN INDIA?

Romi Kher, Cornell University
Deborah Streeter, Cornell University

CASE DESCRIPTION

This case has been designed for use in junior and senior level undergraduate courses in Social Entrepreneurship or Business Planning, since students in either course may pursue business ideas that include social objectives or focus on the "triple bottom line."

CASE SYNOPSIS

In 2008, Greenlight Planet found itself making a critical manufacturing decision. The company had determined that the only affordable production opportunities for their solar-powered lanterns would be in Asia and began looking into cost and logistical details. Manufacturing in India, their target market, would lower transportation costs, avail them of tax breaks and provide the opportunity to create a grassroots movement. But the founders also discovered that Chinese manufacturers were financially competitive and allowed Greenlight Planet to consolidate their supply chain. What should the founders do and which country makes the most sense for the manufacturing decision?

INTRODUCTION

Patrick Walsh faces a critical decision about where to manufacture the solar-powered lanterns that he successfully marketed during the incubation stages of Greenlight Planet, the company he founded in 2004. Pondering the issue, Patrick considers the option of manufacturing in China, which could turn out to be the most competitive option in terms of price. But his partner, Mayank Sekhsaria, favors India as a sensible place to begin assembling the product since his family's business has had considerable success at contracting with factories there and has strong vendor relationships that could facilitate the process. Anish Thackar, the third partner, notes that since the product is sold in India, keeping the production process there will allow the entire management team be based in the same country and create domestic employment in India that could result in favorable treatment from the Central government. Patrick wants to focus on affordability, a crucial element for the ultra-poor consumers Greenlight Planet is targeting. But in this otherwise environmentally friendly industry of social entrepreneurs, he wonders whether the company will draw criticism for the carbon footprint associated with transporting goods from abroad, rather than using local production. The partners are now meeting to discuss their options and move forward with mass production. What should the team decide?

BACKGROUND

2004 – Early exposure to India

During his sophomore year at the University of Illinois, Patrick Walsh was exposed to Engineer Without Borders (EWB), an organization that Patrick today describes as "ostensibly a development NGO but excelling in giving sheltered Western engineering students some intimate experience with the challenges in the developing world." He joined EWB and began working on an electrification project in rural India. The goal of the project was to install a vegetable oil powered generator that would bring electricity to the village for the very first time. While Patrick had read about international development issues at the base of the pyramid, this was his first opportunity to contribute in a meaningful way and he could not wait to move to India for the summer.

During the installation, Patrick discovered that the village school, which was only half a kilometer away from the generator, could not be connected to the grid because the power lines would not reach that far. The villagers did not seem bothered by leaving the school off the grid as the children only attended class during the day, in plenty of sunlight. The team finished the installation and while the project was an overall success, the lack of electrification of the school really bothered Patrick. Spurred by his entrepreneurial spirit, Patrick began researching better alternatives that could offer superior performance at lower prices and more flexibility than the vegetable oil generators he was working with. He also wondered if he could improve upon the traditional kerosene lamps used in Indian villages and offer an alternative that could be cheaper and environmentally friendly.

Having worked semi-autonomously to solve problems with EWB and having dealt with various technical, financial, and political challenges, Patrick quickly learned to maximize his limited experience and resources. Thinking about the problems associated with the usage of kerosene lamps, Patrick hypothesized that solar power could be a viable alternative. After some initial research, Patrick discovered that in the U.S., solar-powered LED's were being used to light home gardens. He reasoned that such a technology could offer a cheaper and environmentally better option for the Indian villager as compared to the biofuel-based systems his team had installed. Patrick decided he would focus on solar solutions and thus, the first seeds for Greenlight Planet were planted.

2005 – Learning about the market

Following the initial project, Patrick was scheduled to spend the following summer in India working on various electrification projects as part of his commitments with Engineers Without Borders. Although the projects themselves focused on using biofuel-powered devices, Patrick decided he could also use this opportunity to pilot, on a small scale, his plans for using solar lanterns as a relatively inexpensive and environmentally friendly light source. Since he had no experience designing solar lanterns himself, Patrick went online to look for existing solutions and found a Chinese solar lantern that fit most of the necessary attributes. He purchased the solar device and took it with him to India and Argentina, in order to test it in under real conditions in the field and solicit feedback from the villagers.

It was not surprising that the concept of the solar lantern was well received in India, given the relatively high cost of fueling the kerosene lanterns that were pervasive in the areas Patrick visited. The solar-powered devices not only were a better and cheaper alternative to kerosene, but they also allowed individuals to light areas selectively to suit specific purposes. Three other things became obvious to Patrick as he worked on the various biofuel electrification projects in India:

- While biofuel powered generators were useful, they would never be scalable to the levels needed to support entire villages, due to cost factors and technological restrictions.
- In contrast, solar lanterns did not have scale restrictions. Furthermore, since villagers were used to paying for kerosene to fuel their lamps, it made intuitive sense that they would be willing to pay for a substitute product if it served their needs better and if the lantern was a quality build.
- Government approaches to village electrification lacked focus and on a national level, India lacked a coherent and integrated strategy.

Armed with this knowledge, Patrick returned to the University of Illinois and began working with a variety of people on design ideas for a solar lantern that would be sold commercially. His primary goal was to create an efficient and cost-effective lantern, using materials easily available in India, his target market.

2006 - Market Validation

2006 turned out to be a notable year for founder Patrick and Greenlight Planet. In January, Patrick received a grant for $10,000 from the EPA and a $17,000 grant from the National Collegiate Inventors and Innovators Alliance (NCIIA) that asked him to build prototype lanterns and test them in India. The grants required Patrick to demo his idea and determine demand. Armed with materials for 100 rudimentary prototypes, Patrick headed off to India during his winter break to build the first batch of lanterns and conduct market trials in the state of Orissa. The trials could not have gone any better for Patrick.

At the end of the very first demo, the translator turned to Patrick and told him that the villager wanted to know if the lantern was for sale. Patrick was shocked! The prototype was basic in design and unpolished. Patrick was even unsure if he could sell his prototypes while carrying out the terms of the grants, which specifically related to testing the technology. Each demo brought another request to buy the device and the overwhelming positive response to his lantern amazed Patrick. While he had hypothesized that there would be some demand for solar lanterns, he was caught off guard at how desperate the villagers were for a cheap and clean source of light. He quickly contacted the U.S. grant administrators for clarification about whether he could in fact sell the lanterns while carrying out the grant responsibilities. Both administrators said yes and by the end of his trip, Patrick was already in business. He returned to the U.S. encouraged with the validation and determined to begin building a serious company while staying in school to finish his degree.

2007 – Partners Onboard

A notable development in 2007 was the addition of Mayank Sekhsaria and Anish Thackar as dedicated partners in the Geenlight Planet endeavor. While working with various students and researchers at the University of Illinois, it became apparent to Patrick that not everyone working on the project had the commitment and dedication that was required to turn this project into a sustainable and financially viable business. However, in watching students move through this revolving door of talent, Patrick noted that Mayank and Anish stayed involved with the project. He knew to succeed he would need additional manpower and he invited the two students to join the business.

With his partners formally on board and buoyed by the overwhelming response to his market trials, Patrick finalized his prototype in the University labs, funding his efforts by applying for other grants and entering business plan competitions. His time at EWB had taught him that everyone from the local community, to the university, to private foundations, to the federal government had funding sources applicable for student projects, and since theirs fit into various niches (green engineering, poverty reduction, student startup companies, etc.), they began applying for grants and other competitions. They were so successful in raising money that by graduation, the team had amassed $100,000 is seed financing. This fundraising delayed the need for outside investors until after a more complete proof-of-concept could be prepared.

THE DECISION

Two points of view

With $100,000 raised and his partners on board, Patrick and his team know they have to make a manufacturing decision soon. Research has convinced the entire team that using U.S. suppliers would be too expensive, so they have all agreed that the lanterns would have to be manufactured somewhere in Asia to be cost effective. The three partners are now ready to present their respective views and make a decision so they can proceed with production.

Patrick has located component manufacturers and assemblers in China and believes that manufacturing in China makes the most sense. Mayank and Anish, on the other hand, favor manufacturing in India, based on their experiences and contacts there. Specifically, Mayank argues that his family can use its personal business contacts and experiences with factories in India to connect Greenlight Planet to a favorable situation.

Case for production in India

Anish and Mayank make the case for manufacturing in India by pointing out that India provides a one-country solution for Greenlight Planet. The lanterns can be assembled and sold in India, eliminating many shipping and import tax issues that would arise if the lanterns were made in China and then shipped to the market in India.

Additionally, the carbon footprint of manufacturing in China and shipping to India is higher as compared to keeping the supply chain integrated within India. The state Government of Orissa is also willing to provide some tax incentives if Greenlight Planet establishes a manufacturing facility and creates local jobs. Finally, they both point out that Mayank's family has an established list of contacts that can be leveraged.

Patrick agrees that the above are good reasons but reminds his partners that it will be unavoidable to import at least some of the components from China, since not all of them are available in India. Thus, it is not possible to keep the supply chain completely contained within one country.

Case for production in China

Patrick then makes the case for production in China by pointing out that based on his conversations with Chinese suppliers; it is possible to select component manufacturers and assemblers that can offer a more streamlined solution. He also reminds them that Chinese electronics factories may have more evolved quality-control processes than Indian ones, making it easier to produce to particular specifications. Finally, on a costs basis, it appears that the product would be less expensive, on an ex-factory basis, if manufactured in China.

Cost considerations

Patrick expects to manufacture the lantern for about $9 total cost in China (see Table 1) and considers the following financial information. Shipping is accounted for and Indian import duties will be 10% for the complete product. Additionally, freight and customs brokerage charges would amount to roughly $0.20 per unit if the finished product is shipped from China.

Table 1: Components and Assembly Costs in China	
Component	**Price FOB Shenzhen**
Solar Panel	$2.45
Battery	$1.60
LEDs	$0.75
Casing and Circuit	$2.75
Final Assembly	$1.30
Total	**$8.85**

Indian customs duties vary depending on whether the whole product is imported in a finished state, or individual materials are imported separately. Table 2 outlines Indian import duties for various renewable energy products.

Table 2: Components and Import Duties (* denotes a special government promoted rate)	
Component	**Import Duty**
Finished renewable energy product (eg: complete solar lantern)	10%*
Solar panels by themselves	5%*
LEDs	20%*
Other components	32%

The team must decide whether to import the complete finished product, or alternatively to import only certain components and assemble the finished product in India. In this latter case, the solar panel, casing, and circuit would be imported, while the other components would be sourced locally. This latter option would reduce freight cost by $0.08 and would save $0.20 on assembly.

Both Anish and Mayank agree that affordability is critical for success for Greenlight Planet but are concerned that none of the three partners have reliable contacts in China. Locating in China also leads to management and business development challenges. As Patrick and Mayank go back and forth, Anish steps in and says “Do we really know whether China is a cheaper alternative to India? Let’s go over the numbers again before we decide which one of us relocates to Shenzen”.

QUESTIONS FOR DISCUSSION

1. Based on your financial analysis, which production destination offers Greenlight Planet the most cost effective option? (back of the envelope analysis is fine)
2. Besides cost considerations, what other factors should come into play in making the decision?
3. Where do you think Greenlight Planet should manufacture its solar lanterns? Why?

A FORENSIC ACCOUNTING INTEGRATED CASE

John P. Osborn, California State University, Fresno

CASE DESCRIPTION

The subject matter of this case consists of three parts. The first part involves the effects on financial statements of recording fictitious transactions and the effects on financial statements of not recording required transactions. The second part involves the analysis of financial information when there are apparent (or should be apparent) inconsistencies between the information reported in the financial statements and other provided information. The third part consists of the analysis of an internal accounting control system that contains some areas of weakness.

This case can be useful in any accounting course after basic accounting topics, including internal control, have been covered. All three parts of the case have been student tested in a Forensic Accounting course after the applicable topics were reviewed in class. The individual parts, or the entire case, can be assigned either as an in-class/group project, take home assignment, or in-class exam.

This case has improved student learning when used relatively early in a Forensic Accounting course as it provides a solid base of the rules surrounding financial accounting and internal control that students need to solve advanced forensic accounting cases. When combined with lecture this case will help get students "up to speed" with their understanding of financial accounting relationships and internal control.

CASE SYNOPSIS

This case provides a practicable example of a small business that has just begun operations and is experiencing business and accounting issues. There are multiple topics included in the case. First, is a real world example of a business recording inappropriate transactions and failing to record appropriate transactions, in order to produce financial statements that reflect a financial position and results of operations that is better than the application of Generally Accepted Accounting Principles (GAAP) would produce.

The information contained in financial statements may look perfectly acceptable, prior to closer scrutiny. There are danger signs that accountants and other users of the financial statements should be aware of. The second part of this case provides an opportunity for students to analyze financial data based on financial relationships and other information to determine whether additional information may be required to determine the accuracy of the financial statements and their component parts.

Third, small businesses with few employees have a built in disadvantage with regard to the application of appropriate internal control. This case provides an opportunity for students to apply some basic concepts of internal control to a business that contains weaknesses that occur in real world situations.

INTRODUCTION AND FACTS

Al B. Seeinyou began operating his new business January 1, 2012 in the central valley of California. The area contained many agriculture businesses, most having a substantial need for pumps. Al, known as Big Al, had worked for one of the large pump manufacturers located in the area. He began with the pump manufacturer on the production line but eventually moved into sales. His employer only sold pumps to large retailers that resold to the consumer, the agricultural businesses.

Big Al was aware that the large retailers maintained a full line of pumps and because of the typically large orders received from the large agricultural companies gave large discounts and excellent customer service to these large volume customers but provided minimal customer service and usually no discounts to small and medium sized customers.

The business Big Al opened, Big Al's Pumps, consisted of selling the more popular pumps to small and medium sized agricultural companies in the area. By buying large quantities of the bestselling pumps directly from the pump manufacturer he would receive large discounts on his purchases and his inventory could be kept reasonably small because he wouldn't carry pumps other than the bestselling ones. He could resell the pumps at twice his cost, prices that would be as low as or lower to his customers than what they would pay to the large pump retailers and he would provide much better customer service. For example, Big Al provided the service of taking orders over the phone and delivering the pumps to the customer, a service not offered by the large pump retailers.

Big Al located and leased commercial space for Big Al's Pumps. He signed the lease agreement October 1, 2011 with the sixty month lease period beginning January 1, 2012 and ending December 31, 2016. The lease agreement provided for a monthly payment of $4,000, payable at the beginning of each month, and an additional two percent of annual gross sales revenue, payable on or before February 1 of the following year. The agreement also included Big Al's payment of a deposit consisting of the payment of rent for December 2016 on October 1, 2011, the date the lease was signed. The period October 1 through December 31 was rent free and allowed Big Al to make the improvements needed to convert the space to his warehouse and small retail area. The rented space already included two moderately sized offices but he needed to make some leasehold improvements. The free rent period also allowed him the time needed to purchase inventory and equipment and hire employees so he could open for business on January 1.

EMPLOYEES OF BIG AL'S PUMPS

Big Al decided not to incorporate Big Al's Pumps so he was not an employee of the business. He did plan on the business becoming successful enough that he could eventually take cash withdrawals from time to time as he would eventually need cash withdrawals to cover his living expenses. The three employees began work Monday, January 2, 2012.

Little Al—Big Al hired his son, Al B. Seeinyou, Jr., known as Little Al. Little Al has had trouble getting and keeping a regular job. Big Al thought all Little Al needed was some direction so he hired Little Al and gave him the title of Store Manager and a weekly wage of $800. Little Al was put in charge of sales at the store, both over the counter sales and taking telephone orders. Big Al's Pumps received very good walk-in traffic because the area contained other agricultural supply stores.

Henry—in the initial stages of the business formation Big Al mentioned to Little Al that the business would need an employee to manage the inventory in the warehouse, pick up pumps ordered from the manufacturer, and make deliveries of pumps to their agricultural customers. Little Al told his Dad that he knew someone who was looking for work and who would be perfect for the job. Big Al interviewed Henry and thought Henry's qualifications were acceptable. When Big Al mentioned to Little Al he planned to call the businesses Henry listed as previous employers Little Al became upset and asked his father why he didn't trust his judgment. Big Al relented and called Henry on the phone that afternoon and hired Henry for $700 per week.

Martha—during the interview with Henry, Big Al mentioned that he was also looking for someone who could do the books, do all the banking, pay the bills, and all other office related duties. Big Al joked with Henry that he knew nothing about accounting, and had never even prepared a bank reconciliation, that he wasn't even sure what a bank reconciliation was. Henry told Big Al that his mother-in-law had been a bookkeeper for the last twenty five years and he had heard her talk about doing everything Big Al wanted. Henry said Martha was available and would send Martha by the next morning. When Big Al got to the store about ten minutes before 8 the next morning Martha was waiting outside the front door. Big Al immediately thought Martha looked very much like his deceased mother and was very impressed with her apparent promptness and motivation. During the interview Big Al didn't understand enough about accounting or what needed to be done in the office so he asked Martha what she had done on her previous jobs. Martha's answers assured him that she could take care of all the accounting and banking and whatever other office related functions were required. He hired her at $600 per week.

ACCOUNTING POLICIES AND PROCEDURES

Martha told Big Al she applied the accrual method of accounting using QuickBooks and applied other accounting rules, as follows:

Cash—all cash received by Big Al's Pumps is deposited into the Cash-Operating account. Cash is transferred from the Cash-Operating account to the Cash-Payroll and Cash-Money Market accounts as needed and available, respectively.

Accounts Receivable/Bad Debts Expense—the collection terms for sales on account are 1/10, net 30. Martha told Big Al most customers pay within ten days and take the discount. She added that the customers who don't get the cash discount pay within 30 days. The allowance method, using the percent of accounts receivable method, was applied for the estimation of bad debt expense. Martha told Big Al she wrote off a couple of uncollectible accounts during 2012.

Inventory—the FIFO method was applied for the cost flow assumption. Big Al makes sure the order sizes are large enough to receive quantity discounts from the manufacturer. Big Al estimated the orders for each type of pump were enough to last for six to eight weeks. When Henry tells Big Al they are low on a particular pump Big Al calls in the order and when it's ready, usually in a day or two, Henry picks it up in the company van. Big Al considered taking a physical inventory at the end of the year but was just too busy.

Property, Plant, and Equipment—during the year Big Al purchased two company vehicles, a van for the pick-up and delivery of pumps and a small truck for himself. Both vehicles will be used one hundred percent for business purposes. He also purchased a small fork lift for the warehouse and office equipment including three desks, two computer work stations, and filing cabinets. Big Al also installed some leasehold improvements such as storage shelves in the warehouse and a sales counter and two display cases in the sales room. Depreciation is computed using the straight line method over various years depending on the type of asset.

Accounts Payable—Big Al instructed Martha to pay all the bills immediately as they are received. He thought it was a good idea that payments to vendors and employees be signed only by him or Martha.

Long Term Debt—Big Al signed a note to the Valley Bank for the receipt of $100,000 on February 1, 2012 and another $100,000 on October 1, 2012. The loan arrangements were for the payment of interest only, at 6% per annum, until January 1, 2015 at which time the remaining principal balance would be converted to a mortgage. Financial statements must be provided to the Valley Bank annually by March 1 following the close of the year. The terms include immediate principal repayment if certain financial conditions aren't met.

Al B. Seeinyou, Capital—to start the business Big Al invested $100,000. He didn't withdraw any cash from the business during 2012, instead living off his savings.

Sales and Cash Collections—sales are approximately evenly split between cash sales and sales on account. Cash collections, whether from current sales or from accounts receivable, are deposited into the Cash-Operating account. Martha said sales increased only slightly from January through December 2012.

Wages—all employees are paid for a five day work week and paid weekly on Friday for the Monday through Friday work week just ended. As of December 28, 2012, a Friday, there were 52 full weeks paid during 2012. Employees were paid Friday, December 28, 2012 and again Friday, January 4, 2013, both checks for a full week.

Figure 1: Format for Journal Entries

At 12/31/2012

Journal Entry #	CORRECT Account	Dr	Cr	ACTUAL Account	Dr	Cr

Table 1: Format for Overstated and Understated Accounts		
Account	**Overstated**	**Understated**
Cash-Operating		
Cash-Payroll		
Cash-Money Market		
Accounts Receivable		
Allowance for Doubtful Accounts		
Inventory		
Prepaid Insurance		
Prepaid Rent		
Current Assets		
Leasehold Improvements & Equipment		
Accumulated Depreciation		
Total Assets		
Accounts Payable		
Current Liabilities		
Long Term Debt		
Al B Seeinyou, Capital		
Liabilities and Owner's Equity		
Sales Revenue		
Sales Returns and Allowances		
Sales Discounts		
Net Sales		
Cost of Goods Sold		
Gross Profit		
Wages Expense		
Rent Expense		
Insurance Expense		
Depreciation Expense		
Utilities Expense		
Payroll Tax Expense		
Bad Debts Expense		
Interest Expense		

Table 1: Format for Overstated and Understated Accounts		
Account	**Overstated**	**Understated**
Miscellaneous Expense		
Interest Income		
Net Income		

Table 2: Financial Information for 2012	
Account	**At 12/31/2012**
Cash-Operating	1,365
Cash-Payroll	1,000
Cash-Money Market	8,736
Accounts Receivable	57,908
Allowance for Doubtful Accounts	(6,734)
Inventory	87,341
Prepaid Insurance	12,000
Prepaid Rent	4,000
Current Assets	165,616
Leasehold Improvements & Equipment	151,905
Accumulated Depreciation	(18,397)
Total Assets	299,124
Accounts Payable	28,000
Current Liabilities	28,000
Long Term Debt	200,000
Al B Seeinyou, Capital	99,124
Liabilities and Owner's Equity	299,124
	Year end 12/31/2012
Sales Revenue	545,967
Sales Returns and Allowances	(17,475)
Sales Discounts	(30,233)
Net Sales	498,259
Cost of Goods Sold	(275,000)
Gross Profit	223,259
Wages Expense	(109,200)
Rent Expense	(48,000)
Insurance Expense	(12,788)
Depreciation Expense	(18,397)
Utilities Expense	(23,000)
Payroll Tax Expense	(14,000)
Bad Debts Expense	(6,734)
Interest Expense	(1,000)
Miscellaneous Expense	(8,000)
Income Tax Expense	(3,000)
Net Income	(20,860)

ILLINOIS ADHESIVES, INC: A CASE OF UNFAIR LABOR PRACTICES?

Mel Schnake, Valdosta State University
Robert J. Williams, Valdosta State University

CASE DESCRIPTION

This case examines the process of good faith bargaining between a labor union and a company. More specifically, this case involves an acquisition and the law of successorship as well as the duty to bargain in good faith and employer lockouts. The behavior of both striking employees and a security firm hired by the company during the lockout are also issues. Further, the acquiring firm has to negotiate a new labor agreement with the employees' union, and the case examines whether the company engages in fair or unfair labor practices as specified in Section 8(a) of the National Labor Relations Act and whether the union engaged in unfair labor practices specified in Section 8(b) of the NLRA.

The case has a difficulty level of three, appropriate for junior/senior level students. The case is designed to be taught in one class hour, and is expected to require one or two hours of outside preparation by students.

CASE SYNOPSIS

A firm and its employees' labor union(s) often share an adversarial relationship. This may be particularly true when one firm acquires another firm and negotiate a new labor agreement with the employees' union. Charges of unfair labor practices and bad faith bargaining may arise in these situations. This case helps students understand what actions are fair and unfair in negotiating an acceptable labor agreement, management's duty to provide information to the union negotiating team, and unfair labor practices during a lockout. This case is an effective teaching tool for students in a labor relations course, a human resources course, and can also be used in the introductory management principles course.

ILLINOIS ADHESIVES, INC

Background

The town of Bluffs City was founded in 1832. By then, it already had several general stores, a blacksmith shop, a distillery, and a sawmill. A year later, the first one room school was established. By 1838, it had become a booming railroad town and the railroad was the major employer for several years. Located on the Illinois River, one of the largest industries in the town was fishing. In 1925, the Bluffs City Fish Company shipped over half a million pounds of carp and buffalo to markets in the northeast. Bluffs City Chemicals began operations in 1955 and quickly became the major employer in the area. BCC manufactures various types of adhesives and sealants, and while unionized for over 50 years, experienced few strikes or difficulties between management and the union. In fact, in those 50 years, the union had gone on strike only once.

In late 2004, BCC sold its Bluffs City plant to Illinois Adhesives, Inc. who continued operations without change. In 2004, the plant employed around 150 full-time employees, represented, as they had been for over 50 years, by the International Brotherhood of Boilermakers Union, Local 798. Immediately after the purchase, the company recognized the union as the exclusive bargaining agent for employees in the bargaining unit of production and maintenance employees, and agreed to be bound by the existing contract until its expiration about two weeks later. The bargaining unit included the following jobs (hourly wage rates in parentheses): helpers ($20.18), janitors ($20.18), warehousemen ($20.18), assistant operators ($21.36), maintenance employees ($21.75) and operators ($21.95). The company also agreed to extend the contract, due to expire on January 16, 2005, for 120 days after the company began operating the facility.

On February 5, 2005 Illinois Adhesives, Inc. began operating the Bluffs City plant. Due to the contract extension agreement, this meant the current contract would expire on June 4, 2005. The company also unilaterally changed the employees' health insurance provider. Under the current contract, employees did not contribute to their health insurance coverage. It also provided that in the event of an employee's death, health care benefits would continue for the employee's spouse and eligible dependents for six months. At this same time, a local employment agency began advertising positions for maintenance workers for the Bluffs City plant.

In April, the company announced that it had conducted a wage survey in March that showed that wages and benefits at the Bluffs City facility were much higher than those at other employers in the area as well as at Illinois Adhesives' other facilities. The company also reported that it had hired a business consultant to review the Bluffs City operations and the consultant recommended that the maintenance department be reduced from 29 to 11 employees and that much of the work of maintenance, warehouse and janitorial functions should be performed by outside contractors.

In a letter dated March 31, 2005, the union formally requested that negotiations on a replacement contract begin. The letter also contained several information requests by the union including: the most recent average straight time hourly earnings report, and an itemized list of fringe benefits and the cents per hour cost of each benefit. Also requested was a complete copy of the current health insurance plan. The company and the union agreed that negotiations would begin on May 12. The company did not respond to the information requests.

Contract Negotiations Begin

The company began the May 12 opening bargaining session by stating that the Bluffs City facility did not meet the company's safety standards and was the company's least competitive adhesives plant. The management negotiating team then said that the company needs more flexibility and needed to cut costs. The union then presented a complete contract proposal which included a \$.25 per hour wage increase. The company then requested that negotiations begin with non-economic items and the union agreed.

At the second bargaining session on May 13, the union requested a copy of the sales agreement between Illinois Adhesives and Bluffs City Chemicals. Between May 17 and May 27, the two sides met a total of eight times and bargained over non-economic items. On May 20, the union sent the company another letter repeating its request for the average hourly earnings and benefits rate information. By May 20, a tentative agreement was reached on most non-economic items for the maintenance, warehouse, and janitorial employees. They also reached tentative agreement on the number of paid vacation days per year based on years of service and that employees could carry over eight vacation days from one year to the next. Also agreement was reached on a code of conduct provision.

At the May 25 bargaining session, the union expressed its concern that the 120 day contract extension would expire in just over a week and asked for the company's proposal on economic terms. The company responded that it hoped to make its economic proposal on May 31, and that a manager from the corporate office would be in attendance to answer the union's questions on health insurance.

The 11th bargaining session was held on May 31, 2005. The company presented its first economic proposal beginning with health insurance. The company offered employees a choice of two health insurance plans, as well as a dental plan. A corporate office employee was present and explained the two insurance plans. The union expressed concern that there was a lack of network doctors in the area under one of the plans (which was the one the company had unilaterally implemented in February). The corporate office representative responded that the union could shop around for a better plan. The union again requested copies of the insurance plans.

At 8:30 pm on May 31 the company made its full economic proposal. It included a yearly wage increase of \$.25 per hour to all bargaining unit employees, except Helpers. About 50 of the 175 bargaining unit employees worked as Helper. The company's proposal also included a \$750 bonus for the first year of the contract, a minimum bonus of \$750 with an additional performance-based bonus for the second year, and performance-based bonuses for years three and four. There were no criteria specified for the performance-based bonuses. The company also proposed that unit employees pay a set amount of their health insurance costs for 2005, eliminating health insurance benefits for retirees, and substituting COBRA coverage for dependents following the death of an employee. The company also proposed reducing the accidental death and disability benefit from two to one times base pay, and changing the 401(k) plan provider from Fidelity to JP Morgan. The company also proposed increasing its matching contribution from 3% to 4% of an employee's pre-tax contribution. The company did not respond to a union request for increased pension plan contributions.

At the June 1 bargaining session, the union stated that it would shop around for better health insurance. The company responded that the negotiations team member who had suggested that to the union had misspoke and that the company was only interested in the current provider. The union made a request to extend the current contract, but the company did not respond. Negotiations then turned to wages. The company provided the union with a copy of its wage survey that stated that its wage proposal was based on this survey. The union revised its wage proposal and asked for a yearly wage increase of 10% per hour which would amount to an average hourly wage increase of $2.14 during the first year of the contract. The company offered a counter-proposal of $.30 per hour per year for all bargaining unit members except Helpers. The company also proposed increased bonuses for years one and two of the contract to $900 and retained its language on performance-based bonuses. The management team also offered increasing the 401(k) matching contribution to 5% and offered health insurance to retirees at the same rates that current employees would pay. The two parties reached tentative agreement on transferring the 401(k) plan to JP Morgan and on the 5% matching contribution. The union then submitted a written request for copies of the health insurance plans and orally requested information about the pension plan.

At the June 2 bargaining session, the company presented a third economic proposal which included an increase in its hourly wage offer to $.35, an increase in the bonuses for years one and two to $950 while retaining the performance-based bonus language. The company also announced that unless a contract agreement was reached by June 4, 2005 at 7 am, the bargaining unit employees would be locked out beginning at 11 pm on June 5. The company then made another economic proposal including a wage increase of $.45 per hour to all bargaining unit employees except Helpers, who would receive a $900 lump sum payment in each year of a three-year contract. All bargaining unit members, including Helpers, would receive $1000 bonuses in years one and two, and the performance-based bonus language would be eliminated. The two sides tentatively agreed that shift differential pay would increase from $.50 per hour to $.55 per hour.

Management's Final Offer

At the June 3 bargaining session, the management team presented the union with its last, best and final offer, however, the document that it presented to the union did not contain many of the prior tentative agreements. The union requested a 60 day extension of the current contract so it could prepare a counterproposal on health insurance. The company refused and at 5:20 pm presented the union with its final offer which now contained most of the previous tentative agreements. The final offer was essentially the company's fourth economic proposal. The union made an oral counteroffer which included capping weekly employee health insurance contributions at $5 for employee only and $10 for employee plus one dependent and $20 for family coverage. The union also reiterated its request for a 10% across the board hourly wage increase, but offered that newly hired Helpers would receive a slightly lower starting wage. The company rejected the union's counteroffer. In response to a union question about the lockout, the company stated that employees would be locked out if a contract was not reached by 7 am the next day, and that the lockout would end when the employees ratified a contract. The two parties then tentatively agreed that the increase in shift differential pay and the company's matching 5% contribution to the 401(k) plan would be retroactive to January 16. The union reiterated its request in writing for pension plan information.

At 7 pm that night the union held a meeting of its members to discuss contract negotiations. The union members expressed a number of concerns including having to pay for health insurance, the Helpers not receiving a pay raise and changing the 401(k) plan from Fidelity to JP Morgan. The members agreed that they would not hold a ratification vote on the contract until the company provided the requested information on the average hourly pay rate, the health insurance plan and the pension plan.

The Lockout

On June 5, the union again offered to extend the current contract. The company refused and at 11 pm locked out the bargaining unit employees. The company had made arrangements for temporary replacement employees to operate the plant during the lockout, and there was no interruption in production. The company used several local temporary employment agencies to fill the jobs, and contracts with these agencies could be cancelled with seven days' notice. They did, however, change from three 8 hour shifts to two 12 hour shifts. The company also hired a private security firm which was already at the plant when the lockout began. The next day, the union established a picket line at the plant entrance. The private security company also established a presence at the plant entrance, putting up a shelter where security guards video recorded the employees on the picket line and regularly patrolled the plant perimeter. Several employees reported to union officials that they had observed guards from the private security firm driving slowly through residential neighborhoods video recording employees and family members, including the employees ' children, in their yards. Several businesses in the town began displaying signs including, "We Support Local 798," and "Scabs Not Welcome Here."

The company informed the union that it would not negotiate again until the union held a ratification vote on the company's final offer. Over the next several days, the two sides dealt with the union's information requests. On June 10, the company provided the union with the average hourly wage and benefit rates. The company asserts that it had previously provided information on the health insurance plan, but the union alleges that it received this information on June 10 also. On June 13, the union faxed two information requests to the company: (1) repeated request for a company dental plan summary description and (2) pension plan information. The company provided a copy of the dental plan information that same day, but stated it had already provided the union with 160 copies of that plan. The company stated it did not have the requested pension plan information because the plan assets had not yet been transferred to it from the previous owner (Bluffs City Chemicals). The company also informed the union that it would not disclose the sales agreement between Illinois Adhesives and Bluffs City Chemicals because it contained confidential information. The union responded that it needed that information for pension, medical and retiree contract issues. The union submitted a revised request to accommodate the company's confidentiality concerns and the company denied it on June 15.

The union held a membership meeting on June 15 to discuss negotiations. The employees were still reluctant to vote on the company's final offer. They believed they needed the requested information in order to assess the company's proposal. Union leaders reminded the members that the company had stated that it would not resume contract negotiations until a ratification vote was held on the final offer. The members then voted and the company's final offer was rejected by a vote of 145 to 2.

On June 28, the two sides held their first bargaining session since the lockout began. The union stated that one sticking point was that the final offer did not include a wage increase for Helpers. The company responded that the Helpers would have received a wage increase if the union had not rejected an earlier proposal by the company to covert the job of Helper to Assistant Operator. The Union responded that the company had never made such a proposal. There was nothing in the unions' bargaining notes about converting these jobs and there was no written proposal from the company. The union asked how many employees this would affect, and the company responded that it applied to 32 production Helpers, but did not include 25 non-production Helpers. The union accepted this proposal and made a counter proposal to the company's final offer. The union proposed a five year contract with yearly across the board wage increase of \$.75 per hour, bonuses of \$1000 for years one and two of the contract, performance-based bonuses for years three through five and caps on weekly employee health insurance premiums as follows: \$10 for employee only, \$20 for employee plus one dependent, and \$30 for family coverage. No agreement was reached on the union's proposal.

At the July 6 bargaining session, the company began by distributing a document entitled "Talking Points" to the union bargaining team members. The document included the following points:

- We offered you a generous proposal considering the efficiencies and cost savings we need to achieve in order to make this plant profitable. Yet, union leadership ignored all the data presented showing this plant is 40% less productive than our other plants.

- The union continues to ignore the cost disadvantages we have in wages and benefits compared to other firms in this area.

- The union counteroffer is far from our final offer. Your counteroffer shows a complete misunderstanding of the reality of our situation.

- Therefore, we are rejecting your counterproposal, withdrawing our final offer, and submitting a new proposal based on what we now know, and based on a comparison of our other plants.

The company's new proposal reduced the helper wage rate to \$14 per hour and the assistant operator wage rate to \$17 per hour. Depending on their specific classification, operators would be paid either \$20 or \$22 per hour. The proposal did not include any wage increases or bonuses for its three year term. The company also proposed contracting out all of the maintenance, warehouse, and janitorial functions which would eliminate 37 jobs. The company also stated that the increases in shift differential and 401(k) plan matching contributions would not be retroactive as had been previously agreed. The company also withdrew previous tentative agreements on vacation, eliminated carrying over 8 vacation days per year, and reduced the number of paid vacation days based on years of service.

The union asked if the company was operating during the lockout. A management bargaining team member stated "Not only are we operating, we're setting all time production records!" The union asked for documentation of this claim and the management team agreed to provide it.

The union then made a counteroffer. It proposed a five year contract with yearly wage increases of $.65 per hour for all bargaining unit employees. It also included a bonus of $1000 in the first year of the contract, a minimum of $1000 bonus in the second year, and included the company's' performance-based bonus language. The union also proposed capping employee health insurance premiums at 2005 levels for the life of the contract. The management team responded that the union's counterproposal was not even close.

At the July 7 bargaining session, the company made only minor changes to its previous proposal except that it now asked for a four year contract. The management team repeated that the plant continued to set production records with fewer employees than before the lockout. The union then counter-offered with the terms of its previous counteroffer except for a four year contract term. The management team stated that it did not have to raise wages and that employees had to pay their share of health insurance costs. The union team stated that subcontracting bargaining unit work was a stumbling block to an agreement. The management team responded that it was more economical to subcontract maintenance and they would provide documentation to support this claim. The union then presented another counteroffer which included a $.55 per hour raise for the first year for all bargaining unit employees except Helpers and Janitors. Helpers and Janitors would receive $900 bonuses in each of the last three contract years, while all bargaining unit employees would receive $1000 bonuses in each of the first two years of the contract. The union also proposed capping medical and dental premiums for the life of the contract at 2005 rates. The management team responded that the proposal was a major move, but the meeting adjourned without an agreement.

On July 11, the company team telephoned the union and stated it was not interested in changing from its last proposal (of July 7). On July 13, the union sent a letter to the company requesting the names, addresses and wage and benefit rates for all temporary replacement employees. On July 19, an Illinois state court issued a temporary restraining order against the union for picket line misconduct which limited the number of striking employees on the picket line at any time to no more than six employees. On July 21, the company denied the union's request for information about the temporary replacement workers. The company also filed an unfair labor practice charge against the union alleging a violation of Section 8(b)(1) of the NLRA for repeated instances of picket line misconduct. An Illinois state court then issued a permanent injunction limiting the number of picketers to a maximum of six and prohibiting picketers from engaging in any intimidating behavior toward replacement workers.

On August 4, the two sides met with a federal mediator. The company requested that the mediator ask the union to list all outstanding information requests. The union again requested the names, addresses and phone number of the pension plan administrator; the sales agreement between Illinois Adhesives and Bluffs City Chemicals; and documentation of the production records since the lockout began. The union also stated it was waiting for a counteroffer from the company.

On August 5, the company submitted a written response to the union's information requests. The company provided information about the pension plan administer and provided three production records that had been set since the lockout began, but denied the request for the sales agreement .

The two sides were scheduled to meet with the federal mediator again on August 12. Before this meeting, the mediator presented the company's counteroffer to the union. This counteroffer was the same as the company's July 7 proposal. The union sent a letter to the company accusing it of regressive and surface bargaining and requested additional information on production, quality, costs of production, and customer complaints. The mediator asked both sides if there was any point in continuing, and both sides said no.

The two sides met again on October 19 and the company offered to allow employees the option to purchase supplemental accidental death and disability insurance, but retained the rest of its July 7th proposal. The union responded that it was sticking with its second counterproposal made on July 7. They met again several times in November and December but were unable to reach an agreement. On December 19, the company filed an unfair labor practice charge alleging the union violated Section 8(b)(3) of the NLRA by bargaining in bad faith by insisting to bargain from the company's final pre-lockout offer and refusing to bargain from the company's regressive July 6th offer.

The union filed several unfair labor practices against the company, alleging the company violated Section 8(a)(1), 8(a)(3) and 8(a)(5). Specifically, the union alleged that the company did not negotiate in good faith from the outset, by refusing to provide relevant information to the union, by withdrawing from tentative agreements on contract issues, by offering a regressive contract proposal, and intending to frustrate negotiations. Further, the Union alleged that the lockout was illegal since the two sides were not at a bona fide impasse at the time of the lockout.

QUESTIONS FOR DISCUSSION

1. If you represented the union what specific actions would you cite to support an unfair labor practice charge that the Company was not bargaining in good faith?
2. Was the lockout of employees by the company legal or illegal?
3. Did the Company have to recognize the union and agree to abide by the existing labor agreement even though the company was not party to the negotiations which produced that contract?
4. Striking union members did engage in some prohibited conduct on the picket line, including throwing nails on the road at the plant entrance to flatten the tires of the replacement workers' vehicles, and yelling obscenities at the replacement workers as they arrived at the plant. Does this fact have any impact on the contract negotiations or the lockout?

5. Did the Company have any legal duty to provide the information requested by the union?
6. If you were the NLRB investigating officer, how would you rule on the union's charges that the Company violated sections 8(a)(1), 8(a)(3) and 8(a)(5) of the NLRA?

AUDUBON HILL: A RELATIONSHIP MARKETING CASE STUDY

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CASE DESCRIPTION

The following case demonstrates how local businesses can flourish even in tough economic times. The case highlights two dominant marketing topics, relationship marketing and customer gratitude, and reveals their favorable effects for a small local business. The case is particularly applicable in an introductory marketing course, although it is also suited for undergraduates enrolled in management, fashion merchandising or retailing courses. It is recommended that students will assess the company's marketing strategy as well as target market, and examine the company's practice of relationship marketing and generation of customer gratitude. Students should expect to spend two hours outside of class reviewing and responding to the case questions in groups. An in class discussion can follow, in which the class hears all of the different group responses.

CASE SYNOPSIS

Audubon Hill Antiques and Gifts is a gift shop located in Saint Francisville, Louisiana. Saint Francisville was founded in 1809 and has traditionally been a popular tourist attraction due to its historic plantations, churches, cemeteries, gardens and renowned golf course. Audubon Hill is located in the downtown market district and the rustic design of the store fits in well with the town's history. The store has been in business for six years and carries a wide assortment of high-end merchandise including gifts, antiques, home décor, jewelry, bath and body products, children and baby items, women's and men's clothing, accessories, seasonal merchandise, souvenirs, and traditional Louisiana specialty foods. Gifts can be found for weddings, baby showers, holidays, and birthdays for all ages. The owner, Kathleen, describes the store as being the place where you can find a gift for anyone and take a little piece of Louisiana home with you. Although Audubon Hill has survived the 2008-2012 global recession thus far, the owner worries about the company's future. Since 2008, tourism in Saint Francisville has been unpredictable and Audubon Hill's current year-to-date sales are down from last year. Kathleen's afraid that Audubon Hill may not experience enough sales to keep the business operating.

AUDUBON HILL OVERVIEW

The downtown market district in Saint Francisville, LA has been steadily experiencing fewer customers than prior years. In the past five years, various local retailers have gone out of business, including clothing and antique shops, video stores, and a neighborhood meat market. The decline in Saint Francisville patronage is likely due to turbulent economic conditions and decreased tourism. According to statistics provided by the director of the West Feliciana Parish Tourism Commission, Katie Smith, Saint Francisville tourism has declined from 2008 – 2011 (See Table 1) and has not experienced nearly the same tourism levels as New Orleans. In fact, Saint Francisville recently had to increase sales tax, which is another indication of the financial hardship being experienced. After seeing several of the local businesses close as well as experiencing a decline in sales, Kathleen, the owner of Audubon Hill Antiques & Gifts, a shop located in Saint Francisville, is worried about her own business and whether it can stand these market conditions. Kathleen states, "In the past few years, I've witnessed many nearby businesses close, and I don't want to end up like one of them. My sales have been mediocre, and I know I need to change some things around this shop to stay afloat, but I don't know what to change."

Table 1: Tourism Statistics for Saint Francisville and West Feliciana Parish

Year	Total Annual Visitors	Percentage Change in Visitors (Base 2008)	Average Monthly Visitors
2012[1]	8,154	N/A	1,019
2011	14,252	-39%	1,188
2010	17,807	-24%	1,484
2009	21,407	-8%	1,784
2008	23,348	-	1,946

Saint Francisville was established in 1809 and rests on bluffs overlooking the Mississippi River. The town and its surrounding parish (i.e. county), West Feliciana, has traditionally generated a large amount of tourism. In fact, the annual financial impact for tourism in the West Feliciana Parish is roughly $18 million. Saint Francisville's plantations such as the Myrtle Plantation, which is proclaimed as one of America's most haunted homes; as well as the picturesque Rosedown, Butler Greenwood, and Greenwood Plantations, are primary tourism venues. In addition, historic churches and cemeteries are other popular sites, including Grace Episcopal, Our Lady of Mount Carmel Catholic Church, United Methodist Church, Hebrew Rest Cemetery, and Locust Grove State Historic Site. Saint Francisville is also home to the renowned golf course, The Bluffs, which has been recognized as one of the best golf courses in Louisiana as well as one of America's top public golf courses. Lastly, Afton Villa Gardens, is another tourist site that includes roughly 250 acres of lavish gardens. Not surprisingly, due to its quaintness and beauty, Saint Francisville is a popular venue for Louisiana weddings, which are often held at the aforementioned plantations, churches and gardens.

Saint Francisville is roughly 40 minutes north of Baton Rouge, Louisiana and two hours northwest of New Orleans, Louisiana. According to the 2010 census, Saint Francisville's population equated to 1,765 people which is only a 3.1% increase from the 2000 census (an increase of 53 people). Residents are primarily white. The median age of Saint Francisville residents was 36.8 years and the median household income was $44,605. See Table 2 for more demographic information.

Table 2: Saint Francisville, LA Demographic Information

	Counts	Percentages
Gender		
Male	848	48.05%
Female	917	51.95%
Age		
0-4	115	6.52%
5-19	389	22.04%
20-39	457	25.89%
40-64	565	32.01%
65 & over	239	13.54%
Race		
American Indian & Alaska native	1	.06%
Asian	11	0.62%
Black or African American	421	23.85%
Native Hawaiian & Other Pacific native	0	0%
Some other race	65	3.68%
Two or more races	25	1.42%
White	1,242	70.37%

Audubon Hill is located at the entrance of the downtown Saint Francisville market district. Matching the historical nature of the town, Audubon Hill is located in rustic building originally constructed in the 1880s, which still retains most of its antique features. The retail space is roughly 4,000 square feet. The back of the shop (1,300 sq. ft.) which includes a kitchen, is rented out approximately two times per month for various occasions, including bridal and baby showers, rehearsal dinners, birthday parties, and chamber of commerce meetings. The cost to rent the space is $400 per day. When such events take place, the shop is divided by two victorian pine doors to isolate the selling space, however for the remainder of the time the space is used to display merchandise.

Table 3: Audubon Hill's Sales by Category			
Category	**Revenue ($)**	**Quantity Sold**	**Margin (%)**
Accessories	8,624.62	297	-214.52
Antiques	2,069.94	78	33.55
Baby	5,017.48	343	14.14
Bath & Body	23,026.21	1,983	7.30
Children	19,294.30	2,961	22.46
Women's Clothing	20,204.99	1,027	22.40
Men's Clothing	5,987.63	255	36.34
Food	8,232.25	1,619	35.19
Gifts	19,334.13	2,715	37.89
Home	48,551.52	2,525	28.70
Jewelry	48,780.15	2,054	26.28
Seasonal	18,417.38	1,582	18.95
Souvenirs	7,896.76	550	19.41

Audubon Hill sells a broad variety of merchandise in hope that customers can find a gift for anyone, even themselves. Product categories consist of *accessories*, which includes purses, wallets, luggage, backpacks and other bags; *antiques*, which includes serveware and home decor items from the 1800s; *baby*, which includes clothing, shoes, pillows, blankets, and books; *bath and body*, which includes candles, soaps, lotions, and fragrances; *childrens*, which includes clothing, toys, games, and books; *women's and men's clothing*; *specialty food items*, which includes different sauces, jellies, baking mixes, and spices used in traditional Louisiana cuisine; *gifts*, which includes gifts for weddings, birthdays, and anniversaries; *home*, which includes home decor items such as lamps and tables, as well as serveware such as platters, glasses, and copper chafing dishes; *jewelry*, which includes earrings, necklaces, rings and bracelets; *seasonal merchandise*, which includes decorations for Mardi Gras, Easter, Halloween, Thanksgiving, and Christmas; and *souvenirs*, which includes key chains, photographs and other memorabilia of the Saint Francisville area. Kathleen mentions that women between the ages of 35-65 represent nearly 90% of her business. Traditionally, roughly 60% of the store's customers were tourists, while 40% were locals; however she estimates that in the past year her customer mix has changed to represent both segments equally since the economic downturn. According to Kathleen, tourists tend to purchase souvenir, jewelry, and food items, while locals tend to purchase gift and home items. Current year-to-date sales and profit margins for each of the categories are shown in Table 3.

The shop is open from 9:30 AM to 5:30 PM every day. Kathleen, the owner, works the shop on most days and is the only full-time employee. Six other individuals are employed part-time, and oftentimes these employees work once every two weeks. Typically Audubon Hill staffs one employee on weekdays and two to three employees on weekends. Kathleen performs all of the management responsibilities and purchases merchandise for the store twice a year.

Kathleen understands the value of relationship marketing and she encourages all employees to foster and grow relationships with customers. By working the shop on most days, Kathleen has placed a strong emphasis on learning and remembering customers' names and merchandise preferences. In fact, local customers greatly appreciate Kathleen's knowledge of customer preferences and merchandise expertise along with the special attention they receive when shopping, which drives customers to continue shopping at Audubon Hill. In an effort to find the perfect gift, local customers will often consult with Kathleen to learn what the gift recipient tends to purchase or desire at Audubon Hill. Customers trust Kathleen's expertise and customer knowledge so much that oftentimes they will call Audubon Hill on their way to a party and say they need a gift for a certain person in a matter of minutes. Kathleen will select merchandise without the customer seeing the item(s) and have the item(s) wrapped prior to the customer's arrival to expedite the shopping trip. Kathleen states, "I understand that people are so busy nowadays, I just want to make my customers' lives easier." Audubon Hill places a large emphasis on providing excellent customer service. Kathleen believes that talking with customers and being friendly is critical to making customers feel welcome. Audubon Hill also offers additional services to make the customer's shopping experience easy and extraordinary. Additional services include gift wrap, delivery to local events (weddings, baby and bridal showers, birthday parties, etc.), and delivery to UPS so that tourists can have merchandise shipped. Another service offered by Audubon Hill includes special orders. When customers desire merchandise that is out-of-stock, Kathleen will special order that merchandise, even if it is the customer's first time at Audubon Hill. Customers often express their gratitude for the treatment and services they receive when shopping at Audubon Hill. In fact, Caryn, a frequent local customer mentioned that, "Kathleen has done so much to help me that I just want to help her in return."

Audubon Hill primarily communicates with customers through facebook and email. Audubon Hill uses facebook to show new arrivals and inform customers of upcoming events. Oftentimes, Kathleen will send personalized emails to local customers mentioning new merchandise that fits their individual tastes or describing an upcoming event or sale. Besides placing merchandise on sale, Audubon Hill also engages in an annual promotion targeting K-12 teachers in West Feliciana Parish. For this promotion, Audubon Hill provides teachers in the district with a gift bag that includes a business card, candy and a 20% off coupon. Kathleen claims that this promotion has been very successful by bringing new customers to the shop and establishing new customer relationships.

Audubon Hill does not currently engage in any traditional advertising, but instead participates in four community events that are sponsored by the city. However, all the events themselves are advertised in *Country Roads* magazine, which publicizes cultural events occurring between Natchez, Mississippi and New Orleans, Louisiana. *Country Roads* is distributed to retailers purchasing advertising space, who then distribute the magazine to their end customers. The four weekend events include the Pilgrimage which occurs in March, Polos and Pearls which occurs in August, Yellow Leaf which occurs in October, and Christmas in the Country which occurs in December. Retailers participating in these events operate until the late hours of the night and offer an open house atmosphere to customers. During these events Audubon Hill samples food merchandise including wine slush and traditional Louisiana spreads, dips and jellies. Kathleen states, “Advertising just doesn’t seem worth it. Sales generated from advertising will not offset its high cost ($400 to $800 per ad in *Country Roads*); and potential customers must drive by Audubon Hill on their way to an advertising retailer anyway. There’s just no point of advertising.” To attract customers, Kathleen decorates the outside of Audubon Hill with a bold assortment of seasonal decorations and signs.

Although four other gift shops are located in Saint Francisville, Audubon Hill differentiates itself by providing high quality merchandise that is thought to never go out of style. Audubon Hill is the only shop selling items considered to be *shabby chic*--a design style using aged items to create an elegant effect. Of the other gift retailers, one solely focuses on antiques, another primarily sells jewelry and wholesale items, the third concentrates on bridal registry and gardening items, and the last sells clothing marketed toward women over sixty years of age. Kathleen states, “I’m the only shop in the area that carries such a wide assortment of merchandise, and I want my shop to appeal to all kinds of customers so they can leave with something that they love.”

This past year (2012) has been very challenging for Audubon Hill. With the turbulent economic conditions, fluctuating tourism and customer segments, Kathleen has been open to new marketing strategies. Kathleen noticed a drop in sales early on this year, and in effort to boost sales, Audubon Hill offered a minimum of 25% off all merchandise for seven months. Unfortunately, these financial rewards to customers were not effective, and Audubon Hill’s sales are currently down by 37% compared to last year. Kathleen claims that “The discounts we offered this year really didn’t do much beside hurt our margins and we really need to think of new ways to generate revenue for the store.” She realizes that important decisions and changes will need to be made if Audubon Hill is going to remain in business.

CAPE CHEMICAL: NEW VENTURE FINANCIAL PLANNING

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CASE DESCRIPTION

The primary subject matter of this case involves a review of the fundamentals of financial statements, preparing projected financial statements for a new venture and examining sources of information, which will aid financial statement preparation. The case requires students to have an introductory knowledge of accounting, finance and general business issues thus the case has a difficulty level of three (junior level) or higher. The case is designed to be taught in one class session of approximately 1.25 hours and is expected to require 3-4 hours of preparation time from the students.

CASE SYNOPSIS

The case tells the story of Ann Stewart, a young business professional who decided to start a new business. Stewart was a sales manager for St. Louis Chemical, a distributor of chemical headquartered in St. Louis. St. Louis Chemical was sold and the acquiring firm did not require her services. As a result of her chemical distribution business experience and the contacts with customers and suppliers, she decided to begin a chemical distribution business. Stewarts has a solid understanding of the chemical industry and the distribution process and while at St. Louis Chemical, she had Profit & Loss (P&L) responsibility, but her knowledge of accounting and finance is limited. She has met with a counselor from the Small Business Development Center at Southeast Missouri State University and has been given a crash course in preparing and using a business plan. She has decided to organize his business as a Corporation. The cash she received from the buyout of her St. Louis Chemical stock options, severance package and savings will provide initial capital. Her father who recently sold a successful business will also be a shareholder and the largest provider of equity capital. Her brother will also provide a small equity investment.

The case contains information on the chemical distribution process and the Small Business Development Center (SBDC) Program administered by the U.S. Small Business Administration. SBDCs provide management assistance to current and prospective small business owners.

BACKGROUND

Ann Stewart, a former sales manager for the distribution operation of St. Louis Chemical, a mid-sized, regional chemical distributor, headquartered in St. Louis, has decided to begin a chemical distribution business. St. Louis Chemical was sold to a large multinational chemical manufacturer. Most of St. Louis Chemical's senior managers, including Stewart, were told their services would not be required. Without adjustments, combining the two firms would result in substantial management duplication.

Ann Stewart is thirty-four years old and had been employed by St. Louis Chemical, since graduation from University of Missouri - Columbia with a degree in chemical engineering. She earned an MBA from University of Missouri - St. Louis after attending evening classes for three years. With St. Louis Chemical she moved through a number of management positions, each with increased responsibility. For the last three years she had been sales manager for the company's southeast region.

As a result of her chemical distribution business experience and the contacts with customers and suppliers, she has decided to begin a Cape Girardeau based chemical distribution business. Stewart gained a solid understanding of the chemical industry and the distribution process while at St. Louis Chemical. At St. Louis Chemical she had Profit & Loss (P&L) responsibility, but her knowledge of accounting and finance is limited. To prepare for staring her new business venture, Stewart met with a counselor from the Small Business Development Center (SBDC) at Southeast Missouri State University and was given a crash course in preparing and using a business plan. Her business will be organized as a corporation. Stewart, her father and brother will provide initial equity capital. Stewart will use the cash received from the buyout of her (limited) St. Louis Chemical stock options, her severance package and a small amount of savings. Her father will invest a portion of the proceeds from his recently sold business. He will be the largest provider of equity capital. Her brother will also provide a small equity investment

First National Bank has agreed to provide a one year $500,000 short term line of credit to finance working capital on the condition that all assets of the company, Stewart and her father's personal assets are used as collateral. Venture Investor LLC will provide an initial $800,000 five-year, interest only loan. If additional funds are required an additional $400,000 will be available, at a higher annual interest. Venture Investors can convert the initial $800,000 loan to equity after five years (at a share price of $3.00).

Stewart always had aspirations of someday owning a business and it appears the time is right to begin the entrepreneurial process.

CHEMICAL DISTRIBUTION

A chemical distributor is a wholesaler. Operations may vary but a typical distributor purchases chemicals in large quantities (bulk - barge, rail or truckloads) from a number of manufacturers. They store bulk chemicals in "tank farms," a number of tanks located in a diked area. The tanks can receive and ship materials from all modes of transportation. Packaged chemicals are stored in a warehouse. Other distributor activities include blending, repackaging, and shipping in smaller quantities (less than truckload, tote tanks, 55-gallon drums, and other smaller package sizes) to meet the needs of a variety of industrial users. In addition to the tank farm and warehouse, a distributor needs access to specialized delivery equipment (specialized truck transports, and tank rail cars) to meet the handling requirements of different chemicals. A distributor adds value by supplying its customers with the chemicals they need, in the quantities they desire, when they need them. This requires maintaining a sizable inventory and operating efficiently. Distributors usually operate on very thin profit margins. *RMA Annual Statement Studies* indicates "after tax net profit as a percentage of sales" for Other Chemical and Allied Products Merchant Wholesalers (NAICS number 424690) is usually in the 3.0% range. In addition to operating efficiently, a successful distributor will possess 1) a solid customer base and 2) supplier contacts and contracts which will ensure a complete product line is available at competitive prices.

SMALL BUSINESS DEVELOPMENT CENTER

A Small Business Development Center (SBDC) provides management assistance to current and prospective small business owners. SBDCs are a combined effort of the private sector, education community and government (state and federal) to stimulate economic growth by aiding development of new businesses. Most SBDCs are housed on university campuses and receive a portion of their operating funds from the schools. Many SBDC counselors are faculty members from a variety of academic fields.

Anyone currently operating a small business or interested in starting a business can receive free, confidential assistance from the SBDC. Counseling and training activities include preparing a business plan, examining sources of financing, preparing loan requests and in general providing guidance on how to start a business.

THE SITUATION

In the meeting with the SBDC counselor, Stewart described the chemical industry, the role of a chemical distributor and thoughts on beginning her business. After her initial investigation of the Cape Girardeau area, Stewart decided to begin operations from a leased warehouse/office building located in an industrial park. The facility would be leased for five years and includes two five-year renewal options. The facility would need to be modified to handle both liquid and dry chemical repacking operations, as well as storage tanks for bulk liquids. Exact numbers have not been developed but she thinks the modifications would cost about $400,000. With the modifications and six plant employees, Stewart estimates the facility will support an annual sales volume between five and ten million dollars. Stewart's customer contacts will provide the majority of the sales and she expects first year sales dollars to approach six million. She is very confident the estimated first year sales can be achieved and can be doubled in the second year of operation. According to *RMA Annual Statement Studies,* distributors report a "Sales/Total Asset" ratio between 2 and 4.

After meeting with the SBDC counselor, Stewart realized that more a detailed financial plan was needed. Expected performance needed to be quantified to remove as much uncertainty about the new venture as possible. With the counselor's assistance Stewart began to project performance for the first year of operation. Together they developed operating assumptions based on Stewart's previous business experience and industry information from RMA. The assumptions will be used to prepare a projected beginning balance sheet and financial statements for the first year.

ASSUMPTIONS

Beginning Balance Sheet

1. Stewart estimates she will need an initial cash balance of at least $400,000 (possibly more) to begin operations. For planning purposes she intends to use the cash account to balance the beginning balance sheet so the beginning cash balance may be greater than $400,000, but it cannot be less. The high cash balance is necessary to pay for the inventory, purchase operating supplies, pay for initial advertising and promotional materials, meet payroll in the early part of the year and in general deal with unexpected startup expenses,
2. Initial inventory investment will require $300,000 (Stewart expects to be able to obtain 30 day credit terms from her vendors). For planning purposes it will be assumed the payment for the initial inventory investment will be made after operations begin. (Assume the inventory and the accounts payable appear on the initial balance sheet)
3. There will be no accounts receivable balance (nothing has been sold yet) but Stewart expects to offer industry term of "net 30" to its customers.
4. Fixed assets will consist of machinery and equipment investment and will be $700,000 and will have a 5-year MACRS class life. (20%, yr. 1; 32%, yr. 2, 19%, yr. 3; 12%, yr. 4; 11%, yr. 5 and 6%, yr. 6)
5. Leasehold improvements will amount to $400,000 and will be amortized over 10 years using a straight-line amortization schedule. ($10,000 per year)
6. Accounts payable will be $300,000 (see initial inventory investment assumption).
7. There will be no liability accruals.
8. First National Bank has agreed to provide a $500,000 short term line of credit (1 year) @ 8% annual interest to finance working capital needs on the condition that all assets of the

company and Stewarts personal assets are used as collateral. Stewart expects to use $100,000 immediately (beginning balance sheet) and the remaining $400,000 will be used, as needed, during the first year of operation. End of the year loan balance will be used to calculate interest expense for the year.

9. Venture Investor LLC has agreed to provide an initial $800,000 five-year, interest only, loan @ 10% annual interest. If a loan reduction is possible, it will be made on the last day of the year. If additional funds are required and additional $400,000 will be available, at 12% annual interest. In addition to annual interest, Venture Investors can convert the initial $800,000 loan to equity after five years (at a share price of $3.00). End of the year loan balance will be used to calculate interest expense for the year.
10. Stewart has decided to organize the company as a corporation with 2,000,000 authorized shares and a $1 par value. Stewart elected to organize the company as a corporation because he anticipated rapid growth and thought the corporation was the best vehicle for raising the large amount of capital required to finance the growth. The limited liability provided by the corporate organization form was also a desired characteristic.
11. Stewart, her father and her brother expected to invest $300,000 (300,000 shares), $400,000 (400,000 shares) and $100,000 (100,000 shares) in the company respectively.

Year One Income Statement

1. Sales volume for the first year is expected to be $5,900,000.
2. The average gross profit on product sales will be 28%. The gross profit will vary significantly from product to product and package size, and Stewart feels this is probably only a "ball park" number. Bulk sales will generate a low margin while packaged sales (55-gallon drums, totes and a variety of small containers) will yield a higher profit margin. For planning purposes Stewart wants the gross profit to be calculated using only product cost. A distributor's success is dependent on this margin and Stewart wants her reporting systems to allow easy tracking of this key number.
3. Plant operating expenses (ex depreciation) will include:
   a. Plant manager @ $70,000 per year (plus 30% for benefit package)
   b. Three warehouse employees @ $41,600 per year (2,080 hours @ $20.00 per hour). Employee benefits (holidays, vacation, workman's compensation insurance, social security and other benefits) are estimated to be 25% of base salary.
   c. Two yard employees @ $52,000 per year (2,080 hours @ $25.00 per hour). Employee benefits (holidays, vacation, workman's compensation insurance, social security and other benefits) are estimated to be 25% of base salary.
   d. Annual facility lease expense will be $60,000. (Operating lease)
   e. Utilities (gas, electric and water) are projected to be $1,000 per month.

f. Repairs and maintenance expenses are expected to be minimal but will be about $18,000 the first year.

g. Supplies (labels, cleaning material, brooms etc) are projected to require $2,000 per month.

h. Delivery expenses will vary per customer and type of sale but will be estimated as 2.00% of sales. Trucking firms, common carriers, will be used to deliver material to the customer.

i. Miscellaneous operating expenses are estimated to be 1.00% of direct operating labor. (Plant manager, warehouse and yard employees, including benefits).

4. Annual plant depreciation expense will be based on equipment purchases of $700,000). Equipment will be depreciated using 5 year MACRS. (20%, yr. 1; 32%, yr. 2, 19%, yr. 3; 12%, yr. 4; 11%, yr. 5 and 6%, yr. 6) Since depreciation is a non-cash expense, this item will be kept separate from other plant expenses.

5. Leasehold improvements will be amortized over a ten-year period using a straight-line amortization schedule. ($40,000 per year)

6. Selling expenses will include:

a. Two sales representatives, each with a base of $50,000 per year. (Plus 25% for benefit package). In addition, each sales representative will have a "travel (non auto) and entertainment budget" of $18,000 per year.

b. One percent of sales will be paid in commissions.

c. Auto operating expenses for two leased autos are estimated to be $4,400 per month ($2,200 per auto).

d. One in-house sales representative @ $40,000 per year. (Plus 25% for benefit package).

e. Promotion and advertising expenses are expected to be $2,000 per month.

f. Bad debt expenses are expected to be .50% of sales.

7. General Administrative expenses will include:

a. Stewart's salary is projected to be $100,000 per year. (Plus 30% for benefit package).

b. A "travel (non auto) and entertainment budget" of $24,000 per year is also planned for year one.

c. Auto operating expenses for one leased auto is estimated to be $2,500 per month.

d. One administrative assistant (office worker) will be paid $31,200 (2,080 hours @ $15.00 per hour. (Plus 25% for benefit package)

e. Monthly technology services are expected to cost $2,400 per month.

f. Utility expenses are expected to be $2,000 per month (mostly for telephone expenses).

g. Office supplies are expected to cost $1,000 per month.

h. Legal and professional fees are projected to be $2,400 per month.

   i. Insurance expense (property, liability, casualty, etc.) is expected to be $24,000 annually.
   j. Miscellaneous administrative expenses are projected to be $800 per month.

8. Interest expense. (See opening balance sheet assumptions regarding bank financing)
9. To simplify the planning process Stewart is projecting a combined state and federal tax rate of 28%.
10. In order to finance expected growth no dividends will be paid in the early years.

Ending Year One Balance Sheet

1. Target cash balance of $200,000. As with the beginning cash balance Stewart is planning to use the cash account to balance the balance sheet so the cash balance may be greater than $200,000, but it cannot be less.
2. A DSO of 39 days) will be used to project ending accounts receivable balance. (use 365 days)
3. Stewart expects ending inventory investment to be 48 days. Use Cost of Goods Sold (CGS) and 365 days to calculate investment.
4. No additional fixed assets will be added during the year.
5. Accounts payables will be projected using an average payment of 36 days. {(CGS/365) x 36 days}
6. The short-term loan (line of credit) from First National Bank balance is expected to be $300,000.
7. No change is expected in the principal balance of long-term loan from Venture Investors. If additional financing is needed additional funds can be obtained from Venture Investors (see beginning balance sheet assumptions).
8. Accrued liabilities are projected to be .50% of sales.
9. Stewarts expects no additional capital infusion during the year and does not intend to pay a dividend.

THE TASK

As an assistant to Stewart, help accomplish the following:

1. Prepare the following statements:
   a. Beginning balance sheet (year 0), complete schedule one. Hint: Do not attempt to complete the ending year one balance sheet until the income statement is complete.
   b. Year one income statement, complete schedule two. Also complete sub-schedules associated with schedule two.

   c. Ending balance sheet for year one,
   d. Cash flow statement for year one, complete schedule three.
2. Will Stewart have sufficient capital for the first year of operation? Explain
3. Explain the importance of the assumptions developed by Stewart.
4. Evaluate projected performance using ratio analysis. Calculate the following ratios and evaluate performance. (Current ratio, Quick ratio, Accounts receivable turnover, Days sales outstanding - DSO, Inventory turnover - using cost of goods sold in the numerator, Total asset turnover, AP deferral period, Times interest earned ratio - TIE, Debt ratio, Basic earning power - BEP, Profit margin, Return on assets - ROA and Return on equity - ROE)
5. Analyze projected performance, from a banker's perspective. Why would the bank renew the short-term loan? What ratios would prove useful in this analysis? Explain.
6. Most entrepreneurs believe it is a positive indicator if expected sales can be exceeded. Explain why this may not always be the case.

SUGGESTED REFERENCES

http://www.census.gov/eos/www/naics/
http://www.rmahq.org/tools-publications/publications/annual-statement-studies

Schedule One
Cape Chemical
Projected Balance Sheets for Years
Ended December 31

	Year 0		Year 1	
	$	%	$	%
Assets				
Current Assets				
Cash				
Accounts receivable				
Inventory				
Total Current assets				
Fixed assets				
Machinery and equipment	700,000		700,000	
Less: Accumulated depreciation				
Net fixed assets				
Leasehold Improvements			360,000	
Total assets	2,000,000	100.00	2,360,906	
Liabilities and Equity				
Accounts payable				
Short-term bank loan				
Accruals			21,240	
Current liabilities				
LT venture capital loan				
Total liabilities				
Common stock ($1 par)			800,000	
Retained earnings				
Total equity				
Total liabilities and equity		100.00		

Schedule Two
Cape Chemical
Projected Income Statement for Ending Year 1

	Year 1 $	%
Net sales revenue	5,900,000	100.00
Cost of goods sold	___________	__________
Gross profit-product	___________	__________
Plant operating expenses	___________	__________
Depreciation expense	___________	__________
Amortization expense	40,000	__________
Total Plant operating expenses	___________	__________
Gross profit	___________	__________
Selling expenses	___________	__________
General administrative expenses	___________	__________
Total S&GA	___________	__________
Total operating expenses	___________	__________
EBIT	132,730	__________
Interest on ST loan	24,000	__________
Interest on LT loan	___________	__________
Total interest expenses	___________	__________
EBT	___________	__________
Less: Taxes	___________	__________
Net income	___________	__________
Less: Dividends on common	___________	
Additions to retained earnings	___________	

Schedule Three

St. Louis Chemical

Projected Statement of Cash Flows for Year 1

	Year 1 $
Cash Flow from operating activities	
Net income	__________
Sources (Uses) of Cash	
Depreciation	__________
Amortization of Leasehold Improvements	40,000
(Increase) Decrease in A/R	__________
(Increase) Decrease in inventories	__________
(Decrease) Increase in A/P	__________
(Decrease) Increase in accruals	__________
Net cash flow from operating activities	__________
Long-term investment activities	
Acquisition of fixed assets	__________
Financing activities	
Increase in ST debt	__________
Increase in LT debt	__________
Issue of common stock	__________
Net cash flow from financing activities	__________
Net increase (decrease) in cash	__________
Cash at beginning of year	__________
Cash at end of year	__________

Schedule Two A

Plant Operating Expenses	Year 1 $
Manager (salary)	
Manager (benefits)	
Warehouse Employees (wages)	124,800
Warehouse Employees (benefits)	
Terminal Yard Employees (wages)	
Terminal Yard Employees (benefits)	
Facility Lease Expense	
Utilities Expense	12,000
Repairs & Maintenance Expense	
Supplies Expense	
Delivery Expense	
Miscellaneous Expense	
Total Plant Operating Expenses	612,770

Schedule Two B

Selling Expenses	Year 1 $
Outside Sales Representatives (salaries)	
Outside Sales Representatives (benefits)	
Commissions	
T&E	
Auto Expense	
Inside Sales Representative (salary)	
Inside Sales Representative (benefits)	
Promotion and Advertising	
Bad Debt Expense	
Total Selling Expenses	

Schedule Two C

General Administrative Expenses	Year 1 $
Officer's (salaries)	
Officer's (benefits)	
T&E	
Auto Expense	30,000
Administrative Staff (wages)	31,200
Administrative Staff (benefits)	
Technology Services	
Utility Expense	
Office Supplies	
Insurance Expense	
Legal & Professional	28,800
Miscellaneous Expense	
Total General and Administrative Expenses	

Schedule Two D

Depreciation Expense

Year	%	Capitalized Amount	Depreciation Expense	Accumulated Depreciation
		$	$	$
1	20.00	____________	____________	____________
2	32.00	____________	____________	____________
3	19.00	____________	_______	____________
4	12.00	____________	____________	____________
5	11.00	____________	____________	____________
6	6.00	____________	____________	____________

Schedule Two E

Amortization Expense

Year	%	Amortized Amount	Amortized Expense	Leasehold Improvements
		$	$	$
1	10.00	____________	____________	____________
2	10.00	____________	____________	____________
3	10.00	____________	_______	____________
4	10.00	____________	____________	____________
5	10.00	____________	____________	____________
6	10.00	____________	____________	____________
7	10.00	____________	____________	____________
8	10.00	____________	____________	____________
9	10.00	____________	____________	____________
10	10.00	____________	____________	____________

THE ROOF IS ON FIRE: THE ETHICAL MINEFIELD OF THE TEXTILE INDUSTRY IN BANGLADESH

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CASE DESCRIPTION

This case is motivated by a recent fire in a textile factory in Bangladesh in which scores of workers lost their lives while producing garments for multinational firms. The case focuses on a multitude of issues involving a multinational corporation's global ethical sourcing program. This case describes a hypothetical assignment facing a public relations and operations manager of Wal-Mart. The assignment revolves around the dilemma of trying to maintain low costs of production while simultaneously trying to ensure tragedies like this one will not happen again. The case provides detailed background information on the social, economic, and political climate in Bangladesh, the current situation of the textile industry in Bangladesh, applicable laws, ethical frameworks, and competitive market considerations. At the end of the narrative the reader is asked to formulate ethically, legally, and financially sound recommendations. The suggested audiences for this case study are upper level undergraduate students and graduate students.

CASE SYNOPSIS

In light of several tragic garment factory fires, including one in which 112 people were killed, this case details the harsh economic realities of the Bangladesh garment industry. Throughout this case our hypothetical manager, Matt Lelander must confront and resolve a multitude of strategic, ethical, and legal dilemmas. Mr. Lelander is presented with a career changing and prodigious task of developing and presenting to his corporation's board of directors a long term strategy to keep the company out of tragedies while maintaining a competitive cost structure. Simultaneously, Mr. Lelander must lay out a plan to repair his company's global image as an ethically responsible organization. Matt has been asked to travel to Dhaka, Bangladesh, to take care of these issues. Additionally, Matt has been presented with several ethical and legal issues, some personal, he must confront. This case provides a detailed background on the Bangladeshi business climate, discussion of applicable domestic and international laws, as well as analysis of appropriate ethical frameworks and decision making.

INTRODUCTION

Matt throws his leased Mercedes into reverse and squeals out of his court mandated drug and alcohol class. It has been a long week for Mr. Lelander, but after finishing his last alcohol class it's time to meet a coworker for a few cool beverages and talk about the events of the past week.

Matt enters the bar and immediately orders a gin and tonic. He then settles into the booth to wait for Samuel. Matt and Samuel work together at Wal-Mart, a major textile distributor with offices in Atlanta. Mr. Lelander manages the local operations and public relations arm of the firm in Atlanta. Sammy (Samuel's preferred name) works in the office of the treasury.

After twenty minutes, Samuel enters the bar and by the dark circles under Samuel's eyes Matt can see that it's been several days since his buddy has had a proper night's sleep.

"So you are all done with your education now?" jokes Samuel. Sammy is one of Matt's closest confidants and the only Wal-Mart employee who knows of Matt's struggle with alcohol. Laughing, Matt raises his glass and wishes Sammy a happy Friday.

"So how are things up stairs in treasury?" inquires Matt.

"I am glad you ask" replies Sammy. "As you know, we are getting squeezed from the big box retail stores and our numbers are not looking good. The CFO is putting pressure on the purchasing team to reduce purchasing costs to compete."

"That's why we outsourced production of textiles to Bangladesh three years ago, if I recall correctly" chirps Matt. "We can produce textiles at a third of the price and without the risk associated with operating a production facility."

"You're correct" responds Matt's colleague, "but this is why I have invited you out for drinks this evening, there was a major incident at one of our Bangladeshi producer's facilities last weekend."

"According to a report from Reuters" Samuel goes on, "fire swept through a garment factory near Dhaka, killing more than 100 people, the blaze at a nine-story textile factory spread quickly as a result of multiple safety violations, trapping hundreds of workers."

"That is terrible" responds Matt and continues, "however, as you know Sammy, working conditions in Bangladesh factories are notoriously poor, with little enforcement of safety laws, and overcrowding."

"Your point is well taken" responds Sammy, "but this case is different, the confirmed death toll is already 112 and most of them are women who are burned beyond recognition. Matt, our suppliers, who we have contracts with, produce the majority of our products in third party factories like this one and we need to figure out what our next steps are to ensure this does not happen again" Sammy continues, "our products are all over this factory!"

Matt inquires, "Why don't we simply find another supplier, there are several of them in Bangladesh?"

"Well there is more" continues Sammy, "the factory was operating without a safety license and had received multiple warnings to clean up their operations, not to mention the fall out in the press is becoming relentless. While we did not contract with the factory directly, we are still being blamed for paying too much attention to costs and not enough to worker's safety. They found clothing designed for our stores in the charred rubble!"

Mr. Lelander exhales deeply and orders another drink. Sammy stares at Matt and adds,

"Guess that will be the last one of those you will have for a couple months."

"What are you talking about?" responds Matt.

"Well, sorry for the short notice, but we have you flying to Dhaka on the midnight flight out of Atlanta tomorrow."

"What do you mean?" replies Matt. "I can't leave my children at home with their mother for that long, not to mention I know absolutely nothing about Bangladesh."

"You don't have much of a choice" laughs Sammy. "All you need to know is in this file with your tickets; we even sprung for a business class ticket this time. Your recent work in Indonesia shows you are the individual for this very difficult job."

"What exactly do you want me to do?" queries Matt.

"Well," responds Sammy, "we have hundreds of garment workers protesting and demanding improved conditions and compensation for their lost salaries, we have our shareholders demanding answers, we are in a PR nightmare, we have a global supply chain that depends on Bangladesh to supply low cost textiles, and we have a supply shortage due to this factory burning down. I need you do figure out a long term strategy to keep our company out of tragedies like the one while maintaining our competitive cost structure. Furthermore, we need you to repair our image as an ethically responsible organization."

"Who do you think I am, Superman?" asks Matt.

Ignoring Matt's last comment Sammy expounds, "Wal-Mart has aggressive plans to expand into Bangladesh's Western neighbor, India, and corporate does not want this incident to derail in any fashion these plans."

Sammy after taking a moment to let everything sink in continues, "We have arranged the head of our ethical sourcing department, Tabitha or Tabby Alber, to pick you up when you arrive Friday morning. Apparently, the burned garment factory has previously failed multiple inspections, yet has never been removed from our supplier's approved list or even been notified of these failures. This was a serious oversight! It appears our ethical sourcing department may have been asleep at the wheel. I hope you are ok with being the ax man."

Matt drowns his drink and calls a cab to take him to his condo in Buckhead.

When Matt finishes his call, Sammy, sensing Matt's trepidation tells Matt, "we realize this is a somewhat extreme and difficult assignment, however, if you are able to successfully navigate these issues, our CEO has personally relayed to me that you will be first in line for the soon to be available chief operations officer position. If you are successful you will be financially set for life."

Matt somewhat sarcastically thanks Sammy for the opportunity and heads out the door to wait for his cab. When the cab finally arrives Matt is deep in thought. Sitting in the back of the cab, Matt reflects on the task ahead. While he never mentioned anything to Sammy, Matt has a history with Tabitha. Matt met Tabitha at an AA meeting a few years ago while working for JBS in Greeley, Colorado. Matt enjoyed Tabitha's company as AA was a new adventure for both of them. However, as Matt recalls, Tabitha received an unexpected transfer to the East coast and they quickly lost contact. Matt wonders if Tabitha was able to find a local AA group after relocating. Similar to Matt's employer at the time Tabitha's employer, Citibank, was unaware of Tabitha's addiction. Matt begins to wonder if Wal-Mart is aware of Tabitha's addiction.

ECONOMIC AND INDUSTRY INFORMATION

The next morning Matt opens up the file on Bangladesh that Sammy gave him. The first page contains a map of the country shown below in figure 1.

FIGURE 1: MAP OF BANGLADESH

Source: www.cia.org

Matt immediately notices the strategic location of this low lying nation. At first glance it appears like Bangladesh is well placed to take advantage of India's growing economy. In

addition Bangladesh's extensive waterways could be potentially valuable for moving commerce. Matt wonders to himself why he has not heard more about this South Asian nation.
He notices the file is divided up into a number of sections to help familiarize him with this nation, these sections include: geography, people, government, economy, and the textile industry in Bangladesh.

Geography

Matt begins to read the first section. Bangladesh is about the size of the US state of Iowa with a total area of 143,998 sq. km, which ranks 95th in the world in terms of land mass (www.cia.gov). It boarders both India and Burma and experiences a tropical climate. The monsoon season runs from June to October, during which much of the country is prone to flooding. The propensity for Bangladesh to flood contributes to food and housing uncertainty for much of the population. Many of the citizens are without private property and are forced to produce crops on land likely to flood (www.cia.gov). Due to severe overpopulation and seasonal monsoons, Bangladesh suffers from water pollution of fishing areas, ground water contamination, and water shortages.

Matt rubs his eyes and sighs, "Just what has Sammy got me into now?" he murmurs.

People

Matt now digs into the second section of the folder. He is immediately shocked by the fact that given its size Bangladesh is the 8th largest country in terms of population with over 160 million citizens. The capital city, Dhaka, itself has over 14 million inhabitants. The country is young, with a median age of 23.6; Matt takes heart in this statistic and hopes the nation will receive the demographic dividend that often comes with having a large working age population. However, Matt notices that Bangladesh scores low on many development indicators including: death rate, life expectancy, health expenditure, sanitation facilities, education expenditure, and literacy rate. For example, only 52.2% of females are literate and 41.3% of children under the age of 5 are underweight (www.cia.gov).

Matt continues to read the folder and immediately notices that almost 90% of the population is Muslim, with a sizable minority of Hindus along the Indian boarder. Mr. Lelander has significant experience in Muslim countries, having spent four months in the world's largest Muslim country, Indonesia. Matt has fond memories of his time in the archipelago nation, as much of his time was spent with an ice cold Bintang in hand. Matt is heartened and starts up his Samsung Galaxy to check out the local spirits of Bangladesh. After a Google search Matt realizes to his horror that Bangladesh is a dry country. Matt has gone over 6 years having at least a drink daily and the thought of dealing with the fallout from the fire without his 'stress reliever' is terrifying.

Government

Matt continues reading. The legal system consists of English common law supplemented with Islamic law. Bangladesh has democratic form of government with elections held on a five year cycle. Politics in Bangladesh is dominated by a rivalry between two women. The current prime minister is Sheikh Hasina Wajed who was elected for the second time in 2009. In the general elections in December of 2008, the Bangladesh Nationalist Party crushed her long-time political rival Begum Khaleda Zia. Interestingly, Matt continues to read, Sheikh Hasina and Khaleda Zia, both former prime ministers, had been jailed for suspected corruption but were released just prior to the voting in late 2008. Just a few months after the election the new prime minister faced a serious crisis as hundreds of border guards mutinied. The mutineers killed 74 people prior to the government suppressing the rebellion (www.bbc.co.uk).

Matt's head begins to pulsate and he realizes the next couple of weeks are going to be challenging. It appears that corruption is part of the fabric of Bangladeshi politics and Matt suspects' business dealings will not be easy in a country where corruption takes place at the highest levels. As Matt continues reading he learns this fire was only one of a recent series of fires in Bangladesh clothing factories. These garment workers have been demanding better pay and conditions for months and these demands have occasionally turned violent. However, despite this the labor unrest, Bangladesh is still the second largest exporter of ready-made clothing after China (Al-Mahmood, 2012).

Matt again quickly jumps on his Galaxy and checks transparency international's corruption perception index (CPI). The CPI scores and ranks countries based on how corrupt their public sector is perceived to be. From past experience, Mr. Lelander knows that the CPI is the world's most comprehensive free source to gauge corruption of a nation. Matt is shocked to find that Bangladesh's CPI is just below that of Pakistan and Vietnam and just ahead of nations like Cambodia and Laos. Overall Bangladesh's CPI is 144th in the world (out of 175) and in the bottom seven in Asia as shown in Figure 2.

Matt is concerned about corruption and continues to investigate. Transparency International (TI) asks a series of questions to people around the world each year and Matt comes across one of these surveys from 2011. When asked if the level of corruption has increased or decreased over the most recent three years 46% of Bangladeshis believe corruption is on the rise, while only 36% believe it has declined.

Matt has time for one more Gin and a few minutes to contemplate the impact of corruption on development before packing his Brigs and Riley suitcase. A quick check of the weather indicates short sleeves are appropriate attire. One last call to his children, who live with Matt's estranged wife and he will be on his way to the teaming metropolis of Dhaka.

Figure 2: Corruption Perception Indicators for Asian Nations

World Rank	Regional Rank	Nation	CPI
1	1	New Zealand	90
5	2	Singapore	87
7	3	Australia	85
14	4	Hong Kong	77
17	5	Japan	74
33	6	Bhutan	63
37	7	Taiwan	61
45	8	Korea (South)	56
46	9	Brunei	55
54	10	Malaysia	49
79	11	Sri Lanka	40
80	12	China	39
88	13	Thailand	37
94	14	India	36
94	14	Mongolia	36
105	16	Philippines	34
113	17	Timor-Leste	33
118	18	Indonesia	32
123	19	Vietnam	31
139	20	Nepal	27
139	20	Pakistan	27
144	**22**	**Bangladesh**	**26**
150	23	Papua New Guinea	25
157	24	Cambodia	22
160	25	Laos	21
172	26	Myanmar	15
174	27	Afghanistan	8
174	27	Korea (North)	8
Note: Table from Transparency International 2012 CPI report			

Economy

After clearing security at Atlanta's Hartsfield-Jackson international airport, Matt races to the business class lounge. Matt surveys the snacks and drinks in the lounge and settles on a Beefeaters and seven. While topping off his drink, a woman comments that she will miss her gin. Matt inquires, "Where are you heading?" the stranger replies that she is on her way to Chittagong.

"And where might that be?" Queries Matt. The stranger responds, "Bangladesh, my home country".

"Intriguing" responds Matt apprehensively, "I am on my way to Dhaka on the Biman flight."

"Me too" smiles the women as she continues, "and just what will you be doing there?"

"I work for Wal-Mart and I need to go investigate the safety conditions of the textile factories used by some of our garment suppliers." Responds Matt

"I imagine the fire last week is prompting this." The elusive stranger responds coldly. "So have you been to my country before?"

Matt frowns slightly embarrassed, "Well to be honest I know very little about your country, by the way my name is Matt Lelander" Matt says as he reaches out to shake her hand.

"I'm Rupa, and I am an economist at the International Monetary Fund or IMF for short."

"Really?" chuckles Matt, "Would you mind giving me the run down on the economic situation in your country? I would buy you a drink, but they are free."

Rupa smiles and then responds, "I would be happy to give you my thoughts on the Bangladeshi economy. What do you want to know?"

"Just the basics and maybe some detailed information about the importance of the textile industry in Bangladesh." Matt replies.

"Well in many regards my country is doing relatively better, since 1996 the average real GDP growth rate is close to 6% per year despite rampant corruption, insufficient power supply, terrible infrastructure, and difficult weather circumstances."

"Yes, I read about the corruption problem earlier today, tis a shame." Matt comments.

"Indeed" agrees Rupa, "Partly due to this Bangladesh remains a poor, overpopulated, and poorly governed. Our economy is not that diverse as 45% of Bangladeshis are employed in the agriculture sector, mainly in the production of rice. Other important sources of income are garment exports and remittances from overseas Bangladeshis which represent almost 12% of GDP (www.cia.gov)".

"What is the average income of Bangladeshis?" Questions Matt

"Well officially, the average GDP per capita is about $2000 per year, but many make much less. We rank 191st in terms of wealth in the world. You will notice a lot of extreme poverty when you arrive in Dhaka, as over 30% of the population lives below the poverty line. This coupled with an inflation rate nearing 9% makes everyday life very difficult for my country people." responds Rupa in a melancholy tone.

"We will now be boarding first, business, and elite fliers" the announcement in the lounge blares.

"Well that's me" says Rupa

"Me too, where are you sitting" responds Matt

"I am in 5A"

"Really, my seat is 5B" says Matt surprised. "I hope we can continue our conversation on the flight."

TEXTILE INDUSTRY IN BANGLADESH

After settling in for the long flight ahead, Matt queries Rupa about the textile industry in her native land.

"Humm, where to start" Rupa says while sipping a drink, "most workers earn about 4500 takas a month at textile plants, plus maybe a little overtime."

"Sorry for my ignorance, but how much is 4500 takas?" replies Matt.

"About $55 to $60 US dollars, so as you can see the salaries of most textile workers are only about 30% of the median salary in Bangladesh," Rupa states confidently as she continues, "Bangladesh has over 4,500 garment factories and is the world's second biggest exporter of clothing behind China. The textile industry is a vital industry for my country as it is the source of much of our foreign exchange reserves. In fact clothing exports make up over 80% of our total annual exports and is a 19 billion dollar industry in Bangladesh."

"I had no idea your country was such an important player in this industry."

"Yes indeed, however due to the important role textiles plays in our economy more attention needs to be paid to the working conditions of the workers. Working conditions and safety standards are of grave concern to me and other good willed Bangladeshis. But we understand the nature of our integrated world economy. In order to compete Bangladeshi manufacturers are forced to operate on tight profit margins, which often encourage them to cut corners. These cost saving techniques often include: subcontracting work to other factories and slashing safety. Since many western garment purchasers go with the lowest bidder, these forces manufacturers to work on high volumes, and since they cannot find enough officially compliant factories to fulfill their orders they must subcontract," sighs Rupa.

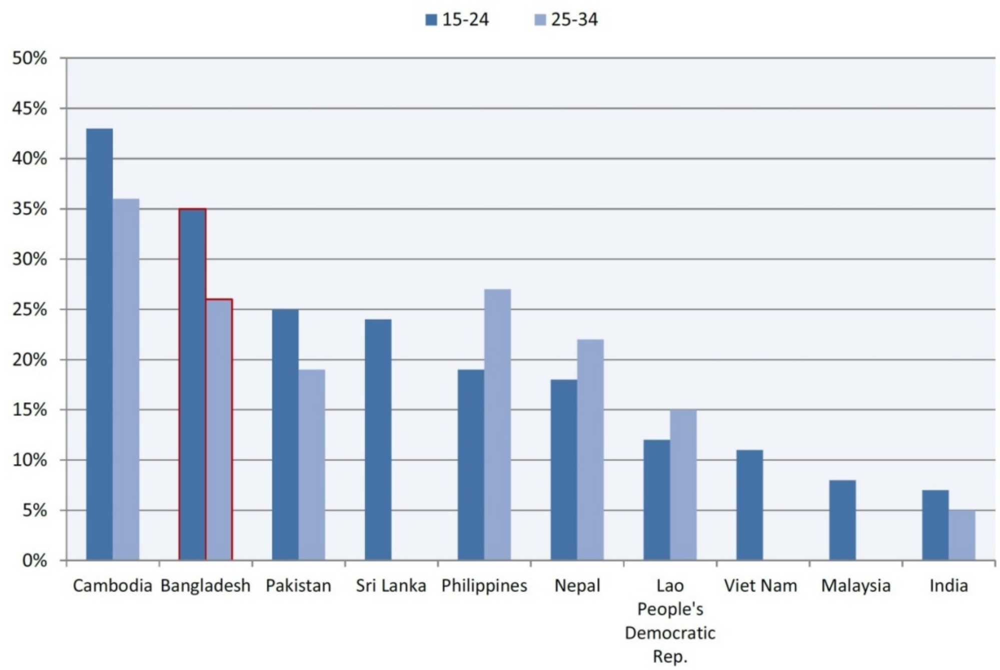
"Ok, thank-you I think I am starting to understand this very complicated process" responds Matt

Rupa continues, "The multi-layered relations in Bangladeshi factories, running from multinational corporations to suppliers to manufacturing groups to subcontractors, provide plausible deniability. Corporate giants are often aware of the poor or even sweat shop conditions required to manufacture their goods, but choose to turn a blind eye so as to deny responsibility if anything happens. The Workers' Rights Consortium has pointed out that factory costs represent only 20% of the sale price of an average shirt. If companies like yours Mr. Lelander would simply increase the cost you pay just 2-3% to cover the cost of safety renovations and training programs, you may not be on your way to Dhaka," she says looking to her right at Matt who is fast asleep.

Matt awakens in the dimly lit cabin as the captain is announcing that "we will be arriving at the Shah Jalal International Airport in Dhaka in approximately four hours." He looks over to find Rupa fast asleep and decides it is a good time to review some of the material provided by Sammy.

Matt opens the folder and begins reviewing the information. He quickly realizes that Rupa's description of the Bangladesh economy was accurate. As the economy struggles with low employment rates there is also a significant brain drain taking place. As the chart below indicates the youth of the country are fleeing to greener pastures. Matt begins to wonder what is causing such a massive youth migration (migration rates are provided in Figure 3).

Figure 3: Youth Intention to Migrate Permanently to another Country, 2011



Source: Gallup World Poll, 2012

Matt pulls out a recent New York Times article which states: "Bangladesh has more than 4,500 garment factories, which employ more than four million workers, many of them young women. The industry is crucial to the national economy as a source of employment and foreign currency. Garments constitute about four-fifths of the country's manufacturing exports, and the industry is expected to grow rapidly." Obviously, this industry is crucial to the Bangladesh economy. Matt ponders just how far a government would go to protect such an invaluable industry.

Matt decides to open his laptop and use the free in-flight business class Wi-Fi. Doing some online research Matt learns that Bangladesh's manufacturing formula depends on keeping wages low and restricting the rights of workers. Workers at now burned factory had recently staged small demonstrations in the months before the fire, demanding wages they were owed. On the night of the fire, more than 1,150 people were inside the eight-story building, working overtime shifts to fill orders for various international brands. Fire officials say the fire broke out in the open-air ground floor, where large mounds of fabric and yarn were illegally stored; Bangladeshi law requires that such flammable materials be stored in a room with fireproof walls, (Manik, and Yardley, 2012).

The inspection found that exits and stairwells at the factory were blocked, workers were unaware of evacuation routes and the factory lacked some firefighting equipment, according to documents found at the factory. These documents claimed corrections would be made by the end of June 2011 (Mattioli, 2012).

Matt is surprised to learn just how dangerous these garment factories have become. According to recent reports, more than 700 workers have died in factory fires in the past five years (Mosk, 2012). The prevalence of this problem is quite surprising to Matt.

Looking back at the folder provided by Sammy, Matt notices an internal Wal-Mart memo. Pulling this memo out Matt reads that Wal-Mart's legal department is "strongly recommending that Wal-Mart issue a new zero-tolerance policy for any violations of its ethical sourcing standards." The proposed policy suggests that Wal-Mart void any contact with a supplier who subcontracts with an unauthorized factory. Matt contemplates the costs and benefits of a zero tolerance policy. Matt contemplates whether or not this policy would economically benefit Wal-Mart?

After several hours of research, Matt realized that Sammy failed to reveal (or was unaware of) several very important legal and ethical aspects of Wal-Mart's garment sourcing issue, which will need to be investigated (or at least contemplated) prior to making any decisions. The labyrinth of legal and ethical regulations Matt must be able to navigate in order to resolve these issues while avoiding potential liability is certainly daunting.

From his research it is apparent that the local and international spotlight is shining heavily on Bangladesh. The International Labor Organization (ILO) issued a press release which stated that, "… is greatly shocked and saddened by the tragic incident of fire in a garment factory at Ashulia adjacent to Dhaka on 24 November 2012 that resulted in the unfortunate deaths of more than 100 workers. The ILO extends its sincere condolences to the bereaved families of the victims and conveys its sympathy to those injured due to the fire. Having a United Nations agency involved only increases Matt's sense of urgency to respond quickly.

Matt with the strong encouragement of the flight attendant finally shuts down his computer just as the plane begins its decent. After landing Matt thanks Rupa for all of her information. Matt then awkwardly asks Rupa if she would like to get a drink, before remembering that Bangladesh is a dry country. Rupa politely declines and then exchanges contact information as they are walking off the plane stating, "in case you have any more questions while you're in Bangladesh."

As Matt walks away he checks his Blackberry and notices a few messages. Before he has a chance to check, his phone rings. Tabby Alber is on the phone and tells Matt to meet her directly outside of customs as she is driving a new silver Mercedes Benz SL class, “you can’t’ miss it!”

After meeting Tabby outside, Tabby suggests they head back to her condo to catch up and discuss recent events, “over an afternoon cocktail of course.” Tabby explains, “I have my sources and in this country coinsures such as ourselves have to stick together.”

Matt never being one to turn down a drink readily agrees while jumping in the passenger side seat, although he wonders just how Tabby can afford such a car on her salary.

After a few drinks and the requisite pleasantries at Tabby’s condo, Matt and Tabby begin discussing business. Matt questions Tabby on why Wal-Mart was still contracting with a supplier using this factory after it had failed several inspections. Matt questions how these plants can continue to operate after failing so many inspections.

Tabby replies that “monitoring typically is conducted by third parties and paid for by suppliers, rather than by the retailers such as Wal-Mart. It is true that Wal-Mart’s standards for suppliers state that suppliers are required to disclose which factories they use. However, when problems are identified or a factory is removed from a supplier's approved list, the news might not be communicated to other suppliers or to the factories themselves. It’s a complicated process.” “Besides,” Tabby continues, “it is my job to ensure we keep our supply channels open. It’s really a win-win for us and the local economy. Don’t worry, Matt all we need is a little time and a few well-placed gifts and this whole situation will blow over.”

Matt either realizing that jet lag is beginning to set in or that he may be in over his head, simply responds, “Let’s hope so for the sake of both of our careers.”

Matt politely excuses himself, insisting that he will take a cab to his hotel as neither he nor Tabby should be driving. As he leaves Tabby’s apartment, Matt finally gets a chance to check his voicemail. Sammy is calling to verify that Matt has settled in and to remind him of the importance of this assignment. In his message Sammy also informs Matt that “the board of directors wants a plan of action in place immediately so this whole mess can be resolved quickly! Investors are unsettled, sales are down, and Wal-Mart is taking a beating in the press.” Sammy concludes his message by inquiring, “have you fired Tabby yet?”

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SUSTAINABILITY AND INTEGRATED REPORTING: A CASE EXPLORING ISSUES, BENEFITS AND CHALLENGES

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CASE DESCRIPTION

The primary subject matter of this case concerns sustainability reporting and the emerging trend of integrated reporting, which combines a company's financial results with information about its sustainability efforts. The case explores the related strategic and reporting issues and the benefits and challenges that sustainability and integrated reporting entail. Secondarily, the case addresses ethical considerations and dilemmas that company executives may encounter when reporting the results of their sustainability activities to stakeholders.

The case has a difficulty level of four to five and can be taught in about 45 minutes. Approximately three hours of outside preparation are necessary for students to address all the questions in a group setting. The case can be utilized in an upper division accounting course to help students become aware of important emerging global reporting trends and to explore the issues, benefits, and challenges that sustainability and integrated reporting entail. The case can also be utilized in a graduate accounting or business course focusing on the organizational and strategic issues. The case and the suggested independent questions have research, technical accounting, communication, and ethical aspects and can be used to enhance students' analytical, research, and communication skills, and may also enhance their awareness of reporting-related ethical issues and challenges.

CASE SYNOPSIS

During the past few decades, formal sustainability reporting has increased significantly in the U.S. and globally. Many public and some private companies have embraced this trend. While many companies currently report on their sustainability efforts and thus their impact on the natural and social environment, reporting is largely voluntary. In addition, most companies issue separate sustainability reports instead of including the information in their financial reports. Recently, a new trend toward combining the information about a company's sustainability efforts with its financial/economic results has emerged. This is referred to as integrated reporting or the integrated triple bottom line. This trend is supported by the International Integrated Reporting Council's efforts to develop a globally accepted integrated reporting framework.

Companies and their stakeholders may derive significant benefits and encounter significant challenges from sustainability and integrated reporting. However, since sustainability reporting is largely voluntary, executives involved in the reporting process may also encounter ethical dilemmas that must be addressed.

This case explores the issues, benefits, and challenges that companies and their executives, who are planning to formally report their organization's sustainability efforts, will tend to encounter. The case can be used to develop students' awareness of the trend toward sustainability and integrated reporting and can enhance their understanding of the related issues, challenges, expected long-run benefits, and ethical considerations.

The case can be utilized in an advanced level accounting or business course; it also can be used in a graduate course focusing primarily on the strategic issues. The suggested questions are independent providing instructors with considerable flexibility to assign selected or all the questions. The case has communication, research, technical accounting, and ethical aspects and can enhance students' analytical, research, and communication skills as well as enhance their awareness of reporting related ethical issues and challenges.

MERGENTHAL CORPORATION*

Mergenthal Corporation is a midsize privately-held company that manufactures and distributes food products. Its product lines are well established and the company's total revenue has grown steadily during its 24-year history. The company is moderately profitable and has accumulated a significant amount of cash reserves. Since the company is privately-held, its management is not subject to short-term stock market pressures to achieve short-term earnings goals and is able to focus on strategies that help the company succeed and build value in the long-run. Mergenthal's board of directors fully supports this long-run focus.

Mergenthal prepares its financial statements in accordance with U.S. Generally Accepted Accounting Principles (U.S. GAAP) and issues an annual report that is publicly available on the company's website. Currently, 82% of the company's products are sold in North America, the majority in the U.S. The company also sells some of its products through independent distributors in Northern Europe. Last year, the company's board of directors voted to spend a significant amount of Mergenthal's accumulated cash to help the company increase its market share in Europe. To facilitate this goal, the company plans to acquire a majority interest in its current European distributor.

The Company's Products

Mergenthal Corporation produces and sells energy drinks and energy bars. Its drinks contain only natural ingredients, such as fruit extracts, natural flavors, and natural sweeteners. Its energy bars are available in 14 different flavors. Each energy bar has no more than five ingredients and primarily consists of dried fruits, nuts, and natural flavors. One of its product lines is sweetened exclusively with Agave syrup, which because its low glycemic index, may even be suitable for individuals who must control their blood sugar levels.

Originally, most of its drinks were sold in recyclable glass bottles. A few years ago, however, the company started filling some its perishable and non-perishable drinks in Tetra Paks, which are significantly lighter and do not need refrigeration until opened. Currently, the majority of its Tetra Pak packaged drinks are sold in Europe where Tetra Paks are very common and frequently fully recycled. Because of its lower weight, the Tetra Pak drinks are significantly less expensive to ship. With its planned expansion in Europe, Mergenthal Corporation is planning to increase the percentage of its drinks packaged in Tetra Paks and plans to apply for the Forest Stewardship Council (FSC) certification. Once obtained, the company is planning to display the highly prestigious logo on its packaging. The company's energy bars already are packaged in fully recyclable wrappers.

Sustainability at Mergenthal Corporation

Ten years ago, the company made a commitment to implement a series of programs that support sustainability of natural resources, enhance employee wellbeing, help preserve the environment, and benefit the community. In support of these goals, the company has successfully implemented a number of initiatives that support sustainable development, including a company-wide recycling program, replacing existing equipment and machinery with more energy efficient units, optimizing manufacturing processes that minimize waste, reusing materials whenever possible, and minimizing packaging while preserving the quality and safety of its products.

The company also adopted programs and procedures that support the wellbeing of its employees. For example, the company installed state-of-art fine particle filtration systems throughout its manufacturing facility, overall enhanced its factory safeguards, and added a fitness facility that is available to all employees and their family members. Two years ago, the company also started providing its own products free of charge in its lunch areas.

A few years ago, the company incorporated its sustainability goals in its mission statement and revised its code of conduct to reflect these goals. In fact, the company integrated the World Commission on Environment and Development (the Brundtland Commission) definition of sustainability, which defines sustainability as a "development that meets the needs of the present without compromising the ability of future generations to meet their own needs" (United Nations, 1987) into its mission statement. Many of the company's employees participated in the revision of the mission statement and the code of conduct. Management and all employees must adhere to this code of conduct. Employees are encouraged to discuss ethical issues and challenges with designated team leaders.

The company is committed to providing the highest quality products and carefully selects ingredients that meet its high standards. In addition, the company requires that all its major vendors adhere to a vendor code of conduct that stresses responsible behavior especially in terms of social responsibility, employee welfare, responsible sourcing, and the preservation of natural resources. Mergenthal requires that its vendors sign and adhere to the vendor code of conduct.

Furthermore, the company generously contributes to selected community projects. For example, during the prior year, the company encouraged its 1,347 employees to donate money for a new park and playground near the company's headquarters and supplemented its employees' $147,300 contribution by donating an additional $352,700. The city manager gratefully accepted the check in the amount of $500,000.

The Board of Directors recently voted to replace its existing office facilities with a new "green" building that will comply with the criteria set forth by the U.S. Green Building Council to earn the prestigious LEED certification. In addition, the company has made significant strides in improving its existing manufacturing facilities so that they will also meet the LEED criteria for existing buildings. Construction on the new building will commence in approximately six months and the building is expected to be ready for use in 18 months.

Communicating Sustainability to Stakeholders

The company's management is aware that many consumers and other stakeholders expect companies to behave responsibly not only with respect to their products and interactions with its customers and other stakeholders, but also with respect to the company's effect on the natural and social environment in which it operates. Management is aware that responsible behavior tends to create goodwill and customer loyalty. Consistent with trends in the consumer and especially food product industry, Mergenthal Corporation communicates its responsible actions to its customers and other stakeholders via advertisements, news announcements, on its company website, and even on its corporate vehicles. For example, the company prominently displays information about its efforts to reduce wasteful packaging and its reduction in water use on promotional materials, magazine advertisements, and on product packaging.

Mergenthal Corporation also periodically makes public relations announcements that emphasize its responsible actions and promote its sustainability programs. The company's public relations staff has also developed a strong relationship with regional news reporters that periodically report on the company's sustainability and other responsible actions. For example, the weekend edition of the large regional newspaper recently reported that the company regularly donates products to organizations supporting the needy, such as St. Vincent De Paul, and that its employees annually utilize two paid work days to support their favorite charity. The company also publishes a monthly "Green News Letter" on its website. For example, the company recently announced that it will build a new green office facility and hopes to earn LEED certification by the U.S. Green Building Council for the new building.

Formal Sustainability Reporting

While the company vigorously publicizes its sustainability efforts, it does not currently issue a formal sustainability report and only briefly refers to its sustainability-related programs and activities in its annual report. The company's Chief Financial Officer (CFO), Kerstin Mannheim, is aware of the global trend toward formal reporting of sustainability-related activities and believes that Mergenthal Company should consider formal reporting in the near future. Kerstin believes that the company would benefit from formal reporting, especially in light of its plans to expand its distribution in Europe where sustainability reporting is expected or required.

Kerstin recently read a report based on a survey by KPMG, one of the "Big 4" global accounting firms that found that currently 83% of the U.S. based large multinational companies issue formal sustainability/corporate responsibility reports (KPMG, 2011). Kerstin is aware that generally, both public and private companies in the U.S. are not required to issue sustainability reports even though some European countries require formal reporting by public entities. Kerstin knows that most companies that are reporting on sustainability are utilizing the guidelines issued by the Global Reporting Initiative (GRI), which currently is working on the fourth generation of its guidelines (GRI, 2012). Kerstin recently noticed that some of its competitors prepare sustainability reports and believes that Mergenthal should also consider formal reporting of its sustainable actions.

Kerstin, who regularly participates in academic and professional conferences and meetings, also is aware of the movement toward integrated "triple bottom line" reporting. She is very interested in recent strides by the International Integrated Reporting Council (IIRC) to develop a formal framework for integrating reporting and recently has reviewed the integrated reports of several companies. She understands the potential advantages of integrated reporting and believes that it would be the preferred method for reporting Mergenthal's sustainability efforts to the company's stakeholders. She is planning to gain the support of the Chief Executive Officer (CEO) and to propose the adoption of an integrated reporting approach to the Board of Directors.

Kerstin meets with the CEO, John Manner, to discuss various financial reporting issues and brings up the topic of sustainability and integrated reporting. She learns that John is aware that many companies, including several of its primary competitors, currently issue sustainability reports. John agrees that in the long-run, the company may benefit from issuing a sustainability report and agrees to support Kerstin's board of directors' proposal to begin formal reporting of the company's sustainability efforts next year. John asks Kerstin to compile information that will be useful in convincing the board of directors that the company should start issuing a separate or integrated sustainability report.

John asks Kerstin to provide a brief outline of the categories and types of issues the company would include in its sustainability report. Kerstin decides to focus on their current sustainability efforts. At the conclusion of their meeting, John indicates that they should include only positive information about their sustainability efforts in their report since currently, sustainability reporting is not required.

Kerstin prepares a table that shows suggested categories, subcategories, and scope of the information that should be included in Mergenthal's integrated report; this is shown in table 1 below. Kerstin also gathers information that will help convince the board of directors of the benefits of integrated reporting and to address objections and questions that may arise.

Table 1: Mergenthal's Integrated Reporting Categories

MAJOR CATEGORIES	SUBCATEGORIES	SCOPE OF THE INFORMATION
Corporate governance	Management strategies Corporate oversight Executive compensation	Current year information Highlighting changes from prior year Basis, projections
Strategies	Long and short-term goals to create value for stakeholders	Current year information Long-term and short-term strategies relating to products, markets, key trends Value creation relating to economic, social and environmental goals
Opportunities and risks	Business, market, regulatory	Long-term and short-term opportunities and risk Related strategies; expected outcomes both qualitative and quantitative
Economic/financial information	Financial/economic performance	Comparative financial statements for three fiscal periods Key ratios including changes over prior two years
Environmental stewardship, safety and performance	Green building Recycling Water conservation CO_2 emissions Value creation in each category	Impact of sustainability efforts (positive and negative performance and goal achievements) Five-year targets Current year performance Percentage change over prior years Comparisons of expected and achieved performance
Employee development and safety	Training and development Health and nutrition Factory and office safeguards	Employee turn over Employee advancement Safety record, including number of injuries Average absences Overall health
Product responsibility and customers	Food safety (including policies, preventive and corrective measures, goals, vendor programs) Quality and affordability	Improvements (targets versus actual) Reportable and non-reportable issues Future targets
Community	Contributions to food banks and charities Community nutrition and health	Impact on community health Contributions qualitative and quantitative

Kerstin shows the list to John who immediately notices that negative sustainability-related events would be included in this report. John again emphasizes that only positive achievements should be included and justifies his stance by reminding Kerstin that reporting is voluntary in the U.S. and that companies have a high degree of flexibility in terms of reporting sustainable development.

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AUTHOR'S NOTE

*The case deals with a fictitious company; any similarities with real companies, individuals, and situations are purely coincidental.

PORTLAND CABINET COMPANY

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CASE DESCRIPTION

This case was written to show the complex and multi-functional nature of managing a successful family business over the long-term. The information presented requires students to perform both qualitative and quantitative assessments in order to understand the problems, potential underlying causes, and possible solutions for the company. Students will have the opportunity to evaluate and assess the following topics:

1. *Evaluation of the major industry trends*
2. *Production management and quality control*
3. *Customer service management*
4. *Sales / marketing control*
5. *The role and impact of internal incentives*
6. *Implications of rapid organizational growth – "growing broke" phenomenon*
7. *Cash flow analysis*
8. *Family business dynamics*

The case has a difficulty level of three and up. The case is designed to be taught in two to four class hours in a management, small business management, or entrepreneurship class. The case could be used broadly in a more introductory management course or in depth in more advanced/focused courses, either at the undergraduate or graduate levels. The case is expected to require about four hours of outside preparation by students.

CASE SYNOPSIS

Portland Cabinet Company (PCC) is a family-owned manufacturing firm that has experienced significant growth since its inception in 1979 to become one of the largest kitchen and bathroom cabinet manufacturing firms in the Portland, Oregon metropolitan area. However, PCC is in serious financial condition. This case is written at a critically challenging point in the history of this 27 year old custom wood cabinet manufacturing company. Although unfolding for nearly two years, only recently has the company fully realized the critical problems it faces.

This firm is facing a plethora of problems and the financial difficulties are a symptom of a set of complex and interdependent issues. This case tries to expose these areas of concern for the company. It attempts to present the reader first with the main symptoms of these problem areas – the critical signs that have finally raised a sense of urgency for the company owner / managers. Ultimately, it is a worsening cash flow crisis that has finally reached a critical point for the company. However, the solution to this salient cash crisis is not obvious to the company, and in fact it is likely complex due to its multi-functional nature. However, time available to deal with the situation is short.

The primary decision makers are Jack Woodruff, 63-year old founder / owner / CEO / sales person for the company, and his 35 year-old son Simon who has worked for the company all his adult life, and currently officially holds the title of vice president and acting president. The current crisis has come at a time that has surely disrupted the intended transition of the business from the hands of one generation to the next. The future of the company, Jack's retirement, a former partner's buy-out arrangement, and family member employment are all at risk.

INTRODUCTION

Simon Woodruff and his father Jack sat together in the office of Portland Cabinet Company (PCC). It was January 2006, and the two were still at odds regarding how to move forward in 2006 to fix the cabinetry business that Jack and his partners had started 27 years ago. The headline article in the day's Business section of *The Oregonian* confirmed the rapidly growing housing market in the Portland metropolitan region. This was PCC's growing customer base. The continued soaring demand for new homes in the region throughout 2004 and 2005 had resulted in more business than the cabinet company had ever seen in its 27 year history. However, growing demand and record sales for the company had led to challenges. Workers and customers had been voicing frustrations, and the company was increasingly struggling with its day-to-day finances.

PLANNING FOR 2006

Simon and Jack both realized the critical position in which PCC found itself. The health of the business was inherently tied to the personal health (financially, emotionally, and physically) of both Jack and Simon. Their conversation had begun earlier in the day, before the standard series of interruptions started for the day.

Jack was first to break the silence:

> *If other companies can be profitable, so can we. All we need to do is increase sales. We need to sell more cabinets to make more money. This is a booming*

market. Our sales people can sell. We should be able to get more sales. Now is the time to be aggressive.

Simon responded to his father:

We can't even handle the current level of sales. Manufacturing is working so hard to keep up, they can't even get out a good job. Service isn't even taking phone calls anymore. Their backlog is too big. More sales will really mess things up. Maybe we need to get rid of some business, to get things back under control, and then figure out what to do.

Jack:

Maybe we need to get better people in Manufacturing and Service. If they can't do their jobs right, we can't afford to be paying them.

Simon:

We've already gone through 2 production managers and 3 service managers. We can't keep firing or losing people. The same s#t keeps coming up.*

Jack:

Well, all I know is you can't make more money without selling more cabinets. And we need more money. So we better sell more cabinets.

Simon:

Maybe we're losing money because we're working too hard and can't do things right. Do you know how many remakes we did last week? Or last month? All that s#t is cutting into profits.*

Jack:

Max (Jack's other son) said it's not bad manufacturing. It's bad installation quality. We can fix that. I know we can build more cabinets. We just have to dig in.

The morning conversation was interrupted by a call on Jack's phone.

Jack:

> *"Jack here."*

Customer (Treeline Homes) on the phone:

> *What the hell kind of business are you running? I've been waiting over a week for your guys to get back out here and fix the counter tops. Hell, I can't even get anyone in your service department to return my phone calls! I had to reschedule my tile guys twice – and now they say they're going to bill me for messing up their schedule. How hard is it to get a guy out here and cut down the counter tops?*

Jack:

> *Hey, I'm really sorry. You should call the service department and they'll get someone out there.*

Treeline Homes:

> *How many times am I supposed to call? Your guys never answer – and they don't return messages either. I'm sick of being treated this way. I've been doing business with PCC for over 5 years. Is this how you treat your loyal customers?*

Jack:

> *I know. Things have been a little rough around here lately. But we've got things under control now. We'll get a guy out there. Tell you what. I'll talk to service and make darn sure we get a guy out there tomorrow.*

Treeline Homes:

> *OK. But one more thing. My secretary just got a rude call from your collections department saying we owe you for the job. How can we owe you? You haven't even completed the job yet. You're not getting anything until you fix the counter tops!*

Jack:

> *OK. I'll look into it. We'll get a guy out there tomorrow.*

Jack (to Simon):

> *I gotta go talk to Max. Why aren't the builders getting any service? How hard is it to schedule crews and get them out to jobs? No wonder our accounts receivables are sliding out.*

Simon:

> *OK. But we really need to get back together and figure out what we're going to do. We need a plan. We can't just keep running around fighting fires.*

PRODUCTION

As Jack left the building to walk next door to the production shop, he wondered whether he had made the right decision moving Max into the roles of production manager and service department manager. Two months ago Max was made the new production manager, after the former production manager of 4 years was fired. Previously, Max had been the financial controller and materials purchaser for the company. The former production manager, John, was hailed as an outstanding production manager during his first several years at PCC. He brought order and control to the shop and was able to meet production quantity and cost goals. However, John was ultimately fired in early 2005 when it appeared that he had lost the ability to control quality and costs in production during the latter half of 2004. While not trained or experienced in production management, Max was eager to assume this role.

Jack:

> *Hey, Max. We need to get a service crew out to Treeline Homes tomorrow. Call him up and schedule an appointment.*

Max:

> *No way. It's not gonna happen. My guys are booked out through at least the end of the week. We're busting our butts trying to make JLS [a large builder customer] happy.*

Jack:

> *Well, you need to get someone out to Treeline. I told him you'd call.*

Max:

> *We gotta finish up JLS. Remember - they owe us $25,000 on previous jobs and they're holding it all until service is complete in the Beaver Estates subdivision. What do you want me to do?*

Jack:

> *I don't know. Just give Treeline a call. I told him we'd get someone out there. Tomorrow!*

Max:

> *Oh, and we ran out of Cherry [a popular wood type used in PCC manufacturing]. So we're not going to make our production schedule this week.*

Jack:

> *Damn it. Can't you get Hardwoods to deliver a rush order?*

Max:

> *Nope. Not unless you've got $2,500 cash. They'll only deliver COD [cash on delivery] to us now. They placed a hold on our credit since we haven't been paying them.*

Jack (while walking away towards the exit door):

> *Just get someone out to Treeline.*

Still relatively new to manufacturing oversight, Max had been experiencing a number of challenges in production. Beyond dealing with the numerous calls and messages from upset builders, Max had been frustrated by production itself. The shop had consistently been unable to hit its production volume targets of $32,000 per day, despite the addition of shop employees to increase capacity. The result was an increase in the number of late jobs. Because of the interdependencies among subcontractor trades in the construction industry, a late job completion in one trade often means the rescheduling of all subsequent subcontractor trades by the builder. This places undesirable logistical and financial burdens on the builders. Thus, when PCC is unable to reach production goals, jobs are late, and customers are angry. It seemed that no matter how much Max pushed his production manager, foremen, and leads, the output remained too low.

Max was also extremely frustrated by the number of non-standard jobs appearing on the schedule that were required to be processed in production. He was frustrated that he was being blamed and criticized for not reaching production figures. Max blamed sloppy sales people and unreasonable customers for most of these remakes.

FINANCIAL SITUATION

Simon, Jack, and Max had all expected very different results from the past year of a booming housing market and record sales volume for the company. Instead of the expected high profitability, PCC had experienced perpetual cash flow crises throughout 2005. In recent months, cash had been so tight that Jack, Simon, and Max had forgone their pay checks on several occasions and in some cases loaned personal money to the company to cover employee payroll or to obtain materials from suppliers.

End-of-month through the 10th of each new month was particularly tight for PCC. Customer invoices are due on the 10th of each month, and payments received temporarily relieved some of the cash pressure. But, the cycle had been repeating for too many consecutive months.

Due to cash pressures, PCC did not have a good payment record with many of its suppliers. As a result, many suppliers had placed PCC on a "cash only basis", requiring that PCC prepay for all materials before production.

Builder-customers were invoiced for cabinet jobs after the installation date. Invoices were then payable "net-10th", on the next 10th of a month. Thus, the lead time to receipt of payment for a given job was a function of the date of installation. The receipt of payment was often delayed beyond the official due date for a few reasons. First, if a customer receives the net-10th invoice in the beginning of a given month, they often assumed their due date to be the 10th of the following month. Second, while payment was expected to be tied to the installation date, many builders did not consider the cabinets "installed" until all post-installation service issues had been resolved. It was not uncommon for a job to require some post-installation service or touch-up and adjustment. Thus, many customers were able to justify delay of payment well beyond the first 10th following installation. The result of these factors was, of course, slow receipt of payment on accounts receivable, while at the same time needing to make payment to suppliers at the time of materials requisition.

To address the standard timing gap in accounts payable versus receivable, the company relied on a line of credit for their month-to-month operating expenses. The limit on this line was a function of the company's accounts receivable, and was currently around \$600,000. As of December 2005, gross Accounts Receivable (A/R) was approximately \$720,000. This amount had been climbing over the past year. A large A/R value had historically been seen as a benefit to the company because it was the basis for determining the bank-set credit limit used for operating capital. However, the bank had recently expressed concern about the increasingly aging A/R values, and had begun to discount A/R amounts that were beyond 30-days past due, and further still for those 60-days past due, and was completely writing off accounts beyond 90-days past due. In fact, if a customer was withholding payment on one job beyond 90 days, the bank was writing off all receivables due from this customer, whether or not these accounts were significantly overdue. The net effect of the growing A/R was a reduced borrowing base for PCC's operating line of credit. Table 1 provides financial data for 2004 and 2005.

	Table 1 PCC Financial Performance April 2004 - December 2005					
	Apr-04	**Aug-04**	**Dec-04**	**Apr-05**	**Aug-05**	**Dec-05**
Sales	606,559	457,822	560,540	719,656	615,273	725,354
COGS	446,275	283,074	457,747	546,591	490,109	554,250
(as % of Sales)	73.6%	61.8%	81.7%	76.0%	79.7%	76.4%
Materials	226,300	108,184	237,740	266,459	235,623	303,135
Direct Labor	105,870	91,266	113,404	147,532	138,387	138,752
Delivery/Installation	25,509	24,120	24,003	25,695	24,882	24,427
Payroll & benefits/taxes	30,955	16,522	23,238	34,077	30,315	35,988
Sub Contractors	46,985	35,276	47,834	56,423	44,284	32,822
Warranty Service	8,802	6,500	8,121	12,827	12,984	12,863
Supplies & Expenses	1,854	1,206	3,407	3,578	3,634	6,263
Total Variable Costs	446,275	283,074	457,747	546,591	490,109	554,250
Contribution Margin	26.4%	38.2%	18.3%	24.0%	20.3%	23.6%
Gross Margin	160,284	174,748	102,793	173,065	125,164	171,104
Operating Expenses						
Fixed	101,108	96,751	105,749	111,365	101,846	108,883
Variable	43,876	37,347	37,897	46,865	44,643	40,745
Total Overhead	144,984	134,098	143,646	158,230	146,489	149,628
Inventory	350,352	394,292	333,538	296,727	327,829	296,823
Raw Materials	259,668	268,643	284,617	246,196	236,565	177,467
Finished Goods	90,684	125,649	48,921	50,531	91,264	119,356
Accounts Receivable	574,284	563,780	671,304	781,288	732,094	720,735
Accounts Payable	552,385	539,957	536,926	518,145	472,534	412,843

HISTORY OF PCC CABINETRY

In 1979 Simon's father, Jack, and 2 partners Jay and Jim left their existing jobs, and started their own cabinet company. All three partners were in their thirties at the time. Their initial assets were the manufacturing and management experience they each brought, $10,000 invested by two of the partners, and various woodworking tools brought by the third partner. They started by making wood cabinetry for small home builders in the Portland metropolitan area. Over the next two decades the firm grew from its modest origins as a small company of 3 employees serving a small number of builders to become one of the largest custom cabinet manufacturers in the region, employing 75 people and with sales of $7.3 million in 2005.

PCC began as, and remained, a regional custom cabinet manufacturing shop. PCC served many new-home builders in the Portland metro (and beyond) area. As the new-home construction industry in the region grew, so too did the number of distinct builders that were customers of PCC. PCC served hundreds of builders, over a range of price-quality points, but best served customers that were building in the middle range of price and quality.

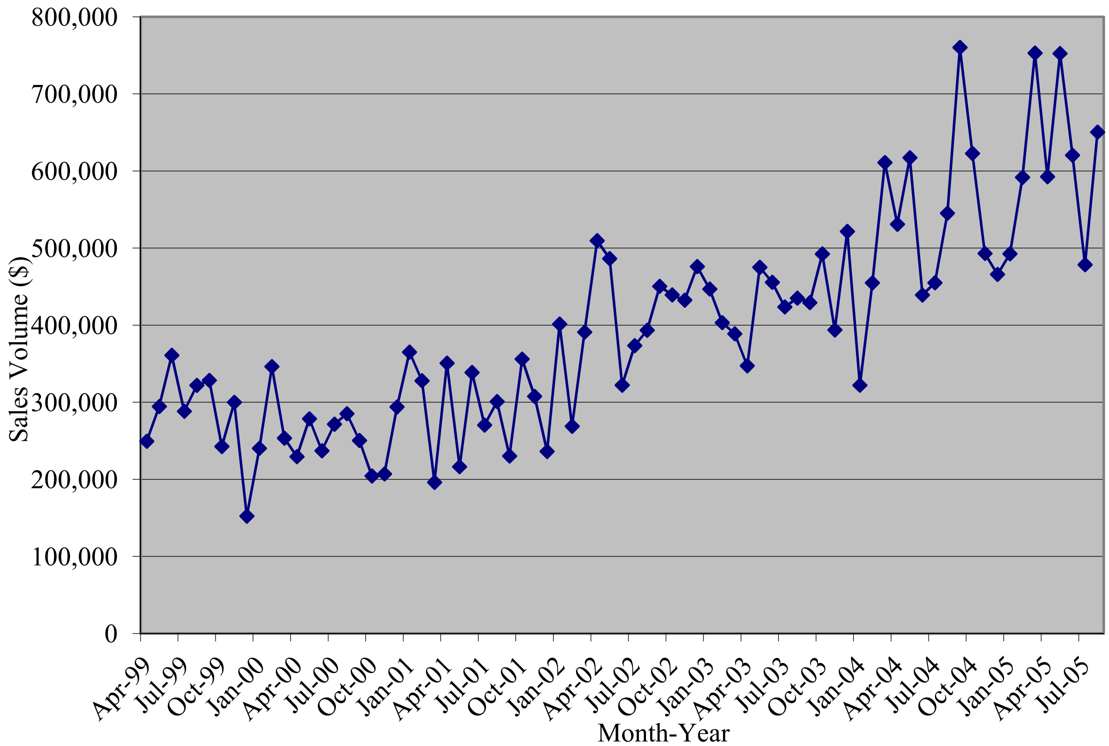
The new-home construction industry growth had also brought an increase in competition among cabinet providers. At the price-quality point where PCC operated, builder-customers were semi-loyal. In the past, all else being approximately equal, a satisfied builder would typically do most or all of his future cabinet business with PCC. However, builders had become increasingly sensitive to both price and quality. The result was a greater degree of shifting of builders from cabinet shop to cabinet shop as they built future homes. It seemed that builders were placing increasing pressure on PCC to drop prices in order to remain competitive. Furthermore, it seemed to Jack that builder-customers had increased expectations in terms of cabinet design features and installed cabinet quality.

Now 27 years after the founding of the company, only 1 of the original 3 partners remained as an active employee/manager. This was Simon's father Jack, who served as CEO, salesman, and part-time sales manager. Jay left the company 15 years earlier, on good terms, to run his own smaller and more high-end cabinet shop. As part of retirement planning for the remaining two partners, in mid-2003, Jack and Jim structured an attractive $1.5M buy-out arrangement for Jim, to be paid by PCC in monthly installments over the next 20 years ($14,500 per month). At that time, it was assumed that Jack would receive similar buy-out terms at his retirement which, at the time, was planned for mid-2005. However, given the challenges facing the company that began in 2004, Jack had felt unable to leave the company. The "retirement" payments were based on the assumption that Jack's sons, Simon and Max, would continue to operate the company well into the future and would be able (and willing) to provide the long-term retirement payments for Jack and Jim.

RECENT GROWTH AND COMPANY INITIATIVE

With the recent boom in the new home construction industry, sales had been at their highest level in the history of the company. While the company had experienced slow and steady growth over its 27 year history, it experienced relatively dramatic growth since 2003. Figure 1 shows monthly sales (booked, not collected) over the past 3 years.

Figure 1
Monthly Sales Volume in Booked Revenue Dollars



After a very successful 2003, and believing the construction industry growth was there to stay, and in response to the growing builder shift to national modular cabinet suppliers, PCC made a major structural change. In 2004, PCC opened a new division, a business unit that would manufacture simplified (less custom) cabinets using a more standardized process and limited woods, styles, and finishes. The goal of this division was to supplement current operations and to be more competitive to the most price-sensitive lower-end home builders who might otherwise shift to modular cabinet suppliers. This division was started with some specific large price-sensitive builder-customers in mind. The company leased industrial space in a building several blocks away from PCC's main production and administrative offices. It was possible that much of this business would not have been with PCC if it were not able to offer this less-custom, lower-price alternative to these price-sensitive builder-customers. Thus at least some of PCC's recent sales growth had likely come by tapping into a market of builders that it had not previously served.

The new division produced 426, or nearly 1/3 of the company's 1300 jobs in 2005. In terms of revenue, the new division contributed approximately 25% of PCC's overall sales revenue. Because of its reliance on more automated processes, the new division ran with a relatively lean crew of 8 employees. These employees ran all the cutting and nailing/stapling equipment, and did all cabinet assembly. While much of the manufacturing for the new division was done on specialized and more automated equipment in the new location, all face-frames for the more standard product line were still manufactured at the home site. Daily face-frame deliveries were made from the home site to the new division for final cabinet box assembly. The process to manufacture this product line was further simplified because, due to its limited color options and reliance on pre-printed paper-wrap wood, it did not require the final paint process.

While Jack and Simon believed that the new division had been successful, they had been unable to disentangle costs to allow for a direct computation of the typical profit margin on these jobs. They suspected it was a relatively low-margin business because they were trying to compete at a relatively low price point. However, because it was the larger builder-customers relying on this product line, they believed low margins were made up in high volume.

CUSTOMERS, SALES, AND MARKETING

The company operated with 4-5 sales people. The role of a sales person was both to generate new business from new builder-customers and to serve and communicate effectively with existing builder-customers to ensure customer satisfaction with the production, scheduling, and installation process to increase the chance of repeat business as these customers built new homes in the future.

Customers

Customers served by PCC were numerous and diverse in size. During 2005, PCC produced and installed cabinets for 1300 homes representing 264 distinct builders. At the large builder end, PCC did 640 jobs (nearly 50% of its overall business in terms of jobs) for its largest 7 customers. At the small builder-customer end, PCC manufactured cabinets for 162 different single-job builders.

Customer loyalty had been fairly high in the industry, although it was not uncommon for a builder to switch cabinet suppliers from time to time or even job to job. The larger customers, while difficult initially to obtain, tended to remain loyal to PCC from sub-division to sub-division. This relationship tended to serve both parties well as each side learned how to best inform and serve the other. Production also became more predictable as a large builder continued to order relatively standard products for it its homes. There were also advantages in terms of economies of scope and location when PCC manufactured cabinets for multiple homes in a single subdivision.

Marketing

Because of relatively high repeat business from established builder-customers, most marketing efforts were done on a service and relationship basis. If PCC produced and installed a quality product and serviced the job to customer expectations, the builder was likely to use or at least consider favorably PCC for the next cabinet job. During periods of time when PCC was actively looking to increase its sales volume (e.g., to maintain levels of manufacturing), sales people had to focus on identifying and hooking new builder-customers. This process of "sales prospecting" was typically conducted in an ad hoc way according to each sales person's past experience and success. Most of the sales people relied on an unofficial drive-around-and-look approach to identifying prospective customers. If ground had broken in a residential area, and foundations were being poured or walls were being erected, it was possible that the builder of these new homes needed cabinets, but had not yet committed to another cabinet provider. Sales people would then determine the builder, typically as posted on nearby signage, and try to contact them about their cabinet needs. If the builder still needed a cabinet supplier, the PCC sales person would ask the builder to consider a bid from PCC. It was estimated that PCC received the business of approximately 40% of the bids it gave to new builders. Bids were calculated based on the dimensions and designs noted on builder blueprints for the home.

Sales And Sales Management

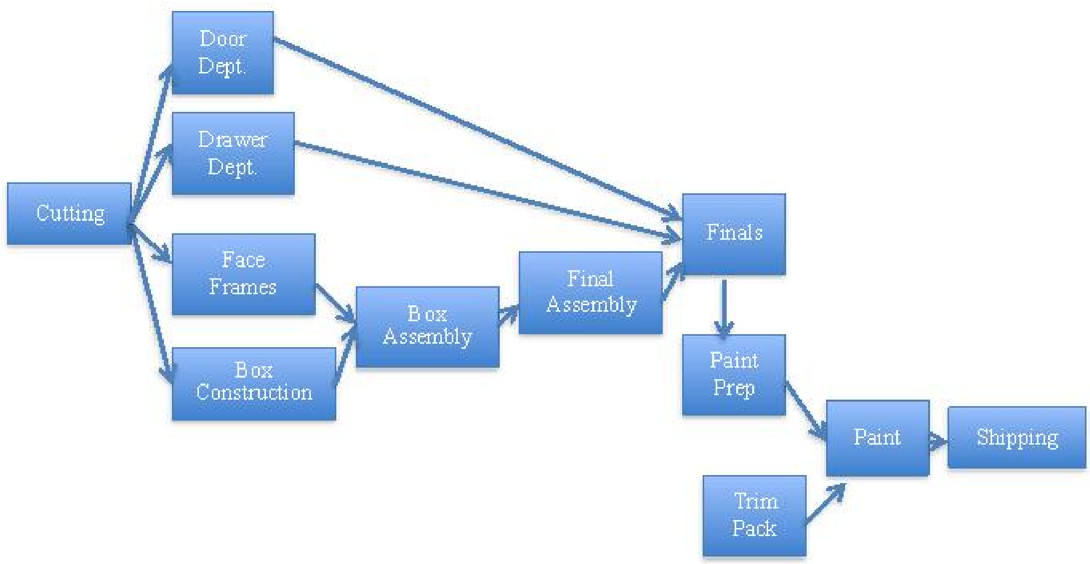
With the recent growth in the new-home construction industry, PCC sales people had no trouble picking up business with new builders in 2004-05. Officially, Jack served as sales manager for PCC. However, during this period of high sales, Jack had seen little need to manage the sales people. As Jack noted: "With record sales like this, they clearly know what they need to do. The best thing I can do is to stay out of their way. "

Sales people had brought in not only high sales volume, but also an increase in the diversity of builders. In particular, PCC had 2 new large builders, BV and JLS, who accounted for 335 distinct jobs over the past year. These two builder-customers were larger than those typically served by PCC and they operated at a point somewhat lower on the quality-price spectrum. As a result, PCC had to keep prices to these customers low to remain competitive.

PRODUCTION PROCESS

The basic cabinet manufacturing process had remained essentially unchanged since the company started. However, as the company grew from small origins to its current position of one of the largest custom cabinet manufacturers in the region, the manufacturing process had been broken up into distinct departments, each completing an operation in the overall production of the cabinets. A basic process flow diagram is shown in Figure 2.

Figure 2: Production Departments and Process Flow



Because homes vary in size, cabinetry requirements, and thus jobs to production, varied in size. A job might require anywhere from 12- 40 cabinet boxes. Jobs also varied in overall and per-box dimensions. Further, jobs vary by wood type, door style, and finish. Aside from the need to stock the different types of wood, and the cost difference (e.g., cherry is more expensive than is maple), the manufacturing process itself does not change as a function of wood type. However, both door style (from the boxiest "ice box" or "European" style to the most detailed "raised panel with outside radius stiles" style) and finish selections (from lacquer-only to hand applied "French Noir") can have a significant impact on required employee skill level, attention to detail, and processing time in their respective departments. PCC quoted customers a 3-4 week lead time for jobs.

PCC tried to schedule production to maintain a relatively consistent volume while simultaneously attaining schedule requirements of the customer. Production level was defined in terms of revenue dollars. For example, a recent production volume target, as set by Simon and

Jack, was to manufacture (precisely, to start cutting on) $32,000 per day. The daily production target had gradually been increased over time in order to keep up with the increase in sales. In 2000, for example, the daily production target was $17,500 per day. Production targets were determined based on the need to ensure on-time manufacture and delivery of jobs to builder customers. To some degree, production capacity was a function of staffing. Staff could be added to each department as necessary to increase its capacity. However, not all departments were easily scalable. Typically, production was initially increased by encouraging workers to work harder or faster. At some point, when this approach was no longer effective, employees were added. Space also limited the ability of PCC to effectively adjust capacity upwards.

Production volume as defined and measured by sales dollars was a reasonable proxy for the actual volume (i.e., work content) of production. However, there was not a direct correlation between the price of a given job and its materials or labor content, because of price differences in variables such as wood, door style, and finish, and because of sales strategies.

Costs had not been tracked or computed on a job by job basis. Production tracked and monitored direct labor costs at an aggregate level. Materials costs were also tracked at an aggregate level, e.g., the total amount paid for materials (lumber and hardware) in a given month. The company had long used the rule-of-thumb relationship that the price of a job approximately reflects 3 components: 1/3 direct costs, 1/3 overhead costs, 1/3 profit. However, as far as Simon could recall, there had been no effort to confirm that this relationship still held. It was possible that it had shifted over time as industry dynamics shifted and competition increased or decreased. Pricing was also a function of the sales person and customer dynamic, and was therefore not directly tied to costs. A commissioned sales person at PCC would price a job as high as possible if they believed the customer would still accept the bid.

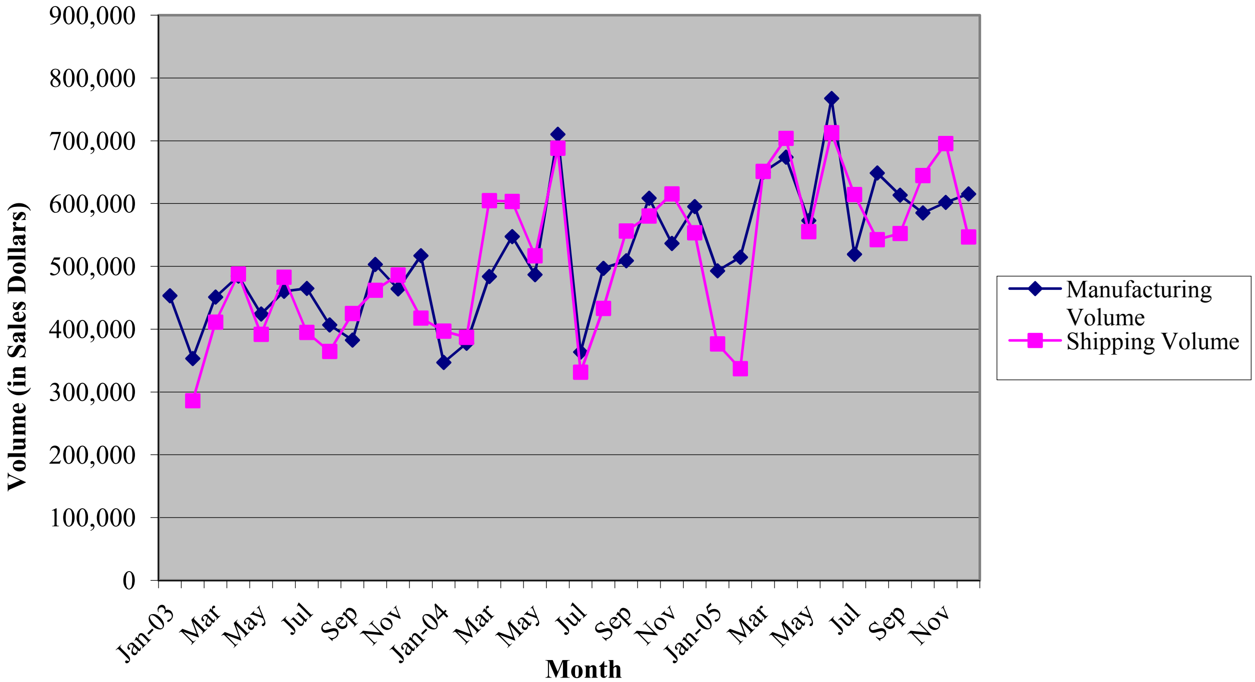
IN-HOME INSTALLATION AND SERVICE/WARRANTY

Scheduling

After a cabinet job had been manufactured and finished, it was moved to the shipping area to await delivery to its destination. Ideally, scheduling and production had coordinated well enough that a job exiting the shop and entering the shipping area would be immediately loaded on to a delivery truck to be delivered to the home the following day. An installation crew would then follow the job and begin/complete installation the next day.

However, it was not uncommon for uncertainty and unexpected events to cause a mismatch between when a cabinet job was ready to be delivered and when a builder was actually ready to accept a job at the home. There is a relatively narrow window in the construction of a new home during which the cabinetry needs to show up. Cabinetry needs to be installed after the walls have been completed and painted, after the sub-flooring has been installed, but ideally before the final flooring has been installed. Because construction relies on the coordination of many distinct subcontractors, each of which might have their own set of uncertainties and unexpected delays, it is difficult for a builder to precisely predict when (s)he will be ready to accept cabinets. Given the cost to a builder in having delays in the construction process, builder bias (or optimism) was to state a date on the early side of actual readiness. The impact of this tendency on PCC was an overloaded shipping area containing jobs that had been completed but that the builder could not yet accept. In fact, over the past 2 years, PCC had rented a number of containers that served as external storage areas for completed jobs that could not be shipped. This practice also required additional handling of cabinet jobs as they were first brought to the shipping area, then moved to an external storage area, then returned to the shipping area, and eventually loaded on to a delivery truck once the builder could accept the cabinets. Figure 3 shows manufacturing and shipping volumes (both measured in sales dollars) over the past 3 years. The gap between manufacturing and shipping volumes reflects the imperfect match between what was manufactured and what was able to be shipped. Such gaps had implications for onsite inventory and the length of the cash payable-receivable gap.

Figure 3
Manufacturing versus Shipping Volume



Installation

Installation of cabinet jobs was mainly performed by outside installers with whom PCC contracted on a job-by-job basis. PCC contracted regularly from among 8 standard installation crews (1-2 installers per crew). The company also had one in-house installation crew. Installers were contacted and given instructions and directions the day before the installation was scheduled. Most installations were completed in one day. Installers were paid by the job completed, as a function of job size, on the grounds that larger jobs typically take longer to install. Installer compensation did not take in to account the complexity or quality of installation.

Post-Installation Service

Sometime shortly, but not necessarily immediately, after installation had occurred, the builder would inspect the cabinetry. Builders typically identified some post-installation service/adjustment needs. Some builders would create a detailed "punch-list" of items that needed attention, while others would call the service department and verbally report the needs. In many cases, a service crew had to first return to the job site to assess the service needs, and then return in a follow-up trip to actually complete the work. Service was required / requested for many different reasons, including simple fixes such as missing bumper pads on the doors or a simple drawer adjustment to more involved fixes such as damaged cabinet faces or mismatched cabinet doors throughout the job. Less frequently, although not as uncommon as the company would have liked, something went significantly wrong and a service order for a "remake" was generated – either by the customer or the installer. Remakes might apply to a single door (e.g., if a customer finds an unacceptable scratch or color variation), or to one or more cabinet boxes (e.g., if the cabinet does not fit the as-built space, either if a sales person made a measurement error or if there was a last minute construction change that was not communicated to PCC), or to the entire job (e.g., resulting from a gap in expectations or communication between the sales person who specified the job requirements and the builder customer).

Service orders for remakes were rushed through the production process, thereby interrupting other jobs in process. Remakes also posed a challenge in that it was difficult to ensure a proper color match between the original job and the new components. Remakes could also be very costly. The cost of remakes was not always recaptured from the customers, depending on how clear it was where the blame for the error lay. It was not uncommon for PCC to absorb any added labor and materials costs for remakes. Remake costs that could not be recaptured or shared with the builder cut significantly into the profit margin on the job. The company did not have a record of service orders, remakes or the cost of service trips and remakes (other than as captured in aggregate labor and materials values).

Based on a recent increase in the number of customer phone calls coming directly to Simon and even Jack, the company was aware that the service department was in trouble. Thinking back, Jack and Simon realized that service concerns were not new. Several months earlier, Rick had quit the position of Service Manager after 12 years. He had recently been complaining about the state of service – or more precisely the state of problems being identified in installed jobs. He had repeatedly tried to alert Jack and Simon to the problem and had requested support, but nothing had changed.

After Rick left, the company pulled Travis from his role as a department lead in manufacturing. It was during Travis' tenure here that Jack and Simon began receiving those menacing calls from frustrated and angry customers. One of the first things Max did after taking control of Production and Service was to remove Travis from the position of service manager, and return him to the shop floor. PCC was again operating with a new service manager, under the oversight of Max.

PCC had 5 in-house service crews (1-2 people each) that it dispatched to homes requiring post-installation service. Upon recent inquiry of the service manager, Simon discovered the following. Of the 7-9 jobs that were installed on a given day, most of these resulted in an immediate service request. In other words, new service orders were being added to the service backlog at a rate of 7-8 jobs per day. Further, most service trips required follow-up service trips, either because new service needs were identified or because the job required additional parts (e.g., bar brackets or scribe) that the service crew did not have on hand. Thus, the service backlog was growing daily.

Service Order Priority And Costs

The service order backlog was excessive. At its current level, Max and Simon realized there was no way to satisfactorily address all customers' service needs in a timely fashion. While a first-in-first-out service scheduling policy might appear most fair from the perspective of the builder-customers, PCC could not afford to use such a service scheduling rule. In fact, because of the current cash flow crisis, PCC found itself needing to first serve those customers who were the most significant. In this case, "significance" was defined as the largest, most angry customer, in other words, the customer currently withholding the most money for its installed jobs. For example, all service crews might spend a week or more on various homes within one or more subdivisions of a specific builder. All other builders, making up over 60 different builders and hundreds of service orders, had no chance of service being completed, or even scheduled, in the foreseeable future. Small builders who had paid for their jobs on-time, in good-faith upfront or immediately after installation, were treated the worst in this service scheduling priority. In fact, at one point in the recent past, Max ordered the service manager to stop taking calls from such builders, knowing that he had nothing reassuring to tell them.

The situation had become so bad in service, that the service manager had neither the time nor experience to evaluate the underlying causes of service requirements. All incoming service orders were added to the service backlog, and those pulled for service dispatch were addressed as soon as possible. No questions were asked. The service department was under so much pressure from angry customers that they did whatever the customer asked – assuming this customer had made it to the "critical" list. The result of this was the repeated incurrence of remake and service costs without question or analysis to avoid similar mistakes in the future. In a recent case recalled by Max, for example, the full set of cabinet doors for a specific job was remade, not once, but twice, reportedly because of damage and poor color match. It was not known when or how the damage occurred, and whether it was due to PPC work or other builder-subcontractor work.

In these days of service chaos, PCC made no attempts to question builder requests or to recapture any costs incurred by PCC. After many months of operating in this crisis mode, it became clear that this could not continue. Simon wondered just how much of their profit margin was being eroded by costs associated with repeating mistakes, unquestioningly doing whatever a builder asked in order to appease their anger, and remaking parts damaged by other trades after cabinet installation.

HUMAN RESOURCES AND STAFFING

Family Personnel

Jack, the CEO and a founding partner of the company, was 63 years old, and currently officially acted as a sales person for the company. This was to be his transitional role for the company, stepping away from day-to-day management, as he worked his way from CEO/President to retirement. However, Jack remained the official CEO, and continued to actively participate in the overall management and direction of the company, providing various levels of oversight and involvement in sales management and in production and as he felt necessary.

Simon, Jack's second son, 35 years old, had had a fluid role with the company during the past 10 years. Simon's entrance to the cabinet business began like most new employees – in one of several low-skilled positions within the production shop. By the age of 25, Simon had worked and /or managed all areas within production. Simon was the production manager in 1998-2001, then sales manager/projects guy/computers 2002-2004, and now officially vice president, acting president, and miscellaneous company analysis and projects oversight.

Max, Jack's third son, 26 years old, had also served in several positions in the company over the past 10 years. Max's recent shift from the administrative/financial side of the business to the production/installation/service functions of the company left a hole in the financial controller position. Thus Max's formal position was structured so that he maintained oversight of the finances as well as having responsibility for production and service.

General Staffing

The company was currently staffed at its highest level ever. Many new production staff had been added in the past year to deal with the increase in sales and production volume. In all, there were approximately 75 people permanently employed by PCC. On the office / administrative side, there were 4-5 additional people in Sales, an office manager (basic human resource and financial functions, overseen by Max), and 2 office support people. On the manufacturing side, Max oversaw a production manager, 3 foremen / production support staff, and 50 shop employees including several department leads. In Installation and Service, reporting to Max, there were 3 staff personnel (a scheduler, a service manager, an install dispatcher), and 5 service crews (7 employees). There were 2 in-house installers, with the majority of installation completed by independent installation crews contracted by PCC on a job-by-job basis. Recent and critical staffing adjustments in family and general personnel had been made in preparation for succession, but also because of unplanned company turnover, part voluntary and part forced, in some key areas. Since experiencing this wave of turnover, the company had made some trial and error attempts to shift remaining employees and fit key people to key positions before settling on this latest organizational structure.

THE FUTURE OF PCC

Jack and Simon, in the office together again, after another frustrating and interrupted day, were resolved to craft a better future for PCC. However, each had a distinct vision for future financial stability. Jack, always the optimist according to Simon, was convinced that they must sell their way out of the current situation. As Jack had repeatedly stated, “If other companies can be profitable, so can we”. In Jack’s opinion, increasing sales was required to return to profitability. And in this booming market, PCC should have been able to get more sales. Simon, on the other hand, often described as a conservative over-analyst by his father, was convinced that more sales would only make matters worse. Simon could not get over the idea of “growing broke”. Simon believed the company must shrink to regain control and lower costs. But how could this be achieved given the company’s current overhead structure? Would it mean layoffs? Closing the new division? “Firing” some of its current customers? Either way, it was clear to both Jack and Simon that the road ahead remained rough. It had been a long day and a long conversation. They agreed to meet again tomorrow morning to resolve the planning session.